BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of

Petitions by AT&T Communications of the Southern States, Inc., MCI Telecommunications Corporation, MCI Metro Access Transmission Services, Inc., American Communications Services, Inc. and American Communications Services of Jacksonville, Inc. for arbitration of certain terms and conditions of a proposed agreement with BellSouth Telecommunications, Inc. concerning interconnection and resale under the Telecommunications Act of 1996.

DOCKET NO. 960833-TP
DOCKET NO. 960846-TP
DOCKET NO. 960916-TP

FIRST DAY - EVENING SESSION

VOLUME 4

Pages 466 through 689

PROCEEDINGS: HEARING

BEFORE: CHAIRMAN SUSAN F. CLARK
COMMISSIONER J. TERRY DEASON
COMMISSIONER JULIA L. JOHNSON
COMMISSIONER DIANE K. KIESLING
COMMISSIONER JOE GARCIA

DATE: October 9, 1996

TIME: Commenced at 6:00 p.m.
Concluded at 8:15 p.m.

PLACE: Betty Easley Conference Center
4075 Esplanade Way, Room 148
Tallahassee, Florida

REPORTED BY: JANE FAUROT, RPR

APPEARANCES:
(As heretofore noted.)

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WITNESSES

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10 and 11			472
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P R O C E E D I N G S

(Hearing reconvened at 6:00 p.m.)

Whereupon,

WAYNE ELLISON

having been called as a witness on behalf of AT&T Communications of the Southern States, Inc., and being duly sworn, continues his testimony as follows:

CONTINUED CROSS EXAMINATION

BY MS. CANZANO:

Q Would it be your position that the switched access charges be repriced based on TELRIC cost?

A Yes. I think they need to be. They need to reflect forward-looking economic cost, yes.

Q And what is the basis of your response?

A I think generally, I would refer -- from an economic perspective, I would refer to that Doctor Kaserman, but in layman's terms the reason you need to price at economic cost, number one, that is the forward-looking cost that the local exchange companies incur in providing services. And by pricing at that level, and making sure that all competitors receive these monopoly elements at the same cost and at the cost of providing the service, you allow competition to drive down the prices of these services to consumers to economic-based cost levels. Said another way, if you require a BellSouth competitor to pay twice what it costs to provide that service to BellSouth, then essentially BellSouth is operating under an umbrella. They can keep their prices high, much above their cost to their customers and still be very competitive because they force the price of their competitors up. So I believe that is the most important reason why you need to price it at economically efficient prices, costs.

Q You are aware of the pending FCC plans to institute access charge reform in the near future, are you not?

A Yes.

Q Have you been involved in those proceedings?

A No, I have not.

Q Will AT&T be involved in those proceedings?

A Yes, I'm sure we will be.

Q Do you agree that access charge reform needs to occur?

A Absolutely.

Q And why do you say that?

A There again, because you cannot have competition between a number of players when one player has a cost advantage. And that's exactly what we have with the access charges at the levels they are at today.

Q Do you believe that access charge reform should be in conjunction with the establishment of a universal service fund?

A I think we are moving along a path where all of these things are occurring pretty simultaneously, and I believe they all need to be addressed. I don't think it is absolutely necessary that they all be done on the same day, but it all needs to be done in the near future absolutely.

Q Mr. Ellison, do you have a copy of what staff has identified as Exhibit Number WE-6, consisting of your deposition transcript and your Late-filed Deposition Exhibits 1 and 2?

A Yes, I do.

Q Have you had an opportunity to review that exhibit?

A Yes, I have.

Q Do you have any changes you want to make to it?

A I had only one minor change on Page 21. On Line 15, the second word in the transcript is found, F-O-U-N-D, that should be filed, F-I-L-E-D. That was all I noticed.

Q So with that change, is this exhibit true and correct to the best of your knowledge?

A Yes, it is.

MS. CANZANO: At this time staff would like to have that marked for identification as an exhibit, please.

CHAIRMAN CLARK: It will be marked as Exhibit 11.

MS. CANZANO: Thank you. And with that, staff has no further questions.

CHAIRMAN CLARK: Commissioners. Redirect.

MR. HATCH: No redirect.

CHAIRMAN CLARK: Okay. Exhibits.

MR. HATCH: AT&T moves Composite Exhibit 10.

CHAIRMAN CLARK: Without objection, Exhibit 10 will be admitted into the record.

MS. CANZANO: The staff moves Exhibit Number 11.

CHAIRMAN CLARK: Without objection, Exhibit Number 11 will be admitted in the record.

MR. HATCH: May the witness be excused?

CHAIRMAN CLARK: He may. Thank you, Mr. Ellison.

WITNESS ELLISON: Thank you.

MR. HATCH: AT&T would call Doctor Kaserman to the stand.

CHAIRMAN CLARK: Mr. Hatch, I take it Doctor Kaserman has not been sworn in.

MR. HATCH: That's correct.

CHAIRMAN CLARK: Would you please stand and raise your right hand.

(Witness sworn.)

CHAIRMAN CLARK: Thank you.

Whereupon,

DAVID L. KASERMAN

having been called as a witness on behalf of AT&T

Communications of the Southern States, Inc., and being duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. TYE:

Q Doctor Kaserman, would you please state your name and business address for the record.

A My name is David Kaserman, my address is Department of Economics, Auburn University, Auburn, Alabama, 36849.

Q And by whom are you employed, Doctor Kaserman?

A By the Department of Economics at Auburn University.

Q Doctor Kaserman, did you prepare and cause to be prefiled in this proceeding direct testimony consisting of some 45 pages of questions and answers?

A Yes.

Q And did you also prepare and cause to be prefiled in this proceeding supplemental direct testimony consisting of some 11 pages of questions and answers?

A Yes.

Q Excuse me, 12 pages.

A Yes.

Q And did you also prepare and cause to be prefiled in this proceeding rebuttal testimony consisting of some 17 pages of questions and answers?

A Yes.

Q Doctor Kaserman, are there any changes, corrections, or additions that you need to make to this testimony at this time?

A No.

Q If I were to ask you the questions contained in this testimony here today, would you give me the same answers contained therein?

A Yes, I would.

MR. TYE: Madam Chairman, I would request that Doctor Kaserman's direct, supplemental direct, and rebuttal testimony be inserted in the record as though given orally.

CHAIRMAN CLARK: It will be inserted in the record as though read.

MR. TYE: Thank you.

DIRECT TESTIMONY OF

DAVID L. KASERMAN

ON BEHALF OF AT&T COMMUNICATIONS

OF THE SOUTHERN STATES, INC.

Docket No. 960833-TP

I. QUALIFICATIONS AND PURPOSE OF TESTIMONY

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, Auburn, Alabama, 36849-5242.

Q. WHAT IS YOUR OCCUPATION?

A. I am an economist. My current position is Torchmark Professor of Economics at Auburn University.

Q. WOULD YOU PLEASE SUMMARIZE YOUR QUALIFICATIONS?

A. I hold a Ph.D. degree in Economics from the University of Florida. My principal field of interest is industrial organization, which encompasses the areas of antitrust economics and the economics of regulation. I have over twenty years of experience as a professional economist and have held positions both in government agencies (e.g., the U.S. Federal Trade Commission) and in academic institutions. In addition, I have consulted on and testified in numerous antitrust cases and regulatory hearings. My primary research interest is in the application of microeconomic analysis to public policy issues, and that interest is reflected in my publications. Over the past twelve years, I have focused much of my research on public policy issues surrounding the telecommunications industry, particularly those issues created by the emergence of competition in the various markets that comprise that industry. That research has resulted in the publication of more than a dozen papers on this subject, with several more papers currently in progress. I also have recently published a major textbook dealing with the economics of antitrust and regulation. In addition, over this same period, I have testified on telecommunications policy issues in more than fifteen states and before the Federal Communications Commission.

Q. **HAVE YOU PREPARED A VITA THAT DESCRIBES YOUR EDUCATION, PUBLICATIONS. AND EMPLOYMENT HISTORY?**

A. Yes. A copy of my most recent vita is attached as Exhibit 1.

Q. **WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

A. I have been asked by AT&T to prepare this testimony in support of its petition to this Commission for arbitration with BellSouth under the provisions of Section 252 of the Telecommunications Act of 1996 (the Act). Toward that end, my testimony addresses four specific topics: (1) the pressing need to implement policies that will promote entry into local exchange markets; (2) the economically efficient pricing standard to apply to local interconnection services and unbundled network elements; (3) the economically efficient pricing standard to apply to wholesale services; and (4) other non-price competitive issues that affect the ability of efficient competitors to enter local exchange markets.

Throughout this testimony, I will attempt to explain the fundamental economic principles that should guide the Commission's arbitration decisions concerning these important topics. Adherence to these principles will ensure that Florida consumers begin to receive the myriad benefits of more competitive local exchange markets as rapidly as possible. It will also help to ensure that the competition that emerges is both efficient and sustainable.

II. THE NEED TO PROMOTE ENTRY INTO LOCAL EXCHANGE MARKETS

Q. WHY SHOULD THIS COMMISSION FAVOR ARBITRATION DECISIONS THAT WILL PROMOTE ENTRY INTO LOCAL EXCHANGE MARKETS?

A. Local exchange telephone markets currently stand as the last remaining segment of the telecommunications industry to fall to competitive market forces. They now represent the final source of significant monopoly power in this sector of the economy. As a result, the consumer benefits of policies that will successfully promote competition in these markets are likely to be quite substantial.

Such competition may arise at two distinct levels, which may be conceptualized as the retail and wholesale stages of the local exchange market. The retail stage involves marketing and delivery of end user services (e.g., services directly involved in reaching the customer -- marketing, billing, collection, operator services and directory assistance to customers), while the wholesale stage provides basic network functionalities (e.g., local exchange switching, transmission, signal processing and connection with the customer location) that are used to produce these end-user services.

Retail-stage services may be provided by a carrier entering the local market and obtaining from an incumbent local exchange carrier ("ILEC") the inputs the competitor carrier needs. Here, a new entrant may use the existing facilities of an incumbent carrier such as BellSouth, but add value in the manner the new entrant presents these services to the customer.[i/]

Services at the wholesale stage, however, require that the new entrant construct from scratch the facilities required to provide these functions -- i.e., become a facilities-based carrier.

While effective competition eventually may arise at both stages, its prospects are currently much brighter at the retail level. Competition at the wholesale stage will require tremendous capital expenditures to fully replicate local exchange networks with the existing technology and, therefore, is not likely to occur either rapidly or on a geographically ubiquitous basis. Instead, competition at this stage is likely to proceed slowly and to focus largely on the more cost effective urban areas for some time to come. At least for the immediate future, considerable emphasis must be placed on competition at the retail stage -- both through resale and unbundled network element based services -- as the most viable vehicle for pro-competitive change. Such retail competition will yield both immediate and long term benefits to consumers.

Q. WHAT IMMEDIATE BENEFITS ARE EXPECTED TO EMERGE FROM ENTRY INTO LOCAL EXCHANGE MARKETS?

A. Consumers will benefit immediately and directly from retail competition both in reduced costs and expanded service offerings. Other markets that have undergone a similar transformation from monopoly to competitive supply invariably have experienced such beneficial effects from retail competition during the early stages of competition. Even when limited to the retail stage, competitive rivalry imposes pressures to improve performance that even the most conscientious regulators cannot replicate. Such pressures lead to innovative production and marketing strategies that lower costs and increase the quality and variety of products offered to consumers.

Indeed, holding quality constant, under appropriate (competitive) pricing standards, the only firms that will have an incentive to enter the retail stage will be those firms that can perform the retail function at costs that are equal to or below those of the

ILECs. Moreover, unlike facilities-based (or wholesale-stage) entry which requires substantial investment, retail-stage entry will enable competitive market forces to surface rapidly and on a geographically widespread basis.

Q. **WHAT LONG-TERM BENEFITS ARE EXPECTED TO RESULT FROM RETAIL COMPETITION IN LOCAL EXCHANGE MARKETS?**

A. The promotion of retail competition may provide the most expeditious path toward facilities-based entry as well. Development of a customer base through successful retail entry can provide the antidote to the substantial sunk costs required for facilities-based entry into local exchange markets. That is, once a competitor has successfully entered the retail stage of a local exchange market via resale of the ILEC's wholesale services or unbundled network elements, developing identity and goodwill with customers, the risks of investing in the network facilities required to provide these services (investments which may not be recovered if entry is not successful) will be lowered substantially. Moreover, once the new entrant begins to develop its own local network facilities, the ability to purchase unbundled network elements from the ILEC at competitive prices will allow such development to proceed incrementally and in a cost-minimizing fashion.

The experience of interexchange resellers that gradually became facilities-based carriers provides a stellar example to substantiate this argument. MCI, Sprint, and all other non-AT&T facilities-based competitors initially entered the interexchange market as resellers. Successful promotion of retail competition will provide additional benefits by paving the way for a more rapid growth of facilities-based competition, just as it did in the long distance industry.

Q. **WILL RETAIL COMPETITION ACHIEVED THROUGH RESALE AND UNBUNDLED NETWORK ELEMENTS ELIMINATE THE ILECS'**

MONOPOLY POWER AND, THEREFORE, THE NEED FOR CONTINUED REGULATION OF THESE FIRMS' PRICING AND PROVISIONING DECISIONS?

A. No. While the beneficial effects of retail competition should not be underestimated, it must be recognized that substantial monopoly power in the provision of wholesale-stage services will remain until widespread facilities-based competition emerges. Due to the presence of such monopoly power and the economic incentive of the ILEC to utilize that power to exclude competitors from its markets at both the retail and wholesale stages, regulators will have a crucial role to play in controlling the ILECs' behavior for the foreseeable future.

Transformation of local exchange markets from monopoly to competition is likely to be a prolonged, contentious, and complex process, and its success will hinge largely upon the ability and willingness of regulatory commissions to implement and enforce efficient pro-competitive policies.

Q. **IS BELLSOUTH LIKELY TO VOLUNTARILY ADOPT EFFICIENT ENTRY-FACILITATING PRICING AND PROVISIONING POLICIES?**

A. No. Monopoly power such as that held by BellSouth is a valuable asset that is not likely to be surrendered voluntarily. As a result, voluntary bilateral negotiations with a monopolist are unlikely to bear competitive fruit. Thus, despite the Act's requirement in Section 251(c)(1) that the ILECs negotiate in good faith, it is not likely that such negotiations will yield the complete pricing and provisioning agreements necessary for successful entry.

Indeed, as an economic matter, it is likely that Congress anticipated the failure of voluntary negotiations to provide an adequate resolution of the terms needed for entry. That anticipation, in turn, motivated the Act's provision for the arbitration process in which we are now engaged. Throughout this process, regulators should expect BellSouth and other ILECs to adopt strategies that: (1) foreclose new firms from entering their markets; (2) encourage existing firms to exit their markets; and (3) extend their monopoly power to other markets. The economics literature refers to these types of anti-competitive strategies as preemption, predation, and monopoly leveraging, respectively. They are designed to maintain, regain, and augment the incumbent's firm's pre-existing monopoly power.

Q. WHAT ARE SPECIFIC ACTIONS AN ILEC MAY TAKE IN ORDER TO PRESERVE ITS MONOPOLY POSITION?

A. The specific actions an ILEC may take to implement these strategies are quite numerous. They can involve both price and non-price terms of sale. With regard to the former, a vertical price-cost squeeze may be used to force competitors from a market or prevent potential competitors from entering. For example, entry into BellSouth's intraLATA toll markets has been frustrated by its pricing access services high in relation to the rates BellSouth charges for its toll services.

Similarly, a refusal to interconnect or the provision of inferior interconnection can have an equivalent effect. For example, a requirement that a new entrant interconnect at a predetermined single point or adopt a specific type of interconnection can increase the entrant's costs by preventing the firm from making efficient use of its network.

Additionally, a refusal to provide specific contractual terms that a potential entrant may require (e.g., quality of service standards with explicit penalties for non-performance) can have similar exclusionary effects.[ii/] As a result, regulators will need to enforce explicit pro-competitive policies pertaining to all aspects of the ILECs' behavior--pricing, provisioning, and contracting -- if the desired market transformation is to be achieved.

Q. IS THERE A DANGER THAT PROMOTION OF RETAIL COMPETITION WILL TEND TO DISCOURAGE FACILITIES-BASED ENTRY?

A. As I explained above, as long as retail competition is fostered through efficient, pro-competitive pricing and provisioning policies, it will tend to promote, rather than discourage, facilities-based entry. Specifically, as long as such competition is not subsidized by pricing wholesale services and unbundled network elements below the relevant economic costs of providing these products, the incentive for facilities-based entry to occur is not dampened in the least by successful resale entry.

The pricing principles I will explain later in this testimony and the specific pricing standards that result from these principles are subsidy-free. As a result, there is no conflict between these standards and the legitimate desire to promote facilities-based competition. Under the correct pricing standards, the two forms of entry are complements, not substitutes. I turn, now, to these pricing standards.

III. THE PRICING OF INTERCONNECTION SERVICES AND UNBUNDLED NETWORK ELEMENTS

Q. WHAT IS THE FUNDAMENTAL ATTRIBUTE OF ECONOMICALLY EFFICIENT PRICES?

A. In the absence of any significant market failures, the fundamental characteristic of efficient prices is that they reflect the marginal or (as is typically measured in the telecommunications industry) incremental costs imposed on the provider to supply the good or service in question.[iii/] The price that consumers pay for a service measures society's marginal willingness to pay for the last unit produced. Marginal cost measures the marginal value to society of the resources used to produce the last unit. Only if the marginal willingness to pay (i.e., the price of a good) is equal to the marginal (or incremental) value of the resources employed in production (i.e., the marginal cost of a good) is the socially optimal level of output realized.[iv]

Q. COULD YOU PLEASE ILLUSTRATE THIS POINT?

A. Yes. Assume the price of some product, say pencils, exceeds the incremental cost of production. Specifically, suppose that the price of pencils is 23¢ and the incremental cost is 14¢. An economist would say that there is a socially sub-optimal level (or an under-allocation) of resources being devoted to the production of pencils.

The reason is that at the prevailing price there are consumers who value the good more highly than it costs the firm (or, more generally, society) to produce the good. Because they do not value the good more than the inflated price, however, they are economically and inefficiently denied consumption of the good. That is, despite the fact that they value the next unit of the good 9¢ more than it costs society to produce that next unit, additional consumption does not occur. In this situation, then, society's resources are fundamentally misallocated. The solution to this misallocation occurs when (and only when) price reflects the incremental (or marginal) cost of production.

Q. WHY IS IT IMPORTANT FOR THE FLORIDA COMMISSION TO APPLY EFFICIENT PRICING PRINCIPLES IN ITS ARBITRATION DECISIONS?

A. In a free market economy, prices serve an extremely important role as signals for resource allocation decisions of all types. For example, high prices encourage consumers to cut back on consumption. At the same time, they encourage producers to increase the quantity of the product supplied. The resulting adjustments provide an equilibrium between production and consumption of the product. With regard to entry decisions, prices serve as traffic signals, directing the flow of productive resources between industries. Consequently, efficient allocation of resources and promotion of competition require very careful attention to the level at which regulators set prices. Specifically, prices must be established at economically efficient (i.e., incremental cost) levels if efficient and pro-competitive outcomes are to be encouraged.

Traditional regulatory pricing policies, however, have not always pursued efficiency. Frequently, other regulatory objectives have dominated efficiency considerations in price making decisions.[v/] As a result, regulated price structures have typically contained substantial elements of cross-subsidization, where the price to one group of consumers exceeds cost in order to hold the price to another group of consumers below cost.[vi/] The resulting departure of price from cost creates economic inefficiency in both the subsidized and subsidizing markets.

Where both of these markets are subject to monopoly supply with entry prohibited by regulatory fiat, such inefficient cross-subsidization policies, while harmful to social welfare, can be sustained. Where entry barriers are relaxed, however, the presence of inefficient prices (such as those that accompany cross-subsidization policies) creates distorted incentives for entry decisions, and eventually these prices become unsustainable.

Specifically, in markets where price is held above cost (that is, the markets that are generating the subsidies), entry may be artificially encouraged. Such entry, in turn, forces these prices downward, thereby eliminating the source of the cross subsidy. In markets where price is held below cost (that is, the markets that are receiving the subsidies), entry is discouraged. Indeed, there is no more effective entry barrier than a below-cost price. It makes little sense, then, to relax legal and regulatory barriers to entry and then set prices below costs through the regulatory process (except where such prices are necessary to compensate for other prices which are below cost). Such a pricing policy is, in effect, regulatory-enforced predatory (or preemptive) pricing.

Therefore, as local exchange markets evolve from monopoly to competition, it is absolutely essential that regulators abandon existing policies of cross-subsidization and inefficient pricing and substitute efficient pricing structures. Once entry is allowed, it is imperative that the correct signals be given to market participants -- particularly potential entrants -- to direct the efficient flow of resources into these markets. Just as faulty traffic signals can cause serious accidents, faulty price signals can cause serious inefficiencies.

Q. GIVEN THE PRICING PRINCIPLE YOU HAVE IDENTIFIED, AT WHAT SPECIFIC LEVEL SHOULD THE COMMISSION SET THE PRICES FOR INTERCONNECTION SERVICES AND UNBUNDLED NETWORK ELEMENTS?

A. Interconnection services and unbundled network elements are crucial inputs that new entrants will need to purchase from BellSouth in order to compete at the retail stage in local exchange markets in Florida.[vii/]

In order to promote efficient entry at the retail stage, the price these entrants should pay for these inputs is equal to the incremental cost that BellSouth incurs to provide them. Moreover, due to the multiproduct nature of BellSouth's operations, the relevant cost to which prices should be equated is what is known as the total service long-run incremental cost, or TSLRIC.[viii/]

TSLRIC is the theoretically correct basis for pricing these inputs for several reasons.[ix/] First, TSLRIC is an <u>incremental</u> cost. As a result, socially optimal purchase and entry decisions will be fostered with prices set at this level. Second, TSLRIC is long-run in nature. Because the decision to enter a market is, by definition, a long-run decision, TSLRIC prices will send economically correct signals to potential entrants. Third, TSLRIC is an economic cost. As such, it includes a normal (competitive) profit on the capital that is invested to provide the relevant service or element. And fourth, the concept applies to total service costs, which means that all costs that can be causally attributed to production of the product in question are incorporated in these prices. Thus, TSLRIC prices for interconnection services and unbundled network elements are subsidy-free and economically efficient. Such prices will promote efficient and sustainable competition in local exchange markets.

Q. IS THE POLICY RECOMMENDATION THAT THESE PRICES BE SET EQUAL TO TSLRIC CONSISTENT WITH THE TELECOMMUNICATIONS ACT OF 1996?

A. Yes. Section 252(d)(1) of the Act requires that the prices for interconnection services and unbundled network elements be

> "based on the cost (determined without reference to a rate-of-return or other rate based proceeding) of providing the interconnection or network element ..."

Moreover, this Section further indicates that these prices "may include a reasonable profit."

Because TSLRIC prices are, in fact, equal to the long-run incremental cost of providing these inputs, including a normal profit on the causally attributable invested capital, the Act's criteria are fully satisfied by such prices.

In addition, the clear and overriding intent of this legislation is to promote competition in local exchange markets. That is, the Act's primary purpose is to put in place a set of pricing and provisioning regulatory policies that eventually will foster a structural transformation of these markets from monopoly to competition. For reasons explained above, that transformation depends heavily upon successful entry by firms that, for some time, will be dependent upon the ILECs for certain network functions and components for which there is currently no alternative. As a result, it is crucially important that these functions and components -- interconnection services and unbundled network elements -- be priced at economically efficient TSLRIC levels. Otherwise, the entry process will be distorted, and the desired market transformation will be artificially delayed. Thus, TSLRIC pricing of these inputs is not only consistent with the letter of this Act, it is also consistent with the Act's overall objectives.

Further, Section 252(d)(2)(A), dealing with charges for transport and termination of traffic, specifies that:

> . . . a State commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless -
>
> (i) such terms and conditions provide for the mutual and reciprocal recovery by each carrier of <u>costs associated with</u> the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier; and
>
> (ii) such terms and conditions determine such costs on the basis of a reasonable approximation of the <u>additional costs</u> of terminating such calls. [Emphasis added.]

Thus, prices based upon the principles of cost causation (linkage of costs to the product giving rise to these costs) and incremental costs appear to be envisioned by the Act. Again, TSLRIC prices correspond directly with these principles and, therefore, clearly satisfy the Act's criteria.

Q. **IS THIS PRICING RECOMMENDATION ALSO CONSISTENT WITH THE TRADITIONAL ECONOMIC CRITERION OF MAXIMIZATION OF SOCIAL WELFARE?**

A. Yes, TSLRIC pricing is entirely consistent with that criterion. Social welfare as used by economists essentially is a reflection of the overall well-being of the community involved, including both the consumers and producers of the product. Maximization of social welfare insures that both groups receive the greatest level of satisfaction attainable from existing resources.

Economists typically arrive at their pricing recommendations by solving a constrained optimization problem wherein some specific objective function (or goal) is maximized or minimized, subject to a given set of constraints. In the usual situation involving regulatory pricing recommendations, prices have been chosen to maximize social welfare subject to the constraint that the market is a natural monopoly[x/]

Due to the technological and economic feasibility of transforming local exchange markets from monopoly to competition, however, the assumption of a static natural monopoly market structure no longer provides an appropriate foundation from which to derive pricing recommendations. Instead, recognizing the tremendous benefits that will flow from a successful transformation of these markets from monopoly to competition, we should select prices for monopolized inputs, such as interconnection services and unbundled network elements, that optimize the pace at which such competition emerges.[xi/]

Because interconnection services and unbundled network elements constitute vital monopoly-controlled inputs that will be required by new entrants into local exchange markets, the lower these prices are set, the more rapid will be the development of resale competition. Viable competition that will be sustainable in the long run, however, cannot be fostered by subsidizing the entry process. The prices for interconnection services and unbundled network elements should be subject to the constraint that they be subsidy-free.

THE REVISED OPTIMIZATION PROBLEM WE NOW FACE, THEN, IS TO FIND A SET OF INPUT PRICES THAT WILL MAXIMIZE THE WELFARE OF THE COMMUNITY SERVED BY OPTIMIZING THE PACE AT WHICH LOCAL EXCHANGE COMPETITION DEVELOPS SUBJECT TO THE CONSTRAINT THAT THESE PRICES BE SUBSIDY FREE. THE OBVIOUS SOLUTION TO THIS PROBLEM IS TO SET THESE INPUT PRICES AT THE LOWEST UNSUBSIDIZED LEVEL. THAT LEVEL, IN TURN, IS EQUAL TO THE (PER UNIT) TSLRIC OF THESE INPUTS. CONSEQUENTLY, SETTING THESE PRICES AT TSLRIC IS CONSISTENT WITH THE TRADITIONAL ECONOMIC CRITERION OF MAXIMIZING SOCIAL WELFARE.

Q. **ARE THERE OTHER BENEFICIAL PROPERTIES OF TSLRIC PRICES FOR LOCAL INTERCONNECTION AND UNBUNDLED NETWORK ELEMENTS?**

A. Yes. In addition to promoting a rapid development of local exchange competition, TSLRIC prices for interconnection services and unbundled network elements exhibit several additional beneficial properties.

First, such prices promote efficient entry decisions. A firm considering entry will compare its expected post-entry revenues to its expected costs. Where the former exceed the latter, profitable entry is feasible. Expected costs, however, are influenced directly by the prices the ILEC such as BellSouth charges for the inputs it sells to its competitors. If those input prices are held above their respective TSLRICs, the entry decision will be artificially distorted. Consider, for example, the consequences of setting the price of an unbundled element at $4 per month if the TSLRIC of that element is only $2 per month. In that case, an efficient firm considering an entry strategy that requires purchase of that particular network element will be inefficiently discouraged from entering. As a general proposition, input prices that exceed TSLRIC artificially dampen the new entrants incentive to enter. Such prices create a disadvantage for the new entrant from the start.[xii/]

Second, a similar conclusion holds with respect to potential entrants' and new competitors' make-or-buy decisions. Such firms must decide which network elements to purchase from the ILEC and which elements to supply or construct themselves. These decisions are founded squarely on a comparison of the incremental costs of the two alternative sources of supply -- one being the entrant's incremental cost of purchasing the element from the ILEC (simply the price that must be paid for it) and the other being the incremental cost of constructing that element anew. If the ILEC's price is held above its incremental cost of providing that network element (i.e., its TSLRIC), an artificial incentive is created for the new entrant to supply that element itself. As a result, the ILEC's existing network infrastructure will be under-utilized and industry costs will be increased unnecessarily. Moreover, the higher costs experienced by the firms that have been artificially encouraged to self-supply undermines the ability of market forces to push the ILEC's retail product prices downward toward competitive levels. As a result, the intensity of competition is dampened.

Finally, by creating parity between the prices charged by the ILEC and the costs the ILEC incurs to provide interconnection services and unbundled network elements, the prospects for anti-competitive behavior are reduced. For example, the ILEC's incentive and ability to engage in a vertical price squeeze against its competitors are reduced by establishing prices for ILEC-supplied monopoly inputs that accurately reflect incremental costs. The reason is that, with upstream prices equal to costs, any attempt by an ILEC to price predatorily at the downstream stage will require the firm to reduce retail prices below its own incremental cost of providing the retail service. It is relatively unlikely that the firm would embark on such a strategy that purposefully inflicts losses on itself on the uncertain prospect that it will be able to recover these losses in the future.

Thus, the pricing of inputs to reflect their underlying TSLRICs can be seen to more closely align the self-interest of the ILEC (to make profits) with the interests of society (both to avoid monopolistic practices that deter competition and to minimize the need for subsequent regulatory intervention).

Q. **IF YOUR RECOMMENDATION IS ADOPTED AND INTERCONNECTION SERVICES AND UNBUNDLED NETWORK ELEMENTS ARE PRICED AT TSLRIC, IS BELLSOUTH LIKELY TO EXPERIENCE A REVENUE SHORTFALL?**

A. No. Claims that strict adherence to efficient pricing principles would bankrupt the ILECs have been employed by various advocates of inefficient prices for decades. The alleged "justification" for raising certain (monopoly) local exchange prices above incremental costs have included: (1) claims of natural monopoly; (2) the alleged presence of ILEC common costs, which may not be captured in incremental cost measures; (3) the need to recover ILEC embedded costs or ensure a return on stranded investment; and (4) the need to generate subsidy flows within the regulated firm to support the universal service objective.[xiii]

Regardless of which of these alleged rationales is employed, the argument fails to provide an adequate justification of the proposed departures from efficient prices, especially input prices paid by competitors for unbundled elements or interconnection services. For instance, natural monopoly conditions no longer appear to extend over the full set of services provided by local exchange companies.[xiv/] Moreover, the perception that TSLRIC prices will automatically fail to cover firm costs often stems, at least in part, from some fairly common misconceptions concerning what is properly included in the firm's prices under this cost concept. In particular, some parties have failed to recognize that: (1) because long-run incremental cost is an <u>economic</u> cost, it includes a normal profit on the provision of the service in question; and (2) because it is a <u>long run</u> cost, it includes the cost of any fixed assets (or overhead) that can be causally attributed to that service. Therefore, the fundamental premise underlying this argument -- that efficient prices necessarily will fail to cover costs -- is questionable.

Even if efficient prices do fail to cover the regulated firm's current costs (which are likely to be inflated both by embedded costs and inefficiencies), they may still generate sufficient revenues to cover the lower (economic) costs that will be realized in a more competitive environment. That is, the ILEC's costs are not immutable. BellSouth's rising profits under current price cap regulation demonstrate this. Regulation of a monopoly has a pronounced tendency to inflate observed costs above those attainable under more competitive conditions.

As with other industries that have undergone a similar transformation, the emergence of competition in local exchange markets is likely to result in substantial efficiency gains that will reduce costs considerably. As a result, the same set of prices that generate insufficient revenues today may yield sufficient revenues tomorrow. Regulators should not assume that the ILEC's costs are completely generated by external forces. Substantial portions of these costs may be within the control of the ILEC itself and these costs will fall with the advent of competition.

Q. IF THE FLORIDA COMMISSION DETERMINES THAT SOME OF BELLSOUTH'S PRICES SHOULD BE RAISED ABOVE TSLRIC, DOES ECONOMIC THEORY PROVIDE ANY GUIDANCE CONCERNING WHICH PRICES SHOULD BE RAISED?

If other financial or policy considerations dictate that some subset of the ILEC's prices be raised above its costs as measured by TSLRIC, fundamental economic principles require that retail prices be raised, not those prices charged to and disproportionately borne by new entrants. Increasing intermediate product prices for competitors above efficient levels creates distortions in downstream production processes which must ultimately be borne by consumers, no matter which carrier they may choose for their retail service.[xv/] As a result, it is more economically efficient to recover any revenue shortfall from final consumers directly in the prices they pay for retail services. Such a recovery mechanism is competitively neutral, as the Act intends.

To the extent prices new entrants pay for unbundled network elements and network interconnection are raised above TSLRIC -- in order to generate revenues to achieve some other objective (e.g., to provide an additive for some recovery of embedded costs found to be "just and reasonable" or to pay for universal service subsidies) --

we are effectively sacrificing competition on the altar of this alternative goal. Such a sacrifice is unnecessary, because there are alternative, more efficient means of raising those revenues. This general policy prescription holds all the more strongly in the local exchange markets today, where public policy is attempting to facilitate a rapid transition from monopoly to competitive supply. Therefore, there is simply no principled basis for raising interconnection services and unbundled network elements prices above TSLRIC.

Q. TO BE CLEAR, IS IT YOUR POSITION THAT FINANCIAL VIABILITY CONSIDERATIONS DO NOT PROVIDE AN ECONOMICALLY RATIONAL JUSTIFICATION FOR INCREASING THE PRICES OF ILEC-SUPPLIED INPUTS ABOVE THEIR RESPECTIVE TSLRICS?

A. That is correct. In order to understand this issue more clearly, it is useful to pose the following three questions:

1. If ILEC-supplied monopoly inputs are priced at TSLRIC will the ILEC's costs exceed its revenues?

2. If TSLRIC prices for ILEC-supplied monopoly inputs do generate a revenue shortfall (i.e., if the answer to question 1 is yes), should regulators ensure that the ILEC is made whole?

3. If TSLRIC prices for ILEC-supplied monopoly inputs do generate a revenue shortfall and the ILEC is entitled to recover at least some portion of it, how should the necessary revenues be recovered?

I answer each of these questions below.

Q. WOULD THE ILEC'S COSTS BE LIKELY TO EXCEED ITS REVENUES IF ILEC-SUPPLIED MONOPOLY INPUTS ARE PRICED AT TSLRIC?

A. Two considerations suggest that the answer to this question is "perhaps but probably not."

First, I am not proposing that all of the ILEC's revenue-generating services be priced at TSLRIC-- only those interconnection services and unbundled network elements that are subject to monopoly power and must be purchased by competitors to enter local exchange markets. ILECs currently sell many other services and products (e.g., vertical services and yellow pages) that are priced well in excess of their costs. As a result, it is not at all clear that pricing this competitively-important subset of services at TSLRIC will create an overall revenue shortfall.

Second, unless there are substantial common costs present in the ILEC's operations, TSLRIC prices will be fully compensatory. Some recent evidence suggests that the magnitude of common costs in this industry has been greatly exaggerated.[xvi] If that is the case, then implementing TSLRIC prices for interconnection services and unbundled network elements will not create a revenue shortfall. Therefore, the answer to question 1 is clearly not an unambiguous "yes" -- it may, in fact, be "no."

Q. SHOULD THIS COMMISSION ENSURE THAT BELLSOUTH IS MADE WHOLE IF ITS TSLRIC PRICES TO NEW ENTRANTS GENERATE A REVENUE SHORTFALL?

A. I am convinced that the theoretically correct answer here is "probably not" or, at least, "BellSouth should not be fully compensated." Several reasons underlie this opinion. First, the traditional regulatory compact, as interpreted in the landmark Hope Natural Gas case, never promised (or could promise) normal profits under all circumstances.[xvii] Firms do not go bankrupt overnight, and many firms (both regulated and unregulated) have weathered prolonged periods of losses without exiting their industries. Thus, a regulatory policy that requires that the ILECs' profits be positive in every period would not appear to be economically optimal.

Second, whatever regulatory compact might have existed under rate-based, rate-of-return regulation would appear to have been voluntarily repealed when Florida shifted to price-cap regulation for BellSouth. A principal feature of this alternative regulatory regime is supposed to be that the firm's stockholders willingly accept increased risks of both financial gains and losses.

Regulatory commissions simply cannot simultaneously continue to hold the ILECs harmless from competitive risk and promote any sort of meaningful competition in local exchange markets. Protection of competitors is fundamentally incompatible with promotion of competition as required by the Act and as planned for the benefit of Florida local telephone customers. As local exchange markets begin to evolve toward competition, ILEC appeals to be made whole (particularly at the expense of their competitors) should be increasingly ignored.

Q. IF THIS COMMISSION DETERMINES BELLSOUTH IS ENTITLED TO RECOVER SOME PORTION OF AN ESTIMATED REVENUE SHORTFALL, HOW SHOULD THE RECOVERY BE ACCOMPLISHED?

A. If it is decided that revenue shortfalls will be caused by TSLRIC pricing of ILEC-supplied inputs and that the ILECs should be at least partially, if not fully, compensated, the theoretically correct answer to this question again leads us to endorse TSLRIC prices for interconnection services and unbundled network elements. That is, if additional revenues are required beyond those realized under TSLRIC input prices, then these revenues should be recovered directly from all end users in a competitively neutral fashion. We should not distort the input prices paid by the ILEC's potential or actual competitors to collect these revenues. In short, under no circumstances does the financial viability issue warrant a departure from economically efficient TSLRIC prices.

Q. PRICING INTERCONNECTION SERVICES AND UNBUNDLED NETWORK ELEMENTS AT TSLRIC OBVIOUSLY REQUIRES EMPIRICAL ESTIMATES OF THESE COSTS. ARE SUCH ESTIMATES CURRENTLY AVAILABLE?

A. Yes. To implement this pricing recommendation, regulators will need to adopt a costing methodology that is capable of providing reasonably accurate estimates of the TSLRICs of the interconnection services and unbundled network elements that new entrants will be purchasing from the ILECs.

Specifically, any model used should generate cost estimates that: (l) are forward looking; (2) employ least-cost but currently available technologies; (3) measure incremental costs; (4) are long-run; and (5) are consistent with cost causation. The model described in Mr. Ellison's testimony, which is based on cost information provided by BellSouth, appears to provide such a methodology.[xviii]

IV. <u>THE PRICING OF WHOLESALE SERVICES</u>

Q. IS THERE AN ECONOMIC DISTINCTION BETWEEN THE SALE OF UNBUNDLED NETWORK ELEMENTS AND WHOLESALE SERVICES?

A. Yes. Under the "unbundled network elements" scenario, a new entrant into a local exchange market has at least two options available. First, the entrant may choose to purchase a complete package of unbundled network elements (including the loop, switch, and local transport) that will enable it to supply end-user services in direct competition with the ILEC. That is, it may enter with no local network facilities of its own. This so-called platform approach offers several desirable economic properties. For example, by purchasing unbundled network elements, the new entrant may be able to devise and configure new service offerings that better meet particular customer needs, thereby serving market niches that would otherwise go unserved. In addition, the platform approach provides a source of market discipline that can help to prevent or overcome anti-competitive abuses that may arise from mispricing of other ILEC services (e.g., wholesale services and carrier access services). Specifically, the flexibility of supply created by allowing new entrants to purchase the complete package of unbundled network elements at efficient prices can help to constrain the ILEC's ability to foreclose entry through various alternative strategic actions.

Under the second entry option using the unbundled network element approach, the new entrant may purchase a subset of the ILEC's network elements and combine those elements with other network components that are either self-supplied or purchased from some other provider(s) in order to produce some end-user service that, again, may or may not correspond directly to an end-user service of the ILEC. That is, these unbundled network elements supplied by the ILEC are simply inputs into a production process. The particular output or service that process yields is determined by the firm purchasing those inputs. It is not constrained by the existing output mix of the ILEC from which the unbundled network elements are bought. As a result, the firm's success in the marketplace will depend upon its ingenuity in designing service offerings that better meet consumers' preferences and its efficiency in combining inputs to produce those service offerings at competitive prices. Moreover, this second approach allows for partial facilities-based competition at the retail stage and permits an incremental investment strategy that ultimately will promote competition at the wholesale stage as well.

Wholesale services, on the other hand, are discounted versions of the ILEC's underlying retail products. A new entrant purchasing a wholesale service, then, must compete directly with the corresponding retail service that the ILEC is already selling. As a result, the feasibility of entering the market as a reseller of wholesale services is directly contingent upon the relationship (or spread) between the existing price of the retail service and the price of the wholesale service. That difference, in percentage terms, is referred to as the wholesale discount. Obviously, the level at which that discount is set -- and not the specific price at which the wholesale service itself is set -- will influence the incentive to enter the local exchange market as a reseller.

As a consequence, the pricing problem presented by wholesale services is somewhat different from the pricing problem presented by unbundled network elements. Specifically, the former pricing problem must incorporate the retail rate charged for the end-user service, whereas the latter pricing problem need only reflect the appropriate incremental costs. Despite this difference, however, the economic principles that apply to these problems are precisely the same.

Q. **IS THE DISTINCTION BETWEEN THESE PRICING PROBLEMS RECOGNIZED IN THE ACT?**

A. Yes. The Act appears to recognize both this difference and the commonality of the economic principles involved. The Act specifies that wholesale discounts be set equal to the costs the ILEC will avoid by selling the service at the wholesale stage versus the retail stage. Specifically, Section 252(d)(3) provides that:

> "A State commission shall determine wholesale rates on the basis of retail rates charged to subscribers ... excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier."

The Act clearly recognizes the need to incorporate the retail rate charged by the

ILEC when establishing the wholesale rate to be paid by resellers competing with that ILEC. Moreover, the avoided cost concept also suggests that the wholesale discount should reflect incremental costs -- here, the incremental costs of reducing or eliminating the ILEC's retail stage operations.

Q. IS THIS PROVISION CONSISTENT WITH THE DICTATES OF EFFICIENT PRICING?

A. The Act's definition of the "costs that will be avoided" is entirely consistent with efficient pricing principles. Specifically, avoided costs should be defined to include <u>all</u> of the long-run incremental costs associated with the retail activities of the ILEC that will be avoided when the ILEC ceases to perform those retail activities. Conceptually, such avoided costs consist of three basic components: (1) the long-run incremental costs that an <u>efficient</u> provider of the retail function would incur (i.e., the TSLRIC of the retail stage); (2) any additional costs that the ILEC currently incurs in the provision of retail services that are attributable to production inefficiencies (i.e., any organizational slack or "fat" contained in the ILEC's observed costs at the retail stage); and (3) any <u>positive</u> economic 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).[xix/]

The first component consists of the costs avoided by an economically efficient supplier of retail services that is minimizing cost and earning a normal profit (i.e., a competitive return). A normal profit or competitive return is the investors' risk-adjusted return on capital investments, measured by opportunities presented in alternative enterprises. It is the very same return a new entrant would expect to earn.

The second and third components of avoided costs (fat and excess profits) are arguably the most avoidable of all avoided costs. If the ILEC no longer provides the retail services, then it no longer bears the cost inefficiencies that it formerly incurred in the provision of those services. Likewise, it is no longer entitled (if it ever was) to any excess profits associated with its retail operations. Consequently, the concept of avoided costs should incorporate all three components, because all three will, in fact, be avoided. I refer to this guidepost for establishing the efficient wholesale discount as the "avoided cost pricing rule." The application of this rule to the pricing of BellSouth's wholesale services will yield economically efficient (and, therefore, pro-competitive) outcomes.[xx/] Moreover, this rule is consistent with Section 252(d)(3).

Q. DOES APPLICATION OF THE AVOIDED COST PRICING RULE RESULT IN AN ECONOMICALLY EFFICIENT PRICE FOR WHOLESALE SERVICES?

A. Whether application of this rule will lead to an economically efficient wholesale price depends upon the efficiency of the retail price to which the (efficient) wholesale discount is applied. Regardless of the efficiency of the retail price, however, it is economically efficient to apply the avoided cost pricing rule. Three simple cases help to explain this point.

Case 1: An Efficient ILEC With No Excess Profit: In this case, the price the ILEC charges for the retail service is equal to the costs the ILEC incurs in providing this service. In other words, the ILEC experiences competitive profits in selling this service. In this case, the application of the avoided cost pricing rule (where avoided costs include all three of the components identified above) will, in fact, result in an economically efficient wholesale rate. That is, the wholesale discount dictated by this rule will result in a wholesale rate equal to the TSLRIC of providing the upstream wholesale service.

A simple example can be used to illustrate this point. Suppose the TSLRIC of providing the wholesale service is $7 per month. Also, suppose the (efficient) TSLRIC of providing the retail portion of the service is an additional $5 per month, yielding a total TSLRIC of the overall service of $12 per month. Assume initially that the ILEC providing this service is economically efficient (i.e., its operations contain no fat) and it is earning a normal (competitive) profit. Under these circumstances, the retail price must be equal to the sum of the TSLRICs of the two vertical stages -- wholesale plus retail. Thus, the retail price from which the wholesale discount is subtracted is $12. With neither fat nor excess profit at the retail stage, avoided cost is simply the TSLRIC of performing the retail function which, in this example, is $5. Thus, application of the avoided cost pricing rule yields a wholesale discount of $5 or a wholesale rate of $7, which is precisely equal to the TSLRIC of providing the wholesale service.[xxi/]

This wholesale rate promotes economic efficiency at both of the vertical stages of production. At the retail stage, the $5 discount encourages efficient reseller entry and discourages inefficient reseller entry. Any potential entrant that can perform the retail function at an incremental cost equal to or below the incremental cost incurred by the ILEC is encouraged to enter and provide that function, thereby placing downward pressure on the price charged to consumers. Any potential entrant that incurs retailing costs greater than the ILEC is discouraged from entering.

Case 2: An Inefficient ILEC With Excess Profits: Importantly, these same efficiency properties will continue to hold under the proposed rule in the presence of inefficient production by the ILEC and/or excess profit (i.e., profits exceeding the ILEC's opportunity cost of its investment.). For example, suppose that, in addition to the $5 TSLRIC at the retail stage, the ILEC incurs an additional $2 in production inefficiencies at the retail stage and an additional $2 in excess profit. In this situation, the retail price is $16 per month ($7 wholesale TSLRIC, plus $5 retail TSLRIC, plus $2 fat, plus $2 economic profit). But this price minus the wholesale discount provided by the avoided costs (which are now equal to $9) still yields the efficient wholesale rate of $7. Moreover, this rate still promotes efficient entry decisions at both the retail and wholesale stages.

Most importantly, unlike some proposed rules, this efficient discount allows competitive market forces to be unleashed on the ILEC's inefficient and overpriced retail operations. Specifically, an efficient entrant paying $7 for the wholesale service will be able to undercut the ILEC at the retail stage, pushing the final product price downward toward the competitive ($ 12) level. Under this rule, market forces will provide consumers the benefits of competitive retailing, placing pressure on the ILEC to improve the efficiency of its retail operations. Whenever the retail price is equal to or greater than the costs the ILEC incurs, application of the avoided cost rule promotes economic efficiency and provides consumer benefits at both stages.[xxii/]

If, instead of the proposed avoided cost pricing rule, we were to subtract only the TSLRIC of an efficient firm at the retail stage, however, the effect would be to insulate the ILEC's inefficiency and excess profit from the forces of competition. Under this approach, the wholesale rate would be set at $11 (the retail price of $16 minus the retail stage TSLRIC of $5). At this wholesale rate, an efficient entrant will be unable to undercut the incumbent's price; and, as a result, the beneficial effects of entry are greatly attenuated. Neither inefficiency nor excess profits are exposed to market forces. Consequently, the ILEC is effectively indemnified from competition at customers' expense.

Case 3: An Efficient ILEC and ILEC Revenues Below TSLRIC Costs:

Suppose a third case, where the retail price is, for whatever reason, held below the ILEC's overall cost of providing the service (i.e., the service is being subsidized). In this case, application of the avoided cost pricing rule will still produce an efficient wholesale discount, but it generally will fail to produce an efficient TSLRIC wholesale rate or price. Quite simply, an efficient discount applied to an ILEC's inefficient price yields another inefficient price. Importantly, however, application of the avoided cost pricing rule in this case still allows competition to arise in the provision of the retail portion of the overall service despite the existence of the below-cost price. In so doing, it maximizes the consumer benefits achievable in the presence of the retail-stage pricing distortion.

Here, again, a simple example is instructive. Assume we have the same TSLRICs used in the preceding example. To simplify the analysis, we further assume that the ILEC's operations are efficient (i.e., we assume zero fat).[xxiii/] Here, however, we assume the ILEC earns negative profits of $2 per month on each unit of the service provided. The retail price charged for this service is now $10 per month ($7 wholesale TSLRIC, plus $5 retail TSLRIC, minus the $2 in negative profit). Because 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.[xxiv/]

As a result, the discount in this case is simply the $5 in avoided costs (i.e., the TSLRIC of the retail function). Therefore, the wholesale price under the avoided cost rule is reduced to $5 in this situation. Notice that this price is below its corresponding TSLRIC by the same amount ($2) that the retail price is held below the total TSLRIC of providing the overall service. The subsidy here is merely shifted from the retail to the wholesale stage.

What, then, are the efficiency properties of this below-cost wholesale price? The fundamental efficiency property is that, as with the preceding case, efficient entry at the retail stage will be encouraged and inefficient entry at that stage will be discouraged. With a wholesale price of $5 and a retail price of $10, any potential entrant that can perform the retail function at an incremental cost of $5 or less (the TSLRIC an efficient ILEC incurs to perform that function) will have an incentive to enter the market on a resale basis. Any potential entrant whose incremental costs exceed $5 cannot profitably enter. By preserving the incentive for efficient resale entry, the avoided cost pricing rule enables competition to arise at the retail stage of production despite the presence of the below-cost price.

Q. **IN YOUR THIRD CASE, WILL THE BELOW-COST WHOLESALE PRICE TEND TO DISCOURAGE FACILITIES-BASED ENTRY AT THE WHOLESALE STAGE?**

A. No. In this case, facilities-based entry at the wholesale stage is already effectively foreclosed by the retail price which has been set below cost. Setting the wholesale price below cost by an equal amount has no independent or additional effect on the incentive for facilities-based entry to occur. The culprit here is the retail rate, not the wholesale rate. Indeed, no pricing standard of which I am aware can provide an incentive to enter at the wholesale stage so long as the retail rate remains below cost. For example, suppose regulators attempt to preserve what might mistakenly be perceived to be an efficient incentive for entry at the wholesale stage by setting the wholesale rate equal to the TSLRIC of providing the wholesale service (which is $7) while continuing to hold the retail rate below cost (at $10). Under this wholesale pricing proposal, no entry will occur at either stage. Obviously, entry as a reseller will be foreclosed. With a wholesale rate of $7, a retail price of $10 and an efficient TSLRIC of performing the retail function of $5, even a firm that is more efficient than the ILEC in carrying out retail operations cannot successfully enter on a resale basis. And, with no resellers in the market, entry as a pure wholesaler is not feasible. Finally, entry as a vertically integrated carrier providing both the wholesale and retail functions is also foreclosed, because the $10 retail price fails to cover the $12 costs incurred by an efficient firm operating at both vertical stages. Thus, incremental cost (TSLRIC) pricing at the wholesale stage in the presence of a subsidy at the retail stage is a formula for preserving monopoly at both stages. It is a policy that is clearly at odds with the legislative intent of the 1996 Act to promote competition as well as the interests of consumers.

Q. BY SETTING THE WHOLESALE PRICE BELOW TSLRIC, WON'T THE ILECS BE SUBSIDIZING THEIR COMPETITORS?

A. No. As long as the retail rate remains below cost, competitors will receive no subsidy. While the wholesale rate does fall below the ILEC's TSLRIC of providing the wholesale service under the proposed avoided cost approach, the entire subsidy flows through to final consumers as a consequence of the equally subsidized retail rates. That is, with the wholesale discount set equal to the correctly defined avoided costs, the wholesale rate is subsidized only to the extent the retail rate is also subsidized. As a result, the ILEC's resale competitors receive no subsidy under this policy.

Q. WILL THE AVOIDED COST PRICING RULE YIELD EFFICIENT OUTCOMES IN THE PRESENCE OF UNEQUAL INTERCONNECTION

AND PROVISIONING ARRANGEMENTS?

A. It will not achieve efficiency under these circumstances unless an appropriate adjustment is made. To this point, I have implicitly assumed that the wholesale services purchased by resellers are completely equivalent to the retail services provided by the ILEC in all relevant respects. In other words, I have assumed that the quality, timeliness of delivery, etc. are identical. That assumption, however, is extremely unlikely to hold in local exchange markets during the transition to competition. Rather, as this transition unfolds, it is virtually inevitable that the interconnection and provisioning arrangements provided to resellers will be inferior in myriad respects.

In the presence of such inferior resale arrangements, a routine application of the avoided cost pricing rule will fail to provide efficient entry signals. Specifically, if resellers attempting to enter local exchange markets cannot receive and process customers' orders in a convenient and timely manner and provide services that are equal in quality to that provided by the ILEC, then even perfectly efficient wholesale discounts will fail to promote efficient entry. Under competitive conditions, one simply cannot market successfully an inferior product at an equal price.

Q. DOES THE NEW ACT RECOGNIZE THIS NEED FOR EQUAL INTERCONNECTION AND PROVISIONING ARRANGEMENTS?

A. Yes. Recognizing this problem, Congress incorporated a provision requiring the ILECs to provide equal interconnection to their competitors. Specifically, Section 25 l(c)(2)(C) of the Act requires ILECs to provide interconnection

> "that is at least equal in quality to that provided by the local exchange carrier to itself or to any subsidiary, affiliate, or

any other party to which the carrier provides interconnections."

Despite this legislative requirement, however, various non-price strategic actions available to the ILECs make the likelihood of fully equal interconnection and provisioning services extremely remote at this point. As a practical matter, virtually any anti-competitive end achievable through manipulation of input and/or output prices can also be achieved through some sort of non-price strategy.[xxv/] As the Rochester experiment and numerous other examples have already made clear, new entrants into local exchange markets will face a host of non-price exclusionary tactics.[xxvi/] Even the best efforts of the most conscientious regulators will prove inadequate to prevent them. Indeed, the impossibility of successfully enforcing equal interconnection to the bottleneck facilities of a vertically integrated monopoly was the primary justification for the 1984 divestiture. The avenues through which ILECs can impede the ability of competitors to successfully reach their end customers are simply too numerous, complex, and subtle for legislators to foresee and regulators to police.

Q. **CAN THE AVOIDED COST PRICING RULE BE AMENDED TO INCORPORATE THE EFFECTS OF UNEQUAL INTERCONNECTION AND PROVISIONING ARRANGEMENTS?**

A. Yes. This rule can easily be amended to incorporate such effects. Specifically, the wholesale discounts applied to the ILEC's retail prices should exceed avoided costs in the presence of unequal interconnection and provisioning arrangements.

Such an additional discount can be justified on several grounds. First, consumers generally are not willing to purchase an inferior product in the absence of a price incentive to do so -- i.e., a discount. As a result, the presence of unequal or inferior interconnection warrants a reduction in the retail rate from which the wholesale discount is subtracted or, equivalently, a total discount from the ILEC's rates that exceeds explicitly avoided costs. Second, the additional discount can be used to compensate the victims of discriminatory interconnection. Firms that have been subjected to such behavior suffer opportunity costs in the form of profits that are lower than the profits that would have been realized with fully equal interconnection.[xxvii/] Without such compensation, these firms may refrain from entering local exchange markets. Third, the additional discount may be justified as an explicit public policy measure designed to promote reseller entry in light of the competitive benefits such entry is expected to bring. Accordingly, a wholesale discount that exceeds avoided costs can be justified on sound economic grounds and is consistent with the Act.

Q. AS WITH TSLRIC PRICING OF INPUTS, IMPLEMENTATION OF THE AVOIDED COST PRICING RULE REQUIRES EMPIRICAL ESTIMATES OF THE RELEVANT COSTS--HERE, THE AVOIDED COSTS. ARE SUCH COST ESTIMATES AVAILABLE?

A. In an effort to calculate the ILECs' "costs that will be avoided" as a consequence of providing services at wholesale rather than retail, AT&T has developed a retail cost model. This model is described in more detail in Mr. Art Lerma's testimony. The purpose of the model is to account properly for the retail-level costs that will be avoided in the long run as an ILEC adjusts its operations to provide wholesale services. The model estimates the costs that are incurred (or not) as a consequence of participation at the retail level. The cost estimations provided by the model represent a sound approximation to the theoretically proper standard for establishing a discount that is dictated by the avoided cost pricing rule.

V. NON-PRICE COMPETITIVE ISSUES

Q. WHY ARE NON-PRICE COMPETITIVE ISSUES RELEVANT TO THIS ARBITRATION PROCEEDING?

A. As noted above, successful resolution of pricing issues will be in vain unless myriad other non-price terms of sale are also made conducive to entry. Neither resellers of wholesale services nor firms purchasing unbundled network elements will be able to enter local exchange markets successfully if the ILECs are able to discriminate in the quality and timeliness of the interconnection and provisioning services they supply to their competitors.

In fact, in situations where input prices have been set at competitive levels, the incentive to discriminate on non-price terms is heightened. Through provision of inferior or untimely interconnection and provisioning services, ILECs can sustain their extant monopoly power against the threat of entry. Consequently, the Florida Commission needs to devote at least as much attention to non-price competitive issues as it does to the pricing issues discussed above.

Q. PLEASE EXPLAIN HOW BELLSOUTH CAN UTILIZE NON-PRICE TERMS OF SALE TO EXCLUDE COMPETITORS FROM ITS MARKETS.

A. The exclusionary effects achievable by manipulating the non-price terms of sale can be easily explained by analogy to a vertical price-cost squeeze. Under a vertical price squeeze, competitors are either denied entry and/or forced to exit by pricing inputs above costs while holding output (retail) prices relatively low, thereby eliminating the possibility of profitable production at the downstream stage.[xxviii/] The success of this strategy obviously hinges upon the impact of higher input prices on competitors' costs. But raising input prices is only one of many strategies capable of raising rivals' costs.[xxix/] For example, an ILEC may require competitors to interconnect at a particular point or adopt a specific interconnection arrangement that prevents these firms from making efficient use of their existing or planned networks. Any number of other non-price terms of sale can have a similar cost-increasing effect. Therefore, raising rivals' costs through the provision of unfavorable non-price terms of sale can have precisely the same exclusionary effects as a vertical price-cost squeeze.

Q. **WHAT SORTS OF NON-PRICE ISSUES ARE LIKELY TO ARISE DURING THE ARBITRATION PROCESS?**

A. Two broad types of non-price competitive issues are likely to emerge. First, and most obvious, technical interconnection and provisioning issues -- such as number portability, dialing parity, and service ordering capabilities -- will be confronted. Due to strategic actions (and non-actions) undertaken by the ILECs, the inputs supplied to entrants are likely to be physically inferior to the inputs supplied by the ILECs to themselves. Regardless of the source, such inferiority will hamper the entry process and delay the advent of competition.

Second, it must be recognized throughout the arbitration process that no monopolist can ever be expected to voluntarily negotiate contracts that facilitate entry into its own market.[xxx/] Under normal competitive contracting, both parties to the negotiation have something to gain. Both parties are willing participants in the negotiation process, and both are anxious to reach an agreement so that the gains from trade can be realized. Under monopoly conditions, however, where one party is attempting to negotiate the terms of supply of inputs that are needed to enter the other party's monopolized market, such mutual benefits are not present. The monopolist simply has nothing to gain and much to lose from an agreement that successfully facilitates entry and, thereby, erodes its monopoly power.

As a result, the Florida Commission must recognize that: (1) BellSouth has a strong economic incentive to exclude competitors from its market; and (2) such exclusion may be accomplished by [a] refusal to provide interconnection or other inputs needed for successful entry, [b] establishment of non-competitive prices for such inputs, [c] provision of inferior interconnection, provisioning, or other inputs, and [d] refusal to negotiate contractual provisions reasonably required by new entrants. Close attention must be devoted to all sources of exclusionary effects if competition in local exchange markets is to develop.

Q. CAN YOU PROVIDE A HYPOTHETICAL EXAMPLE TO EXPLAIN THE ECONOMIC EQUIVALENCE OF THE ALTERNATIVE EXCLUSIONARY STRATEGIES YOU HAVE IDENTIFIED?

A. Yes. Suppose a firm is considering entry into a local exchange market. Such entry requires that firm to obtain interconnection service from the ILEC in order to terminate its customers' calls within the local calling area. The ILEC, in turn, has an economic incentive to foreclose such entry in order to maintain its monopoly position. Such foreclosure may be achieved through any of the four alternative strategies identified below.

First, the ILEC may simply refuse to provide the necessary interconnection service. Because local exchange entry cannot succeed without interconnection to the local network, such a refusal to deal obviously will prevent entry at the retail stage from occurring.

Second, the ILEC may agree to supply the interconnection service but set the price of that service at a prohibitively high level. By setting the interconnection rate in excess of the TSLRIC of providing the interconnection service, a vertical price-cost squeeze can be created that will prevent entry from occurring.

Third, suppose that, in conformity with the requirements of the Telecommunications Act, the ILEC agrees to provide the interconnection service and that regulators set the price of that service equal to its TSLRIC. The same exclusionary effect may still be achieved by providing entrants technically inferior interconnection arrangements, late delivery of promised services or other non-price deficiencies. These actions would raise new entrants' costs by preventing them from making efficient use of their networks. Again, these increased costs have the effect of foreclosing entry.

Finally, suppose the ILEC is required to provide fully equal interconnection at TSLRIC prices. Does this exhaust the avenues through which exclusion of competitors may be achieved? No. Even with equal interconnection provided at efficient prices, entrants can be prevented from entering the market by refusing to provide contractual terms that will make entry commercially feasible. For example, the ILEC may require a long-term commitment that the entrant is unwilling to make. It may refuse to provide quality commitments or penalty clauses that the entrant needs to reduce its risks of nonperformance by the ILEC. By presenting unacceptable contractual provisions and/or by refusing to supply needed provisions, the ILEC can increase the risks (and, therefore, the costs) of entering the market.

All four strategies have economically equivalent effects. They all can be used to exclude competitors from local exchange markets. The Commission will need to be alert to all four sources of exclusionary effects during the course of the arbitration process.

Q. **WHAT IS YOUR RECOMMENDATION CONCERNING THIS COMMISSION'S ACTIONS ON THESE NON-PRICE COMPETITIVE ISSUES?**

A. In my opinion, the Commission should: (1) strictly enforce the flexible and equal (non-discriminatory) interconnection provisions of the Act and institute explicit penalties for failure to perform (including the additional wholesale discount discussed above); and (2) arbitrate contractual provisions, requiring BellSouth to meet reasonable requests for individualized terms and, again, incorporate explicit provisions containing penalties for non-performance. Such actions, in combination with the pricing recommendations I made earlier in this testimony, will be necessary if the ILECs' hold on local exchange markets is to be broken and the powerful forces of competition are to be unleashed.

VI. SUMMARY

Q. WOULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?

A. Yes. Under the provisions of the Telecommunications Act of 1996, state regulatory commissions are assigned responsibility for arbitrating disputes between ILECs and their potential competitors in situations where voluntary negotiations have failed to produce a mutually-agreeable contract. The fundamental issues involved in this arbitration process are likely to be: (1) the prices charged for ILEC-supplied inputs that entrants will need in order to compete in local exchange markets on a resale basis (interconnection services, unbundled network elements, and wholesale services); and (2) the various non-price terms of sale (both technological and contractual) that will accompany these prices. The outcome of this arbitration process will be critical in determining whether and how soon we have viable competition in local exchange markets. Consequently, state commissions should take their arbitration responsibilities very seriously and should adopt policy decisions that will move these markets toward competition as expeditiously as possible.

My testimony presents the basic economic principles and specific pricing and provisioning recommendations that will achieve this objective. Specifically, the Florida Commission should: (1) set the prices for interconnection services and unbundled network elements at their respective TSLRICs; (2) set wholesale discounts equal to or, in the presence of unequal interconnection, greater than avoided costs, where such costs include the TSLRICs of the retail stage plus inefficiencies (or fat) and any excess economic profits; and (3) arbitrate equal interconnection and provisioning arrangements and truly non-discriminatory contractual provisions that recognize the different needs of the various companies attempting to enter these markets. And, when in doubt, err on the side of competition.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

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i/ Analogies may be seen in other industries: One example would be the appliance industry: A number of appliance retail stores may sell to Florida consumers the same national brands of refrigerators and other domestic appliances. Although the same products are marketed by each retail store, the consumer may see each store very differently -- based on the retail prices offered, variety and currency of products arrayed on the outlet floor, hours of operation and attentiveness by sales representatives to customers. Competition will produce distinguishable services, even if the basic product is the same.

ii/ Quality of service problems can be expected to become more prevalent under a price cap regime. Quite simply, under price caps, firms profit from cost reductions, and such reductions often may be achieved through the provision of lower quality services. See Timothy J. Brennan, "Regulating by Capping Prices,", Vol. 1 (June 1989), pp. 133-147.

iii/ Marginal cost, long-run incremental cost (LRIC), and total service long-run incremental cost (TSLRIC) all measure the change in the firm's total costs caused by a change in output. In that sense, they are very similar conceptually. The only difference between them is the magnitude of the change in output contemplated. For marginal cost, the change is infinitesimal. For TSLRIC, the change is the entire output of the service. And for LRIC, the change is finite but less than then the entire output.

iv/ This is one of the most fundamental propositions in economics. For example, Paul Samuelson and William Nordaus write that:

> "Only when prices of goods are equal to marginal cost is the economy squeezing from its scarce resources and limited technical knowledge the maximum of outputs." Paul A. Samuelson and William D. Nordaus, Economics. Twelfth edition, McGraw Hill Book Company, 1985, pp. 487-488.

v/ For example, see the discussion in Peter Temin, "Cross-Subsidies in the Telephone Network after Divestiture," Journal of Regulatory Economics, Vol. 2 (December 1990), pp. 349-362.

vi/ On the widespread use of cross-subsidization in regulated pricing structures, see Sam Peltzman, "Toward a More General Theory of Regulation," Journal of Law and Economics, Vol. 19 (August 1976), pp. 21 1-240. For an explanation of the popularity of such pricing structures among regulators, see T. Randolph Beard and Henry Thompson, "Efficient versus 'Popular' Tariffs for Regulated Monopolies," Journal of Business, Vol. 69, No. 1 (January 1996), pp. 75-87.

vii/ For the purposes of my testimony, interconnection services include the switching, transport and termination of local calls originating on one local carriers' network and terminating on another carriers' network. Unbundled network elements refer to existing local network facilities controlled by the ILEC, such as the local loop, local switch, signal processing and transport functions, that are needed by the new entrant to provide local telephone services.

viii/ TSLRIC measures the total incremental cost incurred in the long run that is caused by the addition (or deletion) of a service or element from an existing set of services or elements. Technically, the prices are set equal to the TSLRIC (which is a total dollar amount) divided by the number of units to be sold, so that prices are stated as dollars per unit.

ix/ These reasons are discussed more fully in the Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig attached to the "Comments of AT&T Corp." in CC Docket No. 96-98, May 16, 1996.

x/ Other constraints, such as uniform prices and normal profits, may be imposed as well. Indeed, the well-known concept of Ramsey prices is derived from precisely this sort of constrained optimization problem. See William J. Baumol and David F. Bradford, "Optimal Departures From Marginal Cost Pricing," American Economic Review, Vol. 60 (June 1970), pp. 265-283.

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xi/ The social welfare benefits of implementing prices that achieve this result are likely to dominate any benefits that might possibly be derived from a set of alternative prices that solve the more traditional optimization problem under assumed static monopoly conditions. Therefore, promoting competition is entirely consistent with maximization of social welfare.

xii/ Which is, of course, why input prices that exceed TSLRIC artificially reduce the speed at which local exchange markets are transformed from monopoly to competition.

xiii Common costs are those costs which are required to provide a group of services, but which do not vary with the quantity of the individual services produced. As such, they are not causally attributed to a particular service or the level of a service. Embedded costs (or stranded investments) reflect items for which costs have been incurred in the past and recorded in a firms' accounting records, but which are not caused by current or future production of services.

xiv/ See Richard Shin and John S. Ying, "Unnatural Monopolies in Local Telephone," RAND Journal of Economics, Vol. 23 (Summer 1992), pp. 171-183.

xv/ Indeed, price mark-ups on interconnection services and unbundled elements have precisely the same economic consequence as the imposition of taxes on these intermediate inputs. But the distortionary effects associated with taxation of inputs are well-known. See Peter A. Diamond and James A. Mirrlees, "Optimal Taxation and Public Production I: Production Efficiency," American Economic Review, Vol. 61 (March 1971), pp. 8-27. On page 24 of this paper, these authors explain that:

> Therefore the optimal tax structure includes no intermediate good taxes, since these would prevent efficiency ... 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.

xvi/ William Baumol, Janusz Ordover, and Robert Willig have recently written that:

> We understand that the portion of forward-looking costs that is unattributable to particular network elements is likely to be small. The aggregated categories of network elements generally comprise discrete physical facilities -- loop, switching, transport, and signaling. Economies of scope, or cost subadditivities, among these categories are likely to be minimal or nonexistent.

Supra, footnote 9.

xvii/ Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 601 (1944).

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xviii Where appropriate ILEC-specific cost data are not available, the Hatfield Model is also a useful methodology for estimating TSLRIC.

xix/ If economic profits are negative, the service is receiving a subsidy and this component should be set equal to zero.

xx/ By "efficient outcomes" I mean that the resulting wholesale rate will support efficient entry but deny inefficient entry, where "efficient entry" means entry by firms that are able to perform the retail function at costs that are equal to or less than the ILEC's costs.

xxi/ In this particular case, the avoided cost pricing rule yields outcomes that are precisely equal to those of the so-called Efficient Component Pricing Rule (ECPR). That is, both yield desirable economic efficiency and competition-enabling properties. This correspondence of results between these two pricing rules, however is not general. Moreover, the general inapplicability of the ECPR to pricing in the telecommunications industry has recently been pointed out by the developers of the ECPR concept. See Affidavit of William J. Baumol, Jarusz Ordover, and Robert D. Willig, supra, Note ix. See also, the recent substantive critiques of the ECPR by Nicholas Economides and Lawrence J. White, "Access and Interconnection Pricing. How Efficient Is the 'Efficient Component Pricing Rule'?" Antitrust Bulletin, Vol. 40 (Fall 1995), pp. 557-579; and William B. Tye and Carlos Lapuerta, "The Economics of Pricing Network Interconnection; Theory and Application to the Market for Telecommunications in New Zealand," Yale Journal on Regulation, Volume 13 (Summer 1996), pp. 419-500.

xxii/ Note that the $9 discount along with the retail price of $16 can encourage entry by firms that have incremental costs that exceed those of a fully efficient provider of the retail service (i.e., the TSLRIC at the retail stage which, here, is $5). Nonetheless, the rule only encourages entry by firms that are at least as (or more) efficient than the ILEC. Moreover, even inefficient entry will tend to move retail prices closer to competitive levels in the presence of monopoly. See Economides and White, ibid.

xxiii/ Relaxation of this assumption would not alter the conclusions of this analysis.

xxiv/ The ILEC will continue to incur the $2 in negative profits as long as the retail price remains at the $10 subsidized level even if it ceases to perform the retail function. As I explain below, the only way to foster resale entry in the presence of the subsidy is to shift that subsidy to the wholesale rate. When that is done, the $2 loss is merely transferred to the wholesale service and, therefore, is not avoided. If the subsidy is not shifted to the wholesale stage, resale entry will not occur. The ILEC, then, will continue to perform the retail function and will continue to bear the $2 loss. Therefore, negative profits are not an avoided cost.

[xxv]/ The provision of discriminatory or unequal interconnection can be seen as a strategy to raise rivals' costs. See S. Salop and D. Scheffman, "Raising Rivals' Costs," American Economic Review, Vol. 73 (May 1983), pp. 267-281.

[xxvi]/ See Mike Mills, "The Front Line for Phone Lines: Bell Atlantic Has Been 'Fighting Tooth and Nail' to Beat Back Competition," Washington Post, October 17, 1994, F 1, which reports an instance in which Bell Atlantic refused to allow employees of a competitor to use its restroom facilities. Additional examples of this sort of behavior are described in Leslie Cauley, "Calls Waiting: Rivals are Hung Up on Baby Bells' Control Over Local Markets," Wall Street Journal, Tuesday, October 24, 1995, pp. A1, A6. Moreover, strategic use of discriminatory interconnection to support monopolization is not new in the telecommunications industry. For an historical discussion of such practices, see David F. Weiman and Richard C. Levin, "Preying for Monopoly? The Case of Southern Bell Telephone Company, 1894-1912," Journal of Political Economy, Vol. 102 (1994), pp. 103-126.

[xxvii]/ The opportunity costs imposed by unequal interconnection provided the fundamental economic justification for the 55 percent discount on access charges paid by AT&T's competitors prior to the implementation of equal access in the interLATA market.

[xxviii]/ It is important to note that, for a price-cost squeeze to be effective, the retail price need not be below the overall cost of providing the service as long as the input price is sufficiently above cost. Competitors will be foreclosed if the spread between the retail price and the input price falls short of the incremental cost of producing the retail portion of the overall service.

[xxix]/ See Salop and Scheffman, supra, Note xxv.

[xxx]/ Indeed, if buyers could successfully negotiate competitive prices from a monopolist, there would be no need for regulation or antitrust laws.

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. 960833-TP

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."

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[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.

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

Docket No. 960833-TP

Filed: August 30, 1996

I. IDENTIFICATION OF WITNESS AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND CURRENT POSITION.

A. My name is David L. Kaserman. My position is Torchmark Professor of Economics at Auburn University.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS HEARING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony responds to several of the economic arguments made by two of BellSouth's witnesses in this hearing. Specifically, the direct testimonies of Dr. Richard Emmerson and Mr. Walter Reid contain some issues that I believe should be brought to the attention of the Florida Commission in order to facilitate pro-competitive arbitration decisions.

While much of these witnesses' testimony is rendered moot by the FCC's "Local Competition Order" issued on August 8th, it is, nonetheless, useful to identify and correct at least some of the inaccuracies they contain. While the FCC Order provides fairly specific guidelines, it leaves some latitude for state commissions to decide the specific pricing and provisioning policies that will govern the contractual arrangements that emerge from the arbitration process. These policies, in turn, will have great importance to consumers, because they will influence strongly the pace at which local exchange markets are transformed from monopoly to competition. As a result, the FCC Order notwithstanding, it is important that the arbitration decisions rendered by this Commission be founded squarely upon sound economic principles.

II. REBUTTAL OF DR. EMMERSON'S TESTIMONY

Q. WHAT DOES THE FCC ORDER INDICATE REGARDING THE PRICES OF INTERCONNECTION ARRANGEMENTS AND UNBUNDLED NETWORK ELEMENTS?

A. As I explained in my Supplemental Testimony, this Order indicates that the prices of these inputs should be "based on the TSLRIC of the network elements."[1] In this respect, the criterion specified by the Order is identical to the pricing recommendation contained in my Direct Testimony, which advocated pricing of interconnection and unbundled network elements at TSLRIC. The Order, however, then goes on to require that these prices be raised above TSLRIC to "include a reasonable allocation of forward looking common costs."[2] In this respect, the Order envisions input prices that exceed by some margin the prices recommended in my prior testimony.

Q. GIVEN THIS REQUIREMENT, HOW DOES YOUR POSITION DIFFER FROM DR. EMMERSON'S POSITION ON THIS ISSUE?

A. Our positions differ with respect to the magnitude of the appropriate mark-up above TSLRIC that is indicated by economic principles. Specifically, I believe that sound economic reasoning dictates a very small mark-up, while Dr. Emmerson appears to believe that a very substantial mark-up is justified economically.

Q. HAVE OTHER ECONOMISTS WHO HAVE WRITTEN ON THE SUBJECT OF EFFICIENT PRICING PROVIDED ANY GUIDANCE CONCERNING WHICH OF THESE POSITIONS IS CORRECT?

A. Yes. The published (peer reviewed) literature on the subject of efficient pricing provides considerable guidance which unequivocally supports my position that any departure from strict TSLRIC pricing of these inputs should be held to an absolute minimum. At least three strands of that literature support this view. Specifically, the literature on (1) pricing in competitive markets, (2) efficient price structures, and (3) fully distributed cost pricing all suggest that regulators set the prices of these inputs as close as possible to marginal costs (or, as an approximation, TSLRIC).

Q. HOW DOES THE LITERATURE ON PRICING IN COMPETITIVE MARKETS SUPPORT TSLRIC (OR NEAR-TSLRIC) PRICES?

A. The literature on pricing in competitive markets has long held that, in equilibrium, competitive prices will equal marginal costs.[3] Indeed, given the assumptions of the competitive model, such pricing is necessary mathematically if firms are attempting to maximize their profits. While not disputing this fundamental proposition, Dr. Emmerson attempts to refute its applicability to the telecommunications industry by arguing that it holds only for single-product firms. In footnote 3 on page 10 of his testimony, Dr. Emmerson writes:

> If a firm 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.

Emphasis added.

In fact, however, the literature on this subject shows just the opposite. In an article in the American Economic Review in 1987, Glenn MacDonald and Alan Slivinsky demonstrate unequivocally that, in long-run competitive equilibrium, multiproduct firms with common costs will charge prices equal to the marginal costs of the individual products.[4] Therefore, contrary to Dr. Emmerson's claim, the competitive model benchmark of marginal cost pricing is not limited to single-product firms. It carries over in full force to the multiproduct situation, even where substantial common costs are present.

Q. HOW DOES THE LITERATURE ON EFFICIENT PRICE STRUCTURES SUPPORT YOUR RECOMMENDATION OF PRICING INTERCONNECTION AND UNBUNDLED NETWORK ELEMENTS CLOSE TO TSLRIC?

A. It has been widely recognized among economists for a very long time that, in situations where marginal cost pricing of a regulated firm's output fails to yield sufficient revenue to cover that firm's total costs, the first-best efficient solution is to set usage prices equal to marginal costs and recover any resulting revenue shortfall from a lump-sum end-user charge.[5] This pricing structure, known generally as nonlinear pricing or, in its simplest form, a two-part tariff, preserves the efficient signals provided to consumers by marginal cost pricing while providing fully compensatory returns to the regulated firm's overall activities.

In the present application, this means that interconnection and unbundled elements should be priced at (or near) TSLRIC; and <u>if</u> a revenue shortfall should materialize (which I believe is a very unlikely event), it should be recovered through a competitively neutral charge levied on final consumers. Thus, Dr. Emmerson's statement on page 9 of his testimony that "forcing service prices equal to LRIC <u>does not allow</u> for the recovery of the shared costs which are beneficial to society" is flatly mistaken. (Emphasis added.) Setting prices equal to LRIC <u>does</u>, in fact, allow for such recovery in an efficient and competitively neutral manner.

Q. HOW DOES THE LITERATURE ON FULLY DISTRIBUTED COST PRICING SUPPORT THE RECOMMENDATION THAT ILEC-SUPPLIED MONOPOLY INPUTS BE PRICED AT NEAR-TSLRIC LEVELS?

A. When regulators set the prices charged by a multiproduct firm equal to TSLRIC plus a substantial allocation of common costs, they are practicing what is known as fully distributed (or fully allocated) cost pricing. In their recent monograph on local exchange competition, William Baumol and Gregory Sidak define this pricing approach as follows:

> The fully distributed cost of product X is defined as the outlay per

> unit of output X, including all expenses attributable to X alone, plus some share of any common costs incurred on behalf of X and one or more other outputs.[6]

Clearly, this is precisely the pricing recommendation contained in Dr. Emmerson's direct testimony.

The economic literature, however, is highly critical of fully distributed cost pricing. For example, Baumol and Sidak write that: "This traditional tool of price regulation is now generally discredited and is increasingly being abandoned in regulatory practice."[7] Similarly, Professor John Wenders writes:

> 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.[8]

Numerous other authors have criticized severely the practice of allocating common costs among the regulated firm's services.[9]

The simple reason for this widespread criticism is that such cost allocations result in substantial departures from marginal cost pricing, which, in turn, lead to significant economic inefficiencies with attendant social welfare losses. Moreover, in the present context, a substantial allocation of common costs to the prices of interconnection arrangements and unbundled elements has the additional detrimental impact of increasing the costs of new entrants into local exchange markets, thereby artificially slowing the entry process and prolonging the monopoly status of the ILEC. Therefore, the prices of these vital inputs should not be burdened with substantial allocations of common costs. Rather, they should be kept as close as possible to the incremental costs of supplying these inputs.

Q. DO THE ILECS HAVE INCENTIVES TO PUSH THE PRICES OF INTERCONNECTION AND UNBUNDLED ELEMENTS ABOVE ECONOMICALLY EFFICIENT LEVELS?

A. Yes. At least two incentives exist for ILECs to advocate input prices that exceed their respective TSLRICs by considerable margins. First, these inputs are supplied under monopoly or near monopoly conditions. In addition, the demands for them are likely to be relatively price inelastic. Consequently, the profit-maximizing monopoly mark-ups above marginal cost are likely to be large. Thus, the straightforward pursuit of monopoly profits encourages the ILECs to advocate substantial mark-ups above TSLRIC.

Second, as noted above, because these inputs will be required by firms seeking to enter local exchange markets, the higher these prices are set the longer the incumbent supplier will be able to sustain its monopoly. In fact, prices that exceed TSLRIC impose costs on new entrants that are not borne equally by incumbents. Therefore, such prices constitute entry barriers that will retard the growth of competition. For both of these reasons (more profits today and more profits tomorrow), ILECs have a clear incentive to allocate a large portion of their costs (common or any other) to the prices of interconnection and unbundled elements.

Q. DOES THE FCC'S RECENT ORDER PROVIDE ANY GUIDANCE CONCERNING THE MAGNITUDE OF THE COMMON COSTS THAT ARE TO BE ALLOCATED TO THE PRICES OF INTERCONNECTION AND UNBUNDLED NETWORK ELEMENTS?

A. Yes. The Order provides considerable guidance on this issue. Specifically, the Order clearly indicates that: (1) these input prices are to be based upon a TSLRIC (or, in the FCC's terminology, TELRIC) pricing methodology, and (2) the deviation of these prices from a strict TSLRIC approach due to the allocation of common costs should be small.

Although the ILECs may attempt to read considerable latitude into the "reasonable allocation" language in the Order, the FCC explicitly excludes elevations in input prices above incremental cost that might emanate from a variety of potential sources. For example, regardless of the veracity of claims regarding inadequate past depreciation policies, the FCC has stated that inclusion of underdepreciated costs (common or otherwise) into the price of unbundled elements and interconnection "is not the proper remedy."[10] Also, whether "common" or not, the FCC has explicitly rejected the recovery of embedded costs in the pricing of these inputs.[11] The FCC also properly excludes recovery of retail-level "common" costs. Specifically, the FCC states that "[T]he relevant common costs do not include billing, marketing, and other costs attributable to the provision of retail service."[12] Inclusion of shared facilities and operations are also not to be considered "common costs" to be tacked onto the prices of vital inputs sold to the ILECs competitors.[13] Specifically, the FCC states that "[C]ertain shared costs that have conventionally been treated as common costs (or overheads) shall be attributed directly to the individual elements to the greatest extent possible."[14] The FCC also removes the prospect for recovery of such costs on the basis of demand elasticity considerations.[15]

Recovery of so-called "opportunity costs" associated with the ILEC's operations (as defined by application of the Efficient Component Pricing Rule [ECPR]) are also explicitly proscribed by the FCC as "improper." Inclusion of such costs are found by the FCC to be different from those found in competitive markets and "would not lead to efficient retail pricing."[16] Any recovery of costs in excess of the stand-alone cost of providing an unbundled element is also (properly) prohibited. Importantly, in this regard, the FCC notes that 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 include all such costs in situations where there are few common costs.[17] The FCC also takes care to proscribe any mark-ups above incremental cost that entail multiple recovery of common costs. Indeed, the FCC states that such mark-ups would be "unreasonable and in violation of the statutory standard."[18] The FCC also precludes mark-up of rates to include the costs of supporting universal service. Specifically, the Commission states:

> [P]ermitting states to include such costs in rates arbitrated under sections 251 and 252 would violate the 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.[19]

In sum, the FCC has specifically excluded a variety of factors that would otherwise be used by the ILECs to raise the price of unbundled network elements and interconnection above incremental cost including:

1. claims regarding inadequate depreciation of "common" costs;
2. recovery of any embedded "common" costs;
3. recovery of any retail-level "common" costs;
4. recovery of "shared facilities and operations";
5. demand elasticity considerations;
6. recovery of "opportunity cost" associated with common costs;
7. any recovery in excess of the stand-alone cost of assets;
8. recovery of "the same common costs multiple times"; and
9. recovery of the common costs used in the provision of universal service (which would include the so-called carrier-of-last-resort obligation).

Q. DO ANY OTHER ASPECTS OF THIS ORDER SUGGEST THAT THE MAGNITUDE OF "COMMON COSTS" TO BE CONSIDERED IN THE PRICING DECISION SHOULD BE MINIMAL?

A. Yes. At least three additional considerations suggest that the FCC contemplates only minimal departures from incremental cost in the pricing of network elements and interconnection. First, the FCC has clearly stated that its approach to pricing is a "long-run, incremental cost methodology" for the establishment of prices for interconnection and unbundled network elements.[20] Significant mark-ups to prices on the basis of common costs is not consistent with a pricing approach that is labeled "long run, incremental cost."

Second, the FCC has embraced the notion of incremental cost calculations for elements (i.e., TELRIC) rather than for services specifically because it reduces the presence of common costs.[21] There are notable advantages to focusing on the incremental cost of elements (TELRIC) as opposed to services (TSLRIC), not the least of which is that it leaves very little common costs to be accounted for.

Finally, the FCC has made it quite clear that any recovery of forward looking common costs much be "consistent with the pro-competitive goals of the 1996 Act."[22] But as I have noted and as the FCC has confirmed, it is incremental cost that provides the competitive market standard against which to judge whether prices are set "consistent with the pro-competitive goals of the 1996 Act."

In sum, given these various constraints that are properly noted in the FCC's Report and Order and the unambiguous pro-competitive tenor of the Telecommunications Act, I expect that arbitrated prices for unbundled elements and interconnection will reasonably approximate the economic benchmark that I established in my direct testimony. That is, any allocation of common costs to these input prices should be small.

III. REBUTTAL OF MR. REID'S TESTIMONY

Q. HAVE YOU READ THE DIRECT TESTIMONY FILED BY MR. WALTER REID IN THIS HEARING?

A. Yes.

Q. AS AN ECONOMIST, DO YOU HAVE ANY CRITICISMS OF THAT TESTIMONY?

A. Yes. There are two aspects of that testimony that appear to conflict with the economic concept of avoided costs. First, Mr. Reid apparently excludes much of BellSouth's short-run fixed costs from his avoided cost calculations. That is, he seems to focus largely if not exclusively on short-run variable (or direct) costs in these calculations. Second, Mr. Reid takes the position that, if BellSouth continues to incur a given cost (e.g., billing) in the provision of some other service (e.g., intraLATA toll), then that cost is not avoided even though the company will no longer need to incur that cost to provide its local exchange service on a wholesale basis.

Both of these arguments are economically invalid. As a result, Mr. Reid has failed to include certain costs in his avoided cost calculations that, as an economic matter, should be included. Consequently, his avoided cost numbers are biased downward.

Q. TURNING TO YOUR FIRST POINT, IS IT YOUR POSITION THAT A PORTION OF THE COMPANY'S FIXED OR INDIRECT COSTS SHOULD BE INCLUDED IN THE AVOIDABLE COST CALCULATION?

A. Yes. Avoidable costs should include not only the short-run variable costs that will immediately be eliminated by providing wholesale instead of retail services, but also those costs that, while fixed in the short run, will nonetheless be avoided in the long run as the ILEC adjusts its other inputs to this altered role. In the short run, costs may be categorized as either "fixed" or "variable" (sometimes referred to as "indirect" and "direct," respectively). In the long run, however, all costs are variable.

At some point, even the most durable equipment must be replaced and personnel decisions at all levels of the corporate structure must respond to the level and type of activities in which the firm is engaged. As a result, the ILEC should not be allowed to exclude certain costs from its avoidable cost calculations simply because it has chosen to focus upon some arbitrarily short time horizon.

Economically, it is necessary to calculate avoidable costs on a long-run basis in order to provide potential entrants efficient signals as to whether to enter the retail stage through resale of wholesale services or through purchase of unbundled network elements. By definition, entry decisions are long run in nature. Any reduction in the wholesale discount caused by adopting a short-run focus will bias the entry decision against the wholesale route. Such a regulatory-induced bias distorts new entrants' investment decisions and slows the entry process.

Q. DOES THE FCC ORDER REQUIRE THE INCLUSION OF A PORTION OF FIXED OR INDIRECT COSTS IN THE AVOIDED COST CALCULATION?

A. Yes. Paragraph 912 of that Order states that:

> We find that, under this "reasonably avoidable" standard discussed above, an avoided cost study must include indirect, or shared, costs as well as direct costs. . . .[I]ndirect or shared costs, such as general overheads, support all of the LEC's functions, including marketing, sales, billing and collection, and other avoided retail functions. Therefore, a portion of indirect costs must be considered "attributable to costs that will be avoided" pursuant to section 252(d)(3).

Thus, the FCC has recognized the necessity of including avoidable fixed costs in the avoided cost calculation.

Q. TURNING TO YOUR SECOND POINT, ARE YOU SUGGESTING THAT CERTAIN COSTS BE INCLUDED IN THE AVOIDED COST CALCULATION THAT ARE NOT ACTUALLY SHED BY THE ILEC WHEN IT BECOMES A PROVIDER OF WHOLESALE SERVICES TO ITS RETAIL-LEVEL COMPETITORS?

A. Yes. Any costs associated with the provision of local exchange services at the retail stage that would no longer be incurred if the ILEC were to exit that market altogether, and provide only wholesale services purchased by other firms which then perform all retail-stage activities, should be incorporated in the avoided cost calculation. Under this approach, new entrants will pay wholesale rates that accurately reflect the costs that their entry and purchase decisions cause to be incurred.

In contrast, under Mr. Reid's proposed approach, described on page 10 of his testimony, the ILEC could effectively force new entrants to pay a portion of the costs of the firm's other (non-local exchange) activities as long as the ILEC can manage to maintain some commercial relationship with its customers. In his example, the cost of billing the customer would not be subtracted from the retail rate to arrive at a wholesale rate, because the ILEC hypothetically continues to provide intraLATA toll services to the customer. Under this approach, the new entrant attempting to compete with the ILEC at the retail stage in the local exchange market will pay a wholesale rate to the ILEC that reimburses the ILEC the cost of billing the customer for toll calls.

This is patently absurd. Not only does it artificially dampen the incentive to enter the retail stage of the local exchange market as a reseller of ILEC-supplied wholesale services, it also dampens competition in the intraLATA toll market by effectively cross-subsidizing the ILEC's sales in that market. As a result, competition is harmed in both markets.

Q. DO THE FCC RULES ADDRESS THIS ISSUE?

A. Yes. The FCC Order clearly specifies that avoided costs are to be calculated on the basis of retail-stage activities that would no longer be required if the ILEC were to specialize in the provision of wholesale services only. That is, they are not to be made contingent upon the costs that the ILEC actually sheds when it loses a customer to a new entrant.

Specifically, paragraph 911 of the Order states:

> We find that "the portion [of the retail rate] . . . attributable to costs that will be avoided" includes all of the costs that the LEC incurs in maintaining a retail, as opposed to a wholesale, business. In other words, the avoided costs are those that an incumbent LEC would no longer incur if it were to cease retail operations and instead provide all of its services through resellers. Thus, we reject the arguments of incumbent LECs and others who maintain that the LEC must actually experience a reduction in its operation expenses for a cost to be considered "avoided" for purposes of section 252(d)(3).

Thus, Mr. Reid's proposed approach is both unsound economically and ruled out by the FCC's avoided cost criteria. As a result, his avoided cost calculations are unreliable and should not be used as a basis for the Florida Commission's arbitration decision on this issue.

Q. DOES THAT CONCLUDE YOUR 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, ¶ 672.

[2] First Report and Order, ¶ 682.

[3] This is a standard result that appears in all or virtually all basic principles of economics textbooks. See, for example, Robert B. Ekelund, Jr., and Robert D. Tollison, Economics, 4th edition, Harper Collins College Publishers, New York, NY (1994), Chapter 9.

[4] See Glenn M. MacDonald and Alan Slivinsky, "The Simple Analytics of Competitive Equilibrium with Multiproduct Firms," American Economic Review, Vol. 77 (December 1987), pp. 941-953.

[5] See, e.g., Ronald H. Coase, "The Marginal Cost Controversy," Economica, Vol.. 13 (1946), pp. 169-182; Robert D. Willing, "Pareto-Superior Nonlinear Outlay Schedules," Bell Journal of Economics, Vol. 9 (Spring 1978), pp. 56-69; Alfred E. Kahn, "The Road to More Intelligent Telephone Pricing," Yale Journal on Regulation, Vol. I (1984), pp. 139-57.

[6] William J. Baumol and J. Gregory Sidak, Toward Competition in Local Telephony, The MIT Press, Cambridge, MA, 1994, p. 56.

[7] Id., p. 56.

[8] John T. Wenders, The Economics of Telecommunications: Theory and Evidence, Ballinger Publishing Company, Cambridge, MA (1987).

[9] See 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; 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; David L. Kaserman and John W. Mayo, *Government and Business: The Economics of Antitrust and Regulation*, Dryden Press, Ft. Worth, TX (1995), pp. 509-511.

[10] First Report and Order, ¶ 706.

[11] First Report and Order, ¶¶ 704-707.

[12] First Report and Order, ¶ 694.

[13] These expenses are to be directly included as part of the incremental cost measurement. First Report and Order, ¶ 682.

[14] First Report and Order, ¶ 682.

[15] First Report and 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."

[16] First Report and Order, ¶¶ 708-712. "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)

[17] First Report and Order, ¶ 698.

[18] First Report and Order, ¶ 698.

[19] First Report and Order, ¶¶ 712-715.

[20] First Report and Order, ¶ 620.

[21] First Report and Order. ¶¶ 678 and 694.

[22] First Report and Order, ¶ 696.

BY MR. TYE:

Q Doctor Kaserman, do you have an exhibit attached to your direct testimony?

A I believe there was an exhibit attached, my resume.

Q Yes, sir. Would that be Kaserman Exhibit DLK-1?

A Yes.

Q Is that the only exhibit you have to any of your testimonies?

A I believe it is, yes.

MR. TYE: Madam Chairman, I would ask that Doctor Kaserman's Exhibit DLK-1 be assigned the next exhibit number.

CHAIRMAN CLARK: It will be marked as Exhibit 12.

(Exhibit Number 12 marked for identification.)

BY MR. TYE:

Q Doctor Kaserman, have you prepared a summary of your testimony?

A Yes, I have.

Q Okay. Could you please deliver the summary at this time.

A Yes, thank you. I appreciate the opportunity to appear before the Commission on these very important issues. The Florida Public Service Commission's fundamental policy objectives were not changed by the Telecommunications Act of

1996, nor by the FCC local competition order. Those objectives have always been and will continue to be the protection and promotion of consumers interest in fair and nondiscriminatory prices and quality services. What have changed, however, are the underlying technological and market conditions that govern the costs and market structure of the local exchange business. Due to these changes, what was once a natural monopoly is now potentially competitive. As a result, the same policies that previously promoted consumers' interest are no longer effective in achieving that end.

A new set of policies that are designed to promote and protect competitive market forces will now serve consumers far better than prior policies which tended to preserve the monopoly status of the incumbent supplier. As recognized in other markets that have undergone a similar transformation, where a natural monopoly ceases to exist and the potential for competition arises, a fundamental shift in the regulatory paradigm is required if consumer interests are to continue to be served.

Specifically, regulatory commissions must abandon existing policies designed to maintain monopoly supply and substitute for them new policies designed to promote and protect competitive market forces. Such a set of policies is clearly mandated by the Telecommunications Act of 1996.

As this act recognizes, there are three alternative pathways that new entrants may follow to reach this market. Specifically, new firms might enter the local exchange market by, number one, building new facilities; number two, purchasing unbundled elements; and, number three, purchasing wholesale services from the incumbent LEC.

Because entry by any of these three pathways offers the prospect for substantial consumer benefits, regulators should implement policies that do not distort the incentives to enter by one route versus another. That is, regulatory policy should be neutral with regard to which entry pathway is chosen favoring none over the others. Such neutrality can only be achieved by setting the prices of unbundled network elements and wholesale services at economically efficient levels, and strictly enforcing the equal nondiscriminatory interconnection and provisioning requirements provided in the act.

In addition, arbitrators will need to require nondiscriminatory contractual provisions that recognize the divergent needs of different entrants. And above all else, the Commission should be ever mindful of the longstanding principle from antitrust, policies should be designed to protect competition, not competitors.

What then do efficient pricing principles require for ILEC supplied monopoly input? The economically correct pricing standard is, as always, incremental cost. For unbundled elements, prices should equal or closely approximate the total service long-run incremental cost, or TSLRIC, of serving these elements. The recent FCC order strongly endorses this basic pricing principle, but chooses to relabel it total element long-run incremental cost, or TELRIC. This renaming of the concept is done to clarify that the incremental cost standard is being applied to elements rather than services. Otherwise, these concepts are identical in all respects.

Thus, both the FCC order and good economics clearly acknowledge the beneficial effects of pricing unbundled elements at or very near TELRIC. Any higher prices will artificially discourage entry through the purchase of unbundled elements and thereby cause a diminution in competition and under-utilization of the ILEC network.

With regard to wholesale services, the applicable pricing standard is the same; incremental cost. Here, however, it is the incremental cost savings or avoidable costs that are realized when the ILEC ceases to provide retail portions of the overall service. Avoided costs, in turn, should contain three components. First, the retail stage cost incurred by a fully efficient supplier of the end user service are avoided when retail activities cease.

Second, any retail stage inefficiencies exhibited by the ILEC which increase observed costs above these fully efficient costs will also be avoided. And, third, any excess profits, in other words, profits that exceed the competitive level currently earned by the ILEC on the given service should also be avoided when the firm shifts to supplying the wholesale service only. All three sources of avoided cost should be included in the wholesale discount provided to entrants making use of total service resale to facilitate entry. Any lower discount will bias the entry decision against this option.

Finally, throughout the arbitration process the Commission should be mindful that virtually any anticompetitive objective that may be achieved through the pricing practices of the incumbent firm may also be achieved through various nonprice terms of sale imposed on firms purchasing necessary inputs from the ILECs. Due to the substantial monopoly powers still held by these firms, they have both the incentive and the wherewithal to pursue a variety of exclusionary practices. To the extent such practices succeed in maintaining, regaining, or extending monopoly power, consumers will suffer higher prices and less choice. Consequently, in its efforts to protect consumers in this new market environment, it will be necessary for the Commission to insist upon competition enabling nonpriced terms of sale, which include both technical interconnection arrangements and contractual provisions.

Local exchange telephone markets are the last remaining segment of the telecommunication industry to fall to competitive market forces. As a result, successful transformation of these markets from monopoly to competition promises to yield tremendous benefits to consumers. But such a transformation requires a set of policies that will promote and protect competition. At the broadest level, these policies contain only three basic elements. Number one, economically efficient pricing of ILEC supplied monopoly inputs. Two, fully equal interconnection arrangements. And, three, entry facilitating contractual provisions. Implementation of such competition enabling policies, however, represents the only means through which this Commission can continue to serve the interests of Florida consumers in today's market environment. Thank you very much.

Q Thank you, Doctor Kaserman. Does that conclude your summary?

A Thank you.

MR. TYE: Madam Chairman, the witness is available for cross.

CHAIRMAN CLARK: Mr. Melson.

MR. MELSON: No questions.

MR. HORTON: No questions.

CHAIRMAN CLARK: Mr. Horton, no questions. Mr. Lackey.

MR. LACKEY: Yes, ma'am.

CROSS EXAMINATION

BY MR. LACKEY:

Q Doctor Kaserman, I am Doug Lackey, I'm appearing on behalf of BellSouth in this proceeding. I have several questions for you. I tried to jot down some notes in your summary as you gave it. I don't have a written copy, so if I get something wrong, please correct me.

Do I understand that your position, your principal that you are advocating is that the price charged for unbundled elements should approximate -- and I couldn't get this down -- TSLRIC or TELRIC?

A The two terms are synonymous, so it doesn't matter, and the answer is yes.

Q So the principal is the price charged for unbundled elements should approximate TSLRIC or its equivalent, TELRIC, is that correct?

A Yes. The only difference and the FCC order explains the only reason they introduced the adjective element substituting for service is to make sure everybody understands that it is the incremental cost of these elements, not the services. And it is very important to understand that, because the forward-looking common costs associated with elements as opposed to services are likely to be very, very small.

Q And the TELRIC or TS -- let's just call it TELRIC so we will be consistent, is that okay with you?

A That's fine.

Q Is it correct that the TELRIC should be calculated based on an assumption that we have an efficient firm involved that is using the least cost technology?

A Yes.

Q And does it also assume that whatever economies of scale that that firm can obtain are to be incorporated into the study?

A Yes, I believe that economies of scale would be reflected in the TELRIC calculation.

Q And just to make sure we are talking about the same thing, what do you understand, briefly, economies of scale to be?

A The short but containing a little bit of jargon answer is economies of scale exist when a firm's -- and it is the firm level -- long-run average costs are declining, which simply means that the unit cost of producing output fall as the firm increases its output or production.

Q Would a rough example of that be that AT&T, if AT&T buys 1,000 automobiles they might be able to get a better price for their automobiles on a per unit basis than I would if I went out and bought one automobile?

A No, sir, that is not a good example of an economies of scale at all. That is an example of a discount in a price due to volume purchasing of an input. The notion of economies of scale is generally premised on an assumption that input prices are constant, and it's really due to a technological, underlying technological conditions that cause the firms costs to fall as the overall size of the firm increases. It is not based on lower priced inputs.

Q Can you give me a walking around example of what you just said, an example of what would show an economy of scale?

A What would show economies of scale would be a cost study that generates declining long-run average costs.

Q I'm sorry, I must have stated it wrong. Can you give me a practical example that illustrates what an economy of scale would be, a noneconomic jargon description?

A Sure. I think one of the best explanations of the concept of economies of scale goes back to Adam Smith and his description of the pen factory. It's a very famous example that talks about, well, if you have a pen factory and they are only producing, let's say, 100 pens a year, then they employ people that have to do various activities in the production of those pens and, therefore, their unit costs may be fairly high. Whereas if the pen factory increases its size, the company producing the pens increases the overall size of the operation, people within the factory begin to specialize. One draws out the pen, one puts the head on the pen, one sharpens the end of the pen, and so on. And as these people become specialized in the functions they are performing, unit cost declines. So specialization of labor is one of the most fundamental components generating economies of scale. Let me add just to clarify, too. Economies of scale are something that almost all firms experience over a certain range of output. And in almost all industries economies of scale become exhausted at a certain range of output. That is as firms get larger beyond some point, their unit costs are likely to go up.

Q Do you think that BellSouth perhaps has economies of scale?

A I imagine BellSouth has economies of scale over some range of output, whether their economies of scale are sufficient to generate what is called a natural monopoly is highly questionable. The only empirical evidence that I am aware of on that issue, I think, is cited in my direct testimony, and that's a paper by Shin and Ying (phonetic) that was published in the Rand Journal of Economics, I think about two or three years ago. The title of the paper is Unnatural Monopoly in Local Telephone. They conclude that the Bell Operating Companies do not have sufficiently large economies of scale to generate natural monopoly conditions.

Q Would you agree that BellSouth perhaps has more, can take advantage of economies of scale more than a new entrant in the telecommunications business, a new small entrant into the telecommunications business?

A Well, they are bigger, so if there are large economies of scale then they should have a competitive advantage in the marketplace in competing with these smaller companies. Their unit costs should be lower, you know, again, if these economies of scale exist and depending on the output range over which they extend.

Q But you have agreed with me earlier that the development of the TELRIC should be or should utilize the economies of scale that in this case BellSouth has, correct?

A Well, TELRIC is basically just -- you can think, the easy way to think of it is it is just incremental cost that we have all heard about and talked about for a long time. It is incremental cost. The reason we get so many adjectives is basically because it's an incremental cost a supplied to a multiproduct company. It's the incremental cost of one of the elements, unbundled elements, let's say a switch or a loop, that is calculated based on this company holding constant all the other products that it is already producing and selling. That's why we have the total service adjectives added to it. Other than that, it's long-run incremental cost.

Q Would the short answer to my question have been yes?

A You would have to repeat the question.

Q That's what I figured. The TSLRIC, or TELRIC rather, that you are advocating that this Commission adopt, assuming there are economies of scale in BellSouth's business, might result in a lower rate than the new entrant or lower cost than the new entrant could actually build whatever he was buying from BellSouth for himself, isn't that correct?

A Well, let's go back again to what TELRIC is. It's a calculation --

Q Madam Chairman -- excuse me, Doctor Kaserman. I believe the prehearing order clearly asks the witnesses to answer yes or no before they start off on an explanation. I think the question was pretty clear.

MR. TYE: Madam Chairman, I'm just not sure the question is susceptible to a yes or no answer.

CHAIRMAN CLARK: Well, Mr. Lackey, ask it again. It seemed to me that it was. Doctor Kaserman, we do require that you answer yes or no and then give an explanation.

WITNESS KASERMAN: Well, I also swore to tell the truth, and I will do my best to do that. Now, could I have that question read back. I had an answer for that question that I think will clarify, and I will preface it with a yes or no, if you like, but I have to have the question read back.

CHAIRMAN CLARK: I'm going to ask Mr. Lackey to ask his question again.

WITNESS KASERMAN: Thank you.

MR. LACKEY: I will try.

BY MR. LACKEY:

Q What I was asking about was whether the TELRIC for a particular element that uses BellSouth's economies of scale might be lower than the cost that a new entrant, a smaller new entrant would face if that new entrant was to build that same or place that same element itself?

A Probably not. I'm sorry, that is as close as I can come. The answer is probably not, and the reason for that is it's not BellSouth's TELRIC, it has nothing to do with BellSouth's operation. The TELRIC is the cost, the *incremental* cost that will be incurred in the long run by anybody that comes into this market and constructs the facilities to provide that service or element. It's *not* BellSouth's TELRIC, it's the TELRIC using the currently available technology and input prices that are out there today in an efficiently designed network except for the fact that the TELRICs that have been presented here take

BellSouth's existing switches. The location of those switches is given.

Q Didn't we agree a few minutes ago that different firms in the same industry may have different economies of scale?

A No, sir, I don't think we did.

Q Well, then perhaps I ought to ask you. Isn't it true that different firms in the same industry may have different economies of scale?

A No. The only way that could arise would be if those firms had access to different production technologies. If you've got a secret patent over the production of local service, then you may have different incremental costs than another firm. But if the technology that will be used by firms is the same and they pay the same input prices, then the incremental costs will be the same.

Q One more question and then I will change subjects. It's your position that the economies of scale for Indiantown Telephone Company are the same as the economies of scale for BellSouth in Florida?

A The economies of scale, the cost of function is the same. Now the level of output may be different.

MR. LACKEY: Madam Chairman, could I get him to answer yes or no before --

WITNESS KASERMAN: I thought that was a yes.

MR. TYE: I think it was a yes, Madam Chairman.

CHAIRMAN CLARK: I'm sorry, I didn't hear the yes, and if would you say yes at the beginning and pause and start your sentence, then we will be clear.

WITNESS KASERMAN: Yes, the economies of scale are the same, but the economies of scale are simply a description of the shape of the cost function. Where the companies are located on that cost function may be different, but the cost function itself, the economies of scale will be the same.

BY MR. LACKEY:

Q You will agree that the telecommunications market has both a retail and a wholesale stage, won't you?

A Yes, we are moving to that point where it will have those two stages.

Q And you agree that in order to have full competition facility-based competition will have to develop, don't you?

A Yes, if by full competition you mean competition that extends throughout the entire industry that is sufficient to warrant deregulation, that will require the facility-based competition as well as the retail stage, yes.

Q You will agree, won't you, that this Commission ought to be careful not to favor resale over facility-based entry into the telecommunications industry, won't you?

A Yes, and conversely they should not favor facility-based over resale.

Q You will agree that there are four national facility-based long distance networks today, won't you?

A Yes.

Q And you will agree that MCI, Sprint, the other owners of the -- well, at least those two started out as resalers, correct?

A Yes.

Q And MCI and Sprint paid tariffed rates for the services they resold, didn't they?

A Yes, I think that's correct.

Q And they bought those services generally from your current client, correct?

A They bought primarily from AT&T right at divestiture. Shortly after divestiture there were other facilities that became available and there arose what became known as carriers carriers from which they bought capacity, as well.

Q Now, when your client sold MCI and Sprint those tariffed services for retail, they didn't give them a discount for avoided costs, did they?

A Well, actually I believe as competition developed in that industry they did, yes.

Q Excuse me. When your client started selling services to MCI and Sprint for resale, they charged them the tariffed rates and didn't give them a discount for avoided costs, did they?

A I think I just answered that. Yes, they did. As competition developed, those tariffed rates fell very rapidly, and I think the fall in those rates was a reflection of the cost savings of not providing the entire through-service.

Q All right. Tell me how the WATS rates that AT&T charged MCI changed from 1982 to 1983?

A I don't know the answer to that specific question.

Q How about '84 to 85?

A I don't have in front of me the WATS rates for any year. I cannot cite you the WATS rate for any year.

Q Okay. So you don't know that they declined during that period, do you?

A Again, I will go back to my general knowledge that, yes, I do know that since '84, since divestiture, AT&T's tariffed rates declined precipitously, their average revenue per minute, even if you just look at residential service has fallen over 60 percent.

Q Between 1983 and 1985, did the tariffed rates for WATS fall?

A I think I have answered that question.

Q Could I have a yes or no. Did they for that time period --

A No, you can't. I don't know the answer.

Q That's what I thought. Thank you. Now, you don't know whether the rates charged to MCI were close to AT&T's marginal cost for the services they were providing, do you?

A In 1984?

Q Yes.

A No, sir, I don't know how close they were to marginal cost.

Q Now, you were working for AT&T back in 1984, weren't you?

A No, sir, I was employed by AT&T on a consulting basis to testify, I wouldn't say I was working for them.

Q I'm sorry, you were testifying for them, just like you are doing now, right?

A Yes.

Q But you never told AT&T that in order to foster competition and move the market ahead, AT&T ought to sell services to MCI at AT&T's forward-looking long-range incremental cost, did you?

A No, sir, I don't think I ever told them that. Nobody ever asked me my advice on pricing of their services.

Q Now, I want to go through just very, very quickly some definitions. And I need to tell you, if you haven't figured it out, if you didn't know, I've got the North

Carolina transcript here, so I just want to read some definitions that we went through and I figure that will be quicker, okay?

A That's fine. Sure.

Q Do you agree that incremental costs are the additional costs 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?

A Yes.

Q Do you agree that incremental costs are forward-looking in the sense that these costs are incurred as the output level changes by a given increment?

A No, they are forward-looking in the sense that they reflect the least cost technology to produce that increment and output. They don't look at, in other words, what the firm spent in the past in order to calculate these costs. That is the sense in which they are forward-looking.

Q Okay. Will you agree that joint costs, the term joint cost refers to costs incurred when two or more outputs are produced in fixed proportions by the same production process?

A Yes, with the caveat that it's not all of the costs incurred when they are produced together, it is a portion that you cannot attribute on an incremental basis to either one.

Q Do you remember when I asked you that question in North Carolina last week?

A I remember talking to you in North Carolina last week, I don't remember that question.

MR. LACKEY: I think I may have the only copy. May I go down there, Madam Chairman?

CHAIRMAN CLARK: Yes, Mr. Lackey.

BY MR. LACKEY:

Q I am handing you what is identified as Page 124 of the transcript of the proceeding we had last week. Look at the one I have marked --

COMMISSIONER KIESLING: Mr. Lackey, would you speak into a mike, please.

MR. LACKEY: Yes. I'm sorry. I'm fading quick. I know you all are, too.

BY MR. LACKEY:

Q I'm handing you what is marked as Page 124 of the North Carolina transcript from last week. Do you see the Q that begins on Line 17?

A Yes.

Q Would you read it?

A "Question: Okay. All right. Will you agree that joint cost, the term joint cost refers to costs incurred when two or more outputs are produced in fixed proportions by the same production process? Answer: Yes.

Q Okay. So when I asked you the question last week your answer was yes, is that correct?

A My answer was yes and this week I added the qualification.

Q Will you agree that common costs are costs that are incurred in connection with the production of multiple products or services and remain unchanged as the relative proportions of those products vary?

A Yes.

Q Will you agree that the FCC treats joint and common costs together under the caption common costs?

A I believe that's correct in the FCC's order.

Q Do you agree that TSLRIC or the TELRIC means the relevant increment, and in this case the relevant increment is the entire quantity of the service that a firm produces rather than just the marginal increment?

A Yes.

Q Okay. And do you agree that TSLRIC includes the incremental cost of dedicated facilities and operations that are used by the service in question?

A Yes.

Q Now, TSLRIC and TELRIC are created by identifying the direct cost associated with the service or the element, is that correct?

A Yes, if by direct cost -- we run into a problem here with some accounting terminology, and I'm not an accountant. So I need to clarify what I mean by direct cost. I mean any costs that are causally attributable to the production of that output. In other words, it does not exclude what are sometimes called indirect costs, administration and overhead, that can nonetheless be causally attributed to the provision of that output or service.

Q Let's talk about an example of that last thing you said. If we learned that for every 100 feet of aerial cable you had to put a telephone pole in, you could then determine or you could create an allocation, if you will, of the cost of telephone poles to aerial cable by looking at the dollar investment in aerial cable, couldn't you? Was I not clear?

A Well, I think the answer is yes, but the reason I hesitate is because incremental costs are applied to an output, and I'm not sure if aerial cable is an output or not. If we want to consider it to be an output, then to the extent those poles are caused by the provision of that output, then they would be a component of the incremental cost of providing that output.

Q And so if I were going to look at the incremental cost of aerial cable, I could assign a portion of the cost of the poles to that aerial cable account, couldn't I? Or cost, I mean, couldn't I? Would you feel better if we used conduit? That's what we talked about last week.

A No, I don't think it matters, the principle is the same.

Q I thought it was.

A I will go back to the same basic principle and that is can you -- and I don't use the word allocate with costs because we are talking about fully distributed costs, we are not talking about incremental costs. Incremental costs are based on the ability to attribute on a cost causing basis some of those costs to the provision of that output. Now, whether you can do that with poles for cable, I don't know.

Q All right. Let's go back, and I think I can close this down pretty quickly. Let me just ask you to assume that for every hundred feet of aerial cable you had to have a telephone pole. That doesn't seem improbable, does it?

A No, it sounds fine.

Q Okay. If I wanted to figure out the cost of aerial cable, somebody wanted to purchase aerial cable from me, wouldn't you agree that in those circumstances you would sort of have to figure in the cost of the poles if you were going to give them the cost of aerial cable?

A Yes. The difficult question, of course, is what portion of the pole gets attributed to on a cost-causative basis the aerial cable. In other words, what other outputs is the pole responsible on a cost-causative basis for being put in the ground.

Q In other words, if there were cable TV hanging on that pole, and there was electric lines hanging on that pole, you would have to figure some way to take that into account, too, is that correct?

A Again, if you can quote, figure out how to do that on a cost-causative basis on an incremental basis, then that portion will become a part of the TELRIC of providing the aerial cable element. If you cannot do that on a cost-causative basis, then the pole does not become a portion of the TELRIC.

Q And the same would be true whether we were talking about poles or we were talking about conduit, correct?

A Any specific input used in the production of the output, the same would be true.

Q Or even buildings, correct?

A That's correct.

Q Now, I want to shift to the application of your principle that we talked about when I first started asking you questions. And I want to give you an example, and I want to talk about how your approach to pricing would apply to this example, all right?

CHAIRMAN CLARK: Mr. Lackey, let me just ask you, can we break here for just ten minutes, or does that interrupt the flow of your questions?

MR. LACKEY: We can break here. That would be fine.

CHAIRMAN CLARK: We are going to take a break until five minutes until 7:00.

MR. LACKEY: I have been with him for about 25 minutes, I don't intend to take more than another 15 and I will be done, though. There is no need to wait, but I don't want you to think I'm going to go all night at this.

CHAIRMAN CLARK: Thank you. We will take a break until five minutes to 7:00.

(Brief recess.)

CHAIRMAN CLARK: We will call the hearing back to order. Mr. Lackey.

MR. LACKEY: Thank you.

BY MR. LACKEY:

Q Doctor Kaserman, I was about to give you a hypothetical to take a look at the application of these principles when we broke, so let me start now again. Let's assume that Ms. White has moved and bought a new house, and she would like a telephone line, and the house is 5,000 feet from the central office and there is no facilities there now. The loop has to be run anew. Let's assume that it's 5,000 feet, so it's all copper, and that the cost of installed copper is $3 a foot, which makes the cost of the loop $15,000, I think. Okay. Can you assume all of that with me?

A Yes.

Q And let's assume that copper is the least cost way of providing this loop, and that the firm that put it in was an efficient firm. Can you go with me on that one?

A Yes.

Q Okay. Now, we can agree that if we put that loop in today then I guess that the cost would be $15,000 for whatever telephone company that owned it put it in, correct?

A That was our assumption.

Q Okay. Now, if the loop already existed, if she already had telephone service and the same conditions applied, it was a 5,000 foot copper run and the most efficient -- that was the most efficient way to do it and the least cost way to do it. If a new entrant came in and wanted to purchase that loop from us, would the cost be $15,000 under the set of assumptions I have given you?

A The cost is what the cost is. I think you may be wanting to ask what the price is, would the price be 15,000.

Q Would the price of the loop to the new entrant be $15,000 under your pricing?

A Yes, and then you would have to break it down into a per month and amortize that investment.

Q Yes, I realize we would have to get it down to a per month figure, but I'm trying to make it a simple example, so let's just stay with my 15 grand if we can for a minute, okay? Now, if the loop had been built six months ago and it was built by a very efficient firm using least cost technology, but the loop cost $20,000 six months ago, the reason for the price difference being that the price of copper has fallen in the last six months, your new entrant would still pay the price of $15,000 for the loop, correct?

A Yes, sir. The new entrant would pay the amortized value of the $15,000, because that's what the competitive market would require in terms of pricing. Again, competitive markets do not honor past investments, they only look at forward-looking current costs.

Q Okay. And if this didn't happen today after all, but rather another six months went by before Ms. White decided to change carriers, and now the cost of installed copper had dropped to $2 a foot, so that the forward-looking cost of the loop would be $10,000, your position would be that the new entrant would only pay BellSouth $10,000 for that loop, correct?

A That's correct.

Q So, even though the most efficient firm using least cost technology six months ago paid $20,000 for it, six months from now if the price of copper has fallen, the new entrant gets the benefit of that forward-looking price according to your pricing theory?

A It's not my pricing theory, this is a very widely accepted theory of incremental costs based on forward-looking cost, incremental cost pricing. It has been around for 100 years in economics. It's what competitive markets drive prices to. If the new entrant chose not to purchase this element from your company, the new entrant might build the facility themselves, then the cost to the new entrant would be the $10,000, not the 20 or the 15.

Q Now let me add one more factor. Let's assume that six months ago when Ms. White showed up, BellSouth didn't want to build this loop, but it had an obligation to because it was the carrier of last resort and was required to serve all comers. Can you make that assumption with me?

A Yes, I can make that assumption, I think, for these purposes. We could debate the validity of it, but I won't take the time to do that.

Q Okay. Well, the question I have then is if the company were required to put the loop in six months ago at a cost of 20,000, and you want us to sell it six months from now when she changes carriers to your client for 10,000, who pays the difference?

A In a competitive market, your stockholders would pay the difference. In a regulated market, I believe that you have options available to recover those costs, perhaps depending on -- first of all, you don't recover these things on each loop individually. No competitive firm does that. It's on the firm's overall operations. And if your firm feels that due to the emergence of competition in the local exchange market and the movement of prices to competitive levels that your firm is going to experience a revenue shortfall, then you have available to you, I understand from this Commission remedies whereby you can bring those costs in and show them to the Commission and show them your revenues and demonstrate this financial problem to them and receive some sort of relief, perhaps.

Q Well, in a competitive market, though, we wouldn't have been required to build that loop to Ms. White's house if we didn't want to, would we?

A You might have for some other reasons, yes. Competitive firms all the time do things that on an individual customer basis they may not make money. There are loss leaders, there are promotional sales, there are all kind of things in competitive markets.

Q There wouldn't have been a governmental compulsion, a requirement that we build that loop in a competitive market, would there?

A No.

MR. LACKEY: That's all I have. Thank you, Madam Chairman.

CHAIRMAN CLARK: Staff.

MS. CANZANO: Staff has no questions.

CHAIRMAN CLARK: Commissioners.

COMMISSIONER DEASON: I have one question. When Auburn plays the University of Florida, who do you pull for?

CHAIRMAN CLARK: Be careful, Doctor Kaserman.

WITNESS KASERMAN: The answer is yes.

MR. LACKEY: Finally.

WITNESS KASERMAN: Commissioner Deason, could I get you to ask my questions in Tennessee in two weeks?

CHAIRMAN CLARK: Redirect.

MR. TYE: No redirect, Madam Chairman. We would ask that the witness be excused.

CHAIRMAN CLARK: We will admit his exhibit into the record.

MR. TYE: Thank you. We move the admission of Exhibit 12.

CHAIRMAN CLARK: And we will excuse you.

WITNESS KASERMAN: Thank you.

(Exhibit Number 12 received into evidence.)

MR. HATCH: AT&T would call Mr. Sather.

CHAIRMAN CLARK: Mr. Hatch, was Mr. Sather sworn in?

MR. HATCH: I was just about to inquire. I believe so. Mr. Sather, were you previously worn?

WITNESS SATHER: Yes, I was.

Whereupon,

L.G. SATHER

having been called as a witness on behalf of AT&T Communications of the Southern States, Inc., and having been previously sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. HATCH:

Q Mr. Sather, could you please state your name and business address for the record, please.

A My name is L.G. Sather, S-A-T-H-E-R. My business address is 1200 Peachtree Street Northeast, Atlanta, Georgia 30309.

Q And by whom are you employed?

A I am employed by AT&T.

Q Did you prepare and cause to be filed direct testimony and supplemental direct testimony in this proceeding?

A Yes, I did.

Q Do you have any changes or corrections to either of those pieces of testimony?

A No, I do not.

Q If I asked you the same questions today, would your answers be the same?

A Yes, they would.

MR. HATCH: Madam Chairman, we would request that the direct and supplemental direct testimony of Mr. Sather be inserted into the record as though read.

CHAIRMAN CLARK: It will be inserted in the record as though read.

DIRECT TESTIMONY OF

L. G. SATHER

ON BEHALF OF AT&T COMMUNICATIONS

OF THE SOUTHERN STATES, INC.

Docket No. 960833-TP

Q. **WILL YOU PLEASE IDENTIFY YOURSELF AND STATE YOUR BUSINESS ADDRESS?**

A. My name is L. G. Sather. My business address is 1200 Peachtree Street N.E., Atlanta, Georgia 30309.

Q. **BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

A. I am employed by AT&T as a District Manager in the Government Affairs organization.

Q. **PLEASE DESCRIBE YOUR WORK EXPERIENCE.**

A. I have thirty-five years of service in the telecommunications industry. I started my career at Northwestern Bell in 1960. My assignments at Northwestern included responsibilities in the installation and maintenance of local services, the engineering of local and toll distribution facilities, construction program planning, long range planning of local and toll networks, the determination and administration of local and toll switching machine capacities, network management of the toll network for peak load conditions, and the economic analysis of network services in support of pricing decisions. In 1978 I transferred to South Central Bell. There I had responsibilities for economic analysis in the areas of Private Line Services, Data Phone Digital Services, Message Toll Service, WATS and 800 Service. From early 1982 to December 1983 I worked on the development of state and interstate access charges for South Central Bell and the development of programs and analyses to support the interstate filing of the transport access charges for most of the Bell Operating companies. In 1984 I joined AT&T and have been involved with various aspects of regulatory and economic analysis relating to the provisioning of our services.

Q. WHAT ARE YOUR CURRENT RESPONSIBILITIES WITH AT&T?

A. I am responsible for presenting AT&T's analysis of industry proposals which impact AT&T's service offerings and capabilities in the nine AT&T Southern Region states. A major portion of my effort is directed towards achieving economically based, nondiscriminatory access charges and structures together with regulatory rules that will allow AT&T to meet its customer needs with services that are competitively priced and profitable.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to request that the Commission direct BellSouth to eliminate all restrictions on the resale of its telecommunications services contained in its tariffs to promote the development of a competitive telecommunications market.

In making this request and recommendation to the Commission I will demonstrate that failure to implement complete and specific requirements for the resale of telecommunications services will allow BellSouth to stifle the development of a competitive local telecommunications environment. The local exchange telephone companies have an economic incentive to utilize resale restrictions to afford themselves a competitive advantage. They have both the economic incentive and, with respect to BellSouth, a long standing history of such behavior.

Q. WHAT IS YOUR UNDERSTANDING OF THE OBLIGATIONS OF LOCAL EXCHANGE COMPANIES REGARDING RESALE OF SERVICES UNDER

THE 1996 TELECOMMUNICATIONS ACT?

A. It is my understanding of the Act that local exchange companies have two obligations with respect to offering their telecommunications services for resale. The first obligation is contained in Section 251(b)(1) and is applicable to all local exchange carriers. It provides that such carriers have "the duty not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of its telecommunications services."

The second obligation is included in Section 251(c)(4), and applies only to Incumbent Local Exchange Carriers ("ILECs"). It requires that they "offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and ... not prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of such telecommunications service ...".

Q. IN SIMPLE TERMS HOW WOULD YOU DESCRIBE THESE RESALE OBLIGATIONS?

A. The local exchange companies are required to make available for resale all existing retail services. That means that any party, or end user, a competing telecommunications carrier, or any entity should be allowed to purchase all telecommunications services that BellSouth offers to end users. Additionally, incumbent local exchange companies must make such telecommunications services available for resale at wholesale rates. Further, BellSouth shall not restrict in any way the manner in which a reseller may configure said services for its customers.

Q. HISTORICALLY, WHAT HAS BEEN THE OVERALL RATIONALE FOR PROHIBITING RESALE OR IMPOSING USE OR USER RESTRICTIONS?

A. In the monopoly environment where pricing decisions were driven to satisfy the revenue requirements of the local exchange company, the pricing of individual services generally did not reflect underlying costs, but often reflected social pricing objectives. Under rate of return regulation, the local exchange company first determined what part of its revenue requirements could be satisfied from services other than residential basic local exchange service and other services deemed by state regulatory commissions as appropriate for profit maximization rates -- a practice known as residual pricing. That type of pricing resulted in some services being priced significantly above cost (like exchange access). Such rates would not be sustainable in a competitive market. The overall purpose of this pricing philosophy or objective was to minimize upward rate pressure on basic residential local service rates.

The resulting rate structure for certain services permitted the monopoly to extract an excessive level of profit from particular service offerings. For example, business local exchange services were priced at a significant multiple above the equivalent or identical service available to residential customers. Another classic example of this pricing practice is reflected in the historically high prices for toll services of the local exchange companies. To ensure that residential local exchange service could not be used by businesses, the ILECs imposed tariffs restrictions on the use of such residential services. When large business customers complained about high toll rates, ILECs created new cut rate offerings to mollify them, such as Foreign Exchange Service and WATS. To ensure that only these large customers could take advantage of these offerings, the ILECs imposed resale restrictions that would not allow end users to aggregate traffic of others and thereby extend the benefit of lower rates to smaller customers. By restricting service arrangements to certain customers, the ILECs chose to extract revenues from small volume customers far in excess of what could be achieved if the same end users had been allowed to join together to take advantage of the volume discounts available to large volume customers.

Q. DOES THE NEED STILL EXIST TO PRICE CERTAIN SERVICES SIGNIFICANTLY ABOVE COST TO SUBSIDIZE ANY OTHER SERVICE?

A. No. BellSouth is subject to price regulations and no longer is subject to rate of return regulation. Also, the revenue/cost relationships of local exchange telephone service have changed because of declining cost and frozen local exchange rates. While historically it may have been true that local service, at least local residential service, was priced below cost, that is not true today. There may be specific pockets or small high cost areas where local residential services are priced below cost, but this Commission, in its investigation of Universal Service requirements, determined and noted in its Order that for BellSouth the statewide average revenues for local residential services were in the range of $23 per month. According to BellSouth, the corresponding cost of this service is purported to be approximately $19 per month. Therefore, assuming that BellSouth figures are correct -- which we tend to question -- revenues exceed the cost by more than 20%. Under such circumstances there is no longer a need for revenue transfers between services.

Unfortunately the use of resale restrictions by ILECs may now be more appropriately termed the abuse of resale restrictions. Today resale restrictions permit ILECs to discriminate — to extract different levels of revenue from different customers who receive similar services. The existence of resale restrictions provides BellSouth the opportunity to stifle the development of competition. The removal of all resale restrictions will promote competition. Contract Service Arrangements ("CSAs") are another means by which BellSouth can discriminate between individual customers.

Q. WAS RESALE USED TO FOSTER THE DEVELOPMENT OF COMPETITION IN THE INTEREXCHANGE MARKET?

A. Yes. Resale was the primary vehicle that was used by new entrants in the long distance market. AT&T, a long distance provider, was required to make all of its services available for unrestricted resale. That requirement remains today. If resale restrictions had been allowed, unquestionably MCI, Sprint, and WorldCom (formerly LDDS and Wiltel) would have had an even more difficult time establishing themselves in the market. A prime example of the value of resale is demonstrated by WorldCom, which originated as a small reseller in Mississippi. Through the use of innovative management and effective resale of other carriers' services and facilities, WorldCom evolved from being a reseller to become the nation's fourth largest facilities based carrier.

Q. IN WHAT WAY HAS BELLSOUTH ATTEMPTED TO RESTRICT AT&T'S RESALE OF BELLSOUTH'S LOCAL SERVICES?

A. BellSouth has restricted the resale of its retail services in two ways. First, it has limited who can purchase certain services. Second, it has imposed unreasonable conditions on how and to whom the services are to be resold.

By precluding specific services or categories of services from being resold, BellSouth effectively isolates these services to their existing customers, thereby shielding particular customer classes from competition. As a result, consumers are stripped of their choice to receive such services from a different provider and continue to be subjected to whatever price BellSouth decides to charge. By restricting how services may be resold or to whom they may be resold, BellSouth controls resellers' ability to compete against it by eliminating the ability to be innovative in packaging and pricing services. As a result, consumer choice remains limited to the services that have traditionally been offered by BellSouth.

Q. WHAT SERVICES HAS BELLSOUTH INDICATED IT WILL NOT MAKE AVAILABLE FOR RESALE?

A. BellSouth has informed AT&T that it will not make the following services available for resale:

- obsoleted/grandfathered services;
- contract service arrangements ("CSA");
- promotional offerings;
- Link-up and Lifeline services;
- 911 and E911 services;
- state specific discount plans or services; and
- N11 service.

Q. DESCRIBE THE GRANDFATHERING PROCESS FOR OBSOLETE SERVICES.

A. ILECs have historically obsoleted services to remove them from the marketplace because of new or advanced technology. Customers of obsoleted services may be handled in two ways: they may be forced to migrate to a substitute service, or they may be permitted to continue with their service on an "as is" basis. This practice of allowing them to continue their service "as is" is known as "grandfathering." BellSouth has stated that its goal is to migrate these grandfathered customers to substitute services. In practice, it has allowed, and even encouraged, grandfathered customers to maintain their obsoleted service for years. Generally, as long as grandfathered customers do not attempt to add new locations, expand their service, or move to a new location, they may keep their grandfathered status indefinitely.

Q. WHY IS IT IMPORTANT THAT OBSOLETED SERVICES BE MADE AVAILABLE FOR RESALE?

A. First of all, it is important to note that AT&T is not asking this Commission to require BellSouth to allow resellers to market and sell obsoleted services to new customers who would be new to these services. AT&T is asking this Commission to require BellSouth to allow the grandfathered customers to be given a choice of being provided their obsoleted service directly from BellSouth or indirectly, through resale, from a reseller. If AT&T is prohibited by BellSouth from offering the obsoleted service to the existing grandfathered customers, these customers will have no choice but to remain with BellSouth if they want to keep their current service. In effect, by limiting the availability of services exclusively to its customers, BellSouth robs these customers of their ability to benefit from competition. Therefore, in order for consumers to have the most choice as envisioned by Congress, it is crucial that resellers be able to resell obsoleted services to the embedded base of grandfathered customers.

Q. IS THERE POTENTIAL FOR BELLSOUTH TO ABUSE THE GRANDFATHERING PROCESS IF GRANDFATHERED SERVICES ARE NOT MADE AVAILABLE FOR RESALE?

A. Absolutely. By grandfathering customers, BellSouth possesses the ability to close off an entire segment of the market from competition. Given that there are very loose standards regarding how long a grandfathered customer may maintain the obsoleted service, and what services BellSouth can choose to grandfather, BellSouth would have the ability to foreclose market segments from competition indefinitely, thereby snuffing out burgeoning competition.

It is crucial that the Commission understand that if BellSouth is permitted to grandfather customers and exclude obsolete services from resale, it will have license to strategically categorize its local services into designated service classifications which are exclusively made available to its existing customers. Such strategic categorizations will allow BellSouth to protect its customer base not on the basis of customer service or superior service performance, but instead, solely because arbitrary barriers to competition will have effectively been put in place.

Q. CAN YOU PROVIDE ANY SPECIFIC EXAMPLES OF BELLSOUTH'S ABUSING THE GRANDFATHERING PROCESS?

A. Yes. On May 15, 1996, BellSouth filed in Florida to (1) obsolete their ESSX and Digital ESSX Service, (2) introduce MultiServ and MultiServPlus as replacement services, and (3) grandfather all existing ESSX and Digital ESSX customers. BellSouth made similar filings in its other states last year. In those states, BellSouth sent letters to its ESSX and Digital ESSX subscribers informing them of the new services and indicating that if they wished to maintain their ESSX and Digital ESSX service beyond December 31, 1996, they were required to sign a three year term plan within 90 days of the tariff approval.

In addition to having its customers sign three year term agreements to continue to receive ESSX, BellSouth has since filed in Georgia and Mississippi to make changes to its grandfathered ESSX tariffs. Among the changes proposed to the grandfathered ESSX service in the filings were pricing changes and the authority to order additional lines. BellSouth's proposed changes would result in enhancements being made to grandfathered services that have supposedly become obsolete and that are to be provided to existing customers solely on an "as is" basis.

It is clear from BellSouth's actions with respect to ESSX and Digital ESSX that its motives have been based on reasons other than traditional reasons for grandfathering. Since BellSouth has the ability to manipulate the marketplace through grandfathering, and in fact has done so, AT&T is requesting that this Commission restrict BellSouth's ability to do so in the future. By requiring BellSouth to make obsoleted (and grandfathered) services available for resale, BellSouth will be precluded from manipulating the process to shield its customers from competition.

Q. WHAT ARE CONTRACT SERVICE ARRANGEMENTS?

A. A contract service arrangement ("CSA") is an offering of tariffed services at customer-specific, non-tariffed rates. In order to be competitive and entice customers to purchase services from it and not a competitor, an ILEC will offer a contract (CSA) to customers for a specified period of time in which designated services can be received at a discounted rate.

Q. WHY IS IT IMPORTANT THAT CSAs BE AVAILABLE FOR RESALE?

A. There is significant potential for competitive abuse if these services are not made available for resale in all manners.

It is imperative that all retail offerings including contract service arrangements be made available with the appropriate wholesale discount the same as other offerings, if resale is to discipline BellSouth in its pricing so that it cannot discriminate against customers and so that customers will have maximum choice.

Additionally, contract service arrangements need to be made available to the public to ensure that there is awareness of this service arrangement being available. This is necessary so that similarly situated customers may understand whether they would like to avail themselves of the contract if similarly situated.

Q. WHAT ARE PROMOTIONAL OFFERINGS OR PLANS?

A. Promotional plans are specific pricing arrangements designed to entice customers to purchase particular services and new features. Generally BellSouth's promotional plans involve waiving a fee, such as a non-recurring charge, or offering the first month of service free of charge.

Q. WHY DOES AT&T VIEW IT IS NECESSARY FOR BELLSOUTH TO MAKE PROMOTIONAL OFFERINGS AVAILABLE FOR UNRESTRICTED RESALE?

A. First, the 1996 Telecommunications Act requires that such services be made available for resale. Promotional offerings are telecommunications services made available to the public and as such meet the requirements for resale, which the Act contemplates. Additionally, allowing BellSouth to utilize promotional offerings to the general public without allowing resellers the same discounting arrangements would constitute an unfair competitive advantage.

Q. PLEASE DESCRIBE LIFELINE AND LINK-UP SERVICES.

A. Link-up and Lifeline are services that include arrangements to help defray the cost of the non-recurring installation fees and to provide reduced monthly service charges for customers who qualify for financial assistance.

Q. WHY SHOULD LIFELINE AND LINK-UP SERVICES BE MADE AVAILABLE FOR RESALE?

A. The reason for making both Link-up and Lifeline services available for resale is so that consumers will be offered the greatest choice possible

Q. WHY SHOULD STATE MANDATED DISCOUNT AND SERVICE PLANS BE MADE AVAILABLE FOR RESALE?

A. State mandated discount plans also are retail offerings, admittedly targeted to a distinct group of customers, such as educational institutions. Although BellSouth is required to make discounted services available to a select group of customers and not the general public, it is still providing telecommunications service to retail customers who are not telecommunications providers. Therefore, BellSouth must make them available for resale as specified by the Act. Furthermore, by making these services available for resale, these customers will be able to select another provider from which to obtain services if they decide they no longer want to receive service from BellSouth.

Q. HOW DOES PROVIDING SERVICES SUCH AS E911/911 AND N11 SERVICE FOR RESALE BENEFIT COMPETITION?

A. Making these services available for resale prevents BellSouth from maintaining monopoly control over providing such services. BellSouth provides these services to customers who are not telecommunications carriers and, therefore, must offer them for resale. In addition, permitting the services to be resold will ensure that consumers can look to other carriers to provide at a minimum, the same type and quality of services they have received from the incumbent LEC.

Q. IN ADDITION TO EXCLUDING CERTAIN SERVICES FROM RESALE, BELLSOUTH HAS PROPOSED CERTAIN USE AND USER RESTRICTIONS UPON SERVICES IT IS WILLING TO MAKE AVAILABLE FOR RESALE. WHAT ARE SOME PROBLEMS ASSOCIATED WITH SUCH RESTRICTIONS?

A. In order for competition to fully develop and for customers to benefit from increased choice, lower prices, and new technology, new entrants must be able to distinguish themselves from BellSouth by repackaging services to offer consumers new services or existing services at different prices. When a new entrant is prohibited from making creative offerings because the incumbent LEC has imposed restrictions on the resale of specific services, the development of competition will be impeded and customer benefits will be realized more slowly. This anti-competitive result is why the Act requires ILECs such as BellSouth "not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of . . .telecommunications service[s] . . . ."

Q. **WHAT TYPES OF RESTRICTIONS HAS BELLSOUTH PROPOSED TO PLACE ON SERVICES THEY AGREE TO MAKE AVAILABLE FOR RESALE?**

A. BellSouth has proposed to restrict services available for resale in two ways: (1) BellSouth has designated specific restrictions it proposes to impose on the use and user of resold services, and (2) BellSouth has indicated that all services available for resale will generally be subjected to the same terms and conditions as are specified for such services in the appropriate section of BellSouth's tariffs.

The proposed restrictions are unreasonable and discriminatory because they prohibit innovation, which impedes competition. Additionally, they are unreasonable because they require resellers to provide services to their customers in the exact same manner as BellSouth provides these services to its customers.

Q. **WHAT MAKES THESE RESTRICTIONS INAPPROPRIATE IN A RESALE ENVIRONMENT?**

A. Imposition of restrictions is inappropriate in a resale environment because they limit rather than enhance competition. To permit BellSouth to impose such restrictions is to dilute the intended effect of the Act, which is to promote competition so that consumers can have increased choices. If resellers are precluded from reselling services in ways that will permit them to offer better, or at least different, choices to consumers, then the Act will have had no effect on monopolists in the local market. The Commission must remove these restrictions to ensure that BellSouth has no authority to control how its competitors will make services available to their new customers, nor the authority to determine to whom such services will be provided.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

SUPPLEMENTAL DIRECT TESTIMONY OF

L. G. SATHER

ON BEHALF OF AT&T COMMUNICATIONS

OF THE SOUTHERN STATES, INC.

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

Docket No. 960833-TP

Filed: August 23, 1996

Q. WILL YOU PLEASE IDENTIFY YOURSELF AND STATE YOUR BUSINESS ADDRESS?

A. My name is L. G. Sather. My business address is 1200 Peachtree Street N.E., Atlanta, Georgia 30309.

Q. HAVE YOU FILED TESTIMONY UNDER THIS DOCKET?

A. Yes. I filed testimony under Docket No. 960833-TP on behalf of AT&T on July 31, 1996.

Q. WOULD YOU SUMMARIZE THE PURPOSE OF THE TESTIMONY THAT YOU FILED PREVIOUSLY?

A. The purpose of my previous testimony was two-fold. First, I explained that the Telecommunications Act of 1996 required BellSouth to offer for resale at wholesale rates any retail telecommunications service provided to non-telecommunications carriers. Second, I explained that the Act prohibits BellSouth from imposing resale restrictions (i. e., use and user restrictions) because such restrictions are unreasonable and discriminatory.

Q. WHAT IS THE PURPOSE OF YOUR PRESENT TESTIMONY?

A. On August 8, 1996, the Federal Communications Commission ("FCC") issued an Order and regulations (collectively referred to as the "FCC Order") to implement the Telecommunications Act of 1996. The purpose of my present testimony is to explain how the FCC Order supports AT&T's positions that the Act: (1) requires BellSouth, without exception, to offer for resale at wholesale rates any telecommunications service that BellSouth provides at retail to non-telecommunications carriers; and (2) prohibits BellSouth from imposing any restrictions on the resale of such services unless specifically permitted by the Florida Commission under certain narrow exceptions.

ISSUE: ***WHAT SERVICES PROVIDED BY BELLSOUTH, IF ANY, SHOULD BE EXCLUDED FROM RESALE?***

Q. PLEASE SUMMARIZE YOUR PREVIOUS TESTIMONY WITH RESPECT TO WHICH SERVICES ARE TO BE MADE AVAILABLE FOR RESALE BY BELLSOUTH.

A. I explained in my previous testimony that the language of the Act is clear and unequivocal: BellSouth must offer for resale at wholesale rates any telecommunications service offered at retail to non-telecommunications carriers. There are no exceptions to that requirement.

Q. DOES THE FCC ORDER SPECIFY WHICH SERVICES ARE TO BE

SUBJECT TO RESALE?

A. Yes. The FCC Order confirmed AT&T's position by concluding that BellSouth must offer for resale at a wholesale rate each retail service that: (1) meets the statutory definition of a "telecommunications service;" and (2) is provided at retail to subscribers who are not "telecommunications carriers." FCC Order No. 96-325, ¶ 871, at 432. The FCC Order does not identify any exceptions to that requirement.

ISSUE: ***<u>WHAT TERMS AND CONDITIONS, INCLUDING USE AND USER RESTRICTIONS, IF ANY, SHOULD BE APPLIED TO THE RESALE OF BELLSOUTH SERVICES?</u>***

Q. PLEASE SUMMARIZE YOUR PREVIOUS TESTIMONY REGARDING WHETHER USE AND USER RESTRICTIONS SHOULD BE APPLIED TO THE RESALE OF BELLSOUTH SERVICES.

A. I explained in my previous testimony that use and user restrictions (i. e., resale restrictions) are unreasonable, discriminatory and anticompetitive because incumbent LECs can use such restrictions to preserve their market position.

Q. DOES THE FCC ORDER ADDRESS THE REASONABLENESS OF USE AND USER RESTRICTIONS?

A. Yes. The FCC Order concluded that "resale restrictions are presumptively unreasonable" except under certain limited conditions specifically identified in the FCC Order and discussed below. FCC Order No. 96-325, ¶ 939, at 465. Before imposing any additional resale restriction, BellSouth must prove to the Florida

Commission that the restriction is reasonable and non-discriminatory, and that the restriction is narrowly tailored. FCC Order No. 96-325, ¶ 939, at 465; 47 C.F.R. § 51.613(b) (to be codified). The conditions under which resale restrictions may be permissible are as follows:

Promotions -- The FCC Order provided that BellSouth must offer promotions for resale, but that short-term promotional prices are not "retail rates" for the purposes of calculating the wholesale rate. FCC Order No. 96-325, ¶ 949, at 469; 47 C.F.R. § 51.613(a)(2) (to be codified). Like AT&T, the FCC is concerned that an incumbent LEC could use promotions anticompetitively to avoid its wholesale obligations. FCC Order No. 96-325, ¶¶ 949-51, at 469-70. The FCC Order provides that incumbent LECs may not use promotional offerings to avoid their wholesale obligation. FCC Order No. 96-325, ¶ 950, at 469-70; 47 C.F.R. § 51.613(a)(2) (to be codified). One example of an impermissible abuse is to offer a series of consecutive 90 day promotions. FCC Order No. 96-325, ¶ 950, at 469-70; 47 C.F.R. § 51.613(a)(2) (to be codified). To lower the potential for abusing promotions for anticompetitive purposes, the FCC Order establishes a presumption that only promotional prices with a duration of 90 days or less would qualify as short-term promotional prices and not constitute "retail rates." FCC Order No. 96-325, ¶ 950, at 469-70; 47 C.F.R. § 51.613(a)(2) (to be codified). The FCC Order does not preclude the Florida Commission from further reducing the 90 day period or imposing other conditions to prevent anticompetitive actions.

Withdrawn Services -- The FCC Order provides that BellSouth must offer for resale at wholesale rates withdrawn services, at least for resale, to grandfathered customers. FCC Order No. 96-325, ¶ 968, at 477; 47 C.F.R. § 51.615 (to be codified). That is consistent with AT&T's position on the resale of withdrawn services that are grandfathered.

Cross-Class Selling -- The FCC Order provides that State Commissions have the discretion to permit or prohibit the resale of: (1) residential services to non-residential end-users; and (2) Lifeline and other means-tested service offerings to end users who are not eligible to subscribe to such service offerings. FCC Order No. 96-325, ¶ 962, at 475; 47 C.F.R. 51.613(a)(1) (to be codified).

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. The FCC Order makes clear that BellSouth has an absolute duty to offer for resale at wholesale rates any retail telecommunications service provided to non-telecommunications carriers. The FCC Order also makes clear that BellSouth cannot impose restrictions on AT&T's resale of such services unless the Florida Commission adopts one of the limited exceptions to that requirement. In short, the FCC Order adopts the AT&T's position on nearly all of the issues related to resale that are before this Commission.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes.

BY MR. HATCH:

Q Do you have a summary of your testimony, Mr. Sather?

A Yes, I do.

Q Would you please give your summary.

A Yes, I will. Commissioners, the quickest way to put consumers first and to give all Florida consumers a full range of telecommunications choices is via resale. My testimony asks the Commission to require BellSouth to offer for resale at wholesale prices any telecommunications service that BellSouth offers at retail to subscribers who are not telecommunications carriers. The Commission should also require BellSouth not to impose any unreasonable or discriminatory restrictions on the resale services. This means that we should start with a new slate or a clean slate in this competitive environment with the removal of all existing end user restrictions. That is beyond the three which we would agree with those included in the FCC order.

The three limitations specifically included in my testimony relate to the area of cross-selling, in other words, we agree that services that are purchased at wholesale, residential services should not be available for -- resold to business customers. We agree with the limitation that grandfathered services should be available only to the same customers that currently have them and not to new customers. We would agree that it is reasonable that as it relates to promotional offerings, that for those that are of less than 90-day duration that the wholesale pricing requirement would not be applicable.

BellSouth however, has refused to offer a host of services for resale. Specifically, grandfathered services, promotional services, contract service arrangements, Lifeline link-up services, E911, 911, N11 services. BellSouth has also requested the imposition of existing use and user restrictions.

The totality of these proposed restrictions will, in effect, undercut the ability of resale to be an effective tool to promote competition by new entrants. Resale has been an effective regulatory tool to promote the development of competition and to discipline retail prices. This has been the experience in the interexchange market. For example, since divestiture and even prior to that AT&T was required to offer all of its services for resale. Resale was a major tool utilized by MCI, Sprint, and others to become effective competitors in the long distance market. In fact, with respect to Worldcom, they started out as a small reseller in Mississippi and have grown via the use of resale services and innovative management to the fourth largest facility-based carrier in the country. We are certain that effective resale rules will allow these same positive results for consumers to be produced in the local exchange markets.

Commissioners, resale restrictions have been a part of the telecommunications industry for a long time. They served a purpose in a monopoly environment where you were pricing to produce a revenue requirement over all services. It is not sustainable in a competitive market. I think if we were to look at a comparison of a different industry we would see that they really just don't make sense. If I might, if General Motors, for example, had a franchise to sell cars in the southeast United States, and General Motors also had a car rental arrangement and a taxi capacity arrangement, if General Motors were to say you can buy a car from me, but you can't resell that car to a car rental agency, because I want to charge them a higher price because they make money on it. If you buy a car from me, your neighbor can't ride with you because that is a shared service arrangement. And until you have a unique agreement with me, you can't let anyone else ride in that car that you purchased from me. This, I think, would ring as unreasonable in any other industry and should ring unreasonable in the telecommunications industry today. Therefore, I request the Commission to require BellSouth to make its services available for resale without restriction. That concludes my summary.

CHAIRMAN CLARK: Mr. Melson.

MR. MELSON: No questions.

CHAIRMAN CLARK: Mr. Horton.

MR. HORTON: No questions.

CHAIRMAN CLARK: Ms. White.

MS. WHITE: Thank you, Madam Chairman.

CROSS EXAMINATION

BY MS. WHITE:

Q Good evening, Mr. Sather.

A Good evening, Ms. White.

Q Now, in your testimony, your direct testimony, you state that AT&T was required to make all of its services available for resale. And that was on Page 6, Lines 5 and 6?

A Yes.

Q Was AT&T allowed to reprice service services prior to offering them for resale?

A Generally it was.

Q And prior to resale, were these services priced by AT&T on a flat rated basis?

A Well, if I might, if we are getting at a couple of specific examples, for example, wide area telephone service or WATS service, was priced at a flat rate per month regardless of the amount of usage. When it was required -- not "it," not only AT&T, but all of the operating companies

-- required to make it available for resale, the structure was changed to reflect the usage. Sort of a retail and wholesale relationship between the small use and the large use arrangements.

Q I'm sorry, the small use and the large use arrangements?

A Yes. In other words, you had a higher unit price for WATS service, minutes of use, or hours purchased in small quantities and you had a lower unit price when purchased in large quantities.

Q And that was after the repricing occurred?

A Yes, that was part of the repricing.

Q Okay. As a result of the FCC order, does the Florida Commission still have the authority to impose reasonable and nondiscriminatory restrictions on resale?

A Yes, it does. I think there is significant guidelines there that they should be tailored and narrow in range, and I think that they certainly should have a public interest demonstration or requirement with them. I think part of the FCC order and part of the act presumes that resale restrictions are unreasonable. It did note that that presumption could be rebutted.

Q So if restrictions are shown to be reasonable and nondiscriminatory, then the Florida Commission has the authority under the FCC order to impose those restrictions on resale?

MR. HATCH: To the extent she is asking my witness for a legal conclusion, I'm going to have to object.

MS. WHITE: I'm asking for his opinion only. I realize Mr. Sather is not an attorney, although I wonder that sometimes. He has got a lot of experience.

CHAIRMAN CLARK: With that understanding, Mr. Sather, you can answer that question.

WITNESS SATHER: It's my reading of Section 251(c)(4)(b) that the state commissions have some latitude in allowing certain resale restrictions.

MS. WHITE: Thank you, Mr. Sather. That's all I have.

CHAIRMAN CLARK: Staff.

MR. PELLEGRINNI: No questions.

CHAIRMAN CLARK: Commissioners. Redirect.

MR. HATCH: No redirect.

CHAIRMAN CLARK: And there were no exhibits, is that correct?

MR. HATCH: That's correct.

CHAIRMAN CLARK: Thank you, Mr. Sather.

WITNESS SATHER: Thank you.

CHAIRMAN CLARK: Mr. Lerma.

MS. DUNSON: Mr. Lerma, were you previously sworn?

MR. LERMA: No.

(Witness sworn.)

Whereupon,

ART LERMA

having been called as a witness on behalf of AT&T Communications of the Southern States, Inc., and being duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MS. DUNSON:

Q Mr. Lerma, will you please state your name and business address for the record.

A Yes. My name is Art Lerma. My business address is 1200 Peachtree Street Northeast, Atlanta, Georgia, 30309.

Q By whom are you employed and in what capacity?

A I am employed by AT&T as area controller.

Q Did you cause to be prepared 19 pages of direct testimony which was prefiled on behalf of AT&T on July 31st, 1996?

A Yes, I did.

Q Do you have any changes or corrections to your direct testimony?

A No, I do not.

Q If I asked you the same questions today as are contained in your prefiled direct testimony, would your answers be the same?

A Yes, they would.

MS. DUNSON: Madam Chairman, I ask that Mr. Lerma's direct testimony be inserted into the record as though read.

CHAIRMAN CLARK: It will be inserted in the record as though read.

DIRECT TESTIMONY OF

ART LERMA

AT&T COMMUNICATIONS OF THE SOUTHERN STATES, INC.

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 960833-TP

Q. PLEASE IDENTIFY YOURSELF.

A. My name is Art Lerma and my business address is Promenade I, Room 5082, 1200 Peachtree Street, Atlanta, Georgia, 30309.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND AND EXPERIENCE.

A. In 1974, I received a Bachelor of Arts degree in Mathematics from Trinity University in San Antonio, Texas. In 1994, I received a Master of Business Administration from St. Edwards University in Austin, Texas with a concentration in General Business and Telecommunications Management.

Q PLEASE DESCRIBE YOUR CURRENT EMPLOYMENT, THE SCOPE OF YOUR RESPONSIBILITIES, AND YOUR PRIOR WORK EXPERIENCE.

A. I am employed by AT&T as Area Controller - Regional Controller Organization. As Area Controller, I have responsibility for AT&T's financial matters and for certain local exchange carrier ("LEC") cost analysis functions in the southern states area. In 1974, I began my career with Southwestern Bell as a supervisor in Accounting Operations responsible for accounts receivable processing and revenue journalization. From 1975 through 1983, I held various line and staff positions at Southwestern Bell Accounting Centers where I was responsible for data processing operations, toll operations, customer billing and collection, payrolls, accounts payable, and the production of corporate books and records. In July of 1983, I transferred to AT&T and accepted the position of Manager - Accounting Regulatory Support responsible for AT&T financial regulatory matters in Texas. From 1983 through 1988, I was primarily involved with the review of LEC cost information filed before the Texas Public Utility Commission or in other regulatory proceedings involving potential changes to access charges. In 1989, I accepted the position of District Manager - Financial Regulatory Matters.

Q. PRIOR TO THIS DOCKET, HAVE YOU REVIEWED ANY BELLSOUTH AVOIDED COST DATA?

A. Yes. In conjunction with regulatory proceedings in Georgia and Tennessee, I have had the opportunity to review avoided cost studies that were filed by BellSouth. In addition, I also have had the opportunity to review similar cost study data for other BellSouth states that was recently made available as part of AT&T's negotiations with BellSouth under the Telecommunications Act of 1996 (the "Act").

Q. DESCRIBE THE LEVEL OF YOUR FAMILIARITY WITH BELLSOUTH'S AVOIDED COST DATA.

A. I have been able to compare the above referenced BellSouth data with data filed by BellSouth in its Automated Reports Management Information System ("ARMIS") reports, with the Federal Communications Commission ("FCC"). This is publicly available data. Specifically, by using Uniform System of Accounts ("USOA") account level details found in some of the ARMIS reports, I have been able to compare data in the ARMIS reports with BellSouth's avoided costs results contained in the above referenced BellSouth data. This has allowed me to perform detailed analyses in an effort to assess BellSouth's compliance with the Act.

Q. HAVE YOU TESTIFIED PREVIOUSLY BEFORE ANY COMMISSION OR

OTHER REGULATORY AUTHORITY?

A. Yes. I filed testimony before the Texas Public Utility Commission in Dockets 7330 and 8585. I have filed testimony before the Arkansas Public Service Commission in Docket No. 86-159U. I have filed testimony before the Tennessee Public Service Commission in Docket No. 95-02499 and Docket No. 96-00067. I have also testified before the North Carolina Public Utilities Commission in Docket Nos. P-7, Sub 825 and P-10, Sub 479. Lastly, I have filed testimony before the Georgia Public Service Commission in Docket No. 6352-U.

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

A. The purpose of my testimony is to describe AT&T's recommendation for establishing wholesale rates for services sold by BellSouth to AT&T for resale by AT&T to Florida consumers.

More specifically, I discuss:

1. my opinion regarding the requirements of the Act with respect to wholesale rates for services subject to resale;
2. the methodology used by AT&T to calculate an avoided retail cost percentage reduction of 41.7% (see Exhibit AL-4) that should be applied to BellSouth's retail local rates to determine wholesale rates; and
3. the results of my analysis of BellSouth avoided cost data studies made available in other regulatory proceedings and in conjunction with AT&T's negotiations with BellSouth under the Act.

Q. DOES THE ACT ADDRESS HOW THIS COMMISSION SHOULD DETERMINE WHOLESALE RATES FOR BELLSOUTH SERVICES THAT MAY BE RESOLD?

A. The Act provides substantial guidance for determining the wholesale rates for services that incumbent LECs, such as BellSouth, must sell to other carriers for resale. The specific language in 47 U.S.C. § 252(d)(3) is that "a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, *excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier."* (Emphasis added.) Thus, to determine wholesale rates, the Act identifies three specific categories of costs that are to be excluded from retail rates: marketing, billing, and collection costs. The Act also prescribes the removal from retail rates of any "other costs that will be avoided." Effectively, the Act prescribes that *all* retail-related costs are to be removed from retail rates to establish wholesale rates.

Q. WHAT IS THE BASIS FOR YOUR CONCLUSION THAT THE ACT REQUIRES THAT WHOLESALE PRICES NOT INCLUDE ANY BELLSOUTH RETAIL-RELATED COSTS?

A. The Act's specific reference and exclusion of marketing, billing, and collection (which includes physical payment processing costs as well as uncollectible costs) from retail rates suggests that the Act's language "other costs that will be avoided" describes costs other than marketing, billing, and collection that will not be incurred because of resale. In other words, if Congress had intended to limit avoided costs only to marketing, billing, and collection costs, there would have been no need for Congress to have included "other costs that will be avoided" in the Act. There are various types of costs that vary with volumes of customers lost to resellers so that when any incumbent LEC loses a customer, the incumbent LEC's retail costs decrease. However, the Act's specific exclusion of marketing, billing, and collection costs from retail rates also shows that "other costs that will be avoided" must include not only all costs directly caused by retailing functions, but also any costs from functions that indirectly benefit or support retailing activities. As an example, with respect to marketing costs, I believe this conclusion is logical because Congress must have realized that competition in some cases will cause incumbent LECs to spend more, not less, for certain marketing activities as the local service market becomes more competitive. Thus, for some types of marketing costs, such as those related to advertising, BellSouth may opt to maintain or increase its current levels of retail advertising although not for the benefit of resellers who will be purchasing wholesale services. The basis for the Act's exclusion of marketing costs to arrive at a wholesale rate, therefore, is that such costs reflect functions that vary with volumes (such as retail sales functions) and functions caused by or only benefiting retailing activities.

AT&T'S MODEL

Q. PLEASE SUMMARIZE HOW AT&T DETERMINED THE AMOUNT OF BELLSOUTH RETAIL COSTS THAT SHOULD BE EXCLUDED FROM BELLSOUTH'S RETAIL RATES.

A. AT&T used its "Avoided Retail Cost Model" (the "Model") to identify all types of BellSouth costs associated with retail activities occurring in the local services market. The end result is a percentage that should be used to reduce BellSouth's local services retail rates in order to reflect the retail costs BellSouth will avoid when it provides local services on a wholesale basis to AT&T.

Q. WHAT ARE LOCAL SERVICES?

A. Local services include basic area message services such as flat rate local services, measured local services, "vertical" features such as call waiting and forwarding and expanded area calling plans.

Q. WHY DOES THE MODEL FOCUS ON LOCAL SERVICES?

A. AT&T has focused on the development of wholesale local services rates because this is the first services category in which AT&T intends to compete with BellSouth. However, the Model also can be used to develop separate wholesale rates for a number of other services categories, such as toll and private line.

Q. DOES AT&T'S MODEL DEVELOP REASONABLE WHOLESALE RATES FOR BELLSOUTH'S LOCAL SERVICES?

A. Yes.

Q. WHY DOES AT&T'S MODEL DEVELOP APPROPRIATE WHOLESALE RATES FOR BELLSOUTH'S LOCAL SERVICES?

A. The Model uses a methodology that is reasonable, as described further in this testimony, and that reflects the best available public data. Thus, I believe it generates appropriate wholesale rates for BellSouth's local services. If BellSouth wishes to challenge the results of AT&T's study based upon "better" data, then, in all fairness to AT&T and this Commission, BellSouth should disclose *all* necessary data for analysis by AT&T and this Commission. Until that happens, the most reasonable means for measuring wholesale rates are the data that are currently available.

Q. UPON WHAT PUBLICLY AVAILABLE DATA DOES AT&T RELY?

A. AT&T relies upon the ARMIS reports that BellSouth filed with the FCC for the year 1995. The specific data that AT&T uses are obtained from the following ARMIS reports:

<u>ARMIS 43-03 (Joint Cost Report)</u>: This report provides the regulated annual operating results of BellSouth for every account in the FCC's Part 32 Uniform System of Accounts ("USOA"). Those data are used to supplement the data from the ARMIS 43-04 report.

ARMIS 43-04 (Access Report): This is the primary data source for the Model. The report provides regulated financial and operating data separated in accordance with Part 36 and Part 69 of the FCC's Rules.

ARMIS 43-08 (Operating Data Report): This report is used as a source of operating data. Table III of the report is used to identify access lines associated with switched services. Information on toll calls and billed access minutes is derived from Table IV of the report.

Q. PLEASE SUMMARIZE THE AT&T MODEL.

A. The objective of the Model is to measure all retail costs which will be avoided by BellSouth when wholesaling services to AT&T and to express the total of the costs as a percentage of BellSouth's retail rates. The Model is divided into three "phases," each of which is described in detail below. Overall, Phase I assigns revenues and costs into seven separate categories; Phase II reorganizes revenues and costs for those seven categories into the five traditional lines of business; while Phase III analyzes the costs assigned to local services to identify costs that will be avoided, and calculates the appropriate reduction to local services retail rates to produce wholesale local service rates. The modeling process is displayed graphically as shown in Exhibit AL-1.

Q. PLEASE DESCRIBE PHASE I IN MORE DETAIL.

A. Phase I of the Model assigns revenues and costs from the ARMIS 43-04 report to one or more of six separate functional categories and the residual is accumulated in an unassigned seventh category: Billing and Collection; Directory; Intrastate Private Line; Special Access; Subscriber Line; Minute Driven; and Unassigned. For certain line items on the 43-04 report that appear on an aggregated basis, the relative percentages calculated from the more detailed 43-03 accounts are applied to separate the aggregated line items. These Phase I categories are more fully described by expense categories in Exhibit AL-2 (Treatment of ARMIS Data). Wherever possible, revenue and expenses are directly assigned to a functional category. For expenses that cannot be directly assigned, they are apportioned based on the characteristics of the expense incurred, operational data, and factors as set forth in Exhibit AL-3 .

Q. PLEASE DESCRIBE PHASE II IN MORE DETAIL.

A. Phase II of the Model takes the revenues and costs assigned to the seven categories in Phase I and ultimately groups the revenues and expenses into five traditional lines of business: Miscellaneous; Private Line; Local; Access; and Toll. Phase II has four steps. Step 1 groups the seven Phase I categories into four consolidated operational categories: Miscellaneous (Billing & Collection, Directory and Public Telephone); Private Line (Intrastate Private Line and Special Access); Subscriber Line; and Minute Driven. Step 2 assigns Minute Driven expenses to Subscriber Line, access service and Interoffice categories. Step 3 assigns Interoffice expenses to Toll Service and Local interoffice. In Step 4, Local Interoffice and Subscriber Line are consolidated to generate Local costs. The Phase II assignment of revenues and costs to lines of business is further detailed in Exhibit AL-2 by type of expense.

Q. THE ALIGNMENT PROCESS YOU JUST DESCRIBED SEEMS COMPLEX--WHY DO YOU BELIEVE THE ALIGNMENT PROCESS TO BE REASONABLE?

A. As stated previously, AT&T has used the best information available to determine costs that will be avoided when BellSouth provides local services on a wholesale basis. Adequate, *service-specific* data is currently unavailable. The AT&T Model, therefore, aligns BellSouth's ARMIS revenues and costs with logical categories of services using direct assignment where possible and reasonable apportionment elsewhere. Every cost reflected on the ARMIS 43-04 report that could not be directly assigned is apportioned to a category of services identified in the Model using assignment methodologies and factors that are consistent with the unique characteristics of the function generating the cost. Because apportionment of costs to several services categories is necessary, in some cases complex calculations are required. The alignment process used in the Model is as reasonable as possible, given information that is publicly available .

Q. PLEASE DESCRIBE PHASE III IN DETAIL.

A. In Phase III, local services costs that will be avoided when BellSouth provides wholesale services to AT&T are identified, aggregated and expressed as a percentage of local services retail revenues. The Model identifies local services costs that will be avoided in two steps : (1) identifying *direct* retail costs; and (2) identifying costs incurred in support of direct retail functions performed (*indirect* costs).

First, the model identifies *direct* costs that will be avoided based on the following criteria: (1) one of three types of costs that the Act specifically identifies as costs that will be avoided; (2) costs that will be duplicated by the reseller when it sells at retail; or (3) costs that are caused by BellSouth's retail activities. The types of costs that the Model identifies as direct costs which will be avoided based upon these criteria, including the FCC USOA account or ARMIS line item reference, and the rationale for that identification, are as follows:

1) **Uncollectibles** (included in account 5300): Costs related to uncollectibles will be avoided 100 percent because the risk for collection of open accounts receivables from retail end user customers moves from the incumbent LEC to the reseller (*i.e.*, if the end user does not pay, the reseller accepts the financial responsibility).

2) **Marketing** (includes accounts 6611-Product Management, 6612-Sales, and 6613-

Product Advertising): The Act specifically lists "marketing" costs as costs that will be avoided. The FCC's Uniform System of Accounts for Telecommunications Companies states that marketing "shall be used . . . to summarize" the costs of Product Management, Sales and Product Advertising. 47 C.F.R. § 32.6610. Moreover, in the USOA, the descriptions of Product Management ("administrative activities related to marketing products and services"), Sales ("cost incurred in selling products and services"), and Product Advertising ("costs incurred in developing and implementing promotional strategies to stimulate the purchase of products and services") clearly reflect that each of these costs are marketing costs. In addition, AT&T will incur all of these types of costs when selling at retail. Thus, the Model identifies 100 % of all such BellSouth costs as costs that will be avoided.

In addition, all costs related to end user order processing and other customer operations, such as investigating customer accounts and instructing customers in the uses of customer services and products, also are reflected under the marketing category in AT&T's Model. These types of costs are included in account 6623. AT&T intends to perform all end user customer service functions utilizing electronic interfaces. Thus, the Model identifies 100% of BellSouth's marketing costs as costs that will be avoided.

3) **Billing and Collection** (included in account 6623 along with other customer expense): Again, the Act specifically lists billing and collection costs as costs that will be avoided. AT&T's Model includes all billing related costs such as postage and billing inquiries, as well as bill payment collection costs. The Model identifies 100% of these BellSouth costs as costs that will be avoided.

4) **Operator-Related Expense**, includes accounts 6621 - call completion services, 6622 - number services (directory assistance), ARMIS 43-04 line 6040 - Depreciation-

Operator Systems, and account 6220 - Network-CO operator systems: Operator costs clearly are retail related. They are not caused by nor do they provide a benefit to a reseller buying wholesale services. Moreover, if AT&T achieves direct routing of local telephone calls to its operators, as AT&T has requested, all operator costs become costs that BellSouth will avoid. The Model identifies 100% of BellSouth's operator related costs as costs that will be avoided.

6) **Operations Testing and Operations Plant Administration** (included in account 6533 and 6534): AT&T has requested an electronic interface with BellSouth's service trouble reporting database. This will allow AT&T to perform both immediate and high quality initial trouble analysis when a customer reports trouble on his line. Based on AT&T's experience, about 50% of its own testing and plant administration costs involve end user customers. Based on this data, AT&T conservatively estimates that approximately 20% of BellSouth's customer related testing and plant administration costs will be avoided.

Second, moving from *direct* cost categories, the Model also identifies that portion of *indirect* costs (including common costs and other indirect costs) that relate to retail activities that also will be avoided. In summary, not identifying indirect costs that are attributable to retail activities will result in resellers subsidizing the cost of BellSouth's retail functions. Moreover, such costs likely will be duplicated by resellers. Thus, those portions of indirect costs attributable to retail services are costs that will be avoided under the Act. The measurement of the portion of these indirect costs that retail functions cause or benefit from, and thus which will be avoided in a wholesale environment, is described below:

1) **Network Support Expenses** (included in account 6110) and **General Support Services** (included in account 6120): Network support expenses include all costs of

transport, including motor vehicles, aircraft, other special purpose vehicles and maintenance equipment. General Support Services includes Accounts 6120 through 6124 - General Support Expenses includes Land, Building, Furniture, Artwork, Office Equipment and General Purpose Computer. The amount of Network and General Support Expenses that will be avoided equals :

$$\text{Expense} \times \frac{\text{Direct local costs that will be avoided}}{\text{Total local costs minus total local indirect costs}}$$

This formula results in a ratio that reflects the relationship between "total avoided" local direct costs and "total" local direct costs. The application of this ratio is reasonable because support expenses will vary directly in proportion to the changes in direct costs that will be avoided. For example, in a wholesale environment, BellSouth's retail sales expenses will be avoided, and therefore, support assets utilized in the retail sales function no longer will be necessary for the wholesale provisioning of local services.

2) **Depreciation-General Support** (as reflected on ARMIS line 6020): These avoided costs are determined using the formula and for the same reasons described in preceding paragraph 1 above.

3) **Executive and Planning** (account 6710), **General & Administrative** (account 6720), and **Operating Other Taxes** (account 7240). These avoided costs are determined using the formula and for the same reasons described in paragraph 1 referenced above.

4) **Return and Income Taxes:** Generally, cost studies reflect return and income tax components of costs. The portion of return related to support assets that are avoided, and the appropriate federal income taxes that should be assigned to this category of

costs that will be avoided is multiplied by a factor determined by the following formula:

$$\frac{\text{General Support facilities investment}}{\text{Total Telephone Plant-in Service}} \quad \text{X} \quad \frac{\text{Direct costs that will be avoided}}{\text{Total local costs minustotal local indirect costs}}$$

5) **Other Interest deductions:** This category represents that portion of costs associated with interest on customer deposits (as reflected in account 7540) which will be avoided because deposits will now be held by resellers. Consequently, the interest that must be paid on deposits will be incurred by resellers and thus avoided by BellSouth.

Q. **HOW IS THE AGGREGATE AMOUNT OF COSTS THAT WILL BE AVOIDED DETERMINED IN AT&T'S STUDY?**

A Exhibit AL-4 provides a summary and Exhibit AL-5 provides the details of the results of the AT&T Model. These exhibits identify both the direct and indirect retail costs that will be avoided, as well as the appropriate local services category revenues. Total avoided direct and indirect retail costs are then divided by the appropriate local services revenues to derive the specific percentage of 41.7%. This percentage represents the amount of BellSouth's retail costs that will be avoided when BellSouth sells local services to AT&T on a wholesale basis. This percentage then is applied to all local services rates to arrive at the wholesale price BellSouth should be entitled to charge AT&T for local services.

Exhibit AL-5 provides supporting detail for all local revenues and costs considered by the Model. The first column, labeled "Total Local BU," provides BellSouth's revenues and costs pertaining to a total local business unit or line of business developed through phases I and II of AT&T's model. The column labeled "avoided retail cost factor" is the percentage of each local cost category that relates to retail functions, as just discussed. The column labeled "avoided retail amount" is the product of the specific local services costs in the first column multiplied by the avoided retail cost factor in the second column.

All pertinent revenues and costs then are converted to a per subscriber line basis. The retail costs that will be avoided is obtained, by dividing the per line local services retail costs that will be avoided, by the local services revenues per line. The local services revenues per line then serves as average rates per line. With respect to BellSouth, the Model identified the local services retail costs that will be avoided by BellSouth to be $ 9.54 per line per month. The per line retail costs that will be avoided, divided by the local services revenues of $ 22.84 per line per month, produces 41.7 percent, which is the percent amount by which BellSouth retail prices should be reduced to achieve wholesale prices.

Q. **WHAT IS THE SIGNIFICANCE OF THE AVOIDED RETAIL COST PERCENTAGE?**

A. This percentage, when applied to the retail prices of particular BellSouth local services, effectively removes the costs of retail functions from BellSouth's retail rates for those services.

Q. **DOES THE AVOIDED RETAIL COST PERCENTAGE PRODUCED BY THE MODEL DIRECTLY RESULT IN A SINGLE WHOLESALE RATE FOR LOCAL SERVICES?**

A. No, it only leads to arriving at the wholesale rate for local services. The Model develops a single avoided retail cost percentage for local services. However, to calculate wholesale rates for services, that percentage is applied to the retail prices which BellSouth charges its retail subscribers for any local services sold at retail. This process is as follows:

$$P_W = P_R - (P_R \times \text{Avoided Retail Cost Percentage})$$

P_W = Price at wholesale

P_R = Price at retail

Q. WHY DOES AT&T PROPOSE A SINGLE AVOIDED LOCAL RETAIL COST PERCENTAGE?

A. The primary reason is that avoided cost data, relating to specific local services that BellSouth offers, currently is not available to AT&T or to this Commission for that matter. This includes a lack of revenues and avoided cost data relating to residential versus business customers.

If this data is made available to AT&T, AT&T will be able to analyze it to determine if the data is sufficient and appropriate for use in developing an avoided retail cost percentage for individual types of services to which the data applies.

Q. DOES THE AT&T MODEL INCLUDE COSTS, OTHER THAN DIRECT, AS COSTS THAT WILL BE AVOIDED?

A. Yes, as I discussed earlier in my testimony, that portion of indirect costs that are caused by or that benefit retail functions are considered costs that will be avoided.

Q. DOES AT&T'S MEASUREMENT OF COSTS THAT WILL BE AVOIDED ALLOW BELLSOUTH TO RECOVER ANY OF ITS JOINT AND COMMON COSTS?

A. Absolutely. Joint and common costs that are caused by, or provide benefit to wholesale functions, would be recovered by BellSouth in the wholesale price it charges AT&T for wholesale services. Remember, the avoided retail cost percentage only removes those direct and indirect retail costs, including portions of joint and common costs, which are associated with retail functions. Joint and common costs associated with wholesale functions remain in the wholesale price.

Q. **DOES A WHOLESALE RATE THAT EXCLUDES ALL RETAIL COSTS RESULT IN A BELOW COST RATE?**

A. No. The key to understanding this concept is to appreciate that BellSouth's local services rates cover all of its costs because of either of two factors: (1) the rates themselves cover all of BellSouth's wholesale costs, or (2) the rates, plus subsidies received from other local services rates (e.g., custom calling services) or other classes of service (e.g., subscriber line charges), cover all of BellSouth's wholesale costs. Thus, although wholesale prices for particular services might appear to be under cost, BellSouth continues to receive these subsidies and, thus, is fully compensated for its wholesale costs.

Q. **HAVE YOU PERFORMED AN ANALYSIS OF ANY AVOIDED COST STUDY DATA PREPARED BY BELLSOUTH?**

A. As stated previously, I specifically have analyzed avoided cost studies filed by BellSouth in regulatory proceedings in Georgia and Tennessee. I also have reviewed BellSouth's Florida avoided cost studies obtained in negotiations and have the following concerns regarding BellSouth's methodologies and assumptions:

1. BellSouth did not attempt to break its costs down to any specific tariffed services categories in either the Georgia or Tennessee avoided cost studies. Instead, BellSouth provided only proposed discounts for the general categories of residence and business services because data for these categories of services was readily available.

2. BellSouth did not provide cost information for all categories of costs. There are several categories of costs that will be avoided and that should not be reflected as costs recovered in wholesale rates. Specifically, BellSouth has not calculated any avoided retail direct costs related to product advertising, product management, operator call completion services, operator directory assistance services, network and

depreciation costs related to operator systems, and customer reported testing and plant administration. In addition, BellSouth has not reflected any avoided indirect costs including network and depreciation support costs, general and administrative costs, customer deposit expense, return pertaining to support assets, and income taxes on return.

3. BellSouth assumes a very short run perspective in performing its avoided cost study, contrary to AT&T's Model which has a long run perspective. For example, BellSouth assumes that resellers will not have electronic interfaces and therefore concludes that BellSouth will perform most customer service functions.

4. In conjunction with negotiations, AT&T obtained avoided cost studies for Florida and has determined that the same shortcomings exist with respect to these studies. Exhibit AL-6 provides a line by line comparison of AT&T's Model to BellSouth's studies. A review of this Exhibit AL-6 allows one to appropriately conclude that BellSouth has omitted numerous categories of cost details which it believes are not avoided. For illustrative purposes, I also have prepared and attached Exhibit AL-7 in an effort to restate BellSouth's study to reflect the missing avoided costs details using AT&T's assumptions.

C. OTHER ISSUES

Q. SHOULD THIS COMMISSION ORDER A REDUCTION OF RETAIL RATES TO WHOLESALE RATES FOR ALL SERVICES AVAILABLE TO NON-CARRIER SUBSCRIBERS FOR RESALE?

A. Yes.

Q. DOES YOUR ANSWER INCLUDE CONTRACT SERVICE ARRANGEMENTS ("CSAs") OR SPECIALLY PRICED SERVICES, SUCH AS PROMOTIONAL SALES?

A. Yes The testimony of Joe Gillan establishes that BellSouth's duty under 47 U.S.C. § 251(c)(4) is to offer for resale at wholesale prices any telecommunications services which BellSouth offers at retail to non-carrier subscribers, whenever AT&T requests the services for resale, regardless of how BellSouth might be pricing those services. To the extent BellSouth offers services to retail consumers, AT&T is entitled to resell those same services at the wholesale rates discussed above.

In summary, if BellSouth is obligated to sell services to AT&T for resale, then BellSouth must offer those services to AT&T at wholesale rates determined in accordance with the Act. Under the Act, the measurement of the wholesale rates begins with BellSouth's retail rates (defined to mean what BellSouth actually charges its retail customers, not merely published retail rates) for those services, whatever they may be at any given time, regardless of the justification for the rates. Thus, I believe that wholesale rates are required for services sold as CSAs, promotions or otherwise.

Q. WOULD YOU PLEASE SUMMARIZE AT&T'S RECOMMENDATIONS IN THIS PROCEEDING?

A. Yes. AT&T recommends that wholesale rates for BellSouth's services subject to resale be based upon a minimum avoided retail cost percentage of 41.7% . In support of this percentage reduction, AT&T has presented as Exhibits AL-4 and AL-5 a summary and a supporting cost study of BellSouth's costs that will be avoided when BellSouth provides local services on a wholesale basis. The direct retail costs that BellSouth will avoid include all billing costs, collection costs, costs pertaining to operator functions and systems, marketing, advertising, and uncollectibles. BellSouth also will avoid indirect retail costs, such as those related to General & Administrative expenses and costs resulting from support assets used in performing the retailing function. In addition, if this Commission decides to utilize BellSouth's studies, special attention should be given to AT&T's analysis provided in Exhibit AL-6. It is clear from Exhibit AL-6 that BellSouth has omitted from its study numerous categories of avoided costs that should be excluded from its retail rates. Additionally, AT&T's alternative analysis, attached as Exhibit AL-7, shows that when the missing categories of avoided costs are included, the results are dramatically different and are more appropriate than those prepared by BellSouth.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

BY MS. DUNSON:

Q Mr. Lerma, did you also prepare seven exhibits which were attached to your direct testimony?

A Yes, I did.

Q Do you have any changes or corrections to those exhibits?

A No, I do not.

MS. DUNSON: Madam Chairman, I would like for Mr. Lerma's exhibits to be marked for identification.

CHAIRMAN CLARK: They will be marked as Composite Exhibit 13.

(Composite Exhibit Number 13 marked for identification.)

BY MS. DUNSON:

Q Mr. Lerma, did you also cause to be prepared 13 pages of supplemental testimony which was prefiled on August 23rd?

A Yes, I did.

Q Do you have any changes or corrections to this testimony?

A Yes, I do. On this particular testimony, on Page 7 of my testimony, Line 10, right after the word reflected, the word on should be in. The next change is on Page 9, Line 25. Right at the very bottom, in that sentence there is an account there listed as 2112, that should be

2121. Then next on Page 10, Lines 1 and 2. The very top of that testimony, beginning with the words motor vehicles, the rest of that sentence should be stricken, as well as all the words up through the words other work equipment on the next line, so that that sentence would read, "These accounts include costs for buildings, furniture, office equipment, and general purpose computers respectively." Next, also on Page 11, Line 23 of the testimony, right in the middle of that sentence is says direct testing. Testing should be testimony. And one last -- well, actually the next one is on the first exhibit to my supplemental testimony, so would you like for me to do that now or separately?

Q We can do that in a minute, but we can finish this one first.

A Those are the only changes to my supplemental testimony.

Q If I asked you the same questions today as are contained in your prefiled supplemental testimony, with the corrections you just identified, would your answers be the same?

A Yes, they would.

MS. DUNSON: Madam Chairman, I request that Mr. Lerma's supplemental testimony be inserted into the record as though read.

CHAIRMAN CLARK: It will be inserted in the record as though read.

SUPPLEMENTAL TESTIMONY OF

ART LERMA

ON BEHALF OF AT&T COMMUNICATIONS OF

THE SOUTHERN STATES, INC.

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

Docket No. 960833-TP

Filed: August 23, 1996

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Art Lerma and my business address is Promenade I, Room 5082, 1200 Peachtree Street, Atlanta, GA. 30309.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by AT&T as Area Controller-Regional Controller Organization.

Q. DID YOU FILE TESTIMONY PREVIOUSLY IN THIS DOCKET?

A. Yes. I addressed the determination of wholesale prices for BellSouth services subject to resale through the presentation of an avoided cost study.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. The purpose of this testimony is to provide the AT&T simplified avoided cost ("ASAC") study. This study complies with the regulations regarding wholesale prices for services subject to resale as set forth in the FCC's Order released August 8, 1996. The ASAC study results in a recommended permanent percentage reduction of 39.99% which would apply to all Florida retail local, toll, and private line BellSouth services rates.

Q. WHAT IS THE CRITERIA SET FORTH BY THE FCC FOR USE IN DETERMINING THE WHOLESALE PRICE FOR SERVICES SUBJECT TO RESALE?

A. Generally, the FCC states that wholesale prices equal retail rates less avoided retail costs. The FCC requires that avoided costs be established by a cost study that considers the following pertinent criteria:

1. The FCC Order provides that "'the portion [of the retail rate] . . . attributable to costs that will be avoided' includes all of the costs that the LEC incurs in maintaining a retail, as opposed to a wholesale, business." FCC Order, ¶ 911, at 455.

2. The FCC Order also provides that "an avoided cost study must include indirect, or shared, costs as well as direct costs." FCC Order, ¶ 912, at 455.

3. Further, the FCC states that "[a] portion of contribution, profits, or markup may also be considered 'attributable to costs that will be avoided'

when services are sold wholesale." FCC Order, ¶ 913, at 456.

4. Under the FCC criteria, "[a]n avoided cost study may not calculate avoided costs based on non-cost factors or policy arguments." FCC Order, ¶ 914, at 456.

5. The FCC Order also provides that the Act "precludes use of a 'bottom up' TSLRIC study to establish wholesale rates that are not related to the rates for the underlying retail services." FCC Order, ¶ 915, at 456.

6. The FCC notes in its Order that "[w]e neither prohibit nor require use of a single, uniform discount for all of an incumbent LEC's services." FCC Order, ¶ 916, at 456.

7. According to the FCC Order, the direct costs in the following Uniform System of Accounts ("USOA") accounts are presumed avoidable:

6611-product management

6612-sales

6613-product advertising

6621-call completion services

6622-number services (also referred to as directory assistance)

6623-customer services (includes billing and collection)

A LEC may rebut the presumption of avoidance by showing costs will be incurred for wholesale activities or the costs are not in the retail price. FCC Order ¶ 917, at 457.

8. Under the FCC Order, indirect expenses in the following USOA accounts are presumed to be avoided in proportion to the avoided direct expenses:

6121 to 6124-general support expenses

6711, 6712, and 6721 to 6728-corporate operations expenses

5301-telecommunications uncollectibles

FCC Order, ¶ 918, at 457.

9. The FCC Order also provides that "[p]lant-specific and plant non-specific expenses (other than general support expenses) are presumptively not avoidable." FCC Order, ¶ 919, at 457. The new entrant may rebut the presumption by showing that any of those costs can be reasonably avoided.

10. Further, the FCC Order states that "based on the record before us, we establish a range of default discounts of 17-25 percent that is to be used in the absence of an avoided cost study that meets the criteria set forth above." FCC Order, ¶ 932, at 462.

Q. ARE THERE COSTS THAT THE FCC ORDER AND REGULATIONS SUPPORT AS AVOIDABLE BUT ARE NOT SPECIFICALLY CAPTURED IN A USOA ACCOUNT?

A. Yes. The FCC states that "[i]n AT&T's model, the portion of return on investment (profits) that was attributable to assets used in avoided retail activities was treated as an avoided cost." FCC Order, ¶ 913, at 456. The FCC found that this approach was consistent with the Act. The ASAC study also includes this same calculation of avoided return and the corresponding income taxes.

Q. HAVE YOU PERFORMED A STUDY THAT COMPLIES WITH THE FCC REGULATIONS FOR DETERMINING AVOIDED COSTS?

A. Yes. It is attached to this testimony as Exhibit ALS-1.

Q. BRIEFLY EXPLAIN WHAT APPEARS ON EXHIBIT ALS-1.

A. Exhibit ALS-1 is the ASAC study and includes all USOA accounts that are presumed avoidable in the FCC's Order in paragraphs 917 and 918. It also includes an amount of avoided costs pertaining to return and related income taxes as supported in paragraph 913 of the FCC Order. In addition, costs are reflected in the ASAC study that are not presumed avoidable in the FCC's rules. These costs are discussed later in this testimony. AT&T believes that all or portions of these other costs can be reasonably avoided. Exhibit ALS-1 also provides a calculation of the revenues subject to resale which in essence include all local, toll, and private line revenues. Lastly, Exhibit ALS-1 provides a calculation of the 39.99 avoided cost percentage reduction, or discount factor, that applies to Florida local, toll and private line retail services.

Q. WHAT ARE LOCAL SERVICES?

A. Local services include basic area message services such as flat rate local services, measured local services, "vertical" features such as call waiting and forwarding and expanded area calling plans.

Q. **WHAT ARE TOLL SERVICES?**

A. Toll services include message services which utilize the public long distance network and are placed over basic subscriber access lines, along with long distance calls placed from mobile and public telephones.

Q. **WHAT ARE PRIVATE LINE SERVICES?**

A. Private line services include dedicated circuits and private switching services.

Q. **HAVE YOU PROVIDED WORKPAPERS IN SUPPORT OF THE LINE ITEMS APPEARING ON EXHIBIT ALS-1?**

A. Yes. Exhibit ALS-2 is a copy of the supporting workpapers for the ASAC study. The cost and revenues are primarily obtained from the Automated Report Management Information Systems ("ARMIS") 43-03 reports as noted in the workpapers.

Q. **WHY ARE ACCESS AND MISCELLANEOUS REVENUES AND COSTS EXCLUDED FROM THE CALCULATION OF THE AVOIDED COSTS DISCOUNT FACTOR?**

A. According to the FCC regulations, "[a]n incumbent LEC shall offer to any requesting telecommunications carrier any telecommunications service that the incumbent LEC offers on a retail basis to subscribers that are not telecommunications carriers for resale at wholesale rates that are at the election of the state commission." 47 C.F.R. § 51.605(a). Access services (see 47 C.F.R. § 51.607(b)) and miscellaneous services are not generally offered to "subscribers that are not telecommunications carriers" and are excluded from the ASAC study. The methodology to accomplish the identification of access and miscellaneous costs is provided on page 3 of Exhibit ALS-2. Because access and miscellaneous costs are excluded from the calculation, access and miscellaneous revenues are not reflected ~~on~~ in the calculation of the revenues subject to resale.

Q. WHAT COSTS ARE INCLUDED IN THE ASAC STUDY THAT ARE NOT SPECIFICALLY PRESUMED AVOIDABLE IN THE FCC ORDER AND REGULATIONS AND EXPLAIN WHY THEY ARE INCLUDED IN THE COST STUDY?

A. AT&T has included costs for accounts 6220 (operator systems), 6533 (operations testing), 6534 (operations plant administration), and 6560 (the portions of depreciation expense pertaining to operator systems and general support assets). AT&T's study reflects those costs based on direction provided in 47 C.F.R. § 51.609(d). That regulation states that "[c]osts included in accounts 6110-6116 and 6210-6565 . . . may be treated as avoided retail costs and excluded from wholesale rates, only to the extent that a party proves to a state commission that specific costs in these accounts can reasonably be avoided when an incumbent LEC provides a telecommunications service for resale to a requesting carrier." Id.

Q. **WHY DOES AT&T'S STUDY CONSIDER AS AVOIDABLE THE COSTS OF OPERATOR SYSTEMS (ACCOUNT 6220) AND A PORTION OF DEPRECIATION EXPENSE PERTAINING TO OPERATOR SYSTEMS (INCLUDED IN ACCOUNT 6560)?**

A. This calculation is necessary and consistent with two other categories of costs that are presumed avoided in the FCC Order and regulations. Specifically, those costs that are captured in accounts 6621 (call completion services) and 6622 (number services) are costs that are avoided because these are operator service-related. Paragraph 917 of the FCC's Order states that these costs are avoided "because resellers have stated they will either provide these services themselves or contract for them separately from the LEC or from third parties." FCC Order, ¶ 917, at 457. Given that resellers will perform their own operator services, the LEC's wholesale business would not require the use of any operator systems and likewise would incur no operator systems equipment costs (which is the definition of account 6220 per the FCC's USOA rules) in the provision of its wholesale business. Likewise, there is a component of depreciation expense pertaining to operator systems assets included in account 6560. Because this depreciation expense is related to operator systems, it too can reasonably be avoided for BellSouth's wholesale business.

Q. **WHY DOES AT&T'S STUDY CONSIDER COSTS OF TESTING (ACCOUNT 6533) AND PLANT ADMINISTRATION (6534) AVOIDABLE COSTS?**

A. According to Part 32 of the FCC's USOA rules, account 6533 (testing expense) includes "costs incurred in testing telecommunications facilities from a testing facility (test desk or other testing system) to determine the condition of plant on either a routine basis or prior to assignment of the facilities; receiving, recording and analyzing trouble reports; testing to determine the nature and location of reported trouble condition; and dispatching repair persons or otherwise initiating corrective action." Account 6534 (plant administration) includes "costs incurred in the general administration of plant operations. This includes supervising plant operations; planning, coordinating, and monitoring plant operations; and performing staff work." AT&T has requested an electronic interface with BellSouth's service trouble reporting database. This will allow AT&T to perform both immediate and high quality initial trouble analysis (including receiving, recording and when a customer reports trouble on his line). Based on AT&T's experience, about 50% of its own testing and plant administration costs involve end user customers. Based on this experience, AT&T conservatively estimates that approximately 20% of BellSouth's customer related testing costs can reasonably be avoided. In addition, all plant administration costs incurred in support of the customer interface portion of testing functions are impacted, so that 20% of these costs can also reasonably be avoided.

Q. **WHY DOES AT&T'S STUDY CONSIDER DEPRECIATION EXPENSES PERTAINING TO GENERAL SUPPORT ASSETS (INCLUDED IN ACCOUNT 6560) AS AVOIDABLE COSTS?**

A Depreciable general support assets are the assets reflected in accounts ~~2112~~ 2121 through

2124. These accounts include costs for ~~motor vehicles, aircraft, special purpose vehicles, garage work equipment, other work equipment~~, buildings, furniture, office equipment, and general purpose computers respectively. Those assets that were previously used to support the retail business are not required in their entirety for the provision of BellSouth's wholesale business. Consequently, a portion of the depreciation expense in account 6560 pertaining to these general support assets can reasonably be avoided. The portion of this depreciation cost that is avoided is calculated using the same ratio that is used to calculate other indirect costs previously mentioned.

Q. **IS AT&T'S TREATMENT OF UNCOLLECTIBLES DIFFERENT FROM THAT REFLECTED IN THE FCC ORDER AND REGULATIONS? IF SO, WHY?**

A. Yes. The FCC's Order and regulations categorize costs from account 5301(telecommunications uncollectibles) as an indirect avoided cost. The rules specify that only a portion of indirect costs shall be determined as avoided. AT&T's study assumes that 100% of these costs are avoided because in a resale environment, the liability for end user uncollectibles transfers in total to the reseller. In fact, in the states where BellSouth has previously filed their avoided cost studies before Commissions (including Georgia and Tennessee), they too have calculated uncollectibles as 100% avoided.

Q. **HOW HAS AT&T CALCULATED THE PORTION OF INDIRECT EXPENSES , OTHER THAN UNCOLLECTIBLES, THAT ARE**

PRESUMED AVOIDABLE IN THE FCC'S ORDER AND REGULATIONS? PLEASE EXPLAIN.

A. AT&T has calculated a ratio of directly avoided costs to total direct costs which is then applied to indirect costs. This ratio is developed by taking directly avoided costs totaling $519,025,000 for BellSouth in Florida, divided by total direct costs of $1,851,059,000. The ratio that results is 28%. The ratio that is applied to avoided return and income taxes is 3.65%. That calculation is provided on page 4 of Exhibit ALS-2.

Q. **IS THE ASAC STUDY APPROPRIATE FOR THIS COMMISSION TO SET PERMANENT WHOLESALE RATES?**

A. Yes. The recommended permanent percentage reduction of 39.99% was calculated consistent with the FCC's criteria for avoided cost studies necessary for setting permanent rates. For that reason, the ASAC study does not rely on the FCC's methodology to produce interim default rates.

Q. **DOES THE ASAC STUDY YIELD A DIFFERENT AVOIDED RETAIL COST PERCENTAGE THAN THE PERCENTAGE FILED WITH YOUR INITIAL DIRECT TESTIMONY?**

A. Yes. The percentage in my initial direct ~~testing~~ testimony was 41.7% and the recommended permanent percentage in this testimony is 39.99%. The difference exists primarily because AT&T reclassified certain costs to comply with the FCC's order and calculated a retail cost percentage for all services, rather than just local services, to simplify the study.

Q. **SHOULD THIS COMMISSION ORDER BELLSOUTH TO PRODUCE A STUDY CONSISTENT WITH THE FCC REGULATIONS?**

A. No. I believe AT&T's study is fully compliant with the FCC's regulations.

Q. **WHY DOES THE COST STUDY PROVIDED IN EXHIBIT ALS-1 COMPLY WITH THE FCC'S CRITERIA AND REGULATIONS FOR IDENTIFYING AVOIDED COSTS?**

A. First, AT&T's cost study is a top-down study based on embedded costs as reflected on BellSouth's publicly available ARMIS reports. Second, all of the USOA cost categories that are presumed avoidable in the FCC regulations, are considered avoided in the AT&T study. Third, to the extent that costs are included in the study that are not presumed avoidable in the FCC regulations, AT&T provides supporting rationale that demonstrates why these costs should be reflected as avoided costs. Finally, AT&T properly identifies costs subject to proration between retail and wholesale.

Q. **IF THE COMMISSION WERE TO DISAGREE WITH YOUR CONCLUSION THAT AT&T'S STUDY IS COMPLIANT WITH FCC REGULATIONS, WHAT DO YOU RECOMMEND THE COMMISSION DO?**

A. First, available cost data in all AT&T avoided cost studies supports a retail cost reduction above the maximum default rate of 25%. Thus, the Commission should order an interim retail cost reduction at the highest end of the default range of 17-25%; specifically it should order a 25% interim cost reduction. Second, the Commission should order BellSouth to produce a detailed study and all supporting information that would allow testing and validation in a regulatory proceeding.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

BY MS. DUNSON:

Q Mr. Lerma, did you prepare two exhibits to your supplemental testimony?

A Yes, I did.

Q Would you please identify any corrections you have at this time to those exhibits?

A Yes. I have only one correction. On Exhibit ALS-1, right near the bottom of that exhibit, under the category labeled revenue base for avoided cost calculation, there is a category there listed as long distance services, and a series of accounts listed right to the left of that. It says 5121 through 5169. 5121 should be 5100. That is the only change to my exhibits.

MS. DUNSON: Madam Chairman, I would request that Mr. Lerma's exhibits be marked for identification.

CHAIRMAN CLARK: The exhibits attached to his supplemental testimony marked ALS-1 and 2 will be marked as Exhibit 14.

(Exhibit Number 14 marked for identification.)

BY MS. DUNSON:

Q And, finally, Mr. Lerma, did you cause to be prepared rebuttal testimony of 10 pages which was prefiled on August 30th?

A Yes, I did.

Q Do you have any changes or corrections to your rebuttal testimony?

A Just a couple. On Page 3 of my rebuttal testimony, Line 19, that sentence says BellSouth shows no avoided costs. Right after the word shows should be little or no avoided costs. So it should read BellSouth shows little or no avoided costs. The next one is on Page 4, Line 17. There is a numbering difference there, that Item Number 5 should be a 3. And, subsequently, on Page 6, there are two paragraphs listed as Items 6 and 7, those should be listed as 4 and 6. And those are the only changes I have.

Q If I asked you the same questions today as are contained in your prefiled rebuttal testimony, with the corrections you just identified, would your answers be the same?

A Yes, they would.

MS. DUNSON: Madam Chairman, I request that Mr. Lerma's rebuttal testimony be inserted into the record as though read.

CHAIRMAN CLARK: It will be inserted into the record as though read.

REBUTTAL TESTIMONY OF

ART LERMA

ON BEHALF OF AT&T COMMUNICATIONS OF

THE SOUTHERN STATES, INC.

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

Docket No. 960833-TP

Filed: August 30, 1996

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Art Lerma and my business address is Promenade I, Room 5082, 1200 Peachtree Street, Atlanta, GA. 30309.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by AT&T as Area Controller-Regional Controller Organization.

Q. DID YOU FILE TESTIMONY PREVIOUSLY IN THIS DOCKET?

A. Yes. I have previously filed both direct and supplemental testimony in conjunction with docket no. 960833-TP.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. The purpose of this testimony is to respond to the direct and supplemental testimonies filed by BellSouth witness Walter S. Reid. Specifically I will address both BellSouth's avoided cost study attached to Mr. Reid's direct testimony as Exhibit WSR-1 (the "original" BellSouth study) and BellSouth's avoided cost study attached to his supplemental testimony. Mr. Reid characterizes the latter as being based upon the FCC's First Report and Order No. 96-325 released August 8,1996 ("Order"). My analysis will show that neither study complies with the FCC-provided criteria for determining a permanent percentage reduction to BellSouth's retail rates in the resale environment.

Q. **HAS BELLSOUTH REPLACED ITS ORIGINAL AVOIDED COST STUDY WITH ONE PREPARED IN ACCORDANCE WITH THE FCC RULES?**

A. No. Mr. Reid in his supplemental study states that the Company does not agree with the FCC's criteria regarding the determination of avoided costs, and BellSouth believes that its original avoided cost study complies with the Telecommunications Act of 1996 (the "Act"). Mr. Reid further states he has prepared Exhibit WSR-3 which is attached to his supplemental testimony, only to demonstrate the impact of the methodology stemming from the FCC's Order.

Q. **WHAT IS YOUR ASSESSMENT OF BELLSOUTH'S ORIGINAL AVOIDED COST STUDY?**

A. BellSouth's original study appended to Mr. Reid's direct testimony improperly omits direct categories of costs that will be avoided or that reasonably can be avoided in a wholesale environment, fails to recognize avoided indirect costs, lacks sufficient detail to permit necessary adjustments to cost categories that are included, and fails to explain why it has included less than 100% of those accounts the Act says always are avoided or that the FCC Order says are presumed avoided. The following is a more detailed assessment of this study:

1. Attached as Exhibit ALR-1 is a comparison of AT&T's simplified avoided cost study ("ASAC"), which is attached to my supplemental testimony as Exhibit ALS-1, and the original BellSouth study. It is apparent from this comparison that BellSouth is not acknowledging all appropriate retail costs that it will avoid or that can reasonably be avoided when it provides those services for resale. There are numerous categories of costs that show no avoided costs at all, although clearly some costs are avoided. Also, BellSouth's study contains no data that allows for the calculation of other costs related to BellSouth's retail services that will be avoided or that reasonably can be avoided.

2. In Exhibit ALR-2, I calculate avoided cost in BellSouth's original and FCC-based studies as a percentage of BellSouth's total 1995 regulated costs by account. BellSouth shows little or no avoided costs for product management (account 6611), call completion (account 6621), and number services (account 6622-directory assistance). These are cost categories that the FCC presumes are avoided. BellSouth, however, provides no convincing rationale or evidence that these costs will remain the same when wholesale service is being provided.

Further, BellSouth concludes in its original cost study that approximately 66.72% of regulated sales expenses (account 6612) and 62.69% of regulated customer service expenses (account 6623) will be avoided. See Exhibit ALR-2. Thus, BellSouth concludes that more than 33% of regulated sales expense and more than 37% of regulated customer service expense is *not* avoided. Mr. Reid states on page 12 of his testimony that "the Company identified all regulated residential and business sales expenses in account 6612," Reid Test. at 12, but no rationale is offered to support the conclusion that over 33% of this expense must continue in a wholesale market. Similarly, there is no support for the continuation of over 37% of regulated customer service expenses, particularly where AT&T will provide all retail customer service functions via the real time electronic interfaces it is seeking with several BellSouth databases, e.g., directory listing and line information, service trouble reporting, pre-service ordering, service order processing and provisioning, and daily local usage data. For both sales and customer service costs, (accounts 6612 and 6623) there is insufficient evidence to support that anything less than 100% of retail costs will be avoided.

3. There are other categories of retail costs reflected on Exhibit ALR-1 that BellSouth will directly avoid but which BellSouth shows little or no avoided costs. The following is a list of these and the rationale supporting why they are costs that will be avoided:

a. Product management (account 6611)- Resellers will manage their own products and services. Current product management costs are incurred in support of retail sales and thus will be or reasonably can be avoided when services are provided on a wholesale basis. BellSouth reflects zero avoided costs for this category. This

BellSouth will avoid all operator related expenses. BellSouth reflects zero avoided costs for these categories.

4 ~~8~~. BellSouth has included little or no costs that are directly related to the retailing of end user services but are commingled with other corporate operations costs or general support service costs. These are the costs that are referred to as indirectly avoided when BellSouth's residence and business services are made available for resale. Exhibit ALR-1 shows these categories of indirectly avoided retail costs included in AT&T's study. Because there is a direct correlation between the total costs of a company and the level of its general and administrative expenses, the largest component of the indirect retail costs, BellSouth has inappropriately excluded the bulk of this category of avoided costs. In addition, a portion of these indirect costs are also presumed avoided in the FCC's regulations. See 47 C.F.R. Section 51.609 (c)(2).

5 ~~7~~. Based on available information, BellSouth's original cost study treats revenues related to categories labeled as Carrier Services, Public Services, and Operator Services as not available for resale. I would agree that all carrier (access) revenues are not subject to resale, but there is no basis for excluding Operator and Public services based on the FCC regulations. Further, the original BellSouth study removes several other categories of revenues for services that BellSouth has indicated it would not make available for resale such as non-recurring, grandfathered services, and revenues from Contract Service Arrangements(CSAs).

Q. HAVE YOU ANALYZED THE REVISED COST STUDY ATTACHED TO

MR. REID'S SUPPLEMENTAL TESTIMONY?

A. Yes. Attached as Exhibit ALR-3 is a comparison of BellSouth's revised cost study (the "FCC-based cost study") with AT&T's ASAC study. As is evident from Mr. Reid's supplemental testimony, BellSouth provides inadequate support for the low percentages of avoided costs it assigns to several accounts the FCC presumes are totally avoided. In fact BellSouth assigns no avoided costs at all to some of the accounts, e.g., call completion costs (account 6621) and number services (account 6622). Next, BellSouth makes no allowance for avoided profit or contribution, although the FCC Order indicates it is appropriate to do so. Lastly, BellSouth underestimates the portion of indirect costs that is avoided by employing an improper ratio calculation. The proper formula should be directly avoided costs divided by direct costs. This is the basis used in the ASAC study and is detailed in the workpapers of my supplemental testimony. The following is a more detailed analysis:

1. Costs in account 6611 (product management) are presumed avoided in the FCC's regulations. See 47 C.F.R. Section 51.609 (c)(1). In BellSouth's FCC-based study, only 19.93% of these costs are reflected as avoided with no convincing arguments that the remainder is necessary to carry on the wholesale business. This account should be shown as 100% avoided.

2. Costs in accounts 6612 (sales) and 6613 (product advertising) are also presumed avoided in the FCC's regulations. See 47 C.F.R. Section 51.609 (c)(1). In BellSouth's FCC-based study, 86.06% of sales and 95.63% of product advertising expense are reflected as avoided. Mr. Reid states that the portions reflected as not

avoided pertain to carrier services, public services, and operator services. It is not appropriate to exclude avoided costs pertaining to public services and operator services because the wholesale discount is applicable to these retail rates as well.

3. Costs in accounts 6621 (call completion) and 6622 (number services) are also presumed avoided in the FCC's regulations. See 47 C.F.R. Section 51.609 (c)(1). In BellSouth's FCC-based study, none of these costs are reflected as avoided. It is my understanding, based on the testimony of AT&T witness Jim Tamplin, that direct routing of operator services is technically feasible and therefore these costs should be 100% avoided. The FCC Order states at paragraph 917 that these costs are presumed avoidable "because resellers have stated they will either provide these services themselves or contract for them separately from the LEC or from third parties." FCC Order, Paragraph 917. Either way, these costs will be avoided.

4. Costs in account 6623 (customer services) are presumed avoided in the FCC regulations. See 47 C.F.R. Section 51.609 (c)(1). In BellSouth's FCC-based study, 65.56% of these costs are reflected as avoided. Mr. Reid states that he utilized the data from the BellSouth original cost study for this account but added as avoidable certain indirect and other expenses. The data from the original cost study is deficient because there are assumptions that many customer functions will continue to be performed by BellSouth while AT&T plans to perform all customer functions facilitated by the electronic interfaces. In addition, there are vague references to additional indirect and other expenses that have been added and to the fact that expenses for public services and operator services are again not treated as avoided. For these reasons, customer service expense should be 100% avoided.

5. Further, the FCC-based BellSouth study understates the indirect costs avoided. First, although account 5301 (uncollectibles) is referred to as an indirect expense in the FCC regulations, the entire amount is avoided by a wholesaler. The cost of uncollectibles transfers from the wholesaler to the reseller when BellSouth provides wholesale service. BellSouth included 100% of uncollectibles in avoided cost in their original cost. However, for reasons that are unexplained, it reflects only 10.91% of uncollectibles as avoided in its FCC-based study.

For all other indirect cost categories shown on Exhibit ALR-2 and ALR-3, BellSouth avoids 10.91%. This is based on a ratio of directly avoided costs to total costs. The FCC's criteria for cost studies provides that indirect costs "are presumed to be avoided in proportion to the avoided direct expenses." FCC Order, Paragraph 918. The ratio should instead be based on directly avoided costs divided by direct costs (total costs less indirect costs). This is appropriate because it is not reasonable to include in the denominator the same expenses to which the ratio should be applied. In the ASAC study this correct calculation produced a ratio of 28%.

6. Lastly, there are several other categories of costs designated as avoided in the ASAC study that are not reflected in the BellSouth FCC-related study. See Exhibit ALR-3. Specifically, the ASAC study includes a calculation for avoided return on in investment attributable to assets used in avoided retail activities. This is an approach that the FCC found consistent with the Act. FCC Order, Paragraph 913. The ASAC study also identifies other avoided costs which BellSouth does not include. The rationale for including these other costs in the avoided cost category is found in my

supplemental testimony.

Q. DOES YOUR ANALYSIS SHOW THAT EITHER OF THE STUDIES PRODUCED BY BELLSOUTH ARE COMPLIANT WITH THE FCC CRITERIA FOR COST STUDIES?

A. No. Neither of these studies complies with the FCC's criteria for cost studies and should be rejected.

Q. WHAT IS THE PROPER WHOLESALE DISCOUNT FACTOR THAT SHOULD BE ADOPTED FOR BELLSOUTH IN FLORIDA?

A. The wholesale discount of 39.99%, as accurately produced in the ASAC study attached to my supplemental testimony, should be adopted because it is produced by a cost study that complies with the Act and the FCC regulations.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.

BY MS. DUNSON:

Q Mr. Lerma, did you prepare three exhibits which were attached to your rebuttal testimony?

A Yes, I did.

Q Do you have any changes or corrections to those exhibits?

A No, I do not.

MS. DUNSON: Madam Chairman, I request that Mr. Lerma's Exhibits ALR-1 through ALR-3 be marked for identification.

CHAIRMAN CLARK: They will be marked as Exhibit 15.

(Exhibit Number 15 marked for identification.)

BY MS. DUNSON:

Q Mr. Lerma, did you prepare a summary of your testimony?

A Yes, I did.

Q Would you please give it for the record?

A Yes. The Telecommunications Act of 1996 requires incumbent local exchange companies to offer for resale its services at wholesale rates, which means retail rates less retail avoided costs. In my direct testimony, I provide my opinion regarding the requirements of the act with respect to wholesale rates for services subject to resale. At that time, I provided an AT&T avoided cost study compliant with the act that produced an avoided retail cost percentage reduction of 41.7 percent applicable only to the local category of services rates.

In my supplemental testimony, I presented AT&T's simplified avoided cost study. This study also complies with the act, and is further consistent with the FCC's order and rules released August the 8th, 1996. The study produces a uniform percentage reduction of 39.99 percent applicable to all BellSouth local, toll, and private line rates, and is the percentage reduction now recommended by AT&T. Specifically, if I can point to the chart here on the left labeled State of Florida, AT&T simplified avoided cost study, you will note at the bottom the 39.99 percent wholesale discount recommended by AT&T. For illustrative purposes, what this particular chart shows is that for the individual categories identified by AT&T as directly avoided costs and indirectly avoided costs, the percentages shown are the specific components for each of those individual sources. So, for example, product management, 1.53 percent is the component of the 39.99 percent made up by product management.

In my rebuttal testimony, I reviewed the two BellSouth studies presented by BellSouth witness Walter S. Reid. My review and analysis of these cost studies demonstrates the insufficiency of the percentage of avoided cost calculated for each account by BellSouth. And the second chart that I have to the right over here pretty much covers this. In the first column you have listed the actual amounts booked to the individual accounts that AT&T in its study has considered as avoided. You will note in the section labeled directly avoided cost, the top portion of that has a category of the services listed as presumed avoided, and then a second category of four services listed as presumed not avoided. Those were the four services that AT&T is rebutting with respect to the FCC order.

Underneath that, under the indirectly avoided costs are all the components of the indirect costs that AT&T has reflected as avoided. To the right of that you will see the specific percentages that AT&T has reflected as avoided in its study. You will note that immediately to the right of that the BellSouth Florida resale study shows the percentages that were calculated as avoided in that study. And quite a few of the categories that are presumed avoided are reflected with a zero there. And lastly, there was a BellSouth FCC based cost study that was also presented, and this column reflects the specific percentages of avoided costs presented by BellSouth in that study.

The price that resalers pay for BellSouth's wholesale services will determine the likelihood that Florida consumers will have local service choices now at competitive prices. Setting the appropriate wholesale rates will make as many services as possible available. Essentially, consumers will be the winners and receive greater value while resalers will establish a viable presence in the local exchange marketplace.

How can we ensure that wholesale rates are appropriately set? The Telecommunications Act of 1996 provides the guidance necessary and the FCC order and rules provide the consistent criteria necessary for doing this. Avoided retail costs must be identified and retail rates reduced. Paragraph 911 of the FCC order and rules concludes that the relevant retail related costs are those costs that will be avoided in maintaining a retail as opposed to a wholesale business. In this particular chart, it says resalers should not have to bear the incumbent LEC's retail costs. And what I would like to illustrate here is that on the left there, the total price to the customer today offered by the incumbent local exchange company includes not only the incumbent LEC's wholesale costs, but also its retail costs. It is those retail costs that we are trying to determine that will not be relevant in a wholesale environment. Under the situation where the resaler is providing the wholesale service to the customer, what we don't want to happen is that the price produced to the customer include not only the resalers retail costs and the incumbent LEC's wholesale costs, but that it still include a component of incumbent LEC retail cost. That is the component that should not be included in there. It is those retail costs that will be avoided and is the subject of what we are trying to identify in these avoided cost studies.

Lastly, in terms of what AT&T recommends in this case, this particular chart will show that the requested action we would like to see is that this Commission adopt the AT&T simplified avoided cost study and adopt a single statewide wholesale discount of 39.99 percent applicable to all local, toll, and private line services.

In closing, an appropriate wholesale rate will enhance the speed of which more innovative services will become available bringing greater value to consumers in Florida.

Q Mr. Lerma, does that conclude your summary?

A Yes, it does.

MS. DUNSON: The witness is available for cross examination.

CHAIRMAN CLARK: Mr. Melson.

COMMISSIONER KIESLING: Madam Chairman, could I ask one question to clarify?

CHAIRMAN CLARK: Yes, ma'am.

COMMISSIONER KIESLING: On the chart that is up there on that easel, in the upper part where you have less access cost --

WITNESS LERMA: Yes.

COMMISSIONER KIESLING: Why isn't that subtracted from the total instead of added, if it is less?

WITNESS LERMA: It is subtracted from the total. There should be a minus there next to that. It is a subtraction, just like the one for less miscellaneous cost. It is a subtraction.

COMMISSIONER KIESLING: Thank you. That's what I couldn't figure out.

CHAIRMAN CLARK: Mr. Melson.

MR. MELSON: No questions.

CHAIRMAN CLARK: Mr. Horton.

MR. HORTON: No questions.

CHAIRMAN CLARK: Mr. Lackey.

MR. LACKEY: Thank you.

CROSS EXAMINATION

BY MR. LACKEY:

Q I can't see those charts you have up there, Mr. Lerma. Are they copies of the charts that were included in the illustrative chart book that your attorneys handed out earlier?

A I believe so.

Q Is there some way we can designate these things so that you and I can know what I'm talking with without me having to point to them on the thing up there? Is there a number on them or something we can use?

A I believe that there is a number designation for the one with the 39.99 percent, Lerma 06 at the bottom.

Q All right.

A And I believe the one to the right of that is labeled Lerma 07.

Q Okay. And the bar chart that is now gone is Lerma 05?

A That's correct.

Q Now, if I understand these charts, and let's look at Lerma 07. If I understand correctly, under the column label AT&T simplified avoided cost study, you have listed the percentage of the corresponding accounts that you have removed as avoided cost, is that correct?

A That's correct.

Q All right. Now, were you in here when Mr. Ellison was testifying?

A Yes, I was.

Q Did you hear my discussion with him about AT&T's use of BellSouth's operators?

A Yes.

Q And do you know or did you know that AT&T was asking this Commission to establish an unbundled rate element for operator services for the various operator services?

A Yes.

Q Now, you have assumed in the calculation of your avoided cost study that 100 percent of BellSouth's operator services costs are avoided, is that correct?

A That's correct.

Q If AT&T uses our operators on an overflow basis, or an emergency basis, or something else, we haven't avoided 100 percent of the operator costs, have we?

A I'm not clear under what circumstance you're referring to.

Q You were in here when I was discussing it with Mr. Ellison, weren't you?

A Yes.

Q All right. And did you hear the discussion about perhaps having one of your operator service centers shut down and having an overflow requirement?

A Yes.

Q Okay. If one of your operator service centers shut down and you had a situation where you needed operator services, you intend to be able to take advantage of ours, don't you?

A I can't answer that operationally. I'm not involved in what specifically we are going to be requesting.

Q I've got a different way to approach it. You will agree with me, won't you, that if AT&T actually intends to use any of BellSouth's operator services, that your exclusion of 100 percent of those expenses would not be correct in that circumstance?

A I disagree with that.

Q Okay. Even if you are going to use our operators, even if we have to be standing by waiting for your call, you think it's fair and right to eliminate 100 percent of the operator expenses in calculating this discount rate, that's your testimony?

A Yes, it is.

Q I'm sorry?

A Yes, it is.

Q Okay. Well, suppose we have to have two operators standing by more than we would normally have just on the off chance you might call us one day, like in a hurricane or some kind of an emergency. Who pays for those operators?

A Is this with regard to the unbundled service that you were asking about awhile ago?

Q No. My question was if BellSouth has to have two extra operators, let's just assume two extra operators standing by because you all have asked for unbundled rates for operator services. And we are worried that if we had another Hurricane Andrew, you might need to use some of our operators, you would be able to use them, wouldn't you? You could just simply call up and use the unbundled rate to get to those operators, wouldn't you?

A In that hypothetical situation, yes.

Q Okay. Well, who pays for us to have the two operators standing by waiting for that emergency for you?

A In that specific example that you're talking about, those costs would not be avoided.

Q Okay. And in that circumstance, if you have eliminated 100 percent of the operator expenses as avoided in your study that would be an error, wouldn't it?

A In that hypothetical situation, it would be, but it's not the situation that AT&T intends to have. AT&T is going to use its own operators.

Q Okay. And I guess you are going to warrant here today then that there will never be a circumstance where AT&T will use any of BellSouth's operators, we can just hang up on you when you call?

A No, that is not my testimony.

Q Okay. Now, let's talk about product management. You eliminated 100 percent of product management expenses, as well, didn't you?

A That's correct, and that's consistent with the FCC order and rules that presumes that product management is a presumed avoided cost.

Q Okay. Now, you will agree with me that the things that are in Account 6611 include things like continuing research and development, product introduction, tariff applications, methods and procedures, and product delivery, don't you?

A Generally, Account 6611 those are the types of functions that are performed.

Q Okay. Now, let's assume just for the purpose of this next discussion that BellSouth is a wholly wholesale company, that we have been beaten down, we have split our company up, and we have got a wholesale network company, okay?

A All right.

Q Now, you're still going to buy our 1-FR service or at least the components of that 1-FR service, aren't you, to sell to your customers on an unbundled basis?

A I'm sorry, would you explain that again.

Q Sure. Let's assume that BellSouth is now a wholesale company. AT&T still hasn't built a local network of its own, but, you know, it has customers, it has local customers, and you are selling to those customers either -- well, it probably would have to be services obtained by taking our unbundled elements and adding them together if we were a wholesale company, wouldn't it?

A That would be one, in addition to resale.

Q Okay. Well, wouldn't we have as a wholesale company product management expenses? Don't we still have to price it?

A Well, it is conceivable that you would have some of those, yes, but in a wholesale environment they would not be anywhere near the type of level of expenses incurred on a retail basis, and that is the only information we have today is what BellSouth is incurring from a retail perspective for product management.

Q Okay. So you concede that there would be expenses, you just say that they wouldn't be as high as they are now, correct?

A I would agree that there would be some product management, and that is one of the accounts that certainly BellSouth had the ability to rebut and provide evidence as to what that level would be in a wholesale environment, and I have not seen that.

Q But you took out 100 percent of the account in your study, correct?

A Yes, consistent with the FCC order and rules.

Q Now, you have also taken out 100 percent of -- I know customer service -- yes, Account 6623. It's six lines down. 100 percent of customer services out, haven't you?

A That's correct.

Q Now, isn't it true that in that customer services account the 6623 account are the expenses associated with

BellSouth's customer services provided to interexchange carriers?

A Yes. And those specifically have been removed in the access adjustment that you see up there labeled less access costs.

Q Well, we are going to get to that shortly. How about, then, the cost related to servicing cellular carriers, that's in there, isn't it?

A Yes.

Q Have you taken that out somewhere?

A No, I don't have any specific information to identify what that is.

Q Okay. But you know that it's in there and you haven't taken it out, correct?

A No, that's not correct, because included in that access cost adjustment that we have made cost related to the provision of any cost to IXCs is included in there.

Q Well, I'm sorry, I was talking about cellular carriers I thought at the end. You had already told me that you had taken out the interexchange carriers.

A I'm sorry, I misunderstood the question then.

Q Okay. You haven't taken out the cost associated with cellular carriers, right?

A No, but I don't have any specific information as to what that is, and BellSouth hasn't provided that information, either.

Q But you know it's in there, right?

A I know there may be some in there, but I don't have any numbers as to what that could be.

Q Do you have discovery rights here in Florida? Do you know? If you don't know, that's fine.

A Yes, we do.

Q Did you ask for that information?

A No, we didn't.

Q Now, let's take a look at the call completion and the number services that you have taken 100 percent out, those are associated with the operator services, right?

A That's correct.

Q Now, down at 6533, testing, and 6534, plant operations. You have taken 20 percent of those out, correct?

A Yes.

Q Now, if I understand correctly, what you have done is you have concluded that 50 percent of AT&T's testing and plant operation administration expenses are associated with customer contacts, is that correct?

A Yes. However, let me explain what that specifically includes, because I think it's important that we do that to understand what it is that we are identifying when we say that 20 percent of those costs are avoided and that 50 percent, as you mentioned, are customer initiated. With respect to testing, in a wholesale environment what we're going to be having is if AT&T is reselling an account that -- we are reselling a BellSouth line, and that customer has problems with their line, they will call a customer repair line to AT&T and report that problem. AT&T will record that problem. We will receive it, we will record it, and we will do some initial trouble analysis. And, in fact, with the electronic interfaces that BellSouth now has agreed to provide, there is a service trouble reporting data base. And what that will allow AT&T to do when it has that customer on the line is to do what we refer to as isolation testing. We will be able to tell is the problem on the customer's premises or is the problem on BellSouth's central office. If it is in BellSouth's central office, then AT&T will refer that call to BellSouth. If it is on the customer's premises, it's likely that AT&T won't have to go back to BellSouth to let them know that that problem exists. No further testing, no further repair work will take place, but there are very time consuming costs involved in providing status back to the customer related to problems that they are having and when the repairman will be dispatched. All of these functions are costs that AT&T will be incurring. Those costs are today booked to Account 6533. And so when we indicate that 20 percent of those costs we estimate as being avoided, those are the specific costs, because BellSouth will not incur those costs on a going-forward basis.

Q I'm sorry, are you done?

A Yes.

Q Do you have a study that demonstrates how that 50 percent figure was calculated?

A What we have is that AT&T's experience was that 50 percent of AT&T's testing costs are customer initiated. With respect to that, we made a conservative estimate that 20 percent of those costs would be related to this initial customer interface, this time consuming function that I just described.

Q If you could, Mr. Lerma, I want to ask you the question, and if you can give me a yes or no answer before you explain. Do you have a study that shows the derivation of the 50 percent?

A We have --

Q Excuse me, Mr. Lerma.

A Yes, we do.

Q Okay. Do you have the study with you?

A No, I do not.

Q Is it the same study you produced in Louisiana and North Carolina?

A Yes, it is.

Q And was that a single page, a single piece of paper?

A Yes, it is.

Q And that's what you call a study?

A What that sheet represents --

Q Excuse me --

A Yes, it is. What that study represents is off of AT&T's books in Account 6533, we are able to determine what portion of those costs was pertaining to customer initiated. And from that perspective, 50 percent of those costs we believe were the customer initiated portion. It was a conservative estimate on AT&T's part to use only 20 percent in this particular circumstance.

Q All right. And there is no study at all to support the 20 percent, you just picked that figure, didn't you?

A As I said, it was a conservative estimate, yes.

Q Who picked it, by the way? Did you pick it?

A It was a collaborative discussion between my peers, and based on the information we had available to us, 20 percent we believe was a conservative estimate. Granted, if this Commission believes that that number should be lower, then that is the Commission's prerogative. But certainly it is not zero. Those are expenses that will be going away. And specifically, I have a data request that was provided by BellSouth by Ms. Calhoun, who responded that that is, in fact, the process that will take place when repair calls -- when a customer calls in. In fact, she states in that data request that if a customer calls BellSouth in error, that they will provide a telephone number to AT&T to call them when they have any repair problems. And so specifically we know that is a function that AT&T will provide, and it was a function that in the production of those costs that would be avoided, Mr. Reid made no calculation of what those costs that would be avoided and didn't produce any information.

Q You said that 20 percent was derived by, I guess you and a group of your peers. Are you all using that number all over the country, then?

A Yes.

Q Now, the costs that are on the bottom half of Lerma 07, those are those indirect costs, right?

A That's correct.

Q Now, to put a point on this discussion and make it short, Paragraph 929 of the FCC order discusses how to allocate or how to determine the ratio of indirect costs, doesn't it?

A No, I would disagree.

Q All right. Why don't we turn to it. We are talking about Paragraph 929 in that order that we earlier discussed. And before Mr. Tye says it, yes, the one we asked you all to ask them to stay. Have you got that paragraph with you?

A Yes, I do.

Q I can't find it. Paragraph 929. Now, isn't it true in 929 that the FCC says we have, therefore, substituted a more straightforward approach in which we apply to each indirect expense category the ratio of avoided direct expenses to total expenses. Did I read that right?

A That's correct, but you're reading in Paragraph 929. This is in a section of the order that pertains to the derivation of an interim default discount rate and not specifically to how the calculation of indirect costs or the portion of indirect costs that should be calculated. This is strictly for the purpose of the default range.

Q All right. And I guess you're going to tell me next that the ratio you got is from Paragraph 918 of that order, is that correct?

A 918, specifically --

Q Could I have a yes or no answer, please, Mr. Lerma?

A Yes.

Q Is 918 the paragraph you relied on?

A Yes, paragraph 918 is the paragraph I relied on.

Q Would you read the sentence in that paragraph that tells you how the ratio is to be calculated?

A Yes. Specifically, what this paragraph states beginning on the third line, it says presumed to be avoided in proportion to the avoided direct expenses identified in the previous paragraph. So what it specifically says, it is to be done in proportion. It does not give a specific formula. The formula that AT&T has used is a common sense formula that takes directly avoided costs as a percentage of direct costs and allocates those to the indirect costs. And that is a calculation that, in fact, I testified in a Texas Southwestern Bell case just last week. Southwestern Bell agreed that that was the appropriate calculation. It's my understanding that Ameritech has also agreed that that is the appropriate calculation. And MCI in its appeal to the FCC regarding this calculation here has indicated that they agree that it should be directly avoided divided by direct costs.

Q Okay. So one of your co-arbitrators said it was right, and two of the Bell companies that aren't here at the table agreed that it was right, according to you, is that your testimony?

A Yes, it is.

Q All right. Now, I want you to tell me where in Paragraph 918 the FCC laid out the numerator and the denominator of the equation necessary to get the ratio?

A Paragraph 918 only provides the guidance, it doesn't give a specific formula.

Q And Paragraph 929 gives you the -- a specific formula, doesn't it?

A I disagree, again. Paragraph 929 provides specifically what the FCC used in calculating its interim default range, and it said specifically that what they did was use a straightforward approach and not an approach that necessarily reflects -- is the correct way to reflect the proportion that they envision in Paragraph 918.

Q All right. Will you agree with me at least that if you had used the ratio that is found in Paragraph 929 that the 28 percent figure found on Lerma 07 would be smaller?

A Yes.

Q Now, you also on the bottom part of that Lerma 07 have a line that is unnumbered that is called return and income taxes, is that correct?

A Yes.

Q And so I guess you must have treated as avoided costs some return and income taxes, is that right?

A Yes. Let me explain what I treated as avoided return is not -- is an avoided return requirement. So, in essence, specifically what we are saying here is -- and the FCC in one of the accounts that it presumed is avoided, they presumed that general support assets, general support expenses would be avoided. And what this adjustment does here, it calculates a return related to the general support assets, that there would no longer be a return requirement for BellSouth in a wholesale environment. And Paragraph 913 of the FCC order and rules says that a portion of contribution, profits, or markup may also be considered attributable to costs that will be avoided when services are sold at wholesale. And in AT&T's model, the portion of return on investment that was attributable to assets used in avoided retail activities was treated as an avoided cost and we find these approaches are consistent with the 1996 act. And that's the same calculation that I have reflected.

Q The FCC rule on determination of avoided retail cost is Rule 51.609, correct?

A Yes, that is the rule specifically.

Q Do you have that rule in front of you?

A Yes.

Q Can you point to the place in that rule where it says that you can treat a return on equity as an avoided cost?

A No, I cannot, because the rules specifically provide treatment on an individual account basis. Avoided return is not done on an account basis, but the criteria for that is provided in 913 in the criteria for cost studies, Paragraph 913.

Q You can find in the order, but you can't find it in the rule, is that correct?

A No, that's not correct. I just specified that the only thing that is provided there are the treatment of specific accounts.

Q Okay. Now, on Lerma 06 there is an entry on the top half that you were asked about earlier that says less access cost, and you have got $6,677,000, is that correct?

A That's correct.

Q Now, just to make sure that I understand what this is, there are no access revenues included in your avoided cost study, so what you have tried to do is to remove the cost associated with access from this calculation, as well, is that correct?

A Yes. The calculation that I have provided in the revenues subject to resale include no access revenues. And so, therefore, in the numerator where we have calculated those costs that are avoided, this adjustment was necessary so that to the extent there were any costs related to the provision of access included in the numerator that those would be removed.

Q All right. And this adjustment is demonstrated on Lerma Exhibit ALS-2, Page 3 of 4, Worksheet 2, correct?

A You're looking at my supplemental testimony?

Q I'm looking at your exhibit, yes. Lerma Exhibit ALS-2. It's called work papers, Page 3 of 4, and it has got Worksheet 2 across the top of it.

A Yes, that is the methodology.

Q And what you did, if I understand correctly, is you went to Bela, Pennsylvania and got the information that you used to make this calculation of the access costs that should be removed, is that correct?

A Yes. Bell Atlantic of Pennsylvania provided methodology publicly in the proceedings that they were involved with with AT&T as to how they identified access costs that were included in the avoided cost calculation. We used that methodology and applied it to BellSouth's actual expenses to calculate the avoided cost number.

Q And the same thing is true on Lerma 06 of the row at the bottom, less miscellaneous cost, that comes off this same worksheet, doesn't it?

A That's correct.

Q And, again, it's based on the information you got from Bell Atlantic, right?

A That's correct.

Q Now, I want to focus back up on the access costs. You took out $6,677,000, correct?

A Yes. That is the amount that was removed from the numerator of the avoided cost calculation.

Q All right. Now, Mr. Lerma, you know, don't you, that the Florida Public Service Commission telephone earnings surveillance report filed by BellSouth Communications, Inc. is a public document?

A Yes.

Q And you know that because Mr. Reid referred to it in his rebuttal testimony, didn't he?

A Yes, I do remember that.

Q Now, I want to hand you a document and see if you can identify it for me.

MR. LACKEY: Madam Chairman, I've only got three copies. That's all the clerk had before the copier died. If we need more copies, I will furnish them, but I believe you can take notice of an official report that's on file with you, unless there is an objection.

CHAIRMAN CLARK: So are you going to give a copy to Mr. Tye and his witness?

MR. LACKEY: I am. I've got three copies, is all I've got.

CHAIRMAN CLARK: Well, are you requesting that we take official notice of something? Do you need to do that?

MR. LACKEY: What I would like to do is just see if he will look at it and agree, and that way I won't have to clutter up the record. I'm just telling you I have only got three copies. So that's what I'm going to try first.

MS. DUNSON: Could he tell us what report he is looking at.

MR. LACKEY: I'm going to bring it to you.

CHAIRMAN CLARK: Mr. Lackey, while they are looking at that, how much more do you have for this witness?

MR. LACKEY: This is it. When I'm through with this, I will be done. Well, I actually have one more question while they are looking at that, if I could.

BY MR. LACKEY:

Q Mr. Lerma, when you made your analysis, you were here when I was talking to Mr. Ellison you said already, correct?

A Yes.

Q And I made reference to your exhibit and the fourth page where you used 11.25 cost of money? I had that right, didn't I?

A That's correct.

MR. LACKEY: Well, Madam Chairman, the table Grinch has eaten the other two copies of the surveillance report. We will find it here in a few minutes.

BY MR. LACKEY:

Q Mr. Lerma, let me hand you what --

COMMISSIONER KIESLING: Why don't you get on a microphone, Mr. Lackey.

MR. LACKEY: I'm going that way, Commissioner.

COMMISSIONER KIESLING: But you're talking while you're going.

MR. LACKEY: I'm sorry. I've got to tell you this is my eighth straight day of this, and --

COMMISSIONER KIESLING: Do you want this on the record? If you do, you need to get to a mike.

MR. LACKEY: Madam Chairman, I have now given a copy to counsel, for Mr. Lerma, and I have one.

BY MR. LACKEY:

Q Do you see the document that I have placed in front of you, Mr. Lerma?

A Yes.

Q Turn to Page 2 of that document, would you, please. It's actually the third page in since the second page is Page 1A.

A Yes.

Q Do you see the heading operating expenses?

A Yes, I do.

Q Do you see the heading on Line 10 called customer operation expense?

A Yes.

Q Now, do you see the column marked 2, interstate toll?

A Yes, I do.

Q Now, interstate toll, BellSouth doesn't have any interstate toll except in those occasional areas where a LATA may lap over a state boundary, does it?

A That is my understanding.

Q So what BellSouth has on an interstate basis is access charges, correct?

A It's what BellSouth has allocated as an access expense.

Q Well, I haven't gotten to the expense yet. What BellSouth has on an interstate basis is access charges?

A Yes.

Q That's the revenue source, right?

A Yes.

Q And if you look over at Column 5, where it says intratoll interterritory, that is intrastate interLATA access, isn't it? That's what intratoll interterritory is for BellSouth in Florida.

MR. TYE: Madam Chairman, is Mr. Lerma being asked to vouch for what these things are, these numbers? He didn't prepare the report. BellSouth prepared the report and submitted it. We don't know if it has even been audited. He is being asked questions on a report that I don't think he has ever seen and he is not familiar with. And it appears to me it's more appropriate for a BellSouth witness to handle this.

MR. LACKEY: Actually, Madam Chairman, I don't think I have asked him about a number on it yet. I have just asked him about columns. And what we are doing --

CHAIRMAN CLARK: Mr. Tye, I understand the questioning to sort of seek a common ground and a common understanding of what the columns are, and I'm going to allow him to ask the questions.

MR. TYE: To the extent the witness understands. I'm afraid Mr. Lerma has never --

CHAIRMAN CLARK: Mr. Tye, if he doesn't understand, he can say so.

MR. TYE: Thank you.

BY MR. LACKEY:

Q Now, Mr. Lerma, how long have you been in the telephone business, by the way?

A Almost 23 years.

Q 23 years. Okay. And you understand that for a company like BellSouth, the Bell Operating Company, that when it talks about interterritory revenues, it's talking about access within the state, intrastate interLATA access, you understand that, don't you?

A I'm not sure I'm clear on that.

Q All right. Did you happen to read Mr. Reid's rebuttal testimony, Mr. Lerma?

A Yes, I did.

Q Didn't Mr. Reid lay this out chapter and verse in his rebuttal testimony for you?

A Would you specifically show me where you're referring to?

Q Of course.

MR. LACKEY: Madam Chairman, I do only have one copy of Mr. Reid's testimony with me, but I assume the other parties have it. I'm sorry, I must have picked up the wrong set. Let me try again.

COMMISSIONER KIESLING: I think it's time for us to schedule another remedial course.

MR. LACKEY: I sort of look helpless, don't I, just sort of standing here.

CHAIRMAN CLARK: Get close to the mike when you make any comments, please.

BY MR. LACKEY:

Q Do you have Mr. Reid's rebuttal testimony with you?

A No, I don't.

Q I'm going to show you Mr. Reid's rebuttal testimony and ask you to turn to Page 19 in it, please.

A Okay.

Q Now, you have read this testimony before, haven't you, Mr. Lerma?

A Yes, I have.

Q And didn't Mr. Reid in his rebuttal testimony point out that in the surveillance report at the place that I took you to, you could see almost $127 million in costs that are avoided, not $6 million?

A Yes, but that is an inappropriate calculation, because what he has got reflected here are separated results for access, and included in separated results you have what they call SPF, subscriber plant factor allocations that include subscriber line costs that are allocated to toll. There are subscriber line costs that will be avoided and have nothing to do with the provision of access, and that's why specifically when the FCC order and rules came out that dealt with the identification of relevant retail costs that are avoided, there was no specific reference made to the use of any separated results.

Q Well, that allocator you mentioned a minute ago is 25 percent, isn't it?

A That is the amount that's allocated to the interstate, but there is also an intrastate subscriber plant factor that allocates costs to the intrastate toll arena including access, and there are subscriber line costs included in that.

Q Well, even if you took 25 percent off of 127 million, you have got a lot more than 6.7 million, don't you?

A It doesn't work that way. It's 25 percent of subscriber line costs, not 25 percent of the costs that are booked to the interstate.

Q So your position is that Mr. Reid is simply wrong, and that these numbers don't relate to access costs, is that your testimony?

A Yes. His demonstration is using separated access dollars that have nothing specifically to do with the actual provision of access. There are costs that have been allocated access and over time specifically accesses recovering costs other than just what it actually takes to provision access.

Q Oh, I see. You don't contest that the 127 million is costs that are allocated to access, you are simply saying it's not a proper allocation, is that correct?

A That's correct. And remember that the adjustments that I have calculated up here attempts to identify only those costs related to the provision of access. The actual retailing costs. So the extent, for instance, that BellSouth is selling access to IXCs, is providing customer service to IXCs, it is only that portion of access expense that we are referring to here, not all costs that are allocated to access. Because as I mentioned before, there are costs allocated to access that involve subscriber line costs that will be avoided and it would be inappropriate to use separated information.

Q And you think this is separated information?

A It appears to me.

Q If it wasn't, would it change your answer?

A I'm sorry, I didn't hear that.

Q If it wasn't, would it change your answer?

A I would be speculating, I'm sorry.

Q Well, I'm sort of curious. Awhile ago I asked you what the column meant and you didn't know, and now you know all of this about that exhibit. Had you seen that before? Did you look at all of this before?

A I know generally about separations. I had not spent the time looking at this exhibit, but I am familiar with how the separations process works.

MR. LACKEY: That's all I have. Thank you, ma'am.

CHAIRMAN CLARK: Staff, how much do you have?

MS. CANZANO: Probably about five minutes worth.

CHAIRMAN CLARK: All right. And is there a lot of redirect?

MS. DUNSON: No, I just have a couple of questions.

CHAIRMAN CLARK: All right. Let's see if we can finish it up, Mr. Lerma.

CROSS EXAMINATION

BY MS. CANZANO:

Q Mr. Lerma, do you believe that the USOA accounts that AT&T provided in its simplified avoided cost study meet the requirements of the Telecommunications Act of 1996? And I realize that you're not an attorney.

A Yes, in my opinion they do.

Q Do you also believe that those same USOA accounts meet the requirements of the FCC's order, again with that same qualification?

A Yes.

Q Have you had an opportunity to review your deposition transcript and late-filed deposition exhibit that staff has assembled and identified as AL-8?

A That is the deposition transcript, my deposition transcript?

Q Yes.

A Yes, I have.

Q Do you have any changes to make to that?

A Yes, just a couple. On Page 16 of that deposition transcript, I believe it is on Line 24, where it says saline, it ought to be salient. And on Page 24 of that transcript, on Line 22, I believe there is reference there to an Account 621, it should be 6120. Those are the only two changes that I saw in there.

Q And with those changes, is this document true and correct to the best of your knowledge?

A Yes, it is.

MS. CANZANO: I would like to have this marked as an exhibit at this time.

CHAIRMAN CLARK: It will be marked as Exhibit 16.

MS. CANZANO: Thank you, Mr. Lerma. Staff has no further questions.

(Exhibit Number 16 marked for identification.)

CHAIRMAN CLARK: Commissioners. Redirect.

MS. DUNSON: I just have a couple of questions.

REDIRECT EXAMINATION

BY MS. DUNSON:

Q Mr. Lerma, would you turn back to your chart that is marked Lerma 6?

A Yes.

Q I believe Mr. Lackey was asking you several questions about this chart dealing with operator services, do you remember those questions?

A Yes.

Q Now, assuming that AT&T resells BellSouth's services, and AT&T needs to purchase operator services on an emergency basis from BellSouth as an unbundled element. Would you assume that BellSouth would charge AT&T a price for that operator service?

A Yes.

Q Do you believe that BellSouth would recover the cost of providing that operator services through the price that it charges for that unbundled element?

A That's correct, it would.

MS. DUNSON: Thank you. I have no further questions.

CHAIRMAN CLARK: Exhibits.

MS. DUNSON: Madam Chairman, I move for the admission of Exhibits 13, 14, and 15 into the record.

CHAIRMAN CLARK: They will be admitted without objection.

MS. CANZANO: And staff moves Exhibit 16.

CHAIRMAN CLARK: It will be admitted without objection. Thank you, Mr. Lerma.

We will begin tomorrow at 9:00 o'clock, and we will begin with Mr. Carroll. See you all at 9:00 o'clock.

(Exhibit Numbers 13, 14, 15, and 16 received into evidence.)

(Transcript continues in sequence in Volume 5.)