AT&T

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October 19, 1996

Mrs. Blanca S. Bayo
Director, Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

RE: Docket No. 960847-TP
Petition by AT&T Communications of the Southern States, Inc. for arbitration of certain terms and conditions of a proposed agreement with GTE Florida Incorporated concerning interconnection and resale under the Telecommunications Act of 1966

Dear Ms. Bayo:

At the hearing this week in the above docket, AT&T agreed to provide the following documents to the Commissioners and parties:

1. A readable copy of the deposition of Dr. David Kaserman which was stipulated into the record by the parties. 11161-96-10/18/96 16

2. The complete document for Exhibit No. 59, Ordering and Billing Forum Issue Identification Form. This exhibit was admitted into the record pending submission of the complete text of the document. 11162-96-10/18/96

I am enclosing an original and 15 copies of each of the above documents. A copy of this letter is enclosed. Please mark it to indicate that the original was filed and return the copy to me. Copies have been served to the parties.

Sincerely,

Tracy Hatch

Tracy Hatch

ACK ___
AFA ___
APP ___
CAF ___
CMU Reitz
CTR ___
EAG ___
LEG 1
LIN 5
OPC ___
RCH ___
SEC 1
WAS ___
OTH ___

Exhibits given to Matilda to place w/ hearing exhs. Jan

DOCUMENT NO. DATE
11161-96 10/18/96
FPSC - COMMISSION CLERK

CERTIFICATE OF SERVICE

DOCKET NO. 960847-TP and 960980

I HEREBY CERTIFY that a true copy of the foregoing has been furnished by U. S. Mail or hand-delivery to the following parties of record this 18th day of October, 1996:

Kimberly Caswell
c/o Ken Waters
GTE Florida Incorporated
Tallahassee, FL 32301-7704

Donna Canzano
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Florida Public Service Comm.
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Tracy Hatch

Tracy Hatch

960847

David L. Kaserman October 4, 1996

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CONDENSED TRANSCRIPT AND CONCORDANCE
PREPARED BY:

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ARBITRATION BETWEEN
AT&T and GTE
BEFORE THE PUBLIC UTILITY COMMISSION

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IN RE: PETITION BY AT&T : DOCKET NO. 960847-TP
COMMUNICATIONS OF THE :
SOUTHERN STATES, INC. FOR :
ARBITRATION OF CERTAIN :
TERMS AND CONDITIONS OF A :
PROPOSED AGREEMENT WITH GTE:
FLORIDA INCORPORATED :
CONCERNING INTERCONNECTION :
AND RESALE UNDER THE :
TELECOMMUNICATIONS ACT :
OF 1996. :

Deposition of DAVID L. KASERMAN
(Taken by Respondent)
Auburn, Alabama
October 4, 1996

Reported by: Paige Paugh, Certified Professional
Reporter and Notary Public

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IN RE: PETITION BY MCI : DOCKET NO. 960980-TP
TELECOMMUNICATIONS :
CORPORATION AND MCI METRO :
ACCESS TRANSMISSION :
SERVICES, INC. FOR :
ARBITRATION OF CERTAIN :
TERMS AND CONDITIONS OF A :
PROPOSED AGREEMENT WITH :
GTE FLORIDA INCORPORATED :
CONCERNING INTERCONNECTION :
AND RESALE UNDER THE :
TELECOMMUNICATIONS ACT :
OF 1996 :
--------------------------x

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APPEARANCES:
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For the Respondent:
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ALSO PRESENT:
BETH CULPEPPER (via telephone)
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Tallahassee, Florida 32399
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Lowder Business Building
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Auburn, Alabama
(334)844-4000 Ext. 2905

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Deposition of DAVID L. KASERMAN taken by the Respondent at The Auburn University Hotel and Conference Center, College Street, Auburn, Alabama on the 4th day of October, 1996, at 1:45 p.m. before Paige Paugh.

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PROCEEDINGS

Whereupon, DAVID L. KASERMAN, having been duly sworn, was examined and testified as follows:

EXAMINATION BY COUNSEL FOR RESPONDENT

BY MR. MIRENGOFF:

Q. This is the deposition of Professor David Kaserman in the arbitration proceeding of AT&T and GTE before the Florida Public Utility Commission. Good afternoon, Professor Kaserman.
A. Good afternoon.
Q. Have you had a deposition taken before?
A. Yes.
Q. So you are familiar with the procedure?
A. Yes.
Q. I am just going to ask you a series of questions about your economic opinions in this matter, and if anything needs clarification, just let me know and I will be happy to try and clarify the question. If you need a break at any time, let me know and we will do that.
A. Thank you.
Q. Professor Kaserman, would you agree that the policy thrust of the Telecommunications Act of 1996 is to promote efficient competition

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in all telecommunications markets?
A. Yes.
Q. Is it fair to say that efficient competition exists when efficient entry occurs and inefficient entry does not?
A. No.
Q. What is your definition of efficient competition?
A. I don't believe I am familiar with the term efficient competition. I am familiar with the term effective competition. Now, you can have efficient or inefficient entry by firms that are efficient or inefficient. And that may or may not lead to effective competition.
Q. What is your definition of effective competition?
A. The definition of effective competition I think that is generally accepted in the economics literature would be synonymous with the definition of an older term called workable competition. It is a little bit of a step back from the notion of perfect competition. And the idea is that there is a sufficient intensity of competition such that public policy intervention in the market basically wouldn't lead to any

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basic improvement in the performance.
Q. What is the standard that competition is being judged against?
A. In general it is the standard of effective competition in policy matters. You can't really judge real markets against the theoretical standard of perfect competition.
Q. What is the standard – how do we know when there is effective competition and when there isn't?
A. To determine whether or not there is effective competition in a market, one needs to examine the underlying market structure factors that go into a determination of the intensity of competition.
Q. If efficient entry is occurring and inefficient entry is not occurring, is that effective competition?
A. No.
Q. What would have to happen in order to move to effective competition?
A. For effective competition to be present in a market, you have to have a sufficient amount of entry occur so that the firms in that market – the firms in that market's pricing decisions

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are adequately constrained by market forces, or you have to have – in the absence of that amount of entry, you have to have entry barriers that are sufficiently low that potential competition can produce the same result; that is, constrain the incumbent firm's pricing discretion.
Q. If inefficient entry is occurring, is that effective competition?
A. The answer is more or less the same. It is not that some entry creates competition. It is whether or not there is enough entry to create competition and/or whether the barriers to entry in that market are sufficiently low. In regard to inefficient entry, it has been well known for a long time that even inefficient entry can intensify competition in a market subject to significant monopoly power. In other words, consumer or social welfare can improve even with inefficient entry in the presence of monopoly.
Q. Was it your understanding that one of the goals of the Telecommunications Act of 1996 is to encourage inefficient competition?
A. Well, again, you have gone back to a term –

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Q. I am sorry. Inefficient entry. Let me rephrase the question. Thanks for clarifying that.
Do you think that it is one of the goals of the Telecommunications Act of 1996 to encourage inefficient entry?
A. No. I don't think it is necessarily the goal to prohibit inefficient entry.
Q. So you think –
A. But I certainly don't think it is a goal to encourage inefficient entry.
Q. Is it your testimony that the Telecommunications Act of 1996 is neutral as to whether there should be inefficient entry?
A. No. I think that if the provisions of the act are implemented in accordance with the law, which I believe by the way is basically what the FCC order does with some exceptions, that the entry that is encouraged will be efficient entry.
Q. You think that is one of the goals, a desirable outcome under the Telecommunications Act of 1996, correct?
A. Yes.
Q. Does efficient entry in the context of the local exchange telephone market mean entry by

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firms that holding quality constant are able to perform at costs that are equal to or less than the ILEC's costs?
A. Yes. That could be a definition of efficient entry.
Q. Would inefficient entry be entry by firms that are not able to perform at costs that are equal to or less than the ILEC's costs?
A. Yes.
Q. You are not advocating that the Florida Commission should adopt the pricing rule that encourages inefficient entry into the local exchange market, are you?
A. No.
Q. Isn't it true that the purposes of the Telecommunications Act of 1996 are not served by subsidizing entry into the local exchange market?
A. That's correct.
Q. And subsidizing entry into the local exchange market isn't sound economics either, is it?
A. I think it probably would not be.
Q. Didn't you state in a report authored by you and several of your colleagues that subsidizing entry into the local exchange market

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isn't sound economics?
A. We probably did.
Q. You don't – you are not changing that view now?
A. No, sir.
Q. You have concluded, haven't you, that prices for interconnection and unbundled network elements must be subsidy free?
A. Yes. Should be subsidy free.
Q. And doesn't subsidization occur when services or elements are priced below the economic costs of providing those products?
A. You will have to tell me what you mean by economic costs for me to answer that.
Q. What is your understanding of economic costs?
A. Let me just say I think it is being used in several different – with several different definitions. The FCC order defines economic costs to be what they refer to as TELRIC, L-R-I-C, plus an appropriate allocation of forward looking common costs. I think in the general economic literature, however, the term economic costs is just used to distinguish what economists mean what they talk about costs from

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what accountants mean when they talk about costs.
Q. So you think the FCC order departed from the normal economic definition of economic costs as that term is used by economists?
A. It uses it in a different way than I am used to it being used. But they do clarify the definition in the order.
Q. I am sorry? They clarify the definition?
A. They clarify what their definition is of economic costs in the order to be what I told you a minute ago.
Q. Which is different from how you as an economist would use the term?
A. Yes.
Q. Focusing now on the economic definition that you as an economist would use, does the concept of economic costs include the value of all inputs required for production including the implicit value of the inputs owned by the producer?
A. Again, we are running into some definition problems. What do you mean exactly by implicit value?

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Q. Well, haven't you written a book that defines those various terms?
A. I have written several books. I am not sure if we define that term in that book or not.
Q. That is certainly a fair response. You were the author along with Professor Mayo of a book called Government and Business; is that correct?
A. Yes.
Q. When was that book published?
A. 1995.
Q. Rather than ask you unfairly to speculate about precise language in the book, I will just ask you to turn to page thirty-two. I believe you will see in the second full paragraph a discussion of the economic concept of costs including a discussion of implicit costs.
A. Yes. This gets at that distinction I was talking about earlier, the distinction between economic costs and accounting costs.
Q. Right.
A. And the fundamental distinction is how and whether indeed what are called implicit costs are accounted for.
Q. And in the standard economic definition

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of economic costs, implicit costs are included, correct?
A. Yes. Where the implicit costs are defined to be the opportunity costs of the resources owned by the firm.
Q. Right. So opportunity costs, then, are included in the standard economic profession definition of economic costs, correct?
A. In the definition of the economic cost to the firm. Now, we also have to make a distinction between private and social costs.
Q. Let's talk about the cost of the firm.
A. You are talking about the private cost, then?
Q. Right. The private economic costs include opportunity costs, correct, in the standard economic definition?
A. Yes.
Q. Thank you. With the standard economic definition in mind, then, does subsidization occur when services or elements are priced below the economic costs of producing these products?
A. No.
Q. Does subsidization occur when services or elements are priced below the economic costs

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as defined by the FCC?
A. No, not necessarily.
Q. Can you explain that answer, please?
A. Yes. The standard for subsidization is one that was to my knowledge originally described in a paper in the American Economic Review by Gerald Faulhaber. And fundamentally an individual service or output in a multi-product firm is receiving a subsidy if the service is priced below its total service long run incremental costs or in the FCC's redefinition or re-labeling, if you will, of that term, the T-E-L-R-I-C of that service. If it is priced below that, it is receiving a subsidy.
Q. Where does that -- where in the economic literature is the concept of subsidization linked specifically to TSLRIC or TELRIC?
A. Gerald Faulhaber's paper in the American Economic Review. I can get you the citation if you want me to look it up in the book you were just flipping through. I'm sure it's cited in there.
Q. If we have the name, I guess we will be able to find it.

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A. Sure.
Q. Haven't you stated in your testimony to the commission that subsidization occurs when services or elements are priced below the relevant economic costs?
A. I very well may have said that. And the relevant costs for subsidization is TELRIC or TSLRIC.
Q. Did you say that in your testimony?
A. I don't know. I don't recall if I said that precisely or not, but that was the point of putting the adjective relevant there.
Q. Do you agree with the statement in the FCC's first report and order, and I am quoting now from the order at paragraph eleven, quote, the incumbent LECs have economies of density, connectivity and scale?
A. Do I agree that they have some economies of scale?
Q. Yes.
A. Yes. I am sure there are some economies, yes. How widely they extend is an empirical question.
Q. Do you agree with the statement in the FCC's first report and order, and I will quote

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here from paragraph six seventy-nine, that as a result of the availability to competitors of the incumbent LEC's unbundled elements at their economic cost, consumers will be able to reap the benefits of the incumbent LECs economies of scale and scope?
A. Do I agree with that?
Q. Yes.
A. Yes.
Q. And hasn't the FCC stated that one of its goals is to enable entrants to share the ILEC's economies of scale?
A. Yes.
Q. So part of what the FCC envisions the entrants obtaining from the ILECs is the benefit of the ILEC's economies of scale, correct?
A. Yes. Again, whatever those economies are.
Q. And if the entrants obtain the benefits of the economies of scale without paying for them, doesn't that amount to a subsidy?
A. I don't know of anyone that has proposed they obtained them without paying for them.
Q. I understand that. But if that did

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occur, if they obtain the benefits of scale without paying for them, that would amount to a subsidy, wouldn't it?
A. If we were to price unbundled elements below TELRIC, that would constitute a subsidy.
Q. That wasn't – can you answer the precise question?
A. Let me have it again.
Q. If the entrants obtain the benefits of economies of scale without paying for them, doesn't that amount to a subsidy?
A. Sure. The phrase, without paying for them, suggests to me that they are not paying anything for them, they are paying zero for them. Some you are providing them unbundled elements at a price of zero which is below TELRIC and therefore it's a subsidy.
Q. Even if they pay something, but if what they pay does not include payment for the economies of scale that they are getting, that would be a subsidy, too, wouldn't it?
A. I have never seen anybody set a price for an economy of scale. Economy of scale determines the firm's cost and the structure of those costs as they change their output. And the

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prices then are based on those costs. So I can't – the question is sort of nonsensical in the sense that nobody buys economies of scale. You buy unbundled elements, and economies of scale then determine the costs of providing those unbundled elements.
Q. Didn't you just testify previously that one of the FCC's goals is that the new entrants will obtain the economies of scale?
A. They obtain the benefits of whatever economies of scale may be there, and the way they obtain those benefits is by efficient cost-based pricing which the FCC has advocated.
Q. Isn't it true that firms possessing economies of scale and scope have common costs?
A. In general, the existence of – it is sort of the other way around. It is sort of the existence of common costs is generally perceived to be the source of economies of particularly of scope.
Q. And if there are significant economies of scale and/or scope, isn't that a sign that common costs are probably significant as well?
THE WITNESS: Can you read that back?
(Requested portion of record read.)

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A. Well, I guess it depends on what you mean by significant. I assume you are referring to some sort of a magnitude. You can have common costs that are low but significant in the sense that they are there. They are present. We know they are there. And that may lead to some economies of scope that may or may not be significant.
Q. Is there a correlation between the magnitude of the common costs and the magnitude of the economies of scale and scope?
A. I would think in general there would be a positive correlation between the size of the common costs and the magnitude of the economies of scope, keeping in mind that these things don't extend forever like economies of scale. They can exist over one range of output and then disappear as you move into a higher range of output or a lower range – well, I would say a higher range of output.
Q. I guess I didn't quite understand your testimony from a moment ago. And I am going to try and restate it. Please correct me if I don't get it right. You said that common costs could be significant but low?

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A. Yes.
Q. Could you explain how that would happen?
A. It is simply – significant is a lot of times used in a statistical sense. And you can have a statistically significant let's say coefficient in a regression model, but it may be a very, very small coefficient. In other words, it has a significant effect, but the magnitude of that effect may not be very large.
Q. Let me clarify. I wasn't talking about significant in some statistically – I just meant by significant, I just meant pretty large.
A. That is a different concept.
Q. When you were answering my questions about significance, were you answering them significance as a concept of being bigger rather than smaller?
A. No. I was answering them with regard to we know they are there and they are present. We are confident that there are some common costs and the question is how large are they. And what is the magnitude of the economies of scope they might generate and over what range of output do those economies extend.

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Q. Since you may not have understood what I meant by significant when I was asking the questions the first time around, let me backtrack and see if the answers change. If economies of scope and scale are significant in the sense of bigger rather than smaller, aren't the common costs likely also to be significant in the sense of bigger rather than smaller as well?
A. Yes.
Q. You have stated in your testimony to the Florida Commission that GTE has a regulatory-induced advantage not shared by its potential competition. Wasn't that your testimony?
A. Yes.
Q. Doesn't GTE face certain regulatory-induced disadvantages that are not faced by the competition?
A. You would have to describe them to me. I am not sure. I am not ruling that out. I don't know what they are.
Q. Will GTE's competitors be required by regulation to provide service to a set of customers at prices below marginal cost?

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A. I think that is one of the things that remains to be seen.
Q. Let's assume that GTE's competitors such as AT&T are not required by regulation to provide service to a set of customers at prices below marginal cost and let's also assume that GTE continues to be required by regulation to do that, to provide services to a set of customers at prices below marginal cost. Under those assumptions, wouldn't that be a regulatory-induced disadvantage to GTE?
A. Let me give you two responses. First, whether GTE currently provides any services at a price below its marginal cost is an empirical question and there are diametrically opposing opinions on that question in the literature and in the regulatory realm as well.
Q. So you are not sure that my assumption is correct?
A. I am not sure your assumption is correct.
Q. Assuming that it is.
A. Let's assume it is. Then the question is if a firm is for whatever reason pricing some of its services below marginal cost, is that a

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competitive disadvantage? Well, it depends. If they are reimbursed for that, no. In fact, it is a competitive advantage. It is called predatory pricing. It keeps other firms from entering that segment of the market.
Q. In my hypothetical they are required to do so after the entrance occurs; that is, after AT&T gets into the market. Would that be a regulatory-induced disadvantage for AT&T – I mean for GTE?
A. I believe you were right the first time. It is a regulatory disadvantage for AT&T. We can put the adjective in front of it and call it regulatory predatory pricing. Prices below marginal cost are generally considered to be predatory in nature. They prevent AT&T from capturing those customers or any other competitor.
Q. Let's hypothesize a situation in which GTE is required by regulation to provide services below cost to a certain set of customers and in the regulatory scheme makes up for that practice of below price costing by maintaining – by having high margins with another set of customers. Let's assume that when competition

occurs AT&T does not bother with the customers that GTE is providing service to below cost because, as you have said, there is no incentive for them to do so, and focuses instead on the customers that GTE is providing service to at a high margin. Let's assume further that GTE is still required by its regulators in that environment to provide services to the one set of customers at below its cost. In that context would you agree with me that AT&T has a regulatory-induced advantage and that GTE has a regulatory-induced disadvantage as a result of that outcome?

A. Let me think about that just one minute. What you have described is a situation of internal cross-subsidization within the price structure of the incumbent firm, GTE in this case. In the presence of such a pricing structure, all firms that enter the market that are not similarly constrained or taxed have an artificially high incentive to enter the segment that is generating the subsidy.

Q. Right.

A. That does not necessarily redound to the benefit of AT&T because we have to remember

AT&T is not the only firm entering these markets.

Q. Right. It would redound to the benefit of all the entrants and to the detriment of GTE, the incumbent, correct?

A. No. I think to the extent competition develops in this subsidizing segment of the market, it will redound to the benefit of the customers who were previously being taxed by the cross-subsidization mechanism.

Q. But my question was –

A. As the prices they pay will be pushed toward the true economic cost of providing service to them.

Q. But my question was, wouldn't it result in a disadvantage to GTE?

A. If regulators insist on attempting to sustain any kind of cross-subsidization policy in the presence of entry, I will agree with you that that will harm GTE's ability to compete. I will agree with you on that. If they cannot lower their price – this is all given all your assumptions, right, that there is a true cross-subsidization occurring and GTE is not allowed to lower its price, which I understand they are under price cap regulations, so they

ought to be able to lower their price. So we have added another assumptions, I guess is what I'm saying, to your hypothetical and that is GTE is not allowed to lower its price in the subsidizing segment and there is nothing being done to correct the below cost price in the subsidized segment, then, yes, GTE is at a competitive disadvantage.

Q. And you oppose in your supplemental or rebuttal testimony, don't you oppose a re-balancing of the rates in the first instance prior to the entry of AT&T and other potential LECs?

A. I do not oppose a true re-balancing of rates for GTE or any other incumbent firm to bring them into line with the costs of providing the services.

Q. When should that occur?

A. What I opposed in my rebuttal is making that a prerequisite to competitive entry.

Q. But you do agree under certain assumptions at least that until the re-balancing occurs GTE does face a competitive disadvantage, correct?

A. Under a number of assumptions I think

that we have already been through, I would agree with that.

Q. Will GTE's competitors, as far as you know, be required by regulation to perform the function of provider of last resort?

A. What do you mean by perform the function of competitor – of provider of last resort?

Q. That they will be obligated to provide service to everyone.

A. There again, I certainly hope they won't be. I think that would be a barrier to entry into this market.

Q. You have no reason to believe that they will be, do you?

A. No.

Q. Let's assume that they are not. Let's also assume that GTE is required by regulation to continue to perform that function as provider of last resort. Wouldn't that be a regulatory-induced disadvantage to GTE?

A. This is not, I don't think, an independent, if you will, regulatory disadvantage. This is simply a restatement under an alias, if you will, of the one we just talked

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about a cross-subsidization. The only reason
GTE might be the last resort would be if they
were pricing below cost and therefore entrants
did not want to serve those customers.
Q. You don't disagree with my statement. You just think it restates the last proposition?
A. That's correct. And therefore subject to all the assumptions and caveats that we went through with regard to that.
Q. You state in your Florida testimony, and I will show it to you if you don't remember it. But I am going to represent to you that you state on page twelve of your Florida testimony that the fundamental characteristic of efficient prices is that they reflect the marginal or incremental costs imposed on the provider to supply the good or service in question. Is that your testimony?
A. Yes.
Q. Would you like me to have a copy of your testimony in front of you for a reference? You won't have to take my word for it each time.
A. That will be fine.
MR. MIRENGOFF: Why don't we make that Exhibit Number 1, please.

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(Kaserman Exhibit No. 1 was marked for identification.)
MR. MIRENGOFF: Exhibit Number 1 is Professor Kaserman's initial the before the Florida Commission. It is called Direct Testimony of David L. Kaserman on Behalf of AT&T Communications of the Southern States, Inc. And I am also going to supply as Exhibit Number 2 his rebuttal testimony.
(Kaserman Exhibit No. 2 was marked for identification.)
Q. So you agree with your testimony on page twelve that the fundamental characteristic of efficient prices is that they reflect the marginal or incremental costs imposed on the provider to supply the good or service in question?
A. Yes.
Q. Do you agree, then, that pricing below marginal or incremental cost does not result in efficient prices?
A. Yes.
Q. And therefore such pricing is not economically efficient, correct?
A. That is correct. Now, let me clarify

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something here that may need clarification. We have been throwing around at least three different terms here with regard to costs and pricing efficiency. We have talked about marginal costs, we have talked about incremental costs and we have talked about total service long run incremental costs and what I consider to be its synonym, total element long run incremental costs. And for purposes of this testimony, I am considering those terms to be close enough that we can use them interchangeably.
Q. We are going to get to whether that is a valid assumption or not. But in answering these questions, I would like you to answer them for the terms that I am using, marginal and incremental costs, and not make any assumption as to whether some other concept like TSLRIC or TELRIC are close to that. Is it fair to ask you to do that?
A. Yes. For the record, I am stating that in my opinion in this industry at this time I think that TELRIC is going to be close to long run incremental cost.
Q. I understand that is your position and we will explore that a little bit. In answering

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these questions, just answer them, if you would, as to marginal and incremental without taking any position on – unless it is required to by the question.
A. Okay.
Q. Thank you. You are familiar with the incremental cost test, are you not?
A. Yes.
Q. Isn't the incremental cost test a method of testing for the presence of cross-subsidization?
A. It is a method along with the TSLRIC method.
Q. Is it a different method?
A. There are some subtle difference, yes.
Q. In your textbook, though, you describe the incremental cost test as a method of testing for the presence of cross-subsidization, correct?
A. That is correct. And TSLRIC is an incremental cost.
Q. But your textbook doesn't talk about an alternative test for cross-subsidization, does it? It just talks about the internal cost test as the method of testing for cross-subsidization;

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am I correct?
A. You mean incremental cost test? You said internal.
Q. I'm sorry. I meant to ask you about the incremental cost test. Isn't that the one test that you describe in your textbook as the test for the presence of cross-subsidization?
A. I really do not remember right now exactly what test we talk about. If it is an incremental cost, if we used the term incremental cost test, then it is I think the same thing as the TSLRIC test of Faulhaber.
Q. Let me show you your textbook. It's page five oh eight and on to five oh nine, discussion of the incremental cost test.
A. Let me just read, I think this will help, the one sentence from the text in that paragraph. In its most simple form, the incremental cost test indicates that if the price charged for a service yields a total revenue that exceeds the incremental cost of the service, then that service is not receiving a cross-subsidy, end quote.
Q. Right.
A. The incremental cost of a service is

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TSLRIC.
Q. But don't you go on to state in your book that the test in its simplest form, as you have just stated it, needs to be refined somewhat?
A. It may need to be refined, yes.
(Brief interruption.)
Q. Just to recapitulate where we were before the interruption or the break, according from your textbook that in its simplest form the incremental cost test states that if the price charged for a service yields a total revenue that exceeds the incremental cost of the service, then that service is not receiving a cross-subsidy?
A. Yes. Again, that is exactly the same as the TELRIC or TSLRIC standard for cross-subsidization.
Q. But you also note in your book, do you not, that it is possible for the price of several individual services to satisfy the incremental cost test but for a group of services collectively to fail that test, correct?
A. That's correct.
Q. So you conclude that the incremental cost test must be expanded, correct?

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A. It can be expanded, yes. I think it would depend upon what the firm was buying.
Q. Don't you state in your book, and let me show it to you. It is the bottom of the first full paragraph on five oh nine. Why don't you read that into the record?
A. Quote, accordingly, the incremental cost criterion must be expanded to require that the revenue from each service individually and for all combinations of services exceed their corresponding incremental costs.
Q. Do you agree with that statement?
A. Yes.
Q. And if either of the two criteria that you read, that is, if either the revenue from each service individually or the combination of services fails to exceed its corresponding incremental cost, then there is a cross-subsidy, isn't there?
A. You know, I am not real sure is the best, honest answer I can give you. It would fail the incremental cost test, but again it would depend upon whether the purchaser was buying just one of these services or a group of the services. I am just not real sure. I would

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tend to agree with you on that, but I am not positive.
Q. I thought it followed from what you had written.
A. It appears to, yes. But I am just not positive about that.
Q. Isn't the incremental cost of a service or network element calculated by determining the total cost to the firm with the service or network element and then subtracting from that the total cost to the firm without the service or network element?
A. That, what you have just defined, is the TSLRIC or TELRIC and in the textbook probably is just called the incremental cost of that service.
Q. But whether or not it is a TELRIC or TSLRIC, it certainly is the incremental cost, correct?
A. Yes. And in the literature on this it is actually – no. That's fine. It is called the incremental cost. That will be all right.
Q. Thank you. Isn't the incremental cost of a pair of services or elements calculated by determining the total cost with the pair of

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services or elements and then subtracting from
that the total cost without the pair of services
or elements?
A. Yes.
Q. Suppose that two network elements both
have a TE or TSLRIC of ten dollars. Would you
propose pricing those two elements at ten
thousand dollars each?
A. If the size of the common costs between
those two elements is small, then, yes, I would.
Q. And if it is not small, then you would
not, correct?
A. If it is quite large, then I think I
would back off and I would then if you are going
to buy the two elements together, then you would
pay the TELRIC of the two elements together which
in that case would exceed the sum of the TELRICs
of the two elements individually.
Q. It would exceed the sum of the two
elements individually by the size of the common
costs, correct?
A. By the size of the common costs
associated just across those two which is
sometimes referred to as a shared cost.
Q. Let's suppose that these two network

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elements that we have been talking about have a
shared cost of five dollars so that the
incremental cost of the two services combined is
twenty-five dollars. You would agree that a
price of twenty dollars for the two network
elements wouldn't generate enough revenue to
cover the incremental cost of providing the two
elements; wouldn't you agree with that?
A. Yes.
Q. So would you propose pricing the
elements together at twenty-five?
A. No. I probably would not, and I need
to think about this a little bit. But when you
are talking about – let's back up. I think this
whole conversation is founded on a premise that
is incorrect, and that is you really have two
very separate issues involved. One is efficient
pricing of the elements. The other is whether
the firm recovers its costs. Those are two
completely separate matters. You can have an
efficient price that is, in fact, receiving a
subsidy.
Q. I am just asking how you would price
it. You say you would not – even though in a
hypothetical situation with the shared cost of

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five dollars, the total incremental cost of the
two services combined is twenty-five, you are
saying you would not price it at twenty-five?
A. If someone were buying the two elements
together, I might. I am really honestly just not
sure about that. My recommendation would be if
they were buying an element by itself, you would
price it at ten dollars. If they were pricing –
if they were buying the two together, you might
mark it up some. I don't think this is relevant
to calculations of unbundled elements. The
reason being is the size of the common costs that
you have imposed on the problem is very much in
excess of that that will be in place for the
unbundled networks elements in this industry.
Q. I understand that is your position. I
promise you we are going to get to that issue.
A. Okay.
Q. But for now, whether you think that it
is a good hypothetical or not, I would just like
to focus on it. I just don't understand what
your position is because – you are just not sure
whether you would do it?
A. Let me clarify that. I think the
efficiency solution is to price each of the

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elements at ten dollars, to price the two
elements together at twenty dollars and if there
is a revenue shortfall for this company, to
address that revenue shortfall without distorting
these prices away from their economical levels.
You can think of it just like a universal service
fund or if the commission decides that GTE has
imbedded costs that should be compensated, that
the issue of how you compensate them should be
kept separate from the issue of efficient pricing
because it is very crucial that prices be set
efficiently. So on reflection, what I am telling
you is I would price each one at ten dollars and
a combination at twenty. If it turns out there
is a revenue shortfall, we will collect that
through some sort of probably an end user
charge.
Q. Would you agree that a price of twenty
for the two elements would involve a subsidy;
that is, if someone could buy the two elements
for twenty instead of twenty-five, there would be
a subsidy there?
A. There would be a subsidy on those
prices. Now, whether or not the people buying
them escape payment of the subsidy depends on how

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you go about reimbursing the firm. But, yes, those prices are receiving a subsidy.
Q. If one of the elements is priced at ten and in my hypothetical the common or shared costs are five dollars, wouldn't there be a subsidy there, too?
A. Again, depending on the size of the common costs, I don't think that that element you could say there is a subsidy, because it is covering the incremental cost of providing that element by itself under the definition you gave of the incremental cost. It is paying the full amount of the cost being caused by the provision of that element, the incremental cost.
Q. So you don't think there is a subsidy in that situation?
A. I don't think so.
Q. But there is one if both are bought together for twenty in my hypothetical?
A. If there are only the two, if we are only talking about two and there is not another one out there that may pick up those common costs, then, yes.
Q. And you would agree with me that if, still hypothetically, TELRIC pricing or TSLRIC

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pricing does not cover the incremental cost for two or more elements, then it fails by definition to satisfy the incremental cost test, correct?
A. Yes. If we have priced them as I said, ten dollars each and you buy the combination for twenty and there are five dollars in shared cost, they are shared only between those two elements, then it's failed the incremental cost test.
Q. If an incumbent sells all of its input at the TELRIC prices, won't it incur losses equal to its shared and common costs?
THE WITNESS: Could you read that back?
(Requested portion of record read.)
A. It will experience losses on the sale of those inputs equal to that amount which then can be made up -- that loss can then be made up through this tax that I mentioned or pricing of other services that the incumbent sells. We are talking about a very small subset of the total number of services that the incumbents sell.
Q. You are saying that the losses need to be made up either through some sort of a tax imposed by this commission or through other services?
A. Well, I am not saying they need to be.

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I am saying they can be made up through some avenue other than distorting the prices that new entrants coming into the market pay by raising those prices above their TELRICs. How that is made up, there are any number of ways possible. GTE is getting into the long-distance market. GTE is under price caps. They have lots of opportunities for profitable ventures elsewhere. And the fact that a very small subset of their services ends up being priced at economically efficient levels and that efficient pricing may generate a revenue shortfall for that small subset of services doesn't mean that the company is going bankrupt or that the company overall has any loss at all.
Q. But it certainly could mean that if no adjustment is made and if for whatever reason GTE isn't able to make it up with other customers in other markets, it would by definition result in a loss, wouldn't it?
A. Theoretically it could. As a practical matter, I think it is highly unlikely. And that is what my testimony addresses.
Q. Why is it inefficient pricing to charge an alternative carrier twenty-five dollars for

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two services where the incremental cost of those two services as you have testified is twenty-five dollars as a result of five dollars of common costs?
A. The problem with charging the twenty-five dollars for the two together is if you do that and then you price the individuals at ten, you have created an artificial incentive for the new entrants then to order the individual components as opposed to the combination of the components and thereby you have in opposition of the intent of the act which we agreed on earlier, you have provided an artificial incentive to bundle. I am sorry. To unbundle these elements and not use the incumbent's network as efficiently as it might otherwise be used.
Q. Isn't the answer to that to charge more than ten dollars for the element taken singly?
A. No. The problem with doing that is then you discourage any socially optimal usage of the incumbent's network because you have now priced those individual elements above their economically efficiency levels, above the cost causation calculated costs that are incurred in order to provide those individual elements.

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Q. What if they are priced at twelve and a half?
A. Then they are each priced at two and a half dollars more than the incremental cost of providing those elements.
Q. So the common costs just have to be eaten by the taxpayer in order to have efficient pricing?
A. It is not taxpayer. It would be spread across all users in a competitively neutral fashion. When I used the word tax, I just meant a competitively neutral method for collecting a sum of money. It may be used to support a universal service. It may be used to reimburse imbedded costs, whatever revenue is needed for whatever purposes. The point is you don't want to distort the prices paid and particularly the prices paid by new entrants in order to collect those revenues.
Q. And your testimony is there is no distortion whatsoever if these new entrants can buy an element at ten dollars that is part -- that shares common costs of five dollars with another element? There is no distortion in that situation?

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A. That is economically efficient. That is not distortionary; that's correct. It is pure and simple marginal cost pricing.
Q. Just for my own clarification. We have been dealing with a hypothetical in which the common costs were stipulated by me to be five dollars. Would any of your answers or analysis change if the common costs instead of five dollars were two dollars?
A. The principles don't change. I think all that changes is how close you're getting to the ideal. And this gets to my supplemental testimony that was filed after the FCC order. I am not sure if it was filed in this state or if I incorporated supplemental in my direct testimony. But the point is the FCC order indicates that there will be an allocation of common costs to the prices of unbundled elements. But it also goes to great length to say that it is going to be a very small allocation, in which case I can't get too upset because we are coming close to marginal cost pricing.
Q. So as a theoretical matter, the FCC is correct -- is it your testimony that the FCC is

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correct that there should be that allocation but you just don't think it amounts to very much?
A. Just the opposite. I thinks as a theoretical matter the FCC is wrong, because, in effect, what they are advocating is fully distributed cost pricing. But as a practical matter, if the costs that you are going to distribute are small, then you come close to the theoretical ideal. So I am happy with that.
Q. Where did the FCC in its order state that the common costs are small?
A. They state it in numerous places. I don't have the order in front of me. They go through and explicitly exclude about eight or nine specific items that the ILECs have argued should be included. They also explain very clearly, and this is the whole reason for them coining the term TELRIC, is to distinguish between elements and services. And they explain very clearly that the reason they do that is that the common costs associated with network elements are small relative to the common costs associated with services.
Q. So you are confident that you could find a statement in the order that says that the

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common costs are or are likely to be small?
A. Yes.
Q. It is really an empirical question, though. Haven't you already testified as to whether they are small or not?
A. I am sorry?
Q. Isn't it really an empirical question as to whether the common costs are small or not small?
A. The exact magnitude of them is an empirical question. However, the relative magnitude compared to services I think can be addressed with very, very simple logic, common sense, if you will.
Q. But it is still an empirical question, isn't it?
A. No, not entirely. If common costs stem from the use of shared resources, as I think we have already talked about in here, and elements don't share much in the way of resources, inputs, then by definition you are not going to have very large common costs.
Q. But it is an empirical question whether elements share inputs, isn't it?
A. That is really an engineering

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question.
Q. By empirical I mean something that you
get not by sitting around thinking about it but
by testing it in the real world through
engineering or through some other check on
reality?
A. Well, again, I am not sure how to
answer that. Anybody that knows anything about
the network I think can make reasonable
statements about the size and nature of the
inputs likely to be shared among different
network elements.
Q. So you think it is or is not an
empirical question as to what the size of common
costs are?
A. I think that – I will go back to what
I said before. I think that the precise
magnitude of the common costs is an empirical
question and it is one, by the way, that the FCC
puts the burden of proof on the local exchange
carriers to document. The magnitude of those I
think is an empirical question. However, I think
that the statement that the general magnitude is
going to be small for common costs as compared to
the common costs of cross-services is, as I said,

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simply common sense.
Q. As compared to – does the FCC state
that the shared cost of elements is small or does
it state that it is small compared to the common
cost of services?
A. I am certain it says the latter. I
believe it says the former as well.
Q. You are not sure, though?
A. I am not positive about the former.
Q. You acknowledge in your testimony, do
you not, that the possibility that an ILEC's
costs will exceed its revenues if its inputs are
priced at TELRIC? Don't you acknowledge that as
possible?
A. Yes, I believe I do.
Q. You suggest in your testimony and I
think you have suggested it here again today that
if an incumbent is to be compensated for losses
resulting from shortfall in revenue, the revenue
should be recovered directly from all end users;
is that your position?
A. That would be one avenue. I think
there are alternative avenues as well.
Q. Isn't the one you specifically suggest
in your testimony some sort of recovery from all

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end users?
A. That would be the most straightforward
way to do it.
Q. You regard end user charges as
competitively neutral?
A. If they are imposed on all end users,
yes.
Q. It is because of its competitive
neutrality that you suggest that as a
straightforward method of compensation through
the end user charge?
A. Yes. In effect, you are taxing –
again tax used in a broad sense, not in a legal
sense. You are taxing end users as opposed to
taxing new firms trying to come into this market
and thereby creating entry barriers.
Q. If the shortfall in revenue to the ILEC
results from a decision by the commission not to
include common costs in the prices paid by new
entrants and a decision is made to compensate the
ILEC for that shortfall, you are saying the
shortfall should be made up by an end user
charge?
A. Again, I will say that is one avenue
through which it could be done.

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Q. Wouldn't that mean that the ALECs were
receiving subsidy from the ILEC customers?
A. I am sorry. Repeat that.
Q. If the shortfall that results from a
decision by the commission not to include common
costs in the price is compensated by an end user
charge, wouldn't that mean that the ALEC is
receiving a subsidy from the customers, primarily
the ILEC customers?
A. No. Again, I believe that if the
prices of these elements are equal to or greater
than the TELRIC of providing those elements, then
the ALECs are by definition paying subsidy free
prices to the CLEC and therefore they are not
receiving a subsidy; and moreover, their own
customers will be paying that end use charge as
well.
Q. At least at the beginning the vast
majority of customers who are paying that end
user charge are likely to be ILEC customers,
correct?
A. Certainly, at the beginning before the
ALECs have entered. If they haven't entered,
they haven't bought any unbundled elements and
therefore they are not receiving a subsidy.

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Q. But even in the period immediately after they enter, don't you think that in all likelihood the preponderance of customers are going to be ILEC customers for awhile?
A. Oh, I agree with that, yes.
Q. You are aware, of course, that the FCC states that the price paid by the ALECs for network elements and interconnection shall include a reasonable allocation of forward-looking common costs, correct?
A. Yes.
Q. You disagree with that, correct?
A. I disagree with the pricing principle involved there because it really represents nothing more than fully distributed costs. However, as I indicated, once you read the rest of the order and you discover they are really talking about a very small departure from efficient prices.
Q. I have read the order and I have the order. I am not going to ask you to go leafing through it. Your position is that they specifically state that – not in a relative sense, but that they specifically state that the common costs are likely to be small?

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A. Oh, yes. Yes. And they also have the, if you recall, the stand-alone cost criteria that says the unbundled element prices cannot seek stand-alone cost. And they point out where the common costs are small that the stand-alone cost will not be much above the TELRIC.
Q. Where they are small. Your testimony is that they specifically find that those costs are small?
A. My reading of the act indicates to me that they very clearly have that in mind, yes.
Q. They have it in mind, but do they say it?
A. I believe they say it, yes.
Q. You state in your testimony that, and I am quoting here, this is page twenty-six, I believe. Go ahead and find that if you would like. You state that some recent evidence suggests that the magnitude of common costs in the industry, the ILEC industry, has been greatly exaggerated. Was that your testimony?
A. Yes.
Q. And you state that if that is the case, if the magnitude of the common costs has been greatly exaggerated, then implementing TSLRIC or

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TELRIC prices will not create revenue shortfall. Is that your testimony as well on page twenty-six?
A. That's correct.
Q. If it turns out, however, that the magnitude of common costs in the industry is not greatly exaggerated by whatever it is that you said constitutes a great exaggeration, then implementing TSLRIC or TELRIC will create a revenue shortfall, correct?
A. They are certainly more likely to if those common costs are large. We get back to what we were talking about a few minutes ago. You are talking about the pricing of just a few outputs among very many outputs provided by this form. Moreover, outputs that are provided under price cap regulation, whereby they are making profits on a number of other activities.
Q. You haven't done any study to show that in the event of large common costs no revenue shortfall will result because of flexibility that the ILECs have elsewhere?
A. It makes sense that if you are pricing at TELRIC for a subset of services and you are pricing well in excess of TELRIC for other

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services such as access that necessarily there will be a revenue shortfall.
Q. My question to you was, it seems as though you are stating that there may not be a revenue shortfall even if there are significant common costs because they can be made up elsewhere in the pricing scheme. Is that what you are suggesting?
A. Yes.
Q. Have you done any empirical study to show that the prices charged elsewhere are sufficient, that there won't be a revenue shortfall even in the event of common costs, large common costs, on the elements that are sold to the ALECs?
A. I have not personally done a study on GTE's costs or revenues. I am aware, however, of the markup above marginal costs for access services in general. I am aware of the markup above marginal costs for intraLATA toll in general, the markup above marginal costs of vertical services in general. And I know that all of these services are generating at revenues well in excess of marginal costs. And as a result, even if common costs are present and are

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large among these network elements, which I believe is not the case, then it is still not clear that if you price these elements to competitors at TELRIC that there will be a revenue shortfall.
Q. So your testimony is it is not clear. You don't know one way or the other?
A. That's correct. I have serious doubts, let me put it that way, that there would be a revenue shortfall for the company as a whole.
Q. That is not stated in your testimony. Your testimony just said it wasn't clear. Doesn't your testimony say it is not clear as opposed to you have serious doubts?
A. I had a phrase in my testimony in the back of my mind I believe where I indicated that I do have serious doubts. Whether I can turn to it at the moment or not –
Q. Well, if you can't I guess the testimony – if you want to look for it, that's fine. Otherwise, the testimony I guess speaks for itself and is before the commission. The evidence that you were referring to in your testimony that you say is recent evidence suggesting the magnitude of common costs may have

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been greatly exaggerated is a statement in the affidavit of Baumol, Ordover and Willig, is it not?
A. Yes.
Q. That was an affidavit prepared for AT&T as an attachment to AT&T's comment to the FCC?
A. Yes.
Q. In that affidavit Baumol, Ordover and Willig state, and this cited at footnote sixteen of your testimony, we understood that the portion of forward-looking costs that is unattributable to particular network elements is likely to be small. Do you see that?
A. Yes.
Q. Do you know where Baumol, Ordover and Willig got that understanding?
A. No, I do not.
Q. Which statements of the magnitude of common costs that supposedly are exaggerated are you referring to in your testimony?
A. I am sorry?
Q. You said in your testimony that recent evidence, which turns out to be Baumol, Ordover and Willig, that recent evidence suggests that the magnitude of common costs has been greatly

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exaggerated. I am trying to find out who is it that exaggerated them and what did they say that constitutes the exaggeration?
A. The source I think that I had in mind when I was writing that was some of the statements by the ILEC's economic experts in various proceedings. Robert Harris I know, Richard Emerson has made similar statements to the effect that the forward-looking common costs of these companies are quite large. I have seen statements that they are fifty percent of the total revenues of the company.
Q. You consider that a great exaggeration?
A. I sure do.
Q. Was there any other – you mentioned several sources, Harris and Emerson, I believe?
A. Yes.
Q. Anybody else that you were referring to when you said that the magnitude of common costs has been greatly exaggerated?
A. Company witnesses I think have made similar sort of statements.
Q. Do you have any particular ones in mind?
A. No. It is just general recollection

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from things I have heard in hearings and testimony that I have read.
MR. MIRENGOFF: If it is okay, Tracy, I will take a short break at this point.
(Brief recess.)
Q. Do you agree with the statement in the affidavit before the FCC of Baumol, Ordover and Willig that at a finer level of disaggregation there may well be nontrivial costs shared among various subcomponents of any particular aggregative network element?
A. In general, I would tend to agree with that statement, yes.
Q. Do you also agree with the FCC order at paragraph six ninety-five, quoting here, at the sub-element level of study, common costs may be a significant proportion of all costs that must be received from sub-elements?
A. I would agree in general with that. I am not sure what they mean by sub-element level.
Q. What do you understand that to be?
A. Well, I don't.
Q. Is it your view that the measurement of costs should be as consistent as possible with principles of cost causation?

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A. Yes.
Q. Is it also your view that accurate distribution of costs with their underlying causal drivers is important?
A. Except for the word distribution. I tend not to use the word distributed with the word cost. I think the word is attribution. Maybe we should look it up.
Q. I wasn't quoting from anything.
A. Well, I try not to use the word distributed –
Q. So you would agree that accurate attribution of costs with their underlying causal drivers is important?
A. Yes.
Q. With respect to the pricing of wholesale services, you state at page thirty-two of your testimony, turn to that if you like, you state that the avoided cost concept suggests that the wholesale discount should reflect incremental costs. Isn't that your testimony?
A. That is my testimony. I think I clarify that by incremental costs we are now talking about incremental costs, if you will, going in the opposite direction. I don't use

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these words in the testimony. But going in the opposite direction of the incremental costs of unbundled elements; that is, we are looking at costs that will be avoided by the incumbent ceasing to perform retail stage activities.
Q. Understood. And you say, do you not, that in the avoided cost context, incremental costs means the cost of reducing or eliminating the ILECs retail stage operations, correct?
A. Yes.
Q. By the same token, shouldn't incremental costs for purposes of the avoided cost model also take into account the incremental costs of providing wholesale services to resellers?
A. In general, yes, that should be taken account of. That is part of what I have proposed in here. That is, in fact, included in there. The so-called cost onsets. You have to make a distinction with regard to these, I think, about the magnitude of them and sort of the nature of them. Are they cost onsets that are caused by – going back to the cost causation principle, caused by the provision of those wholesale services, and if so, how do you recover them.

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Q. But you don't disagree with the principle that whatever incremental costs are incurred by providing the services to the ALECs that consistent with cost causation principles should be factored into the equation, correct?
A. Factored into the equation in a sense that the ILECs should receive compensation for incurring those costs.
Q. You don't deny that the ILECs will incur some such costs, correct?
A. I don't deny that they will. The crucial question is how large are they. This is part of the FCC, I think, approach of putting the burden of proof of them to demonstrate those costs.
Q. That is an empirical question, isn't it?
A. Yes, it is.
Q. Do you recommend that in calculating GTE's avoided cost of retail, the commission should assume that GTE has left all retail markets?
A. I think that in principle that is a reasonable way to go about calculating the avoided costs, because we don't expect them to

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leave the retail markets, but the discount is not applied to all units. It is only to those units that the new firms purchase when they come into the market.
Q. But isn't it reasonable to assume that GTE's retail cost saving per unit will increase with the percentage of retail customers it loses to new entrants?
A. I'm sorry. You are going to need to restate that for me.
Q. Isn't it reasonable to assume that GTE's retail cost savings per unit will increase with a percentage of retail customers it loses to new entrants?
A. I really don't know if that is reasonable or not.
Q. That is an empirical question, too, isn't it?
A. That would be an empirical question. There may be some theoretical insight that could be gained, but I really have not thought about that. I don't know.
Q. Let's suppose hypothetically that the net savings to GTE of abandoning all retail activities in a particular market is twenty

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percent of the current retail price. Do you have
that in mind, that assumption?
A. That their cost savings, their avoided
costs, are twenty percent of the retail price?
Q. Yes. In a situation where they abandon
all retail activities.
A. Okay.
Q. And I will ask you to suppose further
that AT&T signs up ten percent of GTE's retail
customers.
A. Okay.
Q. And suppose further that the commission
goes ahead and adopts twenty percent avoided cost
discount based on a calculation which assumes
that GTE is out of the retail market.
A. Okay.
Q. But suppose it turns out that when GTE
loses only ten percent of its customers the
actual avoided cost savings turn out to be only
say five percent.
A. You want me to assume that?
Q. Yes, I do. You've already said you
don't know what would happen and that it is an
empirical question. I am asking you to assume
those facts. What would happen to GTE's profits

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in that situation?
A. We didn't even need all the
hypotheticals. If you set the wholesale discount
at twenty percent instead of five percent, their
profits will be lower, I would imagine.
Q. So if it turns out that the discount
rate is calculated on the assumption that they
lose all of their customers and it is also true
that when they don't lose all their customers,
when they lose only a small fraction of their
customers, the twenty percent discount turns out
not to be the right empirical number, in that
scenario GTE would lose profits, correct?
A. Yes. What you are posing is very
simply a situation where for whatever reason, in
this case a bad assumption, if for whatever
reason we misestimate the avoided costs, then GTE
will lose money if we overestimate them; then
conversely, of course, they will gain money if we
underestimate them.
Q. You don't know whether calculating the
avoided cost on the assumption that GTE loses all
of its business is going to be a good assumption
in the situation where GTE loses only a small
portion of its customers, correct?

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A. That's correct. I cannot say if that
is an accurate assumption. Again, I am not the
person that calculates the avoided cost.
Q. In this hypothetical that I have asked
you about assuming still that the wholesale
discount is set at twenty percent, then an
alternative carrier whose retail costs are ten
percent at the ten percent market share that it
captures could profitably enter the market,
correct?
A. I'm sorry. I guess I am just tired.
If you could repeat that.
Q. I will try to. We are talking about a
wholesale discount rate has been set at twenty
percent. The alternative carrier captures ten
percent of the market and at that ten percent its
retail costs are also ten percent.
A. But it is getting a twenty percent
discount?
Q. Yes. And under those set of facts, the
new entrant could profitably enter the market,
correct?
A. Holding everything else constant, yes,
that would be an attractive market for them to
enter, whether their ten percent costs are due to

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an overestimate of GTE's avoided cost or whether
it is due to superior efficiency in providing the
retail stage. As long as their incremental cost
is lower than the discount, they have an
incentive to enter.
Q. In my hypothetical which we have been
working with, recall that GTE's avoided costs for
ten percent of the market turn out to be let's
say I think was it five percent? Under those
facts a less efficient -- an ALEC that is less
efficient than GTE at retailing to that ten
percent of the market would be able to enter
profitably, correct?
A. I see the question. Certainly, if you
have set the wholesale discount at a level that
exceeds the avoidable costs, you have created a
situation under which inefficient entry can
occur.
Q. Am I correct that you propose to
include as an avoided cost any positive profit
earned by the ILEC at the retail stage?
A. With some clarification. I have
proposed any positive economic profit.
Q. Right.
A. Which means an excess accounting profit

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above the competitive level.
Q. Positive economic profit which you
equate as excess profit?
A. Yes.
Q. And you propose to include that
positive economic profit or excess profit as an
avoided cost?
A. As a theoretical proposition, it should
be included as an avoidable cost.
Q. And you define positive economic profit
as the excess above normal return on the firm's
activity at the retail stage?
A. That's correct.
Q. So am I correct that your proposed
discount for excess profit refers only to retail
level excess profits in this context, correct?
A. I don't really think that you could
break the profit down into retail versus
wholesales. I think it would just be the excess
profit on the sale of that service.
Q. So you are going to try to identify
firm-wide excess profit and include all that as
an avoidable cost of getting out of the retail
business?
A. It would be the markup at the retail

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stage above the total cost, economic cost, of
providing that service, would be the excess
profit for that particular service or element.
Here we are talking about services.
Q. Its economic profit at the retail
stage, then?
A. Economic profit is an excess return
over all of your costs in the provision of that
service. So it would include both wholesale and
retail.
Q. Why are you going to consider as an
excess profit to be deemed an avoidable cost at
excess that occurs at the wholesale stage which
they are still going to be in as opposed to the
retail stage?
A. Well, again, I don't know how you would
split up the current excess profit between the
wholesale stage and the retail stage.
Q. You can't do that, can you?
A. You really can't. As a result, I think
you would take it service-wide which leads you
then to a more efficient wholesale price.
Q. But if you could separate them out,
theoretically that would be the way to go,
wouldn't it?

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A. No. I have thought about that some. I
really don't think it would. I think the way to
go is to take the total excess profit in the
provision of that service and count that as an
avoidable cost. That way you expose the full
operations of the incumbent LEC to the forces of
the competitive market.
Q. So even if you could separate them out,
your testimony is you wouldn't want to?
A. I don't think you would, no.
Q. Is that consistent with general – do
you think the economic profession would agree
with you on that, if you know?
A. I mean the answer to that is always
going to be yes. I am sure you can find somebody
that won't, but I can find some that will.
Q. You don't know whether – is your
answer that you don't really know?
A. I don't know. This is something I
don't think there has been an awful lot of
literature on.
Q. So in a hypothetical situation, if the
wholesale cost of a service is three dollars and
the retail cost is three dollars and the retail
price is ten dollars, in that scenario the

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revenues are four dollars above cost, correct?
A. Yes. Now, keeping in mind that both of
the three dollars that you mentioned as cost
figures include a normal profit on the provision
of those services.
Q. Right. In that scenario the revenues
are four dollars above costs?
A. Yes.
Q. And you would not try to allocate those
four dollars between wholesale and retail,
correct? You would deem it all as excess profit
or you would deem it all excess profit and
include it as an avoidable cost?
A. Yes.
Q. How would you decide what component, if
any, among that four dollars that you are calling
excess profit is the result of common costs,
forward-looking common costs?
A. I don't think that we are going to run
into the problem of the common costs here. I am
not sure. I haven't been asked this before.
Haven't really thought about it. I don't think
you run into that. Because the profit is
calculated as an excess above total cost, not
above incremental cost. So you are really going

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to be looking at average cost here instead of
incremental.
Q. In my situation the wholesale cost was
three dollars.
A. Wholesale what cost? Marginal or
average?
Q. The wholesale cost of the service.
A. Marginal or average cost?
Q. What is being paid.
A. At the margin or on the average? The
question you've got to specify – if we are going
to call the four dollars an excess profit, then
the two three dollars figures you have quoted me
will be average costs, not marginal costs. And
the average costs I think will include the common
costs as well. So I don't think there is going
to be a common cost left in that four dollars
that we then will have to worry about allocating
or recovering. You are not making a loss. You
are making a profit.
Q. There can still be common costs even
when you are making a profit, correct?
A. Yes. But the profit will be in excess
of common costs.
Q. All we know in my hypothetical is that

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an average cost is three dollars, correct? We
don't know whether there are common costs
associated with that or not, do we?
A. No, not in your hypothetical, we
don't. But the point is that profit is by
definition simply total revenue minus total
costs. And the total costs would include the
common costs.
Q. But it may be that that four dollars
that you are calling profit isn't really profit.
It may be – reflect common costs, correct?
A. No. If I am calling it profits, it's
profit.
Q. It is my hypothetical.
A. It's your hypothetical, but it is my
terminology. A profit again is simply your total
revenue minus your total costs, not your
incremental costs. That is why I was saying on a
unit basis, then, these three dollar figures that
you are quoting to me have to be average costs,
not incremental costs.
Q. But that three dollars – let's
assume – forget about what it is being sold at,
whether there is a profit or not. The three
dollars that it is costing for this service at

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the wholesale level may not include common
costs. There may be a common cost as you
testified before can't be allocated to that three
dollars, correct?
A. This, again, this is purely
definitional. You keep referring to costs and
you are not putting an adjective in front of it.
And I need an adjective in front of it. It is
either incremental or average.
Q. Call it average, then.
A. If it is average, then common costs are
included in it. That is what you have to have
here to calculate the four dollar profit from the
ten dollar price and two three dollar costs.
Those have to be average costs, because your
total costs – for this to be a profit, your
total costs have to be six dollars. That six
dollars has to be your total cost which includes
your common cost.
Q. I don't want to assume it is a profit.
I want to assume that it is an excess, but it may
not be a profit. It may be the result of
profit. It may be the result of common costs
that can't in your analysis be attributed because
you don't want to distribute them.

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A. If it is not a profit, I have proposed
taking it out.
Q. How do you know if it is a profit or
not?
A. Because we can look at the company's
total revenue and their total costs and see if
they are making a profit.
Q. That would include common costs,
correct?
A. Yes.
Q. If it didn't include common costs,
there would be no way to tell, right?
A. If there are common costs, they need to
be included if you are calculating profit because
profit is an excess over the company's total
costs.
Q. Let's assume that in the state of
Florida GTE makes a high margin on toll and
vertical services and let's assume, too, that
GTE's residential basic services bring in less
than TELRIC.
A. TSLRIC?
Q. All right. TSLRIC. Do you have those
assumptions in mind?
A. Yes.

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Q. Let's assume that competition reduces economic profits to zero in retail markets and that unbundled elements are bought at TELRIC as you recommend. And assume further that the firm is efficient. Under these assumptions, could basic residential services continue to be priced below cost?

A. Let me get the assumptions down one more time. We've got high margins on toll and vertical services.

Q. Correct.

A. We've got residential we are assuming is priced below the TSLRIC of providing that service.

Q. Correct.

A. We are assuming competitors enter retail markets and they push the company's economic profit to zero. And then there was one other. I'm sorry. I was trying to write these down.

Q. There are actually two others. Unbundled elements are bought at TELRIC as you recommend, and finally that the firm is efficient.

A. I have got the assumptions.

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Q. My question to you is, could basic residential services continue to be priced below cost?

A. Yes, but only if there is a tax collected from outside this set of prices to reimburse whoever is providing those residential services and below cost rates. Tax, again, used in a very broad sense.

Q. How would it be determined under your proposal for computing avoided costs what level of economic profit by an ILEC is positive or excess?

A. Any accounting profit that exceeds a normal accounting profit for a firm with similar risks would be excessive profit.

Q. Wouldn't this require a regulatory determination of the normal rate of return?

A. Yes.

Q. Wouldn't that involve significant regulatory agency involvement in the process?

A. I am really not sure. I think it depends on how much the regulatory agency may rely on the parties involved to come up with cost estimates and profit estimates to provide to them.

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Q. But it could involve significant regulatory involvement, correct?

A. If they want to get involved in that estimation, then they could, yes. I don't know how significant it would be. But they would have to be provided data.

Q. Should positive or excess profit at the retail stage be computed service by service or for the firm as a whole?

A. We get into a very pragmatic issue on that point. And you could ask the same question about the overall wholesale discount. Should your twenty percent discount that we talked about earlier apply to all of the firm's services or should we estimate an eighteen percent discount for some and thirty percent discount for others? The answer is, as a purely theoretical matter, you would do it service by service. But as a practical issue it is not clear that that is possible to do accurately.

Q. So your answer then is as a practical matter it may well be necessary, staying with my question, the issue of positive or excess profits, to determine it firm-wide?

A. Yes.

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Q. What portion of GTE's rate of return in Florida is excess?

A. I have not looked at GTE's rate of return. I do not know.

Q. You propose, do you not, that the avoided cost calculation include a component for costs at the retail stage that are attributable to production inefficiencies or "fat," do you not?

A. Yes.

Q. Do you have any knowledge that GTE has significant production inefficiencies at the retail stage?

A. As a regulated monopolist, I would be extremely surprised if they didn't. I have not done a study of their efficiencies. I have no empirical data to base that on. Simply experience with all other regulated monopolists that I have seen studies done for.

Q. Whether they actually have production inefficiencies at the retail stage is an empirical question, isn't it?

A. That's correct.

Q. And you have no basis other than your general experience with regulated entities that

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production inefficiencies exist at the retail stage at GTE; is that correct?
A. That's correct. And the nice thing about the avoided cost rule that is proposed in my testimony is that if they are efficient, then that term is simply set to zero. That takes that possibility into account.
Q. Do you have any knowledge that GTE receives excess or positive economic profits in Florida?
A. Oh, I think on some services, I think the services you talked about a moment ago, intraLATA toll vertical services and certain carrier access, that it is extremely likely that they do.
Q. Wasn't your testimony that we would see whether they – for pragmatic reasons, we would see whether they receive excess profit firm-wide, on a firm-wide basis?
A. I said that may be the case. I really don't know. It depends. The practical issue is can you estimate it service by service or can you do it company-wide, and I don't know.
Q. Do you have any knowledge company-wide that GTE receives excess or positive economic

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profits in Florida?
A. Again, I have not looked at their rate of return. I do not know the answer to that.
Q. If an incumbent LEC is subject to a price cap system or a rate freeze, wouldn't that create a major incentive to reduce inefficiency?
A. You have hit on a topic that is a bit of a pet peeve of mine. There is a widespread belief I think among economists at this point in time that price caps provide a superior incentive for cost reduction. But the people that have looked at this I think in more detail have started to question that. Because in practice the way price caps work is very much like standard old rate base rate of return regulation which already provides an incentive for cost reduction in the form of regulatory lags that occur between rate hearings. So therefore it is not clear that they have an incentive to improve efficiency that is greater than the incentive that was provided before, but I am agnostic on that. I really don't know.
Q. So your testimony is that even without this price cap system there is some incentive to reduce inefficiency, correct?

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A. There is some incentive; that's correct.
Q. As to whether the price cap system or the rate freeze creates more incentive, you don't have a position?
A. That's correct. I think that it definitely provides an incentive to reduce your costs. But there is more than one way to reduce costs.
Q. Whether it provides incentive to reduce inefficiency you are agnostic on?
A. In my opinion the jury is still out on that.
Q. I am going to offer another hypothetical situation. In this situation it is similar to the last one. In this situation the cost of a monopoly input is three dollars and the retail cost to the ILEC is three dollars.
A. Can you explain to me what you just said? You are talking about the retail price that it charges for its output or the cost of producing –
Q. The cost of retailing it is three dollars.
A. So you are saying the wholesale cost is

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three and the retail cost is three?
Q. Yes.
A. And we are talking incremental or average or does it matter?
Q. You may have to tell me.
A. Okay.
Q. But in any event, the cost of the input or wholesale is three dollars and the retail cost is three dollars and the retail price is ten dollars. Is it your understanding that under the pricing approach advocated by Dr. Sibley and GTE which is called M-ECPR that the input should be priced at seven dollars?
A. I don't know. I am not sure what Sibley's proposal – the ECPR that he has proposed, what price that would generate for that wholesale service.
Q. Isn't the M-ECPR approach basically to take the – involve the concept of the opportunity – the lost opportunity or the opportunity cost of selling the input?
A. Yes. And I will add the adjective private opportunity cost of the firm selling the product.
Q. And in this situation isn't that seven

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dollars?
A. Well, no. I think the opportunity cost here would be the profit which would be the four dollars.
Q. They forego the four dollars?
A. Right. And they will save three dollars on the retail activities.
Q. Right.
A. Assuming that is all cost. There is no fat in there. There is no inefficiency. There is no profit in that three dollars.
Q. Isn't Sibley's calculation in that situation seven dollars?
A. I believe it would be, yes.
Q. So it is seven dollars?
A. For the wholesale service, would be the price.
Q. That is what GTE is proposing in that hypothetical as you understand it, correct?
A. Yes.
Q. Would I also be correct in calculating the imputed price floor for the ILEC in the retail market at ten dollars in that hypothetical?
A. I believe that would be correct.

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Q. In this situation, this hypothetical, with imputation is the ILEC able to implement a price squeeze against an equally efficient rival?
A. In the situation you have postulated, if the costs are efficient costs and you have the imputation and you have the price at seven dollars, then I believe the ECPR or even the M-ECPR yields the exact same result as my avoided cost pricing rule. That is pointed out I believe in a footnote in my testimony. You get the same answer under certain conditions.
Q. So you are stating that in that hypothetical situation where the retail price is ten, the wholesale price or monopoly input is three and the retail cost to the ILEC is three and the company is efficient, you would propose to price that input at seven dollars just as Sibley would under M-ECPR?
A. Well, let me think about that a minute. I think the difference would be in the profits that the company is earning. So no, I would propose it be priced at three dollars.
Q. So we do have a difference at least?
A. Yes. That is assuming, of course, that

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these costs are the true economic costs at these two stages and that therefore we do have four dollars in excess profit present. And that is the difference – the fundamental difference, I believe, between the Sibley proposal and my proposal. I would expose by pricing the wholesale service at three dollars, it would do two things. First of all, it would fully compensate the company for the provision of that wholesale service. It would provide them a fair rate of return or a normal profit on the provision of wholesale service. More importantly, it would expose that ten dollar price which is by definition above the competitive level. That is why I had a little problem with imputed price floor of ten dollars. He talks about using a competitive price as a ceiling. But this is obviously not a competitive price of ten dollars. But by pricing the wholesale service at three dollars, you then expose that ten dollars to attack by competitive market forces.
Q. My question to you, though, is in this situation with the imputation is the ILEC able to implement a price squeeze against an equally

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efficient rival?
A. No. They are not able to do a price squeeze if that price stays at ten dollars and the wholesale rate stays at seven.
Q. Let's continue to assume that there is no facilities-based competition and the supply of the monopoly input and let's also suppose that consumers buy from whichever firm has the lowest price. Are you with me?
A. Yes.
Q. And suppose that the entrant and the incumbent are both charging a retail price of ten dollars initially, correct?
A. Okay.
Q. And let's say the entrant cuts its price to nine dollars. Just for the record, you have that assumption in mind? I saw you nod your head. You have that assumption in mind, that the entrant cuts its price to nine dollars?
A. Yes.
Q. Under the assumption that consumers continue to buy from the low-priced firm, wouldn't it be true that the market price has just fallen to nine dollars?
A. I think by definition it's fallen to

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nine dollars. The question is, of course, if the entrant is only just as efficient as the incumbent, it is now losing a dollar on every unit that it sells.
Q. Under the M-ECPR approach advocated by Dr. Sibley, what happens to the M-ECPR price at that point when the retail price is cut to nine dollars by the entrants? It falls to six dollars, doesn't it?
A. If that becomes – again, if that becomes the market price, which under his proposal the only way that can become the market price is if the entrant is more efficient than the incumbent and shares then that superior efficiency with its customers by charging this lower price that is just equal to its cost. The question is why would they do that unless the market had become fully competitive, which with just some marginal entry that is not going to happen.
Q. Suppose they are able to come up with the input for a dollar less?
A. Then they are more efficient. And the question is do they make a dollar in profit and continue to price at ten dollars or do they earn

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zero profit? That is what I was saying. It depends on how quickly this market becomes effectively competitive.
Q. But if for whatever reason they are able to drop or they do drop the price to nine dollars, that becomes the market price and the M-ECPR price now becomes six instead of seven; isn't that correct?
A. That is my understanding of how it is supposed to work, yes.
Q. At that point what is the effect on the entrant's profit when the M-ECPR drops to six?
A. Again, this goes back to what the entrant's costs are. If the entrant's marginal costs, average costs of providing the retail stage activity is two dollars, then they will be earning a dollar profit at six dollars. If they had simply undercut and were making a loss at the nine dollars, then their profits would return to normal.
Q. Once the M-ECPR price drops from seven to six, then the drop from ten to nine in the entrant's price doesn't affect its profits, does it?
A. Again, the question is one entrant does

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not determine the market price. So I mean if Professor Sibley wants to say anybody that comes in that wants to charge nine dollars he will change his price ceiling and his imputed floor to the lowest price anybody in the market is willing to charge, then that is how it would work. But I don't believe that is his proposal.
Q. Doesn't he propose under M-ECPR the M-ECPR price is dynamic; that is, it does change as entrants do certain things in the course of entering?
A. Well, it is a bit of a Catch-22, though. If I am an equally efficient entrant and I come in and I am paying seven dollars, how am I going to lower the price to nine? I can't. I would go broke.
Q. If you can come up with the input for less.
A. Where are you going to do that? Now we have got a new assumption; that is, you don't have a monopoly to start with.
Q. Aren't loops purchasable from people other than the ILEC? Where does the ILEC get them?
A. You can get them. I doubt if you can

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get them for less. I don't know. The assumptions have changed here dramatically. And that is all of a sudden we have gone from an assumption, which I think the whole telecommunication act holds, and that is that these firms do have monopolies in the provision of these inputs.
Q. Isn't it an empirical question as to whether right now loops, for example, can be bought from other than the ILEC?
A. Well, again, you have changed the hypothetical here on me again. We are not talking about loops. We are talking about wholesale services. You are going back to unbundled elements.
Q. Well, I was. That is why I talked about monopoly – my question was in terms of monopoly input. This was an M-ECPR.
A. I'm sorry. I thought we were talking about wholesale services. You said the wholesale price is three dollars.
Q. No. I said the price – I thought I said the cost of the monopoly input is three dollars.
A. Wholesale services is a monopoly input,

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too. If I am coming into this market, I can come in by buying wholesale services or I can come in by buying unbundled elements. Either way they are monopoly inputs. That is where we departed, I guess. You want to talk about unbundled elements?
Q. Yes.
A. The answer, I think, is pretty much the same anyway. And that is you are now postulating a situation where the local exchange company does not hold significant monopoly power over the supply of unbundled elements.
Q. I am an agnostic – in my hypothetical I'm an agnostic on that. I'm just saying that for whatever reason, and perhaps because they are able to obtain the element elsewhere or for some other reason, they drop the price to nine dollars. At that point the M-ECPR price drops to six dollars and the effect on the entrant's profits are unchanged, correct?
A. If we want to drop the assumption that unbundled elements are supplied under monopoly conditions, then – and we want to make an assumption that entrants can get into this market at relatively low barriers to entry, then we can

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just go ahead and cut to the chase here and we can say the retail price will be driven to six dollars and the wholesale price would be driven to three. That is what has to happen if we have competition.
Q. All I am suggesting to you, and perhaps in the hypothetical the element that is being supplied at ten dollars by the ILEC can be obtained elsewhere – that the element can be obtained at a somewhat lower cost from an alternative source. That is a possibility, isn't it, for any particular local element?
A. I don't know that it is as a practical matter. But if that is the case, then what you have done is you have moved one step a dollar, in fact, closer to a competitive price for one of the unbundled elements which will definitely drive down the retail price. And under any sort of proposal that sets the input price on the basis of the retail prices in the market, then yes, the dollar will be regained and will be gained and then lost again in this spiral toward a competitive price.
Q. What is the effect of the incumbent's profit in that hypothetical when the price drops

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to nine and the M-ECPR price drops to six?
A. I don't think there would be an effect on their profit. They ought to be able to buy the input for a dollar cheaper as well.
Q. Is there a price squeeze anywhere in that scenario, the possibility of a price squeeze?
A. No. I don't see the price squeeze occurring under that particular scenario.
(Brief recess.)
Q. In your rebuttal testimony, Professor Kaserman, which I think is Exhibit 2 before you, you state on page three that the ILEC has substantial market power in many areas. Do you see that?
A. Yes.
Q. What is your basis for that statement?
A. I think my basic basis for that is fairly common knowledge in this industry and also my background in antitrust. If you look at market shares and/or you look at entry barriers, you find very substantial measures both in this industry.
Q. What is your definition of market power?

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A. It is the ability of a firm to control the market price basically.
Q. Do you have any evidence that prices deviate from marginal costs or total service long-run incremental costs in the local exchange?
A. Yes.
Q. What evidence is that?
A. Various estimates that I have seen in various local markets of the prices in the marginal costs of the three services we have already talked about: the carrier access services, the intraLATA toll services and the vertical services.
Q. Do you have any evidence that looked at overall in terms of all services that prices deviate from marginal costs or total service long-run incremental costs in the local exchange?
A. Well, I don't think that answer – I don't think that question makes sense. I think you have to look at service by service. The question of prices and particularly the question of marginal costs and certainly the question of market power turns on a careful definition of what the relevant market is. I don't think the

relevant market includes all services.
Q. If the margins in one sector of what the ILEC does are offset by what happens with respect to some other service, would it be fair to say then that the ILEC has significant market power?
A. Certainly. This is one of the major concerns I think in the current market environment is that the ILEC will use its monopoly power in some markets to price well in excess of costs and utilize the profits from that activity to price under cost in other areas in order to retard or prevent the growth of competition.
Q. But isn't there a possibility that the ALECs will enter where margins are high and reduce economic profit perhaps to zero in those areas and while the ILEC is still required to provide below cost services? Do you see that as a danger?
A. I see it as an opportunity. I certainly wouldn't call it a danger.
Q. It is an opportunity for the ALECs but it is a danger for the ILECs, is it not?
A. It is a danger for the ILECs. It is an

opportunity for consumers because it drives prices to cost. Now, to the extent that may happen, of course, hinges critically upon the height of barriers to entry among those markets that are generating the excess profits.
Q. If an ILEC has ninety-nine percent of the market for a service that it is required by regulators to provide at below marginal costs, does the ILEC have market power in your view?
A. We are back to the regulatory-induced predatory pricing question. Let me finish my answer.
Q. It sounds like you are going to answer a different question from the one I asked. The question is, does the ILEC have market power in your view in that situation?
A. It very well could have market power. It has ninety-nine percent of the market. So if there are barriers to entry along with that, then by definition it has market power. Now, it's pricing below cost perhaps because the regulatory agency is forcing it to, perhaps because it chooses to in order to prevent competitors from coming into that market.
Q. Let's take the first situation. If it

does so because it is being forced to by a regulator, does it have market power?
A. Then the answer is it may or may not. If the regulator stops predatory pricing and allows that price to rise to a level that covers its cost or above, then the question is will we have entry in those markets? The answer again hinges on the height of the barriers to entry that exist, the economic barriers to entry that exist. All you have done – I think that there is a statement in my testimony to the effect that one of the most effective ways to prevent entry is to charge below cost prices.
Q. But if it is the regulator that is doing that or causing the ILEC to do it, then the ILEC doesn't have market power because you define market power as the power to control what you charge?
A. No. The question is – the question is if this company were not regulated, what power would it have? I mean we sort of got the cart before the horse here. The purpose of regulation is to control market power. And so if you are regulating, that doesn't mean that you don't have market power. It means somebody thinks you do.

Q. But you are not able to exercise it, correct?
A. That is the purpose for regulation, one of the purposes, to prevent you from exercising the monopoly power that you have.
Q. So in that situation the ILEC would have market power – might have market power but it is not able to exercise it? Is that a fair statement?
A. Well, hopefully the appropriate regulation of the ILEC will prevent it from exercising its monopoly power, yes.
Q. Would you agree that competitive entry has occurred already in local toll markets and local transport markets?
A. You put an adjective competitive entry. I think it is probably innocuous. But I will admit that there has been some entry. I don't know how significant it has been. There has been some entry. It is certainly not sufficient at this stage by any stretch of the imagination to leap to the conclusion that these markets are now competitive simply because there are has been some peripheral entry.
Q. You would consider MFS, for example, to

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be an entrant?
A. It is my understanding they are entered in the provision of access and I am not sure what else they may be providing.
Q. Teleport would be another entrant to your understanding?
A. I am not familiar with Teleport's market share again or what they are providing in the state of Florida.
Q. But they are another entrant, correct?
A. It is my understanding that they are providing some services in local exchange markets of some type.
Q. Doesn't GTE offer local toll service as part of a package with basic exchange service?
A. By local toll do you mean intraLATA toll?
Q. Yes.
A. I'm not sure. It is my understanding they are offering some bundled packages where they are combining toll and local services together.
Q. Don't the vast majority of GTE residential and business customers purchase that local toll from GTE?

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A. I do not have market share figures for the intraLATA toll market, so I don't know. But I suspect that is probably true.
Q. Isn't the contribution that GTE receives from local toll an important source of contribution to GTE?
A. I would imagine they are making handsome profits. If you wish to call that contribution, then you may do so.
Q. Let's continue to call it contribution. Doesn't the contribution from local toll help keep basic exchange prices low for GTE customers?
A. That is an interesting question. I have wondered for several years now where those profits go. As I indicated I think at the very front of this deposition, there is considerable debate in the economics literature at this point as to whether local services receive any subsidy whatsoever. If they are not receiving a subsidy, then those profits are not going to hold them low. They are going either to the stockholders or they are going to pay for inefficiencies within the firm.
Q. So the answer is you don't whether the

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contributions from local toll help keep basic exchange prices low for GTE customers?
A. I have serious questions about whether that is the case.
Q. What is your basis for those questions?
A. The debate about whether local service covers its costs or not.
Q. What is your basis for thinking that those people who in the alleged debate say that it doesn't help keep prices low are correct?
A. Again, I haven't reached a firm conclusion. I said I had serious questions, and the questions hinge on what the truth of the matter is in that debate.
Q. You just don't know?
A. And I do not know which side is actually correct.
Q. All right. When AT&T purchases local exchange services for resale, do you know whether it will purchase local toll from GTE or alternatively self-provide local toll?
A. I do not know what AT&T's plans are.
Q. If AT&T does provide local toll, won't GTE lose this source of contribution when it loses retail customers?

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A. That is another area that is subject to debate. When GTE loses an intraLATA toll customer to a competitor, be it AT&T, MCI, whoever, it loses the margin on the toll service. It also saves the cost of providing the toll service and it earns the margin on the access service that it is providing. On net, whether its profits go up or down is another empirical question.
Q. You don't know the answer to?
A. That we do not have the answer to. I can say that I have done some research on this issue with a graduate student here at Auburn and John Mayo, and the empirical results that we have found – and what we were looking at basically is historically has the growth of intraLATA toll competition put an upward pressure on local rates which is what your position would be. We found that the answer is no, it has not. To the extent there has been intraLATA toll competition to this point in time, there has been no increase in local rates, statistically significant increase that we can find.
Q. Has that study been published?
A. No, it has not.

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Q. Is it available? Is it a written study per se?
A. Yes. It is a paper that is written. We have not published it yet.
Q. Have you submitted it for publication?
A. We submitted it and are currently in the process of revising it and will be submitting it whenever we get some time to work on it, to send it back out. It is ready to send back out, I believe.
Q. If AT&T provides local toll and GTE loses a customer to AT&T that is taking this source of significant contribution or profit, you are saying that GTE won't lose the source of contribution when it loses the retail customer?
A. Again, the theory is that you lose the contribution but you also lose the cost of providing that service to the end customer and you now sell access at a substantial markup above cost to whoever is serving that customer.
Q. When you say you don't have to pay the cost of providing the service, the toll service, when you say there is contribution, doesn't that mean that what you get from AT&T is far greater than what you pay to provide it? Do you want me

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to rephrase that?
A. The contribution with the sale of the toll will disappear. I think my point was the total contribution is not the revenues that are lost. It is something smaller than the revenues because you also save the costs. So the true contribution is smaller than the total revenues you lose. Offsetting that are the access contribution, if you will, or profits in the sale of the access to this outside provider now.
Q. But that depends on GTE's continued ability to make that sale, does it not?
A. It depends on their monopoly power and provision of access services which I think is beyond dispute.
Q. What about under the act as the act is implemented? Will that continue to exist in your view?
A. I hope it won't. Are you talking about the pricing of access services?
Q. I think that is what you are talking about, isn't it?
A. Yes. That is markup I think – of course, the FCC has not yet held their access docket. So I really don't know what they are

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going to do on that. I hope they do the right thing. I can't be certain of that.
Q. Has anybody else reached a finding similar to yours, if that is what you have found, that loss of the toll will not overall have an adverse impact on contribution to GTE?
A. I think there is a paper by Mark Seavers that was published in a book that makes very similar type arguments.
Q. Mark Seavers?
A. Yes. I don't know if – I think he may have had some empirical evidence in his paper as well, but I am not sure about that.
Q. When GTE or another incumbent sells toll and local exchange as a bundled package, as you said you think happens, and when the – if, because you don't know, but if the price that GTE charges for the basic exchange is affected by the price it charges for local toll, then under these assumptions isn't the relevant retail price that should be used to calculate wholesale price really equal to the bundled cost of the toll and the local services?
A. No, I don't think so.
Q. Why not?

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A. If the new entrant is purchasing a local service and they are not purchasing the bundled services, the new entrant that is purchasing the local service, then it certainly would not make sense to include the intraLATA toll as part of a bundle simply because GTE had chosen to engage in what is in effect a tying arrangement in the sale of its outputs to its customers.
Q. Isn't the price that the ALEC is paying affected by the so-called tying agreement?
A. It certainly makes it harder for them to get in the market and compete in the presence of that tying arrangement.
Q. Why does it do that if the – and again we are assuming if the price for the basic exchange is lower as a result of the price for the toll, why does that make it more difficult for the entrant to come in under the avoided cost methodology that the act imposes?
A. I am sorry. I'm afraid I've gotten lost here in this example. You have got the ILEC selling a bundled service?
Q. Yes.
A. At a price of –

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Q. I don't think the price is relevant to the example. What I have said, and I think you agreed, is that they frequently do sell toll and local – basic local exchange as a bundled package. I think you testified that it was your understanding although you weren't sure that that frequently happened. Then I asked you whether the contribution that they make on the local toll helps keep the price low on the basic exchange, and you said you didn't know. So in the hypothetical I am asking you to assume that it does. Under that assumption, doesn't the existence of the so-called tying arrangement that lowers the price on the basic exchange service make it easier under the avoided cost method for the entrant to come in?

A. Let me try to rise above this just a moment and take a broader view. You are claiming – I believe I hear you claiming that lower prices promote entrant, that lower prices for retail inputs promote entry.

Q. I think what I am suggesting to you is that under the avoided cost method wherein the price that is going to be paid is determined by the retail price, that the lower that basic price

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is, the easier entry will be, yes, under the new act which calls for the avoided cost methodology?

A. No. I think that is silly. If entry were encouraged by lower output prices, suppose the price of the retail service went to a dime a month, do you think a thirty percent discount would promote entry, a forty percent discount, a hundred percent discount would promote entry? I don't think so. Maybe a hundred percent would, but a ninety percent wouldn't. Because the price is so far below the cost at that point that nobody can compete with any discount.

Q. Is it realistic to – when the price that is actually charged in the real world is a bundled price which takes into account both toll and the basic exchanges, is it realistic to simply call the price to break that down, unbundle it, even as the price was based on the assumption of bundling? Is it realistic to call the price for avoided cost methodology based on the unbundling?

A. We are back to the question of relevant markets. Yes, I think it is. I think that the local exchange service and intraLATA toll are separate markets from an economic point of view.

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I think as such the pricing questions need to be kept separate. I also think that tying arrangements in general are not anticompetitive. However, when they are implemented by a firm with substantial monopoly power, they can be very anticompetitive. There is a huge literature on that.

Q. Why do you consider them separate markets if they are invariably sold, and let's assume that they are, invariably sold by GTE as a bundle?

A. Just because one firm, as you say invariably, which I question they do, sells them as a bundle, they may offer them as a bundle but consumers may not choose them as a bundle.

Q. Let's assume that they are sold invariably or almost invariably as a bundle.

A. By the incumbent firm. They are not sold invariably by new entrants as a bundle. In fact, they are generally sold separate.

Q. We don't know because there aren't new entrants, correct, right now?

A. I thought you indicated there were. I am willing to admit there aren't any significant ones.

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Q. If there aren't, then shouldn't the market be defined by what the only person who is making those sales to a significant degree does?

A. Absolutely not. Where that firm has market power you don't allow that firm to determine what the market is. If we did that, antitrust would just be hand strung in trying to attack monopolies in general because the monopolist could simply redefine the market by bundling with some other product and, presto-chango, you don't have a monopoly.

Q. What if AT&T and other new entrants are also planning to package them the same way, that is, to sell both together?

A. If that is a market outcome in a competitive environment, then in that case bundling is not anticompetitive. But until that happens, I think you need to separate the pricing issues between these two markets.

Q. But you don't know whether AT&T is planning to bundle them that way, do you?

A. No, I don't. I think we will find out when and if we do have the entry which depends, of course, on what the commission does in this hearing.

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Q. If AT&T has suggested that they plan to go that way, wouldn't that be evidence that that is what is going to happen in the new market that you are describing?
A. Again, I think if it is a natural market outcome from market forces, then I think that is fine. If competition is present and driving those outcomes, that's fine. Until that happens, I think these need to be viewed as separate markets. They have historically been separate markets. Consumers have purchased them separate in other markets and continue to do so. And you cannot allow an incumbent firm with monopoly power to tell you what the relevant market is simply by its bundling or tying arrangements that it chooses to implement.
Q. You don't know one way or the other whether that same bundling will continue?
A. I think if you look far enough in the future I think probably a lot of services will be bundled. All long-distance, local and perhaps entertainment services and other things. But hopefully that will be driven by competitive market forces and consumer preferences, not by GTE's corporate decisions of what to price

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together or what to price separately.
Q. Aren't those decisions subject to regulatory review?
A. To some extent in the current regime, I suppose there is some regulatory review. I am not sure to what extent under the price cap regime.
Q. You are the author of a paper called Local Competition Issues and the Telecommunications Act of 1996, are you not?
A. I believe you are referring to the paper that was filed in Virginia?
Q. Correct.
A. Yes. I am the co-author on that paper.
Q. Your co-authors on that paper include Professor Michael Crew and Professor Paul Kleindorfer?
A. Yes.
Q. Haven't they written on the economics of the postal service?
A. I believe they have.
Q. Haven't they in their writings on the economics to the postal services, haven't they endorsed ECPR as an appropriate method for pricing unbundled monopoly elements?

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A. You would have to ask them about their writings. I, frankly, have not even read what they have done on postal services.
Q. So you don't know also whether they endorse the end user fee as a method of making the postal service whole?
A. No, I do not.
MR. MIRENGOFF: That concludes my questions. I don't believe we have any redirect.

(Whereupon, at 4:45 p.m., the taking of the instant deposition ceased.)

Signature of the Witness

SUBSCRIBED AND SWORN to before me this day of , 19 .

NOTARY PUBLIC
My Commission expires:

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CERTIFICATE OF REPORTER

STATE OF ALABAMA)
JEFFERSON COUNTY)
I, Paige Paugh, the officer before whom the foregoing deposition was taken, do hereby certify that the witness whose testimony appears in the foregoing deposition was duly sworn by me; that the testimony of said witness was taken by me to the best of my ability and thereafter reduced to typewriting under my direction; that I am neither counsel for, related to, nor employed by any of the parties to the action in which this deposition was taken, and further that I am not a relative or employee of any attorney or counsel employed by the parties thereto, nor financially or otherwise interested in the outcome of the action.

Notary Public in and for
the State of Alabama