



DEPARTMENT OF THE ARMY  
 OFFICE OF THE JUDGE ADVOCATE GENERAL  
 901 NORTH STUART STREET  
 ARLINGTON, VA 22203-1837



REPLY TO  
 ATTENTION OF

November 5, 1993

Regulatory Law Office  
 U 3741

SUBJECT: Comprehensive review of the Revenue Requirements  
 and Rate Stabilization Plan of Southern Bell Telephone &  
 Telegraph Company, Docket No. 920260-TL

Mr. Steve C. Tribble  
 Director, Division of Records and Reporting  
 Florida Public Service Commission  
 101 East Gaines Street  
 Tallahassee, Florida 32301

Dear Mr. Tribble:

Enclosed for filing in this proceeding are an original  
 and 15 copies of the Direct Testimony of Harry Gildea on  
 behalf of the U.S. Department of Defense and All Other  
 Federal Executive Agencies of the Federal Government.

Copies have been served in accordance with the attached  
 Certificate of Service.

Sincerely,

Peter Q. Nyce, Jr.  
 General Attorney  
 Regulatory Law Office

- ACK \_\_\_\_\_
- AFA 2 \_\_\_\_\_
- APP \_\_\_\_\_
- CAF 1 \_\_\_\_\_
- CML \_\_\_\_\_
- CTR \_\_\_\_\_
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FPSC-RECORDS/REPORTING

**BEFORE**  
**THE FLORIDA PUBLIC SERVICE COMMISSION**

Comprehensive Review of the Revenue  
Requirements and Rate Stabilization Plan of  
Southern Bell Telephone and Telegraph Co.

Docket No. 920260-TL

**DIRECT TESTIMONY**  
of  
**HARRY GILDEA**

on behalf of

**THE UNITED STATES DEPARTMENT OF DEFENSE AND  
ALL OTHER FEDERAL EXECUTIVE AGENCIES**

**ROBERT N. KITTEL**  
Chief

**PETER Q. NYCE, JR.**  
General Attorney

Regulatory Law Office  
Office of The Judge Advocate General  
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901 N. Stuart Street, Suite 400  
Arlington, Virginia 22203-1837

November 8, 1993

1 **DIRECT TESTIMONY OF HARRY GILDEA**

2 **Introduction**

3 Q. What is your name and business address?

4 A. My name is Harry Gildea. My business address is 1220 L Street, N.W.,  
5 Suite 410, Washington, D.C. 20005.

6 Q. What is your professional background?

7 A. Since 1972, I have been a consultant with Snavelly, King & Associates.  
8 Before that time, I was with the Economic Development Administration, a part of the  
9 U.S. Department of Commerce. From 1962 to 1969, I was responsible for the  
10 operations research consulting practice of Peat Marwick Livingston & Company in the  
11 Washington area. Previously, I was a research engineer with Sylvania Electric  
12 Products, a subsidiary of General Telephone and Electronics Corporation.

13 Q. What is your educational background?

14 A. I received the degrees of Bachelor of Science in Electrical Engineering  
15 and Master of Science in Electrical Engineering from the Massachusetts Institute of  
16 Technology in 1958.

17 Q. What is the nature of your work with Snavelly, King & Associates?

18 A. My work is primarily concerned with providing assistance to clients in  
19 cases before state and Federal regulatory agencies involving public utilities. Most of  
20 this work has been in the telecommunications field, but I have also participated in gas,  
21 electric and water cases, as well as several cases concerning the United States Postal  
22 Service.

23 My work in the telecommunications field has encompassed a wide range  
24 of monopoly and competitive services, including local exchange services, message  
25 telephone services, private line services, Centrex, telex, video, data, cellular and other  
26 services.

1 Q. Have you testified previously before the Florida Public Service  
2 Commission?

3 A. Yes. I testified Docket No. 71308-TP, concerning the rates and charges  
4 by Southern Bell Telephone and Telegraph Co. ("Southern Bell" or "the Company".)

5 Q. Have you testified before other regulatory agencies?

6 A. Yes. I have testified as an expert witness before the Federal  
7 Communications Commission and the Federal Energy Regulatory Commission, as  
8 well as the state regulatory agencies of California, Connecticut, the District of  
9 Columbia, Georgia, Illinois, Kentucky, Maryland, Massachusetts, Michigan, Missouri,  
10 New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Tennessee, Texas and  
11 Virginia. My testimony has addressed a wide range of issues in the areas of rate of  
12 return, rate base and expenses, and rate structure.

13 Q. Have you had additional experience in the telecommunications field?

14 A. Yes. I have been a consultant to the Federal Executive Agencies on rate  
15 design and tariff issues in major Federal procurement activities, including the  
16 Aggregated System Procurement ("ASP") for local telephone services and the  
17 FTS2000 system for intercity telecommunications services.

18 In addition, I have performed damage studies in three antitrust cases  
19 involving telecommunications firms. I have also been a consultant to the International  
20 Telephone & Telegraph Corporation, the Radio Corporation of America, Western  
21 Union International, and TRT Telecommunications Corporation in several proceedings  
22 before the Federal Communications Commission, and a case before the United States  
23 Court of Appeals. In addition, I have served as a consultant to the United States  
24 government, the government of Canada, various telecommunications firms, and users  
25 of telecommunications services in proceedings before regulatory agencies. Also, I  
26 testified as an expert witness in a proceeding before the General Services

1 Administration Board of Contract Appeals concerning the selection of  
2 telecommunications firms.

3 Q. For whom are you testifying in this case?

4 A. I am testifying on behalf of the customer interests of the United States  
5 Department of Defense and All Other Federal Executive Agencies ("FEAs").

### 6 **Interests of the Federal Executive Agencies**

7 Q. What are the customer interests of the FEAs in this proceeding?

8 A. The operation of Federal Government activities in Florida requires  
9 extensive use of telecommunications services and facilities provided by Southern Bell  
10 and other firms. Because of the diversity of the Government's telecommunications  
11 requirements, the FEAs are interested in virtually all voice and data services.

12 Pursuant to the *Competition in Contracting Act*, P.L. 98-369, and other  
13 legislation, the Federal government pursues full and open competition in the  
14 procurement of telecommunications services. The FEAs would like to receive  
15 competitive bids meeting their requirements from as many vendors as possible. Each  
16 of these bids might use a different mix of components from the public switched network  
17 of the telephone company and from facilities of other firms. Ideally, there would be no  
18 monopoly, "bottleneck" facilities. Any number of providers could offer any component  
19 of the telecommunications system using interconnections that are efficient and  
20 transparent to the end user.

### 21 **Subject of Testimony**

22 Q. What is the purpose of your testimony?

23 A. The purpose of my testimony is to address Southern Bell's rate proposals  
24 in this proceeding. The focus of my discussion is not on the details of the Company's  
25 proposals, but on the supporting rationale.

1 **Southern Bell's Rate Proposals**

2 Q. What are Southern Bell's rate proposals in this case?

3 A. There are two sets of rate proposals. First, in conjunction with its  
4 proposal to extend the incentive sharing plan, Southern Bell proposes four groups of  
5 changes:<sup>1</sup>

- 6 • to offer an optional expanded local service plan that provides both  
7 residential and business subscribers with local calling capability out to  
8 40 miles at "discounted" rates (-\$7.7 million in 1993; -23.6 million in  
9 1994);
- 10 • to restructure its local message rate services by changing the charges for  
11 additional PBX trunks and changing message unit allowances (\$2.8  
12 million);
- 13 • to institute hunting charges for foreign exchange services (\$0.4 million);  
14 and
- 15 • to reduce some carrier access charges (-\$10 million).

16 In addition, Southern Bell proposes a series of changes to reduce its revenue  
17 by the \$49 million credit approved by the Commission for 1993. This reduction will be  
18 implemented through the following series of changes:<sup>2</sup>

- 19 • reductions and restructure of service connection charges (-\$14.0  
20 million);
- 21 • reductions in PBX trunk, network access register and hunting charges  
22 (-\$29.6 million);
- 23 • elimination of all "additives" on flat rate extended area service charges  
24 (-\$0.2 million); and
- 25 • reductions in rates for some custom calling services (-\$4.3 million).

26 Southern Bell asserts that the total revenue effect of these four changes  
27 is \$48.2 million. In addition, the Company has filed tariffs to modify its "lifeline" offering  
28 for lower income residential subscribers, to institute an "Economic Development Plan,"

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1 Updated Testimony of Nancy H. Sims, October 1, 1993, page 3.

2 *Id.*, page 4.

1 and to expand the "free enterprise zones" for business subscribers. These additional  
2 proposals allegedly reduce the Company's revenues by \$1.5 million.

3 Q. Are these likely to be the only rate adjustments as a result of this case?

4 A. No. The Commission is evaluating Southern Bell's entire revenue  
5 requirement. This evaluation could result in much larger revenue reductions than  
6 discussed in Southern Bell's testimony. If so, the Commission will need to have some  
7 basis for deciding how to implement these reductions. At present, that basis is lacking.

### 8 **Evaluation of Southern Bell's Rate Proposals**

9 Q. Why do you say that there is an inadequate basis for the Commission to  
10 decide how to reduce Southern Bell's rates?

11 A. While the Company's proposals seem to benefit to a fairly broad range of  
12 users, I do not believe it is possible for anyone to provide a meaningful evaluation of  
13 them. Southern Bell has failed to furnish any substantive rationale for selecting its  
14 specific proposals from the virtually limitless set of possibilities. The Company has  
15 also failed to provide critical information needed to evaluate its proposals.

16 Specifically, Southern Bell has not provided cost data to support its  
17 proposals. In most cases, the Company does not even indicate whether the proposed  
18 change will move rates in the direction of costs. With few exceptions, cost is not even  
19 mentioned as a consideration in the formulating the proposal. Even when mentioned,  
20 the costs are not quantified. For example, to support its restructure of service  
21 connection charges, the Company states that its proposals will bring rates "more in  
22 line with costs."<sup>3</sup> However, there are no cost data for service connection activities to  
23 support this assertion.

24 Q. Has Southern Bell justified its proposals by data on its competitive  
25 markets?

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<sup>3</sup> *Id.*, page 25.



1           A.     Again, there are no specific data, only generalizations. For example,  
2 Southern Bell's only proposal concerning carrier access charges is to reduce the  
3 transport rate for switched access. Southern Bell Witness Sims states that this change  
4 was made because local transport is "one of the most competitive elements of  
5 access."<sup>4</sup> However, Southern Bell provides no evidence to show that local transport is  
6 more competitive than other access elements, including dedicated access. Coupled  
7 with the fact there are no costs at all for any access rate elements, the selection of one  
8 element from switched access service seems arbitrary. This same deficiency is  
9 evident from my analysis of all of Southern Bell's proposals. In short, there is no clear  
10 substantive basis for the Commission to determine whether, out of all possible rate  
11 changes, Southern Bell's proposals are the most appropriate. Furthermore, if revenue  
12 reductions go beyond the rate proposals by Southern Bell, the Commission will be  
13 "flying in the dark" as to how to distribute the reductions among customer groups,  
14 services and rate elements.

15           Q.     Why is it important to have a sound basis for rate design proposals?

16           A.     Before 1984, when Southern Bell and the other Bell System companies  
17 enjoyed a virtual monopoly over all telephone services and equipment, it was possible  
18 to maintain a rate structure that departed substantially from the structure of costs. An  
19 important basis of the telephone rate structure, not only in Florida but throughout the  
20 country, was "value of service." Services perceived to be "more valuable" bore higher  
21 rates than those that were "less valuable." Business services were often deemed to  
22 have "greater value" so that business subscribers were charged higher rates than  
23 residential subscribers. Also, long distance service was perceived to be "more  
24 valuable" than local service and therefore bore relatively high rates.

25                     In 1984, when the Bell System was broken up, the telephone companies  
26 lost their virtual monopoly over customer premise equipment. Southern Bell was

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<sup>4</sup> *Id.*, page 23.

1 required to transfer its embedded customer premise equipment to AT&T. This transfer  
2 eliminated the Company's virtual monopoly over customer exchange networks, that is,  
3 intercommunications systems on the subscribers' premises. PBX switches provided  
4 by other firms became much more competitive with the Centrex services offered by  
5 Southern Bell.

6 Also, while Southern Bell originally enjoyed a monopoly in the provision  
7 of intraLATA toll services, actions by the Florida Public Service Commission have  
8 permitted competition for this service. In addition, the activities of Competitive Access  
9 Providers, or "CAPS," have eliminated Southern Bell's previous monopoly position in  
10 providing tie lines between the interexchange carrier and the Company's central  
11 offices.

12 The effect of competition has been to drive the prices for competitive  
13 services to their costs. For example, it is not feasible for Southern Bell to maintain  
14 intercom rates for ESSX service that are significantly higher than the alternative costs  
15 to customers of acquiring and operating PBXs.. It is also not feasible for Southern Bell  
16 to maintain rates for intraLATA toll services that are significantly higher than the rates  
17 charged by other firms to provide the same service. In addition, access charges can  
18 no longer be maintained significantly above the costs that the CAPS incur to provide  
19 alternative access.

20 Because competition is eroding the previously high margins for its some  
21 of Southern Bell's profitable services, it is becoming less and less feasible for  
22 Southern Bell to maintain low rates for services that have not been as profitable.  
23 Primary among these low-profit services is residential exchange access. The rates for  
24 residential exchange services may eventually have to be increased if Southern Bell is  
25 to survive as a viable source of universal telephone service.

1 **Rate Changes Required in a Competitive Environment**

2 Q. What types of rate changes are required in a competitive environment?

3 A. The rate changes can be classified into three categories:

- 4 • rate reductions for the services most subject to competition,  
5 • rate modifications for services for which Southern Bell has a dual role as  
6 both competitor and provider of "bottleneck" services required by  
7 competing firms; and  
8 • rate increases for services previously provided below cost.

9 Q. Please describe the rate reductions required for services subject to  
10 competition.

11 A. Competition in providing intraLATA message toll services is developing  
12 rapidly because there has been a great deal of competition in providing the interLATA  
13 and interstate versions of this service over the last ten years. Therefore, rate  
14 reductions for intraLATA message toll services, which have generally been priced  
15 above costs, will be required.

16 Also, new entrants to the telecommunications markets will naturally  
17 concentrate on the higher capacity, more technologically advanced services.  
18 Therefore, significant rate reductions should be expected for Southern Bell's high  
19 capacity digital private line services. On the other hand, the rates for single channel  
20 private line services, which are not as attractive for new market entrants, will probably  
21 not decline as quickly, and may even increase.

22 Q. Would you please describe the second area of rate adjustments required  
23 in the competitive environment?

24 A. Yes. The second area relates to so-called "bottleneck" services that are  
25 required by telecommunications firms that compete with Southern Bell. Direct Inward  
26 Dialing ("DID") is an example of such a service.

1 DID permits firms with PBX systems to have designated telephone  
2 numbers for each station on the PBX, so that incoming calls may be routed directly to  
3 the instrument. Only Southern Bell provides DID service. DID must be acquired by  
4 firms with PBX switches to obtain service that is comparable to Southern Bell's own  
5 competing ESSX service.

6 For a balanced competitive market to exist, Southern Bell must not be  
7 allowed to use the leverage of this bottleneck DID service to unfairly increase the costs  
8 of competing PBX systems to business subscribers. Therefore, it is necessary to  
9 ensure that DID rates accurately reflect the costs of DID service.

10 Q. Which services are subject to rate increases?

11 A. In the longer run, the primary service that is subject to rate increases in  
12 the competitive environment is residential exchange access. Rate reductions for this  
13 service cannot generally be justified on a cost basis even if the Company's total  
14 revenue requirement is reduced because the service is usually offered below cost.

15 Residential exchange access is offered below cost because residential  
16 services were traditionally priced "residually." Business and message toll services  
17 were priced according to their "value," which was well above cost. Residential  
18 subscribers were expected to pay only for the remaining revenue requirement not  
19 covered by these other, more profitable services. The cost of residential service was  
20 rarely, if ever, used to determine residential rates. The provision of residential service  
21 at below-cost rates was considered desirable because it promoted "universal service."  
22 That is, lower rates encouraged every household to acquire a telephone. This pricing  
23 policy was successful. By 1984, 91.3 percent of the households in Florida had access  
24 to a telephone.<sup>5</sup> The present penetration is 95.0 percent.<sup>6</sup>

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<sup>5</sup> Federal Communications Commission, "Telephone Subscribership in the United States, August 1993.

<sup>6</sup> *Id.*, Percentage for March 1993.

1           Unfortunately, the provision of residential service at rates substantially  
2 below cost is becoming less and less feasible. Competition is driving down the rates  
3 for the most profitable business and toll services, leaving no excess revenue to  
4 subsidize residential rates. Ultimately, it will be necessary to move residential rates up  
5 to the level of cost in order to maintain a viable telephone system.

6           Q.     Do Southern Bell's rate proposals comport with the requirements you  
7 have described?

8           A.     While some of Southern Bell's proposals address the needs of the  
9 competitive marketplace, there are some important omissions. For example, the  
10 services with the greatest competition today include message toll, access charges,  
11 and high capacity private lines. Southern Bell should be proposing rate reductions for  
12 these highly competitive services.

13           Southern Bell is proposing rate reductions for one of the rate elements of  
14 switched access, but no reductions for special access. The Company has addressed  
15 carrier access charges to a limited extent. However, the Company has not proposed  
16 any rate reductions for other access elements, message toll or high capacity private  
17 line services.

18           Q.     Do you believe that Southern Bell should propose reductions for access,  
19 message toll and private line services?

20           A.     I cannot answer definitively because I do not know Southern Bell's costs  
21 for these services. However, I note that Southern Bell's intraLATA message toll rates  
22 have not changed since December 1, 1990.

23           Based on my experience in other jurisdictions, message toll services are  
24 generally priced well above costs. The local exchange carriers are generally taking  
25 advantage of this margin between toll rates and costs to reduce prices and help meet  
26 competitive pressures. Nationally, rates have declined. In December 1990, the

1 Consumer Price Index for intrastate message toll service was 94.5.<sup>7</sup> By March 1993,  
2 the national index had declined to 90.7.<sup>8</sup>

3 Q. Referring to the second need you identify, has Southern Bell proposed  
4 rate modifications for services for which the Company has a dual role as both  
5 competitor and provider of "bottleneck" services required by competing firms?

6 A. Southern Bell has offered rate proposals that address rate elements for  
7 two services that are highly competitive with each other, ESSX and PBX services. It is  
8 very important that the total costs to end users for these services are balanced,  
9 because Southern Bell is the sole provider of ESSX service, while PBX service is  
10 provided partly by Southern Bell and partly by competing firms.

11 Southern Bell is proposing reductions in the rates for network access  
12 registers that are used for ESSX. It is also proposing reductions in PBX trunk rates  
13 and reductions in the rates for hunting, which is used in conjunction with PBX service.  
14 However, the Company is not proposing any changes in DID rates.

15 In short, Southern Bell is proposing to reduce rates on both sides of the  
16 ESSX/PBX equation. However, I cannot determine specifically whether Southern  
17 Bell's rate actions are appropriate because I do not have any cost data for these  
18 services.

19 Q. Has Southern Bell addressed the third need that you identify, the  
20 requirement to increase the rates for services provided below cost?

21 A. I cannot answer this question specifically, because I do not have any cost  
22 data for Southern Bell. Moreover, because Southern Bell's rate proposals are  
23 designed to obtain less revenue in total, I would not expect rate increases for  
24 residential services.

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<sup>7</sup> "FCC Reference Book", May 17, 1993.

<sup>8</sup> *Id.*

1           However, Southern Bell is in fact proposing rate reductions for residential  
2 exchange service. Southern Bell forecasts that the Optional Expanded Local Service  
3 Plan will reduce residential revenues. While I have no specific objection to this  
4 optional plan, I question whether residential revenues should be reduced unless the  
5 Company can show that the current rates are above costs. As I have stated earlier, I  
6 believe it is more likely that these rates are below costs.

7           Q.     Why do you believe that the rates for residential service are below costs?

8           A.     The best evidence I have is that the monthly rates for residential  
9 exchange access are far below the rates for business exchange access. For example,  
10 the monthly exchange access rates in Miami are \$10.65 for residential subscribers  
11 and \$29.10 for business subscribers. The rate for business subscribers is nearly three  
12 times the residential rate.

13          Q.     Is there any economic basis for a higher rate for business exchange  
14 access lines?

15          A.     No. In fact, the average cost of residential exchange access is almost  
16 certainly greater than the average cost of business exchange access lines.

17          Q.     Why?

18          A.     The exchange access line consists principally of the local loop  
19 connecting the subscriber to the telephone company's local central office. On the  
20 average, business customers are located in more densely developed areas, where  
21 telecommunications demands per square mile are the greatest, and the telephone  
22 company offices are more closely spaced. Therefore, the local loops for business  
23 customers are, on the average, shorter than the local loops for residential subscribers.  
24 Also, in more densely populated areas, the local loops will generally be routed over  
25 cables with a greater number of wire pairs, which have a lower cost per pair than the  
26 lower cross-section cables used for residential areas.

1           Finally, local distribution facilities are now being multiplexed in many  
2 densely developed areas to reduce the costs of wire plant and save space in conduits.  
3 The opportunities for saving costs through multiplexing multiple local channels are  
4 greater for service to high density locations such as office buildings.

5           Q.     Do you believe that "universal service" is impaired if residential rates are  
6 not reduced?

7           A.     No.     Most people regard telephone service as a critical element of  
8 modern life.  Furthermore, increases in the rates for residential exchange access will  
9 be ameliorated by reductions in message toll rates.  Moreover, as I stated previously in  
10 this testimony, I believe that residential subscribers ultimately benefit by the rate  
11 changes necessary for the Southern Bell to operate in a competitive environment.

12                  In any event, it is no longer practical for business services to subsidize  
13 middle and upper income residential subscribers.  To aid low income subscribers, I  
14 believe that the proper approach is to maintain an "economy service" or "lifeline"  
15 program that is specifically targeted to the needs of households with income levels that  
16 make telephone service under normal market rates a true financial hardship.

17           Q.     What do you recommend with respect to the Optional Expanded Local  
18 Service Plan?

19           A.     I believe that rate changes for residential customers should be revenue-  
20 neutral in total.  Therefore, if this plan is accepted, there should be an offsetting  
21 increase in the monthly rate for residential exchange access.  The required increase  
22 should be small because the anticipated revenue from the optional plan would be  
23 spread among all residential access lines.



1 **Information Required for Further Rate Reductions**

2 Q. If the Commission determines that Southern Bell's revenue should be  
3 reduced by more than the amount implicit in the Company's proposals, what  
4 information does the Commission need to decide what rate reductions are most  
5 appropriate?

6 A. The required information includes incremental costs for each principal  
7 service and service element; embedded direct costs by customer category and service  
8 group; and information that would enable the Commission to assess the extent of  
9 competition for Southern Bell's services in Florida.

10 Q. How should subsequent rate reductions be accomplished?

11 A. I believe that the best procedure is to decouple the distribution of total  
12 revenue changes from the calculations of the changes themselves. In a separate  
13 inquiry, the Commission would establish a prioritized list of rate reductions and,  
14 alternatively, rate increases. For example, if there is to be a rate reduction, the  
15 Commission might designate the first million dollars to reductions in, say, intraLATA  
16 toll rates, the second million dollars to access charges, and the third million dollars to  
17 PBX trunks and network access registers. Similarly, there would be another prioritized  
18 list for rate increases setting forth, in order, the dollar amount to be recovered from  
19 services that might require additional revenue, principally because they are provided  
20 below cost.

21 In fact, a procedure along these lines was recommended by Southern  
22 Bell's sister company, South Central Bell, in other jurisdictions. Such a procedure has  
23 been implemented in at least three states, Kentucky, Alabama and Mississippi.

24 Q. Why do you recommend this procedure?

25 A. I recommend this procedure because rate structure changes are highly  
26 contentious and controversial. If the revenue adjustments must await determination of

1 the distribution of the rate changes, they are likely to be delayed while various parties  
2 debate their competing rate adjustment agendas. The result is to reintroduce  
3 regulatory lag into a plan that is intended to help reduce regulatory lag.

4 Q. Does that conclude your testimony?

5 A. Yes, it does.

6

CERTIFICATE OF SERVICE  
Docket No. 920260-TL

I hereby certify that a copy of the forgoing document has been sent to each of the parties on the following service list by First Class U.S. Mail on November 5, 1993.

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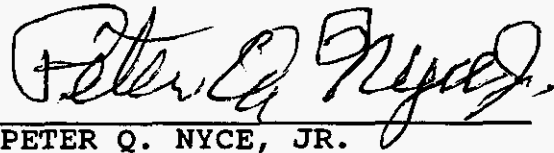
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