

DIRECT TESTIMONY  
  
OF  
  
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PRINCIPAL ECONOMIST  
  
TELECOMMUNICATIONS DIVISION  
  
ILLINOIS COMMERCE COMMISSION

DOCKET NO: 06-0027

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1 **I. Witness Identification**

2  
3 **Q. What is your name, title and business address?**

4  
5 A. My name is Genio Staranczak. I work for the Illinois Commerce Commission as  
6 principal economist in the Telecommunications Division. My business address is  
7 527 East Capitol Avenue, Springfield, Illinois 62701.

8  
9 **Q. Please describe your educational background and previous job**  
10 **responsibilities.**

11  
12 A. I earned my Bachelor of Arts degree in economics from Lakehead University in  
13 1972 and a Doctor of Philosophy degree in economics from Queen's University,  
14 Kingston, Ontario, Canada in 1979. In 1977, I began a 20-year career with Bell  
15 Canada as an economic forecaster first on a regional and then on a national  
16 basis. During the six years I worked directly on economic forecasting, I  
17 participated in a series of yearly rate cases.

18  
19 In 1983, I worked on special assignment to examine economic policy issues  
20 related to a forthcoming long-distance competition regulatory proceeding and  
21 drafted testimony in this regard. In 1986, I became Director - Policy and  
22 Performance where I continued to analyze telecom policy issues, conducted total  
23 factor productivity studies, price responsiveness analyses and was responsible  
24 for developing revenue forecasting methodologies. For the years 1986-1995, I  
25 worked on other regulatory issues such as expanded local calling areas,

26 measured local service, costing studies as well as participating in another  
27 general rate case and working on revenue forecasting issues. During this period  
28 I published two articles in telecommunications journals on competition and rate  
29 rebalancing. I also participated in a number of telecom industry conferences as a  
30 speaker. In addition, for eight years, I was a member of Statistics Canada Price  
31 Advisory Committee, which counsels the government on measurement  
32 methodologies for the consumer price index.

33  
34 In 1995, I became Director of Price Cap Regulation and was primarily  
35 responsible for putting together the price cap formula in Bell Canada's alternative  
36 regulation proceeding. I also authored the methodology used for measuring total  
37 factor productivity and input prices adopted by Bell Canada and most other  
38 Canadian telephone companies who participated in the price cap proceeding. In  
39 addition, I advised on other alternative regulation issues including construction of  
40 the baskets, pricing flexibility and rate rebalancing. From 1997 to 2000, I was  
41 Director of Long-Term Forecasting for the US economy at the WEFA group, a  
42 macroeconomic forecasting and consulting firm based in the Philadelphia area. I  
43 joined the Staff of the Illinois Commerce Commission in September of 2000.

44

45 **Q. Have you previously testified before the Illinois Commerce Commission?**

46

47 A. Yes. I filed testimony in the alternative regulation proceeding, Docket No. 98-  
48 0252/0335, in the universal service proceeding (USF), Docket No. 00-0233/0335

49 consolidated, in the MAG order proceeding, Docket No. 01-0808, in the 271  
50 case, Docket No. 01-0662, in the UNE case, Docket No. 02-0864, in the AT&T  
51 arbitration case, Docket No. 03-0329, in the Alhambra USF case, Docket No. 04-  
52 0354 and in the SBC/CLEC TRO Arbitration Case, Docket No. 05-0442 as well  
53 as numerous other cases.

54

55 **II. PURPOSE OF TESTIMONY**

56

57 **Q. Please describe Staff's testimony in this proceeding.**

58

59 A. The purpose of my testimony is examine whether AT&T Illinois' residential  
60 measured local service offering should be reclassified as competitive in the  
61 Chicago Local Access and Transport Area ("MSA 1") and to propose alternative  
62 courses of action for the Commission to consider with regard to residential  
63 measured local service. I will also discuss whether vertical services such as  
64 Caller ID and Call Waiting, as well as miscellaneous services should also be  
65 reclassified as competitive. Based on the evidence currently available to me, it  
66 does not appear that AT&T Illinois' local measured service offering presently  
67 faces much competition. In my opinion, therefore, it would be better if rates for  
68 measured service were rebalanced before unconditional reclassification of  
69 measured and related services occurs.

70

71 Staff witness Dr. James Zolnierek (Staff Exhibit 2.0) examines whether  
72 residential packaged services, including the legislatively initiated packages, such  
73 as the “Residence Saver Pack Unlimited” should be reclassified as competitive in  
74 MSA 1. Dr. Zolnierek concludes that there are competitive alternatives to the  
75 bundled residential services offered by AT&T Illinois and therefore AT&T Illinois’  
76 bundled service offerings should be reclassified as competitive with the exception  
77 of the “Residence Saver Pack 30”.

78  
79 Staff Witness Robert Koch (Staff Exhibit 3.0) will address whether recently  
80 reclassified residential services pass statutorily required imputation tests. Mr.  
81 Koch’s recommended tests conclude that stand-alone residence network access  
82 lines fail imputation in almost all instances while packaged service offerings pass  
83 recommended imputation tests.

84  
85 **III. Competition for Local Measured Service**

86  
87 **Q. What is local measured service?**

88  
89 **A.** A subscriber to local measured service will be billed separately for each network  
90 access line and billed separately for each local call the subscriber makes. The  
91 rate billed for each local call may be discounted when certain volume thresholds  
92 are achieved. Measured service is currently tariffed as competitive in the MSA 1.

93

94 **Q. What proportion of all residential customers in the MSA 1 area are local**  
95 **measured service subscribers?**

96

97 A. According to figures provided by AT&T Illinois approximately 50% of residential  
98 subscribers in the MSA 1 are measured service subscribers<sup>1</sup>.

99

100 **Q. Is the local measured service market distinct from the bundled service**  
101 **market?**

102

103 A. For the purposes of this proposed reclassification, the answer is yes. Typically,  
104 bundled services consist of packages that offer an access line, unlimited local  
105 calling, a number of vertical features and occasionally unlimited long distance  
106 calling for a fixed price. The bundled service alternative makes economic sense  
107 for subscribers who make a large number of local calls or, who subscribe to and  
108 make extensive use of vertical services such as call forwarding i.e. measured  
109 service subscribers who make a significant number of local calls and/or who use  
110 vertical features will find it less expensive to subscribe to packages than continue  
111 with measured local service.

112

113 On the other hand, subscribers who do not make a significant number of local  
114 calls or who do not make extensive use of vertical services will not find it  
115 economic to subscribe to packages offered by AT&T Illinois. For example, an

---

<sup>1</sup> See AT&T Illinois Exhibit 7.0, Schedule 7.2.

116 AT&T Illinois measured service subscriber who makes 100 local calls a month  
117 (75% of AT&T's residential measured service subscribers make fewer than 100  
118 local calls a month and 60% make fewer than 60 calls a month<sup>2</sup>) would in Access  
119 Area C have a monthly bill usage bill of \$3.00 (assuming the average price of a  
120 local call is \$0.03) and an access charge of approximately \$9.00 per month for  
121 total charges of about \$12.00 per month. In contrast, AT&T Illinois' "no frills"  
122 unlimited local calling package, which it markets under the name "Residence  
123 Saver Pack Unlimited", would cost the same subscriber about \$18.50 per month.  
124 Even if the subscriber purchased a vertical service option for \$4.00 a la carte  
125 from AT&T Illinois, the subscriber's total monthly bill under measured service  
126 would still be \$2.50 less expensive per month (\$16.00 including one vertical  
127 service of \$4.00) than the Residence Saver Pack Unlimited. In other words, for  
128 low volume local callers, bundled services, as provided by AT&T Illinois, are not a  
129 viable economic substitute for measured service.

130

131

132 **Q. Are bundled services offered by competitors viable economic substitutes**  
133 **for measured service provided by AT&T Illinois?**

134

135 A. No. AT&T Illinois witness Sandy Moore, in her testimony (AT&T Illinois Exhibit  
136 2.0), gives examples of packages offered by competitors. The competitors'  
137 packages that Ms. Moore's describes in her testimony, range in price from \$20 to

---

<sup>2</sup> See AT&T Exhibit 7.0, Schedule 7.2.

138 \$50 per month, and include unlimited local calling, two or more vertical features  
139 and in some cases unlimited toll calling as well. Again the rates for these  
140 packages are substantially higher than a subscriber who makes 100 local calls a  
141 month would pay for AT&T Illinois' measured service (\$12 a month with no  
142 vertical services and \$16 a month for one vertical service costing \$4).

143  
144 The rates competitors charge for packages however do not necessarily  
145 correspond to the rates Ms. Moore contends they charge. For example, Ms.  
146 Moore maintains that McLeodUSA prices the Online Preferred Package, which  
147 includes unlimited local calling at \$20.95<sup>3</sup>. McLeodUSA may offer the Online  
148 Preferred Package at \$20.95, but it does not appear to do so in Illinois.  
149 McLeodUSA's website<sup>4</sup> enables potential subscribers to determine, exchange by  
150 exchange, the rates they would be charged for various packages offered by  
151 McLeodUSA. According to the McLeodUSA website, the rate for the Online  
152 Preferred package ranges from \$20.95 in downtown Chicago (prefix 312 814-  
153 xxxx – numbers that are used by Commission staff located on North La Salle  
154 Street, which is in AT&T Illinois Access Area A), to \$20.95 per month for city of  
155 Chicago exchanges (prefix 773-763-xxx which is in AT&T Illinois Access Area B)  
156 to \$20.95 for Springfield (prefix 217 546-xxxx – my home number in Springfield  
157 which is in AT&T Illinois Access Area C<sup>5</sup>).

158

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<sup>3</sup> AT&T Illinois Ex. 2.0 at 6.

<sup>4</sup> See [http://www.mcleodusa.com/ProductDetail.do?com.mcleodusa.req.PRODUCT\\_ID=210415](http://www.mcleodusa.com/ProductDetail.do?com.mcleodusa.req.PRODUCT_ID=210415)

<sup>5</sup> My home number is not in MSA 1 but should be broadly indicative of the rates McLeodUSA charges subscribers who live in Access Area C and MSA-1.

159 **Q. Do many competitors offer local measured service?**

160

161 A. No. AT&T Illinois witness W. Karl Wardin (Schedule WKW-6 of AT&T Ex. 1.0)  
162 lists four service providers who he maintains provide measured service, MCI<sup>6</sup>,  
163 RCN, CIMCO Communications and CoreComm for approximately \$0.05 a call.  
164 RCN<sup>7</sup> and MCI, however, have grandfathered their offerings, which means that  
165 existing customers of this service can continue to subscribe, but potential new  
166 customers cannot sign up. On December 21, 2005 the Commission granted  
167 CoreComm's request for cancellation of its Certificate. My understanding is that  
168 CoreComm has merged with, or been acquired in some manner by, ATX  
169 Communications. When I investigated ATX's offerings on its website<sup>8</sup> I was  
170 unable to find any residential service offerings, which is not surprising for a  
171 company whose corporate motto is to "...help businesses simplify their  
172 communications"<sup>9</sup>. When I checked CIMCO's website<sup>10</sup>, I could not find any  
173 residential service offering let alone a measured residential service offering<sup>11</sup>. I  
174 should also note that revised Schedule WKW-6 lists **\*\* BEGIN CONFIDENTIAL**  
175 **AND PROPRIETARY\*\* XXXXX\*\* End CONFIDENTIAL AND PROPRIETARY\*\***  
176 as offering subscribers a residence access line and unlimited usage for \$14.00<sup>12</sup>

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<sup>6</sup> According to MCI response to Staff DR 1(b), it does not offer measured local service.

<sup>7</sup> According to Mr. Wardin response to AG Data Request 6.7 RCN now offers a bundled package consisting of unlimited local and toll calling as well as a number of vertical features for \$35.00.

<sup>8</sup> See <http://www.atx.com/>

<sup>9</sup> ATX has indicated orally to Staff that it does not provide local service of any kind in Illinois.

<sup>10</sup> See <http://www.cimco.net/cimco/>

<sup>11</sup> CIMCO has asserted in a sworn pleading filed in the companion proceeding to this docket that it only serves business customers although it may incidentally service some residences associated with its business customers doing so pursuant to its business tariffs.

<sup>12</sup> According to Comcast response to Staff DR 1(a), it does not offer measured service.

177 rather than measured service. However, when I checked **\*\* BEGIN**  
178 **CONFIDENTIAL AND PROPRIETARY\*\* XXXXXXXXX \*\* END CONFIDENTIAL**  
179 **AND PROPRIETARY\*\*** response to Staff DR 2(a) I found the company offers  
180 service in **\*\* BEGIN CONFIDENTIAL AND PROPRIETARY\*\* XXXXXXXXXX**  
181 **XX**  
182 **XX**<sup>13</sup>. **\*\* BEGIN**  
183 **CONFIDENTIAL AND PROPRIETARY\*\*** Finally, many CLECs, including  
184 McLeodUSA, Mpower Communications, Sage Telecom, ACN Communications  
185 and Forte in responses to Staff data requests all contend that they do not offer  
186 measured service

187  
188 **Q. In your opinion, why has not competition for residential local measured**  
189 **service developed?**

190  
191 A. In my opinion, competition for local measured service has not developed  
192 because access and local usage are currently priced in manner that makes it  
193 unprofitable for competitors to provide measured service for low volume  
194 customers who do not also subscribe to vertical features. Table 1 below  
195 provides a better idea of what kind of profit margins potential entrants into the  
196 measured local service market face.

197

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<sup>13</sup> I should note that when I checked **\*\* BEGIN CONFIDENTIAL AND PROPRIETARY\*\* XXXXXX**  
**XX**  
**XX\*\***

198

TABLE 1

199

(1)	(2)	(3)	(4)
Access Area	AT&T Illinois Monthly Access Line Rate (\$)	Access Line Rate plus \$4.50 End User Common Line Charge (EUCL)	Monthly Unbundled Network Element (UNE) Loop Rate (\$)
A	2.55	7.05	5.17
B	5.53	10.03	12.40
C	9.00	13.50	14.91

200

201

202 Column 2 lists AT&T Illinois' stand alone access rate by Access Area. Net  
 203 access line revenue for AT&T Illinois would consist of the stand alone access line  
 204 rate plus the end user common line charge (EUCL)<sup>14</sup> which is \$4.50 per line. Net  
 205 Access line revenue is listed in column 3. Column 4 lists the current Unbundled  
 206 Network Element (UNE) loop rate. The UNE loop rate is the rate that  
 207 Competitive Local Exchange Carriers (CLECs) pay AT&T Illinois to rent the  
 208 access loop from AT&T Illinois. A comparison of Column (4) with Column (3)  
 209 reveals that a CLEC's costs of providing the access line exceed the revenue a

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**BEGIN CONFIDENTIAL AND PROPRIETARY\*\*** rate for local service that Mr. Wardin alleges in his testimony.

<sup>14</sup> The End User Common Line Charge (EUCL) is listed as a separate charge on a subscriber's bill and represents access line costs assigned to the long distance network. Subscriber line charge revenue is pocketed by the local service provider.

210 CLEC can derive from a stand alone access line in Access Area B and C.<sup>15</sup> This  
211 access line revenue shortfall can only be made up if the subscriber (a) makes a  
212 lot of local calls or (b) purchases a vertical service or two (which are virtually  
213 costless to supply). For example, a potential subscriber would have to make 100  
214 local calls a month at \$0.03 per call (I will assume the CLEC's costs per local call  
215 are \$0.015) to make up the access revenue shortfall in Access area C and about  
216 150 local calls a month in Access Area B to make up the access revenue  
217 shortfall. As I stated previously in my testimony, 75% of AT&T's measured  
218 service subscribers make less than 100 local calls a month.

219  
220 In my illustrative example, I have assumed that CLECs have no billing,  
221 marketing, administrative or other costs. In the real world, of course CLECs  
222 would incur these expenses and consequently a measured service subscriber  
223 would have to make many more measured local calls than I have indicated for  
224 the subscriber to be profitable for the CLEC<sup>16</sup>. Nevertheless, my analysis clearly  
225 demonstrates why CLECs bundle local calling and vertical services into  
226 packages. The packages enable the CLEC to offset unprofitable access line  
227 services with profitable local calling and vertical services and still come out ahead  
228 – the implicit profits on packaged vertical services and the packaged local calling  
229 more than make up for the implicit losses on the packaged access line. It should  
230 be stressed that the lack of competitive options for “stand alone” access

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<sup>15</sup> The UNE port rate for example is \$2.18 per month. The port allows for switching of calls.

<sup>16</sup> AT&T Illinois' “market priced” wholesale offering, Local Wholesale Complete is priced (after discounts) at about \$24 per month. This “market priced” wholesale offering virtually precludes any CLEC from offering measured service at rates comparable to those offered by AT&T Illinois.

231 suggests that the current pricing structure for local services is an impediment to  
232 the development of a competitive market for access.

233

234 **Q. Table I focuses on the economics of UNE based competition. Are voice**  
235 **over internet protocol (VoIP), wireless and resale based competition viable**  
236 **economic substitutes for measured service?**

237

238 A. No. I will discuss each purported substitute to measured calling in turn. First,  
239 VoIP telephony requires a broadband or similar type of connection, and less than  
240 50% of households currently subscribe to broadband. For households who do  
241 not subscribe to broadband, VoIP telephony is therefore not a viable alternative.  
242 For households that do subscribe to broadband, VoIP telephony can be  
243 substantially more expensive than the measured service offered by AT&T Illinois.

244

245 Wireless carriers do offer blocks of minutes at a set price, but, again the price of  
246 this measured service is more expensive than the measured service offered by  
247 AT&T Illinois. For example, the least expensive wireless plan AT&T Witness Ms.  
248 Moore discusses in her testimony (basic "Anytime Minutes") is offered by T-  
249 Mobile, which she states is priced at \$19.99 per month and includes 60 free  
250 minutes<sup>17</sup>. Ms. Moore neglects to mention that the basic "Anytime Minutes" plan,  
251 charges \$0.45 for every minute in excess of 60<sup>18</sup>. Other wireless plans referred to  
252 by Ms. Moore range in price from \$29.99 per month to \$199.99 per month.

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<sup>17</sup> AT&T Illinois Exhibit 2.0 at 13.

<sup>18</sup> See <http://www.letstalk.com/product/product.htm?prId=19374>

253 Finally, it should be noted that the T-Mobile plan requires a one year contract,  
254 while many other wireless plans require a two year contract.

255  
256 Resale should not be included in any competitive market analysis. Residential  
257 resellers rent the entire line, including loop, port and transport from AT&T Illinois  
258 and receive roughly a 20% discount off the ILEC's retail price. From this  
259 discount, resellers must cover their billing, marketing and administrative  
260 expenses. Since resellers' costs are more than 80% determined by the current  
261 ILEC retail price, resale competition is not effective in constraining the rates  
262 ILECs charge. Moreover, in the MSA-1 there are just a few thousand resale  
263 measured service lines<sup>19</sup> in total, or less than 1% of total measured service  
264 residential lines, which indicates "resale competition" is not a significant factor in  
265 the marketplace.

266  
267 **Q In your opinion, will competition develop for local measured service in the**  
268 **foreseeable future?**

269  
270 | A. No, in my opinion it will not, with the current rate structure. My analysis indicates  
271 that current rates for access and local calling make it unprofitable for competitors  
272 to offer measured service. Furthermore, residential access line rates and local  
273 calling rates are currently indexed to economy wide inflation (as measured by the  
274 Gross Domestic Product Price Index) minus a productivity factor<sup>20</sup>. Since the

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<sup>19</sup> See AT&T Illinois DR response to GS-1.02.  
<sup>20</sup> See Schedule 1 for a description of alternative regulation.

275 productivity factor has exceeded inflation in recent years, alternative regulation  
276 has required AT&T Illinois to, on average, decrease both access and local calling  
277 rates, making it even more uneconomic for competitors to enter the local  
278 measured service market. More specifically, rates for access and usage have  
279 declined between 1.5% and 2.0% per year, on average, since the inception of the  
280 alternative regulation plan in 1994.

281

282 **Q. Please summarize your conclusions regarding competition in the local**  
283 **measured service market.**

284

285 A. AT&T Illinois' own filing indicates that there are, at best, one or two less than  
286 active competitors in the measured service market, and these competitors  
287 provide service to just a few customers. Although there are a number of  
288 competitors offering bundled services, these packages along with the packages  
289 marketed by AT&T Illinois are not viable economic substitutes for measured  
290 service. This is because the packages, cost at least 50% more per month than a  
291 low volume user who makes a hundred local calls or less a month would pay for  
292 access and local usage (and 15% or more per month than a measured service  
293 user who also subscribes to a vertical feature would pay a month) VoIP  
294 telephony is only available to the less than 50% of households who subscribe to  
295 broadband, and can be more expensive than measured usage rates offered by  
296 AT&T Illinois (assuming the average local call is three minutes in length).  
297 Wireless service providers do offer limited forms of measured service, but at

298 rates 1,500% higher than those charged by AT&T Illinois. Finally, resale is not  
299 facilities based competition and consequently will not act to constrain ILEC  
300 measured service prices.

301  
302 Section 13-502(b) of the Public Utilities Act defines a telecommunications service  
303 as “competitive if, and only if, and only to the extent that, for some identifiable  
304 class or group of customers in an exchange, group of exchanges, or some other  
305 clearly defined geographic area, such service, or its functional equivalent, or a  
306 substitute service is reasonably available from more than one provider, whether  
307 or not any such provider is a telecommunications carrier subject to regulation  
308 under this Act”. Section 13-502(c) of the Act requires that the Commission  
309 consider at a minimum five criteria to determine whether a service is competitive  
310 under the above definition, namely:

- 311
- 312 (1) the number, size and geographic distribution of other providers of the  
313 service;
  - 314 (2) the availability of functional equivalent services in the relevant geographic  
315 area and the ability of telecommunications carriers or other persons to  
316 make the same, equivalent of substitutable service readily available in the  
317 relevant market at comparable rates, terms and condition:
  - 318 (3) the existence of economic, technological, or any other barriers to entry  
319 into, or exit from the relevant market;

320 (4) the extent to which other telecommunications companies must rely upon  
321 the service of another telecommunications carrier to provide  
322 telecommunications service; and

323 (5) any other factors that may affect competition and the public interest that  
324 the Commission deems appropriate.

325 My analysis clearly demonstrates that measured service subscribers are an  
326 identifiable and distinct class of users for PUA Section 13-502(b) purposes.  
327 Furthermore, given the evidence to date, my examination establishes that  
328 measured service fails to satisfy any of the competitive criteria listed under  
329 Section 13-503(c) of the PUA. In particular: (1) as I have shown above, there are  
330 effectively no landline measured service competitors in MSA-1; (2) bundled  
331 services and wireless services are not readily substitutable for measured service  
332 because they are not offered at comparable rates; (3) current UNE and  
333 measured service pricing acts as an effective barrier of entry into the measured  
334 service market; (4) the only price constraining competition that is likely emerge is  
335 UNE based (i.e. it relies upon the service of an existing ILEC;) and (5) the public  
336 interest is not served by an immediate reclassification of measured service  
337 because an immediate reclassification will give AT&T the ability to simply raise  
338 rather than rebalance measured service rates.

339

340 **IV. Competition for Vertical and Other Services**

341

342 **Q. What are Vertical Services?**

343

344 A. Vertical services are enhanced services such as Call Waiting and Caller ID that  
345 were recently reclassified as competitive by AT&T Illinois. Most other vertical  
346 services were reclassified as competitive on June 1, 2003. AT&T Illinois'  
347 revenues for the recently reclassified vertical services are about \$100 million in  
348 MSA-1.

349

350 **Q. Is the market for Caller ID and Call Waiting Competitive?**

351

352 A. Not for measured service users in my opinion. In Schedule WKW-6 AT&T  
353 Witness W. Karl Wardin lists more than a half a dozen CLECs that he contends  
354 offer vertical features and such as Caller ID and Call Waiting *a la carte*. But to  
355 purchase vertical features *a la carte* from these companies, a potential customer  
356 would have to subscribe to the services that these companies provide. My  
357 previous analysis indicated that RCN and MCI do not offer measured service to  
358 new customers. Talk America, TDS, Sage, Trinsic and McLeodUSA do not offer  
359 measured service to any customers. CIMCO and CoreComm provide measured  
360 service but only to a few subscribers at most, and do not appear to offer it to  
361 customers currently seeking service. If there is no little or no competition for  
362 measured service, then, if a household is a measured service subscriber, there  
363 cannot be effective competition for vertical services to that household since only  
364 the measured service provider (AT&T Illinois) is capable of supplying vertical  
365 services to that household. That is to say, that because an AT&T Illinois

366 measured service subscriber cannot obtain vertical services from another  
367 provider, the Commission should treat vertical services and measured services  
368 similarly for reclassification purposes.

369

370 **Q. Should AT&T Illinois be allowed to reclassify other services as**  
371 **competitive?**

372

373 A. No. "Other services" are defined as services not previously discussed that were  
374 recently reclassified by AT&T Illinois. Directory listings and non-sufficient check  
375 charge are examples of other services. Again these services are often tied to  
376 measured service, and because measured service is not competitive these  
377 services should therefore not be reclassified as competitive either. That is to say,  
378 measured service subscribers effectively have no choice but to select AT&T  
379 Illinois; consequently, measured service subscribers have effectively no choice  
380 but to accept AT&T Illinois' non-sufficient check charges as well. Some of these  
381 other services may in certain circumstances not be tied to measured services  
382 e.g. non-sufficient check charges may apply to bundled service users as well as  
383 measured service users. However, for the sake of administrative simplicity it  
384 would be best not to parse distinctions between other services that apply to  
385 measured service users as opposed to other services that apply to bundled  
386 service users.

387 .

388 **V. Policy Choices**

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**Q. If the local measured service market is not currently competitive and is unlikely to be competitive in the foreseeable future what should the Commission do?**

A. The Commission has at least two possible courses of action. First, the Commission can simply deny AT&T Illinois' proposed reclassification of measured local service on the grounds that the market for local measured service is not competitive, which is, as I have demonstrated above, clearly is the case. However, this course of action fails to address the underlying reason why the local measured service market is not competitive, namely, that current access line rates and current local calling rates are priced in a manner that makes it uneconomic for competitors to offer local measured service. A simple denial of the AT&T reclassification does nothing to correct the current mispricing of local measured service nor will a straightforward reclassification denial encourage competitors to enter the local measured service market. Consequently, I do not recommend that the Commission simply refuse AT&T Illinois' proposed reclassification and continue on a status quo basis.

**Q. If the Commission concludes that local measured service is not currently competitive and not likely to be competitive in the foreseeable future what is the second option available to the Commission?**

412

413 A. The Commission might initiate a rate rebalancing plan for measured service, Call  
414 Waiting, Caller ID and other recently reclassified services, before these services  
415 are reclassified. During the rebalancing period AT&T Illinois would reduce local  
416 call rates to long run incremental service cost plus an overhead markup. Also  
417 during the rebalancing period, AT&T Illinois would agree to increase access line  
418 and would also agree to reduce rates for vertical features such as call-waiting  
419 and caller ID, so the increased revenue that AT&T Illinois would realize from  
420 access rate increases would be counterbalanced by reductions in revenue AT&T  
421 would experience because of decreases in rates for local usage and vertical  
422 services. In other words, the rebalancing plan would be revenue neutral for  
423 AT&T Illinois (and neutral for measured service subscribers on the whole as well)  
424 but would result in a more rationally priced measured service and vertical service  
425 rates which would lead to a solid basis for increased local measured service  
426 competition.

427

428 **Q. Will increases in access line rates during the rebalancing period result in**  
429 **rate shock for local measured service users?**

430

431 A. Not in my opinion. Increases in access line rates are never popular. But  
432 increases in access line rates will cause very few subscribers to drop service.  
433 Empirical studies of primary access demand<sup>21</sup> suggest that even a whopping

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<sup>21</sup> See Bodnar J. et al. 1988: Cross-sectional analysis of residential telephone subscription in Canada, Information Economics and Policy 3:331.

434 100% increase in local rates (which I am not in any way proposing) would cause  
435 less than one per cent of subscribers to forego service<sup>22</sup>.

436  
437 For those households that continue to subscribe to measured service the  
438 increase in access rates will be counterbalanced by lower calling rates and lower  
439 vertical service rates. The rebalancing plan, as previously discussed, should be  
440 revenue neutral for consumers in aggregate. Local measured service subscribers  
441 who make a lot of calls, or who use vertical features that were recently re-  
442 classified as competitive, will actually be better off under the rebalanced rates  
443 while local measured service subscribers who make relatively few calls will be  
444 somewhat worse off. Finally, measured service rebalancing would likely lead  
445 some customers who currently subscribe to packages to switch back to  
446 measured service, inasmuch as rebalanced measured service rates will actually  
447 benefit some package subscribers as well. It is therefore likely, that AT&T Illinois  
448 would have to reduce some basic package rates in order for these package rates  
449 to be price competitive with the rebalanced measured service rates and  
450 rebalanced a la carte vertical service rates.

451  
452 I note that in the Universal Service Proceeding, Docket No. 00-0233, the  
453 Commission opted for a state universal service plan that effectively required  
454 small rural ILECs to raise their local rates to \$20.39 during the course of a five

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<sup>22</sup> The demand for second and third lines into a home is considerably more price sensitive than the demand for the "primary" line. Consequently a 100% increase in access line rates can cause perhaps 5% of lines to be dropped but four out of the five lines would be "secondary" as opposed to "primary" lines.

455 year transition period. As a result some rural subscribers faced rate increases of  
456 up to \$15 per month for their access line. No party, other than the rural ILECs,  
457 filed an objection to the rate increases implied by the Commission decision in  
458 Docket No. 00-0233 on affordability grounds. In Illinois, average household  
459 income of rural counties is typically less than statewide average household  
460 income.

461

462 **Q. How can the Commission initiate a rebalancing of rates?**

463

464 A. Upon motion of AT&T Illinois or another interested party, the Commission can  
465 initiate rebalancing by re-opening the alternative regulation docket (No. 98-0252)  
466 to allow AT&T Illinois more pricing flexibility for individual services. AT&T Illinois'  
467 alternative regulation plan caps rate increases for all non-competitive residential  
468 services at economy wide inflation minus 4.3%. Under the plan, AT&T Illinois  
469 may change prices for Individual residential services plus or minus 2% on either  
470 side of the cap; this is referred to in the plan as "pricing flexibility". To illustrate  
471 what this means, assume economy wide inflation is 2.5%. The price cap would  
472 mean that AT&T Illinois would have to reduce overall residential rates by 1.8%.  
473 Accordingly, AT&T Illinois can raise the prices of individual residential services by  
474 up to 0.2% or lower them by up to 3.8%<sup>23</sup>.

475

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<sup>23</sup> See Schedule 1 for a more detailed description of alternative regulation.

476 If the Commission allowed AT&T Illinois more pricing flexibility under the cap, for  
477 example, up to 12%, then AT&T could increase access rates while  
478 simultaneously reducing measured local calling and other rates that are covered  
479 under the plan. The value of this pricing flexibility would be enhanced if the  
480 Commission collapsed the number of baskets from four to one. A rise in access  
481 rates would make measured service more attractive to potential competitors and  
482 also result in more economically rational pricing overall.

483  
484 There are, however, at least two drawbacks to this approach. First the  
485 Commission would have to reopen or reconsider its alternative regulation review  
486 order for the purpose of giving AT&T Illinois more pricing flexibility under  
487 alternative regulation and for the purpose of consolidating the number of baskets.  
488 This would, of course, be a contested proceeding before the Commission, and  
489 even if expedited, would delay the advent of more rational local measured  
490 service pricing.

491  
492 A second drawback of this approach is that even if given more pricing flexibility  
493 AT&T Illinois might choose not to move rates quickly to more economic levels.  
494 AT&T Illinois might prefer for example to continue to enjoy huge margins on Call  
495 Waiting and Caller ID rather than move the prices of these vertical features  
496 closer to cost.

497

498 **Q. Why propose rebalancing for measured and other local services before**  
499 **proposing reclassification?**

500  
501 A. The current lack of competition for measured local services likely exists because  
502 prices for measured service are not attractive for competitors. The rebalancing  
503 plan will make measured service more attractive for competitors by moving  
504 prices more in line with costs, but probably still not attractive enough for many  
505 competitors to enter the measured service market. After the rebalancing period,  
506 reclassification will give AT&T Illinois the flexibility to price measured service to  
507 levels that will prevail in a competitive market. This pricing flexibility will likely  
508 mean that access line rates will rise further particularly for Access areas B and C,  
509 and this rise in access rates will make measured service economic for  
510 competitors. In contrast if measured service was to remain indefinitely under  
511 alternative regulation, prices of measured service could not rise to levels that  
512 would prevail in a competitive market. This is because alternative regulation  
513 requires, given current levels of inflation, that residential rates on average fall  
514 every year. In other words, if measured service is kept under alternative  
515 regulation, measured service rates will never move to levels that will attract  
516 competition, because to attract competition residential rates will have to increase  
517 relative to where they are now.

518  
519 To summarize the Commission could initiate rebalancing before allowing  
520 reclassification because (1) rebalancing will move rates for local services closer

521 to cost (2) rebalanced rates will make it more attractive for competitors to enter  
522 the measured service market and (3) AT&T Illinois appears incapable of moving  
523 prices in an economically rational direction on its own as evidenced by its  
524 response to CUB DR 2.03

525

526 **Q. Isn't it likely that little if any competition will ever develop for low volume**  
527 **measured service subscribers since these customers are inherently**  
528 **unprofitable?**

529

530 A. This might be argued by some parties, but it is an argument that I do not accept.  
531 The biggest and most profitable retailer in the world, Wal-Mart, primarily appeals  
532 to households of relatively modest means as does the biggest and most  
533 profitable restaurant chain in the world McDonalds. Both these companies make  
534 a good living serving "low volume" customers and so could competitors for  
535 measured residential phone service as long as AT&T Illinois (with Commission  
536 direction) moves prices for measured service access and measured service  
537 usage in such a way that UNE based CLECs or intermodal competitors can  
538 profitably offer this service.

539

540 **Q. What should the Commission do if it concludes that there is viable**  
541 **competition for local measured service currently?**

542

543 A. The Commission could grant an immediate reclassification of measured local  
544 service but impose a number of consumer protecting conditions and then initiate  
545 a review within three years of this reclassification to determine whether the  
546 reclassification has worked out<sup>24</sup>. During the review the Commission would  
547 examine (1) the extent of competition for measured service; (2) AT&T Illinois'  
548 pricing of measured service during the three year review period; and (3) whether  
549 the consumer protections have in fact safeguarded subscribers. The immediate  
550 reclassification would give AT&T Illinois flexibility to move measured service  
551 prices to rates that would prevail under a competitive market.

552

553 There are least two shortcomings to the immediate reclassification option<sup>25</sup>.  
554 First, in order to avoid controversy AT&T Illinois may not choose to rebalance  
555 local measured service rates much during the immediate reclassification period.  
556 At the end of the reclassification period AT&T Illinois could then argue that  
557 reclassification did not result in any meaningful rate changes and therefore the  
558 Commission should not investigate the reclassification. Once the reclassification  
559 is endorsed AT&T Illinois could then aggressively increase rates which may  
560 potentially cause rate shock for its measured usage subscribers.

561

562 Alternatively, AT&T Illinois could implement very aggressive rebalancing during  
563 the immediate reclassification which could cause immediate rate shock to its

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<sup>24</sup> This option implicitly assumes that the Commission has concluded that there is viable economic competition for measured service; my recommendation is, of course, that it decline to do so.

<sup>25</sup> Assuming the immediate reclassification is lawful and in the public interest; as noted above, I do not recommend that the Commission so find.

564 measured service subscribers. Under this scenario AT&T Illinois might bank on  
565 the Commission's natural circumspection regarding any immediate review of its  
566 initial reclassification.

567  
568 More fundamentally, the immediate reclassification option gives AT&T Illinois too  
569 much pricing discretion for a group of services that do not currently face much  
570 direct competition. Consequently, the Commission would be relying solely on  
571 AT&T Illinois' judgment to initiate the rebalancing that is economically required of  
572 measured service. In this regard AT&T Illinois' post reclassification pricing  
573 strategy as articulated in response to Data Request No. CUB 2.03 should cause  
574 the Commission considerable concern. \*\* BEGIN CONFIDENTIAL AND

575 PROPRIETARY\*\* XXX  
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585 XXX  
586 XXX



Schedule 1

I. SBC ILLINOIS' ALTERNATIVE FORM OF REGULATION

A. Background

On October 11, 1994, pursuant to Section 13-506.1 of the Public Utilities Act ("Act"), the Illinois Commerce Commission ("Commission") entered its Final Order in Docket No. 92-0448/93-0239, Consol. ("Alt Reg Order")<sup>26</sup>, approving an alternative form of regulation for Illinois Bell Telephone Company ("Illinois Bell", "SBC" or "the company"). Typically referred to as "price cap regulation," this alternative form of regulation ties rates for noncompetitive services to an inflation and productivity-based index and, thereby, supplants the company's typical rate base / rate of return regulatory structure, requiring extensive filings<sup>27</sup> if new rates are sought, with a more streamlined process within which price changes can be approved. This process, as it is applied to SBC, consists of an annual filing made by the Company on or before April 1 of each year and the subsequent approval by the Commission of the proposed Price Cap Index ("PCI"), to be effective on July 1 of the same year.<sup>28</sup>

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<sup>26</sup> See, generally, *Final Commission Order, Illinois Bell Telephone Company: Petition to Regulate Rates and Charges of Noncompetitive Services Under an Alternative Form of Regulation*, ICC Docket Nos. 92-0448/93-0239 (Consol.), October 11, 1994 (hereafter "Alt. Reg. Order").

<sup>27</sup> See, e.g., 83 Ill. Admin. Code Part 285.

<sup>28</sup> The Commission's decision to approve tariff changes within the annual filings will be determined based upon the appropriateness of the Company's proposed PCI for the upcoming year, the remaining parameters of the price cap mechanism, the rate design objectives outlined in its Order in ICC docket 92-0448/92-0239 Consol., and the applicable requirements of the PUA.

Most<sup>29</sup> of Ameritech Illinois' noncompetitive services were, for the purpose of price cap regulation, separated and placed into four distinct customers groups, or service baskets at the outset of the plan: (1) Residential Basket, (2) Business Basket, (3) Carrier Access Basket and (4) Other Services Basket.<sup>30</sup> The prices for the services within each of these baskets are allowed to fluctuate over time with the restriction that each basket's Actual Price Index ("API") never exceeds the PCI. The PCI is primarily based upon inflation, but includes offsets for productivity, the company's quality of service and exogenous factors that are beyond the control of the company.

At the outset of the Plan, the PCI was set equal to 100. Pursuant to the Commission's Order, the PCI must be recalculated once each year according to the following formula:

$$PCI_t = PCI_{t-1} [1 + (\% \text{ change in the GDPPI})/100 - .043 \pm Z + Q]$$

where:

- PCI<sub>t</sub> = price cap index for current year,
- PCI<sub>t-1</sub> = price cap index for previous year,
- GDPPI = Gross Domestic Product Price Index,
- Z = exogenous change factor, and
- Q = quality of service component, which is negative.

Similarly, the API of each of the service baskets was set equal to 100 at the outset of the plan. Each basket's API is nothing more than a reflection of the basket's average

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<sup>29</sup> Staff notes that all new non-competitive services are excluded from Ameritech Illinois' Alternative Regulation Plan for one year. Further, in its Order in Docket 96-0486/96-0569 (consol), the Commission concluded that, at the present time, Ameritech Illinois' unbundled network elements, interconnection and transport and termination rates should be excluded from the alternative regulation plan currently applicable to the Company's noncompetitive services. Second Interim Order at 87, Investigation into forward looking cost studies and rates of Ameritech Illinois for interconnection, network elements, transport and termination of traffic, Docket No. 96-0486/0569 (February 17, 1998)(hereafter "Second Interim Order").

<sup>30</sup> A more detailed list of the services included in each of the service baskets can be found in Appendix A, I.A.2.b, of the Commission's *Alt Reg Order*.

price once demand and any proposed tariff changes are properly taken into account.<sup>31</sup>

The API may change at any time during the year when price changes are made. (Order, Appendix A at 3). The API for an individual basket is calculated as follows:

$$API_t = API_{t-1} * \sum_{i=1}^n v_i \frac{P_i(t)}{P_i(t-1)}$$

where:

- API<sub>t</sub> = actual price index for the current year,
- API<sub>t-1</sub> = actual price index for the previous year,
- i = rate element i,
- P<sub>i</sub>(t) = proposed price for the i<sub>th</sub> element,
- P<sub>i</sub>(t-1) = current price for i<sub>th</sub> element, and
- v<sub>i</sub> = revenue weight for i<sub>th</sub> element.

As described in the Commission's *Alt Reg Order*, "the reasonableness of price changes under the plan is determined by a comparison of the PCI applicable to a given year and the API for each of the four customer categories."<sup>32</sup> Specifically, each basket's API must be less than or equal to the PCI at all times. This requirement has implicitly placed the emphasis of the company's annual filings on the calculation of the PCI and the justification of each of its inputs. In addition to determining whether the baskets' APIs are less than the PCI, the Commission must also ensure that any proposed tariff changes are consistent with the requirements of the Act, including Sections 13-505.1 and 13-507.

## B. Filing Requirements

In order to develop a record that the Commission can use to determine whether it should approve SBC's annual rate filings with or without modifications, the Commission

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<sup>31</sup> Under certain circumstances, the basket's API may be recalculated during the year to ensure that it remains less than or equal to the PCI. For example, a price increase in one of the services within a basket would require that basket's API to be recalculated.

<sup>32</sup> Alt Reg Order, Appendix A at 3.

has established a very specific set of filing requirements. In its Order, the Commission stated:

Illinois Bell shall be required to make an annual rate filing no later than April 1 of each year of the plan after 1994. At that time, Illinois Bell shall provide the following information:

- (a) the price cap index for the following 12-month period (July to June), with supporting data showing the GDPPI for the previous calendar year and the percent GDPPI change for that 12-month period;
- (b) the actual price index ("API") for each service basket, including the effects of proposed rate changes under the price cap index for the following 12-month period (July to June) and adjustments for new services added, existing services withdrawn, and services reclassified as competitive or noncompetitive;
- (c) tariff pages to reflect revised rates;
- (d) supporting documentation demonstrating that any proposed rate changes are consistent with the requirements of the price index mechanism;
- (e) a demonstration that Illinois Bell would be in compliance with Sections 13-507 and 13-505.1 of the Act if the proposed rate changes went into effect;
- (f) an identification of any changes to the GDPPI weights and an assessment of the effects of such changes, and any necessary modifications to the PCI;
- (g) the current data showing the calculation of Z for the previous calendar year, with the events causing Z to change identified and described;
- (h) the current data showing the calculation of Q for the previous calendar year, with the events causing Q to change identified and described.<sup>33</sup>

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<sup>33</sup> Alt Reg Order at 92.

Furthermore, the Commission stated that "Staff and all of the interested parties will have an opportunity to file written comments in response to each annual filing and the Company will have an opportunity to file reply comments." <sup>34</sup>

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<sup>34</sup> Id. at 93