

ABSTRACT

POVERTY OF COST MODELS, THE WEALTH OF REAL OPTIONS*

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Attempts to estimate forward-looking costs in the United States and around the world are based on cost models. These cost models are ideal vehicles to adapt to the real options methodology. A stylized cost model is developed to quantify several deficiencies associated with the current telecommunications cost models in use today. Even without the application of real options methodology, the stylized results show a significant difference between the revenue-requirements and traditional discounted present value type models. With the application of real options techniques, the differences become more pronounced .

Policymakers who attempt to use proxy cost models to emulate the market behavior of firms in competition without consideration of real options are acting imprudently. Effective policy for dealing with costs cannot be made without a fundamental understanding of real options theory's implications and importance.

* In Alleman James and Eli Noam, editors, *The New Investment Theory of Real Options and Its Implications for Telecommunications Economics*, Regulatory Economics Series, Kluwer Academic Publishers, Boston, MA 1999.