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OPINION NO. 96-30

CASE 95-C-0657 - Joint Complaint of AT&T Communications of New York, Inc., MCI Telecommunications Corporation, WorldCom, Inc. d/b/a LDDS WorldCom and the Empire Association of Long Distance Telephone Companies, Inc. Against New York Telephone Company Concerning Wholesale Provisioning of Local Exchange Service By New York Telephone Company and Sections of the New York Telephone's Tariff No. 900.

CASE 94-C-0095 - Proceeding on Motion of the Commission to Examine Issues Related to the Continuing Provision of Universal Service and to Develop a Regulatory Framework for the Transition to Competition in the Local Exchange Market.

CASE 91-C-1174 - Proceeding on Motion of the Commission Regarding Comparably Efficient Interconnection Arrangements for Residential and Business Links.

OPINION AND ORDER DETERMINING WHOLESALE DISCOUNT

Issued and Effective: November 27, 1996

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OPINION AND ORDER DETERMINING WHOLESALE DISCOUNT

(Issued and Effective November 27, 1996)

BY THE COMMISSION:

INTRODUCTION AND PROCEDURAL HISTORY

In this decision, we set permanent rate levels for the sale by New York Telephone Company (New York Telephone) and Rochester Telephone Corp. (Rochester Telephone) of local telephone service at wholesale, for resale. (The hearings leading up to this decision encompassed as well rates for the sale by those companies of unbundled links and ports, but, as explained below, the record in that regard was reopened, and

those matters, along with other related ones, will be decided early next year.) These proceedings examined as well many non-price issues arising in connection with resale and the sale of unbundled links and ports, but they have been resolved in various other orders or remain pending. We begin, therefore, with a more extensive procedural history than usual, designed to show the context and scope of the issues we are here deciding.

We instituted the proceeding on November 1, 1995 to establish a wholesale rate for the sale, for resale, of New York Telephone's local telephone service and to consider the proper rates for unbundled links and ports.[1] Our initial expectation was that New York Telephone would file, by January 2, 1996, a tariff removing the restriction on resale of residential service and, by February 1996, would commence offering services at wholesale, for resale, at a rate reflecting a consensus regarding the proper discount from the retail rate. If a consensus on the discount could not be reached, temporary rates were to be set. Local exchange companies other than New York Telephone were ordered to file tariffs removing restrictions on resale of residential service or show cause why they should not be required to do so. Finally, New York Telephone and Rochester Telephone were directed to submit, by March 1, 1996, studies identifying "the costs of provisioning wholesale loop services, and the incremental and embedded costs of exchange access loops, links, and ports."[2] We recognized the potential need for litigation to determine factual issues with respect to costs, but we urged the parties to use a collaborative process to resolve policy and pricing issues.

In the ensuing negotiations, it became clear that attention had to be directed as well to related non-price issues, along with the systems and processes needed to deliver resale.

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[1] Cases 94-C-0095 et al., Order Considering Loop Resale and Links and Ports Pricing (issued November 1, 1995)(the November 1 Order).

[2] November 1 Order, ordering clause 6, pp. 10-11.

By order issued February 1, 1996, we broadened the scope of the proceeding accordingly. We also extended New York Telephone's deadline for filing a resale tariff to July 1, 1996, to take effect October 1, 1996; extended, from March 1 to mid-May, the time by which New York Telephone and Rochester Telephone were to submit their cost studies; exempted Rochester Telephone from the obligation to file embedded cost studies; and expressed the expectation that "full scale introduction of all delivery systems for wholesale services, including links, will be in place by October 1, 1996."[1] Noting that the evidentiary phase of the proceeding (relating to costs) was unlikely to be concluded before resale became available, we directed consideration, in the collaborative discussions, of an interim wholesale discount.

An intensive collaborative effort followed, in which the parties, with facilitation by Administrative Law Judge Eleanor Stein, succeeded in resolving many (though far from all) non-price issues. Most of the unresolved issues were decided by order issued June 25, 1996.[2] The June Order also brought into this proceeding the matter of resale terms and conditions and permanent resale rates for Rochester Telephone, previously considered in the separate case regarding that company's restructuring.[3]

In view of the parties' inability to agree on temporary rates, we established, on May 24, 1996, an expedited temporary rate track,[4] which culminated in the issuance in this proceeding,

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1 Cases 95-C-0657 et al., Order Considering Loop Resale and Links and Ports Pricing (issued February 1, 1996)(the February 1 Order), p. 12.

2 Cases 94-C-0095 et al., Order Declaring Resale Prohibitions Void and Establishing Pricing Terms (issued June 25, 1996) (the June Order); Order Denying Reconsideration and Referring Issues to Arbitration Proceedings (issued November 18, 1996).

3 Case 93-C-0103, Rochester Telephone Corp. - Restructuring Plan.

4 Cases 94-C-0095 et al., Order Releasing Staff Report and Mandating a Hearing (issued May 24, 1996).

on July 18, 1996, of Opinion No. 96-18, setting temporary rates for New York Telephone's wholesale service and unbundled links. In Opinion No. 96-19, issued the same day in Rochester Telephone's restructuring case, we similarly set temporary wholesale and link rates for that company.[1] The temporary rates for both companies are subject to refund or reparation.

To begin the process of setting permanent rates, Administrative Law Judge Joel A. Linsider convened an administrative conference, held on April 23, 1996 in Albany. The parties attending expressed widely differing views on the proper scope of litigation. At one pole was New York Telephone, which emphasized our statements that litigation would be limited to factual issues of cost and took the position that the litigation could be conducted on papers alone, without evidentiary hearings. At the other pole was AT&T Communications of New York, Inc. (AT&T), urging full evidentiary hearings, including discovery, and contemplating testimony on underlying issues of economics and costing method, among other things. At the conclusion of the conference, Judge Linsider requested each party to submit, in writing, a list of the areas it would propose to address in testimony along with justifications for addressing areas that went beyond those referred to in our orders. He also took the first step toward establishing a litigation schedule, directing New York Telephone and Rochester Telephone to prefile, by May 31, testimony in support of the cost studies they were to submit by May 15.

In a ruling issued May 24,[2] Judge Linsider reviewed the parties' written submissions and stressed our directive that hearings be limited to issues of costing, as distinguished from pricing. He identified the core issues for the hearings as

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[1] As noted, permanent resale and network element rates for Rochester Telephone have been moved into this proceeding.

[2] Cases 95-C-0657 et al., Ruling on Scope and Schedule (issued May 24, 1996)(the May 24 Ruling).

> what costs are avoided (or incurred) in providing bundled and unbundled local service for resale; what are the average incremental [and] embedded ... costs of providing exchange access (loops), links, and ports for residential and business customers; and issues raised by the cost studies and supporting testimony submitted by New York Telephone and Rochester [Telephone]. Policy issues related to costing--for example, how to measure incremental cost--are also properly here, though parties are reminded that many such questions can better be argued in brief than through testimony and cross-examination.[1]

The Judge recognized that pricing issues, such as whether to price links and ports on the basis of embedded or incremental costs, might "inevitably be drawn into the hearings," but he went on to admonish the parties "not [to] regard the hearings here as the primary forum for their development" and to use briefs for that purpose.[2] He also recognized that the then pending rulemaking of the Federal Communications Commission (FCC) under the Telecommunications Act of 1996 (the Act) had important implications for this case, but he saw no alternative to going forward in the absence of a definitive word from the FCC and noted that the briefing schedule would permit parties to refer to the FCC's decision in their briefs.

To sum up the applicable procedures, the Judge said:

> The Commission's orders, and efficient practice, call for limiting the scope of the hearings quite strictly to issues of cost,

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[1] May 24 Ruling, p. 10. Judge Linsider noted that the issues list was drawn, with one exception, from that proposed by Sprint Communications Company L.P. (Sprint). The quoted passage included a reference to separated costs; in a later ruling, the Judge clarified, in response to New York Telephone's motion, that separated cost studies need not be filed. (Cases 95-C-0657 _et al._, Ruling on Motions Regarding Proprietary Information and Other Matters [issued June 13, 1996], p. 14.)

[2] May 24 Ruling, p. 11.

> and I intend to do so. At the same time, policy issues that remain unresolved after the Commission's consideration of the collaborative process and that require further development can be dealt with in briefs, as can the implications of the FCC's decision. Those briefs will be available both to me and to the Commission's senior staff as we jointly prepare a comprehensive set of recommendations for the Commission's consideration.[1]

Consistent with our order on appeal modifying the schedule initially set by the Judge,[2] hearings began on July 22, 1996 in Albany and continued through July 25. Testimony was presented on behalf of New York Telephone; Rochester Telephone; AT&T; MCI Telecommunications Corporation and MCImetro Access Transmission Services, Inc. (MCI); Sprint; MFS Intelenet of New York, Inc. (MFS) and Residential Communications Network, Inc. (RCN) (participating for the most part[3] jointly); and Time Warner Communications Holdings, Inc., Cablevision Lightpath, Inc., Tele-Communications, Inc., and the Cable Television and Telecommunications Association of New York, Inc. (collectively Time Warner). Also participating at the hearings were the Public Utility Law Project of New York, Inc. (PULP); the New York Clearing House Association (NYCHA); and the Empire Association of Long Distance Telephone Companies, Inc. and the Telecommunications Resellers Association (Empire). The record compiled at those hearings[4] comprises 1,914 pages of stenographic

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[1] Ibid., pp. 11-12.

[2] Cases 95-C-0657 et al., Order Granting Interlocutory Appeal in Part (issued June 11, 1996).

[3] As discussed below, MFS and RCN took different positions in brief with regard to the wholesale discount.

[4] As explained below, the record has been reopened with respect to unbundled network elements.

transcript;[1] an additional 72 pages of confidential stenographic transcript containing material claimed to be proprietary; and 126 exhibits.[2]

On August 1, the FCC adopted its decision in its rulemaking under the Act, and the rules were issued on August 8.[3] In view of the length and complexity of the FCC's decision, the previously announced briefing schedule in this proceeding was extended by a week, so that briefs were due on August 23 and reply briefs on August 30. Initial and reply briefs were filed by New York Telephone, Rochester Telephone, AT&T, MCI, Sprint, Empire, MFS, RCN,[4] Time Warner, and NYCHA.

Initial staff consideration of the state of the record in light of the FCC's requirements disclosed some concerns about the adequacy of the record, which had been closed before the FCC's action. A conference therefore was convened on September 4, at which the parties were asked their views on the need, if any, to reopen the record. On September 9, 1996, Judge Linsider ruled that the record was adequate with respect to resale but needed limited reopening with regard to unbundled network elements. On September 24, 1996, MCI moved to reopen the

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[1] Pages 77-306 of the transcript constitute the record of the temporary rates track; of those, pages 212-229(a) refer to material claimed to be proprietary and are kept in a separate sealed record.

[2] The exhibits are numbered from 1 through 127, but exhibit 58 for identification was excluded from the record. Tr. 1,909. Exhibits designated by a "P" following the number contain proprietary information and have been kept in a separate, sealed, record; they are Exhibits 3-P, 6-P, 9-P, 32-P through 40-P, 59-P, 62-P, 63-P, 65-P, 67-P, 79-P, 80-P, 82-P, 84-P, 86-P, 89-P, 93-P, 99-P, 106-P, 112-P, and 125-P.

[3] CC Docket Nos. 96-98 and 95-105, First Report and Order (released August 8, 1996)(First Report and Order).

[4] MFS and RCN participated jointly but filed separate briefs. RCN's brief adopts portions of MFS's brief by reference.

record on resale; Judge Linsider denied that motion,[1] and we are here denying MCI's appeal of that ruling.[2] That same ruling determined that cost onsets (i.e., the additional costs incurred in order to provide wholesale services) are to be considered separately and provided for the filing of position papers and replies thereto with respect to cost onsets.[3] A more recent ruling established a schedule for their consideration.[4]

On September 27, 1996, the U.S. Court of Appeals for the Eighth Circuit temporarily stayed the effectiveness of many sections of the FCC's rules pertinent to this proceeding, including most pricing provisions, and on October 15, it made that stay permanent pending final decision on the merits of various challenges that had been brought against the rules.[5] By notice issued October 18, 1996, we invited the parties to supplement their previously filed briefs in light of the stay. Supplements (or statements denying any need to supplement) were filed by New York Telephone, Rochester Telephone, Time Warner, AT&T, NYCHA, and Sprint. On November 12, the Supreme Court of the United States declined to vacate the stay.

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[1] Cases 95-C-0657 et al., Ruling on Motions (issued October 8, 1996).

[2] MCI's appeal alleges, among other things, that the record should be reopened to allow for the introduction of a study based on separated data. But MCI, which has participated actively in the case since the beginning, has shown no need to do so, nor has it otherwise shown a need to reopen.

[3] Separate consideration of cost onsets is consistent with our determination, in the temporary rates opinion, that any recovery of cost onsets should be through separate charges rather than as an offset to the wholesale discount. Cases 95-C-0657, et al., Opinion No. 96-18, mimeo p. 30.

[4] Cases 95-C-0657, et al., Ruling Concerning Consideration of Remaining Network Elements and Cost Onsets and admitting Exhibits (issued November 21, 1996).

[5] Iowa Utilities Bd. et al. v. FCC, 1996 U.S. App. LEXIS 27953 (8th Cir.).

Given the present posture of the case, today's decision deals only with resale (except for cost onsets), and this opinion does not present the parties' views thus far with respect to unbundled elements (except insofar as they may have a bearing on resale). Decisions with respect to resale cost onsets and network elements will be reached separately.[1]

CONTEXT AND OVERVIEW OF ISSUES

General Context

The Act, and the policies toward which we had begun moving even earlier, contemplate three types of competitors entering the market now largely monopolized by the incumbent local exchange companies (ILECs): facilities-based firms, which interconnect with the ILEC but have their own switching equipment and lines to end-users; partially facilities-based firms, which may own some facilities but buy other elements from the ILEC; and service resellers, which buy the ILEC's bundled service at wholesale, re-brand and package it as they see fit, and sell it to end-users as their own. The introduction of competition requires a host of decisions governing the technical and economic relationships among the ILECs and these competitors. Many of the issues posed have been resolved generically, through the collaborative process; others have been resolved bilaterally, through agreements reached between ILECs and new entrants and submitted for our approval pursuant to the Act; and still others will be decided through arbitrations, also pursuant to the Act.

At issue here are the wholesale prices to be paid for telecommunications services purchased from an ILEC (i.e., New York Telephone or Rochester Telephone) at wholesale for resale; the phase of the proceeding in which these prices were considered examined as well the prices to be paid to an ILEC for two network

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[1] For the reader's convenience, Appendix A lists acronyms used in this opinion.

elements: unbundled links and ports.[1] Under our approach, adopted before but consistent with that of the Act, the wholesale prices are to be set by applying to the retail price a discount reflecting the costs avoided by selling at wholesale rather than at retail; that figure is referred to here as the "wholesale discount."

Our consideration of these issues, of course, takes place in the context of the Act as interpreted and implemented by the FCC. The Act itself establishes the basic pricing methods to be applied. The rate for bundled resale is to be determined "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."[2] Rates for network elements are to be "based on cost (determined without reference to a rate of return or other rate-based proceeding) . . . [and] non-discriminatory, and . . . may include a reasonable profit."[3]

As shown by the briefs submitted in the temporary rates phase, these statutory provisions, and others in the Act, lent themselves to a range of interpretations and raised as many questions as they answered. The FCC treated many of these

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[1] Some of this terminology is taken from the Act. The term "telecommunications service" "means the offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available to the public, regardless of the facilities used." The term "resale" is used exclusively to refer to an offering at wholesale rates of a telecommunications service for resale. A "network element" is defined as "a facility or equipment used in the provision of telecommunications service," including "features, functions, and capabilities such as subscriber numbers, databases, and signalling systems." 47 U.S.C. §153(a)(45), (51). The reopened hearings on network elements will consider elements in addition to the links and ports previously examined.

[2] 47 U.S.C. §252(d)(3).

[3] 47 U.S.C. §252(c)(1).

questions in the First Report and Order. For example, several facilities-based carriers took the position that the Act favors facilities-based service over resale, alleging a variety of benefits associated with the former.[1] The FCC rejected that view, holding that "[47 U.S.C.] §251 neither explicitly nor implicitly expresses a preference for one particular entry strategy. Moreover, given the likelihood that entrants will combine or alter entry strategies over time, an attempt to indicate such a preference in our . . . §251 rules may have unintended and undesirable results."[2] Similarly, the FCC explicitly rejected several pricing concepts advanced with respect to resale.

In provisions now stayed by the courts, the First Report and Order set forth in considerable detail the processes the FCC believed states should use in setting wholesale rates and rates for network elements. For purposes of computing the wholesale discount, it identified categories of direct and indirect costs that are presumed avoided unless the incumbent LEC shows otherwise and categories that are presumed not avoided unless other parties show otherwise. It also determined proxy rates that might be used, on an interim basis, by states unable to complete the requisite rate setting processes in time. The proxy wholesale discount is a range extending from 17% to 25%; a state relying on that proxy must "articulate the basis for selecting a particular discount rate" within the range.[3] (These figures may be compared to the discounts we adopted on a temporary basis last June: 15% for New York Telephone [disaggregated to 17% for residential lines and 11% for business lines] and 13.5% for Rochester Telephone.)

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[1] See, e.g., MFS' Initial Brief, pp. 43-45 (facilities-based competition alleged to provide more alternatives to customers and impose greater competitive pressure on ILECs).

[2] First Report and Order, ¶ 12.

[3] First Report and Order, ¶ 932.

The stay of the FCC's pricing rules removes any obligation on our part to follow them and renders moot much of the argumentation presented by the parties. We nevertheless describe portions of that argumentation related to the FCC rules to the extent they are tied to the parties' views on the underlying substantive issues.[1] In addition, the First Report and Order, though no longer binding with regard to the costing and pricing decisions to be reached here, remains worthy of consideration as the carefully studied result reached by a fellow regulatory agency. Indeed, we see much merit in the FCC's conclusions with regard to wholesale rates, and our own method for computing the wholesale discount produces figures not very different from those that would have resulted from our application of the FCC's procedure.

Summary of Parties' Positions

In this section we list, for ease of reference, each active party's final proposal for the wholesale discount. Other highlights of parties' positions are presented as well, including their supplemental comments on the significance of the stay of the FCC's rules.

1. New York Telephone

On the basis of its avoided cost study, modified as it believed necessary in light of the First Report and Order, New York Telephone recommends a wholesale discount of 13.7%,[2]

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[1] Of course, where we report arguments that imply a need to defer to the FCC's costing and pricing approaches, it should be recalled that the arguments were advanced before the Eighth Circuit's stay. As noted, not all parties availed themselves of the opportunity to supplement their briefs in light of the stay.

[2] All figures in this paragraph are taken from a New York Telephone letter of October 4, 1996, in which it reports a change in position that slightly increases its estimate of the aggregate wholesale discount (from 13.4% to 13.7%) and substantially increases its estimate of the disaggregated business discount (from 12.4% to 13.9%). The residence discount is unaffected.

disaggregated into 13.9% for business and 13.6% for residential service and applicable to all services including Centrex and private line, which had initially been excluded. For resellers not purchasing New York Telephone operator services (and thereby permitting additional costs to be avoided) the discount would be 14.1% (disaggregated to 14.3% business and 14.0% residential). New York Telephone would introduce the discount in three steps over a two-year period: an aggregate discount of 9.6% initially (9.9% without operator services), rising to 11.7% (12.0%) in October 1997, and reaching the full 13.7% (14.1%) in October 1998. Separate charges would be imposed to recover cost onsets. New York Telephone warns against setting a high wholesale discount for the purpose of encouraging resale.

In its supplemental comments, New York Telephone reaffirms those proposals (though suggesting the discounts may be overstated), asserting that the stay simply changes the legal standard to be applied in deciding the case and that we are now free to evaluate New York Telephone's evidence on the basis of its inherent strength, without regard to whether it has successfully rebutted the presumptions raised by the FCC. In addition, it suggests that we may disregard "the overly broad cost avoidance test promulgated by the FCC,"[1] under which avoided costs were considered to be those the company would shed if it were to lose all of its retail operations. Instead, it believes, we may decide the case on the basis of whether costs "would actually be shed by [New York Telephone] as its customers choose to have their retail services provided by resellers rather than by the company,"[2] and it points to its arguments on that issue in its briefs in the interim rates phase of the proceeding.

New York Telephone adds that it is considering here only the effect of the Eighth Circuit stay order and that "it

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[1] New York Telephone's supplemental comments, p. 3.

[2] Id.

goes without saying that other judicial, regulatory, or legal developments may occur in the future that would have some effect on resale pricing, and we do not intend, by the views expressed [in its comments], to limit the positions that we might take in response to such changes."[1]

2. Rochester Telephone

Asserting that no avoided cost study on the record (including its own, which calculated a wholesale discount of 5.2%) complies with the FCC's First Report and Order, Rochester Telephone urged that the record be reopened to allow parties to rebut the FCC's presumptions with respect to wholesale rates. It saw no need to adopt the FCC's proxy in the interim, suggesting the temporary 13.5% wholesale discount previously adopted by the Commission affords a more reasonable result.[2]

In view of the stay of the FCC's rules, Rochester Telephone now urges us to adopt its study and, on its basis, set the wholesale discount for Rochester Telephone at 5.9%.[3]

3. AT&T

On the basis of its own avoided cost study, which it regards as the only one meeting the FCC's standard, AT&T would adopt a wholesale discount for New York Telephone of 28.0% (disaggregated to 21.6% business and 29.8% residential) when operator services are purchased from New York Telephone by the reseller and 33.6% (25.9% business and 35.8% residential) when they are not. For Rochester Telephone, as to which residential and business costs were not disaggregated, AT&T calculated a wholesale discount of 20.4% with operator services and 24.5%

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[1] Ibid., p. 4.

[2] Rochester Telephone's Initial Brief, p. 2.

[3] If cost onsets were recognized as an offset to the discount instead of being treated separately, the net discount according to Rochester Telephone would be 5.2%.

without.[1] Cost onsets (as to which AT&T takes a more restrictive view than does New York Telephone) would be recovered through separate charges. AT&T objects to New York Telephone's phase-in of the discount, regarding it as anti-competitive.

AT&T sees no need for supplemental briefing in light of the stay, contending that "the current factual record and briefings seem more than adequate to permit the Commission to make a reasoned judgment."[2] Asserting that the avoided cost studies entail merely a review of certain accounts in the uniform system, it believes every account has been reviewed and every pertinent argument has been made and that the FCC's rules, now stayed, had little substantive effect on our review of those accounts. According to AT&T, the FCC's method is "substantially similar" to the method we developed and was influenced by the staff analysis in New York.[3]

4. MCI

Regarding the record as failing to satisfy the requirements of the First Report and Order, MCI recommends that it be supplemented in the context of the arbitrations being conducted pursuant to the Act. (It adds its view that the results reached in this proceeding cannot, in any event, deny a party the right to litigate rate issues in the arbitrations.[4]) In the interim, it would rely on the FCC's proxy discount.[5] It asserts that "the FCC determined that the wholesale rate for the NYNEX operating companies, using the FCC's approved cost model,

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1 AT&T's Initial Brief, pp. 5, 84.

2 AT&T's supplemental comments, p. 2.

3 Ibid., p. 1. n. 1. AT&T is presumably referring to the temporary rates opinion and the staff study on which it was based.

4 MCI's Initial Brief, p. 4.

5 MCI does not make that point explicitly in its brief, but it so stated at the conference on reopening the record. (Tr. 1,973.)

is 21.3%."[1] In a later motion, MCI sought reopening of the record, lest the arbitrations defer to this proceeding on the issue of the wholesale discount or lest the matter be determined in the arbitration involving AT&T, in which MCI was not allowed to intervene. Judge Linsider denied that motion, and, as noted, we are denying MCI's appeal of his ruling.

5. Sprint

Asserting that New York Telephone's avoided cost study fails to meet the FCC's requirements, Sprint recommended reopening the proceeding for consideration of a proper study. (It would support MCI's suggestion that the issues be considered in arbitrations only if interested parties were allowed to intervene and participate.) Pending completion of that process, it proposed that we set a proxy wholesale discount within the FCC's 17%-25% range and suggested the 21.31% proxy rate cited by the FCC for New York would be appropriate. It recognized, as an additional alternative, that we might adjust New York Telephone's study on the basis of the federal requirements.[2] It noted that while it does not yet provide local service in New York, it does so elsewhere; and it said its position reflects its balancing of the interests of its local service and long distance divisions.[3]

In its supplemental comments, Sprint takes the view that the stay has little effect on its positions or on the process we should follow in this proceeding. Noting that the Eighth Circuit's concerns pertained to the preemptive effect of the FCC's rules rather than their inherent merit, it asserts the

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[1] MCI's Initial Brief, p. 6. MCI may overstate the FCC's endorsement of the figure. It is produced by MCI's model, which the FCC regarded as a reasonable basis, with some modifications, for determining the proxy range. First Report and Order, ¶¶ 925-930.

[2] Sprint's Initial Brief, p. 13.

[3] Ibid., p. 4.

FCC's costing and pricing methods are appropriate for use in New York and urges us to adopt them.

6. Empire

Empire regards the AT&T avoided cost study as the only one on the record that satisfies the FCC's requirements and calls for its adoption with a minor adjustment. On that basis it would set a wholesale discount for New York Telephone of about 34% where operator services are not provided and about 28% where operator services are provided. It would have the discount apply to all services, including certain coin lines and services, and to term and volume discounts. It objects to any recovery of cost onsets, regarding their imposition on New York Telephone as the price of entry into the long-distance market.[1] Its brief includes a vigorous defense of resale as a method for opening markets to competition and urges us to adopt a neutral pricing policy that avoids disincentives to resale.

7. Time Warner

In Time Warner's view, AT&T's avoided cost study fails to meet the criteria in the First Report and Order, and studies submitted by New York Telephone and Rochester Telephone require modification to do so. Time Warner therefore proposed to reopen the record to allow for such modification on an expedited schedule; pending conclusion of that process it would have left in place the temporary rates we previously set. It objected as well to MCI's proposal to consider wholesale pricing issues in individual arbitrations.[2]

Asserting in its supplemental comments that the stay means we need not accept the FCC's definition of avoided costs or cede control over intrastate pricing to the FCC, Time Warner suggests, first, that we disregard the FCC's proxies as a

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[1] Empire's Initial Brief, pp. 45-46.

[2] Time Warner's Reply Brief, p. 7.

benchmark against which the results of arbitrations and costing models should be judged. It argues further that the stay of the FCC's rules casts further doubt on the validity of AT&T's model which, in Time Warner's view, "suffers from innumerable flaws and is inferior to the [New York Telephone] study."[1] In particular, Time Warner stresses the failure of AT&T's study to take into account jurisdictionally separated costs. According to Time Warner, AT&T has calculated the discount on the basis of a fraction that includes only revenues from local services in the denominator while including unseparated total costs in the numerator, thus overstating the fraction. Time Warner sees no evidence in the record that would permit correction of this flaw. It therefore suggests adoption for New York Telephone of a discount of 17.6% for residential service and 12.8% for business service and, for Rochester Telephone, an overall discount rate of 8.58%.[2]

8. MFS

Asserting that avoided costs are overstated in AT&T's study and understated in New York Telephone's and Rochester Telephone's, MFS maintains that none of the studies on the record meet the FCC's requirements and that the record therefore should be reopened. In the interim, it would set the wholesale discount at 17%, selecting the low end of the FCC's proxy range in order to avoid discouraging facilities-based competitors which, in its view, are more important than resellers to the development of competition.[3] It would require resellers to pay for cost onsets, objecting to Empire's suggestion that they represent the price of entry to the long-distance market. It emphasizes the importance

[1] Time Warner's supplemental comments, p. 5.

[2] These discounts do not reflect cost onsets, to be recovered separately.

[3] MFS's Initial Brief, p. 43.

of setting service-specific discounts once permanent wholesale rates are established.

9. RCN

Although it participated in the case together with MFS, RCN dissociates itself from the portion of MFS' brief related to resale. It would set an interim rate on the basis of a wholesale discount of 25%, the high end of the FCC's proxy range.

10. NYCHA

On the basis of the record in the proceeding, NYCHA calculates an aggregate wholesale discount for New York Telephone of 27.88%,[1] which it would apply to all services. It objects to New York Telephone's proposed phase-in, and it would require New York Telephone to bear the cost onsets associated with resale interface systems.

In its supplemental comments, NYCHA believes that the stay of the FCC's rules should not materially affect the record or the result with regard to the wholesale discount, and it continues to advocate its proposed discount of approximately 28%. It suggests that the FCC's rules, though stayed, are consistent with our earlier pronouncements in this proceeding regarding the long-range view that should be taken in evaluating avoided costs and with staff's analysis and our decision in the temporary rates phase. Noting the considerable agreement between the FCC order and the staff's study regarding the accounts that might include avoidable costs, NYCHA contends that the primary difference between the two relates to the percentage of costs that are avoidable within each of those accounts. While the findings in staff's study in the temporary rates phase suggested avoidable percentages slightly lower than the FCC's, NYCHA says, the difference does not compel reopening the record or modifying NYCHA's previous positions, given that the FCC decision, though stayed, remains worthy of high regard as a source of guidance.

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[1] NYCHA's Reply Brief, p. 2.

NYCHA argues as well that the Act's avoidable cost standard requires discounts in the range it proposes, as does a careful study of the record in this proceeding. It objects to any further delay in establishing permanent wholesale discounts, suggesting that only New York Telephone would benefit from that delay and from what it sees as the resulting impediments to the development of competition.

The Avoided Cost Studies

The record contains avoided cost studies prepared by three parties: New York Telephone, AT&T, and Rochester Telephone. Their prominent features are described in this section. All of the studies, it should be noted, proceed by identifying the accounts in the uniform system of accounts (USOA) that contained costs that might be avoided and determining the percentage of those costs that could be expected to be avoided. Once avoided costs are computed, they are divided by revenues from the services to be offered for resale in order to compute the wholesale discount, which is then applied to the retail rate for each service in order to derive the wholesale rate. The studies differ, among other things, in their data sources, the accounts analyzed (having been prepared before the FCC spoke to that issue), the avoidable percentages, and the revenue figures used as the denominator in the wholesale discount fraction.

1. New York Telephone's Study

New York Telephone's study was based on data derived from its financial assurance information system (FAIS), a system whose account categories are consistent with those in the USOA but more finely subdivided. According to New York Telephone, this greater degree of granularity permits a more accurate assessment of the costs to be avoided. The FAIS data are not publicly available but are accessible to staff (and to other parties) under protection as proprietary data.

The FAIS data represent actual expenses incurred in a particular year in connection with each function. The company

therefore regards them as representing "the costs that the company would shed if it ceased performing the function in question."[1] The study used FAIS data for 1995, the most recent complete year for which they were available. The company believes use of those historical data to be conservative, given that costs may decline in the future, thereby reducing the avoidable amount and hence the discount.

Because the FAIS data are broken down by function, not service, they do not permit computation of service-specific discount rates. The only disaggregation permitted by the company's data is the distinction between business and residential services.

The company's study attempted to calculate the costs that are actually shed, or avoided, when a customer switches from New York Telephone to a reseller or, in the company's terminology, "when the customer's services are provisioned by [New York Telephone] through wholesale rather than through retail channels."[2] (New York Telephone notes, however, that a cost that could be shed through the exercise of prudence would also be regarded as avoided even if it were not actually shed.) Characterizing the standard eventually adopted by the FCC as requiring identification of "those costs that would <u>actually</u> be shed if an incumbent LEC exited the retail market,"[3] New York Telephone claims to have modified its study--which initially examined no indirect or shared cost accounts and assumed the ILEC to continue to provide retail as well as wholesale service--to be fully consistent with the FCC's requirements.

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1 New York Telephone's Initial Brief, p. 28.

2 <u>Ibid.</u>, p. 14.

3 <u>Ibid.</u>, p. 19, emphasis supplied by New York Telephone. See ¶ 911 of the First Report and Order for the FCC's statement of this standard.

2. AT&T's Study

AT&T's study relied on publicly available data in the Automated Reporting Management Information System (ARMIS) report filed by incumbent LECs with the FCC. The report presents the LEC's costs in the various USOA accounts specified by the FCC's rules and, AT&T notes, its use was approved by the FCC.[1] On that basis, AT&T rejected New York Telephone's allegation that its own study was superior because it used the more granular FAIS data.

AT&T's model was based on the principle that "if a cost is not incurred to provide wholesale service, then it would not be appropriate to recover that cost from wholesalers and it should be considered 'avoided.'"[2] It analyzed the accounts later specified by the FCC as well as some additional ones.

3. Rochester Telephone's Study

Like New York Telephone's study, Rochester Telephone's sought to identify functions that would likely be eliminated or reduced by the transfer of retail customers to wholesale. It claimed to take a long-term view of these costs, in the sense that resellers have fewer customers now than they can be expected to have in the long run. It also proceeded on the premise that Rochester Telephone would be in the retail business "for the foreseeable future and beyond" and that "Rochester Telephone is not restructuring itself to become solely a wholesale service provider and as such will not eliminate or proportionately reduce general and administrative and network costs."[3] Unlike New York Telephone, Rochester Telephone did not disaggregate its costs even as between residence and business services.

Rochester Telephone acknowledged that its study did not comply with the FCC's directive that avoided costs be premised on

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[1] AT&T's Reply Brief, p. 37, citing First Report and Order ¶¶ 917-918.

[2] AT&T's Initial Brief, p. 72, citing its witness' statement at Tr. 1,528.

[3] Tr. 335-337.

the wholesaler's total departure from the retail market. It therefore did not rely on its study at the briefing stage, urging, instead, that the record be reopened and that, if necessary, an interim wholesale discount be set on the basis of staff's study in the temporary rates phase of the proceeding. In its supplemental brief, Rochester Telephone reaffirms its study, contending it is the only one that properly distinguishes between the fixed retail costs that will not be avoided and the variable costs that will be avoided over the long run, assuming approximately the same loss of retail market share on its part as AT&T experienced over the first decade of full interLATA toll competition.[1]

THE MEANING OF THE AVOIDED COST STANDARD

In the temporary rate phase of the proceeding, the parties directed considerable attention to what the Act means when it requires that the wholesale rate exclude the portion of the retail rate "attributable to any marketing, billing, collection and other costs that will be avoided by the local exchange carrier."[2] A basic difference among the parties turned on whether the discount should reflect costs actually avoided, or shed, when local services are provided at wholesale (as New York Telephone and facilities-based competitors proposed) or whether they should recognize a broader category of avoided costs, sometimes called "avoidable" costs, including indirect costs and resulting overheads (as the resellers argued). The staff report on which our temporary rate decision was based noted our statement, in the November 1 order, that "avoided costs should reflect a long-range view rather than short-run transitional abnormalities,"[3] and understood us to have determined that the discount should be based on avoidable costs. And, in choosing

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[1] Rochester Telephone's supplemental comments, p. 6.

[2] 47 U.S.C. §252(d)(3).

[3] November Order, p. 7, n. 1.

staff's study as its starting point for setting temporary rates, we determined that New York Telephone had "not persuasively refuted the staff's study's conclusion that a very narrow definition of avoided costs makes little economic sense."[1] We nevertheless declined to accept AT&T's claim that staff's study adopted AT&T's method.[2]

In the First Report and Order, the FCC elaborated considerably on the statutory standard. Nevertheless, the parties remained far apart on its meaning, each side in effect declaring victory and contending that its own approach, with a little tinkering, met the FCC's requirements while its opponents' approaches were beyond redemption.

In describing this issue, we begin with a brief review of the FCC's interpretation, which, though no longer binding, provides needed context for the parties' arguments in brief, a description of which then follows. Our decision takes into account not only the arguments in the current round of briefs and supplements but also those presented in the temporary rate phase.

The FCC's Interpretation of the Avoided Cost Standard

Rejecting the suggestion of some LECs that a cost actually had to be shed in order to be deemed avoided, the FCC held that avoided costs "are those that an incumbent LEC would no longer incur if it were to cease retail operations and instead provide all of its services through resellers."[3] It held as well that the costs deemed "attributable to costs that will be avoided" under the statute include a portion of indirect or shared costs, recognizing that some of these indirect costs would continue to be incurred for wholesale operations but expecting

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1 Cases 95-C-0657 et al., Opinion No. 96-18 (issued July 18, 1996), mimeo p. 20.

2 Ibid., mimeo p. 22.

3 First Report and Order, ¶ 911. The FCC there noted that New York, among others, had construed the standard in that manner.

their overall level to fall.[1] In addition, it continued, a portion of contribution, profits, or mark-up may be considered attributable to costs that will be avoided.[2]

The FCC went on to hold that "an avoided cost study may not calculate avoided costs based on non-cost factors or policy arguments, nor may it make disallowances for reasons not provided for in [the statute]."[3] The Act, it continued, "clearly precludes use of a 'bottom-up' [Total Service Long-Run Incremental Cost (TSLRIC)] study to establish wholesale rates that are not related to the rates for the underlying retail services."[4] On the other hand, it said, the statute does not preclude use of TSLRIC studies to identify the portion of a retail rate that is attributable to avoided retail costs.

Turning to specifics, the FCC established a series of presumptions with regard to the costs to be deemed avoidable.[5] Direct costs presumed avoidable were those recorded in accounts 6611 (Product Management), 6612 (Sales), 6613 (Product Advertising), and 6623 (Customer Services). In addition, costs recorded in accounts 6621 (Call Completion Services) and 6622 (Number Services) were presumed avoidable because resellers have stated they will either provide these services themselves or contract for them separately. The FCC permitted these presumptions to be rebutted "if an incumbent LEC proves to the state commission that specific costs in these accounts will be incurred with respect to services sold at wholesale, or that costs in these accounts are not included in the retail prices of the resold services."[6] Indirect costs related to general support

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[1] <u>Ibid.</u>, ¶ 912.

[2] <u>Ibid.</u>, ¶ 913.

[3] <u>Ibid.</u>, ¶ 914.

[4] <u>Ibid.</u>, ¶ 915.

[5] <u>Ibid.</u>, ¶¶ 917-919; 47 C.F.R. §51.609(c), (d).

[6] First Report and Order, ¶ 917.

(accounts 6121-6124), Corporate Operations (accounts 6711, 6712, and 6721-6728), and Telecommunications Uncollectibles, (account 5301) were presumed avoidable "in proportion to the avoided direct expenses identified [above]."[1] Finally, plant-specific and plant-nonspecific costs (other than general support expenses) (accounts 6110-6116 and 6210-6565) were presumed non-avoidable unless a party could show the contrary.

In addition to promulgating guidelines to be used by states in setting the wholesale discount, the FCC also adopted a default range of 17%-25% as the discount to be used by states that had not completed their own discount setting process by the time a rate was needed. The FCC took, as the starting point, a model submitted by MCI in support of its proposal that the discount range be from 25.6% to 33.2%. It saw a need, however, to modify the MCI model in several important respects; among other things, it rejected MCI's premise that product management, sales, product advertising, and customer service costs would be entirely avoided and assumed, for purposes of setting the default range, that they would be only 90% avoided. It also rejected MCI's complex formula for calculating the portions of overhead and general support expense that are attributable to avoided costs, instead applying to each indirect expense category the ratio of avoided direct expense to total expense.[2] As adjusted, the MCI model produced a wholesale discount for New York Telephone of 21.31%.[3]

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[1] Ibid., ¶ 918.

[2] Ibid., ¶¶ 926-929.

[3] Ibid., ¶ 930.

Parties' Arguments

1. Arguments Favoring AT&T's Study[1]

AT&T asserts virtual identity between its study's principle that a cost not incurred to provide wholesale service should be considered avoided and the FCC's principle that "the portion [of the retail rate] attributable to costs that will be avoided includes all of the costs that the LEC incurs in maintaining a retail, as opposed to a wholesale business."[2] In contrast, AT&T maintains, New York Telephone's avoided cost study departs from the FCC's principles in that it is not forward-looking, is not long-run, fails to identify all the avoided direct costs and identifies no avoided indirect costs.

Turning to New York Telephone's study, AT&T contends that New York Telephone all along has proceeded on the premise that the wholesale discount should reflect only avoided costs that are actually shed as a result of resale rather than the broader category of avoidable costs and that the FCC explicitly rejected that method, requiring a forward-looking long-run approach. According to AT&T, New York Telephone's study cannot be cured, violates the FCC's rules, and cannot be adopted by the Commission. AT&T criticizes Rochester Telephone's study on similar grounds, asserting it treats no indirect costs as avoidable and includes, in the wholesale price, costs that the ILEC might continue to incur to serve other markets and customer groups and to compete against its reseller competitors.

In its reply brief, AT&T defends its study against various charges levelled against it. AT&T supports its use of ARMIS data as consistent with the FCC's requirements, disputes Time Warner's suggestion (noted below) that the study's complexity constitutes a flaw, and denies that the FCC implied it

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[1] This and the following subhead are intended merely to help organize a lengthy section. It is recognized that the parties' positions are more complex and that several parties favor neither study.

[2] AT&T's Initial Brief, p. 73, citing First Report and Order, ¶ 911 (emphasis added by AT&T).

had difficulty understanding the AT&T model or found it to be flawed in any way.

Empire also supports the AT&T study (and the MCI study offered before the FCC but not in this proceeding). It contends that they alone take the long-run view required by the FCC and, earlier, by this Commission, and that the AT&T study, as adjusted by AT&T in its initial brief, provides a proper basis for setting wholesale rates. It maintains that AT&T's approach, which would regard as avoided all long-run incremental costs (including indirect costs) that would be avoided when an ILEC ceases to perform retail activities, "applies the principles used in conducting a . . . [TSLRIC] study."[1] New York Telephone's study, in contrast, takes account only of those costs actually shed in the short run, and, according to Empire, does not recognize as avoided those costs that would be avoided by an efficient firm; that approach, it says, encourages inefficiency. (As noted, New York Telephone has said its study does reflect costs that would be avoided by an efficient firm, even if they are not in fact shed.)

Empire suggests, among other things, that the use of publicly available ARMIS data is preferable to use of New York Telephone's FAIS data, whose confidentiality, Empire says, prevents compliance with due process requirements. Empire concludes that "in contrast to the [parties primarily interested in facilities-based competition], parties principally interested in resale have not urged the Commission to erect economic barriers . . . . To the contrary, they have urged this Commission to adopt a neutral policy which sets rates based solely on costs, so that all competitors will have an equal opportunity in the marketplace."[2]

Sprint also believes New York Telephone's study fails to meet the FCC's requirements; in its view, staff's analysis in

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1 Empire's Initial Brief, p. 18.

2 Ibid., p. 8.

the interim phase, though flawed in some respects, provides a better portrayal of New York Telephone's avoided costs than does New York Telephone's own study. It challenges the New York Telephone study's reliance on 1995 data instead of forward-looking estimates that take account of efficiencies realized through process reengineering, and it rejects the argument that a cost must actually be shed in order to be considered avoided. In its reply brief, it denies New York Telephone has successfully rebutted the presumptions established by the FCC.

MCI likewise denies that we may rely on the New York Telephone study, noting its failure to reflect any expenses in many of the accounts listed by the FCC.

2. Arguments Favoring New York Telephone's Study and Rochester Telephone's Study

New York Telephone takes a different view of the status of the various studies under the First Report and Order, regarding its own, after some modification, as fully compliant. It continues to distinguish, as it did in the interim phase of the case, between its own "avoided cost" and AT&T's "avoidable cost" approaches. Under "avoided cost," only costs that are actually shed (or, in a significant qualifier, that would actually be shed through the exercise of prudence[1]) are considered avoided; fixed costs (i.e., those that do not vary with output or with the portion of total output provided through retail channels) are not included. AT&T's "avoidable cost" approach, as New York Telephone sees it, deducts costs from the retail price regardless of whether they would actually be avoided by an efficient firm, as long as they are not "attributable" to the provision of wholesale service. And while the FCC adopts the term "avoidable," New York Telephone asserts, it does not thereby mean to adopt AT&T's method.

New York Telephone contends further that AT&T advocated (through its economic witnesses if not in its study itself) the

[1] New York Telephone's Initial Brief, p. 14, n. 17.

view that services offered for resale should be priced at the TSLRIC of offering the service on a wholesale basis and that AT&T in effect sought the same pricing arrangement for wholesale services as it did for unbundled network elements, which are to be priced on a "bottom-up" rather than a "top-down" basis.[1] Asserting that AT&T's economic witness believed the two pricing methods should converge on a single number,[2] New York Telephone maintains the FCC rejected that pricing construct. It asserts that a LEC's current costs less the costs it would no longer incur if it were to cease retail operations (in effect, the top-down number) differ from the costs it would incur in creating an all-wholesale business from scratch (the bottom-up number) and that the FCC agreed, accepting the LEC's current business as its starting point and declining to treat as avoidable those costs that are attributable to resale operations but that would not be avoided if the LEC left the retail market. It cites in this regard the FCC's statement that the Act precludes the use of a bottom-up TSLRIC study to establish wholesale rates.[3]

Turning to the FCC's requirement that indirect or shared costs be included in the avoidable cost computation, New York Telephone insists that the requirement is based on the expectation that indirect costs will in fact decrease, an expectation subject to rebuttal by persuasive evidence. And citing the FCC's modifications to MCI's approach, it disputes the premise that costs should be deemed avoided if they are not of practical use for the services that resellers will purchase or if they are incurred in competing against resellers. It concludes

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[1] The "top-down" basis refers to retail prices less avoided costs, as specified in 47 U.S.C. §252(d)(3); the bottom-up formula, noted above, refers to the cost-based standard for network elements described in 47 U.S.C. §252(c)(1). While New York Telephone criticizes AT&T's method for its similarity to a TSLRIC approach, Empire, as noted, sees the resemblance as a virtue.

[2] New York Telephone's Initial Brief, p. 15, citing Tr. 1,635.

[3] First Report and Order, ¶ 915.

that the FCC's model "identifies those costs that would actually be shed if an incumbent LEC exited the retail market. This standard goes beyond the costs that would actually be shed in any realistic resale scenario, but it does not go so far as to set a wholesale price that excludes all costs that are associated with or 'attributable to' retail operations. Retail-related costs that would not be shed even if the LEC eliminated its retail operations would not be regarded as 'avoidable' under the FCC's model."[1]

In its reply brief, New York Telephone renews its objection to the use of excessively aggregated ARMIS report data, which frequently include avoidable and non-avoidable costs in a single account, and it challenges AT&T's effort to allocate the ARMIS cost and revenue accounts into a portion assignable to what AT&T terms New York Telephone's "local business unit." Because New York Telephone has no "local business unit" as such, New York Telephone contends, AT&T's allocations are arbitrary and exclude from the pertinent revenue figure (constituting the denominator of the fraction that determines the wholesale discount) revenues from various services that should properly be included. New York Telephone contends as well that AT&T's analysis uses booked revenues, which are reduced to take account of uncollectibles, rather than billed revenues. It sees this as inappropriate, inasmuch as discounts are to be applied to tariffed retail rates rather than collected revenues, and as resulting in a double count of avoided uncollectibles expense.

Supporting its own study in its supplemental comments, Rochester Telephone contends that the FCC's method violates the Act by "making a patently false assumption that the incumbent local exchange carrier . . . will lose all of its retail customers and with a wave of a hand be transformed into a wholesale-only carrier."[2] It contends that only its own study

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[1] New York Telephone's Initial Brief, pp. 19-20, emphasis in original.

[2] Rochester Telephone's supplemental comments, pp. 2-3.

attempts to analyze the costs that would be avoided on the basis of a fair assumption regarding the number of customers that would in fact be lost to resellers. In contrast, it continues, AT&T's study and staff's[1] reached their results by making untenable assumptions, as described in portions of Rochester Telephone's brief in the temporary rates phase.

Rochester Telephone suggests that a discount computed with reference to costs that will not actually be avoided would either confiscate the LEC's assets or require increases in other rates, particularly for basic local service, and that Congress should not be presumed to have intended either of those results or to have intended to give resellers undue benefits to the detriment of facilities-based competition. It contends that AT&T's method would permit resellers to enjoy the benefits of the product development, marketing, and advertising activities that a fully competitive incumbent LEC would have to undertake in order to compete with other facilities-based providers. Rochester Telephone also objects to what it characterizes as AT&T's proposal to treat portions of its costs, such as those related to operator services, as avoided because AT&T wishes to unbundle those services; it suggests that if a reseller wishes to purchase a service comprising a link, port, usage, and features but excluding operator services, it may do so on an unbundled network element basis, the price for which is computed, under the Act, on a different basis from the wholesale discount for fully bundled services.

Contending that we must distinguish between the fixed retail costs that will not be avoided and the variable costs that will be avoided over the long run, Rochester Telephone asserts that only its study does so, inasmuch as it "properly treats as

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[1] Trial staff participated as a party in the separately litigated temporary rates phase with respect to Rochester Telephone. The Rochester Telephone and New York Telephone proceedings were consolidated for purposes of setting permanent rate phases, and staff has participated in the consolidated proceeding on an advisory basis rather than as a litigant.

avoided those retail costs that are actually incremental over very long-run horizon, one that assumes approximately the same loss of retail market share that AT&T incurred over the first full decade of full interLATA toll competition."[1] It regards this approach as conservative, inasmuch as forecasting beyond five years is difficult. AT&T's analysis, in contrast, contemplates loss of all of Rochester Telephone's retail customers, something that Rochester asserts will not happen in the foreseeable future.

Time Warner urges us to take account of the Act's "overriding goal of fostering competition."[2] It warns in this regard that "if the wholesale discount is incorrectly established, unintended economic dislocations could occur."[3] To achieve the goal of promoting competition, Time Warner continues, we must ensure that any avoided cost study we rely on meets the FCC's criteria; and, in its view, AT&T's study fails to do so. It suggests that the greatest of the study's many flaws is its reliance on the ARMIS data, which, in its view, are too aggregated to produce accurate results and designate excessively broad categories of costs as avoided. It contends as well that AT&T's model is highly complex, that its actual operation remains unclear, and that it used assumptions and adjustments that have been impossible to track. Time Warner warns that using such an inappropriate cost model would impede the development of competition, forcing emerging competitors to turn to resale as the most rational economic alternative available.

Time Warner goes on to suggest that we may use our discretion to adopt the New York Telephone and Rochester Telephone studies, with suitable modifications, as consistent with the Act and the FCC's requirements. But it sees a need to

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[1] Rochester Telephone's supplemental comments, p. 6.

[2] Ibid., p. 12.

[3] Ibid., p. 13, citing Tr. 1,192.

reopen the record in order to evaluate the needed changes to those studies.

MFS asserts that AT&T regards as avoidable by the wholesaler all costs that will be incurred by the reseller, regardless of whether the wholesaler will in fact avoid them. It contends the FCC has rejected that approach, allowing incumbent LECs to rebut the presumption of avoidability with respect to costs associated with retailing.

Discussion

We first stated the applicable pricing standard for wholesale service in the November 1 Order, and that statement, which has not been undermined by ensuing events, is worth reiterating:

> The pricing of services for resale should initially reflect all cost differences associated with bulk-provisioning and billing on a wholesale basis as distinct from the costs of provisioning and administering to customers' individual accounts. Other factors may be developed in the course of the investigation . . . that should also be considered. New York Telephone's service resale rates should reflect its best estimate of the costs it will avoid* in providing wholesale service.[1]
>
> * Avoided costs should reflect a long-range view rather than short-run-transitional abnormalities.

Underlying this standard is the idea, reflected as well in the Act's definition of the wholesale price, that a reseller should not bear any of the costs incurred by the LEC in carrying out retail functions taken over by the reseller. Only then could there be fair competition between the reseller and the LEC, inasmuch as each would be able to price its services in a manner reflecting its efficiency in performing those functions. And only then could competition be fairly structured not only between

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[1] November 1 Order, p. 7.

resellers and the incumbent LECs but also between resellers and facilities-based entrants, who would neither enjoy the artificial advantage provided by unduly high resale rates nor suffer the artificial disadvantage of unduly low resale rates.

As some parties stress and the FCC recognized, this "top-down" pricing method, which starts from the retail rate and removes costs that are avoided by reason of changing to wholesale, differs from the Act's "bottom-up" method for pricing network elements. One need not assume the results produced by the two methods converge; and the proper wholesale rate under the Act is not one based on the TSLRIC of wholesale service. Thus, costs need not be "attributable" to wholesale service (in the sense, say, of being part of its TSLRIC) in order to be regarded as non-avoidable. To the extent it suggests the contrary, AT&T's approach is flawed.[1]

On the other hand, in our view (and the FCC's), costs should be treated as avoidable if a prudent, efficient LEC would avoid them if it left the retail business. New York Telephone and Rochester Telephone object to the premise of total departure from retail service, but adopting that premise for purposes of calculating the discount offers the best assurance that the purpose of the exercise will be achieved and that resellers will not be required to pay a wholesale price that recovers some of the costs of the LEC's remaining retail activities. New York Telephone and Rochester Telephone suggest that costs avoided per departing retail customer will be small at first and grow as more retail customers leave and that, accordingly, we should not assign to the initially departing customers the full measure of per customer avoided costs that would be realized if the LEC left the retail business entirely. But the LECs have not adequately supported the level of retail costs they regard as "fixed" in this sense nor justified so short-run an approach.

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[1] From this point of view, it may be noted, the avoided/avoidable distinction is illusory and need not be maintained.

To apply the method and determine the costs that would be avoided if the LEC left the retail business, what is needed is a series of account-by-account, evidence-based determinations. That analysis should be conducted with the greatest practical degree of detail, so that costs within each account may be associated with avoided or non-avoided functions, as the case may be. That need is better served by New York Telephone's more granular FAIS data than by the more aggregated ARMIS data, and we shall use it. These analyses will first be conducted with respect to accounts containing direct retail costs and, like the FCC, we will apply to the indirect costs an avoidance factor derived from the direct cost analysis. As explained below, however, we calculate our factor differently from the FCC.

ACCOUNT-BY-ACCOUNT ANALYSIS

We here undertake the account-by-account analysis referred to above. For convenience, given how the case was argued, we organize the analysis around the FCC's account categories. The discussion here refers primarily to New York Telephone, but Rochester Telephone's costs have been studied as fully. The conclusions reached with respect to New York Telephone have been applied to Rochester Telephone, using its functional accounting system and taking account of pertinent differences in its circumstances.

Direct Costs Regarded by the FCC as Presumptively Avoided

The FCC correctly identified the following accounts as those most likely to contain avoidable direct costs of retail functions, establishing a rebuttable presumption that they are 100% avoidable: accounts 6611 (Product Management), 6612 (Sales), 6613 (Product Advertising), and 6623 (Customer Service). Though we do not necessarily adopt the FCC's presumption, we agree with the premise it reflects: these accounts involve activities, closely tied to retail service, that would be performed by the reseller rather than the LEC. In addition, the

FCC presumed all costs in accounts 6621 (Call Completion Services) and 6622 (Number Services) to be avoidable because resellers have said that they would provide the services themselves or contract for them separately.

AT&T's study (prepared before the First Report and Order was issued) for the most part treated the costs in these accounts as 100% avoidable, and AT&T stands by that result, regarding the FCC's presumptions as unrefuted and seeing no need to modify its position in light of the study. MCI, which did not submit a study, also regards the presumption as unrefuted, citing the absence of record evidence to the contrary. MCI appears, however, to understand the presumption as one of 90% avoidability,[1] probably because of the FCC's comments on MCI's study in the context of its default analysis and the FCC's use there of a 90% factor. New York Telephone's study initially analyzed only some of these accounts and found low levels of avoidability; it modified its position in light of the First Report and Order but saw the FCC's presumptions as largely refuted.

1. <u>Account 6611 (Product Management)</u>

New York Telephone quotes the following definition of this account in the FCC's regulations:

> Costs incurred in performing administrative activities related to marketing products and services. This includes competitive analysis, product and service identification and specification, test market planning, demand forecasting, product lifecycle analysis, pricing analysis and identification and establishment of distribution channels.[2]

New York Telephone maintains that these functions would continue in a totally wholesale environment, in which New York

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[1] MCI's Reply Brief, p. 1.

[2] New York Telephone's Initial Brief, pp. 32-33, citing 47 C.F.R. §32.6611.

Telephone and resellers "would share a common interest" in increasing sales of New York Telephone products to end-users. It cites in this regard a variety of activities connected with product management that are carried out by manufacturers of consumer goods who do not deal directly with a single retail customer and instead simply attempt to stimulate demand for their product in order to increase their sales to their wholesale customers. It therefore regarded the account, up to the briefing stage, as wholly non-avoided;[1] in its October 4, 1996 letter it corrects that position to regard the account as 16% ($27.7 million) avoidable, noting it would no longer incur the retail sales commissions included in the account. New York Telephone regards it as irrelevant that a significant part of its product management activity is now directed to the retail market, contending that the activity would necessarily continue even if it sold entirely through resellers.

Rochester Telephone similarly contends that even as a 100% wholesale provider, it would have to design, develop and offer new services in order to make them attractive to its resellers' end-users and maintain its competitiveness in the wholesale market. MFS cites Rochester Telephone's witness' statement that Rochester Telephone has employees who manage its wholesale products.

Time Warner argues similarly, citing a statement by MCI's witness, under cross-examination, that various product management functions would be required for resale products.[2] MFS and RCN make a similar point, citing the FCC's statement, in its discussion of MCI's avoided cost study, that "some expenses in [account 6611, 6612, 6613 and 6623] will continue to be incurred

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[1] In its brief, New York Telephone says it believes "it would be reasonable to assign a zero percent non-avoidance factor to [the account]." (New York Telephone's Initial Brief, p. 34.) This appears to be a typographical error; New York Telephone intends to assign a zero percent avoidance factor to the account.

[2] Time Warner's Initial Brief, p. 30, citing Tr. 1,381.

with respect to wholesale products and customers"[1]; for default analysis purposes, the FCC regarded these accounts as 90% avoidable.

AT&T, in contrast, maintains that New York Telephone has failed to show any specific costs that would not be avoided. Emphasizing that the activities at issue are now directed to the retail market, it maintains that New York Telephone, if it exited from that market, would do no competitive analysis of it and that the associated costs would be incurred entirely by the resellers. It rejects New York Telephone's assertion that the wholesaler and resellers would share a common interest in performing these activities, wondering whether, if resellers are to pay New York Telephone for its competitive analyses and test market planning, they may also participate jointly in the activities themselves. It responds similarly to Rochester Telephone's argument, contending that as a wholesaler, Rochester Telephone would not perform the same product management functions it performed as a retailer since it would gain no economic benefit from them. It disputes MFS' reliance on the FCC's statement, contending that the default analysis (in which the statement appears) is not the standard to be used in setting permanent rates. In response to Time Warner, AT&T notes its failure to identify specific costs that would not be avoided.

Empire emphasizes, with respect to this account and others, that New York Telephone has failed to identify specific costs, instead offering arguments as to why entire accounts should be excluded from the avoidable cost calculation.[2]

NYCHA believes the record fails to rebut the FCC's presumption of 100% avoidability but, "in an abundance of caution,"[3] assumes in its own calculations that the account is only 90% avoidable. It relies on the FCC's default conclusion,

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1 First Report and Order, ¶ 928.

2 Empire's Reply Brief, p. 13.

3 NYCHA's Initial Brief, p. 12.

which it characterizes as "while all (or a vast majority of) expenses in these accounts should be avoided when service is sold at wholesale, there is some possibility that an incumbent may continue to incur minor expenses with respect to the wholesale market."[1]

In its reply brief, NYCHA maintains that most product management cost will be avoided in a wholesale environment, for the LEC will direct its attention only to serving a limited number of resale customers who will themselves assess the needs of end users and tell the wholesaler what products the public wants. In addition, it contends, many of the costs associated with wholesale product development are recovered through other categories including planning (account 6712) and research and development (account 6723). Finally, NYCHA argues that allowing New York Telephone to recover product management costs will permit it to recover from its competitors costs that it incurs to serve its own retail customers.

The functions in this account are so closely tied to retail activities that will be assumed by the reseller as to belie the LECs' assertions that most or all of them will be continued in a wholesale context. At the same time, it is counter-intuitive that a LEC selling only at wholesale would perform no market research activity at all and would depend entirely on its reseller customers for information on what products consumers want. The FCC recognized as much in treating the account as only 90% avoidable for purposes of setting its default rate, and the considerations recognized by the FCC remain real. In the absence of specific evidence warranting a lower avoidance factor, we adopt NYCHA's proposal and treat account 6611 as 90% avoided.

2. Account 6612 (Sales)

New York Telephone concedes that under the premise that the LEC totally leaves the retail market, the only non-avoidable

[1] Ibid., pp. 12-13.

items in this account would be de minimis. It therefore agrees, in brief, to treat it as 100% avoidable; its supplemental comments are silent on the stay's effect on that agreement. Rochester Telephone, however, maintains that even in a totally wholesale environment, it would be required to maintain a substantial wholesale sales force in order to compete for wholesale customers. AT&T responds that Rochester Telephone has failed to identify specific costs that would not be avoided.

In an argument that applies to advertising expenses (account 6613, next discussed) as well as sales, MFS disputes AT&T's treatment of both accounts as 100% avoided, contending that incumbent LECs already face competition for wholesale business. It cites in this regard AT&T's and Time Warner's announcement that AT&T will resell Time Warner's network-based services in Rochester and elsewhere and AT&T's announcement of a similar agreement with Teleport Communications Group, Inc. It cites as well its own witness' statement that it intends to offer service to wholesalers for resale. MFS contends "it is unrealistic to expect an [incumbent LEC] to sit idly by, allowing [competitive LECs] to compete away its wholesale business, while spending no money on sales and marketing designed to slow such losses in market share."[1] It adds, as a matter of law, that even if wholesale competition lies in the future, the long-range view required by the Commission mandates recognition of an incumbent LEC's costs with respect to sales and advertising to wholesalers. It suggests that the FCC's treatment of these costs as only 90% avoidable in its default analysis is consistent with this rationale.

New York Telephone's concession of 100% avoidability resolves the issue with respect to its avoided costs, for, as explained above, we are assuming, for purposes of analysis, departure of the LEC from the retail business. With respect to Rochester Telephone, the account, like account 6611, will be regarded as 90% avoidable.

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[1] MFS' Reply Brief, p. 19.

3. Account 6613 (Advertising)

Acknowledging, as it does with respect to product management activity, that virtually all of its advertising is directed today at retail customers, New York Telephone insists the question is not whether the costs are now identified as retail or wholesale but whether they would be shed if it left the retail market. Denying that they would be, it sees "strong reason"[1] to believe its advertising activities would continue, albeit modified, in an all-wholesale environment and insists there would remain a need for advertising intended to interest consumers in New York Telephone products and generally promote their use. It would, for example, advertise the virtues of products such as caller ID, call return, voice messaging, and call waiting. It cites, as an example of this sort of activity, advertising by producers' trade associations that encourage consumers to use a product even though the producers do not brand the products or sell them directly to consumers.

Rochester Telephone argues somewhat differently, contending that even in a 100% wholesale market it would continue to promote itself as a reliable, experienced provider of network services in order to encourage end-users to purchase from its resellers. It maintains it would be motivated to stimulate end-user usage through advertising as long as its own profitability depended on the profitability of its resellers.

MFS notes its own intention to offer service for resale in competition with New York Telephone and says that "although MFS would hope that [New York Telephone] does not advertise to its wholesale customers, it is absurd to handcuff [New York Telephone] in this contest by assuming that it will compete for wholesale revenues without being able to advertise."[2]

In response to MFS, AT&T stresses the absence of record evidence of specific wholesale advertising costs and notes that

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1 New York Telephone's Initial Brief, p. 35.

2 MFS' Initial brief, p. 33.

even New York Telephone does not allege a need to advertise to its wholesale customers. (AT&T does not respond to Rochester Telephone's allegation of such a need, however.)

Empire, meanwhile, sees no need for New York Telephone to advertise in order to compete with MFS, noting that prospective resellers are fully aware of New York Telephone's position and pointing to the fact that New York Telephone does not advertise wholesale access service to interexchange carriers even though competitors such as MFS also offer competing carrier access services.[1]

With regard to New York Telephone's argument, AT&T declines what it characterizes as an offer "to step into the shoes of a trade association for resellers of local exchange service."[2] It notes that trade associations make no expenditures without the authorization of their members and wonders, as in connection with product management expenses, whether New York Telephone will offer its resellers control over its advertising budget.

NYCHA contends that even without regard to the FCC's presumption, advertising expense should be found avoidable lest resellers end up paying for New York Telephone's efforts to retain customers. On the basis of proprietary information in the sub-accounts of account 6613, it computes a figure for avoided advertising costs for business services. It also disputes, as inconsistent with New York Telephone's FAIS report, the company's figures for actual business, residential, and unallotted advertising expense.

In response, New York Telephone explains that the inconsistency cited by NYCHA reflects an error in the FAIS report. It also disputes NYCHA's treatment as avoidable of the amount in account 6613.3, contending that that account relates to

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[1] Empire's Reply Brief, p. 7.

[2] AT&T's Reply Brief, p. 43.

advertising for retail public telephone service, which will not be available for resale.

In its reply brief, NYCHA would regard advertising as 100% avoidable given New York Telephone's concession that in a purely wholesale market it would incur no advertising expense directed at end-users. It rejects New York Telephone's comparison to trade associations, contending that the limited choice of telephone subscribers limits the marginal value of additional advertising and arguing, like AT&T, that the resellers who would bear the costs of this advertising will have no voice in how it is conducted. It suggests that unless New York Telephone were willing to pay a portion of its competitors' advertising costs, on the premise that each provider benefits from the "halo effect" of its competitors' sales efforts, each carrier should bear its own advertising costs.

Again, we are dealing here with functions clearly associated with retail activities, and it is essential that, as NYCHA puts it, resellers not end up paying for the LEC's efforts to retain its retail customers. Neither New York Telephone nor Rochester Telephone has adduced evidence of specific costs that would be incurred in a non-retail context, and neither has argued persuasively on a qualitative basis. Rochester Telephone suggests a need to advertise to encourage end-users to buy from its resellers, but it cannot be assumed that end-users would even be aware of the ultimate supplier of the rebranded product they are purchasing. And New York Telephone's analogy to a trade association is specious, for a trade association is not in competition with its members. As AT&T suggests, it is unlikely that New York Telephone would allow the alleged co-beneficiaries of its "generic" advertising to have a say in its development and deployment. Taking all these factors into consideration, but recognizing, again, the inherent unlikelihood of no advertising at all, the costs in this account also will be regarded as 90% avoidable.

4. Account 6623 (Customer Services)

The FCC treated this account as a unit, regarding it as presumptively 100% avoidable, but treating it, for purposes of the default analysis, as 10% non-avoidable. AT&T's study also regarded it as avoided; AT&T comments that "retail customer service expenses are, definitionally, 100% avoided."[1] To the extent costs are incurred to provide service order processing for resellers, AT&T suggests, they should be treated as cost onsets. New York Telephone, however, believes a more finely grained, subaccount-by-subaccount analysis is warranted. Arguments relating to that specific analysis are set forth first, followed by those relating to the account as a whole.

a. Customer Accounting (Account 6623.1)

This subaccount pertains to activities supporting the issuance and mailing of customer bills. New York Telephone agrees that postage and end-user billing and collection functions would be avoided but maintains that functions such as recording, rating, and service and equipment processing would still be required for the provision and billing of resale services. It therefore regards, as non-avoided, costs associated with the carrier access billing system (CABS), toll and local message operations related to responding to toll-usage-related inquiries by resellers, and service and equipment operations needed to maintain the database that associates an end-user's customer record information with the facilities assigned to that customer.[2] It calculates as avoidable approximately $55.6 million out of total costs of $80.1 million.[3] AT&T responds that CABS costs are not included in its own cost study because they relate to exchange access billing; that the investigations encompassed in toll message operations/local

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[1] AT&T's Initial Brief, p. 77.

[2] New York Telephone's Initial Brief, p. 40.

[3] Ibid., Appendix B.

message operations will be virtually if not entirely eliminated in a resale environment; and that the service and equipment operations function will benefit only New York Telephone (unless it is planning to provide resellers non-discriminatory access to the data) and will be avoidable in the wholesale market.

MFS disputes AT&T's view that billing expenses will be wholly avoided, citing the FCC's reference to this account in its default discussion as well as statements on the record that LECs will incur billing expenses to bill wholesalers. It proposes treating the costs as 50% avoided, recognizing that it will be cheaper to render a small number of wholesale bills than a large number of retail bills. Rochester Telephone adds that to deduct the retail costs avoided in the long run without recognizing the wholesale costs still incurred would give resellers a free ride.

b. Service Order Processing
(Subaccounts 6623.2 and 6623.5)

These subaccounts include costs associated with preparing, changing, and handling customer-related service orders and with collecting revenues and handling billing and account inquiries, annoyance call complaints, and updating records. New York Telephone estimates that approximately 90% of these costs will be avoided but asserts that it will not avoid costs associated with the annoyance call bureau (the company organization responsible for handling inquiries or complaints concerning abusive, threatening, or obscene calls) and the premises management information system (PREMIS)/street address guide bureau, which resellers will use in their own service order negotiation process. In addition, New York Telephone estimated that approximately 10% of the remaining costs in these subaccounts would be non-avoided inasmuch as they are associated with misdirected inquiries, such as questions concerning a long-distance bill rendered by an interexchange carrier, and that such misdirected inquiries would continue.

AT&T does not necessarily dispute New York Telephone's claim that PREMIS/street address guide bureau costs would not be

avoided, but regards the costs as small[1] and not separately identified and therefore sees no need to change its own study on their account. With regard to misdirected calls, AT&T sees no proof that a substantial number of such calls will be received. More fundamentally, it contends that the costs of such calls should not be borne by resellers since they are not the causers of those costs. It points to the FCC's emphasis on cost causation in its total element long-run incremental cost (TELRIC) rules and contends that the principle applies to avoided costs as well. Seeing no precedent for recovering the costs of misdirected calls from the intended recipient, it maintains that doing so would protect New York Telephone while requiring resellers to pay twice: once for the misdirected calls handled by New York Telephone and again for the misdirected calls handled by the resellers themselves.

New York Telephone responds that the reference to the TELRIC rules is inapposite, confusing the top-down resale pricing standard with the cost-based, bottom-up pricing standard for unbundled elements. Reiterating its view that the FCC rejected the premise that wholesale price should be based on the incremental costs of the wholesale offering, it contends that the issue, as framed by the FCC, is not whether the costs are caused by the resellers but whether they would be avoided if New York Telephone lost all of its retail business.

Here, too, MFS maintains that order processing expenses will continue to exist even though they will come from wholesale rather than retail customers. AT&T responds, with respect to both items, that any such wholesale costs are better treated as cost onsets.

c. Coin (6623.3)

New York Telephone regarded these costs as non-avoidable since retail coin service will not be resold under the

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[1] They amount to about $3.4 million in 1995; the entire subaccount 6623.2 contains about $392.6 million.

company's tariff or the Commission's June 25 Order. AT&T agrees. Our denial of petitions for rehearing on that point renders moot Empire's objection, in its brief, on the grounds that petitions for rehearing were pending. The agreement by New York Telephone and AT&T that these costs are not avoided remains proper.

d. Customer Instruction (6623.4)

These costs relate to training customers in the use of terminal equipment, communications systems, and the system network. New York Telephone recognizes that they could be regarded as avoidable, but there are no costs in the account for 1995.

e. Other Subaccounts Within Account 6623

New York Telephone regarded subaccount 6623.6 (Amounts Paid to Other Carriers for Billing and Collection Services) and 6623.8 (Certain Equal Access Expenses) as non-avoidable and AT&T similarly did not include them in its avoided cost study. New York Telephone also regards subaccount 6623.7 as non-avoidable but notes that it had no expense in it for 1995 and AT&T declines to engage in a theoretical discussion regarding it.[1]

f. Account 6623 In General

Noting that the account includes the costs of complying with service standard reporting requirements and of responding to PSC complaints, Rochester Telephone maintains these costs would not be avoided even in a 100% wholesale environment unless we eliminated all service standard reporting with respect to wholesale service and exempted Rochester Telephone from responding to Commission complaints from end-users and from resellers themselves regarding Rochester Telephone's service. The account also contains costs for the repair answer function, and Rochester Telephone believes these costs might be considered avoided only if it could be found that the function would be

[1] AT&T's Reply Brief, p. 45, n. 18.

fully automated, that the costs of the new system were somehow covered, and that every reseller would be required as a matter of law to use this hypothetical new system. Since these "sweeping and unjustifiable assumptions" cannot be made, Rochester Telephone maintains, the costs of the repair answer function will not be avoided.[1] AT&T responds that Rochester Telephone has offered no evidence and identified no specific non-avoided costs.

NYCHA alleges two specific errors in New York Telephone's study of this account. First, it contends New York Telephone understated avoidable costs by incorrectly adding back costs associated with a one-time reengineering effort that has nothing to do with wholesaling. New York Telephone responds that NYCHA has misinterpreted an accounting entry and that the credit referred to by NYCHA is simply an offset to a similar expense charged within the same account. NYCHA asserts as well that New York Telephone improperly allocated to residential service all expenses associated with credit and collections; it proposes, instead, that New York Telephone apply its standard practice of allocating between residential and business services on the basis of the number of lines. New York Telephone responds that the credit and collection function is handled for both business and residence services in a residential service center and that while an allocation might be conceptually proper, most of the effort is aimed at residential customers and allocating on the basis of the number of access lines would overstate the portion of the expenses that is business-related.

g. <u>Discussion</u>

In examining this account (and several others), we have reviewed data in the LECs' functional accounting records, in which costs are often recorded by specific job function or task. This permits better informed judgments about the assignment of a company's costs to wholesale or retail activities.

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[1] Rochester Telephone's Initial Brief, p. 9.

With respect to subaccount 6623.1, our review suggests avoidable costs of about $75 million rather than the $55.6 million estimated by New York Telephone; this represents the sum of costs assigned to the job functions designated General Administration/Supervision, Service and Equipment Processing, Remittance, Account Processing, and Customer Billing (including postage). An analogous review of Rochester Telephone's data shows avoided costs of about $9.1 million.

In subaccounts 6623.2 and 6623.5, something less than New York Telephone's 90% estimate is avoided: the costs in subaccount 6623.5, which pertain to message investigation, will not be avoided at all, and of the $392.6 million in subaccount 6623.2, only some $363.2 million are avoidable, as New York Telephone asserts. In sum, of the $523.9 million in the entire account, $411.6 million will be considered avoidable.

5. Accounts 6621 and 6622 (Call Completion and Number Services)

Call completion service includes costs incurred in helping customers place and complete calls (except for directory assistance costs); number service includes costs incurred in providing customer number and classified listings, including preparing or purchasing, compiling, and disseminating those listings through directory assistance or other means. In contrast to the previously discussed accounts, whose avoidability stems from their being the direct costs of serving retail customers, these accounts are likely avoidable because resellers have said they will either provide the services themselves or contract for them separately from the LEC or from third parties.

Rochester Telephone questions the premise that resellers will in fact decline to use the incumbent LEC's operator services. It asserts that "vague statements by one reseller, namely AT&T, of an intention at some unspecified time

to make other arrangements at AT&T's discretion do not justify the exclusion of these costs from wholesale rates."[1]

Rochester Telephone also maintains that, in contrast to many regional Bell operating companies, it does not use a separate subsidiary to publish white and yellow page directories and that its costs of doing so, accordingly, appear in account 6622. Under applicable orders, however, Rochester Telephone is obligated to continue publishing directories, and the costs of doing so will not be avoided regardless of whether Rochester Telephone leaves the retail market. AT&T responds that its study recognizes these considerations and attributes no avoided costs to directory publishing.

New York Telephone takes it for granted that no portion of the operator services accounts would be regarded as avoidable for customers who take operator services from New York Telephone and, accordingly, does not reduce the costs in the accounts; this would be the case even if they rebranded or unbranded New York Telephone's operator services.[2] But even if resellers provided their own operator services or purchased them from a third party, New York Telephone maintains, the FCC's presumption of avoidability would be rebutted by the fact that the costs in the accounts are not included in the retail prices of the resold services; they are recovered, instead, through operator service charges. Time Warner makes the same point, contending that "operator services and [directory assistance] are separately charged and have their own distinct revenue streams," that they are not included in the retail rate, and that the presumption that they are 100% avoided has therefore been fully rebutted on

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[1] Rochester Telephone's Initial Brief, p. 10.

[2] Indeed, New York Telephone maintains, in that event the customers would be responsible for additional cost onsets; Time Warner concurs. MFS asserts wholesale rates for these services cannot be calculated since the LECs have not provided information on these possible cost onsets.

the record.[1] MFS similarly asserts that AT&T's treatment of these costs as 100% avoided would permit resellers to reap a windfall, paying less for wholesale service but also being permitted to retain the revenues associated with the provision of operator services. It cites Time Warner's witness' statement that "if a reseller is permitted to provide the service operator and DA service, and it collects the operator and DA revenues, then no other adjustment is required. The LEC avoids the cost of the services, and the LEC also has an offsetting reduction in revenues since it does not receive the revenues for the service."[2]

New York Telephone develops its position further in its reply brief, where it emphasizes that a reseller providing its own operator service is already avoiding payment of the service's costs, which are recovered through separate charges where applicable. To exclude the costs from the price paid for other services by the resellers, New York Telephone maintains, would permit it to avoid the costs twice. Preventing that result, New York Telephone says, is the reason the FCC declined to require avoided cost treatment for costs not recovered in the rates for resold retail services.

New York Telephone agrees, however, that the proper adjustment in the avoided cost computation for resellers who provide their own operator services would be to exclude operator service revenues from the denominator of the discount fraction, just as operator service costs are excluded from the numerator. It makes that adjustment as part of its revised calculation in its reply brief.

AT&T, on the other hand, maintains that no record evidence has been introduced to rebut the FCC's presumption that these costs are 100% avoided. Characterizing New York

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[1] Time Warner's Initial Brief, p. 29.

[2] MFS' Reply Brief, pp. 21-22, citing Tr. 1,181.

Telephone's argument as based on "a linguistic sleight of hand,"[1] it maintains that all retail services, including operator services, are subject to resale; that none of the avoided cost studies was based on a service-specific analysis; and that the proper way to compute the wholesale discount is to identify the costs avoided in the wholesale market and divide them by total local service revenues[2] for all retail services. In AT&T's view, the retail price for resold services includes the costs in the operator services accounts, even though they are not separately identified; and when those costs are avoided, they are properly included in the numerator of the wholesale discount fraction. The existence of a separate charge for these services, AT&T claims, is immaterial. NYCHA similarly believes the costs in this account should be regarded as 100% avoidable, seeing no evidence that they are not recovered from end-users and suggesting that the eagerness of New York Telephone and resellers alike to provide these services belies any contention that they lose money. It argues as well that New York Telephone's proposed treatment of these services is inconsistent with its treatment of other vertical features and services, noting, for example, that call waiting and call back services are grouped with the underlying service and subjected to an across-the-board discount. (New York Telephone, however, distinguishes operator services on the grounds that only here does a reseller's decision not to buy a product cause New York Telephone not only to avoid the cost of providing the service but also to lose the revenue that covers the avoided cost and provides contribution. As a result, it says, New York Telephone is a net loser in such cases and "increasing the loss by requiring further reductions in the prices of <u>other</u> services makes no sense."[3])

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[1] AT&T's Reply Brief, p. 44.

[2] Excluding subscriber line revenues, which are not discounted.

[3] New York Telephone's Reply Brief, p. 12, n. 27, emphasis in original.

In view of its position that the avoidability of operator service costs depends on whether the reseller purchases them from the LEC, AT&T proposes that two discounts be set--one for a reseller that purchases operator services and another for those that do not. It reasons that if a single discount rate contemplated that the reseller would provide its own operator services (and, therefore, included operator services costs as avoided), it would be unfair to incumbent LECs where they continued to provide operator services; and if a single discount rate contemplated that the LEC provided operator services, it would be unfair to competitors, by denying them the economic benefit of providing the services on their own. Empire also advocates setting a separate, lower wholesale discount for resellers that take operator services from the incumbent LEC and requests that LECs be required to provide those services inasmuch as smaller resellers, unlike AT&T, may be unable to provide them on their own.[1] Rochester Telephone responds that nothing in the FCC's order supports separate discount rates for various resellers and suggests that, in the absence of AT&T's commitment to providing its own service, and given the FCC's failure to allow for different discounts and Empire's demand for LEC operator services as an option, it should be assumed that none of Rochester Telephone's operator service costs will be avoided.

As all parties agree, these costs will not be considered avoided where the reseller takes the services at issue from the LEC.[2] Where the reseller self-provides the services, the costs are avoided, contrary to New York Telephone's argument; but New York Telephone is right in its argument's implication that, in fairness to the LEC, the amount avoided must be offset by the revenues forgone. New York Telephone appears to assume that the offset will always be 100%, but that unsupported assumption does not detract from the soundness of its underlying

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[1] Empire's Initial Brief, pp. 24-26.

[2] This obviates Rochester Telephone's concern about whether resellers will in fact self-provide these services.

theoretical argument. The costs associated with the self-provided activities should be regarded as avoided to the degree they exceed the associated revenues forgone by the LEC, and we have done so in our calculations.

Indirect Expenses

The FCC adopted the view that costs in the following accounts were presumptively avoided in proportion to the avoided direct expenses:

6121	Land and building expense
6122	Furniture and artworks expense
6123	Office equipment expense
6124	General purpose computers expense
6711	Executive
6712	Planning
6721	Accounting and finance
6722	External relations
6723	Human resources
6724	Information management
6725	Legal
6726	Procurement
6727	Research and development
6728	Other general and administrative
5301	Uncollectible revenue-telecommunications

It explained that "because the advent of wholesale operations will reduce the overall level of operations--for example, staffing should decrease because customer inquiries and billing and collection activity will decrease--overhead and support expenses are in part avoided."[1]

Except for uncollectibles in accounts 5301, which AT&T regarded as a direct cost 100% avoided, AT&T's study applied to these accounts an avoidance factor of 27.8%, based on the percentage of direct costs it believed to be avoided.[2] New York Telephone urges that the presumption of pro rata avoidance of indirect costs be modified to recognize its claim that some indirect costs will not be avoided at all and that others may

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[1] First Report and Order, ¶ 918.

[2] AT&T's Initial Brief, pp. 78-79.

decline but not necessarily in the same proportion as direct expenses. It contends, for example, that a 10% reduction in direct costs will not leave it with only 90% of a president, that legal expenses will not be reduced as it switches from retail to wholesale operations, and that payments to retirees will not change. In response to AT&T's regression analysis showing a correlation between indirect costs and overall company size, New York Telephone contends that the correlation across a sample does not necessarily mean that a single company's indirect costs will rise and fall as it expands and contracts. In Appendix B to its brief it identifies the following categories of indirect costs as non-avoided:

Account	Name
6728.9	Other General and Admin.
6711	Executive
6712	Planning
6712.2	Accounting and Finance-General
6722.4	Connecting Company Relations
6722.5	Regulatory & Government Relations
6727	Research and Development
6728	Accidents, Damages and Settlement

It treats the remaining general and administrative accounts as avoidable in proportion to avoidable direct expenses, after normalizing them to back out the effect of a one-time pension enhancement offered in 1995.[1]

We first consider the avoidability of indirect costs generally. We then examine several specific items and, finally, we resolve a dispute regarding the computation of the avoidable factor.

1. Indirect Costs Generally

In its reply brief, New York Telephone provides additional explanation of why it regards various expenses within this group as unavoided. It asserts, among other things, that it

[1] New York Telephone's Initial Brief, p. 47.

will have a president (and the president will have a desk) regardless of whether it is a wholesale or a retail company; that corporate planning activity will continue unabated; that changes in its direct costs will not affect the cost of accounting for those direct costs; that its need to manage its relationships with other carriers will be unaffected by the advent of resale; that regulatory expenses will be unaffected and may in fact increase; that research and development will be required in a wholesale market to the same degree as in the retail market; and that expenses related to accidents and damages will be unaffected by the identity of the purchaser of the company's access lines.

AT&T maintains, however, that New York Telephone failed to rebut the FCC's presumption of pro rata avoidability, having submitted no evidentiary support for the amounts it claims will be non-avoidable. According to AT&T, wholesaling is simpler than retailing, and one could expect executive, planning, finance, and regulatory costs to decline, along with costs for damages, accidents and settlements, as retail sales personnel were shifted to other work. It agrees with New York Telephone that procurement of switches, cable, and other network assets would continue to be required in a non-retail environment, but it contends that procurement of materials and supplies relating to marketing, billing, and operator service functions would decline, as would legal expenses relating to collection efforts, customer complaints, service quality reports, and compliance with applicable Commission rules. Similarly, while some network databases would continue to be maintained, computer related expenditures associated with marketing, billing, and operator services could be expected to decline. AT&T challenges as well New York Telephone's claimed need for a normalizing adjustment, citing evidence that expenses similar to the assertedly extraordinary pension enhancement expenses were incurred in four of the last five calendar years, that New York Telephone makes no claim that similar charges will not be incurred in the future, and that New York Telephone's need to confront the threat of competition makes charges of this nature more likely to recur.

Other parties raise related points. NYCHA sees no basis for New York Telephone's claim that 92% of the costs in the identified accounts should be regarded as non-avoidable, contending that while many of the costs will continue in a wholesale environment, the costs associated with retail functions will necessarily decline. NYCHA calculates that 24% of New York Telephone's indirect costs will be avoided (compared to AT&T's 27.8% figure). NYCHA suggests as well that even if the pension expenses are a one-time cost, they should not be normalized inasmuch as they were initiated by New York Telephone in order to streamline its operations and enhance its competitiveness and that neither customers nor competitors should have to pay for them. New York Telephone responds that the issue is not whether a particular cost is caused by resellers but whether it would be avoided in a wholesale environment; inasmuch as this one-time expense will not be incurred in the future, it cannot be regarded as avoidable.

MFS challenges the calculations in AT&T's study of indirect costs as internally inconsistent; contends that land and building expenses would be avoided only "in the most theoretical sense,"[1] inasmuch as many buildings have useful lives of around 25 years and AT&T has said that forward-looking cost studies should look forward only three to ten years; and claims AT&T fails to recognize the potential increases in unemployment compensation insurance payments and severance packages that might be associated with labor force reductions. It also questions the general premise that indirect costs would be avoided in the same proportion as direct costs. In response, AT&T demonstrates that MFS' charge of inconsistency rests on a misapprehension about how AT&T proceeded. With respect to land and buildings, AT&T argues that in a properly conducted long-run study all costs are variable, and that AT&T's cost study was not confined to a specific time period.

[1] MFS' Initial Brief, p. 35.

New York Telephone's "normalizing" adjustment is rejected; AT&T has shown that similar expenses have been fairly common and can be expected to continue. At most, an adjustment of $80 million could be applied, reducing the 1995 figure to the five-year average of similar expenses, but New York Telephone has not shown a need for even that adjustment, given the volatility in this account.

More generally, we agree with those parties suggesting a link between direct and indirect costs. To be sure, a regression analysis showing correlation between corporate size and overhead expense does not mean that each reduction in size can be predicted to be accompanied by a reduced overhead. But it is fair to infer a relationship, especially over the long run, and the FCC's presumption of pro rata avoidability reasonably did so. We recognize, of course, that no LEC will be left with 90% of a president; but the president's salary or bonus might be lower in a smaller firm, and indirect costs generally could be expected to decline. The pro rata presumption is a fair surrogate for precise calculation of that decline, and we adopt it.[1]

2. Uncollectibles

While the FCC treated uncollectibles as an indirect cost presumptively avoidable in the same proportion as direct costs, New York Telephone regarded them as totally non-avoidable while AT&T regarded them as 100% avoidable. The parties agree that in a wholesale-only environment, all retail uncollectibles would be fully avoided. New York Telephone, however, believes it will experience a more-than-offsetting increase in wholesale uncollectibles, including negotiated bill adjustments. It cites testimony by MFS' witness and Time Warner's witness showing that Sprint Long Distance has experienced long distance reseller write-offs of 1.16% and total uncollectible/disputed billing

[1] As explained below, we calculate the indirect cost avoidance factor differently from the FCC.

adjustments of 2.43%, as well as an AT&T interrogatory response stating that AT&T's retail long distance resale operations have experienced total uncollectibles of 3.6% of revenues.[1] Comparing these figures to its own retail uncollectible rate of 1.6%, it concludes that its new wholesale uncollectibles are likely to more than offset the reduction in retail uncollectibles.

AT&T, in contrast, sees no basis for estimating the level of wholesale uncollectibles and says they should be handled as a cost onset if and when they occur. It asserts that wholesale uncollectibles are likely to be zero if the only resellers are itself, MCI and Sprint, and that even if other firms enter and uncollectibles do eventuate, guaranteeing New York Telephone the right to recover them from other customers diminishes its incentive to be diligent in its collections.

New York Telephone responds that in its dealings even with established firms such as AT&T, MCI and Sprint, it has entered into negotiated bill adjustments that take the place of what would otherwise become uncollectibles. It characterizes AT&T's concern about disincentives to diligence as a general attack on avoidable cost pricing and cites our authority to recognize a cost as avoidable as long as it could be avoided by a prudent LEC. It also disputes the propriety of treating wholesale uncollectibles as a cost onset, noting that they are not a wholly new type of expense arising in the wholesale environment but merely uncollected amounts now billed to a different group of customers. Finally, it disputes AT&T's argument that there is no basis for estimating the level of resale uncollectibles, pointing to the previously cited experience in the long distance resale market.

AT&T, in its own reply brief, continues to assert that it has refuted the FCC's presumption that uncollectibles will be avoided only in proportion to direct costs. It notes that no party denies that 100% of retail uncollectibles will be avoided,

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[1] New York Telephone's Initial Brief, pp. 48-49, citing Tr. 1,168, 1,254; exhibit 83; and exhibit 127.

and it disputes any analogy between wholesale uncollectibles in the local exchange market and in the interexchange market. More specifically, it attributes the uncollectible expenses in the interexchange market to the presence of numerous underlying carriers like itself who compete through price incentives, bonuses, and discounts. In the local exchange market, in contrast, New York Telephone remains the only major underlying carrier, and it has no incentive to offer the kind of discounts and incentives that can increase uncollectibles.

Other parties offer different perspectives on the issue. Time Warner disagrees with AT&T's premise of 100% avoidability, citing the experience in the interexchange market as well as its witness' testimony that a wholesaler in California recently left a California LEC with substantial uncollectibles. Time Warner would recommend use of an uncollectibles factor equal to New York Telephone's actual experience.[1]

Rochester Telephone charges AT&T with inconsistently taking the long view with respect to costs that will be shed (retail uncollectibles) while taking a short view of the costs that will not be shed (wholesale uncollectibles). While the average reseller is a better credit risk than the average residential customer, Rochester Telephone continues, a reseller going out of business will leave the LEC with no recourse against the reseller's customers, thereby imposing on the LEC the burden of uncollectibles associated with not only end-users who are bad credit risks but also end users who are good credit risks and would never have posed an uncollectibles problem had they remained retail customers of the LEC. It charges AT&T with assuming every reseller will be a perfect credit risk and requiring LEC shareholders "to bear all risks and costs of resellers' business failures."[2]

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[1] Time Warner's Initial Brief, p. 27.

[2] Rochester Telephone's Reply Brief, p. 4.

MFS also disputes AT&T's premise of zero uncollectibles, raising the arguments previously described. It adds that the California Public Utilities Commission refused to accept AT&T's assumption, recognizing that providers of wholesale services retain a risk of uncollectibles,[1] and it cites the FCC's presumption as reflecting that agency's rejection of AT&T's assumption. MFS notes as well AT&T's letter to the Connecticut Department of Public Utility Control, filed on the same date it filed its brief in this proceeding, acknowledging that uncollectibles are to be treated as avoided only in proportion to avoided direct expenses.[2]

NYCHA argues that inasmuch as a wholesale customer pays less for a service than does a retail customer, the loss suffered by the seller when the wholesale customer defaults on payment will be correspondingly less. It sees this as the basis for the FCC's conclusion, which it recommends, that uncollectible costs will be avoided in proportion to avoidable direct costs. It notes as well the precautions that New York Telephone can take to minimize uncollectibles, contending that competitive businesses must take such measures in order to survive.[3]

There is no warrant for AT&T's premise that uncollectibles would be fully avoided in a purely wholesale environment. Whatever the credit histories of AT&T, MCI and Sprint, some resellers will inevitably fail to pay their bills (as is the case in the interexchange market, which AT&T has not totally distinguished), and negotiated bill adjustments, if any, would have the same economic effect as uncollectibles. It would

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[1] California Public Utilities Commission, Docket No. R. 95-04-043, Competition for Local Exchange Service, Opinion, p. 29, cited at MFS' Initial Brief, p. 31.

[2] Letter dated August 23, 1996 from AT&T to the Connecticut Department of Public Utility Control, attached as exhibit A to MFS' Reply Brief.

[3] NYCHA's Reply Brief, pp. 12-13.

be unrealistic to assume that a LEC leaving the retail market would incur no uncollectibles expense at all.

On the other hand, New York Telephone has failed to show that uncollectibles will not decline. Not only would a purely wholesale LEC have fewer customers (and, perhaps, a greater percentage of credit-worthy ones); but its revenues would be less and the same uncollectible percentage would mean a smaller uncollectible expense. As NYCHA suggests, this provides a logical underpinning for an assumption of pro rata avoidability, which we adopt.

3. Contribution

Citing the testimony of its witness that "contribution is the most avoidable of all avoided costs,"[1] AT&T maintains that a portion of contribution should be so treated. New York Telephone, however, argues that contribution should not be included in the analysis inasmuch as the analysis should be based on avoided costs, and "contribution is not a cost at all, much less one that can be avoided by a change in the company's activities."[2]

New York Telephone is correct that contribution is not an avoidable cost and, indeed, not a conventional cost at all. It is, rather, a regulatory construct, better examined as part of our consideration of universal service issues or unbundled network elements. No avoidance of contribution will be reflected here, but that determination is without prejudice to the result to be reached in our examination of universal service.

4. Computation of the Avoidable Percentage of Indirect Costs

New York Telephone and AT&T disputed the manner in which the indirect cost avoidance factor should be calculated. New York Telephone did so by dividing total avoidable direct

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1 AT&T's Initial Brief, p. 80, citing Tr. 1,679.

2 New York Telephone's Reply Brief, p. 25.

costs by total expenses; AT&T divided total avoidable direct costs by total direct costs. AT&T's smaller denominator resulted in a larger avoidability percentage.

New York Telephone maintains that its calculation is consistent with the FCC's statement, in its critique of the avoided cost study submitted by MCI in the FCC proceeding, that instead of MCI's calculation it has used "a more straightforward approach in which we apply to each indirect expense category the ratio of avoided direct expense to total expense."[1] It believes as well that this approach is economically correct, since the common costs are incurred in support of all the company's operations, and that AT&T's method results in an artificially inflated avoidance percentage.

In our view, however, AT&T's formula makes better sense, since it can be mathematically transformed into the reasonable hypotheses that a wholesaler and a retailer incur direct and indirect costs in the same proportion or (stated differently) that indirect costs are avoided in the same ratio as direct. Moreover, indirect costs should not be included in the denominator of the factor to be applied in determining the portion of those costs that will be avoided. Some further refinements are needed, however.

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1 First Report and Order, ¶ 929, cited at New York Telephone's Reply Brief, p. 22. Earlier, however, in describing how indirect costs are to be treated, the FCC said they are "presumed to be avoided in proportion to the avoided direct expenses identified in [paragraph 917]." (First Report and Order ¶ 918) That is an incomplete and inherently vague statement, which appears to mean that the ratio of avoided indirect costs to total indirect costs is to be equal to some fraction whose numerator is avoided direct costs but whose denominator is left unspecified. The FCC did not explain why it later specified the denominator as it did in paragraph 929.

AT&T's formula may be stated as

$$AI = \frac{AD}{TD} TI$$

where AI = avoided indirect expenses; AD = avoided direct expenses, TD = total direct expenses, and TI = total indirect expenses. This, of course, is algebraically identical to

$$AI = \frac{TI}{TD} AD$$

In other words, having determined avoided direct expenses, one can simply apply to those direct expenses an "indirect cost loading factor" equal to total indirect expenses divided by total direct expenses. That loading factor, however, should capture only (but all) items affecting indirect expenses. To that end, uncollectibles, which are being treated as avoidable in the same proportion as indirect expenses, should be added to the numerator; depreciation expense, which may not be a good indicator of indirect costs associated with total investments, should be excluded from the denominator (if not already excluded by the definition of direct expenses); and, in its place, capitalized expenditures, which do affect indirect costs, should be added to the denominator.[1] Accordingly, the final indirect expense loading factor is equal to

$$\frac{\text{TI + uncollectibles}}{\text{total operating exp. - TI - depreciation + cap. expenditures}}$$

The calculation of the factor is shown in each of the LEC-specific appendices.

[1] As it turns out, depreciation and capitalized expenses for New York Telephone are nearly equal, making their respective effects on the denominator nearly a wash.

Other Accounts

The FCC identified as presumptively non-avoided various plant specific and plant non-specific expenses, other than general support expenses. AT&T found avoided costs in several of the accounts in this category as well as in several accounts not referred to by the FCC at all.

1. Account 7540 (Interest on Customer Deposits)

AT&T treated as 100% avoidable the interest paid by New York Telephone on customer deposits; it reasoned that if New York Telephone left the retail market it would no longer have customer deposits and would no longer have to pay interest on them.[1] The amount at issue is approximately $1.8 million, corresponding to customer deposits of $36 million.

MFS argued, in testimony and brief, that AT&T had failed to consider New York Telephone's need to find an alternative source of capital funding for the $36 million in customer deposits it would forgo. Noting that customer deposits are a comparatively inexpensive means of raising capital, MFS assumed the rate of return of 11.25% used by AT&T in its analysis and calculated a cost of alternative capital funding of approximately $4 million, to which would be added approximately $1.4 million for federal income tax effects.[2] As AT&T points out, New York Telephone does not raise the issue in its initial brief; in its reply brief, however, it echoes MFS' argument.

AT&T responds that the use of customer deposits to raise capital is an incidental benefit and that it is absurd to suggest a carrier losing that benefit may obtain replacement capital from its competitors. It asserts that resellers will incur their own costs regarding the payment of interest on deposits and should not function as a source of capital for LECs. Empire adds that the cost of alternative capital funding "will be

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[1] Tr. 1,785.

[2] MFS' Initial Brief, pp. 33-34.

taken into account in the profit component of . . . the avoided cost study."[1]

MFS' point is well taken. Customer deposits will decline in a wholesale environment, reducing both the interest expense and the source of funds. There is no need to recognize either in the avoided cost analysis.

2. Accounts 6561 and 6563 (Depreciation of General Support Assets); Account 6110 (Network General Support)

These accounts relate to depreciation of plant in service and amortization of tangible leases. AT&T considered them indirect costs of providing retail services and therefore as avoided, under the FCC protocol, in the same proportion as the presumptively avoided indirect costs. It contended that if a wholesale customer is not using an asset it should not pay the costs or expenses associated with it and that over the long run they are variable and avoidable as the number of end-users served at retail decreases. AT&T adds that competition will require LECs to become more efficient, and a primary focus of their efforts will be in what traditional accounting has called "fixed costs."

In response, New York Telephone contends that the two accounts were correctly treated by the FCC as presumptively non-avoidable inasmuch as they are associated with past investment and, even if they are attributable to retail operations, would not be shed even if the company lost its entire retail business. Rochester Telephone asserts that AT&T has not met the burden of proof imposed on it by the FCC with respect to these accounts.

Account 6110 is a summary that incorporates accounts relating largely to motor vehicle or airline expense, which AT&T believed would be avoided in the same manner as the plant and lease expenses referred to above. New York Telephone challenges AT&T's premise that these costs will be diminished as the number

[1] Empire's Reply Brief, p. 8.

of end-users declines, noting that it uses motor vehicles predominantly for plant repairs and service calls and that the requirements for such vehicles therefore would not change as customers shifted from retail to wholesale channels. (The account related to aircraft expense showed no costs in 1995.) New York Telephone therefore believes the FCC to have correctly treated the account as presumptively non-avoidable and that AT&T has failed to rebut the presumption. Rochester Telephone shares that view.

To the extent depreciable plant can be associated with direct costs in avoidable accounts, the logic of indirect cost avoidance suggests the identified depreciation be regarded as avoided. Our calculations have proceeded on that basis.

3. Accounts 6533-6534 (Testing and Plant Administration Expense)

Considering these accounts as attributable in part to retail services, AT&T regards them as 20% avoided; it bases its figure on studies of the history of its own customer inquiries. New York Telephone appears not to challenge the treatment of Account 6533 and acknowledges $33 million of avoided cost in subaccount 6533.21 (Testing Subscriber Trouble). With regard to Account 6534, New York Telephone denies there is an evidentiary basis for relying on the AT&T study and sees no reason to believe that the plant administration expenses are sensitive to whether New York Telephone's products are sold through retail or wholesale channels. Rochester Telephone agrees, objecting as well to AT&T's treatment of Account 6533.[1]

New York Telephone acknowledged $33 million of avoided costs in Account 6533, but our review comes up with only $28.0 million, and that figure will be adopted. It represents the costs in subaccount 6533.2 (Subscriber Reports) associated with the job functions designated, for one group of activities (job function codes 4040 et seq.), Repair Answering Service,

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[1] Rochester Telephone's Reply Brief, p. 7.

Maintenance Database Administration, Basic Office Services, and Local Supervision, and, for another group of activities (job function codes 4050 et seq.), Customer Service Bureau Operations and Local Supervision. The reasons for avoidability cited by New York Telephone[1] warrant applying the same degree of avoidability to Rochester Telephone, whose circumstances in this regard are unlikely to differ materially.

Of the subaccounts in account 6534, only 6534.21 (salaries and wages) and 6534.22 (miscellaneous expenses) are potentially avoidable. They total $10.552 million; of that, 99%, or $10.446 million (the portion associated with general support rather than network support) is avoidable.

4. Account 6220 (Network Support for Operator Services)

As AT&T points out, these costs should be regarded as avoided in the event a reseller provides its own operator and directory services.

5. Account 7220 (Income Taxes)

AT&T treated this account as partly avoided on the theory that a competitive market would cause the LECs to have fewer local customers, fewer local revenues and correspondingly lower taxes. New York Telephone responds that any reduction in gross revenues relating to resale would be offset by a reduction in avoided costs and that net income and income taxes would therefore be unaffected in the first approximation.

New York Telephone's reasoning is sound; income taxes will not be deemed avoided.

6. Account 7240 (Other Taxes)

AT&T similarly regarded a portion of these expenses as avoided. New York Telephone responds that about 61% of the cost in the account is gross receipts tax, which is recovered not

[1] Tr. 515-518.

through service rates but as a surcharge and that any decrease in these taxes therefore would not reduce the retail revenues that make up the denominator of the wholesale discount fraction. Accordingly, New York Telephone argues they should not be regarded as an avoidable cost even if they would decrease in a wholesale environment. Most of the remainder of the account, it continues, is ad valorem property taxes which, it asserts, also would not be avoidable in a wholesale environment.

AT&T has not shown the costs at issue to be avoided. As New York Telephone argues, gross receipts taxes, which are separately recovered as a surcharge, should not enter into the avoided cost calculations. And while ad valorem taxes may well decline, and could be regarded as avoidable in a manner similar to depreciation, the amount at issue is too small to warrant an analysis of the sort used to calculate avoided depreciation.

Separations and Revenue Issues

Calculation of the wholesale discount requires dividing total avoided costs by revenues from the services to be discounted.[1] New York Telephone and AT&T agreed that the figures used should not take account of interstate/intrastate separations factors. MFS warns, however, that an intrastate discount that failed to take account of separations could duplicate an interstate discount mandated by the FCC; it sees this risk as real even though AT&T has not requested a discount in the interstate End User Common Line Charge (EUCL, also referred to as Subscriber Line Charge [SLC]). It therefore urges that only the intrastate portion of avoided costs be subtracted from the retail rate.

AT&T responds that the First Report and Order requires recognition of all avoided costs, without reference to separations. It also notes New York Telephone's comments that separations factors are "essentially arbitrary" and that since

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[1] E.g., New York Telephone's Initial Brief, p. 52.

the discount is to be applied to both intrastate and interstate services, use of unseparated data is appropriate.[1]

For the reasons cited by New York Telephone and AT&T, MFS's position is rejected. Use of unseparated data is proper.

Time Warner contends that if the numerator of the wholesale discount fraction includes total, unseparated, avoided costs, total revenues derived from the services at issue must be included in the denominator. It therefore urges that the denominator be increased (reducing the discount) by including revenues from the SLC charge, an interstate charge. AT&T objects, on the grounds that the SLC will not be discounted. It notes that New York Telephone similarly excluded the SLC from the denominator of its discount fraction.

Time Warner is correct. If the SLC is excluded from the denominator, the retail expenses associated with it should be excluded form the numerator. Doing so, however, is very difficult, and it is simpler, and no less reasonable, to include the SLC in the denominator. Our analysis does so.

RATE DESIGN, DISAGGREGATION, AND SPECIFIC SERVICES

New York Telephone, believing sufficient data for a service-specific approach to wholesale discounting were not available, disaggregated its proposed rate structure only by distinguishing business and residential service. It initially proposed to exclude Centrex and private line service from the discount, but withdrew that exclusion during the hearings. Rochester Telephone's study also provided a uniform discount, and did not distinguish residence and business service. AT&T distinguished residence and business services but did not further disaggregate.

A variety of issues are posed under this heading, including AT&T's assertion that New York Telephone has skewed its calculations on account of its changed position with regard to Centrex and private line, suggestions for further disaggregation,

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[1] New York Telephone's Initial Brief, p. 28.

and New York Telephone's proposal to phase in the wholesale discount over a period of years.

Centrex and Private Line

New York Telephone initially excluded Centrex and private line services from its avoided cost study on the premise that these services would not be offered for resale. It abandoned that position during the hearings and submitted, in response to various data requests, additional information regarding the costs that would be avoided in connection with these services.[1] Contrary to New York Telephone's initially stated expectation, the inclusion of Centrex and private line in its study reduced the discount rather than increasing it. New York Telephone's witness attributed the effect to the inclusion in the calculation of the roughly 800,000 additional Centrex access lines.

AT&T and Sprint object to New York Telephone's modification of its study, which Sprint characterizes as an attempt "to further decrease the total available for discount of gross avoided business and residence expenses by inflating the denominator with increased access lines without also adjusting the numerator with relevant avoided costs for these services."[2] AT&T presents a detailed critique of New York Telephone's revisions, contending they are replete with imprecisions and unsupported contentions. It maintains that New York Telephone has failed to carry its burden of proof with respect to the amendment to its study and notes that the new testimony in any event has no effect on AT&T's cost study, which is not based on the number of Centrex lines. New York Telephone does not respond.

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[1] The determination that Centrex and private line would be offered at discount renders moot the arguments in favor of doing so offered by such parties as Empire and NYCHA.

[2] Sprint's Initial Brief, p. 12.

On the state of the record, New York Telephone has not supported the modifications to its study associated with the inclusion of Centrex and private line. These services will be available for resale, as required by the FCC, and must be discounted; the best course of action for now is to apply to them, as to other services, a discount computed without regard to New York Telephone's revisions in its study.

Service Specific Discounts

MFS contends that when a permanent wholesale rate is established (something it believes may be done only after the record is reopened and supplemented) avoided costs should be calculated on a service-by-service basis. It regards that as mandated by the statute's provision that "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 . . . costs that will be avoided by the local exchange carrier."[1] Because no party has calculated avoided costs on a service-specific basis, MFS continues, the across-the-board rates proposed "are inconsistent and excessive."[2] It notes that AT&T's witness testified that New York Telephone's avoided cost is approximately $12.18 per line but that AT&T's across-the-board discount of 34.8% would come to more than that amount for some lines and less for others. It credits Congress with foreseeing such problems when it purportedly determined that avoided costs should be determined service-by-service.

In response, AT&T and New York Telephone agree that the data now available do not permit service-by-service disaggregation beyond the establishment of separate discounts for business and residential service.

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1 Telecommunications Act §252(d)(3); emphasis supplied by MFS.

2 MFS Initial Brief, p. 48.

NYCHA, on the other hand, favors a single discount omitting even business/residential disaggregation, which it regards as potentially arbitrary inasmuch as disaggregating on a revenue basis would support a higher discount for business service while the same disaggregation on an access line basis would suggest a higher discount for residential service.

In a series of questions posed by Judge Linsider and Mr. Taratus to the parties following the conclusion of the hearings, other issues were raised relating to possible disaggregation of the discount, including the application of higher discounts to services having relatively higher contribution levels. New York Telephone objects, arguing that contribution levels are unrelated to avoided cost and should not be used in setting discounts, and it warns that doing so would artificially encourage the resale of products that have high contribution levels while discouraging the resale of low-contribution services and leaving only the incumbent with the responsibility of providing them. Time Warner would leave the matter open for further consideration in the context of universal service reform.

AT&T, however, suggests that to the degree excess contribution is not reflected in the costs used to calculate the discount, an additional discount based on the additional contribution would be appropriate, assuming the needed data were available and administrative difficulties could be resolved. It suggests that contribution for these purposes could be measured on the basis of embedded costs. NYCHA believes the contribution issue can be addressed in part by declining to disaggregate residential and business services. A single discount, in its view, would slightly reduce (at the wholesale level) the contribution of the business services that have historically

contributed a great deal and slightly increase the contribution provided by residential services that have contributed less.[1]

New York Telephone responds to AT&T's point on contribution by arguing that an additional discount for high-contribution services could not be administered, since it would require cost studies for all resold services. That, it says, would be inconsistent with the First Report and Order, which requires the discount to be based on avoidable costs, and would imply a very low discount for low-contribution or subsidized services such as residential exchange access.

Time Warner also opposes disaggregation beyond the residential/business split, citing the difficulties of administering such disaggregation fairly. In any event, it urges, the LEC should not be given the discretion to decide on its own what discount should be applied in a particular circumstances.

MFS is unpersuasive in arguing that service-specific discounts are required by law; as New York Telephone properly responds, the statute requires only that the retail rate used as the starting point be service-specific and imposes no such requirement with respect to the discount applied to that rate. In any case, the record at this point provides no basis for disaggregating beyond the residential/business split. And even as to that disaggregation, changes since the temporary rates decision have made the residence/business split used there no longer proper. In particular, the inclusion of Centrex and private line makes it more difficult to determine the business line count used in the interim rate disaggregation, and the inclusion of additional accounts in the analysis means the accounts that split along residence/business lines no longer loom as large as they did. Accordingly, even that disaggregation will

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[1] The revised results submitted by New York Telephone in its October 4 letter reverse this effect, since a single discount would now be lower than a disaggregated business discount and higher than a disaggregated residential discount.

be dropped, and a single wholesale discount will be set for each of New York Telephone and Rochester Telephone.

Varying the Discount Over Time

1. New York Telephone's Proposal

As noted above, New York Telephone proposed a two-year, three-step phase-in of the discount, on the premise that the shift of customers to resellers and the associated reduction in the company's costs will occur over time. New York Telephone recognizes that in setting temporary rates we rejected the proposed phase-in, stating that "the long-term view of avoided costs requires immediate implementation of the full discount, whatever it may be."[1] It contends, however, that its proposed phase-in does reflect the full level of avoided costs, but also recognizes, realistically, that they will not be avoided immediately. It notes as well that it is not proposing specific term and volume discounts, suggesting they are customer specific and better handled in individual contracts.

AT&T, Sprint, Empire, and NYCHA object to New York Telephone's phase-in proposal. AT&T asserts that the proposal is intended to slow down New York Telephone's competitors as much as possible.

New York Telephone has shown no reason to change the determination in the interim phase that its phase-in is unacceptable.

2. The Suggestion in the Linsider/Taratus Letter

In their letter posing questions to the parties, Judge Linsider and Mr. Taratus raised the possibility of a graduated discount moving in the opposite direction from the one proposed by New York Telephone. The incumbent LEC would begin with a high discount for higher-margin services and features and reduce the discount over time to a floor of avoided costs only. The letter

[1] Opinion No. 96-18, mimeo p. 33.

asked whether "the higher overall (average) discount level initially provided to resellers under this variant [would] usefully serve to encourage competitive entry [and whether] the additional pricing flexibility for incumbents [would] be appropriate as a balance to this effect."

New York Telephone objects to any such attempt to "greenhouse" competition by setting artificially low wholesale rates; it warns that doing so could lead to uneconomic bypass and reduced allocative efficiency and undermine the benefits of competition. AT&T suggests it is more important to make proper cost-based pricing decisions than "to engage in competitive social engineering,"[1] but believes there may be circumstances in which an additional discount for excess contribution would be appropriate. It objects to linking those decisions with pricing flexibility for the incumbent LEC, however.

A phase-in of the sort suggested would pose administrative difficulties and risk skewing the competitive market. We do not adopt it.

ICBs

New York Telephone argues that an individualized resale discount different from the generally applicable one would be appropriate for individual case basis (ICB) offerings to large customers. Because ICBs may entail cost avoidance measures of their own, New York Telephone asserts, the additional avoided costs it will experience when these offerings are provided to resellers may be less than the avoided costs associated with other services.

Empire is skeptical, noting the company's original position that it would avoid no costs in offering Centrex and private line services at wholesale. It warns that the company's position would open a large loophole that would stifle the growth of competition and cites the FCC's statement that the statute provides no exception for promotional or discounted offerings,

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[1] AT&T's Initial Brief, pp. 96-97.

including contract and other customer-specific offerings. The FCC went on to state that a contrary result would permit incumbent LECs to avoid the statutory resale obligation by shifting customers to non-standard offerings.[1]

NYCHA also objects to New York Telephone's proposal, which, it contends, was raised for the first time in brief. It sees nothing in the record to support the suggestion that ICB avoided costs would be lower than those for other business services and argues that what has been reduced in an ICB is not costs but contribution. It warns as well that a reduced discount for ICBs would diminish competition in an important segment of the market and that the Commission, instead, should take steps to open competition in a segment of the market where a formidable entry barrier is posed by incumbent carriers having locked up large customers in long term agreements. It recommends that after wholesale rates are adopted, we allow customers under pre-competition ICBs an opportunity to solicit competitive bids and terminate their ICBs without liability.

The concerns expressed by the parties objecting to special treatment of ICBs are reasonable. At a minimum, further examination of the proposal and its likely effects would be needed before it could be adopted.

DISCOUNTING BY CLECS

Time Warner asks that we expressly acknowledge that the requirement to offer services at the wholesale discount does not apply to competitive local exchange companies (CLECs), i.e., LECs other than the incumbent. It cites the FCC's finding that the Act does not impose wholesale pricing requirements on CLECs because they lack the market power of the incumbent LECs.[2]

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[1] Empire's Reply Brief, pp. 13-14, citing First Report and Order, ¶ 948.

[2] Time Warner's Initial Brief, p. 31, citing First Report and Order, ¶ 976.

In its reply brief, Rochester Telephone takes the contrary position, recognizing that the Act does not require CLECs to discount but urging that we consider such a requirement. It suggests that where a CLEC has more facilities than the ILEC and a customer wants service from the ILEC, the ILEC should be able to resell CLEC services just as the CLEC could resell those of the ILEC.

The issue is clearly beyond the scope of this phase of the proceeding, and we see no need to resolve it here.

CONCLUSION

The specific decisions in this analysis imply the following wholesale discounts, as calculated in Appendices B and C:

New York Telephone:
LEC provides operator services: 19.1%
Reseller provides operator services: 21.7%

Rochester Telephone:
LEC provides operator services: 17.0%
Reseller provides operator services: 19.6%

The Commission orders:

1. The pending interlocutory appeal filed by MCI Telecommunications Corporation and MCIMetro Access Transmission Services, Inc., described in the foregoing opinion, is denied.

2. Within two weeks of the issuance date of this opinion and order, New York Telephone Company and Rochester Telephone Corp. shall file tariff amendments consistent with this opinion and order and serve copies of those tariff amendments on all active parties to these proceedings. The tariff amendments shall not take effect until approved by the Commission.

3. These proceedings are continued.

By the Commission,

(SIGNED) JOHN C. CRARY
Secretary

APPENDICES

ACRONYMS USED IN THIS OPINION[1]

ARMIS	Automated Reporting Management Information System (a financial report filed by ILECs with the FCC)
CABS	Carrier Access Billing System (the billing system used by LECs to charge interexchange carriers for the access services provided to them)
CLEC	competitive local exchange company (a LEC other than the incumbent)
EUCL	end-user common line charge (also known as SLC, it represents a rate charged to end-users to recover the portion of local loop costs allocated to the interstate jurisdiction)
FAIS	Financial Assurance Information System (a financial data base maintained by New York Telephone that uses account categories consistent with those in the USOA but more finely subdivided)
ICB	individual case basis (a contract between a LEC and a particular customer)
ILEC	incumbent local exchange company
LEC	local exchange company
NYCHA	New York Clearing House Association
PREMIS	Premises Management Information System (used by business office representatives in the service ordering process to obtain address and living unit information)
SLC	subscriber line charge (also known as EUCL; see above)
TELRIC	total element long-run incremental cost (a version of TSLRIC applied by the FCC to costing network elements)
TSLRIC	total service long-run incremental cost (a costing method that, in brief, attempts to measure the difference between the total costs of the company when it produces the service in question and its total costs when it does not produce any of the service)
USOA	Uniform System of Accounts

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[1] Omitted from this list are some commonly used acronyms representing the names of parties or government agencies.

NYT Indirect Expense Loading Factor
95-C-0657

	($000)
Total Indirect Operating Expenses - *(See worksheet)*	1622929.1
Total Operating Expenses - *(from PSC Report)*	6410264.6
Total NYT Uncollectibles -	109233.7
Total 1995 Depreciation Expense -	1485026.0
Total 1995 Capital Expenditures -	1439388.7

$$\text{Indirect Loading Factor} = \frac{\text{Total Indirect Expenses + Uncollectibles}}{\text{Total Oper Exps - Total Indirect Exps - Depr Exp + Capital Expenditures}}$$

$$= \frac{1622929.1 + 109233.7}{6410264.6 - 1622929.1 - 1485026.0 + 1439338.8}$$

$$= \boxed{36.53\%}$$

* Uncollectibles are treated as indirect

NYT 1995 Indirect Expenses

Account No.	Description	Amount ($000)
6121	Land/ Buildings	182218.7
6122	Furniture / Artwork	5677.8
6123.1	Office Support Equipment	12943.6
6123.21	Station Apparatus/ Key Systems/ Small PBX	19269.8
6123.22	Large PBX	47.8
6124	General Purpose Computers	258942.9
6711	Executive Expense	54253.3
6712	Planning	71.2
6721	Accounting & Finance	41498.3
6722	External Relations	77759.7
6723	Human Resources	84472.0
6724	Information Management	130230.5
6725	Legal	28483.0
6726	Procurement	15865.1
6727	Research and Development	68732.4
6728	Other General/Administrative	642463.0
	Total Indirect Costs	1622929.1

Summary of NYT Avoided Costs
(ILEC Provides DA/Call Completion)

Account	Description	($000) Total Company Avoided
6611	Product Management	152244.1
6612	Sales	125082.9
6613	Advertising	45260.3
6621/6622	Call Completion/DA Services	0
6623.1	Customer Accounting	75025.0
6623.2	Service Order Processing	363230.0
6533	Subscriber Line Testing	27980.0
6534	Plant Operations Administration	10446.5
6561	Depr. Expense - Operator Systems	0
6561	Depr. Expense - General Support	10574.0
6220	Operator Systems	0

Total Direct Expenses	809842.8
Indirect Loading @ 36.53%	295835.6
Total Avoided Direct / Indirect Expenses	1105678.4
Total Revs Related to Resale Operations *(Includes DA/Call Completion revs)*	5778388.7

Wholesale Discount = 19.1%

95-C-0657 Summary of NYT Avoidable Costs
(Reseller Provides Own DA/Call Completion)

Account	Description	($000) Total Company Avoidable
6611	Product Management	152244.1
6612	Sales	125082.9
6613	Advertising	45260.3
6621/6622	Call Completion/DA Services	183038.9
6623.1	Customer Accounting	75025.0
6623.2	Service Order Processing	363230.0
6533	Subscriber Line Testing	27980.0
6534	Plant Operations Administration	10446.5
6561	Depr. Expense - Operator Systems	4493.6
6561	Depr. Expense - General Support	10574.0
6220	Operator Systems	148.1

Total Direct Expenses	997523.4
Indirect Loading @ 36.53%	364395.3
Total Avoided Direct / Indirect Expenses	1361918.7
Less DA/Call Completion Revenues	134812.1
Net Avoided Direct/Indirect Expenses	1227106.6
Total Revs Related to Resale Operations *(Does not includes DA/Call Completion revs)*	5643576.6

Wholesale Discount = 21.7%

Rochester Telephone Corporation
Indirect Expense Loading Factor

	Amount
Total Indirect Operating Expenses (See Page 2)	$41,045,500
Total Uncollectibles	$2,436,651
Total Operating Expenses	$187,916,143
Total 1995 Depreciation Expense	$56,104,899
Total 1995 Capital Expenditures	$42,023,538
!995 Account 6622.2 - Directory Publishing	$11,882,339

$$\text{Indirect Loading Factor} = \frac{\text{Total Indirect Expenses + Uncollectibles}}{\text{Total Direct Expenses* + Capitalized Expenditures - Directory Publishing}}$$

$$= \frac{\$41{,}045{,}500 \quad + \quad \$2{,}436{,}651}{\$78{,}883{,}404 \quad + \quad \$42{,}023{,}538}$$

$$= \boxed{35.96\%}$$

* Calculation of Total Direct Expenses

Total Operating Expenses	$187,916,143
Indirect Expenses	(41,045,500)
Depreciation Expense	(56,104,899)
Directory Publishing	(11,882,339)
Total Direct Expenses	$78,883,404

Rochester Telephone Corporation
1995 Indirect Expenses

Acct No.	Description	Amount
6121	Land and Building	$5,824,967
6122	Furniture and Artworks	47,601
6123	Office Equipment	511,909
6124	General Purpose Computers	7,542,387
6711	Executive	3,706,070
6712	Planning	943,433
6721	Accounting and Finance	4,390,746
6722	External Relations	3,140,726
6723	Human Resources	3,145,977
6724	Information Management	4,586,154
6725	Legal	904,845
6726	Procurement	443,539
6727	Research and Development	0
6728	Other General and Administrative	5,857,147
Total Indirect Expenses		**$41,045,500**

Rochester Telephone Corporation
Summary of Avoided Costs
Based on Calendar Year 1995

(ILEC Provides DA/Call Completion)

Act #	Description	Amount Avoidable*
6220	Operator Systems Expense	$0
6533	Testing Expense	416,830
6534	Plant Operations Administration Expenses	137,113
6561	Depreciation Expense	2,026,241
	Exclude Depreciation - Operator Systems	(1,107,113)
6611	Product Management	2,610,545
6612	Sales	1,129,638
6613	Advertising	1,826,779
6621	Operator Services	0
6622.1	Directory Assistance	0
6623.1	Order Processing & Instruction	9,101,190
6623.2	Billing and Collection	7,402,589

Total Avoided Direct Expense		23,543,811
Indirect Loading @	**35.96%**	8,467,136
Total Avoided Expenses (Direct and Indirect)		$32,010,947
Total Revs Related to Resale Operations (Includes DA/Call Completion Revs)		$188,799,360

Wholesale Discount = **17.0%**

Rochester Telephone Corporation
Summary of Avoided Costs
Based on Calendar Year 1995

(Reseller Provides Own DA/Call Completion)

Act #	Description	Amount Avoidable*
6220	Operator Systems Expense	$217,795
6533	Testing Expense	416,830
6534	Plant Operations Administration Expenses	137,113
6561	Depreciation Expense	2,026,241
6611	Product Management	2,610,545
6612	Sales	1,129,638
6613	Advertising	1,826,779
6621	Operator Services	2,793,300
6622.1	Directory Assistance	1,629,347
6623.1	Order Processing & Instruction	9,101,190
6623.2	Billing and Collection	7,402,589

Total Avoided Direct Expense		29,291,366
Indirect Loading @	**35.96%**	10,534,148
Total Avoided Expenses (Direct and Indirect)		39,825,514
Less DA/Call Completion Revenues		(3,547,164)
Net Avoided Expenses		$36,278,350
Total Revs Related to Resale Operations (Does not Include DA/Call Completion Revs)		$185,252,196
Wholesale Discount =		**19.6%**

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