STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

OPINION NO. 96-18

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 CONCERNING
TEMPORARY RESALE AND LINKS RATES

Issued and Effective: July 18, 1996

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STATE OF NEW YORK
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BY THE COMMISSION:

INTRODUCTION

In this opinion, we address ourselves to two relatively narrow but still important matters of the many being considered in this proceeding: (1) the appropriate level of temporary wholesale rates for New York Telephone Company's (New York Telephone's or the company's) retail residential and business access and related services; and (2) whether to make temporary New York Telephone's existing rate for unbundled links and, if so, whether the temporary rate should differ from the rate now in effect. We established this temporary rate track of the proceeding in an order issued May 24, 1996,[1] and the procedural history and substantive background set forth in that order need not be repeated here in detail.

The May 24 order declared our expectation to decide the temporary rate issues in July, "following an expedited hearing."[2] Consistent with that directive, Administrative Law Judge Joel A. Linsider initially promulgated a schedule that called for the filing of testimony on June 4, hearings on June 10 and 11, and a single brief on June 18. After it became clear that parties were willing to waive cross-examination and that the hearing accordingly could be an abbreviated one at which testimony would simply be introduced, Judge Linsider modified the schedule to provide for two rounds of briefs, the first to be submitted on June 11 and the second on June 18.

The following parties submitted testimony on the temporary rates issue: New York Telephone; AT&T Communications of New York, Inc. (AT&T); MCI Telecommunications Corporation and MCImetro Access Transmission Service, Inc. (MCI); MFS Intelenet of New York, Inc. (MFS); and the Cable Television and Telecommunication Association of New York on behalf of Cablevision Light Path, Inc., Time Warner Communications Holdings, Inc., Telecommunications, Inc., and its other members (CTTANY). In addition to its testimony prepared specifically for the temporary rates track, New York Telephone introduced the testimony it had prefiled for the permanent rates track. It was understood by all parties that cross-examination with regard to that testimony had been waived with respect to the temporary rates track only and that the witnesses might be cross-examined on that testimony during the hearings scheduled for the permanent rates track.

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[1] Cases 95-C-0657 et al., Order Releasing Staff Report And Mandating a Hearing (issued May 24, 1996) (the May 24 order).

[2] May 24 order, p. 3.

All of the foregoing parties filed briefs and reply briefs, as did Sprint Communications Company L.P. (Sprint).[1] In addition, the Public Utility Law Project of New York, Inc. (PULP) filed a brief and the New York Clearing House Association (NYCHA) filed a reply brief.

The record for the temporary rates phase comprises 306 pages of testimony and 17 exhibits. Pages 212 through 229(a) of the transcript, constituting the direct testimony of AT&T witness James F. Dionne, contain proprietary information and are part of a separate transcript being kept under seal. (A redacted version of Mr. Dionne's testimony, containing no proprietary information, appears as part of the regular transcript at pages 194 through 210.) The sealed record also includes Exhibit 7-P, submitted by New York Telephone and Exhibit 10-P submitted by AT&T, both of which contain proprietary information. Redacted versions of the two exhibits, which omit proprietary information, are included in the public record as Exhibits 7 and 10.

We begin this opinion with a brief overview of context, definitions, and the parties' positions and then take up a threshold question regarding the nature and purpose of temporary rates. We then consider the rates for resale and, finally, those for unbundled links.

OVERVIEW OF CONTEXT AND PARTIES' POSITIONS

Basic Concepts

This proceeding, part of our general effort to increase the availability of resale as a means of promoting the growth of competition in telecommunications, predates the enactment of the federal Telecommunications Act of 1996 (the Telecommunications Act or the Act). The Act, however, now provides the frame of

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[1] Several briefs failed to comply with various aspects of the requirements as to form set forth in our rules, notably the requirement to include a table of contents (16 NYCRR §4.8(c)). Parties are reminded of their obligations in this regard.

reference for our efforts here, though the degree to which our actions are constrained by the Act (and by the actions the Federal Communications Commission (FCC) will be taking pursuant to it) remains to be determined. It appears to contemplate each of the three forms of competition potentially faced by incumbent local telephone companies: facilities-based competitors, which interconnect with the incumbent network by buying access but have their own switching equipment and lines to end users; partially facilities-based competitors, which may own switching facilities but buy the incumbent's link to the end user; and service resellers, which compete by buying the incumbent's bundled service, rebranding it, packaging it as they see fit, and selling it to end users as their own. Firms competing in each of these ways, and some in more than one, are represented in this proceeding, and the clash of interests is therefore complex. To the extent a firm uses resale, it benefits from a large wholesale discount; New York Telephone is joined by its primarily facilities-based competitors in favoring a smaller discount in order to deny that benefit to the resellers who compete with both of them. Meanwhile, partly facilities-based firms purchasing New York Telephone links favor a low link price based on incremental cost; New York Telephone advocates a price based on embedded costs, to allow it to recover its investment and to avoid giving what it regards as an unfair advantage to its competitors.

The provisions of the Act most directly related to this phase of the proceeding are those setting forth the basis for pricing bundled resale and network elements.[1] Under the Act, 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, such as links, are to be "based on cost (determined without reference to a rate of return or other rate based proceeding) . . . non-discriminatory, and . . . may include a reasonable profit."[3]

In setting temporary rates here, we are acting pursuant to Public Service Law §§113 and 114, following compliance with the notice and hearing requirements there set forth.

Staff’s Report

The staff report accompanying the May 24 order was directed primarily toward the temporary wholesale discounts. Disavowing any effort to resolve conceptual or methodological

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1 In the interest of consistency, we follow the definitions included in the Act. In particular, the Act distinguishes between a "telecommunications service" and a "network element." 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 of a telecommunications service for resale at wholesale rates. 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). In addition, we use the term "wholesale rates" to conform to the language of the Act and to common usage, notwithstanding our recent determination that New York Telephone’s tariff should be regarded as a "resale" tariff and not what parties in the collaborative phase of the proceedings characterized as a "wholesale" tariff.

2 Act §252(d)(3).

3 Act §252(c)(1).

questions that required litigation for full exploration, staff declared its intention to be formulation of its opinion as to the best possible estimate, given time and informational constraints. After reviewing the cost studies that had been submitted by New York Telephone and AT&T during the collaborative phase of the proceeding and concluding, with respect to an issue discussed in greater detail below, that the long-range view of costs contemplated by the Commission required that the discount be based on "avoidable" rather than "avoided" costs, staff revised the two studies in accordance with its critique, found that the two studies as so revised tended to converge, from widely differing starting points, on the 15% to 16% range, and concluded that a wholesale discount of 15% "should be viewed as the estimate staff would provide to the Commission if no further information were available and no further investigation into avoided costs would occur."[1] Consideration of the minimum and maximum plausible values for the avoidable portions of certain disputed expenses led staff to identify a range of 12% to 18% around its 15% mid-point. Staff also disaggregated its estimate to separately measure avoided costs for residence and business services and came up with a best estimate discount of 17% for residential service and 11% for business service.[2] Finally with respect to the wholesale discount, staff agreed generally with New York Telephone's position that cost onsets related to making wholesale services available should not be used to reduce the wholesale discount but should be recovered, if appropriate, on a transaction-specific basis.

With regard to unbundled links, staff saw a possibility that the $24.75 embedded cost figure on which the current price is based might be too high. It recommended making the link rate

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[1] Staff Report, p. 7.

[2] Staff workpapers showed a calculated business discount of 10.25%, but all of these figures represent estimates within a range, and for present, temporary-rate purposes, the 11% figure is reasonably within the range.

temporary and "reducing that rate as soon as feasible" by the amount of any costs reflected in the current rate that are not incurred in wholesale provisioning of links.[1]

Overview of Parties' Positions

1. New York Telephone

New York Telephone continues to advocate a wholesale discount of 8.9% for business service and 11.5% for residence service, to be phased in over a two-year period. The figures do not reflect cost onsets, which would be separately recovered, in part from the services involved and in part from all ratepayers as an exogenous cost under the Performance Regulation Plan approved last year.[2] The company calculated these figures as "avoided costs," i.e., costs "actually shed when a unit of output is sold to a reseller rather than to a retail customer."[3] It regards alternative standards (such as "avoidable costs") as contrary to Commission precedent, to the Act, and to sound economic theory, arguing, among other things, that an excessive discount would create an artificial pricing incentive for the entry of resellers to the market.

With respect to links, New York Telephone would leave permanent its current, embedded-cost based rate of $24.75, but proposes increases in two non-recurring rate elements.

2. AT&T

AT&T proposes a wholesale discount of at least 34.8%, a figure based on its own avoided cost study or the staff recommendations as AT&T would modify them. It asserts the need to base the discount on a long-term view of avoidable cost, contending the Act requires no less and that only such an

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[1] Staff Report, p. 11.

[2] Case 92-C-0665, New York Telephone Company - Incentive Regulation, Opinion No. 95-13 (issued August 16, 1995).

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

approach permits the development of economically efficient competition between resellers and incumbent local exchange companies. With respect to links, AT&T advocates reducing the current rate to a level consistent with New York Telephone's long-run incremental cost submission and making that new rate temporary pending further investigation. It questions whether the current rate, based as it is on embedded costs, complies with the Act and contends that it constitutes a material barrier to facilities-based entry to the local exchange market.

3. MCI

MCI advocates a temporary wholesale discount of 30% and rates of $8.50 per month for residential links and $6.00 for business links. Like AT&T, it advocates a resale discount that takes account of long run changes in avoidable costs and contends that New York Telephone's approach would bar the entry of potential resellers and fail to comply with the Act. Similarly, it contends that New York Telephone's embedded cost-based link rate fails to comply with the Act and bars facilities-based competition.

4. Sprint

Favoring a resale discount large enough to encourage resale competition but warning against a discount so steep as to discourage facilities-based competition, Sprint regards staff's recommendations as a reasonable temporary measure. It objects to New York Telephone's embedded cost-based link rate and favors a rate set at total service long-run incremental cost (TSLRIC) plus a fair allocation of joint and common cost.[1]

5. MFS

Asserting that the Act favors facilities-based competition over resale, MFS warns against regulatory incentives, such as too large a wholesale discount, that might favor resale.

[1] Sprint's Reply Brief, p. 4

On the basis of studies thus far available, it regards staff's proposal as "slightly high" and advocates a business service discount of 7% to 9% and a residential service discount of 12% to 15%. It regards New York Telephone's current link rate as grossly excessive, anticompetitive, and inconsistent with the Act; and it favors a temporary recurring link rate of approximately $7 in the Metro LATA and $12 in the rest of the State.

6. CTTANY

Asserting the superiority of facilities-based competition over resale and urging that the Commission's goal be to ensure its development, CTTANY warns against an excessive temporary wholesale discount that might discourage investment by facilities-based providers; it asserts that facilities-based investment lost to New York because of an excessive temporary discount might never be regained. In contrast, it asserts, a temporary wholesale discount later found to be too small would have done no lasting harm; for resellers need to invest little capital in order to provide service and can shift their efforts from one geographic market to another relatively easily. It reasons that resellers discouraged from coming to New York by the small temporary discount could easily enter the State when and if the permanent rate of the discount were increased.

CTTANY therefore advocates a restrictive view of avoided costs, at least at the temporary stage.

7. NYCHA

Endorsing an "avoidable cost" standard for computing the wholesale discount and supporting staff's overall estimate, NYCHA would, however, apply that 15%-17% estimate to all services instead of disaggregating it between residential and business services as staff did. It argues that staff's application of a smaller discount to business services could impede the development of competition and new services, which are driven by business users. It objects as well to New York Telephone's exclusion of Centrex and Private Line services from the discount.

With respect to links, NYCHA questions New York Telephone's assertion that costs equal or exceed current rates.

8. PULP

PULP takes no position on the level of temporary rates, addressing itself only to the issue, next discussed, of the significance of the temporary rates to be set here.

NATURE AND EFFECT OF TEMPORARY RATES

The parties differ in their views regarding the nature of the rates to be set here and the process to be followed in setting them. New York Telephone and AT&T, for example, agree that it would be desirable for the temporary rates to approximate as closely as possible the permanent rates ultimately to be set, and no party directly challenges that desideratum. But the parties offer widely different views of its importance and of whether the process for setting temporary rates should resolve issues in a manner deemed binding in the permanent phase.

AT&T takes the firmest position on this point, regarding it as "critically important" that temporary rates approximate the anticipated permanent rates and contending that if the temporary discount is too low, competitors (by which it means, in this context, resellers) will delay entry in the hope of achieving a better permanent rate and the temporary rate process will have been a waste of time.[1] Consistent with that view, AT&T urges that we now resolve, on a permanent basis, subject only to court review on appeal, "all major conceptual issues relevant to calculating a wholesale discount."[2] Where we expect alternative approaches might be considered in the permanent phase, AT&T urges, we should so state.

[1] AT&T's Initial Brief, p. 3.

[2] Ibid., p. 28.

New York Telephone, characterizing interim rates as a necessary evil at best, expresses similar concern about the uncertainty they produce, urges that efforts be made to set temporary rates that approximate the permanent level, asserts that its temporary rates proposals are the same it would offer for permanent rates, and asks the temporary rates remain in effect for the shortest possible period. It stops short of AT&T's position regarding the binding nature of the decisions to be made here but offers its own understanding of the rates to be set, proposing that they be considered "interim" rather than "temporary"--in other words, that they not be subject to refund. Arguing that the prospect of refunds augments the uncertainty of interim rates, it warns that a refund to the company in the event the temporary discount were found too large (usually referred to as reparations) might be "politically unpopular and difficult to administer,"[1] and it therefore warns that a rate subject to refund "could operate as a one-way ratchet by creating an environment in which rate changes favorable to [New York Telephone] are less likely to be ordered than changes unfavorable to [it]."[2]

Other parties see the temporary rate process in a very different light. Contending that "the purpose of the interim rate is merely to serve as a placeholder until the correct, permanent rate can be established," and characterizing the interim rate litigation as having been "designed for speed, not accuracy,"[3] CTTANY points to the large amount of information yet to be analyzed in setting a permanent wholesale discount and to the absence of a definitive statement by the FCC construing the avoided cost section of the Telecommunications Act. It urges that the process of setting a permanent rate not build on the temporary rate litigation, that every issue be examined _de novo_

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[1] New York Telephone's Initial Brief, p. 7.

[2] _Id._

[3] CTTANY's Initial Brief, p. 2.

in the permanent stage, and that the Commission declare that neither the interim rates nor the arguments and methods used in reaching it are relevant to determining the permanent rate. It warns that attempting to prejudge the permanent rate could risk distorting the market and argues, in its reply brief, that New York Telephone's and AT&T's divergent understandings of the Act underscore the difficulty of trying to determine a permanent resale rate before the FCC interprets the statute. CTTANY also cites Public Service Law §114, which provides for temporary rates where necessary to "facilitate prompt action" and "avoid delay," and argues that such proceedings are by their very nature cursory, designed to achieve stop-gap measures.

MFS takes a similar position. It acknowledges the importance of predictability in ratemaking but notes the uncertainties generated by the yet-to-be-construed Act and sees a need for temporary rates subject to refund in order to create economic incentives for facilities-based investment. NYCHA and PULP argue similarly, urging that temporary rates not be allowed to influence the permanent ratesetting process.

Temporary rates, as CTTANY suggests, should be reasonable placeholders calculated by a process that permits them to take effect sooner than could rates set on the basis of a full review of the facts and issues. And while it is desirable that temporary rates resemble the permanent ones ultimately set, there can be no assurance that they will do so; and for that reason, they are made subject to refund. New York Telephone's suggestion that they be regarded as "interim" rates that are not subject to refund is at odds with this basic understanding of temporary rates and is contrary to our intention in directing that temporary rates be set.

AT&T's proposal that we effectively decide most of the case now also must be rejected, for if the case could be decided now, there would be little need for temporary rates. Much analysis remains to be done before permanent rates can be set; and the FCC's construction of the statute, expected to be released in August, must at least be taken into account. AT&T

itself recognizes the amount of work still to be done, having reserved the right to cross-examine New York Telephone's witnesses in the permanent track even with regard to testimony concerning which it waived cross-examination in the temporary track. We do not go as far as CTTANY suggests and see no need to declare explicitly our intention to consider all issues de novo; but, as a practical matter, the nature of the temporary ratesetting process is such that we are reserving judgment on many of the issues raised by the parties. Consistent with that approach, we will limit as well our discussion of the parties' arguments in brief, concentrating on those needed to reach this temporary rates decision.

RESALE DISCOUNT

Avoided vs. Avoidable Costs

As explained in the staff study, a fundamental difference among the parties, accounting for a considerable part of the differences among their discount calculations, turns on whether the discount should reflect costs actually avoided, or shed, when local services are provided at wholesale or whether they should recognize a broader category of avoidable costs, including indirect costs and resulting overheads. Noting our statement last November that "avoided costs should reflect a long-range view rather than short-run transitional abnormalities,"[1] staff understood us thereby to have mandated a discount based on avoidable costs. It went on to analogize the avoided-cost approach to the use of historical test year data in a traditional rate proceeding and the avoidable cost approach to the use of projected data, which, though imprecise, could yield more realistic and reliable results. It noted as well that an avoided-cost approach would limit the wholesale providers' incentive to shed costs, inasmuch as costs not actually shed

[1] Cases 95-G-057, et al., Order Considering Loop Resale and Links and Ports Pricing (issued November 1, 1995)(the November 1 Order), p. 7, n. 1.

could be recovered from competitors, and might thereby result in requiring competitors to subsidize the wholesalers' retail operations.[1]

Of all the parties, only Sprint supports the temporary discounts that result from staff's analysis. AT&T and MCI support staff's conclusion on avoidable costs but offer a variety of modifications that substantially increase the resulting discount; New York Telephone and its facilities-based competitors advocate a narrower reading of avoided costs and a correspondingly much smaller discount.

AT&T presents a comprehensive policy case, including both economic and legal considerations, in favor of a broad avoidable-cost approach, one that removes from the wholesale price all costs "attributable" to retail functions. It argues at considerable length that only such an approach will encourage the emergence of fair resale-based competition, which requires a market in which a reseller that is a more efficient retail provider will be able to sell at a price lower than the retail price of its wholesale supplier and in which total price will be driven to long-run incremental cost; and only such an approach complies, in AT&T's view, with the requirements of the Telecommunications Act. MCI raises similar considerations.

New York Telephone, on the other hand, insists that the term "avoided cost" means only costs that are actually shed when a customer switches from New York Telephone to a reseller.[2] It regards this approach as consistent with the November 1 order, where we required New York Telephone's resale rates to reflect

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1 Staff Report, p. 4.

2 The company characterizes the change as one in which "the customer's services are provisioned by [New York Telephone] through wholesale rather than through retail channels." (New York Telephone's Initial Brief, p. 8.) The company explains that it uses the term "channel" as a way of referring to the different functions the company is required to provide when services are offered to resellers rather than end users; but the terminology tends to downplay the differences between the two functions.

"its best estimate of the costs it will avoid in providing wholesale service,"[1] and with both the language and the legislative history of the Telecommunications Act. It emphasizes the Act's reference to "costs that will be avoided" by the local exchange carrier; and it contrasts this avoided-cost, or "top-down," standard with the "bottom-up" standard for pricing unbundled network elements. The latter is based on cost and may include a reasonable profit, suggesting that the top-down standard for wholesale services is to be distinguished by allowing for a price greater than one based solely on the cost of providing wholesale service. New York Telephone adds an analysis of the legislative history of the Act that purportedly confirms this reading by suggesting a Congressional intention not only to promote resale but also to protect local telephone service rates and universal service by preserving the local exchange companies' ability to recover contribution in the pricing of services offered for resale.

MFS similarly regards a narrow avoided-cost standard as consistent with the Act, citing, like New York Telephone, the distinction between the Act's provisions for resale pricing and for network element pricing. Contrasting the Act's exclusion of contribution from the link price (which is to be strictly cost-based) with the avoided cost provisions that, in its view, preserve recovery of contribution through the wholesale rate, MFS suggests this distinction exemplifies Congress' general preference for facilities-based competition over resale and its interest in ensuring that local exchange resale does not undercut the development of facilities-based competition.

AT&T offers a detailed, close reading of the Act's avoided-cost standard, emphasizing its reference to costs that "<u>will</u> be avoided." It understands that wording as forward-looking and as contemplating a long-run approach to avoided costs. New York Telephone, in contrast, emphasizes the definitiveness of the word "will" rather than its tense, arguing

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[1] November 1 order, p.7.

that it limits avoided costs to those that actually will be avoided by the local exchange carrier.[1] MCI, meanwhile, challenges New York Telephone's view on the grounds that the statute speaks of "marketing, billing, collection, and other costs that will be avoided by the exchange carrier," implying that marketing costs must be excluded from the wholesale rate; but New York Telephone, MCI points out, objected to considering product management and advertising expenses as avoided costs because they will continue to be incurred in a resale environment.[2] But on New York Telephone's reading, once again, the point of the statute could be to exclude marketing expenses from the rate only to the extent they "will be avoided."

Looking beyond the specific words of the resale pricing section, New York Telephone argues, as already noted, that the presence in the Act of different pricing standards for network elements and resold services means that the resale standard must be different from the network element standard. The latter is strictly cost-based; hence, according to New York Telephone, the former may not be. Yet, according to New York Telephone, that is precisely what would result from AT&T's efforts to interpret avoided costs so broadly as to result in a wholesale price set on the basis of TSLRIC.[3]

New York Telephone is correct that the presence of two standards suggests that they somehow differ; but other than implying rejection of the most extreme application of AT&T's approach, the point sheds little light on exactly what the two sections do mean.

More broadly, what these arguments do suggest is that the Act's wording permits a range of approaches to avoided cost and that states are free to choose within that range. We expect

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[1] New York Telephone's Reply Brief, p. 5.

[2] MCI's Reply Brief, p. 2, citing New York Telephone's Initial Brief, pp. 32-33.

[3] New York Telephone's Reply Brief, p. 4.

to identify the parameters of that range more definitively in the permanent rate phase of this proceeding and to consider whether the relatively extreme positions taken by New York Telephone on the one hand and by AT&T and MCI on the other might be precluded by the Act. For present purposes, it is enough to reject the claims that either of the approaches is required by the Act and to determine, which we do, that no party has shown that staff's interpretation of the data for purposes of setting temporary rates is forbidden by the Act.

Turning to the economic rationale for its approach, New York Telephone contends that a narrow avoided-cost standard maximizes efficiency by allowing a reseller to price its service below the incumbent's retail price whenever the reseller's incremental costs are less than the incumbent's avoided costs--in other words, when the reseller could provide the retail customer service functions more efficiently than the incumbent. It attempts to show, as it claims it did in the incentive regulation proceeding,[1] that the inclusion of contribution in the wholesale rate does not impair efficient competition as long as the same level of contribution is maintained in wholesale and retail rates. In contrast, a wholesale rate with less contribution than the retail rate (or none at all)--the result of a discount greater than actual avoided costs--would create an anti-competitive advantage in favor of New York Telephone's competitors. The company disputes as well the claim that a discount limited to avoided costs denies resellers an adequate margin to cover their fixed costs, contending, as it did in response to a similar argument in the incentive regulation case, that each market participant is responsible for recovering its fixed costs through the contribution (i.e., the component of a price designed to recover the excess of embedded over incremental costs) it includes in its total mix of services.

Finally, New York Telephone contends that the avoided-cost calculation should take account only of costs that vary with

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[1] Case 92-C-0665, supra.

respect to the allocation of New York Telephone's output between what it terms wholesale and retail channels. This would exclude, and regard as non-avoidable, embedded costs without regard to the functions they are attributable to, for they are by definition fixed with regard to output quantity; and costs that depend only on the total quantity of service supplied on the company's network, without regard to the proportion of that quantity that is sold through retail channels. It would exclude overhead functions on the premise that "to a reasonable first approximation, they would not be changed by shifts in the company's output between wholesale and retail channels. A company still needs a president and he or she still needs a desk, whether it is a wholesale company, a retail company, or something in between."[1] Similarly, New York Telephone argues, while "land and building" expense may be variable, it varies only in the long run with respect to the overall size of the company and, even in the long run, does not vary with respect to the allocation between retail and wholesale of a fixed volume of output.

MFS also offers a policy argument in favor of a narrow avoided-cost standard; it rests in part on the assertedly greater benefits produced by facilities-based contribution. MFS argues, among other things, that a new entrant using its own facilities (except for the link, which it must purchase from the incumbent) can challenge all aspects of the incumbent's services except the link. Resale, in contrast, provides fewer challenges to the incumbent and, according to MFS, offers "few benefits beyond delivery of a combined local and long distance bill, or simple restructuring of the products of the incumbent. . . . In a resale environment the incumbent LEC continues to control the prices of its competitors by controlling the cost of services over its bottleneck network. Only the construction of alternate networks will subject the rates and service quality of the

[1] New York Telephone's Initial Brief, p. 21.

incumbent LEC to real competition."[1] MFS therefore warns against providing artificial incentives to resale, and it cites a California Commission decision responding to that admonition.[2]

CTTANY similarly argues the superiority of facilities-based competition and warns against impeding its development by setting too large a wholesale discount.

In contrast to the foregoing arguments in favor of a narrow standard, the staff report on the one hand and AT&T and MCI on the other present overlapping but not congruent arguments in support of a broader avoidable-cost standard. The staff report suggests that the primary reason for this approach is to ensure that sheddable costs in fact are shed, and that resellers are not called upon to subsidize their wholesale providers' inefficiencies. In its reply brief, AT&T emphasizes this argument, asserting that "the fundamental flaw in [New York Telephone's] methodology that if its costs do not actually decrease, the resellers should continue to pay the bill, even if the costs have no causative relationship to [New York Telephone's] provision of service to resellers. Thus, according to [New York Telephone], a cost is avoided only when it is 'actually shed' by [New York Telephone]. Without doubt, this gives [New York Telephone] the incentive to 'shed' costs in as limited and as slow a fashion as possible."[3]

But to the extent an avoidable cost standard merely prevents subsidized inefficiencies, New York Telephone concedes the point, agreeing "that costs that are prudently sheddable in

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1 MFS' Initial Brief, p. 13.

2 It characterizes the California decision as having cut back an AT&T proposal for deep discounts similar to the one AT&T advanced here; it does not say how the discount ultimately approved in California compares with staff's proposal here. New York Telephone has argued the irrelevance of out-of-state actions and data; but though they of course do not bind us, they can be instructive if analyzed judiciously.

3 AT&T's Reply Brief, p. 5.

the resale context should be shed."[1] The more fundamental difference involves New York Telephone's argument that the avoidable cost approach requires the exclusion of costs "attributable" to retail activities even though they "would not be shed and indeed could not be shed through reasonable and prudent modifications of the company's activities in response to shift of customers from retail to wholesale channels."[2] According to New York Telephone, eliminating those costs results in a wholesale rate that includes less contribution to embedded costs than does the retail rate, thereby working to the unfair competitive advantage of the reseller. Yet according to AT&T and MCI, only if those costs are removed will they (and other resellers) be spared the burden of paying twice (once on their own behalf and once on New York Telephone's) for functions attributable to retail activity and of supporting, out of the limited margin between the wholesale price and a maximum retail price that cannot exceed New York Telephone's, the contribution reflected in New York Telephone's rates. MCI adds an admonition against reducing a properly computed wholesale discount "in order to protect the cable industry from competition from resellers."[3]

The parties developed these issues in considerable detail and with considerable economic sophistication in their testimony and briefs, and we will need to consider them carefully in setting permanent rates. For present purposes, however, it is enough to decide that New York Telephone has not persuasively refuted the staff study's conclusion that a very narrow definition of avoided costs makes little economic sense. For one thing, despite New York Telephone's concession that prudently sheddable costs should be removed even if not actually shed, it has not shown how one would go about following through on that principle other than by judgmentally imputing, in a manner

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[1] New York Telephone's Initial Brief, p. 34, n. 52.

[2] Id. Emphasis in original.

[3] MCI's Reply Brief, p. 8.

similar to what staff has done, the shedding of a greater degree of costs than is shown by New York Telephone's study.

In addition, New York Telephone has failed to prove its counter-intuitive claim that costs such as advertising will not be avoided by a change from retail to wholesale service. New York Telephone declares flatly that advertising expenses will not be avoided in a resale environment."[1] It argues that while product-specific advertising is generally directed only to the retail market, the level of advertising expenditures is not expected to decrease as volume shifts from retail to wholesale channels; that advertising is properly treated as a fixed cost; and that reduced retail volumes might in fact prompt more, not less advertising.[2] AT&T's response may be overstated in asserting, as flatly as New York Telephone asserts the contrary, that advertising is "not needed to provide wholesale services"[3]; but AT&T goes on to argue persuasively that leaving advertising in the wholesale rate in effect requires the reseller to pay for its own retail advertising expenses while also supporting those of New York Telephone, which would thereby be freed of the need to recover those expenses from its remaining retail customers. In its own reply brief, New York Telephone attempts to refute this "double payment" analysis. AT&T cited the example of a postage meter that had been acquired to provide retail services and alleged that a failure to regard its costs as avoided meant that a reseller would have to pay for its own postage meter as well as continuing to support New York Telephone's through the wholesale rate. New York Telephone contends, however, that the meter must be seen as a fixed cost, covered through contribution, and that as long as the contribution generated by the wholesale and the retail rates were the same, no unfairness to the reseller would result. But while that analysis may be reasonable with

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[1] New York Telephone's Initial Brief, p. 33.

[2] Id.

[3] AT&T's Initial Brief, p. 15.

regard to the postage meter--an issue we do not reach here--advertising cannot be seen as such a fixed cost and we cannot agree with New York Telephone that it should be regarded as anything other than at least partly avoidable.

To sum up: at this stage of our analysis, staff's approach to setting temporary rates emerges as both lawful and reasonable, and we adopt it in principle as a basis for setting temporary rates. That decision, however, should not be taken as implying a permanent decision on the underlying issues of theory and method. In particular, we should not be understood to endorse AT&T's claim that staff's study adopted its method; and the use we are making of staff's study should not be taken to imply endorsement of AT&T's approach. Similarly, our adoption of staff's method as our starting point eliminates the need in this expedited process to consider many of the specific objections leveled by the parties against each other's studies; but our silence on those issues should not be taken as tacit endorsement of one view or another.

Specific Cost Items

Staff's study identified a series of cost areas in which it disputed New York Telephone's claim of non-avoidability. New York Telephone continues to maintain the costs are non-avoidable; AT&T and MCI contend they are avoidable to a greater extent than staff believed and criticize staff's study in several other areas. These issues are discussed in order.

1. General and Administrative Expense

In their respective studies, New York Telephone regarded General and Administrative (G&A) expenses as non-avoidable while AT&T believed that 13.5% of the expenses would be avoided. AT&T offered two justifications for its position: statistical studies showing that the level of G&A expenses varies by company size (its premise being that wholesale provisioning of local services would reduce New York Telephone's overall size); and the assertion that 13.5% represented the ratio of retail function investments to total company investments. Staff endorsed the first of AT&T's justifications, finding it unrealistic that no G&A expenses would be avoided, and it selected 5% as an estimate of the avoidable G&A expenses.

Referring specifically to this item, New York Telephone renews its general claim that the advent of resale will simply shift the deployment of assets from retail to wholesale functions but will not reduce the company's total output or change its overall size. Consistent with its overall approach, New York Telephone therefore denies that any G&A costs will be avoided.

AT&T, for its part, contends the proper avoidance factor is "at least 25%."[1] Suggesting that New York Telephone maintains a bloated overhead that would be reduced by competition and that in any event, should not be paid for by the company's competitors, AT&T's witness asserted that New York Telephone annually expends $139 per line for Corporate Operations while the Bell company average was only $74. On the premise that G&A expenses would be removed from the business at the same rate as direct expenses would be avoided, AT&T's witness calculated a 27.8% avoidance factor.

AT&T's arguments that 5% avoidance is too conservative may be considered further in the permanent phase. For now, it is a reasonable placeholder.

2. Network Support

On the basis of an analysis of proprietary New York Telephone data, staff estimated that 10% of land/buildings, furniture/artwork, office equipment, and general computer expenses, and 5% of motor vehicles expenses, were avoidable; this was consistent with AT&T's assessment that 12.7% of the ARMIS network support account was avoidable, and staff therefore accepted AT&T's estimate. New York Telephone challenges this view on the same theoretical grounds raised with regard to G&A expense and argues that no network support expense is avoidable.

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[1] Tr. 209.

But that argument remains unpersuasive, and staff's judgment with regard to the data appears reasonable.

3. Product Management, Sales, and Advertising

AT&T asserted that these expenses were 100% avoidable while NYNEX regarded only certain sales expenses as avoided. Staff estimated that product management expense was 20% avoidable and that sales and advertising expenses were 50% avoidable but, in the absence of sufficient information to assess the avoidable portion accurately, based its recommendation on an analysis that used maximum and minimum plausible avoided cost projections based on proprietary NYNEX data.

New York Telephone in brief reiterates its theoretical objections to regarding these indirectly affected expenses as avoidable; its specific observations with regard to advertising have been noted above. AT&T, on the other hand, argues that what it characterizes as staff's compromise does not go far enough inasmuch as New York Telephone will provide no marketing or product development services to AT&T as a reseller nor will it advertise to resellers any more than it advertises access services to interexchange carriers. In AT&T's view, unless nearly 100% of advertising and sales expense is removed from the wholesale rate, New York Telephone's retail competitors would effectively be required to pay for advertising that is used against them.

While AT&T's arguments suggest staff's view is, if anything, conservative, it remains a fair estimate for purposes of setting temporary rates.

4. Depreciation

AT&T argued for the avoidability of 13.5% of depreciation expense for total general support equipment; New York Telephone regarded depreciation expenses as non-avoidable. Staff adopted a figure of 10% of depreciation expenses associated with building and computers, consistent with the 8.6% of total general support depreciation expense identified in the AT&T study.

New York Telephone again argues that resale will not reduce the size of the company and that, in any event, a reduced need for buildings and computers would neither reduce its depreciation expense nor warrant exclusion of the expense from resale rates. AT&T responds that the company’s treatment of existing plant as "sunk" shows its method is not long-run or forward-looking.

Given a broader view of avoidability than New York Telephone’s, staff’s judgment appears to be reasonable.

5. Uncollectibles

Staff agreed with AT&T that 100% of uncollectible expense related to the services at issue would be avoided in a wholesale environment inasmuch as resellers would be responsible to the wholesale provider for all payments on account of their customers’ usage. It criticized New York Telephone’s study for reflecting uncollectibles as a net against revenues, suggesting that had the effect of treating 0% of uncollectible expense as avoidable.

New York Telephone maintains that it did consider uncollectible expense to be avoidable but did so, consistent with its treatment of uncollectibles as an offset against revenues rather than as an expense, by reducing the denominator instead of increasing the numerator of the avoided cost/revenues fraction. It goes on to argue that its treatment of uncollectibles as, in effect, 100% avoidable is conservative, inasmuch as some level of uncollectibles can be expected even from wholesale customers. It notes in this regard that its relationship with its access charge customers--cited by AT&T as demonstrating the absence of uncollectibles in a wholesale environment--has been marked by "negotiated bill adjustments between [New York Telephone] and interexchange carriers [that] take the place of what in the retail market would become uncollectibles."[1] It therefore denies that the risk of uncollectibles in the wholesale environment is zero, though in the absence of definitive data, it conservatively assumes that to be the case.

In its reply brief, AT&T raises a different aspect of the issue, contending that treating uncollectibles as an offset to revenues rather than as an expense, thereby reducing the denominator instead of increasing the numerator of the cost/revenue fraction, affects the calculation in a manner that reduces the computed avoidable cost percentage.

New York Telephone’s treatment of uncollectibles does regard them as avoidable, but AT&T’s critique of the offset-against-revenues computation is proper. Staff properly treated uncollectibles as an avoidable expense.

<u>Cost Onsets</u>

Staff’s study recognized that New York Telephone’s introduction of wholesale local services "will require new features and systems specifically designed to support the effective provisioning of wholesale service to competitors."[2] It cited as examples systems that provide electronic interfaces for service order processing, trouble administration, credit and collections, and billing and usage detail. The study agreed generally with New York Telephone’s proposal to recover these costs on a transaction-specific basis rather than as an offset to the wholesale discount; it reasoned that doing so would permit competitors to determine which features and administrative activities they desired to purchase. Several issues relating to cost onsets have been raised, including whether, how, and to what extent they should be recovered.

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[1] New York Telephone’s Reply Brief, p. 14.

[2] Staff Study, pp. 8-9.

1. Arguments

a. Recoverability of Cost Onsets

AT&T and MCI object to allowing New York Telephone to recover its cost onsets. AT&T distinguishes two categories of cost onset: the network reconfiguration costs incurred to design and put into place the electronic interface systems that permit wholesaler and reseller to serve end users efficiently; and those of a more recurring nature, associated with actual service operations, including the ordering of service and its provisioning by New York Telephone on behalf of its resellers. Denying that the first category of costs are "caused" by resellers, AT&T views them as costs of carrying out the network restructuring that New York Telephone must accomplish as a condition for entering the interLATA toll market; it notes as well that the Telecommunications Act makes no reference to cost onsets. Like intraLATA presubscription (ILP) costs, AT&T asserts, these cost onsets should be seen as an "entry fee" to be borne by the regional Bell operating companies. AT&T adds that all players, resellers included, will incur industry restructuring costs that benefit the market as a whole and that any recovery of these costs should be from carriers on a per-line basis, "as was done in the interexchange marketplace with the transitional network reconfiguration charge."[1] As for the second category of costs, AT&T agrees that they should be recovered in appropriate charges but argues that those charges should be set at incremental cost.

New York Telephone responds that AT&T’s first category of cost onsets result not from New York Telephone’s desire to enter the interLATA market but from obligations imposed on incumbent local exchange carriers, by both the Commission and the Telecommunications Act, regardless of whether they intend or attempt to enter the interLATA market. To AT&T’s point that the Act makes no reference to cost onsets or net avoided costs, New York Telephone responds that in its view, the most reasonable

[1] AT&T’s Initial Brief, pp. 31-32.

meaning of "avoided cost" is "net avoided cost" and that nothing in the Act preempts the normal ratesetting process with respect to cost onsets. Cost onsets incurred by resellers, New York Telephone continues, are market oriented, motivated solely by profitability; but New York Telephone’s are mandated, making denial of recoverability confiscatory. Finally, New York Telephone disputes AT&T’s analogy to recovery of network configuration costs in the interexchange marketplace, preferring the analogy of ILP costs, which the Commission determined should be borne solely by interexchange carriers.

With regard to the second category of cost onsets, New York Telephone sees no need to limit the charges to incremental costs and believes that these, like others, may include a reasonable level of contribution.

MCI, meanwhile, asserts that resale implementation costs should be recovered out of the margin remaining in the wholesale rate. It argues that firms in competitive markets recover start-up costs, if at all, by increasing (to the extent the market permits) the margin over recurring costs reflected in their prices; and it maintains that a separate recovery mechanism for cost onsets would constitute double recovery.[1] In addition, MCI argued that requiring New York Telephone to absorb cost onsets would provide a necessary incentive to keep those onsets to a minimum.[2]

To MCI’s proposal that cost onsets be recovered out of the contribution remaining in wholesale rates, New York Telephone responds that not all of its wholesale rates will be contributory. Even for contributory services, it goes on, the wholesale price that maximizes efficiency is equal to retail price less avoided cost, and reducing that price by denying recovery of cost onsets would be economically inefficient. Finally, it says any incentive New York Telephone might have to

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[1] MCI’s Reply Brief, p. 6.

[2] Tr. 246-247.

inflate its cost onsets would be kept in check by the review in this proceeding of New York Telephone’s cost studies and by the incentives provided by the Performance Regulation Plan and competition.

b. Manner of Recovery

Perhaps because they direct their efforts to denying that cost onsets should be recovered at all, no party takes issue in brief with New York Telephone’s more specific proposal that they be recovered through a separate charge rather than as an offset to the discount.

Developing its position more fully, New York Telephone contends that if it were not permitted to recover cost onsets, they would be recoverable as an exogenous cost in the rates for non-basic services under the terms of the company’s Performance Regulation Plan.[1] Attempting to strike a compromise between imposing on resellers the cost onsets and imposing that burden as an exogenous cost on ratepayers who are not responsible for its incurrence, the company proposes to recover only a portion of its cost onsets from resellers and the remainder from non-basic ratepayers generally as an exogenous cost. The specifics of the company’s proposal are discussed below.

c. Magnitude of Cost Onsets

New York Telephone sees three types of cost onsets associated with the advent of resale: (a) one-time, up-front systems development costs; (b) systems maintenance costs; and (c) costs resulting from the operation of [its] resale customer

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[1] The Plan freezes rates for basic services, but provides, subject to specified procedures and limitations, for an annual increase in the prices of non-basic services to reflect "exogenous changes." These changes are limited "to the effects of: (a) jurisdictional separations rules changes; (b) PSC mandates (excluding revenue effects of market share loss); [and] (c) legislative tax changes affecting only utilities." (Plan, §IV(G)(3).) New York Telephone presumably considers cost onsets to represent the effects of a "PSC mandate."

contact center.[1] The system development costs are those associated with new information system programming that the company asserts is needed to permit the company and resellers to exchange resale service order, trouble reporting and testing, and billing information. The systems maintenance recurring expense pertains to maintenance and administration of these electronic interfaces. The resale customer contact center will process reseller service orders that cannot flow through the electronic interfaces, handle inquiry functions, and collect overdue account balances. On the basis of specified estimation procedures, the company calculates one-time costs of $21.6 million in expense and $11.6 million in capital costs and annual recurring expenses of $14.1 million.[2]

2. Discussion

Of all the issues discussed with respect to cost onsets, only two are ripe for decision now: specific costs incurred to serve specific resellers in specific transactions (AT&T's second category) should be borne by the resellers affected[3]; and other cost onsets, to the extent they are recoverable at all, should be recovered through separate charges rather than as an offset to the discount. Decisions on the remaining issues require, among other things, strictly audited information on the level of costs involved, and since the costs, for the most part, are still to be incurred, that information remains to be developed. We need not, and do not, decide now such questions as to whether any recovery should be from resellers only or from customers more generally, or how cost

1 New York Telephone's Initial Brief, p. 36.

2 Ibid., p. 37.

3 Whether the price charged those resellers must be limited to incremental cost (as AT&T maintains) or may include contribution (as New York Telephone proposes) is among the issues here left open.

onsets should be viewed pursuant to the exogenous change provisions of the Performance Regulation Plan.

We anticipate dealing with such matters in the permanent phase, to the extent the needed information is available. Meanwhile, the temporary rates set pursuant to today's decision will make no provision for recovery of cost onsets (except for the transaction-specific costs noted above).

Application of the Discount

In its study, staff disaggregated its 15% overall discount to a discount of 17% on residence access lines and 11% on business access lines. New York Telephone offers a more detailed "rate design," including a two-year phase-in, to which other parties object.

On the premise that some cost avoidances are associated with a customer's total account while others relate to individual features, New York Telephone proposes to apply the avoided cost discount in two ways: in part through a per line credit applied to the local exchange line charge, and the remainder as a uniform discount across all feature and usage charges except for the end user common line charge ("EUCL"), Centrex recurring charges, and private line charges. Because this structure permits a portion of the discount to be realized without regard to volume of usage, New York Telephone asserts, it will permit resellers to market their services to lower-volume users that might otherwise not be attractive. With respect to Centrex and private line, New York Telephone says they will be available for resale but that orders will be processed manually, rather than through new automated interfaces and, accordingly, virtually no costs will be avoided. It adds that EUCL was excluded because it is an interstate cost recovery mechanism rather than an actual service.

Asserting as well that cost avoidances will be realized over time, as the resale market grows, New York Telephone proposes a two-year, three-step phase-in of the discount, which would be introduced on October 1, 1996, raised on October 1, 1997, and increased to its full level on October 1, 1998. The staff study opposed the phase-in as inconsistent with our direction that the discount reflect a long-term view of avoided cost, but New York Telephone insists that its analysis captures all the costs that will be avoided in the long run, and that it would be unrealistic to fail to recognize that the full level of long-run cost avoidance will not be achieved immediately.

With respect to cost onsets, New York Telephone proposes a surcharge of 20¢ per resold line per month for one year to recover the resellers' share of system establishment costs; the remainder, as noted above, would be treated as an exogenous cost to be recovered from all non-basic service ratepayers under the company's regulatory plan. To recover recurring costs of maintaining the service center for resellers and the electronic interface system, the company proposes a per-line account maintenance charge of 37¢ per month, based on the estimated costs for the fifth year of operation rather than the higher cost level in the transitional first four years. New York Telephone notes that other non-recurring charges for transactions might have to be developed as resellers make specific requests for services.

In its reply brief, AT&T characterizes the phase-in as an effort on New York Telephone's part to slow down its competitors as much as possible and urges summary rejection of the proposal as unsupported. It adds that pricing policy generally should be decided in the permanent phase of the proceeding.

MCI maintains that the Telecommunications Act requires the discount to be applied uniformly to all charges, including the retail access line rate and including private line and Centrex charges. It disputes the company's view that cost avoidance relates solely to the automated interfaces that will handle orders from resellers and suggest that sales, marketing, and advertising expense will be avoided in connection with private line and Centrex as well.[1]

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

As noted, the staff study rejected New York Telephone's phase in, and the company has not argued persuasively in its favor. The long-term view of avoided costs requires immediate implementation of the full discount, whatever it may be.

As for Centrex and private line service, the February 1 order tentatively determined that they should be excluded for now from the discount, the staff study proceeded on that basis (omitting both costs and revenues associated with those services from the discount calculation), and we seen no need to change that result for purposes of setting a temporary rate. This issue, too, may be revisited in the permanent phase.

Accordingly, the temporary wholesale discount, at the level recommended in the staff study, should be applied to all voice-grade access lines and related features and usage services, except for (1) Centrex, private line, PBX, and coin telephone services, and (2) promotional offerings.[1]

Conclusion as to Temporary Wholesale Discount

For the reasons discussed above, and with the understanding that we have reserved judgment on many of the underlying issues, we are satisfied that the results of staff's evaluation of the data provide a lawful, reasonable, and suitably cautious basis for setting a temporary wholesale discount, subject to refund or reparation. We emphasize our expectation that these rates will be in effect only briefly, and will yield in a matter of months to the permanent rates to be set in October.

[1] New York Telephone has been authorized to exclude promotional offerings and public coin service from resale. Cases 94-C-0095, et al., Order Declaring Resale Prohibitions Void and Establishing Tariff Terms (issued June 25, 1996), pp. 10-12.

UNBUNDLED LINKS

Background and Context

As recounted in the staff study, the dispute here centers on whether unbundled links should continue to be priced on the basis of embedded costs, as New York Telephone urges, or should be reduced to reflect only incremental costs, as most other parties favor.[1] The current link rate, which became permanent in March 1995, is $24.75, comprising an embedded cost of $22.85 and a "service access charge" (SAC) of $1.90.[2] The staff study expressed concern that certain expenses were inappropriately included in the embedded cost figure and recommended that the link rate be made temporary and that it be reduced as soon as possible by the amount of any costs that were not incurred in the wholesale provisioning of links.

Also pertinent to this issue is the standard set in the Telecommunications Act for pricing unbundled network elements such as links. The standard, set forth in §252(c)(1), is that the price be "based on cost (determined without reference to a rate of return or other rate base proceeding) . . . non-discriminatory, and . . . may include a reasonable profit." The parties disagree on whether that provision precludes pricing on the basis of embedded costs.

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[1] The case also encompasses unbundled ports, but they received little attention from the parties. They are relatively low-priced, are used by few customers, and have not been the subject of complaint. Accordingly, we have no basis for acting on port rates now, even by making the existing rates temporary, though the matter may be considered further in the permanent phase of the proceeding.

[2] New York Telephone's Initial Brief, p. 51, n. 71. The SAC is a charge separate from the rate for a "link" and it recognizes the additional (incremental) costs of re-routing links from their normal termination points (on the main distribution frame in the New York Telephone central office (CO) to a new termination point nearer the competitor's collocated "cage" in the same CO. It is a new cost, incurred only when the link is rerouted.

Positions of the Parties

1. New York Telephone

New York Telephone asserts it is entitled to recover in its link rates the full embedded cost of the links but suggests, as a less preferred alternative, that if recovery of embedded cost is not permitted, the link rate be set at long-run incremental cost plus an allocation of joint and common costs.

In arguing for recovery of embedded costs, the company maintains that to ignore embedded costs would violate the regulatory compact, denying investors recovery of costs that have been prudently incurred and that would have been recoverable under prevailing regulatory policies. It would also impose "enormous social costs" on telephone customers insofar as local exchange companies faced diminished incentives to invest in their networks and higher costs of capital.[1] Even under the Performance Regulation Plan, it argues, under which prices are not affected by costs actually incurred over the life of the Plan, the traditional entitlement to recover embedded costs "was taken into account in establishing the initial rates and the price reduction commitments specified in the Plan, and in its exogenous cost recovery provisions."[2] The company adds that recovery of embedded investment is particularly important inasmuch as its competitors have the option but no obligation to use the incumbent LEC’s links. Setting the link price at conventionally determined incremental cost, New York Telephone maintains, would afford its competitors that option for free.

New York Telephone recognizes that a link price based on embedded costs may exceed the bundled retail loop rate. Rejecting the suggestion that this result is anti-competitive (by reason of making it difficult if not impossible for a competitor forced to purchase New York Telephone’s links to price its own services at a level below New York Telephone’s retail rate), New

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[1] New York Telephone’s Initial Brief, p. 44.

[2] Ibid., p. 45.

York Telephone insists that as long as the LEC supplies links on a non-discriminatory basis and effectively charges itself, by imputation, the same price for a link that it charges its competitors (adjusted for any difference in the cost of supplying the link to itself), pricing the link above cost would not be anti-competitive.

New York Telephone maintains as well that embedded cost pricing is consistent with the Telecommunications Act. Citing the statute's reference to a "just and reasonable" rate for unbundled network elements,[1] it notes that wording is identical to the provision of the Communications Act of 1934 that, it says, has always been interpreted to allow local exchange carriers a reasonable opportunity to recover actual costs of service, including a return on investment and a reasonable allocation of joint and common costs. It points as well to the allowance of cost plus "a reasonable profit," arguing that a carrier cannot make a profit on the service unless it is able to recover all of the costs that it actually incurs. Finally, it points to a separate provision, relating to transport and termination of traffic,[2] which, in its view, uses different wording in referring to incremental costs. In sum, it maintains, "the Act does not include any language that would require, or even permit, a LEC's actual costs to be ignored in setting ceilings for network element rates."[3] It understands the clause that specifies that the rate be set "without reference to a rate of return or the rate base proceeding" as meaning only "that price determination under the act need not follow the full panoply of procedural and substantive rules associated with rate of return ratemaking."[4]

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[1] 47 U.S.C. §252(d)(1).

[2] 47 U.S.C. §252(b)(2).

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

[4] Id.

New York Telephone goes on to argue that its cost studies provide a proper basis for setting link rates. It contends they comply with the cost manuals approved by the Commission in March 1995[1] and that, accordingly, alternative methods, including the TSLRIC approach advocated by other parties, should not be considered here. It also rejects the staff study's suggestion that certain cost elements should be excluded in setting the rate, asserting that staff misunderstood the company's response to staff's inquiries on these matters. According to the company, its new studies, submitted on May 15, show an embedded cost for links of $27.10 per month, which would support a rate even higher than that now in effect. It does not propose to increase the rate on that basis; but inasmuch as embedded costs have gone up rather than down since the existing rates were approved, the company concludes, there is no basis for making the rates temporary.

In the alternative, New York Telephone argues that if it is not permitted to recover embedded costs, the link rate should be set at long-run incremental cost pursuant to its incremental study, plus an allocation of joint and common costs. It argues that requiring a firm to price its services at incremental cost without providing any mechanism for recovering common costs would "rapidly lead to bankruptcy."[2] It suggests that a rate computed along these lines would comprise a long-run incremental cost of $14.51 per month, and a common cost allocation of $4.81 per month, making a total rate of $19.32 per month, to which an SAC charge would be added. (If the SAC charge remained $1.90, the total charge would be $21.22)

Finally, the company suggests that non-recurring link charges be increased consistent with the higher than previously estimated costs shown in the recent study with regard to servicing, provisioning, installation, dispatch, and completion.

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[1] See Case 89-C-0198, letter dated July 13, 1995 from Secretary John J. Kelliher to all local exchange carriers.

[2] New York Telephone's Initial Brief, p. 48.

2. MFS

Urging adoption of a rate based on incremental costs, MFS characterizes the existing $24.75 rate as "grossly excessive"[1] and as based on an outdated, discredited, embedded cost method that is contrary to the Telecommunications Act as tentatively construed by the FCC. It points to the FCC's statement, in its Notice of Proposed Rulemaking under the Telecommunications Act, that §252(d)(1) "precludes states from setting rates by use of traditional cost of service regulation, with its detailed examination of historical carrier costs and rate bases."[2] It argues that this price stands in the way of an efficient market, which requires prices based on long-run incremental costs; establishes entry barriers even to competitors that can provide the other elements of local exchange service more efficiently than New York Telephone; and wastes resources by encouraging entrants who can provide their own links for less than $24.75 a month to do so, even if their costs exceed New York Telephone's incremental costs, thereby needlessly stranding New York Telephone's link investment.

MFS goes on to argue the benefits associated with facilities-based competition rather than resale and argues that establishing a temporary wholesale discount for resellers while leaving the current link rates in place on a permanent basis would create unwarranted and uneconomic incentives to compete via resale rather than via facilities-based offerings.

Responding to New York Telephone's references to the traditional regulatory compact, MFS observes that the opportunity to recover embedded costs applies to utility revenues in the aggregate and not to rates for individual services, some of which have been priced above embedded costs and others below it. Similarly, MFS contends that New York Telephone's argument that recovery of common costs is needed to avoid bankruptcy is true on

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[1] MFS' Initial Brief, p. 4.

[2] Ibid., p. 5, citing CC Docket No. 96-98, Notice of Proposed Rulemaking (April 19, 1996), Par. 123.

a company-wide basis but does not require that every service bear a portion of common costs. In any event, it continues, a properly computed total service long-run incremental cost would include much of what New York Telephone now considers common costs. MFS disputes as well New York Telephone's construction of the Telecommunications Act, arguing the Act must mean that traditional pricing standards are not to be used and that the cost of an unbundled network element is to be "a true cost based on economic principles, rather than an artificial regulatory 'cost' based on historical accounting principles. This standard requires the use of incremental costs."[1]

Turning to the specific level of the link rate, MFS proposes a temporary rate of approximately $7.00 in the New York Metro LATA and $12.00 in the rest of the State. It bases this recommendation on New York Telephone's incremental cost study, which showed incremental costs of $12.86 for business links and $15.56 for residential links--figures that MFS regards, without further analysis, as serving only as the upper bound of New York Telephone's incremental costs. It refers as well to incremental cost data and negotiated link rates submitted in other jurisdictions, all of which, in its view, show its proposal to be appropriate. It suggests, as well, that if class of service deaveraging is desired, the business rates could be decreased by $1.00 and the residential rates increased by $1.00 from the average for each LATA.

Finally, MFS objects to New York Telephone's proposed increase in the non-recurring links charge, arguing that it is a matter to be taken up in the permanent phase of the case inasmuch as it is based on cost studies that have not been subjected to adequate review.

3. <u>AT&T</u>

Citing various statements by staff and the Commission assertedly favoring incremental cost-based pricing of links, as

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[1] MFS' Reply Brief, p. 4.

well as the language of the Telecommunications Act, AT&T concludes that "the propriety of the existing link and port rates, based as they are solely on embedded costs[,] is, at the very least, suspect."[1] In view of the time and litigation needed to determine the incremental costs of unbundled network elements, AT&T favors lowering the existing rates and making them temporary. Contending that the existing rates constitute a barrier to facilities-based entry, it contends that making them temporary would ameliorate the situation slightly and making them temporary at a level consistent with incremental costs would be substantially better. While it believes New York Telephone’s study to overstate incremental costs, it regards that study’s results as closer to actual incremental costs than are the existing embedded-cost-based rates, and it favors temporary link and port rates at the levels set forth in New York Telephone’s long-run incremental cost submission.

In its reply brief, AT&T characterizes New York Telephone’s reliance on the regulatory compact as misplaced, contending that the company at its own request was freed from rate of return regulation by its Performance Regulation Plan. It takes issue as well with New York Telephone’s reading of the Telecommunications Act and it argues that the proper method for setting link rates is based on TSLRIC, contending that an efficient firm that recovers TSLRIC will prosper without regard to recovery of embedded costs.

4. MCI

MCI also regards embedded-cost pricing of links as inconsistent with the Telecommunications Act and as creating a substantial barrier to competition in the local exchange market. It urges that a temporary rate be set on the basis of TSLRIC, a method that allows New York Telephone to recover costs plus a reasonable profit inasmuch as a reasonable profit is included in TSLRIC. It objects to relying on New York Telephone’s calculated

[1] AT&T’s Initial Brief, p. 33.

$14.34 incremental cost, noting that it is twice the figure reported by New York Telephone's affiliated company in Massachusetts, where marginal costs for residential and business links were calculated by NYNEX as being $7.53 and $5.37, respectively. MCI suggests an interim rate that uses the Massachusetts cost data, increased by 10% to account for variations between the marginal cost method used in Massachusetts and TSLRIC. The resulting temporary monthly rate would be $8.50 for residential links and $6.00 for business links.

In its reply brief, MCI disputes New York Telephone's regulatory compact argument on grounds similar to those cited by AT&T.

5. Sprint

Sprint favors a temporary link rate based on TSLRIC, but would allow New York Telephone incremental cost plus a fair allocation of joint and common costs. It suggests allowing a level of contribution to joint and common costs that reflects costs of an economically efficient local exchange carrier, but not to exceed 15%.

6. NYCHA

Referring to the incremental cost data filed in other jurisdictions, NYCHA supports a link rate in the range suggested by MFS.[1]

Discussion

Having reviewed the arguments presented, we can identify at least three potential bases for requiring New York Telephone to reduce its link rate: a decision that New York Telephone's embedded costs are overstated; or a decision that the link rate should be based on incremental cost; or a judgmental

[1] In so doing, however, NYCHA specifically disassociates itself from MFS' suggestion that staff's proposed wholesale discount is excessive.

decision that a balancing of regulatory goals (including the proper encouragement of competition) requires a link rate above incremental but still below embedded cost. On the other hand, New York Telephone asserts, in arguments still to be probed, that a link rate properly based on embedded costs would be higher than the current rate.

In these circumstances, the link rate clearly should be made temporary pending further examination. And, in view of the various factors suggesting the current link rate may eventually be found too high, the temporary rate should be reduced somewhat from the present level, consistent with the goal of having the temporary rates approximate, to the extent possible, the likely permanent rates. This is not to say that the permanent rate necessarily will be reduced from current levels, but only that our current review of the arguments and evidence suggests a likelihood of that happening.

Accordingly, we adopt, as a fair temporary rate level, New York Telephone’s alternate proposal, based on its incremental cost study. That represents a move in the direction that appears likely, and New York Telephone’s willingness to offer the proposal, even as a less-favored alternative, suggests the move is a suitably cautious one. We stress, again, that in setting rates in this way, we do not imply any endorsement of New York Telephone’s method nor do we reach the underlying issues of how embedded and incremental costs should be reflected in setting link rates or of whether New York Telephone’s cost studies are sound. We will deal with those matters in the permanent phase, and for now we simply adopt the number in New York Telephone’s alternative proposal as a fair temporary rate, given our judgment, on a variety of grounds, that some reduction in the current rate may prove warranted. Should our decisions on those issues yield a permanent rate that differs from this, parties will be protected by the availability of refunds and reparations.

The Commission orders:

1. By not later than five days after the issue date of this opinion and order, New York Telephone Company shall file tariff amendments consistent with the foregoing opinion setting temporary rates, pursuant to Public Service Law §§113 and 114, for the services and network elements discussed in that opinion, to the extent those services and network elements are available pursuant to existing tariffs and applicable Commission orders. A copy of the compliance filing shall be served on each active party to this proceeding. The tariff amendments shall take effect on one day's notice and shall specify that the rates there described are temporary, subject to refund or reparation. The requirement of the Public Service Law and 16 NYCRR §530.70 for newspaper publication of the amendments directed by this ordering paragraph is waived.

2. New York Telephone Company shall maintain accurate records of its billings at the temporary rates put into effect pursuant to this opinion and order, sufficient to provide a basis for determining any refunds or reparations that may be needed upon the approval of permanent rates, and shall make all such records available to the Commission's staff upon its request.

3. These proceedings are continued.

By the Commission,

(SIGNED) JOHN C. CRARY
Secretary