

1       **Access Costs and Charges**

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3       **Q.     Please turn to the third and final section of your testimony, regarding carrier**  
4       **interconnection costs and switched access charges. First, why are these issues**  
5       **included in this proceeding?**

6       A.     These issues are intimately connected to the issue of Universal Service. Switched  
7       access service is an important source of revenues that has historically been used to help  
8       pay for the costs of providing Universal Service. If these rates are greatly reduced, as  
9       some carriers have advocated, there will be increased pressure to replace this revenue  
10      stream with an alternative source of funding, such as higher local exchange rates. This  
11      form of "rate rebalancing" as it has been called, may endanger the Universal Service  
12      goal, particularly if it is implemented in an extreme manner. Also, questions have arisen  
13      concerning whether or not switched access charges should be applied to local traffic  
14      that is originated by one carrier and terminated by another carrier in a competitive local  
15      exchange market. The interconnection question was transferred to this docket from the  
16      competitive certification dockets by a Commission Order of October 4, 1995:

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18               We also direct MFS, Bell, and the other applicants with petitions pending, and  
19               any other interested party to explore the interconnection costs and an  
20               appropriate mechanism for recovering such costs, on a permanent basis in the  
21               Universal Service Investigation. Each party should include in its analysis an  
22               identification of all costs and subsidies currently existing in each LEC's access  
23               charges and a proposed resolution for restructuring rates in a manner which  
24               permits an appropriate reduction of such charges. The scope of this analysis  
25               should also include a review of the costs and subsidies for new local exchange  
26               carriers access charges.

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28               Order as quoted in October 6, 1995, Secretarial Letter from John G. Alford.

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**Q. What is your view of proposals to lower switched access rates?**

A. I don't find the concept of reducing access charges to be objectionable, provided this can be accomplished without forcing local exchange customers to pay higher rates. Quite the contrary, the general trend in telecommunications costs and rates is downward, and it is not unreasonable for the interexchange carriers and their customers to share in the benefits of this downward trend. In many jurisdictions access charges have declined, yet local rates have remained relatively stable.

What I find objectionable is the concept of implementing reductions in access charges through a "revenue neutral" filing that allows the LEC to maintain an excessive level of revenues and profits in a declining cost environment, and imposes a massive shift in the revenue burden from the toll to local category. Such an extreme shift is unwarranted, unnecessary, and inappropriate. So too would be any proposal to eliminate the contribution to joint costs that is provided by switched access rates, if this is accompanied by a plan to recover the lost revenues through an end-user line charge or higher local exchange rates prior to the emergence of competition. This solution represents, in effect, a shift in the revenue burden from toll carriers to local exchange customers.

**Q. Some say that switched access charges must be decreased immediately, due to the threat of competition. How well supported is this argument?**

A. Not well at all. Switched access continues to be a market overwhelmingly dominated by the incumbent local exchange carriers. While competitive access providers have emerged as niche players in some of the nation's larger metropolitan areas, they have limited facilities and very limited market penetration. The traditional local exchange carriers generally continue to enjoy an extremely large share of the switched access market (i.e. more than 90%), even in areas where competitors have entered the market. Furthermore, new entrants do not necessarily focus on price cutting. For instance,

1 Metropolitan Fiber Systems (MFS) has emphasized faster service, greater reliability  
2 and better transmission quality, rather than cost savings.

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4 **Q. Won't access rates decline as competitive pressures increase?**

5 A. It is reasonable to assume that nationally, access rates will continue to trend downward,  
6 as a result of technological improvements, increasing traffic volumes, and improved  
7 efficiency. To the extent competition increases, it will tend to hasten or reinforce this  
8 downward trend. One of the advantages of effective competition is that it forces all  
9 carriers to operate more efficiently, and it creates incentives for cost cutting and  
10 technological enhancements. However, there is certainly no basis for concluding that an  
11 immediate and massive shift in revenue responsibility is necessary from access to local  
12 exchange.

13 Quite the contrary is true. The evidence suggests that access markets are  
14 characterized by monopoly conditions, and that new entrants are unlikely to emphasize  
15 switched access rate reductions as a primary strategy for gaining market share. When  
16 over time access prices do decline, it will be as a result of increased volume, reduced  
17 cost, and lower profits. That type of access price reduction, the product of external  
18 economic forces, is quite unlike the price reductions typically advocated by incumbent  
19 LECs and their larger interexchange customers: a government-enforced shifting of  
20 revenue responsibility from access to local markets.

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22 **Q. Do you accept the proposition that switched access rates need to be  
23 redesigned?**

24 A. Yes. Recent FCC actions to encourage unbundling, expanded interconnection rights,  
25 and co-location are designed to increase competition in the switched access market,  
26 and potentially to improve efficiency and drive down access rates. However, the full  
27 impact of these changes may be years away. Even if one accepts the conclusion, it  
28 does not follow, by any known logic, that an immediate reduction in access prices

1 should be accomplished at the expense of local exchange ratepayers. To the contrary,  
2 much of the required modifications of switched access rates can be accomplished within  
3 the access category alone. For example, terminating access rates could be increased, in  
4 order to fund a reduction in originating rates (and vice versa, with regard to 800  
5 service).

6 Competition, as it increases, should eventually drive down the overall level of  
7 switched access prices--but it can also serve to drive down costs and profits, as well.  
8 Therefore, and given the massive uncertainty which presently exists concerning federal  
9 legislation and other factors, it would not be appropriate to raise local rates at this  
10 juncture, in order to accommodate a downward shift in switched access prices which  
11 might or might not eventually occur in the absence of regulatory action.

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13 **Q. In your opinion, should access rates and local exchange rates be rebalanced at**  
14 **this time?**

15 A. No. In my opinion, the appropriate response to these uncertainties is not to be found in  
16 any "rebalancing" of local and access rates. For more than 15 years, interexchange  
17 carriers have advanced the argument that the joint costs of local networks (e.g. the loop  
18 costs) should be entirely the responsibility of local ratepayers. As market conditions  
19 have evolved, some parties have continued to recycle these arguments, by adapting  
20 them to fit changing market conditions. Prior to divestiture, the argument was that toll  
21 competition was increasing, and thus local rates needed to be increased while toll rates  
22 needed to be reduced. In the mid-1980's, the theme was amplified and repeated  
23 throughout the country, with an emphasis on the potential effect of the divestiture. Some  
24 of the Bell Operating Companies even implied that unless local rates were dramatically  
25 increased at the time of divestiture, disaster would befall them. Local rates were not  
26 increased as much as requested or predicted, and events subsequently proved the  
27 argument to be false. LEC profits remained strong "bypass" never grew as rapidly as  
28 predicted, and in most markets the LECs enjoyed strong growth in their switched

1 access service, despite the fact that rates were not reduced as much as the IXCs had  
2 sought. Not only has history proven this argument false, it is inherently inconsistent with  
3 both economic theory and common sense.

4 By such reasoning the local exchange networks are preexisting entities for  
5 which the LECs and their subscribers are responsible and to which interexchange  
6 carriers more or less incidentally connect in the course of completing long distance calls.  
7 To IXCs, the cost of the local subscriber's loop, drop wire, line card, and channel  
8 connection should be considered exclusively part of the incremental cost of local  
9 exchange service, as distinct from the cost of providing switched access and other  
10 categories of service. If that is the case, then it is wrong for the LECs like Bell to charge  
11 more than cost for access.

12 In contrast, in my view these are joint costs necessary for the provision of toll,  
13 access, and custom calling service, as well as local exchange service. To assign the  
14 entire amount of these joint costs to local exchange is not valid, and the resulting total  
15 cannot meaningfully be arrayed beside the revenues derived from basic local exchange  
16 service.

17 The LECs actually have many revenue sources which help cover these joint  
18 costs, including toll, switched access, and custom calling; the facilities used in providing  
19 dial tone are also required for (and used by) other services that the LECs provide--  
20 including interstate switched access, intrastate switched access, intrastate toll, and  
21 custom calling. The poles, cable, drop wire, line card, and channel connection are  
22 equally required for the provision of these other services. The portion of the LECs' total  
23 costs that are most properly and exclusively attributed to basic local exchange service  
24 (i.e., to basic Universal Service) are the usage costs associated with local calling  
25 volumes. These costs primarily consist of the usage sensitive central office switching  
26 costs, and the costs of interoffice trunking or transport, which is required to handle  
27 calls from one part of the local exchange to another. Even if a line is intended strictly  
28 for local calls, it can also be used to place and receive toll calls, and vice versa.

1                    Sometimes it is argued that "access" (or access lines) can be viewed as a  
2 separate product, thus "solving" the joint cost problem. However, even if one were to  
3 accept this notion as valid, it does not solve the pricing problem or change the  
4 fundamental nature of the situation. To the contrary, the product thereby defined is an  
5 intermediate product used jointly in two or more markets. Generally, access is provided  
6 to the other lines situated within the same city, but it is simultaneously provided to the  
7 toll carriers with points of presence in that city; and via their facilities, access is  
8 provided to millions of lines located in hundreds of other cities around the state and  
9 country. It makes no economic sense to impose the entire cost of the access line, as  
10 part of the price of local service, on the particular customer who requests installation of  
11 the line. Rather, it is appropriate to recover the cost from all of the beneficiaries of that  
12 line--including the other local customers in that city and the toll carriers that are  
13 interconnected to the new line, whether directly or indirectly.

14                    It should be recognized, however, that the same reasoning applies to local  
15 service. If we focus on the incremental cost of providing local service in a situation in  
16 which all other services are still provided, then for most customers the loop is not part  
17 of the additional cost incurred to provide local service. In other words, loops are  
18 needed to provide toll, access, and custom calling services; and thus they are not  
19 incremental to the decision to purchase or provide local service.

20                    In this regard, it is helpful to recognize the distinction between cost allocations  
21 and cost recovery. In preparing an incremental cost study (the kind of cost study  
22 appropriate to the determination of the costs of basic Universal Service), it is no more  
23 appropriate to allocate loop costs to basic local exchange service than it would be  
24 appropriate to allocate these costs to other services. However, even though loop costs  
25 are not allocated to the services which use the loop, they nevertheless are recovered  
26 from customers that purchase those services. These costs are recovered as a result of  
27 markups, or contribution, generated by setting at least some prices within each service  
28 category at a level exceeding incremental cost. Stated another way, incremental cost

1 can be used as a pricing floor, but if joint and common costs are to be recovered, it is  
2 necessary to set at least some prices above the floor. This is what occurs in competitive  
3 markets, and it is also a reasonable approach for regulators to use in setting prices for  
4 regulated services.

5 By longstanding tradition and in accordance with the principle of value of  
6 service, discretionary service like toll have been priced to provide a larger percentage  
7 contribution to joint and common NTS costs than have essential services like local  
8 dialtone. If local access for toll calls were priced at half a cent per minute, toll calls  
9 would be treated essentially the same as local calls, with no consideration of their higher  
10 value, or of the tremendous benefits that IXCs receive when they interconnect with the  
11 local network.

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13 **Q. Is contribution the same as subsidy?**

14 A. No. Often, contribution, the difference between the incremental or marginal cost of a  
15 service and the revenue it provides, is identified or described as a "subsidy." This  
16 usage is not only prejudicial, it is erroneous. In economics, a good or service is not  
17 being subsidized unless the revenue it generates is less than its marginal cost of  
18 production. As pages 3 and 4 make clear, the direct cost of residential local exchange  
19 service is extremely low--usually less than \$2.00 per month. Since the local exchange  
20 rates cover this cost many times over, it is clear that local service is not being  
21 subsidized. While these revenue/cost comparisons appropriately exclude the joint costs  
22 of the local loop, even if these costs are considered, the conclusions are not appreciably  
23 different. The incremental costs of a local loop vary somewhat, depending upon loop  
24 length, density, and other factors. In the high cost wire centers that were the principal  
25 subject of our investigation, loop costs are high enough to require subsidies in some  
26 cases. For most customers, however, the cost lies somewhere in the general range of  
27 \$5 per month, and is more than covered by contributions from the local exchange rate  
28 and FCC subscriber line charge alone. In most cases, further contributions are available

1 from switched access, intraLATA toll, and custom calling services. Accordingly, there  
2 is no evidence to support the argument that massive subsidies exist. Rather, the level of  
3 contribution of local service to joint and common costs is substantial, although it may be  
4 lower than the contribution provided by certain other services, including toll and  
5 switched access, when stated in percentage terms.

6 If the price of local service is paired with a cost analysis which includes all the  
7 NTS costs of the local loop and ignores all other sources of revenues that help pay  
8 these costs, the appearance is created that a huge shortfall, or “subsidy” exists. Under  
9 this sort of analysis, any plan to support Universal Service will require a whole lot of  
10 cash. But if developed using an appropriate analysis of costs and realistic estimates of  
11 revenues available as sources of support, the funding of true Universal Service (not just  
12 maintaining current penetration levels) should not be burdensome. Furthermore, it is  
13 worth noting that when an incumbent LEC estimates its costs, using present technology  
14 and market conditions, the results may be higher than actually necessary. Incumbent  
15 carriers may be forced to become more efficient, and their costs may fall in response to  
16 these competitive pressures.

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