

1 **RATE DESIGN**

2

3 ***Local Service Rates***

4

5 **Q. What do the Companies propose in regard to local exchange services?**

6

7 A. The Companies' requested changes are summarized on pages 39 and 40 of Mr.

8 Chopp's testimony:

- 9
- 10 1. Eliminate Outside the Base Rate Area (OBRA) Charges.
- 11 2. Increase GTE'sW Residence Low Income Telephone Assistance Plan (LITAP)
- 12 discount from \$3.50 to \$4.50 to match the current Contel discount.
- 13 3. Eliminate Seasonal Service Discount.
- 14 4. Merge the rates and apply residual rate treatment.
- 15 A. Merge GTE'sW to Contel structure
- 16 B. Use Contel usage structure for merged offering
- 17 C. Grandfather multiparty service to existing customers

18 [GTE, Chopp Testimony, pp. 39-40.]

19

20 **Q. What is the effect of these changes on revenues?**

21 A. Overall, revenue will be decreased by \$686,000 as a result of these changes. The bulk

22 of this change (\$666,000) comes from the elimination of OBRA charges. The increase

23 in the LITAP discount results in an \$11,000 reduction, while elimination of the Seasonal

24 Service Discount results in a \$20,000 increase. Merger of the GTE and Contel rates

25 and related residual rate treatment result in an additional \$28,000 reduction.

26

1 **Q. Would you please discuss the Companies' proposal to merge their rate**
2 **structures?**

3 A. Yes. The Companies' have proposed to use Contel's rate structure as the basis for a
4 merged tariff applicable to both companies. For instance, Contel's use of a single rate
5 for one-party, PBX, and Key customers will be adopted, rather than GTE's
6 differentiated rates. As well, GTE will no longer divide its customers into two Rate
7 Groups with different rates. Other changes that relate to merging the two rate structures
8 include the simplification of GTE's usage rate structure, the elimination of multiparty
9 service for new customers, and elimination of a separate rate for GTE residential key
10 system customers.

11
12 Although the overall effect of the Companies' local rate design proposals is a reduction
13 in revenue, the proposed merger of rate structures causes several rate classes to
14 experience rate increases which, in my opinion, are not justified. I disagree with some
15 other aspects of the proposed rates as well.

16
17 **Q. Could you please explain the first of these disagreements?**

18 A. Yes. I fundamentally disagree with the Companies' proposed rate increases for
19 residence basic local service. As shown on Schedule 2 of my exhibit, most of GTE's
20 existing residential customers will experience a significant rate increase if the
21 Companies' proposals are accepted. Rate Group I One-party R1 flat rate customers
22 will experience a 31% increase in their monthly rate while this Group's measured
23 service customers will see an 8.5% increase. GTE has proposed to increase its LITAP
24 discount, which provides some relief for its low income customers. However, after the
25 effects of the rate merger are considered, Rate Group I measured rate LITAP
26 customers will receive a 19% increase in their rate, while flat-rate LITAP customers

1 will get a 31.7% increase. From a policy perspective, there are several problems with
2 these proposals.

3
4 **Q. Would you please explain the first of these problems?**

5 A. Yes. These increases will have an adverse impact on universal service. As price
6 elasticity studies conducted in other jurisdictions have shown, if local rates increase
7 substantially, universal service will be adversely affected. The proposed increases in
8 basic local service could force some customers off the network and discourage
9 potential subscribers from joining. To be sure, the demand for local exchange service is
10 less sensitive to price changes than is the demand for toll and other discretionary
11 services; nevertheless, studies have shown that local rate increases can induce a decline
12 in telephone subscribership, contrary to the goal of universal service.

13
14 Furthermore, even if they remain on the network, local customers may suffer as a
15 consequence of paying substantially higher rates for local telephone service. If forced to
16 spend a larger portion of their income on basic telephone service, local customers have
17 less income available to pay for other living expenses, such as electricity, gas, clothing,
18 food, etc. This effect can be particularly detrimental to ratepayers on fixed incomes
19 (e.g., retirees) and others with little discretionary income.

20
21 The effects of high local rates can be even more severe in the long term. If the initial rate
22 hike should cause the number of subscribers to drop, the value of telephone service
23 would decline for the remaining subscribers. At the same time, with fewer customers on
24 the network, those remaining would have to pay a higher portion of the utility's fixed
25 costs, resulting in further increases to their rates, additional departures from the
26 network, and so on. This double spiral of increasing rates and declining subscribership
27 and service value would obviously run counter to the public policy objective of

1 universal service, to the detriment of telecommunication customers and society in
2 general.

3
4 **Q. Would you please explain the second problem with the proposed rate**
5 **increases?**

6 A. POTS--plain old telephone service--is an essential service in every sense of the word.
7 Not only is it a social and business necessity, but it also creates profit for the
8 Companies by enabling them to sell various add-ons at a high markup.

9
10 Gillette used to practically give away the razor in order to make money on razor blades.
11 Polaroid sells inexpensive cameras and cleans up on film. As any car dealer knows,
12 most of the profit margin is in the options. For the phone company, the biggest profit
13 margins are in enhanced services, which cannot exist without POTS. Therefore, it is
14 economically reasonable to keep basic rates very low. The Companies earn large
15 amounts from intrastate toll, interstate access, custom calling, and other add-on services
16 which arise when additional customers join (or remain on) the network. It is penny-wise
17 and pound-foolish to discourage customers from buying basic service by imposing
18 substantial price increases in a context where overall revenues are excessive.

19
20 The problem with this pricing strategy will become more apparent if the local exchange
21 market is opened to competition and cable television or other firms attempt to gain a
22 large share of the market. Some potential entrants may be attracted by the margins to
23 be earned on switched access service and by the convenience of generating large
24 revenue streams from a handful of customers (e.g., AT&T, MCI, and Sprint).

25 Nevertheless, to provide any significant volume of originating and terminating switched
26 access to residential customers, even those entrants who are seeking profits in the
27 switched access market will find it necessary to convince large numbers of households

1 to sign up for service. New entrants may find it easier to gain market share if customers
2 have just experienced large increases in GTE's rates (particularly at a time when costs
3 are trending downward).

4
5 Stated another way, the residential exchange market is important not only for its direct
6 revenues but also for its indirect implications for other categories, such as custom
7 calling switched access, and toll. Precipitous increases in residential local rates would
8 not be desirable at this time, considering all of the uncertainties which exist concerning
9 the nature and extent of local competition in the future.

10
11 **Q. What is the third problem with local rate increases?**

12 A. From the standpoint of cost-based pricing, local rates today should be below where
13 they were a few years ago because of higher productivity (due mainly to technology but
14 also due to cost savings measures introduced by the phone companies.) Prices have
15 plummeted for computers, TVs, VCRs, telephone instruments, and other electronic
16 equipment. Network enhancements that once required new hardware and were labor
17 intensive can now be done by reprogramming and automated procedures. It is
18 reasonable to assume that both toll and local phone service should follow this
19 downward cost curve.

20
21 There is a danger in the Commission's accepting the implicit proposition that residential
22 rates have nowhere to go but up. As competitive pressures on GTE increase, the
23 pressure for some form of regulation other than rate of return-based rates will also
24 increase. Many local exchange companies are asking for--and some are receiving--
25 regulatory supervision in the form of price caps. Similarly, legislation which is currently
26 being considered in Congress calls for a movement away from traditional regulation.
27 The starting point of most price-cap proposals--the benchmark--is invariably the

1 current rate structure. The Commission should therefore be very cautious about
2 granting GTE local rate increases at this time.

3
4 **Q. What is the fourth danger in accepting the Company's rate proposals for
5 residence local services ?**

6 A. There is a danger to the long-established principle of rate continuity, which the
7 Company's proposals violate. Even in a proceeding in which a revenue increase is
8 required (which the instant docket is not) a rebalancing of rates, where merited, should
9 be gradual. This is consistent with traditional ratemaking principles, which include the
10 notion that drastic increases are unfair and unreasonable.

11
12 **Q. Returning to your discussion of your disagreement with the Companies'
13 proposal to merge rates and structures; what is your second disagreement?**

14 A. The merger has the effect of narrowing the differential between lower valued residence
15 service and higher valued business service. As shown on Schedule 2, while GTE is
16 proposing a 31% increase for its Rate Group I, base rate area flat rate residential
17 customers, GTE's base rate area flat rate business customers will experience only a
18 17% increase. In business Rate Group II, flat rate residential customers are to receive a
19 16.5% increase, while single-line business customers will get a less than 1% increase.

20
21 As shown on Schedule 3, Contel's urban flat rate residential customers will get a
22 proposed 17% reduction in rates, while urban flat rate business customers will get a
23 34% reduction.

24
25 It is widely recognized by regulatory commissions that, because of the higher cost and
26 value of business exchange service in comparison to residence, the rates for the former
27 service should be higher. This pattern of higher cost and value is a function of several

1 factors, most notably the typically higher level of usage per line by business customers.
2 Besides the usage-related cost and value differences, it is generally understood that
3 business users have a greater ability to absorb the cost of telephone service than
4 residential customers. Each of these factors supports the policy of higher rates for
5 business exchange customers. As I stated above, the Companies are proposing to
6 narrow the business/residence rate differential in this case.

7
8 The appropriate business/residential rate differential is ultimately a policy matter for the
9 Commission to decide. It should be evaluated in terms of the value of service, the
10 customers' ability to pay, the universal service goal, and other important policy
11 considerations. The Companies' proposal to alter the existing differentials has not been
12 adequately supported, in my opinion, and will impose an unnecessary burden on
13 residential subscribers.

14
15 Since the Companies have not offered adequate justification for their proposed
16 changes, I recommend that the existing business/residence rate relationships be
17 maintained.

18
19 **Q. What is your third disagreement with the Companies' rate structure merger**
20 **plans ?**

21 A. A merger of GTE's basic business service, key system, and PBX rates has been
22 proposed, despite the differences in usage and cost which apply to these different
23 categories. As shown on Schedule 2, while Rate Group I, single-line business
24 customers will get a 17% increase in rate, the merger of single-line, key and PBX rates
25 results in a less than 1% increase for flat rate key customers and a 27% reduction for
26 base rate PBX customers. Reductions are even greater for Rate Group II customers:

1 key and PBX customers will get 13% and 37.5% reductions, respectively. Cortel's
2 tariff already contains a uniform single-line, key and PBX rates.

3
4 Workpapers to Mr. Chappell's exhibit show considerable differences in usage among
5 the three business service categories. While single-party business lines carry an average
6 of ***** outgoing calls per month, key system and PBX lines carry *****
7 outgoing calls per month, respectively.

8
9 As discussed previously in my testimony concerning the Companies' cost-of-service
10 studies, the costs of each of these services is substantially different, due to these usage
11 differences. PBX service is nearly three times more costly to provide than ordinary
12 single line service, and key service is about twice as costly as single line service. These
13 discrepancies can and should be reflected in the rates.

14
15 The rationale for charging higher rates for customers with key and PBX systems is
16 based on the fact that the value of service and usage costs per line increase significantly
17 in a situation where there are numerous lines feeding into a single telephone system.
18 Cost and value increases result from the fact that each line in the system can be utilized
19 to a greater degree than could a typical single line standing alone.

20
21 I recommend that roughly the same differential between the three services that currently
22 exists in GTE's tariff be maintained. That is, an approximate 1.18 markup for key
23 systems over the rate for single-line service, and a 1.60 markup for PBX systems over
24 the rate for single-line service.

25
26 **Q. Turning once again to the Companies' proposal; can you discuss the OBRA**
27 **elimination in further detail?**

1 A. Certainly. GTE currently assesses an OBRA charge to customers who are outside the
2 base rate service area. Similarly, Contel offers Suburban options for many of its local
3 services. In most cases, these customers pay an additional \$3.00 above the rate paid
4 by base rate area, or urban, customers. Overall, about one third of Contel's residential
5 customers fall into the suburban category. GTE's residential local service customers
6 outside the base rate area will receive a \$167,000 reduction, while the business OBRA
7 customers will receive a \$188,000 reduction, because of this elimination. Contel's
8 suburban residential customers will receive a \$310,000 reduction, while its suburban
9 business customers will get a \$31,000 reduction. These reductions are isolated
10 specifically to the elimination of OBRA mileage charges and do not include the effects
11 (positive or negative) of the rate structure merger.

12

13 **Q. What is your reaction to the Companies' proposal concerning OBRA charge**
14 **elimination?**

15 A. I have no objection to this change. Admittedly, there is some cost justification for the
16 existing pricing scheme, since the cost of a long loop is generally higher than the cost of
17 a short loop. However, the actual pattern of costs is not precisely reflected in the
18 existing rate design. For instance, there can be instances where a central office (or
19 remote) is located at the edge of town, or within a suburb, and thus some customers
20 paying the higher rate may actually have a loop which is of average, or below-average,
21 length. In any event, loop costs are only one consideration in developing rates, and
22 those costs are partially recovered from other services, as well.

23

24 **Q. Do you agree with the proposal to eliminate GTE's existing rate group in**
25 **exchange for a single tariff?**

26 A. Yes. Local exchange rate groups are explained on sheet No. 1 of Section 6 of GTE's
27 current tariff. As described, "Local Calling Scope Rates are based on the number of

1 exchange access arrangements within the Exchange Area Boundary." Rate Group I
2 applies to Local Exchange Areas or EAS areas that contain 1 to 5848 arrangements,
3 Group II applies to those above 5848. In effect, the rate groups reflect the number of
4 people who can be called without paying a toll charge, and thus reflect a difference in
5 the value of service between smaller and larger calling areas. Given the small relative
6 differential in these rates, and the public policy goal of intercustomer equity, I
7 recommend that merger of the rate groups be permitted.

8
9 **Q. Do you agree with the Companies' proposal concerning the change in the**
10 **LITAP discount?**

11 A. I agree with the intent of the increase in the discount. Increasing the discount for low
12 income households tends to promote the public policy objective of universal service.
13 GTE proposes to increase its \$3.50 discount to \$4.50, thereby matching the existing
14 discount of Contel.

15
16 However, as discussed above, due to the rate merger, GTE's LITAP customers will
17 actually endure a significant rate increase. As shown on Schedule 2, the Tel Assist
18 customer electing flat rate service is currently paying \$9.87 per month, which is \$3.50
19 below the \$13.75 rate for regular flat rate service within the base rate area. Since GTE
20 has proposed a \$17.50 flat rate, a \$4.50 discount results in a new rate of \$13.00 for
21 LITAP customers. This is an increase of more than 31% over what they are currently
22 paying.

23
24 The huge increase in rates for these customers is masked by the Companies'
25 handwaving about an increase in the discount. The \$11,340 reduction in revenues the
26 Companies are claiming is simply the multiplication of the \$1.00 increase in the discount
27 times the 945 GTE LITAP customers times 12 months. What the Companies fail to

1 mention in their testimony is that GTE's LITAP customers will actually contribute an
2 additional \$26,166 to Company revenue if all of the rate design proposals are put into
3 effect.

4
5 If my recommendations concerning residential local exchange service are adopted, the
6 \$4.50 discount to both measured and flat rate service will be acceptable.

7
8
9 **Q. Do you agree with the Companies' proposal to eliminate Contel's seasonal**
10 **service discount?**

11 A. Yes, even though the Companies' have not bothered to support this rate proposal nor
12 shown cost levels or relative usage levels to justify elimination of this discount. This rate
13 is simply set aside for those with second homes, regardless of usage patterns. These
14 customers could opt instead for Vacation Service to these homes.

15
16 **Q. Are there any other rate merger issues in the Companies' proposal that you**
17 **have analyzed?**

18 A. Yes, there are. First, the Companies have proposed to merge the existing residential
19 manual key customers into the R1 rate class. I disagree with this proposal for reasons I
20 outlined above concerning the merger of all business rates. Accordingly, I recommend
21 that a similar relationship between the residential single-line and manual key rates be
22 maintained.

23
24 Additionally, the Companies have proposed to grandfather R2 and R4 services at the
25 existing tariff rate. Consistent with my recommendation to lower residential access
26 service rates, I disagree with this proposal. Instead, I recommend that these customers
27 move to the residential one-party rate class and have that service established. They will

1 enjoy better service at roughly the same price they are paying now. In addition, I
2 recommend that no service charge be applied to this upgrade in service.

3
4 **Q. Have you analyzed the Companies' proposals concerning measured service?**

5 A. Yes, I have. The Companies have proposed to continue offering both residential and
6 business measured service under the merged tariff. Currently, GTE's measured service
7 tariff includes four elements: distance, duration, number of calls, and time of day. The
8 first three of these elements are combined in a table that consists of four mileage bands,
9 with setup and per-minute charges. Discounts are offered for off-peak calling; 35% in
10 the evening and 60% for night/weekend calling. This schedule applies to both
11 residences and businesses. On a typical evening residential call of 3.5 minutes to a
12 location 15 miles away, a customer would incur a cost of \$.026 for setup and \$.02 for
13 each minute (rounded to 4 minutes) for a total of \$.106. This would then be discounted
14 by 35% and billed to the customer at the rate of \$.069. On a typical daytime business
15 call of 2 minutes to a location 15 miles away, the business would incur a total cost of
16 \$.046.

17
18 Currently, Contel's residential customers pay \$.10 per message regardless of duration,
19 distance or time of day. Business customers pay \$.0375 per minute regardless of
20 distance or time of day. The same calls described above would cost the Contel
21 residential customer \$.10 and the Contel business customer \$.075.

22
23 The Companies are proposing to use Contel's existing rate structure in their combined
24 tariff. As a result, some of GTE's usage customers will experience an increase in the
25 usage portion of their bill, while others will experience a decrease. In general, those
26 placing relatively short duration calls will experience the greatest increase--particularly if

1 their calls are concentrated in the evening and night/weekend periods. Conversely,
2 those placing daytime calls of relatively long duration will experience some savings.

3
4 As I noted previously in my examination of the Companies' cost studies, local usage is
5 not very costly to provide. Recalling this analysis, the Companies have estimated the
6 cost of the first minute to be ***** and each additional minute to be *****. The
7 Companies' have combined the cost of the first minute with ***** additional
8 minutes to arrive at a cost of ***** per call for residences. The Companies have
9 used an average holding time of ***** for businesses resulting in a cost of *****
10 per minute, equaling the total cost of the first plus ***** divided by *****.

11
12 While I have no reason to dispute their estimate of usage costs, I would note that the
13 proposed rates include rather hefty markups. The Companies have taken a per call cost
14 of ***** and proposed a rate of \$0.1000. This reflects a markup of more than
15 *****. GTE/Contel has applied a similar markup to the rate for business usage. Mr.
16 Chopp's testimony gives no explanation for how or why this markup was established.

17
18 **Q. What buyup rates are the Companies currently experiencing?**

19 A. Of GTE's current 29,121 residential single-line customers, only 246, or less than one
20 percent are subscribing to measured service. In areas where measured service is
21 available, 18,929 of Contel's 25,574 residential customers have selected measured
22 service, a buyup rate of 74%. According to the exhibits of Mr. Chopp, the proposed
23 rate structure would encourage 1,446 current GTE customers to switch to the
24 measured service option, and 11,549 Contel customers to switch to the unlimited
25 option. Mr. Chopp notes that this expected switch to the unlimited option by Contel
26 residential customers is due to the narrowing of the differential between the two options.

1 Currently, at a threshold of 110 calls per month the unlimited option becomes
2 economically preferable. The Companies have proposed an 87.5 call crossover point.

3
4 The anticipated buyup rate of 5% for GTE customers is based on the premise that the
5 more simplified usage tariff will encourage customers to convert to the measured option.

6
7
8 I agree with the Companies' proposal to simplify the tariff by charging on a per-call
9 basis. From a consumer's perspective, a per-call charge would more readily encourage
10 cost-monitoring than would a per-minute distance-sensitive charge because ratepayers
11 can be expected to more easily keep track of the number of calls they make than of the
12 total minutes they spend and the places they call. Furthermore, according to the results
13 of a customer survey in Indiana, of the four possible elements of local measured service
14 billing, call duration is by far the most bothersome.

15
16 **Q. Do you agree with the relationship between the flat rate price and the**
17 **measured service price that has been proposed in this proceeding?**

18 A. No, I do not. The Companies have set the Option 2 - unlimited usage rate at double
19 that of the measured service monthly rate for both residences and businesses. Given this
20 differential, and the applicable usage rates, only residential customers that make more
21 than 87 local calls per month would benefit from the unlimited service. However, as
22 shown on Chopp exhibit 3, the Companies have estimated the number of residential
23 calls to be just ***** per month.

24
25 Although I do not have statistics on dispersion of calling volumes for residential
26 customers, it is readily apparent that the proposed rates are skewed to encourage
27 residential customers to select the measured service rate option. In fact, only customers

1 who make ***** times the average number of calls each month will find the unlimited
2 usage rate to be less costly. The Company has estimated that 95% of their customers
3 will select the unlimited option--despite the fact that it will be more costly for most of
4 them.

5
6 I recommend that an appropriate balance be maintained between the unlimited usage
7 rate and the measured service rate. For residential service I recommend that the
8 measured service rate be set at roughly 65% of the flat rate. Additionally, I recommend
9 that the usage rates of \$.10 per call for residences and \$0.035 per minute for
10 businesses be adopted by the Commission.