REBUTTAL TESTIMONY OF DR. RICHARD D. EMMERSON

ON BEHALF OF BELLSOUTH TELECOMMUNICATIONS, INC.

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. [redacted]33-TP

AUGUST 30, 1996

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND 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 ("BellSouth" or the "Company"). My business address is 341 La Amatista, Del Mar, CA 92014.

Q. ARE YOU THE SAME RICHARD D. EMMERSON WHO FILED DIRECT TESTIMONY IN THIS DOCKET ON AUGUST 12, 1996?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL 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 BellSouth regarding interconnection, unbundled network elements (UNEs), and resale of existing services. I discuss the basic economic principles that should underlie the Commission's consideration of these issues and I respond to certain positions raised by AT&T in its direct testimony, particularly that of Dr. David Kaserman and Mr. Joseph Gillan.

REGULATORY POLICY SHOULD NOT FAVOR ONE ENTRY MECHANISM OVER ANOTHER

Q. DR. KASERMAN SUGGESTS THAT THE COMMISSION SHOULD SEEK TO PROMOTE RETAIL COMPETITION IN THE SHORT RUN. DO YOU AGREE?

A. No. First and foremost, the Telecommunications Act of 1996 ("Act") reflects a balanced approach to the various opportunities for competitive entry by new entrants. Resale and purchase of unbundled network elements, which Dr. Kaserman refers to as retail competition, should not be preferred over facilities-based competition, which Dr. Kaserman refers to as wholesale competition. Both are equally important to the pro-competitive goals of the Act. While retail competition may develop more rapidly at first, the Commission should not embrace an approach that discourages facility-based competition. Second, the idea that anything or anyone other than free markets can pick winners and losers in the competitive arena has been soundly debunked. The Commission should strive to eliminate any legal or regulatory barriers to competition and prevent the improper exercise of market power to restrict competition, but should avoid trying to pick particular firms or competitive strategies as winners.

Thus, Dr. Kaserman's suggestion that, "at least for the immediate future, considerable emphasis must be placed on competition at the retail stage...as the most viable vehicle for pro-competitive change", is suspect. Creating large retail discounts or pricing unbundled network elements artificially low to aid retail competition in the short term is likely to limit competition to the retail arena, turning a short term bias into a long term one. Although large retail discounts may favor retail competitors, it will directly reduce the incentives of facilities based entrants to enter the market and will result in reduced or eliminated competition from firms that would otherwise build their own networks

Q. DOESN'T DR. KASERMAN'S ANALOGY TO THE DEVELOPMENT OF COMPETITION IN THE INTEREXCHANGE MARKET SUPPORT THIS POSITION?

A. No. Assuming for the sake of argument that the interexchange market is competitive, discounts and pricing strategies like those proposed by AT&T, and supported by Dr. Kaserman, were not necessary to the development of competition in that market. Firms like MCI and Sprint simply bought services from AT&T for resale in the same way that other large customers did. These firms may have received volume discounts, but not resale/wholesale discounts. Discounts on access charges, which non-dominant interexchange carriers received, related to differences in dialing patterns that end users experienced. It is rather amazing that AT&T and others have evidently forgotten that those access discounts were for "unequal" access, and went away as carriers converted to FGD. The standard claim at that time was that customers using FGA had to dial 20 or more digits, while AT&T's customers only dialed 11. Such discounts were not regulatory mandates to "jump start" competition in a resale market to set the stage for facilities-based competition. Moreover, as far as I am aware, AT&T was not calculating any discounts using forward looking incremental costs.

There are other differences which render the analogy inappropriate. For example, when MCI and Sprint sought to enter the interexchange market, they were upstart firms confronting certain competitive disadvantages, like lack of brand recognition. AT&T is not in the same position. AT&T has perhaps the most recognized brand in the world, as well as access to large capital resources. Regulatory handicapping of BellSouth is not appropriate for firms like AT&T and MCI.

Q. DR. KASERMAN SUGGESTS THAT IT IS IMPORTANT TO REDUCE THE ENTRY RISK FOR COMPANIES ENTERING THE LOCAL EXCHANGE MARKET? DO YOU AGREE?

A. No. The Act was designed to remove legal and regulatory barriers to competition in all telecommunications markets, not to make entry risk free. Again, the marketplace should, and only the marketplace can, determine winners and losers. Regulatory policy should not attempt to eliminate risks that a firm entering any market will confront. AT&T needs to get into the local market to protect its own earnings. Margins in interstate toll will evaporate as more and more Bell operating companies are granted interLATA authority.

PRICING SERVICES AT TRADITIONAL LRIC DOES *NOT* PRODUCE A PROFIT FOR THE LEC; RATHER, IT GUARANTEES THAT THE LEC WILL *NOT* RECOVER ITS SHARED INVESTMENTS AND SHARED COSTS.

Q. DOES THE TELECOMMUNICATIONS ACT OF 1996 (THE "ACT") SPECIFICALLY PROVIDE FOR A REASONABLE PROFIT IN THE PRICING STANDARDS ESTABLISHED FOR ARBITRATION?

A. Yes it does. Section 252(d), in discussing pricing standards, states that "interconnection and network element charges" "may include a reasonable profit." The Federal Communications Commission's ("FCC's") recently released *First Report and Order ("Order")* on local competition and related topics also states that prices "will include a reasonable allocation of forward-looking joint and common costs."[1]

Q. DO DR. KASERMAN AND MR. GILLAN ASSERT THAT A PRICE EQUAL TO INCREMENTAL COST OR TSLRIC YIELDS A PROFIT FOR THE LEC?

A. Yes, as surprising as it may seem, both Dr. Kaserman and Mr. Gillan suggest that a price equal to TSLRIC yields a profit to the LEC. This claim appears to be based on the fact that TSLRIC includes a component for the cost of capital.

Q. IF INCREMENTAL COST OR TSLRIC INCLUDES THE COST OF CAPITAL, DOES A SERVICE PRICE EQUAL TO INCREMENTAL COST OR TSLRIC PRODUCE A PROFIT?

A. No, but contrasting terms like profit and contribution clearly will help substantially in the debate here. BellSouth does not make "profits" on individual services or elements because of BellSouth's joint and common costs. Particular services or elements may make a contribution to BellSouth's total costs, and, if enough services or elements make contributions, BellSouth as a firm may make a profit in the accounting sense. BellSouth as a firm does not make a profit in the economic sense of the word until it has recovered all its joint and

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[1] *Order* at ¶ 672.

common costs and a return on the capital invested in its operation as a whole.

It is critical to recognize that an incremental cost calculation only includes the cost of capital (both the cost of debt and equity) for the investments which are directly attributable to the service in question. If each service is priced equal to its incremental cost, then the incremental cost of each service, including a return on the directly attributable capital, will be recovered, but the common costs of the firm will remain completely unrecovered, and the firm certainly will not generate a profit.

Consider again the numerical example of the provision of services A and B that I offered in my direct testimony. Products A & B each have a traditional incremental cost per unit of $.25 and with demand of 100 for each service; their total incremental cost is $25 per service. However, to produce either A or B, the firm must also spend $50 per period on a machine; in this simple example, the $50 is a common cost of these two products. Of the total $25 incremental cost of service A, assume that $3 represents the cost of equity for a normal return to pay shareholders for the investment in the capital equipment that is specifically attributable to the provision of service A. Even when the firm has recovered the $25 of traditional incremental cost for A and the $25 of traditional incremental cost of B, both $25 including a return on investment to shareholders for *that portion* of the capital investment, the firm must still recover an additional $50 in common costs. Without generating $100 in revenue in total, the firm cannot be said to recover its costs.

Q. FOR A LEC, DOES PRICING SERVICES AT TRADITIONAL LRIC OR TSLRIC LEAD TO A LOSS?

A. Yes. It is completely nonsensical to suggest that any (and implicitly every) multiservice firm can earn a "reasonable profit" simply by pricing its services at traditional LRIC or TSLRIC. LECs have common costs that must also be recovered. By pricing services A and B at incremental cost, my hypothetical firm does not earn a reasonable profit, rather it suffers an economic loss of $50.

Q. ARE THERE SIGNIFICANT JOINT AND COMMON COSTS IN THE OPERATION OF BELLSOUTH'S FLORIDA NETWORK?

A. Yes, I described the significance of these costs in my direct testimony.

Q. DO THESE JOINT AND COMMON COSTS APPEAR IN INCREMENTAL COST MEASURES?

A. No. Incremental cost measures like LRIC, TSLRIC and the FCC's proposed TELRIC are not intended to and do not account for joint and common costs because those costs are not incremental. Thus, although TSLRIC, for example, allows for a return on capital attributable to a particular service, it does not allow any contribution to shared costs or any return on capital employed that is not attributable to a particular service.

Q. ARE JOINT AND COMMON COSTS REAL COSTS?

A. Yes, these are costs that are necessarily incurred in order for BellSouth to remain in business, as they are incurred by every other multiproduct firm. In fact, because there are substantial joint and common costs, BellSouth can provide services more efficiently. BellSouth, however, cannot ignore these costs. If these costs are not recovered, the services or elements that benefit from sharing facilities and costs will disappear from BellSouth's offerings.

Q. IS THE TELRIC MEASURE PROPOSED BY THE FCC LIKELY TO RESULT IN THE ATTRIBUTION OF ALL JOINT AND COMMON COSTS?

A. TELRIC may result in the attribution of more joint and common costs than a TSLRIC measure, but many joint and common costs are likely to remain unattributable.

To the extent that more joint and common costs are attributable to elements under the TELRIC measure than to services under the

TSLRIC measure, the cost of those elements will increase. It should surprise no one then if TELRIC prices would be substantially greater than the incremental cost of the various underlying services.

Q. HAS THE FCC RECOGNIZED THAT JOINT AND COMMON COSTS ARE REAL COSTS THAT MUST BE RECOVERED BY BELLSOUTH IN THE PRICES OF ITS UNBUNDLED ELEMENTS?

A. Yes. The FCC recognized in its Order in Docket 96-98 at Paragraph 696 that joint and common costs must be recovered in the prices for unbundled elements.

Q. DOES DR. KASERMAN PROPOSE A METHOD TO RECOVER JOINT AND COMMON COSTS?

A. Yes. He proposes that instead of BellSouth recovering any portion of the joint and common costs of its network through unbundled elements and interconnection, which Dr. Kaserman refers to as a "subset" of BellSouth's services, that it instead recover these costs through other products and services like vertical services and Yellow Pages.

Q. DO YOU AGREE THAT BELLSOUTH CAN RECOVER THE JOINT AND COMMON COSTS OF ITS NETWORK FROM RETAIL SERVICES LIKE YELLOW PAGES ADS AND VERTICAL SERVICES?

A. No. First, a discussion of Yellow Pages has no place in this docket. Even if it did, the directory publishing business is a separate line of business carried on by an affiliate of BellSouth in a competitive environment. Prices for those services are already subject to competitive pressure. Dr. Kaserman tells the Commission "it is absolutely essential that regulators abandon existing policies of cross-subsidization and inefficient pricing and substitute efficient pricing structures," but tells the Commission that BellSouth should look to recover its joint and common costs from its telephone operations from its yellow pages and vertical services. What would purchasers of yellow pages advertising say about paying for the joint and common costs of BellSouth's network elements?

Second, the FCC Order in 96-98 requiring BellSouth to make vertical services available at TELRIC prices seems to undermine, or at least be inconsistent with, Dr. Kaserman's position. For example, BellSouth would be required to make vertical services available to competitors at the unbundled TELRIC price. If joint and common costs are simply allocated to retail services rather than to the underlying network elements, competitors purchasing the unbundled elements will be able to price substantially below BellSouth's now-inflated retail costs. Competitors purchasing unbundled elements will have no joint and common network costs of providing the service because they can simply purchase it from BellSouth; their costs are variable, not fixed. Thus, allocating joint and common costs to retail services that are available as unbundled network elements effectively means that BellSouth will not recover its joint and common costs.

Q. WHAT WOULD BE THE EFFECT OF DENYING RECOVERY OF JOINT AND COMMON COSTS IN THE PRICES OF UNBUNDLED ELEMENTS?

A. There would be two effects. First, new firms considering undertaking the risk of entering the market on a facilities basis would be aware that successful entry would yield, at most, recovery of the incremental costs of entry, without the possibility of contribution towards the firm's joint and common costs and without any reward for the risk of entering. These firms would be unlikely to undertake the risks of entry.

Second, BellSouth, faced with receiving no contribution from the unbundled network elements towards its joint and common costs, would have to balance the returns on other investments that could yield at least some contribution, with investing in new elements and its carrier of last resort obligations. Just as the incentives created by such pricing would make new entrants less likely to enter on a facilities bases, they would make BellSouth less likely to invest in facilities. To the extent BellSouth may be constrained by its legal obligations to invest in new facilities, pricing without recovery of joint and common costs is unfair.

Q. HOW SHOULD JOINT AND COMMON COSTS BE ALLOCATED?

A. The fundamental issue, of course, is not allocation but recovery. In competitive markets, firms recover joint and common costs by pricing above incremental costs where demand permits. Allocating these costs to elements for which there are competitive alternatives, is likely to result in the costs not being recovered because purchasers will turn elsewhere. In addition, to the extent that the recovery of joint and common costs is artificially precluded for one set of services (UNEs), this will send the wrong signals to the market and to BellSouth internally. For example, because the allocation of costs for a particular element may be too high relative to the market, BellSouth and new entrants will invest in such elements even though such investment would be inefficient.

Q. DR. KASERMAN IMPLIES THAT BELLSOUTH DOES NOT HAVE SIGNIFICANT COMMON COSTS IF COSTS ARE CALCULATED AT THE UNBUNDLED NETWORK ELEMENT LEVEL. IS HE CORRECT?

A. No. First, the existence of common costs or economies of scope are well known in the telecommunications industry. It is because of these common costs that the entire issue of cost allocation or fully distributed costs or the full allocation of costs has received so much attention in the industry at different points in time. Economists are fond of describing why allocations of common costs are inappropriate and why these costs should be recovered on the basis of demand information, rather than simple cost allocation rules.[2] Without common costs in telecommunications there would, of course, be nothing to allocate; the entire issue of fully distributed costs would simply not exist.

Second, Dr. Kaserman's suggestion that common costs are minimal appears to contradict another portion of his testimony. Elsewhere, he claims that other parties have misconstrued AT&T's position on pricing, that AT&T does not preclude pricing retail services above TSLRIC. He implies that the LECs can obtain contribution to recover their common costs from retail services.[3]

In my direct testimony, I illustrated the magnitude of these common costs for LECs (40%-50%) and described why LECs are likely to have a larger proportion of common costs than other firms. In contrast, Dr. Kaserman's testimony on the implied absence of common costs is based on speculation and conjecture. His claim, that the incremental costs of UNEs will somehow absorb all common costs and lead to a firm which has negligible common costs, is simply assertion without theoretical foundation or factual basis. Such claims are not credible in part because UNEs are by definition components which become new services; UNEs are not some radical new product. They will be offered

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[2] The citations from the economics literature are numerous and include articles authored by William Baumol. Dr. Kaserman cites Dr. Baumol in support of his position.

[3] Any such recovery will be difficult or impossible as described on p 11.

for sale to customers like any other service; they are simply services which have been unbundled and did not previously exist. LECs have had unbundled portions of services in the past and it did not seem to cause common costs to somehow disappear.

If common costs are fully absorbed in the incremental costs of the UNEs, the incremental cost of UNEs will be substantially greater than the incremental cost calculations for old services. If one were to sum up the incremental costs of the UNEs that an old service utilizes, this cost sum would be substantially greater than the incremental cost of the old service itself. For BellSouth, for which common costs represent approximately one-half of the total costs of the Company, on average I would expect that if Dr. Kaserman is correct, the sum of the UNE costs must be approximately twice as large as the incremental costs of the old service itself.[4]

EVEN INTERMEDIATE SERVICES SOLD TO OTHER PROVIDERS SHOULD NOT BE PRECLUDED FROM MAKING A CONTRIBUTION TOWARD COMMON COSTS

Q. YOU STATED IN YOUR DIRECT TESTIMONY THAT THE ALEC HAS THE OPPORTUNITY TO UTILIZE THE UBIQUITOUS FACILITIES OF

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[4] On average I would expect one dollar of what was once considered common costs to follow each dollar of incremental cost for the old service.

THE INCUMBENT LEC WHEN AND WHERE IT CHOOSES. IS THIS POINT RELATED TO MR. GILLAN'S TESTIMONY?

A. Yes. Mr. Gillan states that: "Teleport, in fact, has publicly stated that its business strategy is to win customers first and then build facilities in an efficient way to serve them."[5] When customers have an existing supplier, they then have the luxury to slowly negotiate an agreement with a second supplier. The supplier has the opportunity to place facilities after customers and contracts are in place. A LEC facing a franchise obligation has no such opportunities.

Q. DR. KASERMAN SUGGESTS THAT PRICES FOR UNES ABOVE INCREMENTAL COST WOULD INVITE INEFFICIENT ENTRY. DO YOU HAVE AN OPINION IN THIS REGARD?

A. Yes. First, I find it telling and in my mind contradictory that in one breath Dr. Kaserman tells the Commission, "it is absolutely essential that regulators abandon existing policies of cross-subsidization and inefficient pricing and substitute efficient pricing structures," and in the next breath, proposes an artificial regulatory rule to price one subset of "services" at the direct cost of providing them without regard to the need to recover joint and common costs. This is clearly a proposal for handicapping and inefficient pricing.

[5] Citing Telecommunications Reports, October 16, 1995, page 20.

Second, Dr. Kaserman's opinion appears to be based on a theoretically simple world without common costs; in such a theoretically simple world, prices can exist equal to incremental cost. As I discussed earlier, LECs face significant common costs and the prices in this industry for most services and for most providers are unlikely to equal traditional incremental costs. In the real world of telecommunications, prices for all services, including UNEs, must exceed incremental costs in order to recover common costs.

Third, because of the existence of common costs, establishing prices for UNEs at traditional LRIC or TSLRIC implies even higher prices for retail services than would otherwise exist, if the LEC is to financially survive. Prices for the retail components must now exceed traditional incremental costs by an even greater amount. Obviously, such a result directly contradicts Dr. Kaserman's testimony on economic efficiency; his policy recommendation results in an incentive for inefficient retail entry.

Finally, Dr. Kaserman's testimony on this point is devoid of dynamic considerations. In real markets, firms must make real investments on the basis of current circumstances and expected future circumstances. Much of the important market activity in the real world, and particularly investment and entry decisions, occur because there are transitory windows of opportunity. A firm enters a market or offers a new product not because the world is in long-run equilibrium, but rather because the world is temporarily out of equilibrium which creates an entry opportunity. The higher the price in the market, the stronger the signal to firms that there is a market opportunity. The higher the price for UNE's, the faster the rate of development of facilities-based competition. Dr. Kaserman's recommendation essentially sends the signal to potential new entrants that there is no opportunity to recover any portion of their own common costs by entering this industry.

WHOLESALE DISCOUNTS MUST BE BASED ON RETAIL RATES AND THE COSTS THAT WILL BE AVOIDED BY THE LEC NOT ON PENALTIES AND CLAIMS OF QUALITY DIFFERENTIALS

Q. IN YOUR OPINION, HAS MR. LERMA PROPERLY INTERPRETED THE SPECIFIC LANGUAGE IN SEC. 252(d)(3) OF THE ACT?

A. No. Mr. Lerma correctly quotes the relevant section of the Act: "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." However, much of the rest of the language in Mr. Lerma's testimony, beginning at page 4, indicates a misunderstanding of the language of the Act and a misunderstanding of the fundamental economic concept of cost causation. For instance, he asserts at page

10, line 24: "[a]gain, the Act specifically lists billing and collection costs as costs that will be avoided." The Act does not state that billing and collection costs will be avoided, but rather it requires that the portion of marketing, billing, collection and other costs that will be avoided will determine the wholesale discount. To simply assume or assert that all costs which are categorized in ARMIS accounts as "marketing," "billing," or "collection" costs, should be included in a calculation of a wholesale discount ignores fundamental economics and the language of the Act.

Q. HAS AT&T ONLY SELECTIVELY RECOGNIZED THE ECONOMIC PRINCIPLE OF COST CAUSATION?

A. Yes. For example, Mr. Lerma at least appears to be willing to accept the economic principle of cost causation for the category of "other" cost, yet he ignores this principle with regard to costs which he deems to be marketing, billing or collection costs.

However, in each instance, the Act indicates, and sound economics dictates, that it is only those costs that will be avoided that should be included in the calculation of the wholesale discount.

Q. HAS MR. LERMA OVERSTATED THE CALCULATION OF THE APPROPRIATE WHOLESALE DISCOUNT?

A. Yes, it appears that he has. First, there will clearly be marketing costs, for example, which are simply unaffected by the movement of some proportion of customers from retail to wholesale offerings. Second, some resources will simply be redeployed as customers move from retail to wholesale offerings, rather than being avoided. For example, an employee dedicated to retail billing functions may be reassigned to wholesale billing activities; clearly the salary and benefits of such an employee will not be avoided as customers move from retail to wholesale offerings.

Q. MR. GILLAN CLAIMS (AT PAGE 17) THAT: "... THE WHOLESALE DISCOUNT SHOULD REFLECT THE FULL REMOVAL OF ALL RETAIL COSTS THAT WOULD BE AVOIDED BY BELLSOUTH IF IT OPERATED IN A WHOLESALE CAPACITY." DO YOU AGREE WITH THIS CHARACTERIZATION?

A. No. Such a calculation will overstate the costs that BellSouth will avoid due to wholesale rather than retail provision for some units of demand. BellSouth will continue to provide both retail and wholesale services going forward and these costs vis-a-vis the previous costs of a higher proportion of retail forms the proper basis for a calculation of the costs that will be avoided. A hypothetical construction of a firm that does not provide any retail services is simply not germane to the calculation of the costs BellSouth will actually avoid. Volume insensitive retail costs will not be avoided nor will any "retail" resources that will be redeployed to wholesale activities. If BellSouth would truly lose its entire retail segment, the redeployment of resources to wholesale activities would be massive in size and scope.

Q. DR. KASERMAN SUGGESTS THAT RESALE RATES REFLECT THE INCREMENTAL COSTS OF REDUCING OR ELIMINATING BST'S RETAIL STAGE OPERATIONS (P.26)). ARE THERE COSTS INVOLVED IN REDUCING OR ELIMINATING BST'S RETAIL STAGE OPERATIONS?

A. Yes. BST is a vertically integrated firm that undertakes the production, wholesaling and retailing of local telephone service. Vertically integrated firms reap efficiencies from savings on production and transactions costs. Integration of production with wholesale and retail functions in a single firm can substantially reduce transactions costs, especially where complex products and relationships are involved. Thus, there would be substantial costs involved in dividing roles among separate firms with differing incentives in the production and sale of local telephone service. For example, specifying in an enforceable manner the roles that separate retail firms would play in network planning and sharing the cost and risk of network investment would be difficult and costly. BST's vertical integration, similar to that of the major interexchange firms, efficiently aligns incentives within a single company in these situations. Thus, the risks of network construction are spread throughout the production, wholesale and retail sides of the business, and risks are minimized by the presence of a retail side dedicated to ensuring efficient utilization of the network. Firms that are interested in resale of BST's services as a vehicle to compete with BST may be less interested in furthering efficient investment in and usage of the network, creating substantial additional costs.

Eliminating BST's retail function would not avoid the transactions costs of dealing with independent retail firms. Transactions costs of dealing with independent retailers would include contracting, contract monitoring, marketing and retailer relations costs. To the extent that independent retailers do not agree to undertake the roles played by BST's retail arm in network planning and operation, including assuming risks of network investment, those additional costs must be included in the resale rate.

Q. MR. GILLAN BRIEFLY LISTS THE RESULTS OF A "REGRESSION" STUDY OF THE "MIXED CATEGORY" OF CORPORATE EXPENSES AND COMPANY RETAIL REVENUES. DO YOU HAVE ANY COMMENTS?

A. Yes I do. First, it is difficult to comment in detail since Mr. Gillan has provided almost no details of his analysis or a reason for the choice of the functional form of the model.[6]

[6] The "mixed" accounts are those which Mr. Gillan asserts contain both retail and wholesale expenses.

Second, and perhaps more importantly, simple correlation does not cause costs to be avoided. It should come as no surprise to anyone that larger companies, or larger states have larger corporate overheads and corporate expenses. I would expect a relatively high correlation between any portion of corporate overheads (retail, wholesale or mixed) and any measure of the size of the franchise obligation such as wholesale (i.e. access) revenues, population or even the number of public toilets within the franchise area of each BellSouth state. One can only speculate whether Mr. Gillan would accept allocating such costs to wholesale revenues if I could produce a regression with a similar or superior fit using this variable. Of course, to suggest that corporate overheads will be avoided simply because of the existence of a statistical correlation with retail revenues, is simply not credible. It is not credible to believe that corporate expenses are likely to rise if revenues rise due to a rise in prices for example.

Q. DOES MR. LERMA EMPLOY A SIMILAR TECHNIQUE TO THAT USED BY MR. GILLAN?

A. Essentially, although the method employed by Mr. Lerma makes no pretext of relying on statistical techniques. For example, beginning at page 12, Mr. Lerma describes the loading of other "retail" accounts with network support, general support services, depreciation-general support, executive and planning, general and administrative, operating other taxes, return and income taxes, and other interest deductions. At page 12, line 11 he simply asserts: "[t]he application of this ratio is reasonable because support *expenses will vary directly in proportion* to the changes in direct costs that will be avoided."

Mr. Lerma bypasses the pretext of statistical relationships and simply asserts that costs will vary in direct proportion.

Q. IS THE APPROACH USED BY MR. LERMA AND MR. GILLAN SIMILAR TO THE OLD FULLY DISTRIBUTED COST TECHNIQUES USED IN THE PAST IN TELECOMMUNICATIONS?

A. Yes, their approaches are similar to the old fully distributed cost (FDC) techniques.

Q. DOES AN ESTIMATE OF 41.7% OF THE RETAIL <u>PRICE</u> AS A WHOLESALE DISCOUNT COMPORT WITH COMMON KNOWLEDGE IN THE TELECOMMUNICATIONS INDUSTRY?

A. No. This calculation does not pass the industry "red face" test for several reasons. First, Dr. Kaserman and Mr. Gillan discussed the "enormous" or "tremendous" capital investment required for the provision of local service by LECs. However, if one were to believe the fully distributed cost calculations of Mr. Lerma and Mr. Gillan, the descriptions of the local exchange network over the past few decades would have focused on the "enormous"" *retail* costs of providing such services and how difficult it would be to replicate these retail activities.

Second, in his testimony Dr. Kaserman devotes significant space to discussions of the "monopoly power" of the LECs. The very notion of significant monopoly power for a facilities-based provider and a high proportion of costs that would be avoided through reduced retail activities appears contradictory. It begs the rhetorical question: why would a facilities based provider with significant monopoly power need to spend significant resources on retail activities that would be avoided?

Third, this wholesale discount calculation contradicts a great deal of AT&T's testimony and other material regarding AT&T's estimates of the costs of basic local exchange service. With a business local exchange rate of $44, Mr. Lerma *implies that BellSouth can avoid* $18.35 ($44 X .417) of retail costs per month. However, AT&T has claimed that total loop costs for the three density zones where the vast majority of business customers are located in Florida are between $11.89 and $9.11 per month.[7] Even AT&T's estimate of the state-wide average of

[7] Ex parte submission to the FCC by AT&T and MCI in CC Docket No. 97-98, July 3, 1996, page 9.

the costs of basic local exchange service in Florida is only $17.71[8] Certainly it is not possible for BellSouth to be able to construct and maintain the facilities necessary to provide basic local exchange service for $17.71 while simultaneously being able to avoid $18.35 in low cost areas. AT&T's positions are simply contradictory.

Q. DOES THE CUSTOMER MIX WHICH MR. LERMA HAS IMPLICITLY UTILIZED IN HIS DISCOUNT CALCULATION MATCH THE LIKELY CUSTOMER MIX FOR AT&T?

A. No. I expect that AT&T will likely offer resale to a relatively higher proportion of business customers than BellSouth's mix of customers in total. In part, I expect such a mix since the dollar discount for business customers is greater than for residential customers. In contrast, Mr. Lerma's discount calculation is implicitly based on the average mix of business and residence customers. Implicitly, Mr. Lerma has adopted an approach that overstates the costs that will be avoided by no longer providing retail service to business customers.

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[8] *Id.* This includes cost for the following: loop distribution, concentration, and feeder, end office switching, port and signaling, signaling network elements for links, STP and SCP; transport network elements for dedicated, common and tandem switch; and operator systems. In addition, it is claimed that this cost includes a reasonable proportion of overhead costs of the Company.

Q. SHOULD ANY VOLUME INSENSITIVE RETAIL COSTS BE INCLUDED IN THE CALCULATION OF THE COSTS THAT WILL BE AVOIDED?

A. No, not unless there is an expectation that the LEC will lose virtually its entire retail market. The nature of a volume insensitive cost is that it is independent of the volume of retail (in this case) services. If retail volumes fall by 10% from the levels which would otherwise have occurred, by definition the volume insensitive retail costs will not be avoided. The Act is clear that only the costs that will be avoided by the LEC are to be reflected in the wholesale discount.

Q. HAS MR. LERMA INCLUDED COSTS IN HIS CALCULATION THAT MAY BE VOLUME INSENSITIVE?

A. Yes, it appears that he has improperly included costs in his calculation that may be volume insensitive. Mr. Lerma's method will lead to an overstatement of the costs that will be avoided by the LEC.

Q. BEGINNING AT PAGE 26 OF HIS TESTIMONY, IN DISCUSSING WHOLESALE DISCOUNTS, DR. KASERMAN LISTS THREE COMPONENTS WHICH HE CLAIMS SHOULD BE INCLUDED IN A CALCULATION OF THE COSTS THAT A LEC WILL AVOID. DO YOU AGREE WITH HIS DISCUSSION?

A. No. It is not clear if Dr. Kaserman has advanced a listing of items that might theoretically be "avoidable" under certain circumstances or whether he has simply created a list that will produce the greatest discount for AT&T under the greatest variety of circumstances. Dr. Kaserman claims that his "avoided cost pricing rule" will yield economically efficient and pro-competitive outcomes; it does neither and it is inconsistent with other portions of Dr. Kaserman's testimony.

It is critical to recognize that the Act does not call for the calculation of theoretically "avoidable" costs, i.e., costs which might, theoretically be avoided under some contrived circumstances. Rather, the Act mandates recognition of the costs that will be avoided.

Q. IS IT NECESSARY TO FOLLOW DR. KASERMAN'S LIST OF THREE ITEMS WHEN CALCULATING THE COSTS THAT BELLSOUTH WILL AVOID BY PROVIDING A WHOLESALE RATHER THAN A RETAIL UNIT OF SERVICE?

A. No. Dr. Kaserman's list of items and his approach is neither necessary nor useful for calculating the costs that BellSouth will avoid. These three items are unrelated to the language of the Act, they are theoretically incorrect, and are impractical even if they had theoretical value.

The costs that BellSouth will avoid are simply what they are. With regard to Dr. Kaserman's second item, even if one were to accept his speculation of inefficiencies, any inefficiency that exists and is avoided will be reflected in the avoided cost calculation. If BellSouth has inefficiencies which can be avoided, they will be reflected in the avoided cost calculation.

Q. IF, AS DR. KASERMAN IMPLIES, BELLSOUTH HAS SIGNIFICANT INEFFICIENCIES, ARE THERE ANY POLICY IMPLICATIONS?

A. Yes. If BellSouth is, as inefficient as Dr. Kaserman implies, then the Commission probably need engage in no additional regulatory oversight of BellSouth. In unregulated markets, firms that are very inefficient, generally do not survive. The new competitive opportunities, especially the opportunities for facilities-based competition, will make inefficient firms highly vulnerable; the Commission need only step back and allow the market to work to eliminate such inefficiency.

Q. DR. KASERMAN'S THIRD ITEM TO BE INCLUDED IN HIS "AVOIDED COST PRICING RULE" IS "ANY POSITIVE PROFIT." DO YOU HAVE ANY COMMENTS ON THIS ITEM?

A. Yes. I recommend rejecting this item for at least three reasons. First, it appears that what Dr. Kaserman means by "profit" is what would normally be called "contribution" in the telecommunications industry.[9] Without recovery of common costs, the equity holder will receive no profit whatsoever. Implicitly, Dr. Kaserman asserts that contribution to recover common costs "will be avoided" and that this contribution should be included in the calculation of a discount.

Second, Dr. Kaserman's discussion of "avoidable" costs (his terminology at page 27, line 1) or avoidable profits is based on a vague notion of entitlement. He states: "[l]ikewise, it [the LEC] is no longer entitled (if it ever was) to any excess profits associated with it retail operations." In the next sentence he jumps from his assertion of excess profits and his notion to what the LEC is "entitled," to the simple assertion that all three components will be avoided.

Of course, the common costs of the LEC are not avoided when a portion of BellSouth's retail service is replaced by wholesale activities. Even if one accepts a portion of Dr. Kaserman's convoluted argument and adopts his pricing proposal, the foregone contribution from former retail sales would represent an opportunity cost of wholesale service, not an opportunity cost which is avoided.[10]

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[9] At page 26 he states "(3) any positive profit earned by the ILEC at the retail stage (where positive economic profit is the excess above a normal return on the firm's activities at this stage). (Emphasis in the original).

[10] If one accepts Dr. Kaserman's backwards notice of cost avoidance, one could set the price for the wholesale service at zero; at this price, the LEC would "avoid" all of the retail revenue which would therefore be included in the avoidable cost calculation. Of course a negative price for the wholesale service could be proven in with this notion as well.

Third, Dr. Kaserman's claim that only "positive profits" should be incorporated into his calculation is self serving and internally contradictory.

Q. IS DR. KASERMAN'S PROPOSAL TO PRICE UNES AT TSLRIC INCONSISTENT WITH HIS THREE-PART "AVOIDED COST PRICING RULE?"

A. Yes. To see this, it is useful to think of his UNE pricing rule as establishing the price of one set of inputs or components of the final good provided to consumers. In contrast, Dr. Kaserman's so-called "avoided cost pricing rule" is proposed to, in essence, establish the price for the retail component. In Dr. Kaserman's hypothetical numerical examples at pages 27-31 of his testimony, it is useful to think of the wholesale input (which has a TSLRIC of $7 in his examples) as a single UNE used in the production of the final end-user service. The retail function (which has a TSLRIC of $5 in his examples) is the only other function or component necessary to create a final end-user service. The discount in effect determines the implied price for the retail function or retail input.

In Dr. Kaserman's case 2 (an inefficient ILEC with excess profits) he implicitly proposes an implied price for the retail input of $9, despite a $5 TSLRIC for the retail function. It appears that when AT&T wishes to purchase a function from BellSouth, such as a wholesale package or a UNE, Dr. Kaserman proposes to price that function at TSLRIC. However, when it appears that AT&T may wish to be in the market of selling a function, i.e., the retail activity, Dr. Kaserman is willing to propose a price that may be substantially greater than TSLRIC.

He also claims at page 29 that "[m]oreover, this rate still promotes efficient entry decisions at both the retail and the wholesale stages." To Dr. Kaserman, sometimes a price at TSLRIC promotes economic efficiency, while at other times a price above TSLRIC promotes economic efficiency. However, such a proposal, no matter how cleverly crafted, is simply contradictory.

Q. DOES DR. KASERMAN'S DISCUSSION AT PAGES 27-31 REVEAL ANYTHING ABOUT HIS NOTION OF PROFIT AND COMMON COSTS?

Yes. It is clear from his case 1, beginning on page 27, that Dr. Kaserman considers a firm efficient only if it has no common costs. To be more realistic, his case 2 should be reworked as "an efficient LEC with common costs." With this more realistic label, it is obvious that Dr. Kaserman proposes that BellSouth be prohibited from recovering any of its common costs from the services that AT&T wishes to purchase, but that it be allowed to recover any and all common costs through the prices of services which will compete with AT&T services.

Q. YOU STATED EARLIER THAT DR. KASERMAN'S CLAIM THAT ONLY "POSITIVE PROFITS" SHOULD BE INCORPORATED INTO HIS CALCULATION IS SELF SERVING AND INTERNALLY CONTRADICTORY. WOULD YOU PLEASE EXPLAIN YOUR STATEMENT?

A. Yes. Again, to be clear, recognize that when Dr. Kaserman uses the term profit, he appears to mean "contribution." He claims that only "positive profit" should be included to increase the size of the wholesale discount, and that negative profit (a cross-subsidy) should not be allowed to reduce the size of the discount.

This result is self serving since it provides the largest wholesale discount to AT&T under a variety of situations. Also, I believe the contradictory nature of the argument is at least somewhat obvious: contribution, or profit should only be considered in some instances (when it is positive and will work to increase AT&T's discount) but should be ignored in other instances (when it is negative and will reduce AT&T's discount).

Earlier, I discussed why one must proceed with caution when considering profits or contributions (positive or negative) when calculating the costs that a LEC will avoid. It may, however be instructive to read Dr. Kaserman's own words: "[b]ecause negative profits are not avoided by selling at wholesale versus retail, the $2 loss involved in the sale of this service does not enter into the calculation of the efficient wholesale discount. That is, negative profits do not constitute avoided costs." It appears that Dr. Kaserman believes that his rule is theoretically correct only at certain times, when it works to his client's advantage.

Q. AT PAGE 19 DR. KASERMAN IMPLIES THAT THE RETAIL FUNCTION SHOULD BEAR THE FULL BURDEN OF THE RECOVERY OF COMMON COSTS. HE APPEALS TO AN ARTICLE BY DIAMOND AND MIRRLESS IN THE ECONOMICS LITERATURE ON TAXATION. DO YOU HAVE ANY COMMENTS?

A. Yes. It is instructive to read part of the quote Dr. Kaserman provides at *footnote* xv: "*In the absence of profits, taxation of intermediate goods must be reflected in changes in final good prices. Therefore, the revenue could have been collected by final good taxation, causing no greater change in final good prices and avoiding production inefficiency.*"

There are three important implications of this quote. First, it is based on a scenario of zero profits. However, firms in this industry, and many others, obtain contribution and profit from intermediate services; some firms which only provide intermediate services must obtain all their profit and contribution from such services. Second, unlike the quote, for BellSouth it is not possible that "the revenue could have been collected by final good taxation." BellSouth does not have sovereign taxing authority to recover its common costs through a tax on AT&T's final goods and services. And third, this quote implies that no telecommunications firm, including AT&T should obtain profits or contribution from any service sold to a business customer since all services sold to businesses are used as factor inputs to produce other *final* goods and services. If Dr. Kaserman's position were correct, he must advise his client to stop obtaining any contribution or profit from its business customers since these telecommunications services are intermediate services.

Dr. Kaserman has chosen a very narrow and theoretically simple basis for his recommendation. He selectively ignores not only economic theory and economic literature which is more realistic and applicable, he also ignores the characteristics of real firms and real telecommunications networks.

Q. IS DR. KASERMAN INCONSISTENT IN HIS TESTIMONY IN SUGGESTING THAT BELLSOUTH SHOULD BE FORCED TO PROVIDE A GREATER DISCOUNT THAN THAT REFLECTING THE COSTS THAT BELLSOUTH WILL AVOID?

A. Yes. Dr. Kaserman's recommendation not only contradicts the language of the Act, it contradicts his testimony regarding economic efficiency. Economic efficiency requires that the wholesale discount reflect only the costs that will be avoided by BellSouth by avoiding a portion of its retail activities.

Dr. Kaserman expresses concern that a price for a UNE greater than incremental cost will induce "inefficient entry" in the facilities-based segment of the market. However, a wholesale discount greater than the costs that BellSouth will avoid will implicitly, according to Dr. Kaserman's testimony, lead to *inefficient entry into the retail market.*

In real markets, vertical integration often leads to lower costs in total. In such instances, it is less costly to have the productive activities within a single firm rather than organized through a set of contracts with multiple firms. However, Dr. Kaserman essentially recommends that if economies of vertical integration exists, the Commission should simply pretend that they do not exist by establishing unreasonably large wholesale discounts that will invite retail entry which Dr. Kaserman's own testimony indicates is economically inefficient.

Q. DOES THIS MEAN THAT IF ECONOMIES OF VERTICAL INTEGRATION EXIST FOR BELLSOUTH, THAT OTHER FIRMS CANNOT COMPETE THROUGH RESALE?

A. Certainly not. It does mean however, that other firms must bring something else to the table. Each firm must be able to utilize its own costs advantages or its own comparative advantages in offering, something unique to customers via combinations of services, quality, functions, features and prices. And of course, other firms have the opportunity to vertically integrate themselves, including vertical integration in areas which BellSouth is not currently allowed.

Q. DR. KASERMAN MENTIONS THE "HATFIELD" MODEL IN HIS TESTIMONY. IN YOUR OPINION SHOULD THIS COMMISSION CONSIDER THE HATFIELD MODEL OR ITS RESULTS FOR THIS PROCEEDING?

A. No. For a variety of reasons the Hatfield model produces unreliable cost estimates. It should not be considered in this proceeding. For example, in a joint submission, Sprint Corporation and US West, Inc., in CC Docket No. 96-45, filed on July 3, 1996, state at page 2: "Sprint and US West do not support the modifications proposed by Hatfield and E.I. and believe they produce distorted and misleading results."

Q. AT PAGE 13 OF HIS TESTIMONY, MR. ELLISON DISCUSSES BELLSOUTH'S COST OF MONEY AND SUGGESTS THAT A LOWER COST OF EQUITY SHOULD BE USED FOR "MONOPOLY NETWORK ELEMENT." DO YOU HAVE AN OPINION IN THIS REGARD?

A. Yes. I reject the concept of using different costs of equity or costs of money for different services. BellSouth does not acquire debt which is specific to projects or services, nor does it make equity offerings specific to unbundled network elements. Even if such an approach were theoretically valid, different costs of money for different services would be difficult and costly to implement in practice.

It is also clear that the telecommunications industry is becoming more, rather than less competitive. This proceeding and AT&T's recommendations in this proceeding demonstrate that BellSouth now faces greater risk than even in its provision of services, especially in its provision of unbundled network elements. This cases BellSouth's cost of capital to be higher rather than lower.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.