

A NEW OPPORTUNITY

Cost-Based Pricing of Bell Atlantic-New Jersey Access Services

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ECONOMICS AND TECHNOLOGY, INC.

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Executive Summary

A NEW OPPORTUNITY: COST-BASED PRICING OF BELL ATLANTIC-NEW JERSEY ACCESS SERVICES

The state's current regulation system, which was authorized by the New Jersey legislature in its 1992 *Telecommunications Act*, offers Bell Atlantic-New Jersey, Inc. ("BA-NJ") expanded pricing flexibility and the opportunity for significantly increased earnings in exchange for a commitment by BA-NJ to substantially increase its level of investment in New Jersey's telecommunications infrastructure under the so-called "Opportunity New Jersey" (ONJ) Plan. In the five years following the Board of Public Utilities' adoption of the ONJ Plan, BA-NJ has enjoyed major financial benefits even though it has not increased its investment as promised and has opposed competition at every turn. The increased pricing and earnings flexibility coupled with reduced investment and continued monopoly pricing practices has enabled BA-NJ's profits to soar under alternative regulation. Consumers clearly have suffered under the ONJ Plan from unnecessarily inflated prices for many services, and have received few benefits in the form of new services and increased competitive choices. Since the adoption of the ONJ Plan in 1993:

- *BA-NJ's actual investment and financial performance under the ONJ Plan indicates that the Board's expectations with respect to infusion of new investment capital have not been realized;*
 - BA-NJ's financial return on equity (ROE) jumped from 22% to almost 40% [Figure 1, p. 5];
 - Rather than put those profits back into its telecommunications infrastructure, BA-NJ actually *disinvested* some \$76-million between 1993 and 1995 [Figure 2, p. 6];
 - The New Jersey Ratepayer Advocate found that between 1993 and 1996 BA-NJ invested \$545-million *less* than the level it had forecast in its ONJ Plan;¹

1. The Board's Inquiry into Bell Atlantic-New Jersey, Inc.'s Progress and Compliance with Opportunity New Jersey, its Network Modernization Program, *Order Approving Stipulation*, NJ BPU Docket No. TX96100707 (July 10, 1997), at 5, (continued...)

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- In constant dollar terms, BA-NJ's capital expenditures actually *decreased* once the new regulatory scheme had been put in place.²
- *BA-NJ has paid increasing dividends to its parent holding company since 1993 [Figure 3, p. 7], and in fact, BA-NJ's dividend payments to Bell Atlantic Corp. are among the highest, on both a relative and an absolute basis, of any BA operating company [Figure 6, p. 9];*
- In 1997, BA-NJ provided a \$559-million dividend to its parent — equating to approximately \$93.17 per access line per year (or \$7.76 per line per month). By way of comparison, BA-NY's dividend was only \$42.52 on a per-access line basis (\$3.54 per line per month);
- *BA-NJ continues to impose grossly excessive charges for the monopoly switched access services it furnishes to long distance carriers and correspondingly excessive charges for intrastate toll services it furnishes to its own end user customers;*
- Over the period 1994-97, BA-NJ's intrastate access charges exceeded the costs it actually incurs in providing access services by between \$100- and \$160-million annually [see Figure 7, p. 10];
- In that same period, BA-NJ had collected some \$500-million in excess of cost from New Jersey interexchange carriers for these essential services and received between \$200- and \$290-million in excessive revenues from its own toll rates annually during that same 1994-97 period [Figure 8, p. 11].

It is clear that a major source of BA-NJ's high profit levels stems from its policy of charging prices substantially in excess of cost for certain monopoly network usage services, particularly for “switched access” services that BA-NJ furnishes to intrastate long distance carriers for originating and terminating calls on the BA-NJ local network. These high access charges — which translate directly into correspondingly excessive intrastate long distance rates for customers — have traditionally been rationalized on the theory that they provide a source of “subsidy” to support below-cost residential dial tone line service. However, it is apparent from BA-NJ's sustained excessive profits that such “subsidies” or “hidden taxes” are no longer required and, moreover, that *the excessive access and toll revenues are not even being utilized for this purpose*. In a declining cost industry, there can certainly be no justification for a 100% increase in subsidy funding since 1991. In short, there is no justification for the \$160-million in excessive access prices that persists in the current BA-NJ revenue structure.

1. (...continued)
citing Advocate Brief, at 15-16.

2. *Id.*, at 5.

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A far more effective, efficient and publicly beneficial method of encouraging investment in New Jersey's telecom resources is to *reduce* access charges to cost. And unless access charges are reduced to cost, competition in all segments of the market (interLATA long distance, intraLATA long distance and local) will be stymied. Carriers entering the market will wish to offer a bundle of all services for all market segments, but by having to pay long distance access rates that BA-NJ does not incur, will not be able to offer pricing packages attractive enough to compete effectively with those of the incumbent.

Legislation that is currently pending would change the historic practice of setting access charges substantially in excess of cost. Under the proposed statute, S-1556, BA-NJ would be required to reduce intrastate switched access charges to cost over a three-year transition period. At the same time, BA-NJ would receive a \$100-million reduction in annual property tax payments to New Jersey municipalities. The bill provides for municipal funding levels to be maintained by dedicating a portion of the state telecommunications services sales tax for this purpose. Most importantly, all of the access reductions will be flowed through to customers and, therefore, customers effectively receive a \$160-million "tax" reduction over three years.

Moreover, because profits from existing access charges are neither required nor are being used by BA-NJ to subsidize basic residential dial tone service, elimination of the above-cost portion of intrastate access would have no adverse effect upon BA-NJ's local rates and would have only a modest impact on BA-NJ's overall financial performance. For example, if the access charge and property tax reductions that are currently before the legislation had been in effect for 1997, BA-NJ's 1997 return on equity would still have been an extremely robust 33%. Indeed, even with the proposed reductions in access charges, earnings levels would still be excessive by normal regulatory standards. Reducing BA-NJ's access charges to cost will thus result both in lower long distance prices to customers and in increased competition in the New Jersey telecom market, without any substantial adverse impact on BA-NJ, and without requiring any increase in local telephone rates.

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A NEW OPPORTUNITY: COST-BASED PRICING OF BELL ATLANTIC-NEW JERSEY ACCESS SERVICES¹

Bell Atlantic New Jersey's earnings have grown to excessive, supracompetitive levels since the adoption in 1994 of the Company's "Opportunity New Jersey" alternative regulation plan.

In 1992, the New Jersey legislature enacted new telecommunications legislation that, among other things, authorized the Board of Public Utilities (BPU) to modify the manner in which it regulated dominant incumbent local telephone companies such as Bell Atlantic-New Jersey (BA-NJ). Specifically, the 1992 *Telecommunications Act* permitted the Board to replace the traditional cost-plus "rate of return" ("ROR") regulation system with "incentive regulation" in which the telephone company's costs and rates were substantially de-linked and under which BA-NJ would be permitted to increase its earnings well above traditional ROR regulation levels.

Following enactment of the 1992 law, BA-NJ asked the BPU to adopt an incentive regulation plan that it called "Opportunity New Jersey" ("ONJ"). Under ONJ and in exchange for adoption of an alternative form of regulation, BA-NJ committed to undertake a significant acceleration of its planned deployment of advanced network technologies and services.² This promised acceleration was expressed in terms of explicit time commitments for the complete deployment of each of four specific technologies: Advanced Intelligent Network (to be deployed by 1998), Narrowband Digital Services (by 1998), Wideband Digital Services (by 2000), and Broadband Digital Services (by

1. Economics and Technology, Inc. (ETI) was asked by AT&T to analyze BA-NJ's financial performance under the Opportunity New Jersey Plan, the extent to which BA-NJ has complied with the infrastructure goals established in that plan, and the likely impact on BA-NJ of proposed legislation to reduce BA-NJ's switched access charges to cost. The project was conducted under the overall direction of Dr. Lee L. Selwyn, with the assistance of Joseph W. Laszlo. The views expressed in this study are those of ETI, and do not necessarily reflect the views of its sponsor.

2. Application of New Jersey Bell Telephone Company for Approval of its Plan for an Alternative Form of Regulation, *Decision and Order*, NJ BPU Docket No. TO92030358, (May 6, 1993) ("NJ Alternative Regulation Order"), at 73.

2010).³ According to the case made by BA-NJ (and cited in the BPU's Order), these date commitments represented a significant advance over BA-NJ's previously planned deployment times, and would lead to incremental annual expenditures that would exceed BA-NJ's "business as usual" projected network investment by some \$1.5-billion between 1992 and 1999.⁴ The BPU specifically included the ONJ infrastructure investment commitment as an integral element of the alternative regulation plan that it ultimately adopted in 1994.⁵

In adopting the ONJ Plan, the BPU accepted BA-NJ's argument that accelerated investment in an advanced telecommunications architecture would have direct economic benefits for New Jersey. The Board found that "ONJ ... will promote diversity in telecommunications products and services and will encourage the maximum efficiencies of the public switched network."⁶ The Board further found that such commitments would serve as a balance to the profits BA-NJ stood to earn under an alternative form of regulation. Accordingly, the Board reserved "the right to commence a proceeding and examine key aspects of the plan to ensure that NJ Bell does not receive the benefits of an alternative form of regulation without at the same time fulfilling its obligations."⁷

Indeed, the Board explicitly recognized the need for some degree of oversight with regard to BA-NJ's implementation of ONJ, finding that "a drastic deviation from the ONJ schedule submitted by NJ Bell will have a direct and likely negative impact on the level of economic development" in the state.⁸ As a result, the Board required BA-NJ to "furnish information in its annual Infrastructure Deployment report showing how and to what extent the plan and ONJ positively impact the New Jersey economy," and reserved the right to undertake any of a number of options, including "altering ... depreciation allowances ..., restructuring BA-NJ's ability to implement indexed price increases, or, in the extreme scenario, voiding the [alternative regulation] plan and instituting a traditional rate proceeding" if BA-NJ failed to live up to its ONJ obligations.⁹ Finally, the Board also stated that it reserved the right "to seek a further acceleration of the benefits of ONJ if the technology and/or costs of actual deployment become more advantageous than projected."¹⁰

3. *Id.*, at 73-74.

4. *Id.*, at 74-75.

5. *Id.*, at 1; 87-98.

6. *Id.*, at 97.

7. *Id.*

8. *Id.*

9. It should be noted that the information furnished by BA-NJ in these filings is in large part proprietary, thus preventing meaningful public scrutiny of the most relevant data for assessing the company's compliance with its ONJ commitments.

10. *Id.*

Since adoption of ONJ, BA-NJ’s investment in New Jersey’s telecommunications infrastructure has fallen short of BA-NJ’s explicit incremental investment commitments, contributing directly to the sustained and persistent excess earnings that BA-NJ has been able to realize under alternative regulation.

The Board’s foresight in instituting those controls was borne out by the first review of the ONJ Plan, undertaken in early 1997. In that review, the Division of the Ratepayer Advocate and the Board Staff together showed that “[t]he record demonstrates that expenditures lagged expectations” substantially.¹¹ The Advocate argued that BA-NJ’s skyrocketing financial performance under alternative regulation, and the emerging reality that the commitments BA-NJ undertook under ONJ would not cost it nearly as much as its projections had indicated, required that the Board revisit and expand the terms of the ONJ Plan.¹²

The Advocate’s analysis showed that between 1993 and 1996 BA-NJ spent \$545-million less than it had forecast for ONJ in the Alternative Regulation proceeding.¹³ Moreover, in constant dollar terms, BA-NJ’s capital expenditures actually *decreased* during those years of the plan.¹⁴ BA-NJ contended that it had never entered into a binding commitment to invest specific amounts of capital cited in the alternative regulation decision, or to deploy any specific technologies,¹⁵ but that its commitment was to a timetable for making the four service capabilities available to customers on an accelerated basis.¹⁶ The BPU eventually approved a settlement under which it accepted that BA-NJ had complied with the terms of the plan, but also clarified and added to BA-NJ’s ONJ obligations. The Board also reasserted its continued oversight of the ONJ plan. Moreover, the Board-approved settlement was not the final word; intervenors in the multi-phase local competition proceeding have expressed concerns that BA-NJ continues to avoid compliance with the terms of its ONJ commitments.¹⁷

11. The Board’s Inquiry into Bell Atlantic-New Jersey, Inc.’s Progress and Compliance with Opportunity New Jersey, its Network Modernization Program, *Order Approving Stipulation*, NJ BPU Docket No. TX96100707, (June 10, 1997), (“Order Approving Stipulation”), at 8.

12. *Id.*, at 4, citing Advocate Brief, at 10-13.

13. *Id.*, at 5, citing Advocate Brief, at 15-16.

14. *Id.*, at 5.

15. *Id.*, at 6, citing BA-NJ Initial Brief, at 6-7.

16. *Id.*, citing BA-NJ Initial Brief, at 1-2.

17. See In the Matter of the Investigation Regarding Local Exchange Competition for Telecommunications Services (Universal Service Phase), NJ BPU Docket No. TX95120631, Initial Briefs (dated December 5, 1997) of New Jersey Cable Television Association at 9-10, MCI at 68-69, and AT&T at 73-82, and Reply Brief of Advocate (dated December 15, 1997) (continued...)

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The legislature enacted the 1992 law specifically to encourage investment in New Jersey by incumbent local telephone monopolies, investment in telecommunications resources that it expected would catalyze economic activity and development throughout all parts of the state. In enacting the 1992 law, it would appear that the New Jersey legislature relied upon two central — albeit unsubstantiated — premises:

- (1) That only the incumbent local telephone monopolies had the physical capability and financial capacity to make the investment in New Jersey’s telecom infrastructure that was required to bring broadband services to all parts of the state and to all of its citizens; and
- (2) That the only way to spur the incumbent monopolies to invest in New Jersey (and thereby to expand the scope and capabilities of their networks) is to provide them with opportunities to increase their earnings overall.

Now, six years after enactment of the *Telecommunications Act* and five years after the BPU’s adoption of alternative regulation for BA-NJ, it has become painfully clear that BA-NJ did not respond to its self-created “incentives” to invest in New Jersey’s infrastructure.

- BA-NJ’s profits have soared. Since enactment of the 1992 statute, BA-NJ’s financial return on equity (ROE) jumped from about 20% to the 40% range [Figure 1].¹⁸ While the BPU’s price cap plan requires BA-NJ to “share” 50% of all earnings in excess of 13.7%

17. (...continued)
at 14-22.

18. Even when expressed on a regulatory accounting basis, BA-NJ has been permitted to amass earnings that would indisputably be considered “excessive” under traditional rate of return regulation standards. Reported financial results differ as between regulatory (FCC, PUC) and financial (SEC) reporting requirements. In general, earnings and ROE as reported on FCC Form M and as compiled in ARMIS, which are based upon regulatory accounting practices and depreciation rates and are limited to those segments of the utility’s business that are subject to regulation, tend to be *lower* than results reported on the 10-K.

There are several reasons for this. In 1994, Bell Atlantic and most other Regional Bell Operating Companies (RBOCs) changed their method of financial reporting from SFAS 71 to Generally Accepted Accounting Principles (GAAP), and in so doing took substantial write-downs of their embedded asset base. These write-downs were not, however, recognized for *regulatory* ratemaking purposes. Thus, regulatory reporting necessarily reflects a higher value for the firm’s net investment. As such, the rate of return on that investment will usually be lower on the Form M than on the 10-K. In addition, BA and other RBOCs have been systematically shifting the more profitable segments of their businesses out of regulation (for example, the transfer in 1998 of BA-NJ’s yellow pages business to a separate BA subsidiary), thereby leaving the relatively less profitable revenue sources under the Form M reporting umbrella. Since the 10-K financial results more accurately reflect the Company’s ability to attract capital as well as revealing the extent of its continuing market power in the local telephone business, this study focuses primarily upon 10-K financial results. Regulatory basis results are, however, useful in examining certain results of regulatory policies. For example, as we discuss *infra*, BA-NJ’s dividend payments to its corporate parent have consistently exceeded its earnings when reported on a regulatory basis, effectively creating a net outflow of capital from the state.

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with its ratepayers,¹⁹ this “return on investment” calculation is limited to specified “noncompetitive” services and does not apply to services not embraced within the price cap (for example, Centrex services). Moreover, inasmuch as BA-NJ has not been required to undertake a detailed cost allocation as between its price capped and other services, any “return on investment” figure that is limited to price cap services is subject to massive manipulation by BA-NJ²⁰ and is therefore meaningless as an indicator of BA-NJ’s performance under price cap regulation. For this reason, in this report we examine BA-NJ’s performance on a *total company* basis.

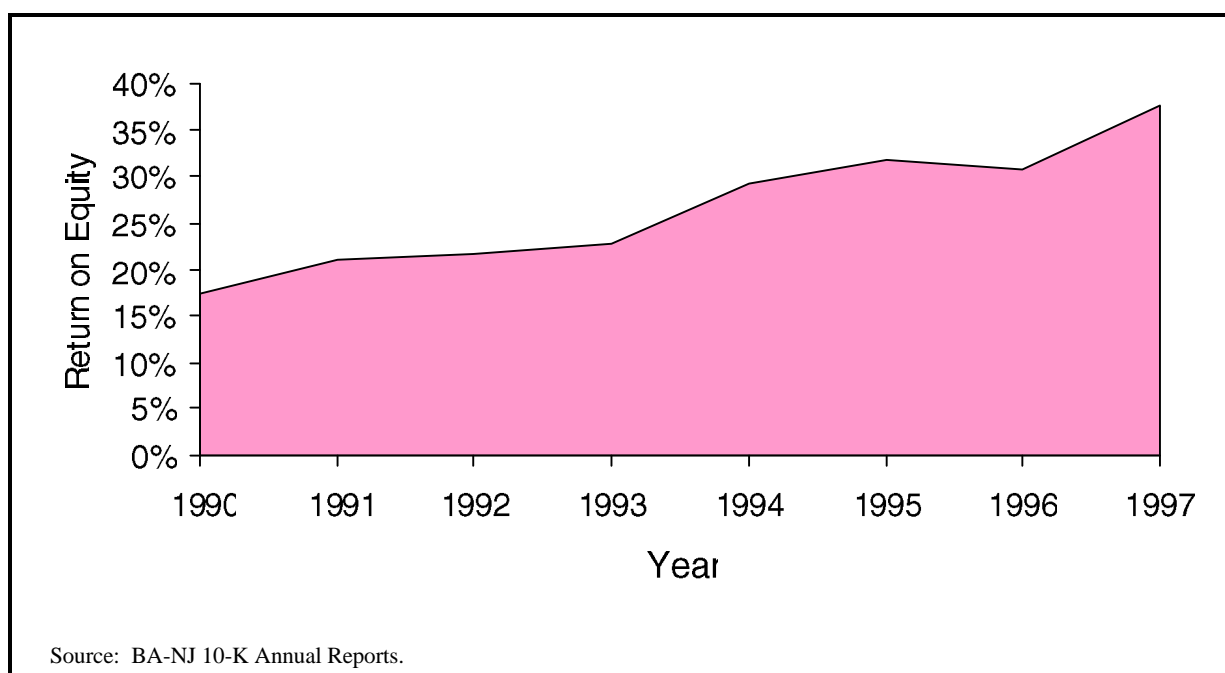


Figure 1. BA-NJ’s financial return on equity has soared since 1994, when the alternative regulation plan went into effect.

- Instead of reinvesting those excess earnings back into its New Jersey infrastructure or infusing new capital into the state as BA-NJ’s ONJ Plan had promised it would do, between 1993 and 1995 BA-NJ actually *disinvested* in New Jersey — i.e., its depreciation accruals in each of those years *exceeded* its gross new investment, resulting in a *net decrease* in the value of BA-NJ’s New Jersey plant [see Figure 2].

19. NJ Alternative Regulation Order, at 45.

20. In fact, the exclusion of certain services from price cap regulation confronts BA-NJ with an enormous incentive to shift (allocate) as much cost (investment and expense) as possible to its price cap services, thereby depressing earnings in this category while increasing returns on services that fall outside of direct regulatory scrutiny.

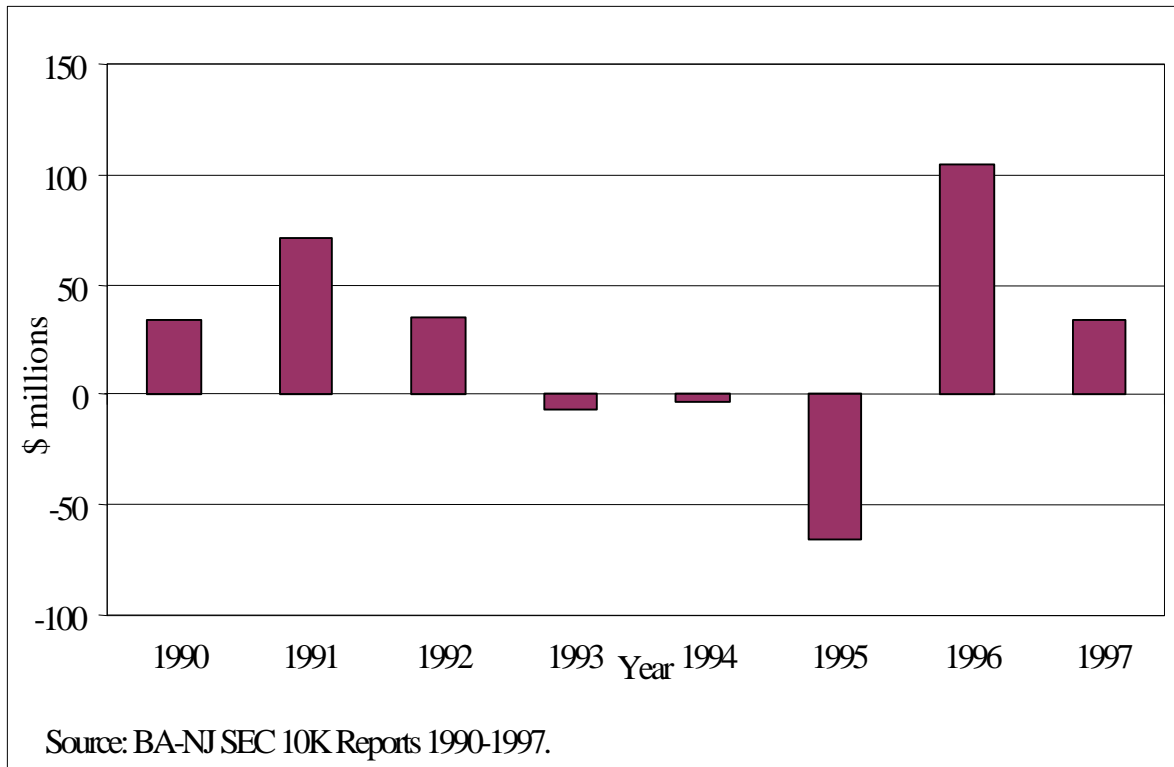


Figure 2. Rather than increase its investment in New Jersey as promised, BA-NJ disinvested in New Jersey's telecommunications infrastructure in 1993-1995.

- Bell Atlantic has *reduced* its capital investment in New Jersey by extracting more cash from its New Jersey subsidiary than its regulatory basis earnings in each year since 1990. Dividends to the parent company have exceeded regulatory earnings by \$360-million since enactment of the 1992 law [Figure 3].²¹ In 1997 alone, BA-NJ provided a dividend of \$559-million to its parent.

21. Comparison of dividend payments to regulatory basis earnings is appropriate because it directly portrays the effect of the alternative form of regulation that was adopted by the BPU. Since the express purpose of affording BA-NJ pricing and earnings flexibility was to encourage the BA-NJ to reinvest in the state, BA-NJ's consistent and persistent extraction of earnings from New Jersey highlights the failure of this program to achieve its intended purpose.

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- Since the 1984 break-up of the former Bell System, Bell Atlantic Corp. (now Bell Atlantic-South) has invested more than \$4-billion in *non-local telco* businesses, an investment that has been funded largely by profits and retained dividend payments extracted from its local telephone monopolies, including BA-NJ [Figure 4]. Bell Atlantic has also traded on the consistently high earnings from its local telco monopolies to finance far riskier non-telco ventures [Figure 5].
- BA-NJ's pattern of extracting capital from its home service area is not replicated in all other jurisdictions. For example, during 1997, when Bell Atlantic Corp. extracted some \$559-million from BA-NJ (which has 15% of the RBOC's total access lines), its sister operating company, BA-NY, paid Bell Atlantic only about \$488-million in dividends, even though the New York affiliate serves almost 30% of BA's total access lines [see Figure 6]. In fact, BA-NJ's contribution to total dividends paid to the parent company was greater than for any other single Bell Atlantic state.

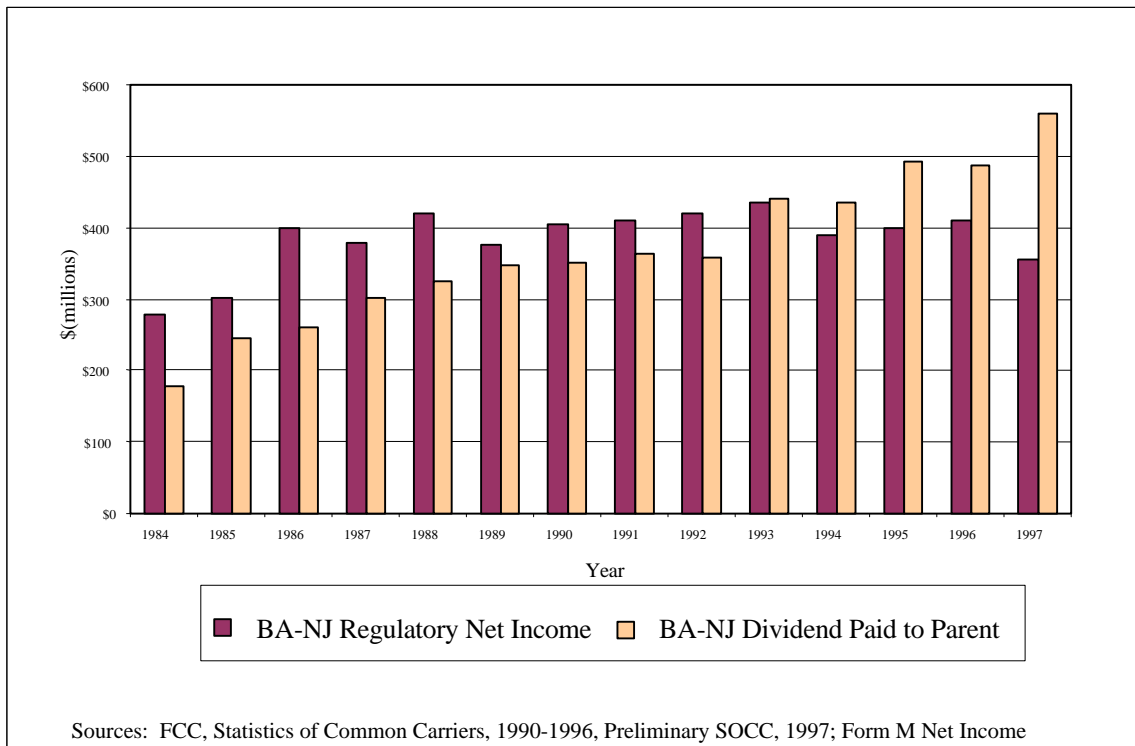


Figure 3. Dividend payments by BA-NJ to Bell Atlantic Corp. have exceeded BA-NJ's (regulatory basis) income in every year since the 1994 implementation of the alternative regulation plan.

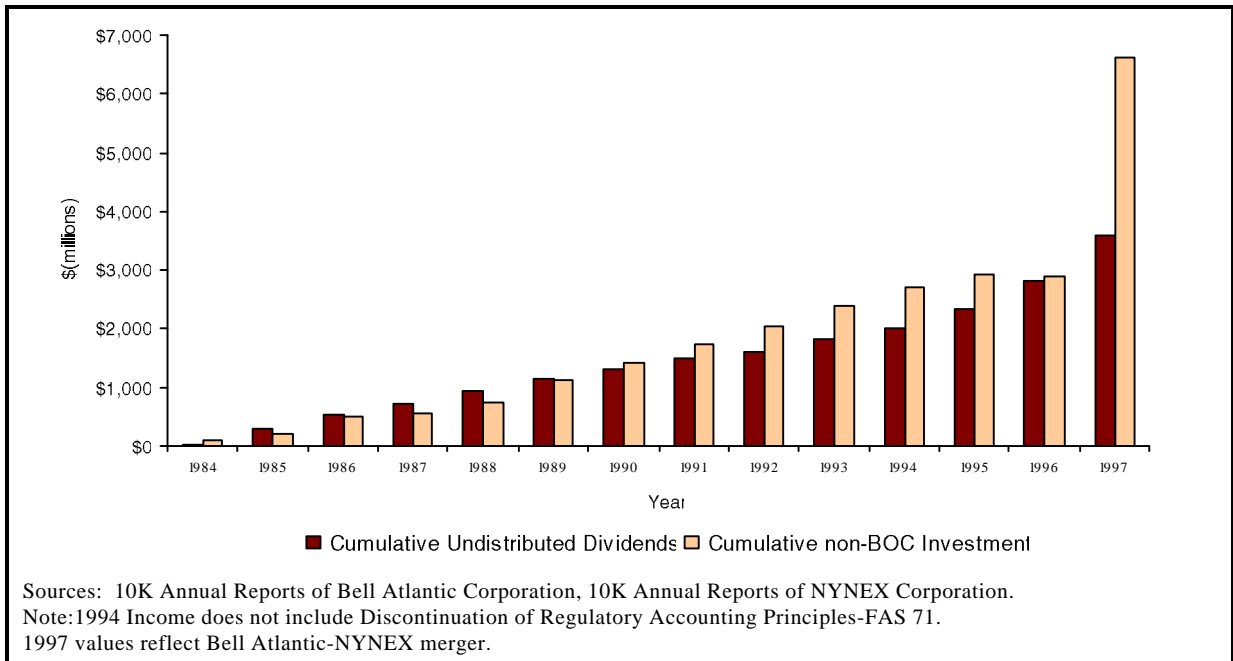


Figure 4. Undistributed BOC dividends have potentially provided sufficient financing for virtually all of Bell Atlantic’s non-BOC investment activities.

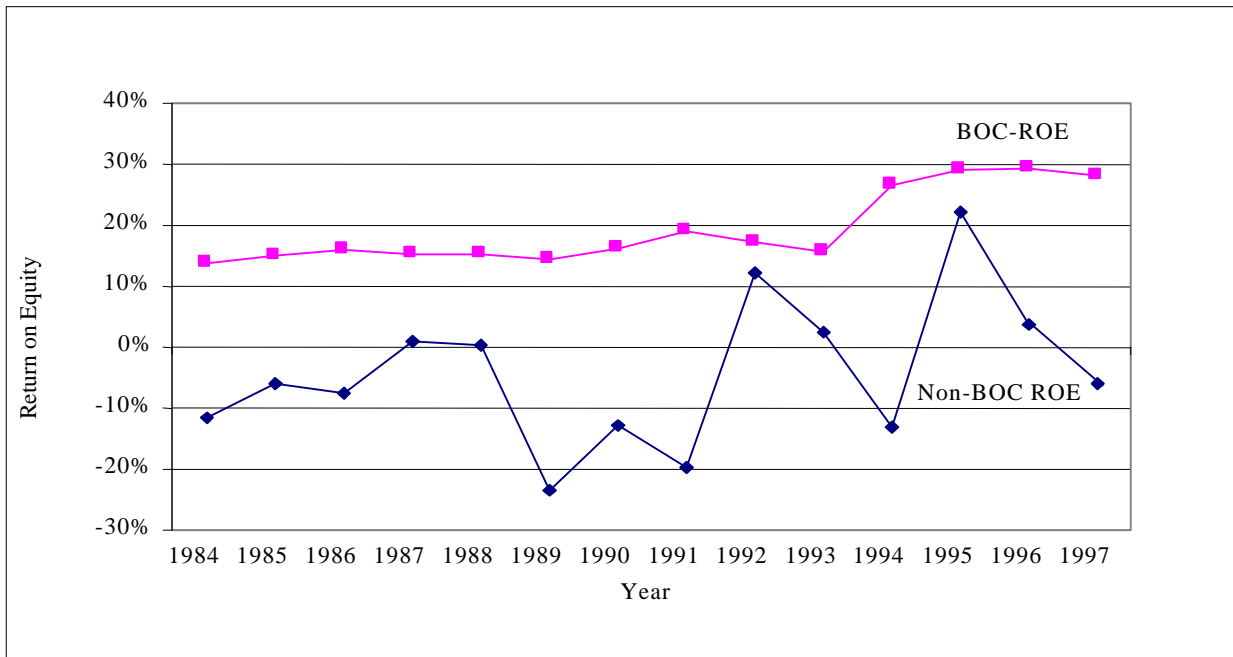


Figure 5. BA’s non-BOC ROE is far more volatile than the returns of its BOC subsidiaries.

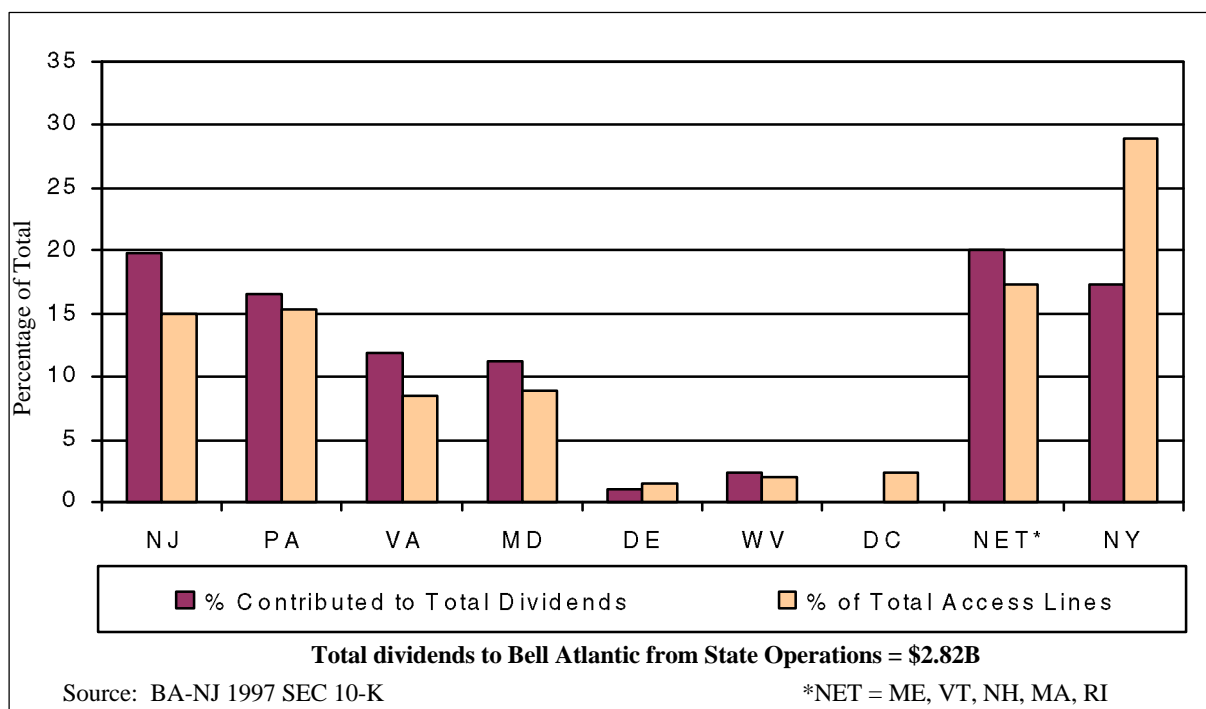


Figure 6. BA-NJ’s 1997 dividend payments to its parent, Bell Atlantic Corp., exceeded the amount contributed by any other Bell Atlantic state.

The requirement that BA-NJ reduce its monopoly intrastate switched access charges to cost-based levels would not necessitate offsetting rate increases in other services and would still leave the Company with supracompetitive earnings.

Despite its persistent excessive earnings and its failure to reinvest those earnings back into its New Jersey network, BA-NJ has been permitted to impose grossly excessive charges for the monopoly switched access services it furnishes to long distance carriers and correspondingly excessive charges for intraLATA toll services it furnishes to its own end user customers. These high access charges — which translate directly into correspondingly excessive intraLATA long distance rates — have traditionally been rationalized on the theory that they provide a source of “subsidy” to support below-cost residential dial tone line service. However, it is apparent, from the telephone company’s sustained excessive profits, that such “subsidies” are no longer required and, moreover, that the excessive access and toll revenues being garnered by BA-NJ are not even being utilized for this purpose. A far more effective, efficient and publicly beneficial method of encouraging investment in New Jersey’s telecom resources is to *reduce* access charges to cost, flow-through those reductions in lower intrastate toll rates, and in so doing encourage competitive entry and investment in all segments of New Jersey’s telecom market.

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Over the period 1994-97, BA-NJ's intrastate access charges exceeded the costs it actually incurs in providing access services by between \$100- and \$160-million annually [see Figure 7]. Over the four year period, BA-NJ had collected some \$500-million in excess of cost from New Jersey interexchange carriers for these essential services. Projecting forward based upon recent growth rates for access minutes and revenues, we estimate that between 1999 and 2002, BA-NJ will generate excess profits of nearly \$1-billion from its intrastate switched access services [see Figure 8]. Assuming that the continued growth of access usage follows historical trends coupled with the minimal level of competition in the switched access market that is likely to develop over this period, these excessive profits are likely to persist and to grow.

Through imputation of these excessive access charges into its own intraLATA toll rates, BA-NJ had also collected between \$200- and \$290-million in excess toll revenues annually during that same 1994-97 period [Figure 9]. These excessive toll revenues are solely the result of the uneconomic, inflated access charges that BA-NJ is currently allowed to charge, and have no relationship whatsoever to the cost (including reasonable profit) of providing toll services themselves.

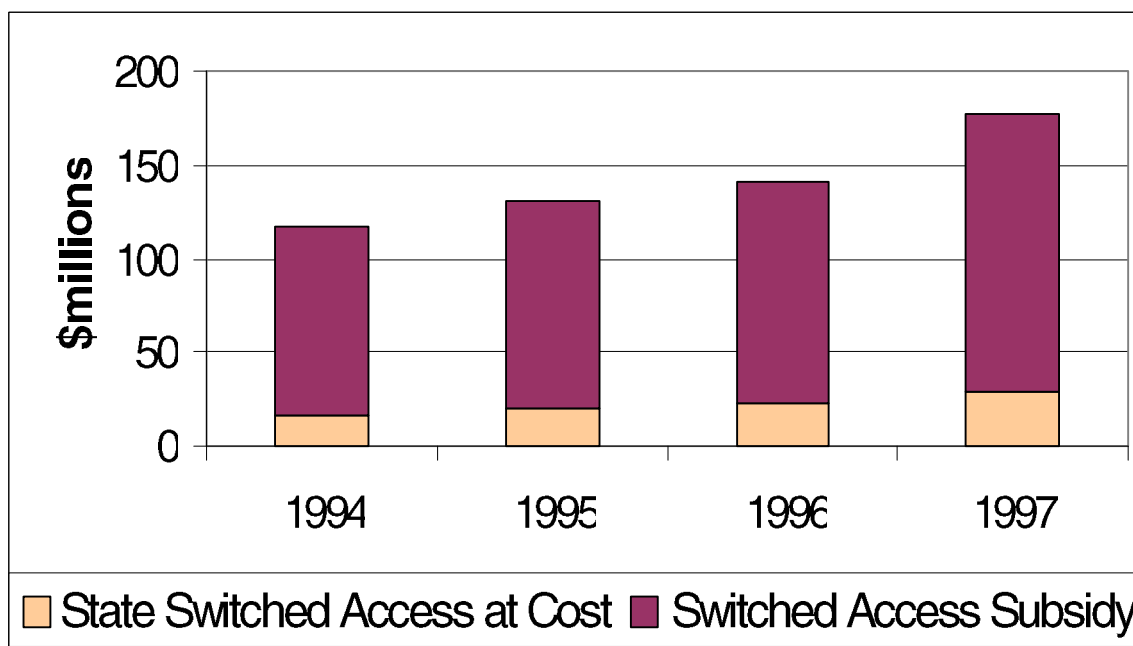


Figure 7. BA-NJ's intrastate switched access rates vastly exceed its costs.

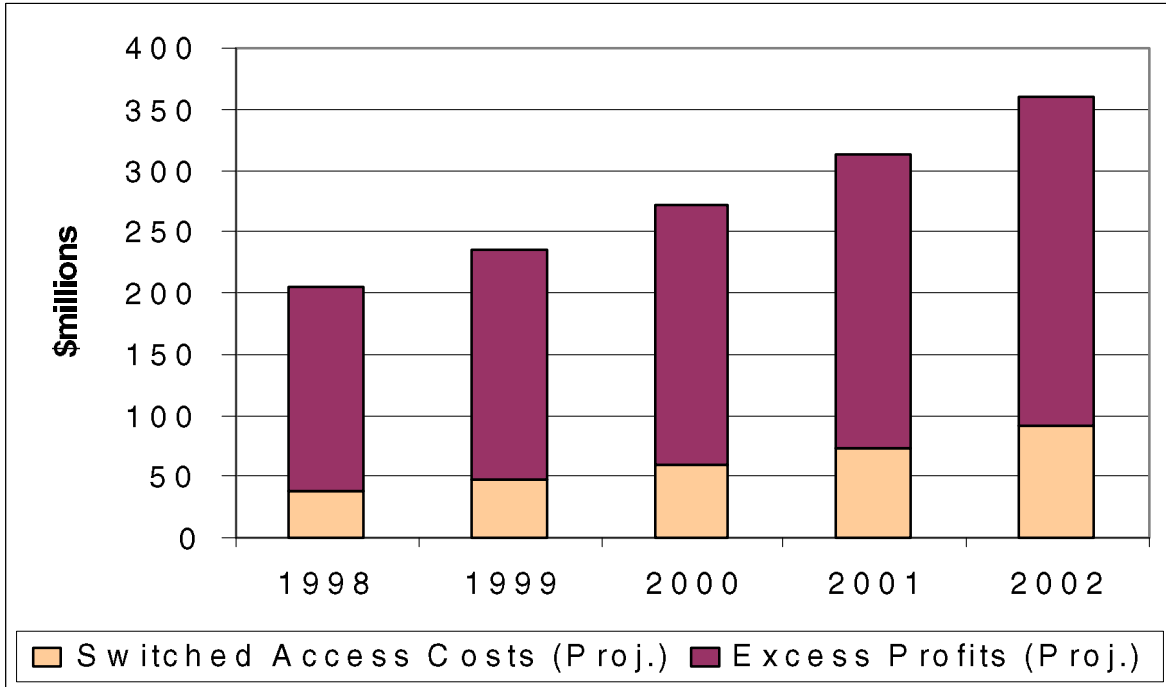


Figure 8. Over the 1999-2002 period, BA-NJ will earn close to one billion dollars in excess profits if its switched access rates remain at their current, inflated levels.

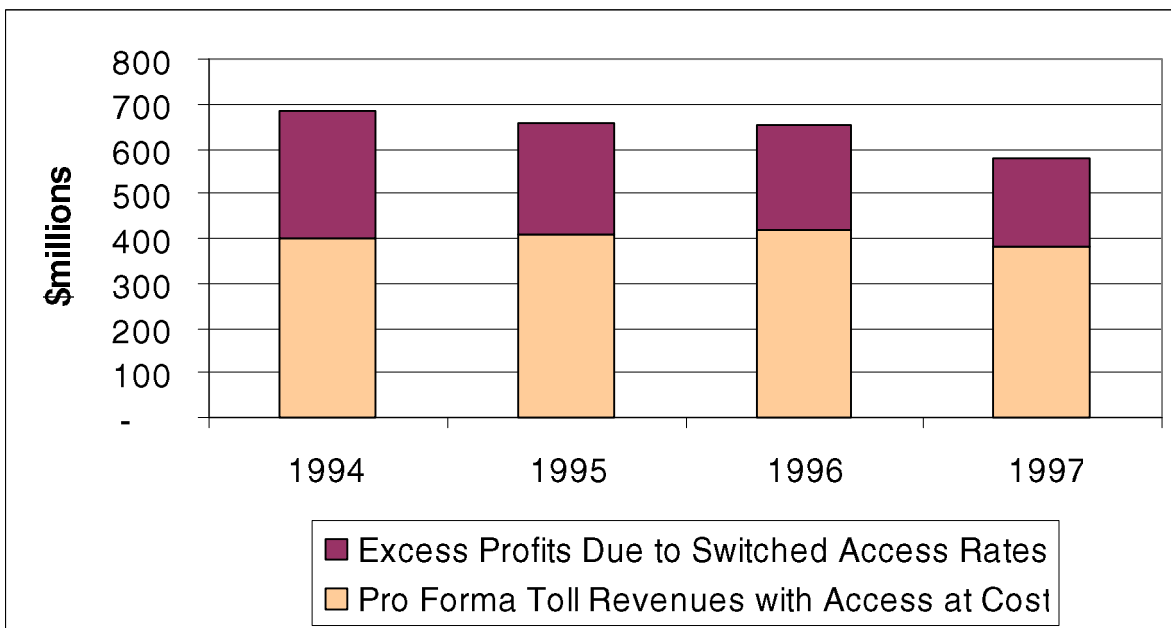


Figure 9. BA-NJ could substantially reduce its intraLATA toll rates if switched access were priced at cost.

Significantly, demand for long distance services overall has continued to grow, due in part to IXC marketing efforts and to the lower prices that have resulted from the intense competition in the long distance business. Thus, without any particular effort or investment on its own part, demand for BA-NJ's access services has skyrocketed, as have associated revenues [see Figure 10]. In 1997, BA-NJ furnished some 7.3-billion *intrastate* switched access minutes, an increase of more than 80% relative to the demand in 1994, just three years earlier! During that same period, BA-NJ's intrastate switched access *revenues* grew from \$117-million in 1994 to more than \$177-million in 1997, a gain of 51% in just three years. While a portion of this growth can be traced to overall growth in demand for telecom services in general, the bulk of the gain is explained by a significant jump in average customer long distance usage: In 1994, the average BA-NJ access line used 800 intrastate switched access minutes; as of 1997, that per-line demand had jumped by 50%, to more than 1200 minutes [Figure 11].²² This per-line demand growth has been driven by switched access usage overall, which has grown by over 80% between 1994 and 1997, while access lines have only grown by 17% in the same time period [Figure 12].

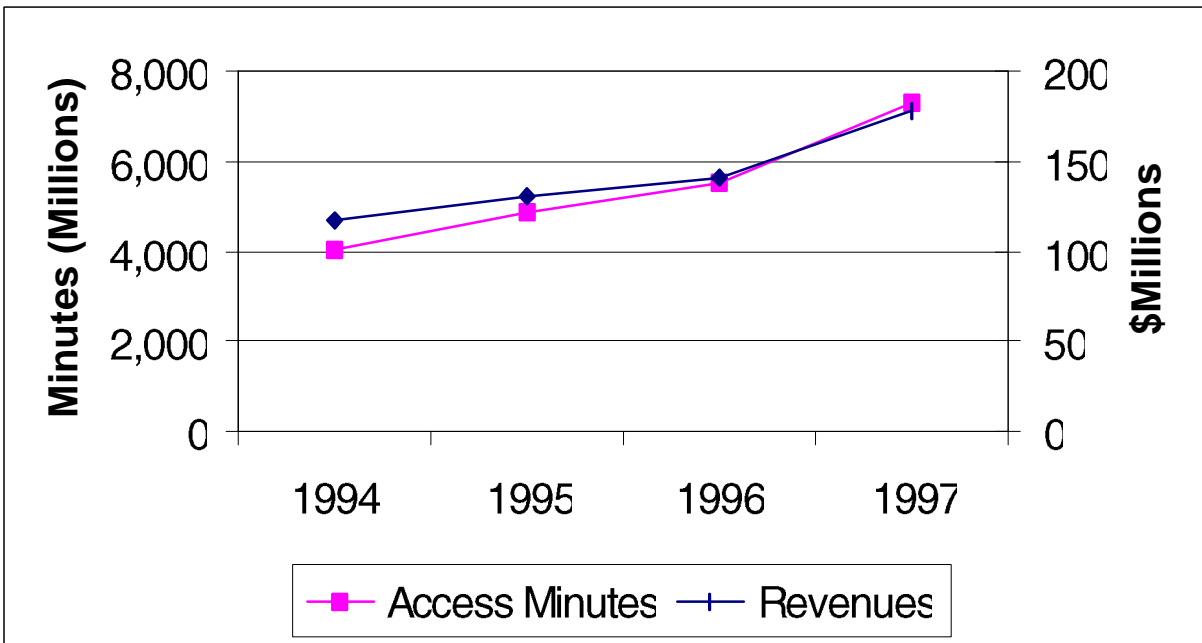


Figure 10. BA-NJ's intrastate access minutes and revenues are experiencing substantial and sustained growth.

22. On May 5, 1997, 1+ presubscription for intraLATA calling became available in New Jersey, and thus some of the 1997 increase in intrastate switched access minutes is attributable to customers shifting their intraLATA toll service from BA-NJ to an interexchange carrier, which would be required to purchase switched access service from BA-NJ to handle that traffic.

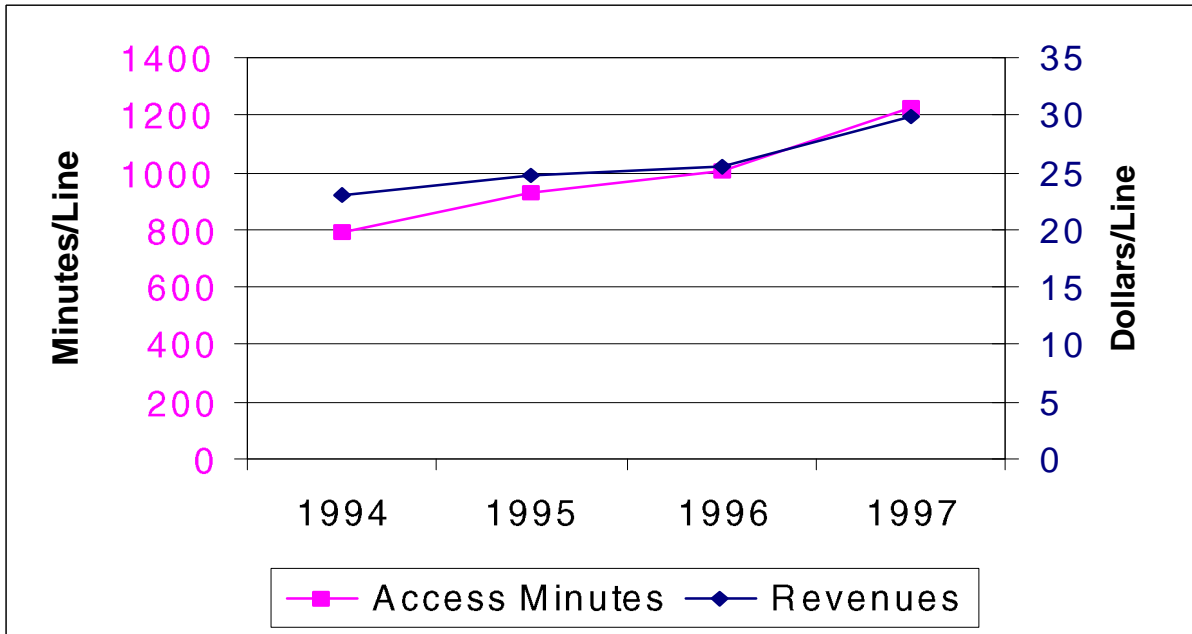


Figure 11. Even on a per-line basis, BA-NJ's intrastate access minutes and revenues exhibit steady growth.

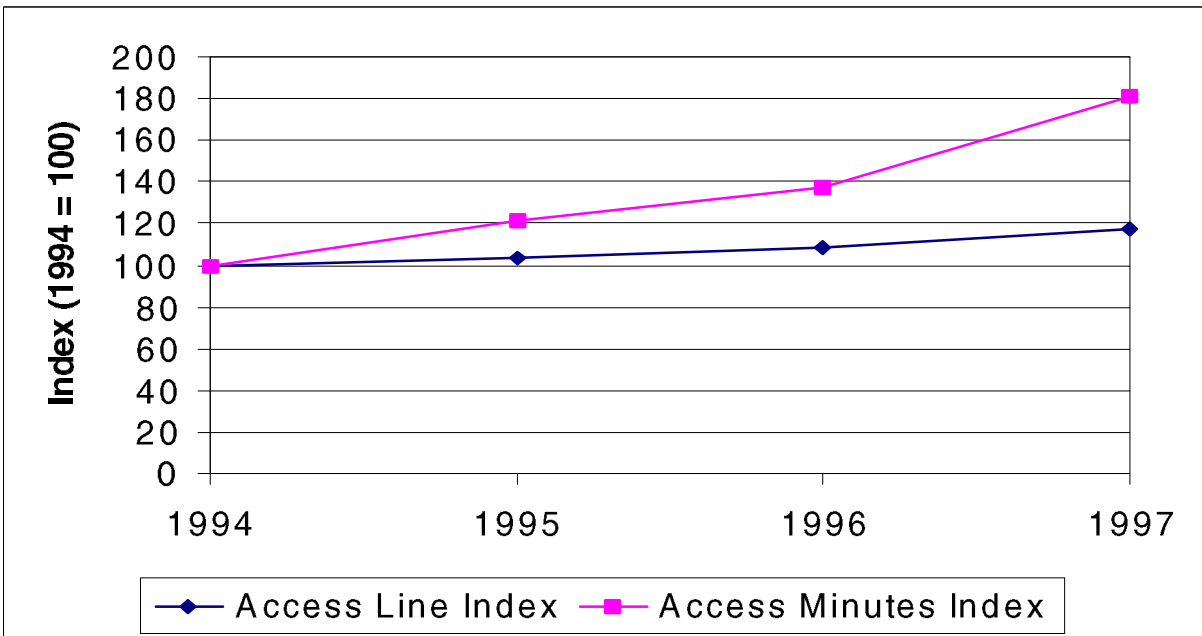


Figure 12. Growth in switched access usage has far outpaced growth in access lines.

It is clear that switched access rates could, and indeed *should*, be reduced to cost, and that this can be accomplished without any offsetting adjustment to local service rates. Legislation that is currently pending²³ would change the historic practice of setting access charges substantially in excess of cost. Under the proposed statute, BA-NJ would be required to reduce intrastate switched access charges to cost over a three-year transition period. Figure 13 shows the impact of this proposal on projected switched access revenues between 1998 and 2002.

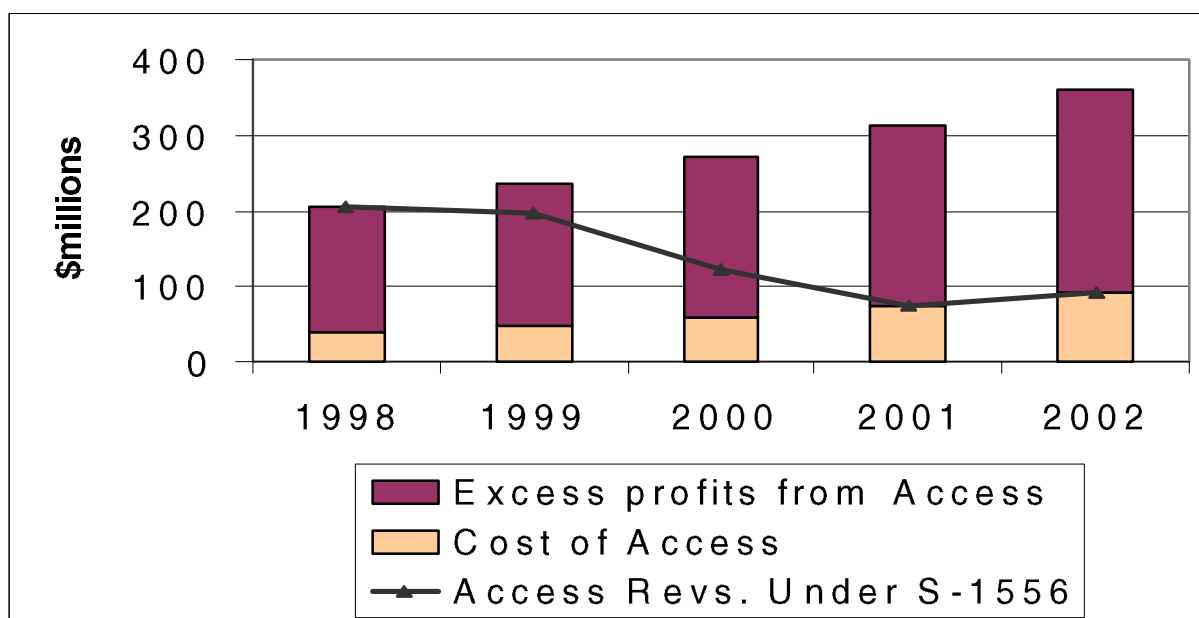


Figure 13. Under S-1556, access revenues would be reduced to cost by 2001.

At the same time, however, the Company would receive a \$100-million reduction in annual property tax payments to New Jersey municipalities, also phased in over three years.²⁴ We have prepared an analysis to simulate the effect of these changes on BA-NJ earnings assuming that the law had been enacted in 1994 and that the three-year transition had occurred over the 1995-97 period.²⁵ In addition to eliminating the above-cost portion of the switched access charge, we have also assumed that the lower access charges were flowed through, dollar-for-dollar, in lower end

23. *Telecommunications Tax and Rate Relief Act (Sec. 1)*, S-1556 (Inverso/Kenny).

24. The bill provides for municipal funding levels to be maintained by dedicating a portion of the state telecommunications services sales tax for this revenue.

25. The legislation would require interexchange carriers (IXCs) such as AT&T and MCI to flow-through any access charge reductions, dollar-for-dollar, to their end-user customers in lower intrastate toll rates. BA-NJ would not, however, be subject to a similar flow-through requirement. For purposes of this analysis, we have assumed that BA-NJ would nevertheless make commensurate reductions in its intraLATA toll rates, although, as the dominant local telephone monopoly in New Jersey, BA-NJ will not necessarily be compelled by marketplace forces to match competitor rates precisely.

user intraLATA toll rates. The bill provides for dollar-for-dollar flow-through in inter- and/or intraLATA intrastate toll rates. Because BA-NJ currently provides only intraLATA toll service, the example assumes all BA-NJ toll rates flow through access reductions. It is important to note that this access rate reduction has a demand stimulating component as well. That is, had BA-NJ reduced its access rates to cost-based levels over a 1995-97 transition period and had BA-NJ and the IXC's flowed through the lower access charges in lower toll rates (as the IXC's would be required to do under the pending legislation), the demand for intrastate long distance services would have increased over that period, resulting in a corresponding increase in the volume of intrastate switched access and intraLATA toll minutes that would have been furnished by BA-NJ.²⁶

In 1997, BA-NJ's intrastate switched access revenues were approximately \$180-million, or nearly \$160-million above the \$22-million cost of this service. A flow-through of cost-based access charges in BA-NJ's intraLATA toll rates would have lowered toll rates by \$200-million, before adjusting for stimulation. Offsetting this revenue decrease by the \$100-million in property tax reductions, taking into account the demand stimulation effect described above, and adjusting for state and federal corporate income taxes, the net impact of the proposed legislation upon BA-NJ's 1997 *after-tax net income* would be only \$84-million, reducing BA-NJ's after-tax ROE by five percentage points to 32.7% [see Figure 14]. Offsetting these modest decreases in earnings, and not reflected in this analysis, are the substantial cost savings that BA-NJ is realizing as a result of its recent merger with NYNEX,²⁷ as well as the continuing growth in demand for telecommunications services generally, of which BA-NJ will continue to realize a major share.

26. The FCC has estimated the demand elasticity associated with interstate toll at -0.723 and with interstate switched access service at -0.49. *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, CC Docket 87-313, FCC 90-314 (rel. October 4, 1990), Appendix C, at 10-11. Assuming, conservatively, demand elasticity at half the FCC's estimates, i.e., at -0.362 for toll and -0.245 for access, BA-NJ toll and access revenues would have been stimulated by some \$72- and \$38-million, respectively, during 1997, bringing the net revenue decrease (relative to the actual above-cost 1997 level) to about \$240-million.

27. Bell Atlantic estimates place such savings as high as \$270-million annually. The Bell Atlantic-NYNEX Joint Proxy Statement projected ultimate annual synergies of \$900-million. Joint Proxy Statement at 42. Reinforcing these expectations of extensive cost savings, a high-level Bell Atlantic executive is quoted in the June 26, 1997 *New York Times* as complaining that "the companies were foregoing \$5 million in revenue for each day they could not combine their operations." According to the article, "that sum represents both the cost savings and potential synergies the companies could realize by merging." At a rate of \$5-million per day, annual merger-driven cost savings and other synergies would top \$1.8-billion, even more than had been forecast in the Joint Proxy Statement. "Justice Department Deals a Setback to Ameritech in Michigan," *The New York Times*, June 26, 1997, at D1. Since BA-NJ represents approximately 15% of the new (post-merger) Bell Atlantic, merger-driven cost savings for BA-NJ *alone* would appear to exceed \$270-million annually!

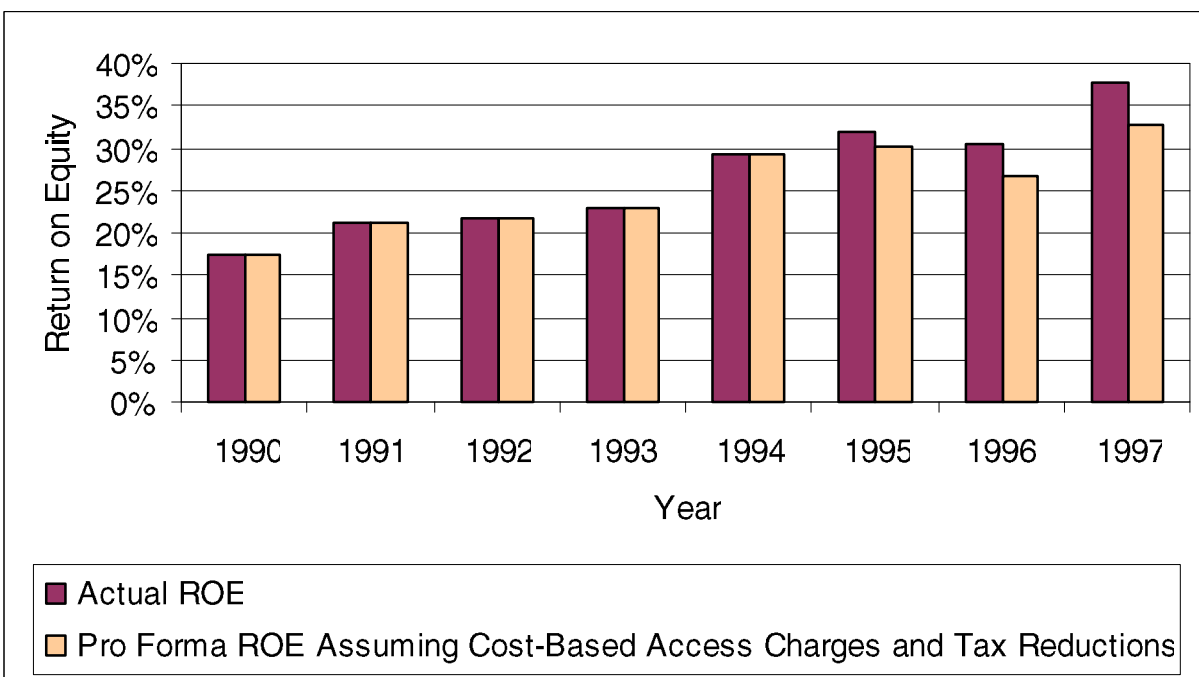


Figure 14. Combined with the proposed property tax reduction, reducing access charges to cost will have minimal impact on BA-NJ’s already substantial 10-K based return on equity.

The outcome under S-1604, Bell Atlantic’s alternative legislation,²⁸ would be quite different. This proposal would *not* reduce access charges to cost-based levels, but would instead merely reduce them by some \$67-million, only partially offsetting the proposed \$100-million tax reduction. BA-NJ will also reduce its intraLATA toll rates by some \$33-million, a reduction that will also be offset dollar-for-dollar by the property tax reductions. BA-NJ is not required to reduce its intraLATA toll rates to correspond to the \$67-million access charge reduction, and because of its position as the incumbent monopoly provider of intraLATA toll service, it is unlikely that the BA-NJ will be forced to do so by competitive pressures. Indeed, experience in other states confirms that even after competitors enter the intraLATA toll market, the incumbent is still able to maintain intraLATA toll rate levels above those set by IXCs. It is therefore unlikely that BA-NJ will need to reduce toll rates beyond the \$33-million in reductions under the proposed legislation so as to incorporate the effect of the intrastate switched access reduction. Accordingly, we have estimated the impact of S-1604 on BA-NJ’s return on equity [Figure 15] assuming toll rates are reduced only to the extent required in the legislation. Consequently, under S-1604, BA-NJ’s financial performance actually *improves* when compared with the status quo. This results from the effect of demand stimulation resulting from the lower toll and access rates are taken into account, *the combination of revenue stimulation and the \$100-million in property tax reductions will more than offset the proposed rate decreases.*

28. *Telecommunications Tax Equity and Rate Relief Act (Sec. 1)*, S-1604 (Bennett/Adler).

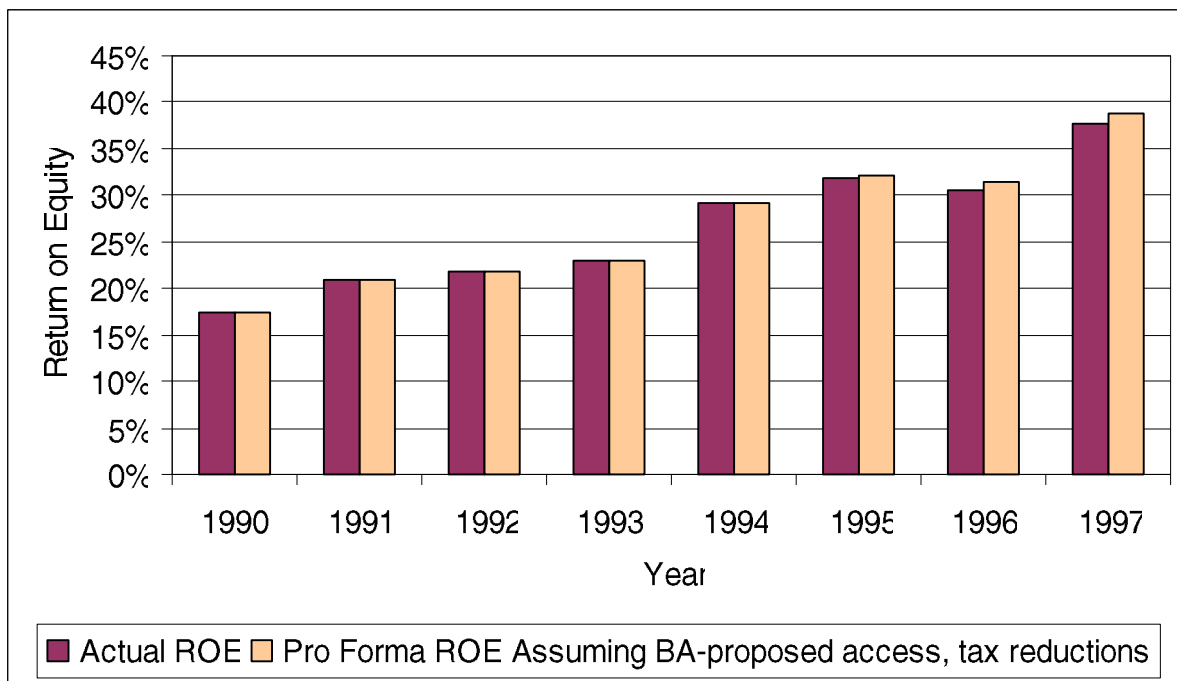


Figure 15. BA-NJ's alternative legislative proposal, S-1604, would increase BA-NJ's return on equity relative to its current level.

Besides the direct benefits from reduced rates for intrastate long distance services, the reductions proposed in the original legislation, S-1556, will have the additional benefit to consumers of encouraging the development of increased competition. Relieving potential competitors of the burdensome cost imposed by the current, inflated rates they pay for intrastate access will reduce one of the key financial barriers to entry in the New Jersey market. Such competition will increase consumer choice, spur the rapid introduction of new and innovative services (which the ONJ Plan's regulatory arrangement was intended to provide in the first place), and create a new source of pressure on BA-NJ to reduce rates for services to levels that reflect the cost of providing them.

The proposed changes in revenue and cost levels can thus be accomplished without any need to increase other BA-NJ rates, such as basic local service, because BA-NJ will still be enabled to maintain roughly the same earnings levels as it has enjoyed under alternative regulation. In fact, these earnings levels, even with the proposed reductions in access charges, would still be excessive by normal regulatory standards and, as such, should be reexamined and reinitialized by the BPU in light of BA-NJ's failure to satisfy the specific investment commitments it made as a *quid pro quo* for alternative regulation.

Appendix | **SOURCE DATA FOR FIGURES**

Table 1	Selected Bell Atlantic-New Jersey Financial Data
Table 2	Selected Bell Atlantic Corporation Financial Data
Table 3	Bell Atlantic-New Jersey Access and Toll Revenue and Cost Data
Table 4	Bell Atlantic-New Jersey Return on Equity and Pro Forma Return on Equity Under Access Reduction Legislation

Table 1

Selected Bell Atlantic-New Jersey Financial Data

	1990	1991	1992	1993	1994	1995	1996	1997
Return on Equity (10-K)	17.47%	21.02%	21.74%	22.86%	29.29%	31.81%	30.55%	37.70%
Net Investment (\$M) (10-K)	\$33.6	\$71.3	\$34.6	-\$6.6	-\$3.5	-\$65.9	\$104.1	\$34.2
Net Income (SOCC) (\$M)	425.9	427.5	461.1	487.3	455.7	496.2	491.1	630.7
Dividend to Parent (SOCC) (\$M)	349.0	362.2	357.1	439.5	434.7	492.0	487.6	559.0
Sources: Bell Atlantic-New Jersey annual SEC Form 10-K; FCC annual <i>Statistics of Common Carriers</i> (SOCC).								

Table 2

Selected Bell Atlantic Corporation Financial Data

	1990	1991	1992	1993	1994	1995	1996	1997
BOC Return on Equity	16.14%	18.96%	17.05%	15.70%	26.47%	28.95%	29.42%	25.05%
Non-BOC Return on Equity	-12.94%	-19.78%	12.22%	2.35%	-13.07%	22.24%	3.84%	-6.03%
Cumulative Undistributed Dividends (\$B)	\$1.316	\$1.513	\$1.620	\$1.826	\$2.024	\$2.338	\$2.808	\$3.594
Cumulative Non-BOC Investment (\$B)	\$1.422	\$1.736	\$2.037	\$2.376	\$2.716	\$2.925	\$2.885	\$6.613
Sources: Bell Atlantic Corporation annual SEC Form10-K; NYNEX Corporation 1997 SEC Form10-K. Note: 1997 values reflect Bell Atlantic-NYNEX merger.								

Table 3

Bell Atlantic-New Jersey Access and Toll Revenue and Cost Data

	1994	1995	1996	1997
Total Access Revenue (\$M) (10-K)	\$122.6	\$137.3	\$147.8	\$187.1
Switched Access Revenue (assumed to be 95% of total access revenue)	\$116.5	\$130.4	\$140.4	\$177.8
Switched Access Lines (M) (ARMIS)	5.0E	5.27	5.52	5.95
Access Revs. if Priced at Cost (assumed to be \$0.004/Minute) (\$M)	\$16.0	\$19.5	\$22.1	\$29.1
Percent Markup Over Cost	626%	567%	536%	511%
Toll Revenues (\$M) (10-K)	\$687.3	\$655.2	\$651.4	\$581.4
Toll Revenues with Access at Cost (\$M)	\$400.4	\$407.5	\$419.7	\$383.2
Sources: Bell Atlantic-New Jersey annual SEC Form 10-K; FCC ARMIS Reports 43-07.				

Table 4

Bell Atlantic-New Jersey Return on Equity and
Pro Forma Return on Equity Under Access Reduction Legislation

	1994	1995	1996	1997
Actual ROE (from Table 1)	29.29%	31.81%	30.55%	37.70%
Pro Forma ROE Under S-1556	29.29%	30.12%	26.63%	32.71%
Pro Forma ROE Under S-1664	29.29%	32.18%	31.37%	38.72%
Source: ETI calculations based on analysis of S-1556, S-1604, SEC Form 10-K data.				