SUPPLEMENTAL TESTIMONY OF
DAVID L. KASERMAN
ON BEHALF OF AT&T COMMUNICATIONS OF
THE SOUTHERN STATES, INC.
BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

Docket No. [redacted]

Filed: August 23, 1996

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is David L. Kaserman. My business address is the Department of Economics, College of Business, 415 West Magnolia -- Room 203, Auburn University, Alabama, 36849-5242.

Q. DID YOU PREVIOUSLY FILE DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL TESTIMONY?

A. Subsequent to the filing of my Direct Testimony in this docket, the Federal Communications Commission ("FCC") issued an order that contains specific rules concerning how state regulatory commissions are to implement the provisions of the

Telecommunications Act of 1996 (the "Act").[1] My Supplemental Testimony compares the general areas raised by the FCC Order and my prior direct testimony.

Q. DO YOU FIND THE FCC'S ORDER TO BE GENERALLY CONSISTENT WITH THE POLICY RECOMMENDATIONS CONTAINED IN YOUR DIRECT TESTIMONY?

A. Yes, very much so. The FCC Order closely corresponds to the policy recommendations I have advanced in that testimony and elsewhere.[2] Four specific examples drawn from the introductory section of the FCC Order help to illustrate this basic correspondence:[3]

1. The FCC in its Order points out that local exchange competition will bring benefits to consumers.[4] My prior direct testimony emphasizes this same point on pages 3-5.

2. The FCC explains in its Order that, due to the possession of significant market power, the ILECs are not likely to voluntarily negotiate entry-facilitating agreements with their potential competitors.[5] This same point is made on pages 6-7 of my prior direct testimony.

3. The FCC emphasizes in its Order the importance of adopting economically efficient prices for inputs supplied by the ILECs to new entrants, including the desirability of basing these prices on the total service (or, under the FCC's terminology, total element) long-run incremental costs --TSLRICs-- of those

inputs.[6] Subject to a relatively minor exception which I discuss later in this testimony, this is precisely the same pricing standard advocated in my prior direct testimony.

4. The FCC explicitly recognizes in its Order that operational issues are likely to be a particularly problematic area that will require continual enforcement efforts on the part of regulators.[7] This point is made throughout Section V (pages 36-40) of my prior direct testimony.

In these and many other important respects, the FCC Order is supportive of the general policy recommendations I have advocated.

Q. **WITH REGARD TO THE PRICING OF INTERCONNECTION ARRANGEMENTS AND UNBUNDLED NETWORK ELEMENTS, HAS THE FCC EMBRACED POLICY PARAMETERS THAT ARE CONSISTENT WITH THE INPUT PRICING BENCHMARK YOU ADVOCATED IN YOUR DIRECT TESTIMONY?**

A. Yes. In that testimony, I advocated pricing these monopoly inputs at their respective TSLRICs. In its Order, the FCC acknowledges that "[i]n competitive markets, the price of a good or service tends towards its long-run incremental cost."[8] They also note that "economists generally agree that prices based on forward-looking long-run incremental costs (LRIC) give appropriate signals to producers and consumers and ensure efficient entry and utilization of the telecommunications infrastructure."[9] In this regard, the FCC states that prices should be "based on the TSLRIC of the network element."[10] Moreover, the FCC properly notes that, because the offerings of the ILEC will generally be "network elements" rather than services, the appropriate focus should be on the incremental cost of the elements to be priced.

Additionally, the FCC requires the application of each of the cost standards that I discussed in my prior direct testimony. Specifically, the FCC requires that prices be based on the forward looking incremental cost method known as Total Service Long Run Incremental Cost ("TSLRIC").[11] Within its discussion of this methodology, the Commission requires that cost measurement should be "long run" and reflect "incremental cost."[12] The FCC also mandates that costs studies reflect the most efficient technology available.[13] Finally, the importance of attributing costs on the basis of cost causation is recognized by the FCC when it states that:

> Costs must be attributed on a cost-causative basis. Costs are causally-related to the network element being provided if the costs are incurred as a direct result of providing the network elements, or can be avoided, in the long run, when the company ceases to provide them.[14]

Thus, it is clear that the five costing principles I described in my prior direct testimony are an integral part of the costing methodology prescribed by the FCC for use in the pricing of interconnection and unbundled network elements.

Q. **ARE THERE ADVANTAGES TO THE FCC'S FOCUS ON THE INCREMENTAL COST OF ELEMENTS (TELRIC) AS COMPARED TO A**

FOCUS ON THE COST OF SERVICES (TSLRIC)?

A. Yes, there are notable advantages to focusing on the incremental cost of elements (the FCC-coined phrase TELRIC -- "Total Element Long Run Incremental Cost") as opposed to services (TSLRIC -- "Total Service Long Run Incremental Cost"). First, a fundamental principle of sound economic costing is cost causation. In this regard, the necessity of pricing network elements dictates that it is the cost of these elements, rather than the services they underlie, that should be the focus of analysis. Second, at the level of cost analysis for services, the identification and attribution of the cost drivers becomes difficult as particular assets may be used to provide multiple services. The inability to identify the cost drivers at the "service" level can lead to claims by the ILECs of large "common costs" that allegedly must be recovered in the pricing of services to competitors.

In contrast, by focusing on network elements, the ambiguity regarding cost drivers is significantly reduced. For instance, a central office switch may provide inputs into multiple services that are offered by the ILEC and, therefore, raise the prospect of significant "common costs." In contrast, if the switch itself is to be priced, then the specter of large common costs erodes. It is in this sense that the FCC states "we believe that TELRIC-based pricing of discrete network elements or facilities, such as local loops and switching, is likely to be more economically rational than TSLRIC-based pricing of conventional services."[15]

Q. **DOES THE FCC ORDER EXPLICITLY RULE OUT ALTERNATIVE PRICING METHODOLOGIES PREVIOUSLY ADVOCATED BY THE ILECS THAT TEND TO DRIVE RECOMMENDED INPUT PRICES**

SUBSTANTIALLY ABOVE TSLRIC?

A. Yes. The FCC has concurred with the proposition that, relative to an incremental cost approach, several alternative methodologies to cost determination and pricing are unsuitable. Specifically, the FCC has rejected the notion championed by the ILECs that pricing of network elements and interconnection should reflect embedded costs.[16] Similarly, the FCC has clearly rejected the notion that network element and interconnection prices should be used to raise any required revenues for universal service subsidies.[17] Also consistent with the establishment of pro-competitive pricing, the FCC has explicitly rejected the notion that prices for these vital inputs be based upon an Efficient Component Pricing Rule ("ECPR") methodology.[18] In sum, the FCC has in large measure embraced the efficient, pro-competitive pricing benchmark I described in my prior direct testimony and has explicitly renounced the alternative pricing methodologies traditionally championed by the ILECs.

Q. DOES THE FCC ORDER CONTAIN ANY PROVISIONS THAT VARY FROM THE IDEAL ECONOMIC PRICING BENCHMARK YOU ARTICULATED IN YOUR DIRECT TESTIMONY?

A. Yes. While embracing the concept of incremental cost as the heart of its pricing methodology, the FCC nonetheless indicates that prices for interconnection and network elements "include a reasonable allocation of forward-looking common costs."[19] Economists generally have been quite critical of any such "allocations" of costs in the determination of pricing.[20] In particular, cost allocations can be the source of considerable deviations from economically efficient outcomes and are potentially the source of regulated prices that are antithetical to the development of competition in local exchange telephone markets.

Q. DOES THIS REQUIREMENT CAUSE THE FCC'S RULES TO DEPART SUBSTANTIALLY FROM THE PRICING BENCHMARK YOU HAVE RECOMMENDED?

A. No. The FCC has unequivocally embraced rules that dictate a "long-run, incremental cost methodology" for the establishment of prices for interconnection and unbundled network elements.[21] It is precisely this benchmark that I have advocated. While the ILECs may prefer to read considerable latitude into the "reasonable allocation" language in the FCC Order, it is important to bear in mind that the FCC explicitly excludes elevations in input prices above incremental cost that might emanate from a variety of sources. Specifically excluded as factors that may be used by the ILECs to raise these prices above incremental cost are: (1) claims regarding inadequate depreciation of "common" costs;[22] (2) recovery of any embedded "common" costs;[23] (3) recovery of any retail-level "common" costs;[24] (4) recovery of "shared facilities and operations;"[25] (5) demand elasticity considerations;[26] (6) recovery of "opportunity cost" associated with common costs;[27] (7) any recovery in excess of the stand-alone cost of assets;[28] (8) recovery of "the same common costs multiple times,"[29] and (9) recovery of the common costs used in the provision of universal service.[30]

Moreover, the FCC has embraced the notion of incremental cost calculations for elements (i.e., TELRIC) rather than for services specifically because it reduces the magnitude of common costs.[31] Finally, the FCC has made it quite clear that any recovery of forward looking common costs must be "consistent with the pro-competitive goals of the 1996 Act."[32]

Given the various constraints that are properly noted in the FCC Order and the unambiguous pro-competitive tenor of the Telecommunications Act, I expect that arbitrated prices for unbundled network elements and interconnection arrangements will approximate the economic benchmark that I described in my prior direct testimony.

Q. IN LIGHT OF THE FCC ORDER AND YOUR DIRECT TESTIMONY, WHAT SPECIFIC PRICING POLICY DO YOU RECOMMEND FOR UNBUNDLED NETWORK ELEMENTS AND INTERCONNECTION ARRANGEMENTS?

A. I recommend that these monopoly inputs be priced at levels that are very close to their corresponding TSLRICs (or TELRICs). That is, the allocation of common costs to these competitively-sensitive prices should be kept to a minimum. Moreover, the Florida Commission should bear in mind that the larger are the deviations of these prices from incremental costs, the larger are the efficiency losses imposed on consumers and the larger are the prospects for anticompetitive behavior on the part of BellSouth. And most importantly, to the extent that ILEC-supplied inputs are priced above their respective TSLRICs, the desired transition of local exchange markets from monopoly to competition will be slowed.

Q. ARE THERE ANY OTHER AREAS IN WHICH THE FCC ORDER

DEPARTS FROM THE POLICY RECOMMENDATIONS YOU ADVOCATED IN YOUR DIRECT TESTIMONY?

A. The only other departure of which I am aware involves the recommendation (contained on pages 34-35 of my prior direct testimony) that an additional compensatory wholesale discount above avoided costs be considered in the prices set for the ILEC's wholesale services in order to compensate competitors for unequal interconnection and provisioning of these services.[33] The option of an addition to the wholesale discount beyond the ILECs' avoided costs now has been foreclosed by this Order.

Q. IN LIGHT OF THIS RESTRICTION, HOW WOULD YOU ALTER YOUR POLICY RECOMMENDATION TO THIS COMMISSION?

A. Because the Florida Commission will be unable to compensate new entrants for discriminatory or unequal interconnection and provisioning arrangements, it becomes even more important that 1) the wholesale discount be properly established based on a full and accurate identification of avoidable costs, and 2) the equal interconnection provision of the 1996 Act (Section 251 (c)(2)(C)) be strictly enforced. Such enforcement, in turn, is likely to require the imposition of explicit penalties (other than the additional wholesale discount) for violating that provision. In the absence of such penalties, there will be little or no incentive to comply, and unequal interconnection will frustrate the growth of local exchange competition.

Q. DO YOU HAVE ANY OVERALL COMMENTS REGARDING THE FCC'S

LOCAL COMPETITION ORDER?

A. Yes. While I do not find that every detail of this Order reflects strict economic principles which promote effective competition, I believe that, overall, the FCC has done an excellent job of providing state commissions with a set of rules that will serve the pro-competitive mandate of the 1996 Act. If this Order is properly implemented by these commissions, local exchange markets will be transformed from monopoly to competition as expeditiously as possible. And to the extent that occurs, consumers will benefit tremendously.

Q. DOES THAT CONCLUDE YOUR SUPPLEMENTAL TESTIMONY?

A. Yes.

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[1] Federal Communications Commission, First Report and Order, CC Docket Nos. 96-98 and 95-185, August 8, 1996 ("FCC Order").

[2] For example, see David L. Kaserman and John W. Mayo, "Regulatory Policies Toward Local Exchange Companies under Emerging Competition: Guardrails or Speedbumps on the Information Highway?" mimeo, 1995.

[3] This list, of course, is not exhaustive. Numerous other areas of agreement exist.

[4] FCC Order, ¶ 3.

[5] FCC Order, ¶¶ 10 and 15.

[6] FCC Order, ¶ 29 and Section VII.

[7] FCC Order, ¶ 19.

[8] FCC Order, ¶ 675.

[9] FCC Order, ¶ 630.

[10] FCC Order, ¶ 672.

[11] FCC Order, ¶¶ 672, 673.

[12] The FCC Order defines the long run as: "a period of time long enough so that all of a firm's costs become variable or avoidable." FCC Order, ¶ 677. Incremental costs are defined as: "the additional costs (usually expressed as a cost per unit) that a firm will incur as a result of expanding the output of a good or service by producing an additional quantity of the good or service." FCC Order, ¶ 675.

[13] Specifically, the FCC states: "We, therefore, conclude that the forward-looking pricing methodology for interconnection and unbundled network elements should . . . employ the most efficient technology for reasonably foreseeable capacity requirements." FCC Order, ¶ 685.

[14] FCC Order, ¶ 691.

[15] FCC Order, ¶ 678.

[16] FCC Order, ¶¶ 704-707.

[17] FCC Order, ¶¶ 712-715. "We conclude that funding for any universal service mechanisms adopted in the universal service proceeding may not be included in the rates for interconnection, network elements, and access to network elements that are arbitrated by the states under sections 251 and 252." FCC Order, ¶ 712.

[18] FCC Order, ¶¶ 708-711. "We conclude that ECPR is an improper method for setting prices of interconnection and unbundled network elements because the existing retail prices that would be used to compute incremental opportunity cost under the ECPR are not cost-based." FCC Order, ¶ 709.

[19] FCC Order, ¶ 682.

[20] A typical criticism comes from Professor John Wenders, who states: "The topic of costing is filled with sloppy thinking and rhetoric. Costs can be discovered; costs can be identified; costs can be estimated; but costs cannot be allocated. They are not a pie to be divided up among customers. Never use the word allocated in the same sentence with costs. . . . So much regulatory discussion of costs is crippled by the idea of 'allocating costs' that it is important to begin by purging one's vocabulary. Costs can be caused, and costs can be avoided, but they cannot be allocated." John T. Wenders, The Economics of Telecommunications: Theory and Evidence (Cambridge, MA: Ballinger Publishing Company, 1987). A recent monograph on regulation in telephony also addresses fully allocated cost pricing as follows: "This traditional tool of price regulation is now generally discredited and is increasingly being abandoned in regulatory practice." William J. Baumol and J. Gregory Sidak, Toward Competition in Local Telephony (Cambridge, MA: The MIT Press) 1994, p. 56. See also, William J. Baumol, Michael F. Kodhn and Robert D. Willig, "How Arbitrary is 'Arbitrary'? -- or, Toward the Deserved Demise of Full Cost Allocation," Public Utilities Fortnightly, Vol. 120, No. 5, Sept. 3, 1987, p. 16; and Ronald Braeutigam, "An Analysis of Fully Distributed Cost Pricing in Regulated Industries," Bell Journal of Economics, Vol. 11, Spring 1980, pp. 182-196; George Sweeney, "Welfare Implications of Fully Distributed Cost Pricing Applied to Partially Regulated Firms," Bell Journal of Economics, Vol. 13, 1982, pp. 525-533; and David L. Kaserman and John W. Mayo, Government and Business: The Economics of Antitrust and Regulation (Ft. Worth, TX: The Dryden Press), 1995, pp. 509-511.

[21] FCC Order, ¶ 620.

[22] FCC Order, ¶ 706.

[23] FCC Order, ¶¶ 704-707.

[24] FCC Order, ¶ 694. "[T]he relevant common costs do not include billing, marketing, and other costs attributable to the provision of retail service."

[25] These expenses are to be directly included as part of the incremental cost measurement. FCC Order, ¶ 682.

[26] FCC Order, ¶ 696. "[W]e conclude that an allocation methodology that relies exclusively on allocating common costs in *inverse proportion to the sensitivity of demand for various network elements* and services may not be used."

[27] FCC Order, ¶¶ 708-711. "We conclude that ECPR is an improper method for setting prices of interconnection and unbundled network elements because existing retail prices that would be used to compute incremental opportunity costs under ECPR are not cost-based." (¶ 709)

[28] FCC Order, ¶ 698. There is likely to be only a "minimal difference" between the forward looking incremental cost attributable to a particular element that excludes common costs and the stand-alone costs that includes all such costs where there are few common costs.

[29] FCC Order, ¶ 698. "*Any multiple recovery would be unreasonable and thus in violation of the* statutory standard."

[30] FCC Order, ¶¶ 712-715. "[P]ermitting states to include such costs in rates arbitrated under sections 251 and 252 would violate th[e] requirement [that universal service support be recovered in an equitable and nondiscriminatory manner] by requiring carriers to pay specified portions of such costs solely because they are purchasing services and elements under section 251."

[31] FCC Order, ¶¶ 678 and 694.

[32] FCC Order, ¶ 696.

[33] Paragraph 914 of the FCC Order explicitly rules out this sort of additional discount, stating:

> Our analysis also precludes a state commission from adopting AT&T's suggestion that an increment should be added to the base discount rate to compensate resellers for alleged deficiencies in the provisioning of services.