DIRECT TESTIMONY OF DR. RICHARD D. EMMERSON
ON BEHALF OF BELLSOUTH TELECOMMUNICATIONS, INC.
BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION
DOCKET NO. 960833-TP
AUGUST 12, 1996

INTRODUCTION

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS.

A. My name is Richard D. Emmerson. I am the President and CEO of INDETEC International, Inc. I am testifying on behalf of BellSouth Telecommunications ("BST" or the "Company"). My business address is 341 La Amatista, Del Mar, CA 92014.

Q. WHAT EXPERIENCE AND QUALIFICATIONS DO YOU HAVE PERTAINING TO YOUR TESTIMONY?

A. My academic qualifications include a Ph.D. in economics from the University of California, Santa Barbara in 1971. From 1971 through 1979, I was a full-time member of the Economics Department at the University of California, San Diego (UCSD). Since 1979, I have taught continuously (part time) at UCSD; I was the Director of the Executive Program for Scientists and Engineers (EPSE) at UCSD during 1990-1991, and I continue to teach courses on costing and pricing for EPSE at the present time. I have written articles in professional economic journals, and I have performed research projects for government agencies and private industry. I have also served as an expert witness in antitrust and business litigation cases. I have testified before many Public Service Commissions on various economic and policy subjects such as access charges, bypass, rate structure, competition, terminal equipment pricing, network services pricing, and cost analyses in the jurisdictions of California, Colorado, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, Montana, Nevada, Oklahoma, Pennsylvania, Virginia, Washington, Washington D.C., and Wisconsin, as well as in Canada. Over the course of the past 12 years, my provision of expert witness testimony in over 40 telecommunications regulatory hearings has aided in establishing appropriate cost standards in several jurisdictions within the industry. I have also worked for regulators and telephone companies in nearly a dozen foreign countries during the past three years.

My work experience includes past positions as Senior Vice President of Criterion Incorporated, President of the Institute for Policy Analysis, and President of Economic Research Associates. These companies performed economic analysis for competitive firms, regulated firms, government agencies, regulatory commissions, and trade associations. INDETEC International, Inc. provides consulting and training services to international telephone companies, Lucent Technologies, the United States Telephone Association (USTA), Bellcore, Commission staff members, partners and managers of large accounting and consulting firms, and interexchange companies (these services were formerly offered through INDETEC Corporation and Emmerson Enterprises, Inc.).

During the past 20 years, I have taught a wide variety of courses ranging from basic economics for telecommunications to highly specialized courses in incremental cost study methodology. State regulatory commission staff members from numerous states periodically attend my classes in order to improve their understanding of current economics for telecommunications.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. AT&T Communications of the Southern States, Inc. ("AT&T") has petitioned the Florida Public Service Commission ("FPSC" or "Commission") to arbitrate certain terms and conditions in its negotiation with BST regarding interconnection, unbundled network elements ("UNEs"), and resale of existing services. I discuss the basic economic principles which should underlie the Commission's consideration of these issues and I respond to certain positions raised by AT&T in its petition.

A LOCAL EXCHANGE COMPANY (LEC) SHOULD NOT BE PROHIBITED FROM PRICING ITS SERVICES TO OBTAIN CONTRIBUTION TO RECOVER ITS SHARED AND COMMON COSTS

LEC Shared Costs are Significant

Q. AT&T PROPOSES THAT BST PRICE ITS UNBUNDLED NETWORK ELEMENTS (UNES) AND INTERCONNECTION SERVICES EQUAL TO INCREMENTAL COST.[1] DO YOU AGREE WITH THIS PROPOSAL?

A. No, I do not. A multiservice network-based Local Exchange Company (LEC) has shared costs which must be recovered by pricing services above incremental cost.

Q. ARE THE SHARED COSTS OF A MULTISERVICE NETWORK-BASED LEC LIKE BST SIGNIFICANT?

A. Yes, they are. Shared costs include some of the costs of general engineering of the network, right-to-use fees that apply to multiple functionalities, portions of many physical facilities, the cost of capital and depreciation expenses on facilities which are not directly attributable to individual services, operating expenses and even taxes. For example, Mr. Frank Kolb of BellSouth, in Georgia Public Service Commission Docket 5755-U (page 3) testified: "Q. COULD SOUTHERN BELL PRICE ALL OF ITS SERVICES AT INCREMENTAL COST? A. Not if Southern Bell wants to stay in business. The incremental cost of all services provided by Southern Bell represents approximately 50% of the total cost of doing business."

---

[1] AT&T's Petition for Arbitration at pages 35 and 39.

Similarly, Barb Smith of Southwestern Bell Telephone, in Kansas Docket No. 190,492-U (page 7) testified: "SWBT has conducted a preliminary analysis in Texas that shows that the difference between the sum of the LRIC studies for all services and the total costs of the company in Texas will be at a minimum in the range of 40% to 50%. I would expect Kansas to have shared and common costs in the same range. Pricing services equal to the LRIC or TSLRIC will not allow SWBT to recover significant portions of its costs."

I personally have supervised both cost studies and the development of cost study methodologies. I find that I am unable to assign or determine a methodology to assign between 40% and 55% of a LEC's total forward looking costs to individual services using incremental cost principles.

Q. PLEASE EXPLAIN WHY SOME COSTS DO NOT APPEAR TO BE INCREMENTAL TO SERVICES.

A. First, many activities performed by LECs cannot be found to vary with the LECs' scope of services. Examples are activities such as: creating, updating and maintaining large computer systems for customer and network administration; executive function, legal and administrative work pertaining to the corporate entity as a whole. Indeed, extended unresolved disputes about how to fully distribute costs can be explained by a lack of a clear cost causitive relationship. Thus engineering and activity based studies do not assign all costs to services.

Second, econometric techniques have not demonstrated a statistically significant relationship between individual services and general overhead expenses, perhaps because there is little independent variation in LECs' scopes of services or because there is no such relationship.[2]

Finally, the very nature of many costs is clearly shared. Resources (such as certain rights to use fees, computer programming, and general organizational activities) are performed once without the need to expand the scale of activities to accommodate greater volumes of business including adding products or services.

Q. DO YOU BELIEVE THAT A LEC HAS CHARACTERISTICS WHICH CAUSE IT TO TEND TO HAVE A HIGHER PROPORTION OF SHARED COSTS THAN OTHER COMPETING FIRMS?

A. Yes, there are several factors which I believe will cause a LEC, like BST, to tend to have a higher proportion of shared costs than other competing firms. These factors include: 1) a large number of services offered; 2) network-based service provision; 3) a franchise obligation to provide ubiquitous service over broad geographic areas; 4) large scale and lumpy investment characteristics; 5) predominance of services rather than products; and 6) "leasing" of virtually no unbundled components from other providers.

---

[2] There certainly is a relationship between a LEC's overall size an its shared and common costs. There is no evidence, however, that size measured by the firm's <u>Scope</u> of services matters; it appears that all costs (TSLRIC, shared, and common) are all proportionately smaller, perhaps because the population, geography, and/or overall operations are smaller.

Q. WHAT DO YOU MEAN WHEN YOU SAY LEC'S ARE "LEASING" VIRTUALLY NO UNBUNDLED COMPONENT?

A. I have used the term lease in a generic sense to mean using the facilities of others (at a price) rather than buying or building one's own facilities. LECs will tend to own rather than lease facilities. In contrast, a high proportion of Inter Exchange Company (IXC) and Alternative Local Exchange Company (ALEC) costs may be comprised of expenditures to lease facilities from LECs. At one point in time, AT&T claimed that approximately 60% of its toll revenues were paid to LECs for access services. Therefore the leasing of LEC facilities (i.e., access payments) became part of the direct cost or incremental cost of AT&T's toll service. An ALEC too may lease a significant proportion of its facilities from LECs and, therefore, will necessarily have a higher proportion of incremental costs and a smaller proportion of shared costs, vis-à-vis the LECs. To illustrate, the cost of leasing meeting rooms is generally more "variable" (with respect to use) than is owning ones own facilities. Thus the incremental cost of any type of given type of use would be higher for leased rooms.

Q. IF A NETWORK-BASED COMPANY LIKE BST IS REQUIRED TO SET RATES FOR EACH SERVICE JUST SUFFICIENT TO COVER LONG-RUN INCREMENTAL COST (LRIC), WILL THAT COMPANY RECOVER ALL OF ITS COSTS AND EARN A REASONABLE PROFIT?

A. No, it will not. Service prices which only generate total revenue equal to the sum of all service incremental costs will not cover total cost. As I have discussed, there are shared costs incurred by a company, especially a multiservice network-based company like BST, which are *not* incremental to any one service but which are never the less valid costs of engaging in its business activities. In total, service revenues must exceed service incremental costs by a margin sufficient to recover all costs of the firm, including the shared costs of the firm. Even if it were determined that some costs presently categorized as shared and common were incremental after all, prices would need to cover those higher costs and contribute toward the remaining (nonincremental) costs. To simply assure that each service does not receive a subsidy, by establishing all service prices at, or slightly above, LRIC, does not guarantee that a provider recovers all of its costs. BST cannot be said to have priced its services to attain a reasonable profit until its prices are set sufficiently above LRIC to recover its shared costs. In short, if BST is required to set service prices at LRIC, with no provision for shared costs which must necessarily be incurred to provide business services, then it can not earn a profit on those services.

Q. CAN YOU ILLUSTRATE THIS POINT WITH A NUMERICAL EXAMPLE?

A. Yes. Consider products A & B each with an incremental cost per unit of $.25 and with demand of 100 for each service. The incremental cost for the sum of the units demanded is $25 for A and $25 for B. However, to produce either A or B the firm must also spend $50 per period on a right to uses fee; say a computer operating system. In this simple example, the $50 is a shared cost of these two products. The firm has found a source of economic efficiency: it can produce both A and B spending $50 once rather than twice (once for each product). Obviously, if the prices per unit of both services A and B are forced to equal their incremental costs of $.25, the firm will face a loss of $50 per period. Similarly, if the firm is forced to price one of its services at incremental cost, the firm will face a loss unless it can double the contribution margin on its remaining service. The greater the efficiencies of sharing facilities and costs, the larger the shared costs of the firm and the greater the need to price services in excess of LRIC. In other words, such increased efficiencies will increase shared costs but with a more than offsetting reduction in incremental costs. However, these larger shared costs must be recovered for the firm to remain in business.

Q. ARE SHARED FACILITIES AND SHARED COSTS BENEFICIAL?

A. Yes, the increased efficiencies from sharing facilities and costs is desirable for the firm and desirable for society as well. However, these costs must be recovered from the services which the firm provides; forcing service prices equal to LRIC does not allow for the recovery of the shared costs which are beneficial to society. It is inappropriate to penalize a company for improving its efficiency by not allowing recovery of shared costs. To illustrate this, recall products A and B described earlier where the incremental costs per unit for each is $.25, the shared cost is $50, and 100 units of each service are demanded. Consider what occurs if a new machine becomes available which costs $75 per period but which reduces the incremental cost of both services from $.25 to $.10. With demand for A and B at 100 units the new machine offers the opportunity to reduce total costs from $100 to $95 (i.e., $75 + $10 + $10). Society is clearly better off with the use of the new machine; however, if the company is artificially constrained to price any of its services at incremental cost, it is difficult for the company to make the economic decision which is best for society.

Competition Tends to Drive Prices to Costs (Including Shared Costs)

Q. YOU RECOMMEND REJECTING THE PROPOSAL TO PRICE SERVICES OFFERED TO OTHER TELECOMMUNICATIONS PROVIDERS AT LRIC. DOESN'T COMPETITION DRIVE PRICES TOWARD COSTS?

A. Yes, it does. However, competition does not necessarily drive prices to LRIC.[3] Competition tends to drive prices to a point where all valid business costs are just recovered, and shared costs are valid costs of business activity. When competition drives prices toward costs, these shared costs are a component of the costs a provider must recover, even in the most competitive of markets.

Q. SHOULD PRICES FOR INTERMEDIATE SERVICES (I.E., SERVICES NOT SOLD TO END USERS) BE ALLOWED TO MAKE A CONTRIBUTION TO HELP RECOVER THE SHARED COSTS OF A FIRM?

---

[3] If a firm only provides a single product, all of its costs are generally included in a calculation of LRIC. Because the majority of the economics literature implicitly or explicitly deals with single product production, a casual reading of parts of the economics literature would lead one to believe that competition drives prices toward LRIC; this is true only for a single product firm.

A. Yes, in a competitive environment, every activity must be allowed to make a reasonable contribution to help recover the shared costs of the firm. Many firms strictly offer business-to-business services, i.e., they only offer intermediate products or services to other firms and do not sell to end-users.[4] Many of these firms may have substantial shared costs which must be recovered from the prices of the intermediate products or services which they sell to other firms. In general, firms in real markets selling intermediate services have shared costs which must be recovered through the prices of the intermediate products or services which they sell to other firms. It is obvious in these instances that providers must obtain a reasonable contribution from each intermediate service or they will be unable to continue in business.

Even Intermediate Services Sold to Competing Providers Should Not be Precluded From Making a Contribution Toward Shared Costs

Q. IF ONE ASSUMES THAT ONE OR MORE OF THE SERVICES IN THIS PROCEEDING IS A MONOPOLY SERVICE, OR AN ESSENTIAL SERVICE, SHOULD THAT SERVICE BE PRECLUDED FROM PROVIDING A REASONABLE CONTRIBUTION TOWARD THE SHARED COSTS OF THE LEC?

---

[4]Catalogs and directories exist for "business-to-business" products and services; many of these products are used as components or inputs to produce products for final consumers. Some of the firms which are largely or completely intermediate-products firms are obvious and well known such as Intel, Boeing, McDonal-Douglas, U.S. Steel, Alcoa Aluminum, or Peabody Coal. However, many other firms which one might consider as final goods producers, such as Beatrice Foods, Detroit Diesel, Kellogg, Phillip Morris, Proctor & Gamble, or Frito Lay, provide relatively few, if any, products to end users. These firms rely on other firms to actually provide products to end users. Certainly, any firm which only provides intermediate services must recover all of its shared costs from those intermediate services.

A. No, all services should be allowed to provide a reasonable contribution to the shared costs of the LEC.

First, it is likely that the reason a service or service element is essential precisely because it is produced most efficiently as a unique element in the supplier's scope of services buy sharing costs.[5] Thus there necessarily would be shared costs to be recovered.

Second, it is possible that a telecommunications provider would *only* provide services which some customers would consider to be "monopoly" or "essential" services. Such classifications do nothing to make the shared costs of a firm disappear or be magically recovered elsewhere. Under such a rule, a LEC which provides some "monopoly" or "essential" services as well as other services, would be faced with attempting to recover most if not all of its shared costs from the "other" services at a time when expanding competition makes it difficult or impossible to obtain such contribution.

Q. WOULD THE AT&T POSITION, THAT UNBUNDLED NETWORK ELEMENTS (UNES) BE PRICED AT INCREMENTAL COST, LEAD TO PERVERSE RESULTS AS LOCAL COMPETITION EXPANDS?

---

[5] An essential facility is a component which cannot be equally efficiently produced, acquired or substituted by another firm. This occurs when one firm has economics of scope which cannot be replicated by another firm. These economies are the very source of shared and common cost which would not be recovered with prices equal to incremental costs.

A. Yes, it would appear that AT&T may not object to <u>service</u> prices which are above incremental cost (indeed, AT&T prices above its incremental costs to recover its unique shared and common costs); rather AT&T objects to prices of what it claims are monopoly components which are greater than incremental cost and which provide some contribution to the shared costs of the LEC. As AT&T or other companies enter the facilities-based segment of the market and offer equivalent or alternative UNEs, these companies, like BellSouth, will need to recover their joint and common costs. A market price will emerge which, in all likelihood, will be higher than BellSouth's incremental cost. It appears that AT&T would then allow BST to raise its prices for these services which would lead to higher end user prices. Therefore, under the AT&T proposal, as local competition expands, prices for unbundled intermediate component services (which were previously considered as monopoly components) would be allowed to rise in order to contribute to the significant shared costs of the LEC. This leads to the perverse result that the expansion of local competition would lead to increased prices rather than decreased prices.

In contrast, starting with intermediate services priced to correctly provide a reasonable contribution toward shared costs could emulate competitive results from the outset of the establishment of the unbundled services.

Q. ISN'T IT UNFAIR FOR AN ALEC TO PAY MORE THAN THE LRIC FOR A SERVICE IF IT BELIEVES THAT IT NEEDS THAT SERVICE TO PROVIDE ITS OWN SERVICES?

A. No, it is not. The incremental cost of services represents only a portion of the total costs of a LEC. LEC shared facilities and shared costs are shared by end-user services by those interconnecting with the LEC, and by those who use the LEC's unbundled facilities to which their value added services are appended. This is especially true in the increasingly competitive environment today. Similarly, I expect that each of the components or intermediate services which the ALEC purchases from *other* sources (such as switch providers and other carriers) are priced to provide a reasonable contribution to the shared costs of those other suppliers. I don't expect AT&T to provide services to a reseller at LRIC even though the reseller may need the services it receives in order to provide its own services. I don't expect AT&T to price its own access services at LRIC. As a general matter, I expect that an ALEC "needs" most of the facilities and factors of production they purchase, not just the ones they purchase from a LEC; however, this does not preclude prices for each of these components from generating a contribution to its provider.

Q. DOESN'T AN ALEC HAVE TO RECOVER ALL OF ITS SHARED COSTS FROM END-USER SERVICES?

A. No, I expect that most ALECs will obtain some combination from both intermediate services (including access services to IXCs) and end-user services. The very nature of competition to date, with the terms "alternative access vendor" or "competitive access provider" indicates that providing intermediate services (e.g., access to IXCs) will be a significant service and a source of contribution. To the extent that the ALECs have shared costs, I expect they must obtain contribution from both intermediate and end-user services. Every firm must recover its shared costs from the services it provides. For example, to the extent that an ALEC only provides access services to IXCs, it must obtain all of its contribution, to recover its shared costs, from those intermediate services.

However, the critical distinction is that the ALEC has the opportunity to utilize the ubiquitous facilities of the incumbent LEC when and where it chooses. An ALEC facing a franchise obligation has no such opportunities.

Forcing LECs to price intermediate services at LRIC would allow ALECs to utilize the shared facilities and shared costs of the LEC ubiquitous network when and where they choose without contributing to the recovery of LEC shared costs. By doing so, the ALEC would avoid incurring the associated shared and common costs. Without a contribution from intermediate services, the LEC's end-user customers must provide *all* of the contribution to cover its shared costs; however, both the LEC's end-user customers and the ALECs purchasing unbundled LEC component services share in the capabilities of the LEC's ubiquitous network.

Q. HOW ARE THE CIRCUMSTANCES FOR THE INCUMBENT LEC AND THE ALEC DIFFERENT?

A. ALECs will benefit from the incumbent's economies of scope. When an incumbent LEC provides an unbundled loop, for example, the incumbent LEC does not share in the benefits associated with any shared costs of the ALEC purchasing the unbundled loop. Even with local interconnection, it is the incumbent LEC which has placed a ubiquitous network of facilities in advance of the demand for services in order to satisfy carrier of last resort obligations to serve customers in a timely fashion. Facilities-based ALECs have far greater latitude to build facilities if, when, and where they choose, utilizing the facilities of the LECs in all other instances. The reverse is not true at this time.

Q. IF THE LEC IS PRECLUDED FROM OBTAINING A REASONABLE CONTRIBUTION FROM INTERMEDIATE SERVICES, WHAT WILL BE THE EFFECT ON THE LEC'S END-USER CUSTOMERS?

A. The burden on LEC end-user customers of recovering shared costs will continually increase in such a scenario. Assume that BST's total costs are $100, with $50 of shared costs and $25 of incremental costs for residential local service and $25 of total incremental costs for all other services. Also assume that residential service generates $25 in revenue, just covering its incremental costs. Initially then, on average each service (other than residential local service) must generate $2 in contribution for each $1 of incremental cost; i.e., the other services must provide on average 200% contribution to recover the $50 of shared costs.[6]

For simplicity, also assume that BST initially had 100% market share of the other end-user services in its territory. Later, other end-user service providers

[6]For simplicity we ignore demand elasticity in this example without loss of generality.

enter by purchasing unbundled loops and other unbundled BST facilities which are priced at incremental cost, capture 50% of the end-user market for these other services. BST must now obtain $4 in contribution above its incremental costs (i.e., a 400% contribution) from each of *its* end-user customers. If residential local service is subsidized to some degree, as the economics literature suggests, then the contribution levels must be even higher in each scenario.

Peculiarly, both the new end-user service providers (ALECs) and BST explicitly or implicitly utilize at least a portion of BST's shared facilities and receive some of the benefits of its shared costs. However, when unbundled components are priced at incremental cost, only BST end-user customers will pay for the benefits of the shared facilities and shared costs. Obviously, this creates an artificial advantage for ALECs and an unsustainable disadvantage for BST.

Q. IF THE LEC IS FORCED TO PRICE INTERMEDIATE SERVICES AT LRIC, WOULD THE EXISTENCE OF A RATE CAP FURTHER CONSTRAIN THE LEC'S ABILITY TO RECOVER ITS SHARED COSTS?

A. Yes, absolutely. Without contribution from its intermediate services, the LEC will be forced to attempt to raise prices for its services offered to end-user customers. Obviously, the existence of a rate cap on end-user services would constrain or preclude such shared cost recovery.

PRICING UNES AT INCREMENTAL COST WOULD RETARD THE GROWTH OF FACILITIES-BASED COMPETITION

Q. DOES PRICING UNES AT INCREMENTAL COST PROVIDE AN INCENTIVE FOR FACILITIES BASED COMPETITION?

A. Certainly not. A competing firm would virtually never choose to take the risk of constructing facilities when it has the opportunity to "lease" unbundled components from the incumbent LEC priced *at incremental cost*. First, the lessor avoids incurring the shared cost altogether. Further the competing provider can lease facilities priced at incremental cost at the time, scale, location and duration of its choosing and it can change any of these factors as market conditions change. Even its incremental costs can be abruptly reduced, unlike the costs to the owners of the leased facilities. Pricing unbundled components at LRIC will essentially guarantee that alternative providers will construct no new facilities to compete with the incumbent LEC. This, of course, is contrary to both economic efficiency and the job-promoting intentions of the Telecommunications Act of 1996.

WHOLESALE DISCOUNTS MUST BE BASED ON RETAIL RATES AND THE COSTS THAT WILL BE AVOIDED BY THE LEC, NOT ON NOTIONS OF OPERATIONAL PARITY OR JUMP-STARTING COMPETITION

Q. WHAT DOES THE TELECOMMUNICATIONS ACT OF 1996 ACT SAY IN REGARD TO ESTABLISHING A WHOLESALE DISCOUNT?

A. SEC. 252(d)(3) states: "a State commission shall determine the wholesale rates on the basis of retail rates charged to subscribers for the telecommunications services requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier."

Q. DOES THE STATEMENT IN THE ACT ESTABLISHING THE CONSIDERATION OF "COSTS THAT WILL BE AVOIDED" CORRESPOND TO THE ECONOMIC PRINCIPLE OF COST CAUSATION?

A. Yes, it does. Recognition of the costs that will be avoided corresponds to the economic principle of cost causation in instances in which costs may be reduced.

Q. DOES AT&T'S PROPOSAL COMPORT WITH THE ACT IN YOUR OPINION?

A. No, it does not. AT&T proposes an additional 15% retail cost adjustment for "full operational parity" and a 10% - 15% adjustment to "jump-start" competition. These adjustments are not supported by economics and they are completely unrelated to a wholesale rate which reflects the costs that BST will avoid.

Q. SHOULD A CALCULATION OF AVOIDED COSTS FOR THIS PROCEEDING REFLECT THE RETAIL COSTS WHICH AT&T (OR

ANOTHER WHOLESALE CUSTOMER) HAS INCURRED OR WILL OCCUR?

A. No. Such costs are irrelevant to the calculation of the costs which the LEC will avoid. AT&T may be able to readily leverage its existing retail functions or it may have to duplicate some of the retail functions of BST. Section 252(d)(3) of the act is quite clear: it is the costs that will be avoided by the LEC which determine the wholesale discount, not costs which must be incurred by AT&T.

Q. YOU STATED THAT THE AT&T RECOMMENDATION IS NOT SUPPORTED BY ECONOMICS. IN MARKETS WITHOUT ECONOMIC REGULATION DON'T LOWER QUALITY SERVICES COMMAND LOWER PRICES?

A. In most markets lower quality services are often, but not always, provided at lower prices. When the lower quality of service has a correspondingly lower cost of providing the service, there is a very strong tendency for the price of the service to be lower as well. Often, however, the lower level of quality does not produce a lower cost. For example, in publishing, reprints of a specific article, even in some volume, are often of lower quality *and higher price* than the comparable service of obtaining the entire published package. Similarly, in order to make lodging available where and when it is needed, the cost of a motel room may be higher, and the quality lower, than one's own home. Markets determine these matters.

When BST provides a wholesale service, the costs that will be avoided are simply what they are. If there is a quality differential which has a corresponding cost differential, it will be reflected in the costs that will be avoided.

Q. SHOULD THE WHOLESALE DISCOUNT BE INCREASED TO JUMP-START COMPETITION?

A. No. The Act and the economic principle of cost causation/avoidance are quite clear; the wholesale discount should be based on the costs that BST will avoid. "Jump-starting" competition is unrelated to cost avoidance and should be ignored.

It appears that the intent of the Act is to encourage facilities-based competition, allowing the purchase of unbundled components and the resale of services in order to allow a smooth and rapid transition to competition and to allow firms to avoid inefficient replication of facilities. To "jump-start" resale is at odds with the implied intent of the Act. It can even preclude more efficient providers of facilities from entering into markets.

In addition, it is hard to imagine that AT&T needs the kind of jump-start that one sometimes hears discussed for infant industries. It is also hard to imagine AT&T offering the Regional Bell Operating Companies (RBOCs) an additional jump-start discount on interLATA services when the RBOCs are allowed to provide interLATA services.

Q. WHAT DOES THE ACT STATE IS BST'S DUTY WITH REGARD TO RESALE?

A. SEC. 251(a)(1), for example, states that BST has the "duty not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of its telecommunications services."

Q. IS THERE AN ECONOMIC REASON WHY SERVICES WHICH ARE CROSS-SUBSIDIZED SHOULD HAVE A "REASONABLE" LIMITATION ON RESALE?

A. Yes. There are at least two economic reasons that cross-subsidized services, i.e., service offered at rates to end-users which are priced below incremental cost, should have some reasonable limitation on resale. First, the resale of cross-subsidized services could increase the demand for the service leading to a greater subsidy to be borne by the incumbent LEC, BST in this case. To the extent that resellers will market harder or more creatively, then the subsidy burden imposed on BST will increase.

And second, BST itself must incur costs equal to the incremental cost of providing the subsidized service each time the service is sold. To allow other firms to resell the service, and to use it as a competitive springboard to offer other services, now or in the future, is not competitively neutral. Such opportunities shift the benefits of the subsidy from the consumer to the alternate provider.

Q. WHAT ALTERNATIVES ARE AVAILABLE FOR "REASONABLE" LIMITATION ON THE RESALE OF SERVICES WITH RESPECT TO CROSS-SUBSIDIZED SERVICES?

A. Two alternatives are possible: To proscribe the resale of cross-subsidized services, except at the discretion of the LEC, or to establish a retail market price at or above incremental cost from which resale prices are calculated.

Q. HOW CAN A RESELLER SURVIVE FINANCIALLY IF IT MUST PAY A MARKET PRICE FOR A SERVICE WHICH IS OTHERWISE PROVIDED BY BST AT A CROSS-SUBSIDIZED RATE?

A. The reseller can survive in the same way in which BST survives: by offering other profitable services which are of value to customers in order to finance the subsidy. The difference is that resellers have the choice of when, where, and at what scale to enter the market while BST must serve all customers in a timely manner, relying on these same implicit subsidies. Of course, if and when the subsidy source become explicit, either the reseller would need access to the funds or BST could afford to sell the service at the cross subsidized rates, obtaining the rest of the market price from the subsidy.

PREVENTING A PRICE SQUEEZE

Q. AT&T SUGGESTS THAT PRICING UNES ABOVE INCREMENTAL COST CREATES PRICE SQUEEZES ON NEW ENTRANTS.[7] IS THIS CORRECT?

A. No, it is not. An anticompetitive price squeeze is based on the relationship between prices wholesale (input) prices and retail prices. It is not determined by the price of the input itself.

Note that AT&T also claims that price of switched access is fourteen times its TSLRIC.[8] If AT&T's claims were correct, no firm would be able to provide intraLATA toll services; they would have been completely squeezed out of the intraLATA segment of the market. Of course, the reason firms do survive offering intraLATA toll services is that an anticompetitive price squeeze is not established by the price of the input itself, rather it is determined by the relationship between input and final end-user prices. Forcing BST to price its services at TSLRIC to prevent a price squeeze is simply bad business, bad economics and bad regulatory policy.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.

---

[7] AT&T's Petition for Arbitration at page 36.

[8] AT&T's Petition for Arbitration at page 40.