

1. **Would the loss of intraLATA toll revenues by local exchange carriers (LECs) be detrimental to rates for local services?**

No. In the first place, there is no evidence that carriers are playing a "zero-sum" game and that the competitors' gain will be the LECs' loss. To the contrary, toll usage is trending upward, and the development of competition in a telecommunications market typically leads to further stimulation of usage.

Hence, the dominant carrier's minutes of use and revenues may continue to rise even as its market share declines. This has been AT&T's experience.

The Commission may recall the results of the 1990 Staff Survey. It determined that, of the seventeen states responding to the survey questions, "none reported any revenue loss attributable to, or any increase in local rates as a result of, sanctioned intraLATA toll competition." [Joint Staff Report, Case No. PUC850035 (April 4, 1991), p. 5.]

It should also be noted that a fair assessment of the impact of intraLATA toll competition must consider changes in costs, as well as revenues. As competitors gain an increased share of the retail toll market, they will tend to increase their usage of the LEC's wholesale services, including switched access.

We would note that for some LECs in Virginia, access revenues far outstrip toll revenues as a percentage of total revenues. Bell Atlantic - Virginia, for example, reported 1993 network access revenues of more than \$540 million; in the same year its Long Distance Network Service revenues were less than \$130 million--not even a quarter of the access revenue amount.

Of course, LECs may protest that their per-call and per-minute revenues from toll exceed those from access, which is true; however, gross revenues and

profits are not the same thing. Since retail toll service costs the LECs substantially more to provide than wholesale access service, these extra costs can be reduced or eliminated as the LECs shift away from serving the retail toll market.

Most toll traffic that an LEC loses to competitors will be subject to the LEC's access charges. Depending upon the LEC's particular circumstances, it is quite possible that access service will be more profitable than retail toll service, and thus any loss of retail toll market share may actually enhance the LEC's bottom line. In the absence of persuasive evidence concerning the unique circumstances of a particular LEC, there is no basis for assuming that changes in the LEC's role from that of a retail toll provider to that of a wholesale access provider will have any adverse impact on LEC profitability, or on its local exchange prices. While it is true that long-distance calling generates revenues in excess of the relevant direct costs (either embedded or marginal) and makes a contribution towards the LECs' joint and common costs, the same can be said about both switched access and local exchange service.

Of course, this does not mean that either toll or access "supports" local service, or that a reduction in such alleged "support" would adversely impact local rates. To the contrary, local exchange service also provides a substantial contribution towards the LEC's joint and common costs, as numerous cost studies reveal. In fact, in most jurisdictions, both access and local exchange service actually provide a larger percentage contribution than retail toll to the local loop and other joint and common costs.

In understanding this pattern of relative profitability, it is important to realize that

the wholesale services that LECs sell to competing toll carriers do not involve the same activities that the LECs provide at their retail toll customers, or, at least, not to the same degree. Consequently, it costs the LECs substantially less, per minute of traffic, to sell in the wholesale market than in the retail market.

When selling toll services directly to retail customers, for instance, a LEC must pay staff to handle customer inquiries, investigate customer complaints, and make bill adjustments. But when selling access services, the LEC does not incur these types of costs to the same degree. For example, it does not incur the high level of billing and collection costs that would attend a comparable volume of calling by many individual retail toll customers (assuming a reasonable level of efficiency in the LEC's wholesale billing and collection activities). Likewise, the LEC as a wholesaler does not have to provide call-by-call bill inquiry services, a labor-intensive activity associated with retail offerings.

The LEC's uncollectible rate should also be considerably lower when selling access, as opposed to selling toll to many retail customers. Competing carriers purchasing the LEC's services will have little to gain and much to lose from failing to pay their bills promptly. When the LEC sells wholesale, the competitor--not the LEC--assumes the risk and incurs the expense of uncollectibles associated with serving individual retail customers.

Another area in which the cost of providing access service is lower than toll is in promotional marketing and sales. Advertising costs, in particular, are related almost exclusively to the promotion of the LEC's image and services to its retail, rather than wholesale, customers. It is obvious that the LEC will not have to

promote its wholesale services to competing carriers through television, radio, or newspaper advertisements. If it wants to advertise to wholesale customers (e.g., in areas where local exchange competition will be permitted), it can do so at minimal cost, through letters sent to a handful of firms.

Advertising, promotional marketing and direct sales expenses are the types of costs that competing toll companies must incur directly within their own operations for promoting their retail toll services. The internal costs that a LEC incurs to market its own retail services should not be considered as part of the cost of its wholesale services.

In most intrastate markets, the profit margin on access service is considerably higher than the profit on retail toll service. Specific data concerning the relative profitability of toll and access service is generally claimed to be "confidential" and thus the LECs prevent this information from being publicly disclosed.

2. **Should intraLATA toll competition be delayed until LECs can compete in interLATA toll markets and/or federal legislation on this is passed?**

No to both. The absence of competition is preventing Virginia ratepayers from getting the broader selection and better service that are already found in interLATA toll markets. The familiar claim that "one-stop shoppers" will desert to IXCs has not been borne out by actual experience. In most other states, the BOCs retain a large share of the intraLATA market, despite their inability to provide inter-LATA service.

The prohibition on BOC participation in interLATA markets results from the settlement of an antitrust case; as the MFJ makes clear, the BOCs can enter the interLATA markets whenever they can demonstrate that they lack sufficient market power to impede competition. Since the BOCs agreed to these restrictions as part of an antitrust settlement, and since these restrictions will not be lifted until the federal court, or Congress, finds it appropriate to do so, the restrictions do not constitute sufficient reason to deny customers the benefits of competition in Virginia's intraLATA toll markets.

4. **Should this intraLATA toll docket and the access rate docket (Case No. PUC880042) be consolidated?**

Yes, if this consolidation will expedite, rather than delay, approval of intraLATA toll competition. In order for effective intraLATA toll competition to develop, access charges need to be kept to a reasonable level.

If competition is approved in the Virginia intraLATA market, the LECs will be selling service to two distinct types of customers--toll service in the retail market to their own end-use customers and service in bulk quantities in the wholesale market to other toll carriers (e.g., AT&T or MCI). These competitors are not purchasing the LEC's service for their own consumption but rather as a necessary component of the toll services they offer to their customers in the retail marketplace.

The Commission should seek an appropriate balance between retail and wholesale rates. It should not condone a "price squeeze" which compresses

retail and wholesale rates to the point where insufficient margin exists for an efficient toll carrier to operate in the intraLATA market without incurring a loss.

Wholesale prices are normally lower than the corresponding retail prices, consistent with the higher level of service which is provided at the retail level. For example, in 1993, AT&T paid an average of \$.085 per access (wholesale) minute of use (MOU) and charged an average of \$.196 per retail MOU. [AT&T 1990 Form M.] The difference between the wholesale and retail price level provides the necessary gross profit margin which allows AT&T to recover the costs it incurs in providing retail service to end users.

This normal pricing pattern, with retail prices well above wholesale prices, is typical of most sectors of the economy. This pattern exists for many reasons, but chief among them is the fact that the markup pays retailers for value-adding services (promotion, exposure to a wider customer base, conduct of single-item transactions, etc.). Of course, these services would not be possible in the absence of a sufficiently large gap between the retail and wholesale prices. In other words, if the publishing firm--or any manufacturer--sells directly to retail customers at its wholesale price, it will greatly undermine the viability of its retailers.

These retailers cannot survive without an adequate gap between the wholesale and retail price levels. A manufacturer who narrows or eliminates it will, in the long run, either drive its retailers out of business, or lose them as outlets for its products. Since most manufacturers prefer to market the bulk of their production through independent retail firms and wish to maintain the viability of these retail distribution channels, they are careful to charge significantly higher

prices to individual retail customers than to their wholesale customers. Similarly, the level of access charges should be set by the Commission at a level which is sufficiently low to allow IXCs and resellers to compete effectively in the intraLATA toll market, while ensuring that the LECs maintain a reasonable level of profit in serving the wholesale market.

5. **Should presubscription accompany the introduction of intraLATA toll competition? If so, how should it be implemented?**

Yes. Presubscription and equal access (including 1+ dialing) are necessary for the expeditious development of effective competition. Without equal access, the LECs will continue to enjoy near-monopoly shares of their intraLATA toll markets, and effective competition will develop very slowly, if at all.

Initially, the imposition of a 1+ dialing requirement could be limited to the larger local exchange companies (Bell Atlantic - Virginia, GTE), since they have adequate technical resources and substantial, diverse revenue streams.

For other LECs, a slower, more cautious approach would be reasonable. In fact, for some of the smaller LECs the costs of immediately implementing intraLATA presubscription might be unreasonably high, and thus a considerable delay, or phase-in might be appropriate. The extent and timing of implementation should be directly related to the central office technology in place, the availability of necessary software, and the magnitude of the implementation costs, rather than simply to the size of the LEC. In the absence of unique problems (e.g., use of central office equipment for which appropriate

software is not available), it is reasonable to anticipate that all LECs can eventually offer intraLATA toll presubscription and equal access--after sufficient experience has been gained with the larger companies.

6. **What procedures should be altered to effect fair competition among wide range of potential rivals now operating under different regulatory regimes (large LECs, independents, IXCs, resellers)?**

As the Commission knows, the legal dimensions of this issue are many; and the factual circumstances facing these various categories of competitors differ greatly. Rethinking all the different provisions of the various rules and procedures promises to be a complex and daunting task that can be reasonably attempted only after the relevant policy determinations have been made by the Commission. In this response, therefore, we will avoid discussion of specific procedures and confine ourselves to examination of the broader policy implications of the question.

The Commission can and should adopt rules which maximize the likelihood that emerging intraLATA toll competition will be truly effective. For instance, the Commission can require a high degree of unbundling, and it can mandate reasonable wholesale rates for unbundled basic service functions, to ensure that entrants are provided with a viable opportunity to compete, and to prevent LECs from leveraging their monopoly power in one sphere to enhance their competitive position in another sphere.

We agree with the official position statement recently adopted by the National Association of

Regulatory Utility Commissioners (NARUC), as set forth below:

The framework for transitioning to industry-wide competition must be properly laid or we risk having unregulated monopolies, increasing telephone rates, decreasing subscription levels, diminishing quality of service, and infrastructure dis-investment for some areas. Because of the incentives and opportunities for dominant providers to frustrate competition, there must continue to be oversight of the transition... The development of competition is a time-intensive, pro-active effort. Removing statutory and legal barriers to entry is the first step. However, the subsequent steps which will actually allow competition to develop will be where the hard work lies. [NARUC Bulletin No. 48, November 28, 1994, p. 5.]

In responding to the procedures question, the LECs can be expected to argue for "a level playing field," and to insist that if other competitors, who enjoy pricing freedom, are allowed into the market, they should be given similar freedom. The Commission should reject any such argument, because it is based on the fallacious assumption that once competitors are allowed to enter a market, it will immediately and instantly become effectively competitive. This is far from true.

Economic theory demonstrates that there is generally a direct relationship between market share and market power: i.e., the larger its market share, the

greater a firm's ability to exercise market power and earn excess profits and/or pursue strategies for sustaining its dominant position in the market. For instance, by controlling 60 percent of a particular market while the remaining 40 percent is divided equally among a dozen firms, a firm is likely to have substantial control over the pricing and output within a market. Such a market, while technically populated with a reasonable number of competitors, may be little better than an unregulated monopoly in terms of its outcome. Most of the studies in economics which illustrate this phenomenon focus on concentration ratios (the percentage of industry sales, output, employment, etc. claimed by a given number of firms--typically four or eight), since these ratios provide a practical measure of market power.

Firms with very limited market shares cannot place significant competitive pressure on a dominant firm. Unless and until the dominant firm's market power is eroded, the only protection which exists from this power is the continued regulatory oversight provided by this Commission and the FCC.

Strategic pricing is particularly viable and likely when the dominant firm operates in both competitive and noncompetitive markets, or in both competitive and noncompetitive segments of the same market. In both cases, the firm may be able to finance its aggressive pricing strategies in the most competitive markets or market segments by maintaining high prices in the least competitive areas, where it is not subject to competitive pressures. (This could be done overtly, through actual price manipulations, or covertly, through the manipulation of cost allocations).

Similarly, a firm in this position can recover marketing and advertising expenses

aimed at the competitive segments, as well as a disproportionate share of its overhead expenses, by maintaining relatively high prices in the markets where it enjoys a monopoly--e.g., basic local exchange service, while cutting prices in other markets (e.g., retail intraLATA toll). This technique will allow the firm simultaneously to maintain low prices in the competitive markets and to earn ample overall profits.

In an effectively competitive market, prices are restrained by costs, and costs are restrained by pressures and incentives which encourage efficiency. That is, the market price of a good tends to fall to the level of its marginal cost of production by the most efficient producer (including the cost of capital as one factor of production).

Once competition becomes effective, the LECs' power to control or influence price levels will be greatly reduced, or eliminated. At that time, it may be possible for the Commission to treat them like other firms.