BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of
Resolution of petition(s) to establish nondiscriminatory rates, terms, and conditions for interconnection involving local exchange companies and alternative local exchange companies pursuant to Section 364.162, F.S.

DOCKET NO. 950985-TP

SECOND **DAY - MID AFTERNOON SESSION**

VOLUME 8

Pages 876 through 938

PROCEEDINGS: **HEARING**

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

DATE: **Tuesday, March 12, 1996**

TIME: Commenced at 8:30 a.m.

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

REPORTED BY: SYDNEY C. SILVA, CSR, RPR
Official Commission Reporter
(904) 413-6732

APPEARANCES:

(As heretofore noted.)

I N D E X

WITNESSES - VOLUME 8

EXHIBITS - VOLUME 8

P R O C E E D I N G S

(Hearing reconvened at 12:40 p.m.)

(Transcript follows in sequence from Volume 7.)

NINA W. CORNELL

resumed the stand as a witness on behalf of MCI Metro Access Transmission Services, Inc. and, having been previously sworn, testified as follows:

CONTINUED DIRECT EXAMINATION

BY MR. MELSON:

Q Dr. Cornell, would you please summarize your direct and rebuttal testimony?

A Yes.

CHAIRMAN CLARK: We didn't have any other exhibits?

MR. MELSON: No. That was another copy of the resume attached to one of the other pieces of testimony.

CHAIRMAN CLARK: Thank you.

COMMISSIONER JOHNSON: Let me make sure I got the provisions that we were going to strike correct. That was in the -- she had two sets of rebuttal testimony. In the February 20th, you weren't striking anything from that?

MR. MELSON: No, February 20th is completely in. It is the January 26 that a big piece is lopped out of.

COMMISSIONER JOHNSON: Okay, thank you.

A My -- shall I go ahead and summarize?

CHAIRMAN CLARK: Yes, go ahead.

A Thank you.

My direct testimony addresses primarily, although not exclusively, the issue of the appropriate interconnection charge for interconnection of competing local exchange carriers. I want to come back to what I said then, which has not changed from what I said in the case against BellSouth, which is that you really should order mutual traffic exchange.

Why? It is the least cost method of providing for interconnection. It is the method, moreover, that brings by far the biggest benefits to end users, and that's something we should not lose sight of. It will not create, it cannot create, pressures for an upward spiral in local exchange rates now or after whatever current price cap plans are up for renewal or re-examination.

Another reason why you should adopt it is that it is neutral with regard to the technology and architecture of entrants. You have already heard this issue of if there's only one switch of the entrant, is it an end office switch or a tandem? You don't have to answer that question if you use mutual traffic exchange.

Finally, it really does save costs for a measurement system. Particularly, it saves upward cost pressure to keep on moving to fancier and fancier measurement systems. And I'm prepared to explain that if you would like to hear it.

If you do not use mutual traffic exchange, which I hope very much you will, you should charge -- you should allow the incumbent local exchange carriers to charge no more than the average TSLRIC of terminating a call.

I don't want to repeat what's already in the record about how you institutionalize costs. What you really institutionalize is prices and an amount in those prices that at one time was a recovery of a cost that may have now gone away because somebody has become more efficient. But the market cannot push that out of the price if you put anything else above the direct TSLRIC cost in that price.

I would point out that anything higher not only is bad for consumers, which is what I was just talking about, but it creates an artificial barrier to entry. So it is the second whammy at the consumers, if I can put it that way, that they are now deprived of as much competitive pressure, not just directly in the rates but the ability of firms to even come in and apply pressure.

Finally, anything higher will add to the local exchange rates as the pressure for imputation builds in order to try to allow for the possibility of entry.

None of these are good for consumers. None of them are necessary if you use mutual traffic exchange.

I want to emphasize when I talk about asking if you won't use mutual traffic exchange when I urge you that you not set the rate any higher than average total service long-run incremental cost I am not telling you to do that for all prices.

This is a very unique situation, it is a very unique industry -- and maybe "very unique" is unnecessary or redundant, unique is unique. But there are very few other instances where you have essential monopoly input functions that must be supplied by one firm in the market to other firms in the market.

Local interconnection is such an essential monopoly input function. Yes, all firms must supply it to each other. But when you start in a market where one firm has 100% of the market, it has everything and everybody else is an entrant trying to make their way in, the ability to use the essential monopoly input function in an anticompetitive manner to prevent that entry resides with the incumbent who has 100% of the market. That's just fact.

It is for that reason that you have got to look at this not as customers. The ALECs, to use the term that's used here, are not "customers" in the normal sense of the incumbents, or vice versa. This is a mutual dependency in order to have a competitive market; and to have it bring the biggest benefits to consumers, you need to get those prices as low as possible.

Mutual traffic exchange does that, it covers costs, it pays back everybody by paying in kind for what they use.

Under no circumstances should you set switched access rates as they currently are as the price for local interconnection. If you want to use a TSLRIC price for local interconnection and then set switched access equal to that, that's fine. In fact, that's good. But the other way around is very damaging for any possibility of local competition.

That was all I was going to say in summary of my direct.

In terms of my rebuttal, I'll try to be even briefer. Basically, my rebuttal testimony was directed at two testimonies that were filed in direct, one was by Dr. Beauvais and one was by Mr. Poag.

And I basically am urging you to reject virtually all the proposals that Dr. Beauvais has brought in front of you. I believe that his measurement data when he rebuts me or says there's no problem with the cost of measurement, he has told you what he has discovered in the past to be the cost of measuring local exchange traffic.

GTE does not propose to use a local exchange interconnection, they propose to use switched access; and he does not tell you what is the cost of GTE to measure switched access traffic. In the jurisdictions that I have been able to see both sets of numbers on the same comparable basis -- that is, let's say, '94 to '94 comparison of cost data -- it has always been cheaper to measure local than switched access. It's suspicious.

He has the wrong view of a price squeeze and the wrong definition of one.

He would impose additional and unnecessary costs on entrants, all of which builds this upwards spiral of local exchange rates and creates barriers to entry, artificial barriers to entry.

And finally, his declining block tariff structure proposal is a proposal that is absolutely guaranteed to hinder entry. It is designed to ensure that customers do not split their custom among carriers so that they can try out with, say you have a business customer who has ten lines, it is designed to ensure that customer does not take one or two lines and try an entrant but that it is a winner-take-all kind of proposal.

Finally, my rebuttal testimony responds to arguments that Mr. Poag made that opposed mutual traffic exchange, and it is full of details as to why I think he is wrong in his arguments.

Q Does that conclude your summary?

A Yes.

MR. MELSON: Could I ask one supplemental question, Commissioner Clark? It is based on some testimony given this morning and I think would aid in the Commission's understanding.

CHAIRMAN CLARK: Dr. Connell, I'm going to let him ask his question and give people the opportunity to object to it. So please don't answer quickly.

Q (By Mr. Melson) Dr. Cornell, I was going to ask you: Assume an environment in which the Commission has approved a per minute of use charge for local termination. In that environment, would it be a true statement that if traffic is in balance that the possibility of a price squeeze has been eliminated?

MR. FONS: I'm going to object to the question. In the first instance it has not been attributed to any witness this morning. And the only witnesses that have testified this morning are the ALECs, there has been no LEC witness today; so all this would be is to be bolstering testimony or countering the testimony of another ALEC and show the inconsistency.

CHAIRMAN CLARK: Mr. Melson.

MR. MELSON: I believe Dr. Cornell has a different view on this question than a previous witness has given and I believe it is important to get her view on the record.

COMMISSIONER JOHNSON: What's the question?

MR. MELSON: If you are in a situation where the Commission has established a per minute of use rate, if traffic is in balance, does that automatically eliminate the possibility of a price squeeze? There was testimony this morning to the effect that it does.

CHAIRMAN CLARK: Through cross examination?

MR. MELSON: Yes, ma'am.

CHAIRMAN CLARK: Mr. Melson, I think if it is not covered in her direct or rebuttal that it is in fact supplemental testimony and I don't think I can allow it. It may come up, you may have the opportunity to ask it on redirect.

MR. MELSON: Commissioner Clark, I understand that is the strong custom at the Commission. I believe as a matter of law I should be entitled to rebut anything that has been said in the proceeding, but I will abide by your ruling. I think the Commission's practice has room for improvement.

CHAIRMAN CLARK: Is in error?

MR. MELSON: Yes, ma'am.

CHAIRMAN CLARK: Okay. Ms. Wilson.

MS. WILSON: I have no questions.

MR. CROSBY: No questions.

CHAIRMAN CLARK: Mr. Logan?

CROSS EXAMINATION

BY MR. LOGAN:

Q Good afternoon, Dr. Cornell.

A Good afternoon.

Q I have a few questions for you.

Dr. Cornell, would you agree with the statement that telecommunications services should be priced efficiently?

A Yes.

Q Are you familiar with the term "the efficient component pricing rule"?

A The badly misnamed efficient component pricing rule, yes.

Q Would the application of this efficient component pricing rule result in efficient prices?

A Oh, no, absolutely not. That's why it is badly misnamed.

Q Why is that so?

A Because the application of the rule -- and maybe to make this have any intelligence, I should tell what you the rule is.

It has been propounded as the purportedly appropriate way to price an essential monopoly input function when you move from a monopoly to a world in which you have entry. And the rule was promulgated to say you should price that essential monopoly input function at its direct economic cost plus all of the so-called contribution that the monopolist would lose by virtue of making the input available.

And in its application by various proponents of it, it has been, for example, offered to explain an interconnection rate for local exchange carriers that would have been some dollars per month per line that they served plus the full application of switched access charges. And that amount, the dollars per month, were -- and I apologize that I don't remember numbers well off my head, but it was in the $20 to $30 range. Because the claim was made that a business customer would have created that much, quote, "contribution" from local exchange, custom calling, switched access attributable to that line, intraLATA toll, and therefore the company should recover all of that in the price of interconnection.

Well, I don't think it takes a lot of imagination to realize that there is absolutely no possibility of entry in that world. But worse than that, from your standpoint, there's absolutely no possibility whatsoever of challenging that level of revenue recovery that is built into all of those so-called lost contributions. They are completely insulated from competitive pressure of any form whatsoever.

In other words, the firm that was the monopoly would recover all of its contribution, so-called, and indeed might be better off going out of business except for holding on to one line so it still is providing interconnection and recovering the entire quantity of contribution that it used to get when it was providing 100% of market.

It is anything but efficient.

Q Okay. Dr. Cornell, are you aware of any instance in which the efficient component pricing rule has been used to set the price for interconnection?

A Yes. It was used in New Zealand after a long and protracted court battle in which I did participate and did oppose it. And the result was it was set at that initially and there was no entry.

My understanding is that the New Zealand government finally got tired of the interaction between New Zealand Telecom and Clear Communications, which was the would-be entrant, and threatened to rate of return regulated telecom unless it backed off of the use of efficient component pricing rule for interconnection charge.

Q Dr. Cornell, you spoke of reviewing Dr. Beauvais' testimony in this docket; is that correct?

A Yes.

Q Have you had a chance to read his deposition?

A Yes.

Q Would you agree or disagree with Dr. Beauvais' statement in his deposition that saying you believe in imputation is the same as saying you believe in the efficient component pricing rule?

A No, and it is a wrong statement.

Q Why is that?

A Imputation is a statement that the price floor for a service should be the price charged to the entrant or to the dependent competitor for the essential monopoly input function plus the remainder of the costs or the costs for all of the nonessential input functions, if I can put it that way, or the nonmonopoly, I guess, would be the correct way. But the price can be higher than that in the market. That's just the price floor.

What the use of the efficient component pricing rule is to translate directly into the price. If the price in the market were to rise, it simply, if you really believe in the efficient component pricing rule, would cause the input price to rise; and so you collapse the price to the price floor and it becomes both the floor and the ceiling at the same time. There's no ability for price to diverge from that.

Q Dr. Cornell, a few questions about

imputation. Do I understand your testimony correctly that, in order to prevent price squeeze, the price charged by a LEC for local service must cover the imputed price of local interconnection charge to its competitors?

A I'm sorry, could you repeat that?

Q Yes. Is it your testimony, I'm referring to Pages 21 through 23 of your direct testimony, is it correct that what you are saying is that, in order to prevent a price squeeze, the price charged by a LEC for local service must cover the imputed price of local interconnection charge to its competitors?

A Yes. Plus the remainder of the cost of supplying the service, yes. Otherwise you would have no entry by an equally efficient firm.

Q And how would you define imputation when you talk in those terms, price squeeze?

A Imputation means that the price charged to the end user must recover -- where you have a single price to an end user, if you have like toll, you would have to say revenues from that very narrowly defined service. But either the price must recover the price or the revenues that the entrant would pay for the essential monopoly input function, plus all of the remainder of the costs that are incurred to provide that service.

And as I say, you can do it either as a revenue test in the case of, say, intraLATA toll where each intraLATA toll service must recover it, or you can do it as a price test in the case of local exchange service, which in itself is already a bundle of functions.

COMMISSIONER JOHNSON: Where do you describe that in your testimony? I know you do, I just --

WITNESS CORNELL: Yes. In looking at my testimony, I talk about it on Page 22, Line 24, through Page 23, Line 9. I think I also talk about it in my rebuttal, both with regard to Mr. -- Dr. Beauvais, I apologize, and Mr. Poag.

COMMISSIONER JOHNSON: Where you define imputation?

WITNESS CORNELL: Actually, I define price squeeze. And you prevent a price squeeze by having imputation. So where at Page 23, Line 1, I say, "If that monopoly supplier sets the price or prices at the bottleneck monopoly inputs --"

COMMISSIONER JOHNSON: I'm sorry, where was that again?

WITNESS CORNELL: In the direct, the February 6 direct, Page 23, starting at the very end of Line 1, the last two words of Line 1, "If that monopoly supplier sets the price or prices at the bottleneck monopoly inputs at a level such that its end user price does not recover both the prices for the monopoly inputs and the rest of the cost of producing the end user service, a price squeeze exists."

The way you prevent a price squeeze is by imputation. So if you have --

COMMISSIONER JOHNSON: Hold up, I apologize, I just can't find it in here where you were reading from.

WITNESS CORNELL: On Page 23 of my February 6 direct starting at the very end of Line 1 are the words, "If that."

COMMISSIONER JOHNSON: Okay, I was looking in the wrong section. Okay.

WITNESS CORNELL: Through the first word on Line 5, I have defined a price squeeze.

COMMISSIONER JOHNSON: Uh-huh.

WITNESS CORNELL: Literally, imputation is the condition, the pricing constraint, on the incumbent that eliminates the price squeeze. So similarly, the proper price floor is a price that recovers the price charged -- or prices if there is more than one monopoly input function -- and the cost of the rest of the inputs for that service.

That price floor, that is the sum of two pieces. What they charge MCI Metro for termination plus all the rest of their costs has got to be, if you want there to be any chance of competition, you have got to say that's the price floor for local exchange. Otherwise, you create a price squeeze.

What you do when you have a price squeeze is you are telling a firm that is just as efficient as the incumbent, "Go away, we don't want you," which is not good for consumers. But you are also telling a firm that is more efficient, "You must take your efficiencies and in effect spend them, compensating for this price squeeze." And every bit of that increased efficiency spent to compensate for a price squeeze or any other artificial barrier to entry is an amount of efficiency not able to go out and be offered to consumers in the marketplace.

COMMISSIONER JOHNSON: Why -- this is kind of interrupting in the middle of your question, sorry about that, but it gets back to the question Mr. Melson tried to ask.

Why would a usage rate formula not cure the price squeeze problem? Particularly if the rate was as some of the parties have suggested, the TSLRIC?

WITNESS CORNELL: If it is at TSLRIC and no higher, it will mostly cure the price squeeze unless you have some rates out there for some consumers that are below cost. That's point one.

If it is higher than that, however, you begin to move into a world in which you have automatically created an artificial barrier to entry. And I really would like to take two sentences to say why.

COMMISSIONER JOHNSON: I would like to hear it.

WITNESS CORNELL: It is very important to remember whenever an entrant faces higher costs for something than the incumbent, there's a barrier to entry.

Barriers to entry can be natural, the market creates that situation. If you buy in bulk, you pay less per unit to the outside supplier. You then have to incur costs in-house that the outside supplier no longer -- for functions the outside supplier doesn't supply to you. But that's okay.

But when you do that artificially through any competitive behavior or through regulatory rules that add costs that don't really exist in nature, so to speak, you have created an artificial barrier and made it harder for entry to take place.

And this is a market in which there are plenty of natural barriers to entry, I just urge you not to add to them.

COMMISSIONER JOHNSON: In your TSLRIC -- and I guess generally TSLRIC, does that always include return on capital?

WITNESS CORNELL: Yes, it does. It --

COMMISSIONER JOHNSON: What doesn't it include? It doesn't include many common and shared costs and any other contribution? Or what wouldn't it include that you think the incumbents might want it to include?

WITNESS CORNELL: Well, the incumbents would like it to include as much as you will let them, frankly.

I mean, the discussion about the attempt to have interconnection at so many dollars a line plus switched access came out of Maryland, that was the original position of Bell Atlantic. And I have seen this elsewhere, I might add.

What it does not include is costs that do not vary because the service is offered. So all of the costs that are left out of TSLRIC of interconnection are costs that these firms would incur anyway, that they would otherwise be recovering from their end users anyway, if they recover them, if the market lets them. There is nothing left behind that is caused by offering interconnection that is not paid for in a TSLRIC rate.

COMMISSIONER JOHNSON: Thank you.

Q (By Mr. Logan) Dr. Cornell, just a couple more questions on imputation. Are you familiar with Mr. Michaelson's testimony in this docket on behalf of United?

A Yes, I am.

Q Are you familiar with his statement or suggestion that any imputation test should not be applied just to basic local service but should also be applied in the aggregate to the costs and revenues for providing all residential services or all business services in any given exchange?

A Yes, I am.

Q Is it your opinion that Mr. Michaelson's imputation test would be adequate to protect competitors from price squeezes?

A No.

Q Okay. And why is that?

A It is totally deficient.

The problem with Mr. Michaelson's imputation test goes back to what I tried to say a little bit earlier, is that in essence it forces an entrant to do one or more of at least two things. It is an "either/or" or an "and," I'm not sure which.

One is if it is more efficient it may have to use the efficiencies to make up for the price squeeze on local. Or it's got to limit its marketing attempts only to those customers who take the average or above average of the whole panoply of services that he throws into his imputation test. Because if they try to compete for a customer who only takes basic local exchange service, they will lose money, the entrant will.

Not having the base of almost 100% from which to play the averages that the incumbent at least starts with, the entrant can't afford to take the chance that when it puts its price list out there and tries for customers that it only gets the customers who take basic local exchange and nothing more. Any entrant who is attractive to those customers under Mr. Michaelson's rules is going to be driven out of business again.

I think it's bad for consumers because you deny consumers the benefit of whatever greater efficiency may be sitting there. But you also deny the so-called bottom end of the market the benefits of competition.

If you keep artificially constraining entrants only to compete for the high revenue customers, you have limited who gets the benefits of competition to the high revenue customers. You have, of course, opened the world for the incumbents to come screaming in and say, "See, they're cream skimmers." I heard that term more times that ever I thought I would have to deal with it. It's a dairy term, it should stay there.

And they come in screaming and saying, "Look, you should do all these things to punish them because they're only going after high revenue customers." Well, of course they are only going after high revenue customers, you structured the market so that's all they could have gone after in that world.

Once again, if you have a situation right now where you have some customers whose rates do not cover rates for basic exchange service, do not cover the full cost of that service, you get around this problem by mutual traffic exchange. Everybody can compete for everybody; and now you let the market fight it out rather than having who entrants can compete for created out of the interconnection price structure.

Q Dr. Cornell, turning to Page 17 of your testimony, I think starting on Line 18, is it correct that it is your opinion that you expect traffic between LECs and ALECs generally to be in balance?

A Over time and particularly after there's true number portability, yes.

Q Would it change your opinion if you learned that traffic between a particular incumbent LEC and neighboring LECs was out of balance along their EAS routes?

A No, not in the slightest.

Q Why is that?

A Well, what you have -- and I speak with some experience about small towns attached to big towns. Not that my small town, which is miniscule, is attached to anything.

But when you have a situation which you have a big city which is where most of the doctors are and a big city which is where most of the big shops are, you can have an imbalance of traffic from the small town to the big town because that's where the businesses are.

When you take into account sort of that kind of traffic pattern, as I say, it is not always in balance; although, surprisingly, there are a number of instances where it is or where it is very close.

It, however, is not what we are talking about in this docket. We are talking about overlapping markets, not adjacent markets. We are talking about overlapping markets. And there it is a much more likely circumstance as networks grow over time it will come into balance, particularly if you have true number portability, so that there is no distortion of traffic going first to the original -- you know, the carrier that was the incumbent, or was the original provider of service to the customer then the number got ported using remote call forwarding, which adds a distortion into this measurement of traffic in terms of the balance. How much of it came through the ported numbers? Who knows.

CHAIRMAN CLARK: Dr. Cornell, if you could just follow up on that. I am not clear as to how number portability affects the balance of traffic.

WITNESS CORNELL: Okay, let me try.

In a world with true number portability, a customer can keep his or her telephone number even though that customer goes to a different service provider. And so they take all of their lines, if they want to. If they decide, "I'm going to use MCI Metro, or Time Warner, or whomever, I'm going to take all my lines. I've tried them out with two and now I want all."

And when somebody from either Sprint-United/Centel, or if you are in GTE territory, GTE, who has remained with GTE and calls them, the call goes directly over to Time Warner and MCI Metro, whoever was the new carrier. In a world before you have true number portability, that call first goes to Sprint-United, because that's who gave out the number originally. And that happens even when the person dialing the number is already an MCI Metro customer, for example, sticking with MCI Metro.

So that a call that should have been entirely terminated within the MCI Metro network, one MCI Metro customer to another, because of the use of RCF for remote call forwarding, goes over first to the Sprint-United, let's say, network and then back to MCI Metro. So you begin in a world of multiple firms to see these additional traffic flows that involve one flow to the incumbent local exchange provider, one flow back to the carrier now serving the ported number. And you can have traffic flows where it starts with an MCI Metro customer and ends with a Time

Warner customer. And you've put Sprint-United in the middle in my example due to this remote call forwarding. Well, that's going to, if you pardon my use of the term, mess up what the real traffic flows are in terms of where the call started and where it finished if you try to measure them in a measurement capacity of measuring it on the trunks coming in and the trunks going out.

CHAIRMAN CLARK: So you are saying that it will show as traffic terminating on a Sprint -- terminating on Sprint for which they should get compensation when, in fact, if you didn't have to do number portability it would just show it terminating on Time Warner?

WITNESS CORNELL: Yes. I'm not -- I don't know precisely, you made the statement "for which they should be compensated," and, of course, I don't --

CHAIRMAN CLARK: Well that's their argument.

WITNESS CORNELL: That's their argument, yes.

CHAIRMAN CLARK: I guess is that a problem, though, when you have -- if you only have one ALEC? I can see where there's a problem with two because it will show it as -- or will it, in fact, show it as terminating on Sprint as opposed to terminating on

Time Warner?

WITNESS CORNELL: I would think it would show it as terminating on Sprint. That is, let's assume you have an MCI Metro customer and a Time Warner customer, and the Time Warner is calling the number that was originally assigned by Sprint-United but it's an MCI Metro now, so it has been ported. It will come in from Time Warner's network. I mean, Time Warner isn't going to necessarily know that's a ported number.

The customer is going to pick it up and dial 234-4567, whatever the number is, and it will come across the trunk and terminate at the Sprint switch. The Sprint switch will be where it is determined that that was a ported number and then it will go on to MCI Metro.

CHAIRMAN CLARK: But it seems to me because it ultimately terminates somewhere else it's a wash. Because they would have had to pay -- Sprint would have had to pay terminating to Time Warner and --

WITNESS CORNELL: To MCI Metro, but it gets it from Time Warner.

CHAIRMAN CLARK: Right.

WITNESS CORNELL: Well, it gets paid by Time Warner and it pays MCI Metro, but it's not a wash either to Time Warner or to MCI Metro.

CHAIRMAN CLARK: Well, they would have been paying -- if not Sprint, they would have been paying each other.

WITNESS CORNELL: Well, again, if you have mutual traffic exchange --

CHAIRMAN CLARK: Well, wait a minute. You're confusing me now. Because I'm just trying to determine why that distorts traffic from being out of balance and I'm having trouble seeing how number portability distorts the balance of traffic.

WITNESS CORNELL: There are two reasons actually that it distorts the balance of traffic. We have been focusing on one; and I'll finish with it and then go to the second.

In this particular instance, what you get is an image of more traffic terminating, if I recall correctly. I did the hypothetical as the Time Warner customer is calling someone who is really a Metro customer but it looks as if Time Warner is terminating more minutes to Sprint and fewer minutes to MCI Metro. Okay?

So there is a potential given that each of these, if it is a per minute charge, each of these charges is going to be set up, how many minutes do I terminate to Sprint and how many terminate back? The fact that you have now stuck one in as a terminating minute to Sprint that should have been a terminating minute to Metro can produce problems in that balancing out; and similarly, the fact that it should have been from Time Warner to Metro but it appears as a Sprint to Metro, can you have distortions in that relationship.

I can't sit here and draw you mathematics, but it is possible.

CHAIRMAN CLARK: Okay. Let me see if I understand correctly. What you are saying is if you, in fact, have a per charge --

WITNESS CORNELL: Yes.

CHAIRMAN CLARK: -- then you will be making, transferring, money. For instance, it may go from MCI Metro to Sprint when the money should have actually gone to Time Warner because that's who actually terminated the number ported call?

WITNESS CORNELL: That's right. Or Time Warner pays Sprint, Sprint pays Metro in the world that you're describing where there is money changing hands. But you have now incurred all of these transaction costs for a payment which should have gone directly from Time Warner to Metro.

CHAIRMAN CLARK: I guess what is confusing me is I don't think it affects the balance of traffic. It may have you changing money more times; but I don't see how the traffic itself would be out of balance, it causes the traffic to be out of balance.

WITNESS CORNELL: You would be right if there were only two parties. But once you start introducing more parties, you really have the potential what would have been in balance between the to two of them not showing up as balance.

You also have a second factor that I haven't --

CHAIRMAN CLARK: Let me be clear. I think among all of the parties you do have balance --

WITNESS CORNELL: That's right.

CHAIRMAN CLARK: -- among all of them. But you may not have balance between two of them.

WITNESS CORNELL: That is correct.

CHAIRMAN CLARK: Because you have more than one party.

WITNESS CORNELL: That is correct.

CHAIRMAN CLARK: Okay.

WITNESS CORNELL: The second problem with the remote call forwarding number portability. It is very necessary; I'm not trying to tell you not to do that and, again, at rates that make sense. But because it does produce problems with quality of transmission, it is going to mean that some parties won't want to use it and will -- instead some business users may say, "We'll split our traffic. We'll keep our original telephone numbers, keep half our lines with the incumbent, and use the entrant only for outgoing calls where the telephone number doesn't matter." And now you really distort the pattern of traffic flow.

CHAIRMAN CLARK: Okay.

WITNESS CORNELL: Unambiguously.

Q (By Mr. Logan) Dr. Cornell, just a couple more questions. In economic terms, what is the cost to an incumbent LEC terminating a local call on its own network?

A It is average TSLRIC.

Q Now, if the incumbent LEC is required to cover the imputed price of local termination in its end user rates, isn't the implicit cost to the incumbent LEC terminating a local call really higher than the TSLRIC?

A No.

Q Why is that?

A The reason is that no matter what you do with accounting costs you can't change what are economic costs.

The cost to terminate a call is the cost to terminate a call. You can require accounting treatment of that higher price; but all you are really doing is giving an accounting amount of money that's available now for coverage of joint common, which is the usual term but shared costs is a better phrase for that. It is a real cost to the entrant who must pay that price. It is an accounting benefit, in effect, to the incumbent who must impute it but who genuinely has those revenues to help pay for shared costs. The entrant does not have them to pay for shared costs.

That's why imputation is not sufficient to permit competition. It is absolutely necessary to prevent a price squeeze but it is not a sufficient protection. Pricing at TSLRIC is the only thing that is sufficient protection; mutual traffic exchange is the cheapest way to price at TSLRIC.

COMMISSIONER JOHNSON: You were asked the question above, I think he asked you what the LEC's cost was and you said average total long-run incremental cost?

WITNESS CORNELL: That's right.

COMMISSIONER JOHNSON: Versus -- and I

thought you just changed it and said TSLRIC. Maybe it would help me, if there's a difference, I don't know them. So if you would explain that to me, that would help for my edification.

WITNESS CORNELL: First, I am going to apologize. I try not to but I tend to be sloppy.

TSLRIC is actually a kind of total cost concept. It is the total cost of providing for -- the total forward-looking cost for providing the service in question. So if you are going to compare to it a price or a rate, you really have to talk about a per unit version of TSLRIC, which is really I said average TSLRIC. When I talk about setting price at TSLRIC, I really am meaning average TSLRIC.

COMMISSIONER JOHNSON: Okay. I thought they were two different pricings. All right, thank you.

WITNESS CORNELL: If you set it at TSLRIC you would have clearly barred entry.

COMMISSIONER JOHNSON: I got you.

WITNESS CORNELL: If you think about it.

COMMISSIONER JOHNSON: Okay.

MR. LOGAN: Thank you, Dr. Cornell. No further questions.

CHAIRMAN CLARK: Mr. Horton?

MR. HORTON: Yes, ma'am, I think I have just one.

CROSS EXAMINATION

BY MR. HORTON:

Q Dr. Cornell, do you advocate mutual traffic exchange? Are you proposing that as a permanent plan or as an interim solution in this proceeding?

A My proposal would be that it would -- I'm sorry, neither, in a sense. That is, I cannot answer that yes or no or one or the other.

I would advocate that you start with mutual traffic exchange. If there is reason to believe there is a real problem with it, let's say a year after true number portability has been introduced, then I would look at how far traffic is out of balance. If that amount out of balance is sufficient to cover the transactions cost of ordering some other proposal, then I would suggest that a per minute rate at TSLRIC -- average TSLRIC, thank you, Commissioner -- not higher, be substituted for mutual traffic exchange. But I think it is really important to examine those transaction costs before you delve into it. It is not worth incurring all of them for something that might only be $1,000 a month or less.

MR. HORTON: Thank you, that's all I have.

COMMISSIONER JOHNSON: How do you feel about if we were to determine that the traffic was out of balance and say it was 30%. Say it was enough that it would justify incurring those costs to do a usage rate. How do you feel about then setting that rate and making it retroactive for whatever that out-of-balance-minutes cost?

WITNESS CORNELL: First of all, I feel very opposed to retroactivity. Now, I realize -- after yesterday's hearing I went back and I started playing with numbers with my calculator to say, "Wait a minute, what are we really talking about here?" And so we started literally sort of sitting down and saying what if, what if, what if, in terms of numbers.

And so I said I'm really opposed to retroactivity because I do not believe in having a world in which you are trying to open the doors to competition and there's an unknown-sized ax hanging overer somebody's head that suddenly two years into entry I might get hit with a whopping liability for which I have made no preparation in terms of the rates I have charged my customers.

This is very important. One of the things you must understand is even if traffic is in balance over a period of time, if I might get hit with a liability in Month One because Month One I'm out of balance against me, so to speak, I have got to build it into my rates. Because the fact I may get it in Month 12 is irrelevant; I may be out of business because I haven't met my cash flow obligations over the course of those 12 months. So I have got to build it into my rates and capture it now to pay it now even if I will get it back in 12 months.

Just there's no way around it. The moment you make a cash payment, you have put that in the price floor of local exchange. Please do not think otherwise. Balance, because balance is not absolute automatic day-by-day an identity, which is the only way you would not have it in the rate, you have got to put that money aside to meet a possible obligation. And the only way to do it is to charge the end user for it. That's the only place you get the money.

COMMISSIONER JOHNSON: But that may be okay. Because otherwise, if it is out of balance, someone else is paying for it. Someone is paying for it; someone's end user or someone is paying for that out of balance if it is 30% or 40%. And if we find out later it's 30% or 40%, then do we tell whoever that party is, "Sorry, you can't recover it even though you didn't cover your costs because it was so far out of balance"? And they got that money from somewhere or someone had to pay that lost revenue.

WITNESS CORNELL: Can I come back to my musing with numbers yesterday? Because I would like to put it in perspective.

I began to ask myself, "Okay, what if there were 5 million minutes a month going from ALEC 1 to the incumbent?" And I did admittedly apply a 10% out of balance; I didn't go all the way up to 30, but you can you modify these numbers. And I did write it down because I told you I'm not good at remembering numbers. So please bear with me.

Suppose it is 5% out of balance. That's 500,000 minutes. And I'm going to say let's assume that it costs a quarter of a cent a minute real TS -- average TSLRIC to terminate a call. And that's in the ballpark; there are nonproprietary numbers that are up to approximately .3 cents, .4 cents; there are numbers that are lower than that that are proprietary.

So let's say a quarter of a cent a minute. That seemed to me on the high side of the numbers I've seen in real costs to terminate. Okay? So 500,000 minutes times a quarter of a cent per minute means that the company that was the recipient of more traffic was out $1,250.

Now, it does not seem to me that your job is to say, "In order to capture $1,250, we are to put into place a whole panoply of costs that are way above that just to deal with that." So the first thing I would say is, one, why not retroactivity, until you are up to a potential imbalance, for which, if it existed, it is worth the costs, you should be saying, "Forget it. We'll do mutual traffic exchange. It is by far the cheapest."

Then I said to myself, "Okay, what gets you to a point where you need this kind of to even think about it?" Because the nice way to do this is not to suddenly discover that for six years it has been out of balance -- not that the LECs will let you get that far, I will assure you of that. But to say, "Okay, suppose this is real? What do we have to do?"

Well, obviously, if we are talking 5 million minutes a month from an ALEC, and so 10% less than that from the incumbent in this hypothetical I gave you, I asked myself, "What is that?"

Well, let's assume -- which I think is a reasonable assumption based on numbers I've seen -- that a business line generates approximately 1,000 minutes of local traffic a month. You would have to have 5,000 business lines being provided by the ALEC to produce -- assuming all they serve is business --

to produce 5 million minutes, if I have done my math correctly, a month.

So it is clearly not worth it there. I mean, and that produces -- at a 10% imbalance, that produces $1,250.

So what if you had 50,000 business lines served by an ALEC, one ALEC. If it's spread out among all, you're still back to the whole problem that you're multiplying the cost to put in a measurement system by the number of ALECs.

So I said, "What if you said there's some minimum threshold, in effect, market share before I'm going to worry about this problem?" Because anything less than that is just not worth the transactions cost; I'm making the cost of everything higher. This is the old -- I don't know whether it is Benjamin Franklin, but the old aphorism, it's penny wise and pound foolish. You're spending a pound to save a penny, and that's not worth it.

So I would suggest you really look hard at saying that the amount of traffic that is going in one direction between the incumbent and a single ALEC has to be up to some minimum amount per month. 50 million minutes is a good number because that just produces 12. If it is 10% out of balance, it produces $12,500 worth of missed costs, uncompensated costs, for termination.

Before you let yourself be drawn back into this dispute -- and the reason is you slow the drive to put in all of this measurement stuff. And you allow the business to get going; you allow the market to get going; you have got a trigger point at which you are going to entertain evidence to the effect that it is out of balance; but you are going to let other places that aren't as sensible, as I think you have been in your BellSouth decision, get the cost of measurement down to a cost that's reasonable to incur. Or discover that it isn't reasonable to incur it and to say, "Forget it, we've decided this was a bad idea in the first place." And you won't have imposed it on consumers in Florida.

COMMISSIONER JOHNSON: So you're saying -- if I understood you, you're saying if we were to do something where we're looking at the situation where you are not in balance, we should do that on a ALEC-by-ALEC basis with respect to the LEC-to-the-ALEC in looking at that particular situation and seeing how much out of balance that was. And if it didn't meet the threshold, then we kind of -- we throw that one out and look at another ALEC; and if it doesn't meet the threshold, throw that one out?

WITNESS CORNELL: I would do it slightly differently. But it comes to, in terms of what you have to do, it comes to the same thing but with less cost all around. Because regulatory proceedings are very costly.

And that is, I would say once any ALEC in this market has gotten up to the point where they are exchanging with the old incumbent at least X amount of minutes a month of traffic, of local traffic, then we will, if it is out of balance, you can come in. But until then, it is not worth the transactions costs -- the cost of measurement, the cost of billing, the extra cost of auditing -- that you will impose on the entire system. So don't bother us with a statement about in or out of balance until you are at least seeing from one ALEC at least something like 50 million minutes a month of local traffic.

COMMISSIONER JOHNSON: Okay. I see what you are doing, you are focusing on the minutes.

WITNESS CORNELL: That's, by the way, the right way to focus on because then nobody has to report whether they're doing CENTREX or PBX and how many lines all that kind of stuff they are doing to individual customers.

COMMISSIONER JOHNSON: If we did it that way and didn't look at the totality, if there were a lot of ALECs that were right under that threshold and if those are not in balance, the cost to the LEC, the one LEC because these are dealing with one LEC, could end up being substantial and not recovered.

WITNESS CORNELL: I think if you draw your threshold correctly, I have a couple of things to say, which is, (a) not likely. I mean, $12,500 of uncompensated termination cost is not a big number in this industry. We are not talking pain.

Two, if you have made it clear that the alternative is going to be a rate at average TSLRIC, nobody in this industry is not going to drive to keep getting up their traffic numbers as fast as they can convince customers, and so it isn't going to last very long that anybody is hovering, if all you are dealing with is a growth situation.

You are simply not dealing with a very long period of time where this limps along. Now, if you make it clear that the sky is the limit for the interconnection charge, you have created a real incentive to try to keep the number hovering right below. But if you do it right and say the fallback, if the traffic is out of balance and there's enough of it to make this worth doing, is going to be average TSLRIC -- we're not, you know, don't come in and assume you can impose these huge, high interconnection charges like you did with switched access -- you have an entirely different dynamic and one that is you are just simply not talking about anything that can last long enough to matter.

So that, again, there's no need to think about retroactivity, there's no need to be worried about it, because it just isn't going to be sitting there as this big sort of giant sucking sound, if I can borrow from some other politician. It isn't there.

COMMISSIONER JOHNSON: Thank you.

CHAIRMAN CLARK: I think we'll go ahead and take a break until 20 minutes until 3:00.

(Brief recess.)

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CHAIRMAN CLARK: We'll call the hearing back to order. And before we continue with cross examination of Dr. Cornell, I have a press release that Mr. Crosby has distributed and we also have some information from Staff at Ohio regarding the Ohio actions on interconnection.

MS. CANZANO: The legal director, Mr. Paul

Duffy, indicated to us that on Thursday, February 29, the Ohio Commission brought in Ameritech and Time Warner for what's equivalent to oral argument, which was continued to the next day, to March 1. There was no agreement reached and apparently they sent the parties back for further negotiations.

No order was rendered and I guess the issue is still pending.

CHAIRMAN CLARK: It seems to me that we don't have an order that we can take official recognition of. We have a press release. Unless it is stipulated into the record without objection, it is not something we can take official recognition of.

MR. CROSBY: I believe the parties may be willing to stipulate, though, Madam Chairman.

MR. WHALEN: We have no objection to that going in as long as it is recognized that it's what it is, that is, a news release.

CHAIRMAN CLARK: Okay. We'll mark it as Exhibit 23, and we'll admit it into the record without objection. It will be the Public Utilities Commission of Ohio News Release dated March 1, 1996, having to do with settlement terms for interconnection contract.

(Exhibit No. 23 marked for identification.)

CHAIRMAN CLARK: Mr. Horton, I believe you were next?

MR. HORTON: No, I have no further questions.

CHAIRMAN CLARK: Mr. Rindler?

MR. RINDLER: I have no questions.

CHAIRMAN CLARK: Ms. Weiske?

MS. WEISKE: Thank you.

CROSS EXAMINATION

BY MS. WEISKE:

Q Good afternoon, Dr. Cornell.

A Good afternoon.

Q You said in response to Commissioner Johnson that you had some concerns about the transactions costs related to retroactivity?

A Yes.

Q Would you have those same concerns related to a cap or do you view the retroactivity proposal she asked you about as a cap? A cap on bill and keep, I'm sorry.

A I always have problems and concerns about the transactions costs that might come with a cap. Again, my statement earlier to Commissioner Johnson was that if the traffic going between a single ALEC and the incumbent were high enough that you knew that imbalance really had gotten you to the point where maybe you had to think that it was worth the transactions cost, or at least examine it, then it would be appropriate to look.

But I think the thing I was trying to stress is that we are a long way from there. You are going to have to get up to quite a bit of market share -- not even "share," that's not the right measure -- sort of absolute size on the part of an ALEC before you are into anything that is anything other than I think I used the phrase penny wise and pound foolish in terms of worrying about traffic being out of balance.

If the amount of traffic being exchanged is only 5 million minutes a month, you're just not going to get to numbers big enough unless it is all going one way. And that, we know, is not going to be what happens.

Q And so is it fair to say that your recommendation is bill and keep, and it's not bill and keep with some sort of cap?

A That's correct. I think what I said was bill and keep with a statement at most by the Commission, Look, don't bother us with this issue unless you have got markets that are now exchanging, I made the tentative recommendation of, 50 million minutes a month of local traffic between a single ALEC and yourself and you have reason to believe that's out of balance by some not 1% or 2% and over the course of a year, not one month it's out of balance, you have to show that it doesn't right itself.

Because there are natural fluctuations around a trend. You don't want to start something that ends up in effect netting out over the course of a year to zero payments. That's not worth the transactions cost either.

Q Now is it also your recommendation on behalf of MCI that if the traffic is discernibly out of balance then it is your recommendation that compensation for the termination of local traffic would be on a minute of use basis and that would be equal to TSLRIC?

A Average TSLRIC, yes.

Q I know this has been discussed a little bit but for my benefit, at least, could you go back through and use examples of what definitionally is included in TSLRIC and what you believe is not appropriate to be included? And again we are both talking about average TSLRIC.

A Yes. Let me do it first very conceptually and then try to list elements, if I can do it that way.

The very basic fundamental principle behind TSLRIC is you are looking for all the costs, both volume-sensitive and volume-insensitive, that are caused by the decision to offer this service. So you want to pick up everything that gets added because -- excuse me -- all costs that get added -- because you offer that service, but nothing else.

You are not picking up costs that would be there whether you offered the service or not. You are not picking up costs that do not vary whether you offered that service, or didn't offer that service, or didn't offer 22 other services but offered three. That's the president's desk, or at least the efficient president's desk.

Sort of moving from the general point, which is you are picking up everything that's caused by that service but nothing more, you are going to pick up costs that vary with the amount of that service that you offer, those are volume-sensitive costs. Are you going to pick up I almost call them startup costs, although it's not a very good phrase, those costs that do not vary with the amount of the service that you offer but are there because you offer the service.

You are going to pick up -- in that definition of costs, this is a long run measure so it is going to be capital costs including a return on that capital, whether it is debt or equity or the mix of it -- all of those costs of capital. You're going to pick up labor costs. You're going to pick up material costs. All of which are caused by offering that service.

And to the extent that in telecommunications we tend to use the return on capital and profit somewhat synonymously, you are obviously paying a profit, a normal profit, which is the cost of capital, on the capital that is caused by offering interconnection. So you are not talking about anything that leaves the firm worse off than if they had not offered interconnection at all. They have got everything -- they haven't made money on it in the sense that they are not now better off for having offered it, but they are not worse off.

Q So under that definition, would joint and common costs be included in average TSLRIC?

A No. And I would like to go back and just explain why I say that.

Joint and common costs are a kind of unique telephony phrase. They aren't very good terms I don't believe in terms of economic costing any more.

Joint and common costs are costs that do not vary with volume, because otherwise they are volume-sensitive costs and they are costs of a service.

They are costs that are part of -- I don't want to say necessarily overhead, they are really shared costs, which is a better term, that are caused by a multiplicity of offerings. For example, there are some shared costs of a switch that are there because you have decided to offer an array of switch services but they are not caused by any one of the switch services. And if you take one switch service away, namely interconnection, they don't go away at all; they don't change.

So they are there whether you offer this service or not, and the decision to offer this service does not change the quantity of them.

Q You referred a number of times this afternoon to transactions costs. I want to make sure that you and I are thinking of transactions costs in the same way. When I think about transactions costs, I look at things like measurement costs. Do you have different costs in mind when you use the term "transactions costs"?

A I have additional costs in mind. I would point out there are different kinds of potential measurement costs, as well.

Q Maybe first, at least for my benefit, you could explain the difference you believe exists in measurement costs and then add to what else you think are appropriate transaction costs.

A Okay. If the system goes in with mutual traffic exchange and mutual traffic exchange not about to end tomorrow, there will be measurement but it will be engineering sizing measurement. That is, each trunk group will be monitored, measured, the traffic coming in will be measured. Peak load may even be stored for a while to see if there are trends -- all done to see whether trunk routes need to be expanded, to be enlarged, or to use a telephony term, reinforced to carry more traffic.

But those measurements will not be 24-hour-a-day measurements, they will not be stored for long periods of time, months and years, and they will not be used for any purpose other than for sizing.

That is the baseline measurement cost that will take place no matter what you do.

And now we start talking about transactions measurements costs on top of that basic. The first and the most simplified is that you will start recording 24 hours a day these engineering available kind of numbers, collecting them, storing them, for which you will have to build a program because that's not what you would do if you weren't measuring this traffic.

Today, there is no system that I have been able to find out -- and I have talked to engineers at MCI, I have talked to engineers at CAPs, I have talked to engineers or had lawyers talk to engineers for incumbent local exchange companies -- there is today no method to take those numbers of minutes coming in over a trunk that is labeled a local or intraLATA toll trunk combined and say -- I'm going to use the word "sort." I have often been lax in my terms and I apologize. And I have used the word "measure," and it is really "sort," to tell if it is a thousand minutes coming in over that hour, how many of those are local and how many are intraLATA toll. That information does not come in on the terminating end of that trunk and it is not available.

You can do that split by having the originating carrier present you a percentage local usage because it could be measured at the originating end, not at the terminating end. And they can present you with that split and now you must take that PLU and bounce it up against these measurements you have now captured 24 hours a day and capped to get a sort between toll and local.

That's, still, it is more transactions cost for measuring than if you are just doing the monitoring for engineering purposes. The real concern I have is that, confronted with this need to use the PLU from an entrant, every one of the incumbent LECs that I have talked to has been looking for and talked about starting to find a way to take a new system entirely that would work off of the SS7 signal which does contain the information available to sort the traffic and create a whole new both measurement and sorting system.

US West has proposed to do this and it put cost numbers into this into the proceedings in Washington and Oregon. They are confidential and they are high. They are very expensive. This is the cost I worry about out of a measured local termination regime is that somebody will come in and say, "We have to do it and we get to ask the ALECs to pay for this very expensive sorting and measuring system that's untried and not been done before." That's really the big number.

The others are numbers and they are real but that's the big one. And that's the pressure you will be under is to say, "We don't trust them, we don't want to use their PLU, we want to measure our own and sort our own." And that's when you get into really big numbers.

Q Were there other transactions costs outside of measurement costs?

A Yes. Then you start in on the cost of having every month to take these tapes of the stored number of minutes of use, if you ever get this very expensive system, this expensive SS7 system and its tape results, and literally convert them every month into a bill. You are going to have to do the equivalent of that even if you do a netting out process.

So now you have bill rendering. You have to transmit the bill, either by the mail, or by electronic tape, or whatever it is you agree -- those guys agree to do.

Then you have to monitor the bill, audit the bill, find out from the ALEC's point of view that the bill was accurate. Was it really that number of minutes of use? Why did they say we had 2 million and they say we had 1 million?

This goes on all the time now with the CAPBS billing for switched access between local exchange carriers and the interexchange carriers.

And then you have to dispute the bill and you have to argue with the other side that your bill was too high. And then finally you have to go through the whole process of exchanging money or, if it is netted, one side or the other has to pay a check.

Those are all the real costs of the system if it is done on a MOU basis. And they are not trivial. These are not trivial costs.

Q Didn't you just state that your experience with implementation of a system to measure traffic on a minute of use basis in Washington and Oregon you had seen a number that was very high?

A Yes.

Q Have you had an opportunity to review Dr. Beauvais' testimony for GTE?

A Yes.

Q Doesn't he state that the measurement costs are very low?

A He does, but he uses the cost of measuring local measured service, and that is not what is at stake here. You are not going to use the same measurement system. You are not going to be able to because measured local traffic is measured at the originating switch. You're talking about something that measures at the terminating switch.

GTE has proposed to use switched access charges, which means you are going to be into the CABS billing and measurement system, which is more expensive still than local measured service traffic every place, as I said before, I have been able to see those numbers side-by-side on comparable, you know, '94/'94 numbers.

Q You had some earlier discussion, I think, with counsel for AT&T on imputation and price squeezes. So that I understand it correctly, you would not need an imputation test for the termination of local exchange traffic if your recommendation of bill and keep were adopted. Is that fair?

A Mutual traffic exchange?

Q Right.

A That's very fair.

Q But if this Commission went to a minute of use approach, for example, for compensation, then it's your position that an imputation test is required to avoid a price squeeze as you have defined price squeeze?

A That's correct.

Q If the result of this docket or any docket dealing with interconnection -- let me back up.

If in six months we have various ALECs in the market terminating local exchange traffic, and we also have the incumbent LECs in this proceeding in the market terminating local exchange traffic, and traffic is in balance, is there still a possibility of a price squeeze?

A Oh, absolutely.

Q Why would that be.

A When, maybe it's because of how I use the phrase "in balance." Over time, traffic is likely to be in balance. But it is not likely because it is not a "totology," so to speak, to be necessarily that each hour of each day the traffic is in balance, each day it is in balance, even potentially each month that it is in balance.

And so you can have a situation in which in January the ALEC pays the incumbent; in February, the incumbent pays the ALEC; in March, the ALEC pays the incumbent; in April, the incumbent pays the ALEC; and so on, and it bounces back and forth. But the fact is that each of the months that one is the payer, one has to have that cash available to pay.

And if the price is high and you're the one out of balance, there's only one place, particularly in ALEC, there's only one place either of them can get it is from their customers. And so you have to build it into the price of the service that uses that input.

Even if over the course of the year it comes out to be about the same amount of money exchanged, you can't get around either the need to pay it or the need to put it in your rate to have the money to pay it. And that's where the price squeeze comes in.

If the incumbent does not recover in its basic local exchange rates that price of termination, and it is set at a penny or two pennies a minute, and the entrant has to have that cash on hand, it's got to find a way to put it into its local exchange rate or you're back to the various problems enumerated earlier.

If it is equally efficient, it can either not compete for half the market in order to be able to recover from those upper revenue spenders that money, and so whatever ability it might have to force efficiency for basic local exchange service is lost, or its got to be more efficient but spend those efficiencies on making up for the price differential in basic local exchange rather than being able to go up and say -- I mean, suppose it can offer in terms of its real cost local exchange service for $2 less but it's got to use the $2 to make up for the price squeeze, look at what consumers have lost. It can't go out and say, "I'll charge you $2 less." All it can do is say, "I'm charging you what the incumbent is charging you."

If it is $3 more efficient but needs $2 to make up the price squeeze, consumers only get the benefit of, "I'll offer you service for $1 less." It's $3 more efficient; but because of this artificial building into the rate of contribution above direct cost, which is average TSLRIC, it cannot advertise local exchange service for $3 less even though it is that much more efficient than the incumbent.

That's the real price you impose on end users if you set that interconnection charge above average TSLRIC.

Q Dr. Cornell --

COMMISSIONER DEASON: Let me ask a question. Would not the incumbent LEC also be required for cash flow purposes to price that terminating rate into their charge for local service?

WITNESS CORNELL: Well, to begin with, at the outset they can't change their rates if they are a price-regulated firm. Two, at the outset they also have almost 100% of the market; so they can play the averages, they can go off of what the average consumer out there earns them in total revenue.

But the entrant cannot do that because it does not know -- I mean, it can either deliberately try to ensure it only catches average consumers or above, but it can't afford, if the first three consumers who sign up are below average revenue generators, it cannot be certain that the next three who sign up will counterbalance it.

So you have got a situation in which the entrant coming in in that circumstance, (a) because the LEC cannot change its rates right now; and, (b) because those rates will not pass an imputation test of certainly for a price above average TSLRIC, particularly the residential rate right now won't pass it. That if it is anything higher, you're right back into the world I tried to describe earlier that the entrant will somehow say, "I'm not going to take anybody who doesn't generate more than average or at least more than basic local exchange service revenue." And that hurts those customers who otherwise might have been the target of competitive entry.

Q (By Ms. Weiske) Dr. Cornell, there's a statute in Florida that requires that the charge for -- that the cost for furnishing interconnection must be recovered in the charge. Are you generally familiar with that?

A Yes.

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(Transcript continues in sequence in Volume 9.)