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February 21, 1996

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

Re: Resolution of Petition to Establish Non
Discriminatory Rates, Terms, and Conditions
for Resale Involving Local Exchange Companies
and Alternative Local Exchange Companies
pursuant to Section 364.161, Florida Statutes
Docket No. 950984-TP

Dear Ms. Bayo:

Enclosed for filing in the above-styled docket are the original and fifteen (15) copies of Rebuttal Testimony of F. Ben Poag.

Please acknowledge receipt and filing of the above by stamping the duplicate copy of this letter and returning the same to this writer.

Thank you for your assistance in this matter.

Sincerely

J. Jeffrey Wahlen

- ACK
- AFA
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- CAF
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- CTR
- EAG
- LEG
- LIN *5*
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JJW/csu
Enclosures

cc: All parties of record

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ATTORNEY

1 BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

2 REBUTTAL TESTIMONY

3 OF

4 F. BEN POAG

5
6 Q. Please state your name.

7
8 A. My name is F. Ben Poag.

9
10 Q. Have you previously filed testimony in this proceeding?

11
12 A. Yes, I filed prepared direct testimony.

13
14 Q. What is the purpose of this testimony?

15
16 A. This testimony is being filed to respond to the direct
17 testimonies filed by Mr. Devine for MSF-FL and Dr.
18 Cornell for MCImetro.

19
20 Q. On page 7 of her testimony, and on page 23 of his
21 testimony, Dr. Cornell and Mr. Devine, respectively,
22 propose that the price for unbundled services be set at
23 TSLRIC. Do you agree?

24
25 A. Absolutely not. As indicated in my direct testimony,

1 such pricing of unbundled services would have severe
2 implications.

3
4 First, it would be discriminatory to provide these
5 services at one price for ALECs and another price for
6 IXC's, AAV's and cellular providers. These unbundled
7 services will be used for both local and toll services,
8 there is no rational basis for attempting to have
9 separate rates for different classes of customers for
10 essentially the same service.

11
12 Second, it is totally inappropriate that the ILEC recover
13 all its shared and overhead costs only from its end user
14 customers. This creates an imbalance in the market and
15 allows the ALEC to retain excess profits.

16
17 Third, it would result in arbitrage of special access
18 services and substitution of lower priced unbundled loops
19 for switched access services.

20
21 Q. Would it fix the arbitrage and discrimination problems if
22 the companies reduced their rates for special access
23 services to long run incremental cost.

24
25 A. It would fix the discrimination problem in terms of rates

1 charged to other users (IXC, AAVs) of these services, but
2 it would have a severe negative impact on Sprint-
3 United/Centel's ability to continue to support universal
4 service and carrier of last resort obligations.
5
6

7 Q. How?

8
9 A. Any rate reduction for special access services changes
10 the crossover point at which IXCs and end user customers
11 will substitute special access for switched access and
12 toll services. The ILEC would not only lose the
13 contributions from special access service but would also
14 lose additional revenue contributions from the switched
15 access and toll services. The shortfall would result in
16 additional cost recovery burdens that would have to be
17 recovered from Sprint United/Centel's end users under Dr.
18 Cornell's proposal. This would handicap Sprint-
19 United/Centel in the competitive market, erode support
20 for universal service, and create unfair profit margins
21 for the ALECs.
22

23 The arbitrage would not be an issue because the repricing
24 would effectively result in 100% arbitrage, i.e., all
25 services get the lower price.

1 Q. Please summarize your concerns regarding an incremental
2 cost approach to pricing.

3
4 A. First, it is generally accepted that incremental costing
5 methods are not used for price setting but are rather a
6 price floor which is used to test for cross-
7 subsidization. Second, firms have other costs in
8 addition to the incremental cost of products and services
9 which must be recovered if the firm is to maintain
10 profitability. These other costs can generally be
11 categorized as shared costs and common overhead costs.

12
13 An example of shared cost would be a software program
14 which provides two features, for example, call waiting
15 and three-way calling. By the definition of an
16 incremental cost study, the shared software cost would
17 not be included in the incremental cost of either of the
18 individual features. However, unless you had that
19 software in place you could not provide the service and
20 unless you could recover the software cost with revenues
21 from one or both features, it would not be a financially
22 prudent decision to offer the services.

23
24 In addition to shared costs, there are also common
25 overhead costs. From a facilities perspective, the SS7

1 network would be an example of an overhead cost. SS7 is
2 a network manager that makes all other pieces of the
3 network work more efficiently and provides additional
4 services capabilities, e.g., CLASS services. These types
5 of costs, and many more real costs, do not get included
6 in the economic definition of an incremental cost study.
7 However, the underlying expenditures are necessary to
8 efficiently and effectively provide the requested
9 services, and the costs need to be recovered for the firm
10 to be profitable. They should not be recovered only from
11 Sprint-United/Centel's end user customers. Further, new
12 entrants will be entering markets where there is a
13 significant revenue/cost margin for the packages of
14 services for which new entrants will be competing with
15 the LECs. These large revenue/cost margins result from
16 the social pricing of LECs' services under rate base rate
17 of return regulation. Under rate base rate of return
18 regulation, a LEC's basic service rates were developed
19 based on a residual revenue requirement basis; cost of
20 individual services was not a factor. Basic service
21 prices were kept low with the shortfall of revenues being
22 made up from other services, e.g., toll, access and other
23 discretionary services. Cost in metropolitan areas are
24 lower, but actual prices for basic services are higher.

1 The net result of these prior pricing decisions is that
2 revenues from Sprint-United/Centel's high density low
3 cost exchanges provide contribution to its high cost low
4 density exchanges. In the historical monopoly
5 environment, such pricing could be maintained. However,
6 with local competition, these revenue/cost mismatches
7 provide new entrants with significant market
8 opportunities. Therefore, shifting additional shared and
9 overhead costs to the LECs to attempt recovery in an
10 environment where existing revenue/cost distortions
11 already favor new entrants is inappropriate and will
12 exacerbate these revenue/cost distortions.

13
14 Q. Do you agree with Dr. Cornell on the possibility of a
15 price squeeze?

16
17 A. No. Given the fact that other ALECs have signed
18 agreements which provide unbundled loops based on special
19 access prices, it would appear that the possibility of a
20 "price squeeze" is more of a theoretical concern than a
21 real threat.

22
23 Applying theory in the real world is not difficult given
24 the existing revenue/cost distortions for LEC services.
25 Prices for LEC services are generally average prices and

1 do not reflect economic cost differences. Due to
2 historical social pricing policies, prices for some
3 services far exceed cost while others are below cost.
4

5 If the ILECs' prices reflected true economic costs,
6 application of the theory would be more appropriate.
7 However, there continue to be social, political and legal
8 considerations that prohibit LECs from doing so. That
9 being the case, the Commission should not attempt to
10 force a text book theory on a real world market which did
11 not develop in the traditional economic sense. This is
12 not to say that economic theory should be ignored, but
13 suggests that it must be applied within the confines of
14 the existing social, political and legal constraints and
15 with the goals of universal service in mind.
16

17 Whether a "price squeeze" will ever occur in a manner
18 that impairs the development of competitive local
19 exchange service is difficult to predict. If a price
20 squeeze occurs at all, it would probably occur in
21 geographic areas where the cost of an unbundled loop
22 exceeds average cost. These areas are not likely to be
23 targeted by new entrants, at least initially. If a
24 "price squeeze" does in fact occur, the Commission will
25 need to balance the goal of universal service against the

1 goal of fostering local exchange competition.

2
3 Q. Are there other problems with Dr. Cornell's price squeeze
4 theory?

5
6 A. Yes. Dr. Cornell's argument appears to address only the
7 worst case scenario, that is basic residential service,
8 and even in this analysis, fails to include the revenues
9 from other services which are associated with the access
10 line itself. Additionally, Dr. Cornell does not address
11 the price squeeze from the perspective of business
12 services. For example, using Sprint United/Centel's rate
13 for a special access service and a voice grade electrical
14 cross-connect, the charge would be \$20.35 per month.
15 However, this service, when connected to the ALEC's
16 switch, can replace a PBX trunk, which at Winter Park
17 exchange rates including the subscriber line charge is,
18 \$54.06, a 166% margin. In addition to the \$54.06, the
19 ALEC would also get access and intraLATA toll revenues
20 over that same facility. Clearly, the PBX trunk, the
21 access charges and the intraLATA toll rates are far in
22 excess of their costs.

23
24 Similarly, where an end user customer has 24 PBX trunks,
25 the ALEC can purchase a DS1, the equivalent of 24 voice

1 grade circuits, for \$112.75 per month plus \$4.45 for the
2 electrical cross-connect. Thus, the unbundled loop
3 charge, with the electrical cross-connect is \$117.15 as
4 compared to \$1,297.44 that Sprint United charges for the
5 24 PBX trunks. Again, the \$1,297.44 does not include the
6 additional revenues that the ALEC will also get for toll
7 and access services. The difference between Sprint
8 United/Centel's charges to end user business customers
9 versus the charges for unbundled loops is a windfall
10 market opportunity for MCImetro. There is no real world
11 price squeeze. When "MCI-Rural" enters the local service
12 market in Kenanville, then we should worry about a price
13 squeeze.

14

15 Q. Does that conclude your rebuttal testimony?

16

17 A. Yes.

18

19

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