

1 **POLICY OVERVIEW**

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Q. Do you agree that another important policy objective is to set rates as close as possible to costs?

A. No, I do not. Setting rates by "cost tracking" is an illusory goal. Certain types of cost analyses have legitimate economic objectives (e.g., rates based on marginal cost promote efficiency). However, strict adherence to a policy of cost-based rates would conflict with at least some of the Commission's policy goals. Universal service is a prime example. The positive externalities of basic exchange service that I have described earlier in my testimony militate for rates set at a relatively amount in order to promote widespread participation on the network.

Q. What are some other problems with cost-based rates?

A. For one thing, multiple definitions of "cost" render the term hopelessly ambiguous as a general principle. Without an agreed-upon definition of cost (and a defined methodology), widely differing rate designs can be defended, each on the basis of cost. In fact, fully allocated cost studies can be manipulated to justify nearly any rate design.

A further problem is that the level of cost does not necessarily imply an appropriate rate level. For instance, if all its rates were set equal to marginal cost, GTE/Contel would be unable to recover their embedded cost-based revenue requirement, since marginal costs are generally far below average embedded costs. Some services must therefore be priced above this level. However, I do not believe that local service rates are priced below a reasonable estimate of marginal costs.

1 This discussion of cost tracking is not meant to imply that I disagree with the use of cost
2 analyses for rate design. To the contrary, where valid cost data are available, they are
3 extremely useful to the conduct of a comprehensive review of alternative rate structures
4 and levels, and to an evaluation of the likely outcomes of various policy decisions.
5 Nevertheless, the cost analyses should be viewed as a means to an end-- a rate design
6 and policy furthering the public interest. Cost tracking should not become the end itself.
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