

Section 5: CBT's Rate Restructuring Proposal

Q. The Company claims that it must raise residence rates to this extent because “CBT’s existing rate structure cannot efficiently accommodate interconnection, collocation, unbundling and resale.” [Emmerson Direct Testimony, p. 13.] Does this state the problem accurately?

A. No. Dr. Emmerson goes on to say that

CBT’s existing rates should be rebalanced (i.e., rise or fall to better reflect the cost) to be more economically efficient and more likely to be sustainable in a competitive environment. In particular, the Commission should permit CBT to bring business and residential local exchange rates into closer correspondence with their respective long-run service incremental costs (“LRSICs”) and to deaverage local exchange rates to better reflect the costs of serving subscribers in different geographic areas. [Id.]

There are three fundamental problems with CBT’s stated position. First, the major rebalancing that the Company proposes is a massive revenue shift from business to local to position CBT for competition. Yet the Company’s claim of a huge “business subsidy” to residence service is refuted by my cost/revenue studies (reported in section 4 of my testimony). Furthermore, as Staff’s and the OCC’s analyses of CBT’s revenue requirement both reveal, the Company is not experiencing a revenue shortfall but is actually over earning. [OCC, Schedule KLH-1.]

Second, CBT’s approach puts the cart before the horse, since there is no *a priori* way to determine what an appropriate competitive position should be in a context where the carrier enjoys substantial market power and the ultimate criterion is whether or not a proposal is in the public interest--not simply the Company’s interest. There is a crucially important distinction between a rate change which is merited in response to competitive pressures, and one that will prevent, reduce, or inhibit competitive pressures. Logically and equitably, major pricing changes should be in response to competition, not in anticipation of it. If prices are realigned by a dominant carrier in advance of competition, there is significant risk that the rate adjustments

will serve that carrier's interests, but not the broad public interest. Rebalancing could have the effect of thwarting or distorting market forces, confusing customers, erecting barriers to entry or discouraging entry. Clearly, pricing changes should not be allowed which advance an agenda of discouraging competitive entry, or which reduce the likelihood that effective competition will quickly emerge.

Third and most importantly, at this early stage in the evolution towards a more competitive market, the Commission continues to have an important role in protecting captive customers from unreasonable rate changes. The Company's proposed rate restructuring would shift much of the cost burden from business subscribers to residence subscribers. Thus CBT's proposed changes would allow it to cut prices in submarkets where it may anticipate the strongest downward pressure on rates resulting from competition, while "financing" these price cuts with increases in submarkets where it may expect competitive entry to be more difficult, and less immediate.

Q. How does CBT attempt to justify this enormous cost shift?

A. CBT's major argument is that business service is "subsidizing" residence service. According to CBT witness Dr. William E. Taylor,

Historically, subsidies or contribution flows have been used by regulators to sustain certain pricing structures that could not possibly survive in an open and competitive telecommunications industry. For example, contributions have been provided by local business rates and rates for vertical services (call waiting, call forwarding, etc.) And carrier access services to help keep residential rates low (in most instances, below cost). These are all *implicit* subsidies because they are all embedded within service rates. While the CBT Plan recognizes all such implicit subsidies, it proposes specifically to eliminate (through rate rebalancing) only one, namely, the contribution from business to residential rates. [Taylor Direct Testimony, p. 6.]

Q. Is this argument valid?

A. No. Sometimes, the difference between the direct (or incremental) cost of a service and the revenue it provides is identified or described as a “subsidy.” Thus, for example, it might be suggested that because switched access service is priced well in excess of its direct economic cost, that this service is providing a massive “subsidy” of some other service (e.g., basic local exchange). Any such suggestion is erroneous. According to the economic literature, a good or service is not being subsidized unless the revenue it generates is less than the relevant marginal or incremental costs of producing it. Therefore, LRSIC (TSLRIC) is the accepted test for cross subsidies for a service or family of services. On this point, the Company’s economic consultants and I are in full agreement: a price below incremental cost (a subsidized price) is undesirable [Taylor, p. 10.] Our major disagreement comes in regard to what the LRSIC of residence service actually is. I have demonstrated in the previous section of my testimony that the LRSIC of basic local exchange service is less than \$2 per month, while the LRSIC of the entire family of services provided to residence customers is less than \$20 per month. Hence, no subsidy exists, and there is no economic justification for increasing residence rates.

Q. Dr. Taylor also claims that the proposed rate rebalancing “will bring both business and residential rates closer to their respective incremental costs.” [Id.] Do you agree?

A. No. Since residence service is as a whole and for most individual subscribers already priced far above its incremental cost (LRSIC), to increase the rates for that service would move residence service prices *away* from incremental cost, not closer to it. While some services may contribute more than others to the recovery of joint and common costs, any service that covers its direct costs is not being subsidized. Large mark-ups, or contributions above direct cost, are quite typical in this industry, due not only to the presence of joint and common costs, but also to the existence of economies of scale, scope and density. Most residence customers also provide large contributions in excess of the direct economic costs of their service. This is

demonstrated by my LRSIC studies described earlier, in which the direct cost of providing residence basic local exchange service was estimated to be less than \$2 per month. Since the residence local exchange rates cover this cost many times over, it is clear that residence basic local service is not being subsidized by business service.

A service priced above LRSIC is making a contribution to joint and common costs, and the firm is better off producing it than not producing it, regardless of the pricing or contribution levels of other services. Thus, a service is “subsidized” only if the total incremental revenues it generates are less than the corresponding LRSIC. As my cost studies demonstrate, a pure LRSIC approach applied to local exchange services also shows that revenues for that service far exceed LRSIC. The alleged “subsidy” of local service is an artifact of the Company's incorrect analysis, which overestimates loop costs, then wrongly assigns all of these overstated costs to local service in violation of the LRSIC concept. If the LRSIC approach is used appropriately and consistently across all services, the pattern of alleged “subsidy” disappears.

Q. Your cost results suggest that business local service is priced even farther above LRSIC than residence local service. Is it necessary to increase the price of residence basic local service in order to reduce the price of business (non-residence) local service or other services ?

A. No. While CBT claims it has a large and growing revenue deficiency (\$37.23 million for the test year), the OCC's analysis has reached quite the opposite conclusion. According to the OCC's analysis, CBT's test year over earnings amount to almost \$50.5 million. [Schedule KLH-1.] Since the Company is currently generating more than ample revenues relative to its economic costs, it is well positioned to reduce business rates in response to competitive pressures, without any necessity for increasing residence rates. Indeed, residence rates should be lowered.

Q. Dr. Emmerson also expressed concern that failure to raise residence rates would make rates for unbundled loops uneconomic. If some retail residence local exchange rates are less than the wholesale cost of an unbundled loop, will this preclude competition from emerging in local markets?

A. No, not necessarily. If the price of local service is paired with a cost analysis which includes all the joint costs of local switching and local loops, and if the analysis ignores all other sources of revenues that are available to local carriers to help pay these joint costs, the appearance is created that a huge shortfall, or “subsidy” problem exists. Under this sort of misleading analysis, it will seem that a price squeeze exists, and competitors will be unable to enter local markets. In reality, however, when they sign up a residence customer, new entrants can anticipate the same various sources of revenue that the incumbent carrier has enjoyed, in addition to the basic local rate. If the new carrier accurately studies its costs, and matches these costs with a realistic estimate of all the various revenues that will be available to offset these costs, there is no reason to assume a price squeeze will exist, or that competitive entry into residence markets will be impossible. This is particularly true if the unbundled loop rates are set at reasonable levels, consistent with the TELRIC estimates that I have provided.

Q. Are there logical reasons, even if they are not in the public interest, why the Company would seek to rebalance its rates?

A. Yes. While it is clear that competition produces many benefits--increased customer choice, increased pressures for maximum efficiency, etc.--it should also be recognized that it can have negative effects on the incumbent carriers and their captive customers, at least over the short term. For one thing, competition slows the incumbent’s growth rate as its market share declines, reducing the benefits of economies of density and scale, and the growth in revenues and profits just discussed. Furthermore, competitive pressures will tend to be strongest where margins are perceived to be the highest and/or barriers to entry are the lowest.

These factors tend to create strong incentives for the incumbent carrier to reduce prices in the markets where margins are high, or barriers to entry are low, or both. Conversely, where competitive pressures are weakest, either because margins are lower, or because barriers to entry are higher, or both, the incumbent may attempt to *raise* prices. That is, the unevenness of competitive pressure may encourage the incumbent carrier to make an effort to “rebalance” its rates in an effort to sustain profitability in the face of price reductions in the more competitive markets. One of the most significant features of most systems of reduced regulation is that the carrier is given greater freedom to engage in such rebalancing of its rates. The extent to which this occurs will depend in part on the amount of pricing freedom the firm is given under the particular plan that is adopted, and it will depend in part on the extent to which the Commission is able to reduce barriers to entry in various markets.

Assuming barriers to entry persist in some areas, prices will likely rise in those areas, unless the Commission acts to prevent it. Consider, for example, the situation where new carriers will incur relatively high average costs if they attempt to enter smaller markets, because the market isn’t large enough for the carrier to gain the benefits of economies of scale and density. In this situation, new carriers will be less likely to enter the smallest markets. The problem is most acute in rural areas and for very small carriers (e.g., a 5 percent market share).

In such circumstances, the incumbent may have an incentive to increase its prices in these markets, perhaps stopping just short of the point where it estimates a potential entrant’s average costs would be. This is sometimes referred to as entry-detering pricing (maximize profits subject to a constraint of not enticing competition into the market). Simply stated, without regulatory constraints and without effective competition, if the incumbent is free to charge “what the market will bear,” it will have an incentive to greatly increase rates in rural markets relative to urban markets, where barriers to entry are lower.

Q. Assuming universal service funding will keep rates reasonable in high cost areas, can the Company expect to compete without raising residence rates?

A. Yes. As shown on schedule KLH-1, attached to OCC witness Hagans's testimony, CBT is massively over earning rather than experiencing a revenue shortfall; hence any over-pricing of business services can appropriately be solved without an offsetting increase to residence services. In my opinion, competition, as it increases, will eventually drive down the overall level of switched access rates and business local service rates. However, competition may also drive down many other rates, including residence local service rates. There is every reason to anticipate that competitive forces will create downward pressures on the underlying costs of all local services, including switched access, custom calling and basic local exchange service. While the competitive pressures may not be as immediate, or as strong, in residence markets, there is certainly no reason to assume that the appropriate pricing trend in those markets is sharply upward. To the contrary, if competition is strong enough, profit margins may decline, creating downward pressure on nearly all local rates, including those paid by residence customers. In general, telecommunications prices are likely to decline over time, as a result of technological improvements, increasing efficiency, increasing volumes, reduced costs, and lower profit margins resulting from increased competition.

That type of gradual price reduction, the product of external economic forces, is quite different from the pattern of sharply increasing rates that is proposed by CBT. This aspect of the Company's proposal essentially consists of a large, government-enforced, shifting of revenue responsibility prior to opening local markets to competition. This shift would be quite advantageous to the Company, since it would allow it to cut its switched access and business local service prices, without any need to cut its costs or trim its profit margins.

However, such a radical change would not be in the public interest. A longstanding principle of rate making is that even where revenue shortfalls exist (not the case here), customers should not be exposed to sudden and extreme increases in rates, particularly if the increases are unrelated to improvements in service quality or expansions in service offerings,

and even more particularly if no reasonable substitute for the service is readily available. Otherwise, the abrupt nature of these increases may cause subscribers to drop off the system, to the detriment of universal service and society in general. For equitable and other reasons, regulatory commissions have often found that “rate shock” should be avoided, or minimized. Where customers do not have other viable options (e.g., where effective competition does not exist), extreme or abrupt rate increases are not appropriate or desirable. Substantially increasing rates to residence customers would violate the rate continuity principle.

Reducing business local service and switched access rates is not objectionable, provided this can be accomplished without a corresponding exercise of monopoly power against captive local residence customers. The general trend in telecommunications costs and rates is downward, and it is not unreasonable for businesses and interexchange carriers and their customers to share in the benefits of this downward trend. In fact, the testimony of other OCC witnesses indicates that CBT is currently enjoying excess profits, which would indicate that a reduction in business and/or access rates would be appropriate. However, such a reduction should not be financed through a “revenue neutral” filing, thereby allowing CBT to maintain an excessive level of revenues and profits in a declining cost environment, and imposing a massive shift in the revenue burden.

Q. The Company’s plan also calls for rebalancing rates according to density zones (rate bands), with subscribers in the least densely populated wire centers paying the most. The Staff Report endorses this approach. Do you?

A. No. This deaveraging of basic rates runs directly counter to principles of value of service and universal service pricing. To the extent costs are higher in low density areas, this problem should be dealt with through an explicit universal service support mechanism, rather than by forcing these customers to pay higher than average rates. However, I agree that it would be reasonable to make a transition to uniform retail rates across all three bands, as suggested in the Staff Report. [Staff Report, p. 60.]

