

Q. Are incumbent local exchange carriers (LECs) like BA-NJ required to sell their retail services to competitors at wholesale prices?

A. Yes. Section 252(c) of the Telecommunications Act of 1996 (TA 96, the Act) spells out the duties specifically required of ILECs. Among them is the following:

(4) RESALE- The duty--

(A) to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and

(B) not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of such telecommunications service, except that a State commission may, consistent with regulations prescribed by the Commission under this section, prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from offering such service to a different category of subscribers.

Q. How are the pricing issues with respect to the resale of the services of the incumbent LECs distinct from the pricing issues with respect to interconnection, transport and termination, and unbundled service elements?

A. In the Act, Congress clearly distinguished between the pricing of incumbent LEC services at wholesale for resale by competing carriers, and the pricing of unbundled service elements and carrier-to-carrier functions, including transport and termination of traffic between carriers.

Wholesale prices are addressed in §252(d)(3) of the Act, which reads as follows:

(3) WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES- For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

On the other hand, interconnection, transport and termination of traffic charges, and prices for unbundled elements are addressed in §252(d)(1), which reads as follows:

(d) PRICING STANDARDS-

(1) INTERCONNECTION AND NETWORK ELEMENT CHARGES-

Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section--

(A) shall be--

- (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and
 - (ii) nondiscriminatory, and
- (B) may include a reasonable profit.

In other words, wholesale resale pricing is to be “from the top down,” while interconnection and network element pricing are to be “from the bottom up.” While it is obvious that this difference in treatment opens the door to arbitrage if competitive LECs are able to detect and take advantage of inconsistencies between the two pricing approaches, that appears not to have troubled Congress. At any rate, as I understand the Board’s Order, in this phase of the proceeding we are concerned solely with the wholesale/resale issue, in which pricing is to be “top down” as avoided costs are removed from the retail prices of services competitive LECs buy from incumbent LECs.

Q. How should the discount(s) be computed?

A. In its Implementation Order, the FCC states as follows:

908. The statutory pricing standard for wholesale rates requires state commissions to (1) identify what marketing, billing, collection, and other costs will be avoided by incumbent LECs when they provide services at wholesale; and (2) calculate the portion of the retail prices for those services that is attributable to the avoided costs. Our rules provide two methods for making these determinations. The first, and preferred, method requires state commissions to identify and calculate avoided costs based on avoided cost studies. The second method allows states to select, on an interim basis, a discount rate from within a default range of discount rates adopted by this Commission. They may then calculate the portion of a retail price that is attributable to avoided costs by multiplying the retail price by the discount rate.

...

910. Based on the comments filed in this proceeding and on our analysis of state decisions setting wholesale discounts, we adopt a default range of rates that will permit a state commission to select a reasonable default wholesale rate between 17 and 25 percent below retail rate levels. A default wholesale discount rate shall be used if: (1) an avoided cost study that satisfies the criteria we set forth below does not exist; (2) a state commission has not completed its review of such an avoided cost study; or (3) a rate established by a state commission before release of this Order is based on a study that does not comply with the criteria described in the following section...

The FCC goes on to say that “A state commission must establish wholesale rates based on avoided cost studies within a reasonable time from when the default rate was selected.” Id. Although the FCC establishes certain guidelines for determining what costs are to be considered avoided, the choice of cost study methodology is left up to the states: “Ideally, a state would use a study methodology that is consistent with the manner in which it sets retail rates.” ¶915.

Q. In the case of New Jersey, what methodology would that entail?

A. Inasmuch as current retail tariffs in New Jersey are set to recover embedded costs, avoided costs would best be calculated using New Jersey-specific embedded cost information supplied by the LECs, organized according to USOA accounts.

Q. What accounts should be treated as avoided costs for purposes of the wholesale discount(s)?

A. I have not made an exhaustive analysis of all the accounts and subaccounts which have historically been utilized in setting retail rates and which might be relevant to an avoided cost study. However, it seems clear to me that certain major categories of costs can be largely or wholly avoided in at least some wholesale transactions. These would include 5300 (uncollectible revenue), 6611 (product management), 6612 (sales), 6613 (product advertising), 6220 (operator systems expense), 6621 (call completion service), 6622 (number services expense), and 6623 (customer service).

Expenses in certain other accounts might be partially avoidable: 6112-6116 (network support expenses); 6121-6124 (general support expenses); 6711 (executive); 6712 (planning); and 6721-6728 (general and administrative expenses).

There will be variation, however, in the extent to which most of these expenses are applicable to any one service and in turn can potentially be avoided when that service is provided on a wholesale basis. Ideally, the avoided cost percentage will be calculated individually for the different service offerings, taking into account the degree to which each service is responsible for that expense. For example, product advertising may be a fully

avoidable cost of both custom calling and basic local service; however, the magnitude of the costs that are avoided may differ considerably. Advertising may well represent a relatively large share of the embedded cost of custom calling; in contrast, advertising is of negligible relevance to basic local service.

Q. Are there any studies establishing wholesale discounts based upon such avoided embedded costs?

A. Yes. I have reviewed the detailed results of studies performed in several other jurisdictions, as well as the summaries of a number of state-specific studies as described by the FCC in its Implementation Order. The discounts vary not only in the percentage level at which they are set, but also in their breadth of application—that is, some states apply the same discount across the board to all services, while others distinguish at least a few major subcategories (e.g., residential and business local exchange). When allowance is made for these differences in specificity, the average discounts cluster in the vicinity of 20%. In my opinion, this is an appropriate overall benchmark for the Board to use in judging the reasonableness of discount proposals advanced by the parties in this proceeding. Any figure that is substantially higher or lower than this is likely to be based on a one-sided view of avoided costs.

Q. Should promotional services be available for resale?

A. Yes. The discount from retail prices should apply to promotional retail rates. To rule otherwise would be to allow the incumbent LECs to discriminate in favor of their retail customers. Furthermore, by requiring promotional rates to be offered to both wholesale and retail customers, the Board can discourage the incumbent from establishing promotional rates that are anticompetitive in their effect. The FCC has confirmed this interpretation in its Implementation Order:

948. Section 251(c)(4) provides that incumbent LECs must offer for resale at wholesale rates "any telecommunications service" that the carrier provides at retail to noncarrier subscribers. This language makes no exception for promotional or discounted offerings, including contract and other customer-specific offerings. We therefore conclude that no

basis exists for creating a general exemption from the wholesale requirement for all promotional or discount service offerings made by incumbent LECs.

However, the FCC does provide for “reasonable restrictions on promotions and discounts” at the discretion of state commissions. ¶952. Furthermore, an incumbent LEC may apply the wholesale discount to the regular retail rate (not the promotional rate) when the promotional rate is in effect no more than 90 days and is not part of an attempt to evade the restriction. 47 C.F.R. §51.613(a)(2).

To the extent promotional rates are not available to wholesale customers (e.g. as a result of short term promotions), I believe the Board should require that incumbent LECs treat the revenues lost to promotional pricing as a retail marketing cost. In a competitive market, short term promotional discounts can reasonably be thought of as a “cost of doing business.” When selling the underlying service to another carrier, the Company is able to avoid this cost. Hence, the impact of short term promotions should be taken into consideration in developing the avoided cost discount that applies to wholesale purchases. If this discount is appropriately calculated, including the cost of below-normal, promotional pricing not available to wholesale customers, the competitive LEC will have the option of responding to the incumbent LEC’s promotional prices without being subjected to a price squeeze.

Q. Should the Board impose any restriction on cross-category sales?

A. Yes. As provided in §251(C)(4)(b) of TA96, cited above, the Board is empowered to prohibit at least some cross-category sales. The FCC has narrowed state options somewhat by declaring most cross-category restrictions presumptively unreasonable. ¶964. However, it has left room for states to prohibit cross-category resale of means tested services (e.g., Lifeline) and to prohibit the resale of residential service to nonresidential end-users. ¶962. In my opinion, both these restrictions are eminently desirable, and I urge the Board to adopt them.