

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service
Commission held in the City of
Albany on September 16, 1998

COMMISSIONERS PRESENT:

Maureen O. Helmer, Chairman
John B. Daly
Thomas J. Dunleavy
James D. Bennett

- 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 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.
- CASE 98-C-1357 - Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements, Filed in Cases 95-C-0657 and 94-C-0095.

ORDER DENYING MOTION TO REOPEN PHASE 1
AND INSTITUTING NEW PROCEEDING

(Issued and Effective September 30, 1998)

BY THE COMMISSION:

INTRODUCTION

In our Phase 1 Opinion in these proceedings,¹ we set rates for a wide range of network elements and, as part of that process, determined certain of New York Telephone Company's (New York Telephone's) switching costs. We elaborated on the basis for that determination in our Phase 1 Rehearing Opinion.²

By motion dated June 10, 1998, a group of parties³ (the Moving Parties) request that Phase 1 of the proceedings be reopened in order to take into account new evidence on switching costs submitted by New York Telephone in the hearings recently concluded in Phase 3. New York Telephone has responded in opposition to the motion. For the reasons described below, the motion is denied but the issue will be considered in a plenary review of network element pricing to begin in January 1999.

BACKGROUND

In Phase 1, we were confronted with two fundamentally different cost analyses. New York Telephone offered a study that estimated forward-looking network element costs on the basis of adjusted, company-specific, historical data. AT&T and MCI presented the "Hatfield Model," said to calculate the costs that would be "incurred by an efficient local exchange company (LEC)" and to be "adaptable to any LEC or geographic area, provided the appropriate state-specific and company-specific information is

¹ Cases 95-C-0657 et al., Opinion No. 97-2 (issued April 1, 1997).

² Cases 95-C-0657 et al., Opinion No. 97-14 (issued September 22, 1997).

³ The moving parties comprise AT&T Communications of New York, Inc. (AT&T), MCI Telecommunications Corporation and MCI metro Access Transmission Services, Inc. (MCI), Sprint Communications Company, L.P., and WorldCom, Inc.

available and input into the model."¹ We found both presentations seriously flawed in their methods and inputs; but though we were somewhat more skeptical of the Hatfield Model than of New York Telephone's study, we saw no need to reject Hatfield entirely (nor any basis for relying on New York Telephone's study entirely). Noting that the needed adjustments to inputs brought about a considerable narrowing of the initially wide gap between the two studies' results, we set element rates, for the most part, at a point within that narrowed range. Much of the Phase 1 Opinion was devoted to discussing those needed input adjustments.

The present motion pertains to the inputs used for switching costs.² Struck by the extremely wide discrepancy between the switching cost figures used by the two studies (New York Telephone's \$586 per line and Hatfield's \$125 per line, both inclusive of installation costs), we regarded that gap as itself calling the figures into question and went on to cite various other factors that led us to reject both estimates. We used, instead, a Staff analysis that was based on a per-line installed cost, derived from historical data, of about \$300.

In our discussion, we twice referred to the matter of vendor discounts. First, in describing our adjustment to capture the downward trend in switching costs, we noted, in a statement that forms much of the basis for the pending motion, that we "did not take account, however, of the atypically large discounts received by New York Telephone from its vendors after 1994 in connection with a major switch replacement program."³ We made a similar statement in describing downward adjustments to the installation and power factors.⁴ These comments reflected New York Telephone's attribution of those large discounts to the

¹ Phase 1 Opinion, mimeo p. 21, quoting Tr. 2,608-2,609.

² See, primarily, Phase 1 Opinion, mimeo pp. 84-86 and Phase 1 Rehearing Opinion, mimeo pp. 38-41

³ Phase 1 Opinion, mimeo p. 85, n. 1.

⁴ Ibid., Attachment C, Schedule 2, page 1 of 3.

switches having been purchased as part of its program to replace analog switches with digital. New York Telephone suggested that vendors were willing to offer unusually large discounts in connection with such replacement programs (to encourage upgrades that create a market for new software), but that the replacement program was nearly complete and the discounts therefore were unlikely to continue.

In the Phase 1 Rehearing Opinion, we affirmed our switching cost analysis in the face of challenges by both New York Telephone and MCI. In response to New York Telephone's broad-based critique of its method, we acknowledged the propriety of modifying several steps in the analysis but regarded the net effect of those modifications as too small to warrant a change in the overall result. We rejected other aspects of New York Telephone's critique, including a claim, which we found unproven, that the 5.72% price reduction factor was belied by certain Bureau of Labor Statistics data said to show that central office switch prices were increasing rather than decreasing. But we rejected as well MCI's claim that the price reduction factor was too low, finding that MCI had "offered no new reason for rejecting the fully explained premise that the unusually large discounts associated with analog to digital conversion would not be replicated."¹

PARTIES' ARGUMENTS

The Petition

The Moving Parties assert that new evidence elicited in Phase 3 shows that the deep discounts said in Phase 1 to be available only for analog-to-digital replacements are, in fact, available for all purchases of new switches. They argue that the availability of this information in Phase 1 would have resulted in "substantially lower" switch costs and therefore urge that, "to prevent injustice," Phase 1 be reopened to consider this

¹ Phase 1 Rehearing Opinion, mimeo p. 40.

"newly discovered" evidence and recalculate New York Telephone's switching costs.¹

More specifically, the Moving Parties point to New York Telephone's contracts with its two major switch vendors (Lucent and Nortel), made available recently in response to AT&T's Phase 3 discovery requests, and to the Phase 3 responsive testimony of AT&T witness Catherine Petzinger, pre-filed on May 13, 1998 and admitted at the Phase 3 hearings in June.² Noting Ms. Petzinger's asserted demonstration that New York Telephone's Phase 1 switching costs were overstated, they point specifically to her testimony that the discounts provided for in the newly-available contracts apply to all new switch purchases, not solely to replacements of analog switches, and that those discounts should not be seen as one-time special deals.³ The Moving Parties observe that these contracts, and the actual terms governing New York Telephone's switch purchases, were unavailable when Phase 1 was decided, and they contend the Phase 1 switching cost determination must be revisited inasmuch as it "relied upon [New York Telephone's] misrepresentation of fact."⁴ (That

¹ Moving Parties' Motion, p. 2.

² The contracts themselves are at least provisionally protected as proprietary information (pending the Administrative Law Judge's ruling on final proprietary status), as is the full, confidential, version of Ms. Petzinger's testimony. The Moving Parties incorporate the redacted, public, version of Ms. Petzinger's testimony in their motion and ask us to take administrative notice of the confidential version. We are free to use any of this material without formally taking administrative notice, for it is already in the record of these proceedings.

³ Petzinger pre-filed testimony, pp. 8-10, now Tr. 6,012-6,014 (public version) and 6,052-6,054 (proprietary version). In a follow-up letter dated June 30, 1998, the Moving Parties point as well to portions of proprietary Exhibit 310-P, received in evidence at the Phase 3 hearings, which, they say, similarly establish that the substantial discounts offered by the switch vendors apply to all new purchases, not only to analog replacements.

⁴ Moving Parties' Motion, p. 6.

relief, they add, would be warranted even if the misrepresentations of fact were the unintentional result of "sloppy cost study preparation," a possibility they acknowledge; they suggest New York Telephone's Phase 1 cost experts may themselves have been unaware of the actual terms governing the new switch purchases.¹⁾

The Moving Parties argue further that the switch contracts belie what they characterize as a "key element" of our decision: our observation that the substantial discounts received by New York Telephone in connection with the analog switch replacements were atypical and unlikely to continue. They attribute these conclusions to our reliance on unsworn statements to that effect in New York Telephone's briefs, which spoke of the analog replacements as being nearly completed and of the discounts as being unavailable in connection with other switch purchases. Because Ms. Petzinger's analysis of the actual discounts now shows them to be substantially greater than those we contemplated (and because, in the view of the Moving Parties, the larger, post-merger Bell Atlantic is "virtually certain" to be even better able than its predecessors to obtain substantial discounts for future purchases of new switching equipment), the Moving Parties see a need to reopen Phase 1 to redetermine switch costs in light of this newly discovered evidence.

New York Telephone's Response

As an overview to its response, New York Telephone acknowledges that the Phase 1 results overall may have to be reexamined in the future to take account of changing circumstances, but it sees no need to do so now, or on a piecemeal basis. It contends that the two-tier discount structure seen by the Moving Parties as "new information" in fact was well-known in Phase 1. Moreover, it argues, the terms of the Lucent and Nortel contracts are irrelevant to our Phase 1 analysis of switching costs, which was based on actual prices

¹ Id.

realized in recent switch purchases and therefore obviated detailed analysis of the switch purchase contracts; and our analysis in any event incorporated a "productivity" adjustment to reflect assumed future decreases in switch prices.

More specifically, New York Telephone begins by reviewing its Phase 1 testimony on switching costs, based on its Switching Cost Information System (SCIS), and the AT&T and MCI testimony, reflecting the results of their Hatfield Model. With respect to the Hatfield Model, it notes the recognition, in the Model's switching price input source, that vendors charge lower prices for new switches than for later capacity additions, and it cites as well the testimony of MCI's witness Mercer that vendors did not distinguish between replacement switches and other new switches. It accordingly denies the novelty of the information now presented on the identity of "new" and "replacement" discounts, asserting that the only basis for regarding the information as new is its own erroneous statement, in its response to an on-the-record information request and later in its brief, that the higher discount level was limited to analog-to-digital replacement; in fact, it says, "one of the two vendors offers essentially the same discount level for replacement purchases as for new switch purchases."¹ In any event, it adds, its Phase 3 rebuttal testimony showed that a mature network like its own tends to grow by additions to existing switches rather than by new or replacement switches and that the analog-to-digital replacement was an exception to that rule.

Reviewing as well the treatment of the issue in the Phase 1 Opinion and the Phase 1 Rehearing Opinion, New York Telephone contends further that any alleged defects in its costing model and inputs, including vendor discounts, have no relevance to our decision, which rejected New York Telephone's cost study and relied, instead, on the Staff analysis described

¹ New York Telephone's response, p. 4, n. 4. It attributes its error, and another not directly pertinent here, to intra-company miscommunication or misunderstanding.

earlier. But, it continues, even if contractual discount levels were pertinent to the Phase 1 decision, the "growth" discount, rather than the "new switch" discount, would be the one to be looked to in a forward-looking analysis, inasmuch as new switch purchases are relatively rare in a mature network such as New York Telephone's, except in the context of the nearly-completed analog-to-digital replacement program. It presents a proprietary analysis said to show that the vendor discounts implicit in the Phase 1 decision are, in fact, greater than currently available levels for growth purchases and only slightly less than currently available new switch discounts.

Finally, New York Telephone denies that the discounts potentially negotiable by the post-merger Bell Atlantic provide any basis for reopening Phase 1. It contends it already has negotiated new agreements reflecting the merger, none of which affect the points described above, and that, in any event, the productivity adjustments included in the analysis used in the Phase 1 Opinion take account of decreases in the negotiated prices of switches over time.

DISCUSSION AND CONCLUSION

New York Telephone correctly argues that selective updates should be avoided, for they can produce unfairly skewed results. But the motion here, at least on its face, requests not a selective update to capture new cost trends as much as the correction of an asserted material error said to have been caused by a flaw in the record for which New York Telephone was responsible. Closer examination therefore is needed to determine how to properly characterize the situation.

To begin, New York Telephone suggests that the Phase 3 testimony really sheds no new light on the discount situation, inasmuch as the record, through the testimony of MCI witness Mercer and otherwise, recognized that the proper distinction was between new (including replacement) and growth switches rather than between replacement switches and others. But that argument is unpersuasive. New York Telephone may now belittle, as

"inadvertent misstatement," its own assertion that the higher discounts were uniquely associated with the analog-to-digital replacements (a claim implying, at least, that other new switch purchases would be discounted at some lower rate); but the statements were unequivocal and were made not only in discovery response and brief but also on cross examination.¹ (Indeed, New York Telephone's witness added that he "would certainly change [the] numbers" in his switching cost study if it turned out, contrary to his then-existing belief, that the deep discounts would continue to be available on a going forward basis.) We took that claim seriously--we had no reason not to--and referred to it in the Phase 1 Opinion. Accordingly, the newly available information changes the state of the record with regard to vendor discounts. New York Telephone suggests the new information bears only on the vendor discounts contemplated in its SCIS study and therefore does not affect our analysis, which declined to rely on the SCIS study. But, as noted earlier, our analysis also made judgments that relied on assumptions regarding the level of vendor discounts, and the newly available information, as explained, might have had a bearing on those judgments.

New York Telephone suggests as well that the new information lacks significance because relatively few new switches are purchased for a mature system like its own and the discount that should be contemplated in a forward-looking analysis of such a system is the lower one associated with growth purchases. That argument, however, requires factual support and cannot be assumed to be true in evaluating the motion to reopen. More conceptually, it forgets that a Total Element Long-Run Incremental Cost (TELRIC) analysis of the sort used in these proceedings contemplates the construction of a new system. Even if there were a factual basis to New York Telephone's argument, it might be inapposite to a TELRIC analysis.

¹ We have no information suggesting that New York Telephone's errors were deliberate. But careless errors of this sort in a party's presentation are nonetheless distressing and disruptive of the process.

But while considerations such as these suggest a degree of merit to the motion, the nature of our switching cost estimate must be kept in mind. Staff regarded its Phase 1 switching cost result, and we adopted it, not as a mathematically precise calculation of switching costs but as a reasonable forward-looking estimate, building on actual historical data that included both new switches and "growth" additions to existing switches, that could be used to set rates given the wide gulf between the parties' estimates and in the absence of a persuasive study by any party. The new information might warrant modifying that estimate in one way, but the prospect of that modification would not negate the overall reasonableness of the rates we set. And while the adjustment called for here would not be an update, the rationale for disfavoring selective updates--they fail to recognize that other updates might move in the opposite direction--bears on selective after-the-fact modifications such as this one, as well.

To state the matter somewhat differently, we are not dealing here with a simple arithmetic correction to the Phase 1 calculations. The premise regarding discounts affected our Phase 1 judgments in a variety of ways, and each of those judgments would have to be reevaluated in light of the modified premise called for by the motion, with unpredictable results. For example, continuation of the deep discounts would imply, among other things, modification of our adjustment to the installation factor, and that, in turn (following our method in all other respects), would limit the apparent effect of the deeper discounts. But the resulting installation factor would itself be questionable on other grounds, appearing to be out of line with those for other companies, and its propriety would have to be assessed, as would various other issues posed by the modified discount assumptions.

Once switching costs were reopened, one might also envision changes to the Staff analysis that would increase the calculated switching costs (New York Telephone pressed for some in its earlier petition for rehearing, and we rejected them in

part because of other corrections tending in the opposite direction). The web of interconnected effects argues strongly against making the selective modification urged by the motion without a comprehensive review of switching costs or, indeed, all element costs.

Such a review will certainly be needed at some point, for the rates set in Phase 1, though sound and worthy of being left in place at least for now, were not regarded as an eternally valid last word. Costs change continually, as they always have; and, perhaps even more importantly here, the continuing evolution of the telecommunications industry may warrant revisiting certain premises of the Phase 1 decision. Although there is no clearly correct time to undertake a comprehensive review of the network element rates that have been set, January 1999 appears to be a reasonable time for beginning that process. Nearly two years will have elapsed since issuance of the Phase 1 opinion, providing a reasonable amount of experience with the rates there set. The interval, as noted, has seen continued evolution of the telecommunications industry, including, among many other things, very substantial growth in demand for additional lines and in Internet usage. Moreover, the Federal Communications Commission may by then have completed its review of New York Telephone's application, pursuant to §271 of the Telecommunications Act of 1996, for authority to provide long-distance service. And several matters related to the switching costs immediately at issue, such as rebundling of network elements, also should have been resolved by then.

Accordingly, we take this occasion to announce our intention to undertake, beginning in January 1999, a comprehensive reexamination of network element rates.¹ Orderly procedure suggests deferring to that reexamination any

¹ The schedule for that proceeding should be determined by the Administrative Law Judge, taking account, as always, of the interests in dispatch as well as thoroughness. The Judge should report to us in June 1999 on the status of the proceeding and its likely end date.

consideration of the switching cost modifications implied by the pending motion, and that motion, accordingly, is denied without prejudice to the substantive issues it raises.

It appears, finally, that even if the modifications sought here were clearly warranted--something that has not been shown--there would be no compelling need to act sooner. While the effect of the adjustment on switching prices cannot be presumed to be trivial--though it might turn out to be so--switching costs in general represent a much smaller component of CLEC expense than do the much more significant link costs. Moreover, the switching prices at issue here are much lower than New York Telephone's retail prices, providing ample margin to competitors even at their present levels. In addition, the rates set in Phase 1 have remained temporary; and even though all other Phase 1 rates are planned to be made permanent, switching rates are planned to be kept temporary, subject to future refund or reparation.¹

The Commission orders:

1. The motion described in the text of this order is denied, without prejudice to the substantive issues raised therein.

2. A proceeding is instituted to examine, beginning in January 1999, the need for any changes in the rates set in these proceedings for unbundled network elements.

3. These proceedings are continued.

By the Commission,

(SIGNED)

JOHN C. CRARY
Secretary

¹ We noted our intentions in this regard at our September 16, 1998 session. Our action, however, must await expiration of the comment period under the State Administrative Procedure Act.