Rate Design

Q. Do you agree with the Company's local residential rate design proposal?

A. No. While some aspects of the Company's proposals are reasonable, I believe the Company has gone too far with some aspects of its proposed redesign.

The most disturbing thing about the Company's proposal is that most residential customers would face a very substantial rate increase at a time when they have few, if any, competitive alternatives. As discussed later in my testimony, the Company has reduced some of its toll and access rates by fairly large amounts, and it hasn't increased local rates for most business customers. The effect is to shift the revenue burden away from toll carriers and business customers onto residential local exchange customers, exacerbating the problem of substantial increases to residential local rates.

While there is some merit to some aspects of the Company's rate design proposals, I strongly disagree with the magnitude of the proposed residential rate increases. The underlying rationale for these increases–that local service is "subsidized" by other services–is invalid, as I have previously discussed. Furthermore, because the proposed rate changes are so drastic, they violate basic principles of intercustomer equity and rate continuity.

Q. You have already explained your disagreement with the Company's "subsidy" analysis. Would you please explain your concerns regarding intercustomer equity and rate continuity?

A. Yes. While I recognize that residential local exchange rates generate lower contribution levels than the rates for some other services (e.g. business local exchange), that fact alone does not justify the rather drastic realignment of rates proposed by the Company. The Company proposes to substantially increase rates for residential basic local service while largely exempting business local exchange rates from any increases, and proposing decreases to toll and switched access rates. All of US West's residential customers would experience rate increases, and in some cases these increases are quite large.

Consider, for instance, members of the Low Income Telephone Assistance Program, who already devote a relatively high portion of their income to necessities like telephone service. They would see their monthly local exchange rates increase by nearly 25%, under the Company's proposal. Most residential customers within the BRA would experience an increase of almost 20% in the monthly rate they pay for basic local service, and customers outside the BRA would experience an even larger increase, as I will discuss later in my testimony.

At this early stage in the transition to competition, there is no justification for the Commission abandoning its historic job of protecting customers from excessive rates, nor is there any reason to assume that competition will protect customers from excessive rate increases. If US West's proposed increases are approved by the Commission, most customers will simply grit their teeth, curse the Commission, and pay the bill. The idea of trying a competitor won't even occur to them, or it will seem too risky.

While some customers might respond to these increases by switching to Cox Cable or another competitor, not all customers have the option of using another carrier. Even if this option theoretically exists, they may not be willing to take the risk at this early stage in the transition to competition. Mr. Teitzel cites Cox Communications as a major competitor. [Direct, p. 29] However, the Cox cable system only passes by a portion of US West's existing customers, and this places an upper limit on the extent to which customers can switch to the Cox service if the US West rates are increased to excessive levels. An even more important consideration–but one that none of the US West witnesses mention–is that Cox doesn't sell its cable services to 100% of the homes it passes. To the contrary, cable operators throughout the country have found it more profitable to charge prices which are so high, they discourage a large fraction of the population from buying cable service. Cox Cable will be focused on convincing their existing customers to add telephone service to their existing cable service. Customers who can't afford cable service, or feel it is overpriced, are unlikely to consider getting their telephone service from Cox.

The historic pricing practices of the cable industry are oriented towards profit maximization–not achieving universal service or fully exploiting potential economies of scale. In the telephone industry, regulators have acted to prevent monopoly profits and encourage universal service. This has had the beneficial effect of lowering prices and expanding the market to encompass nearly every business and household. In contrast, the cable industry has a long history of charging "whatever the market will bear," subject only to limited price regulation and relatively weak competitive pressure (e.g. from over the air broadcasts and direct satellite providers). Given the freedom to choose, the cable industry has historically set prices which seem attractive to some, barely tolerable to others, and grossly excessive to still others. Given this historic context, I question whether Cox reasonably can be viewed as the "savior" for customers faced with excessive rate increases. Moreover, the possibility exists that Cox will respond to US West's rate increase by increasing its own rates–just as a price increase by one of the major airlines will often trigger an increase in ticket prices by all of its rivals. Thus, I believe the Commission should evaluate the proposed rate increases under the assumption that many, if not most, customers will be forced to pay the higher rates–regardless of how unreasonable or excessive they may seem to be.

Regulators have historically recognized that when a revenue increase is required, or a rebalancing of rates is merited, the adverse impact on customers should be ameliorated to the extent feasible, by moderating the magnitude of any rate increases, and phasing in rate realignments on a gradual basis. While I don't fault the Company for wanting to increase residential rates more than business, it has been too extreme in its proposals, requesting rate increases which drastically exceed the rate of inflation, and asking the Commission to impose nearly the entire burden of the rate increase on residential customers.

Furthermore, the proposed increases could have an adverse impact on universal service. Basic local service is considered a necessity by most customers, and thus it is highly price inelastic.

Nevertheless, a 20-25% increase in basic local service rates is so extreme, it would force thousands of customers off the network and it would discourage many potential subscribers from joining. The impact would be especially strong amongst those with low incomes, and those who don't value telephone service very highly–precisely the customers that state and federal policies to advance universal service are designed to help entice onto the network. This provides an additional reason why the Company's proposed increases are too extreme and contrary to the public interest.

Q. Would you please comment on US West's low use rate proposals?

A. The proposal to convert low use option customers to a budget measured service seems to be largely responsive to market trends. The primary change reflected in the Company's proposal is to shift away from rates that vary with the number of calls that are placed, and to focus exclusively on the number of minutes used by the customer. This conforms with industry trends. In recent years, we have been inundated with TV, radio, and magazine advertisements for claiming to offer long distance service for 10, 7, and now even 2 cents per minute. Similarly, the wireless industry is increasingly selling its services on a per-minute basis (frequently in the form of "packages" which include a group of features and a specified number of minutes per month). My only objection to the Company's proposals in this area is that the usage rate is being reduced too far. The Company has not offered any justification for the proposed rate of 2 cents per minute, which is substantially lower than the 3 cent rate US West charges its competitors for Resale/Sharing service. I recommend that the Company's low use rate proposals be accepted, with the exception of the usage rate, which should instead be set at 3 cents per minute. At a 3 cent rate, customers will still save money, compared to the current 20 cent per call rate, for calls lasting up to 6 minutes. The overall effect of my recommendation is to increase revenues from this category by approximately 12%–about the same percentage increase that would apply to flat rate customers under my recommendations.

Q. Would you please comment on US West's residential zone proposals?

A. I have no objection to expanding the BRAs to accommodate suburban growth. The zone increments are intended to recover a portion of the higher cost of serving low density rural areas. As formerly rural areas are developed to higher densities, it is reasonable to reflect this change by expanding the BRA boundary, as the Company proposes in this proceeding.

Furthermore, I have no objection in principal to charging somewhat higher rates outside of the BRA, to recover a portion of the higher cost of serving customers in these low density areas. However, the Company's proposals go too far, resulting in excessive increases for these customers. Currently, households that are located outside the BRA incur an exchange zone increment charge of either $1.00 (zone 1) or $3.00 (zone 2). The Company initially proposed to increase these rates to $3.00 and $5.00, respectively. In its revised filing, the proposed rates were increased even further, to $5.00 and $7.00 for zone 1 and 2 respectively. Combined with the proposed $2.50 increase applicable to all customers, the end result of the Company's proposals would be to increase rates for zone 1 customers by approximately 45%, and to increase rates for zone 2 customers by approximately 40%. Increases of this magnitude are clearly not in the public interest, regardless of what the underlying cost information may suggest.

I don't deny that rural Arizona is much more costly to serve than urban areas like Phoenix and Tucson. While I'm not in a position to confirm or refute the specific loop costs shown in the Company's studies, the alleged costs of $40.65 for zone 1 and $63.70 for zone 2 are certainly not outside the realm of plausibility. Based upon experience gained in other states, I know that costs can be very high outside the base rate area, particularly where population density is low and distances from the wire center are long. Regardless of the costs, however, it is not reasonable to expect customers in these areas to pay rates that far exceed those paid by their urban counterparts.

Historically, extreme disparities between urban and rural rates have been avoided by regulators. For example, the high cost of serving rural areas has been recovered in part by allowing carriers to charge higher for toll and access services than would otherwise be allowed. In both the federal and state jurisdictions, access rates have historically been regulated on a cost of service basis; the high costs incurred in rural areas is one of the reasons why this Commission and the FCC have allowed US West to charge so much for these (and other) ancillary services. One can legitimately question whether this historic rate design practice should be phased out, in favor of more explicit forms of high cost support. However, there is no justification for introducing extreme disparities between rural and urban rates, for eliminating existing sources of support without simultaneously instituting an adequate replacement.

Better methods of providing high cost support are actively being investigated in many jurisdictions. In some jurisdictions, new approaches are already being implemented. For instance, the State of Kansas recently implemented a new, competitively neutral, explicit mechanism for high cost support. My firm was privileged to work with the Kansas Corporation Commission (KCC) in carrying out this effort. The KCC initially established the Kansas Universal Service Fund (KUSF) as a "revenue neutral" mechanism which replaced a portion of the existing access revenues. It recently replaced this system with a forward-looking cost-based mechanism. The KCC recognized that costs per line can vary widely with density and distance from the central office. Therefore, in order to take these factors into account, the KCC decided to target support on the highest cost (i.e., least dense, most distant) areas within each wire center. Wire centers and zones within these wire centers were not given support unless the relevant costs per line exceeded 125% of the statewide average costs per line.

If the Commission wants to ensure that rural areas (outside the BRA) generate revenues which are sufficient to cover the relatively high cost of serving these areas, it should not attempt to achieve this change by drastically increasing rural rates. If the Commission is convinced that the existing system if implicit support is not sustainable or acceptable, it would be appropriate to modify the existing Arizona universal service fund, or to establish a new fund. Either of these solutions would be more logical, and more reasonable, than drastically increasing rural rates, as proposed by the Company.

The Company's attempt to solve the high cost problem violates the principle of rate continuity, resulting in excessive increases for zone 1 and 2 customers. Furthermore, a policy of drastically increasing rural rates tends to conflict with the long standing public policy goal of encouraging universal service, as well as specific policy objectives set forth in the 1996 Telecom Act. Congress has sought to ensure that urban and rural rates remain reasonably comparable, notwithstanding any underlying cost differences, and notwithstanding the trend towards increased competition. As the FCC has explained, "the primary role of federal high-cost support is to enable reasonably comparable rates among states, while the primary role of each state is to ensure reasonably comparable rates within its borders." [FCC News Release, October 21, 1999, p. 3.]

Accordingly, I recommend that US West be allowed to increase the zone increment charge to $2.25 per month in zone 1 and $4.50 per month in zone 2. In combination with the $1.58 increase discussed above, this recommendation results in an overall increase of $2.83 per month, or approximately 20%, for customers in zone 1 and an increase of $3.08 per month, or approximately 19%, for customers in zone 2. This is the maximum increase which I believe can reasonably be imposed on these customers.

Q. Do you have any comments concerning US West's proposal to charge less for additional residential lines?

A. Yes. The Company has proposed to deviate from its longstanding practice by charging residential customers who have one line a higher price than those who have two or more lines. The Company's primary justification for increasing the initial line rate is the claim that it needs to bring its prices more in line with costs. Yet, US West does not provide any evidence that suggests that the cost of providing second, third, and fourth lines is any less than the cost it incurs supplying the first line. Here again, a close look at the Company's rate proposals reveals a noticeable gap between the pricing principals it claims to be following and the reality of what it is actually proposing.

The only justification offered by the Company for this new approach to pricing residential local service is the claim that it is responding to customer expectations: "US West believes Arizona residential customers have an expectation that the purchase of multiple access lines should be priced in a manner reflecting perceived economies of scale." [Tietzel, Direct, p. 28] While I don't dispute the possibility that some customers expect there to be some economies of scale associated with providing local exchange service, the Company hasn't demonstrated that any such economies of scale actually exist.

In truth, given the technology used by US West in providing local exchange service, the cost of providing the second and third line is likely to be very similar to the cost of providing the first line. In some cases, the cost may actually be a somewhat higher. For example, if the second line is primarily used by teenagers who talk more than their parents, or if the second line is primarily used for hours-long connections to an internet service provider, the usage costs associated with the second line will be greater than those associated with the first line. With regard to the loop and port costs, these will generally be about the same for both lines. While economies of scale do exist in the telephone industry, they apply equally to first and additional lines. That is to say, marginal cost tends to be less than average cost, but this is true for both first and additional lines. There is only one aspect of the cost of providing telephone service which clearly involves some savings as customers opt for additional lines: the cost of the facilities which are used to connect them to the distribution cable. For example, the drop wire which connects the customer's home to the distribution cable running along the street will typically contain two or three pairs of copper wire. Thus, a second line can often be added without the necessity of installing another drop wire. However, this is a relatively minor cost element, which doesn't provide sufficient justification for pricing first and additional lines at significantly different levels.

Furthermore, the Company hasn't offered any market research or other documentary evidence which would suggest that most customers think about, or expect there to be, economies of scale in providing additional telephone lines. To the contrary, I would anticipate that most customers accept the fact they must pay the same price for a second telephone line as they do for their first one. If a customer decides they want a second line, they are unlikely to be surprised or disturbed if they are informed that the price of a second line is the same as the first one.

In addition, I would note that US West's existing tariff structure is consistent with the general practice in the industry. Historically, residential customers have not been offered discounts for purchasing multiple lines. To the extent pricing differentials have existed in the industry, they typically operate in the opposite direction. For instance, business customers whose usage is heavy enough to require multiple lines are sometimes charged higher "key system" or "trunk" rates, consistent with their greater ability to pay and more intensive level of usage.

I would also note that the mere fact that Cox Cable is offering a lower price for additional lines is not sufficient justification for US West doing so. For one thing, US West still dominates the local exchange market, and Cox Cable is just one of the competitors the Company faces. There is no need for US West to match the pricing philosophy of this particular competitor. For another thing, the technology used by Cox Cable is fundamentally different than that used by US West, and it has fundamentally different cost characteristics. Each additional telephone line sold by US West involves a distinct pair of copper wires running back towards the wire center. In contrast, Cox Cable relies upon a different technology, using coaxial cable which is shared by hundreds of different customers. If US West provides a residence with 5 lines, it will use roughly 5 times as much wire than if it provides that residence with 1 line. In contrast, Cox Cable will use the exact same amount of wire if it provides a residence with 5 lines or 1 line. Furthermore, Cox Cable can obtain "set top boxes" which have the capacity to provide multiple lines of telephone service to the same residence at essentially the same cost than if they purchase just 1 line. Accordingly, virtually the only additional cost Cox Cable incurs when it sells a residence 2 or 3 lines is the additional usage-sensitive costs which it will incur if the purchase of multiple lines encourages the customer to sometimes place longer or more frequent telephone calls. In contrast, when US West provides a residence with multiple lines, it will not only incur additional usage sensitive costs, it will also incur additional loop and port costs.

Finally, I would point out that pricing additional lines at a lower level than the first line tends to increase the price charged for the first line–assuming one is attempting to recover a given level of revenue. For instance, if the Company had proposed to charge the same price for primary and additional lines, it would have been able to recover the same level of revenue from residential local exchange service without having to propose as large an increase in the monthly rate. Accordingly, I recommend retaining the historic practice of pricing primary and additional lines at the same rate–just $14.76 per month for customers located inside the BRA.

Q. Do you have any comments concerning US West's other residential rate proposals?

A. Yes. The Company has proposed to reduce the non-recurring charge associated with connecting residential local exchange service by approximately 25% (from $46.50 to $35.00) for both flat rate and low use option customers. Aside from some general remarks about the overall level of the current rates, the Company provides no evidence why these rates should be reduced to this extent. Mr. Teitzel mentions that Cox Cable is charging just $40.00, and that this fee is waived for new customers. Of course, there is a fundamental difference between the situation facing Cox Cable and that facing US West. As a new entrant, Cox Cable would potentially have to charge every one of its customers this non-recurring charge-because they are all changing from the incumbent's service. In contrast, whenever US West retains a customer, it doesn't have to apply this charge. Thus, it isn't surprising that Cox Cable is offering to waive this fee; it needs to do so in order to compete with US West.

I have no objection to reducing this fee somewhat, since the current level is rather high. However, instead of reducing the rate all the way to $35.00, I recommend reducing it to $40.00

per month for both flat rate and low use option customers. This is the same level nominally charged by Cox Cable. With regard to low income customers who qualify for the Telephone Assistance program, it would be reasonable to reduce the rate further, to just $25.00. This would further advance the goal of universal service, and is consistent with the general philosophy of this program, which encourages customers who might otherwise not be able to afford telephone service to join the network, for the benefit of society as a whole.

As for the remaining residential rate proposals, I have not studied all of the proposed rates in detail. However, for illustrative purposes, I have assumed the remaining residential rate proposals will be accepted by the Commission.