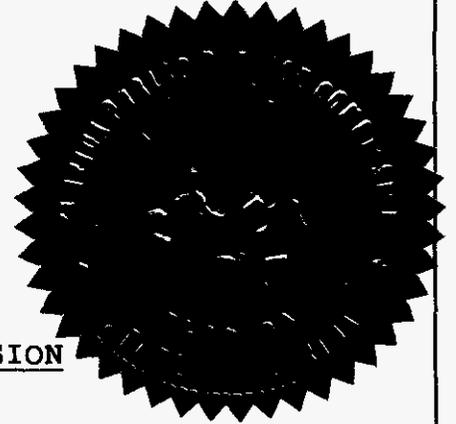


BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of

DOCKET NO. 950985-TP

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, Florida Statutes.



SECOND DAY - EVENING SESSION

VOLUME 10

Pages 1107 through 1167

PROCEEDINGS:	HEARING
BEFORE:	CHAIRMAN SUSAN F. CLARK COMMISSIONER J. TERRY DEASON COMMISSIONER JULIA L. JOHNSON COMMISSIONER DIANE K. KIESLING COMMISSIONER JOE GARCIA
DATE:	March 12, 1996
TIME:	Commenced at 8:30 a.m.
PLACE:	Betty Easley Conference Center 4075 Esplanade Way, Room 148 Tallahassee, Florida
REPORTED BY:	JANE FAUROT, RPR

(Appearances as heretofore noted.)

DOCUMENT NUMBER - DATE

03075 MAR 14 96

FPSC-RECORDS/REPORTING

I N D E XWITNESSES

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EXHIBITS

<u>Number:</u>		<u>Identified</u>	<u>Admitted</u>
35	GEM-1, Composite Exhibit attached to direct testimony	1110	1166
36	Deposition transcript of Mr. Michaelson	1166	1166

P R O C E E D I N G S

(Transcript continues in sequence from Volume 9.)

Thereupon,

GENE E. MICHAELSON

was called as a witness, and having first been duly sworn,
was examined and testified as follows:

DIRECT EXAMINATION

BY MR. WAHLEN:

Q Could you please state your name and business
address for the record, please.

A My name is Gene E. Michaelson. My business
address is 999 Third Avenue, Suite 3500, Seattle,
Washington, 98104.

Q Mr. Michaelson, on whose behalf are your
testifying in this case?

A Sprint-United/Centel of Florida.

Q Thank you. Mr. Michaelson, did you prepare and
cause to be filed rebuttal testimony dated February 21st,
1996 consisting of 26 pages?

A Yes, I did.

Q And attached to your testimony did you include a
Composite Exhibit GEM-1, consisting of three documents?

A Yes, I did.

MR. WAHLEN: Commissioner Clark, if we could have
that exhibit identified for the record, please.

1 CHAIRMAN CLARK: We will identify the exhibits
2 referred to as GEM-1 as Exhibit 35.

3 (Exhibit 35 marked for identification.)

4 BY MR. WAHLEN:

5 Q Mr. Michaelson, do you have any corrections to
6 your testimony?

7 A Yes, I do. I have two minor corrections. The
8 first is on Page 5, Line 25 of my testimony. The first word
9 on that line is "change," the word should actually be
10 "maintain." The second change is on Page 26 of my testimony
11 on Line 7. In the middle of the sentence it says "will" and
12 it should be "well."

13 Q Do you have any further changes to your testimony?

14 A No, I do not.

15 Q With those changes, if I were to ask you the
16 questions contained in your testimony today, would your
17 answers be the same as those contained therein?

18 A Yes, they would.

19 MR. WAHLEN: Commissioner Clark, we would like to
20 move Mr. Michaelson's testimony into the record as though
21 read.

22 CHAIRMAN CLARK: The revised rebuttal testimony of
23 Mr. Michaelson dated February 21st, 1996, will be inserted
24 in the record as though read.

25

1 BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

2 REVISED REBUTTAL TESTIMONY

3 OF

4 GENE E. MICHAELSON

5

6 **Q.** Please state your name, business address, and title.

7

8 **A.** My name is Gene E. Michaelson. My business address is
9 999 Third Avenue, Suite 3500, Seattle, Washington 98104.

10 I am a partner in the Telecommunications consulting
11 practice of Ernst & Young LLP.

12

13 **Q.** On whose behalf do you appear?

14

15 **A.** I am appearing on behalf of Sprint-United/Centel.

16

17 **Q.** What is the purpose of your testimony?

18

19 **A.** The purpose of my testimony is to address the direct
20 testimony of Dr. Nina W. Cornell on behalf of MCI Metro
21 Access Transmission Services, Inc. filed in this docket
22 on February 6, 1996

23

24 **Q.** Please describe your professional qualifications and
25 experience.

1 **A.** I began my career with Ernst & Ernst (now Ernst & Young
2 LLP) Telecommunications Consulting practice in June 1977
3 as a staff consultant. I became a partner in the firm on
4 October 1, 1987. During my career with Ernst & Young
5 LLP, I have consulted with both wireline and wireless
6 companies in the areas of public policy, business
7 strategy, and product/service pricing, costing, and
8 profitability. I have completed and reviewed over 200
9 cost studies of various types for local exchange carriers
10 throughout the United States and in several foreign
11 countries. They include long-run incremental and direct
12 embedded cost-of-service studies for virtually every
13 major service provided by local exchange carriers today.
14 I have testified before regulatory commissions in
15 California, Illinois, Minnesota, Florida, and Nevada in
16 support of these studies. In addition, I have completed
17 and reviewed jurisdictional separations studies prepared
18 pursuant to Parts 36 and 69 of the Federal Communications
19 Commission's ("FCC") rules and regulations. I have also
20 prepared and presented papers at several
21 telecommunications industry conferences and led numerous
22 training programs on the subject of jurisdictional
23 separations, telecommunications accounting, incremental
24 cost-of-service, and the pricing of telecommunications
25 services.

1 Q. Have you prepared an exhibit to this testimony?

2

3 A. Yes. Exhibit GEM-1 is a composite exhibit consisting of
4 three documents, each of which was prepared by me or
5 under by supervision.

6

7 Q. Do you agree with Dr. Cornell's statement of the policy
8 goal in this proceeding, which begins on line 1 of page
9 4 of her testimony?

10

11 A. No, I do not. Dr. Cornell's sole goal is to promote the
12 development of effective competition in local exchange
13 markets, which she equates with making sure enough
14 consumers choose the services of one of a number of new
15 entrants. Her policy recommendations flow directly from
16 this statement of her policy goal. There are several
17 fallacies associated with this erroneous statement of the
18 policy goal in this proceeding. First, she is confusing
19 a means with an end. One goal in this proceeding should
20 be to promote a modern, efficient, telecommunications
21 industry in Florida. If, and only if, appropriate ground
22 rules are established, local exchange competition can be
23 a means to achieving this policy goal. Effective
24 competition, however, cannot simply be equated with the
25 marketplace success of a number of well-heeled new

1 entrants. Regulatory handicaps placed on existing local
2 exchange companies can ensure the success of new entrants
3 while destroying truly effective competition and harming
4 the public. For example, charging competitors less for
5 local termination than Sprint-United/Centel is implicitly
6 forced to charge itself and its customers would ensure
7 the success of the new entrants but would, at the same
8 time, waste economic resources and harm Sprint-
9 United/Centel's customers.

10
11 Second, efficiency cannot be the only goal of the Florida
12 Public Service Commission in this proceeding.
13 Presumably, the Commission is also interested in
14 promoting universal service and in ensuring that citizens
15 in every area of Florida are served by at least one
16 carrier. Finally, the Commission will have to balance
17 the interests of Florida consumers, particularly lower
18 income consumers who subscribe only to basic service,
19 with the interests of competitive entrants.

20
21 In short, the Commission cannot accept Dr. Cornell's a
22 priori contention that what is good for MCI is good for
23 Florida. This is very important because most of Dr.
24 Cornell's policy recommendations proceed directly from
25 this policy position.

1 Q. Do you agree with Dr. Cornell's statement beginning on
2 line 21 of page 7 of her testimony of the specific
3 principles that should govern compensation arrangements
4 for terminating local traffic?

5
6 A. No, in part, I do not. First, Dr. Cornell states that
7 new entrants must be treated as co-carriers, not as
8 customers. In a competitive market, it is not possible
9 to price discriminate among users of a company's
10 services. Arbitrage is the inevitable result. Further,
11 as Mr. F. Ben Poag has testified, large users will demand
12 that they be given co-carrier status if a price advantage
13 can be obtained via this artificial distinction. Dr.
14 Cornell contends that there is some fundamental
15 difference between the situation of interexchange
16 carriers, who are "customers" and intraexchange carriers,
17 who are "co-carriers." Her reasoning is that the local
18 exchange carriers have a mutual need for services from
19 each other in order to complete calls while, by
20 implication, local exchange carriers and connecting
21 interexchange carriers have no such mutual need. This is
22 plainly incorrect. It is time to recognize that the
23 exchange/interexchange distinction is a regulatory
24 concept that is becoming increasingly difficult to
25 ~~change~~ ^{maintain}. It is inappropriate to expect local exchange

1 companies to price discriminate between exchange and
2 interexchange carriers and increasingly difficult to
3 effectively accomplish in a competitive environment where
4 the same facilities can be used for both exchange and
5 interexchange services.

6
7 Also, I need to comment here on Dr. Cornell's statement
8 that compensation must be reciprocal. She later
9 explains, beginning at line 25 of page 9, that she means
10 "that the entrant can charge the same exact price as the
11 incumbent charges for performing the same task, namely
12 terminating a local call." The problem is that Dr.
13 Cornell is not recommending that the same payment occur
14 for performing the same task. My reading of her
15 testimony is that she is recommending that there be no
16 compensation for terminating local calls of other
17 carriers. Each carrier would simply be required to
18 terminate the traffic of other "co-carriers" at no
19 charge, regardless of call volumes, costs, functions
20 performed, or any other factor whatsoever. As I read her
21 testimony, reciprocity in fact means that co-carriers
22 don't charge each other for terminating their calls, a
23 policy she calls "mutual traffic exchange." I am not
24 aware of any economic rationale for this element of Dr.
25 Cornell's first principle.

1 However, I do agree with her second principle, "that it
2 is very important that the compensation arrangements for
3 terminating local exchange traffic foster efficiency
4 rather than inefficiency." Unfortunately, Dr. Cornell's
5 policy recommendations violate this principle. A price
6 of zero is not an economically efficient charge for
7 terminating competitors' local traffic.

8

9 **Q.** Please comment on Dr. Cornell's arguments in favor of
10 "mutual traffic exchange."

11

12 **A.** Mr. F. Ben Poag has addressed this proposal in his direct
13 testimony, which he refers to as "bill and keep." I will
14 not repeat those arguments here, but I want to emphasize
15 my agreement with them.

16

17 Also, I want to comment on the support that Dr. Cornell
18 offers for "mutual traffic exchange." First, she argues
19 that this approach is "obviously reciprocal." Given her
20 definition of reciprocal, this is obviously true, but I
21 have already stated that I know of no justification for
22 reciprocity, as she defines it, meaning no charge for
23 local traffic termination. Her second argument is that
24 "mutual traffic exchange is by far the least cost means
25 of compensating for terminating traffic." While it is

1 obviously true that not paying for something minimizes
2 the cost of acquiring it, this is not an appropriate
3 justification. Third, she argues that this mechanism
4 gives Sprint-United/Centel the least ability to impose
5 "unnecessary and anticompetitive" costs on entrants.
6 While I agree that if no compensation mechanism for
7 terminating local traffic is established, it can't be
8 abused, this misses the point. If Sprint-United/Centel
9 is forced to incur costs to terminate local traffic for
10 competing carriers without being compensated for it, it
11 will obviously have a huge incentive to discourage such
12 terminating traffic. As a result, Dr. Cornell's
13 recommendation would have the effect of giving the
14 incumbent local exchange carrier an incentive to insist
15 on interconnection arrangements that minimize its costs,
16 even if they are economically inefficient. Her fourth
17 argument is that her recommendation is "neutral in terms
18 of technology and architecture." For the reasons just
19 discussed, paying nothing for terminating access is not
20 technology and architecture neutral. On the contrary,
21 different prices that reflect different costs for
22 alternative technologies and architectures of
23 interconnection are "neutral in terms of technology and
24 architecture." This is what Sprint-United/Centel has
25 proposed. By giving new entrants a choice between

1 connecting at the end office or at a tandem, Sprint-
2 United/Centel is providing competitors with a wide range
3 of architectural choices. Dr. Cornell's fifth and final
4 argument is that only mutual traffic exchange will incent
5 Sprint-United/Centel to cooperate in the development of
6 number portability but she later characterizes these
7 incentives as "slight." I would say that these
8 incentives are slight to the point of being non-existent.
9 I do not see how failing to compensate me for terminating
10 local traffic from your customers gives me an incentive
11 to cooperate in developing a mechanism that will
12 facilitate you taking customers away from me so there
13 will be more terminating traffic. I am obviously more
14 inclined to pursue number portability if I believe that
15 I will be compensated for the costs it creates. In any
16 case, number portability is an important issue that has
17 been addressed in federal legislation and is extraneous
18 to this proceeding.

19
20 Q. Please comment on Dr. Cornell's rejection of Sprint-
21 United/Centel's proposal to use elements of interexchange
22 switched access charges as a basis for local compensation
23 arrangements, which begins at line 22 of page 20 of her
24 testimony.

25

1 **A.** Dr. Cornell rejects the company's approach because she
2 says current regulation prevents it from reflecting these
3 interconnection rates in its own local exchange rates.
4 She goes on to assert that relaxing these regulations
5 would increase the prices that Floridians pay for
6 telephone service. It is extremely important to examine
7 this portion of her testimony carefully, because it goes
8 to the heart of the issues in this proceeding. As I read
9 her testimony, she refutes her own earlier arguments in
10 favor of "mutual traffic exchange" when she testifies
11 that "[i]f Sprint and GTEFL were able to reset their
12 local exchange rates in order to pass an imputation test,
13 it would make entry at least possible, although it would
14 create a significant and unnecessary spiral in local
15 exchange rates." She is clearly conceding that explicit
16 charges for local traffic termination are compatible with
17 efficiency and competitive entry, but that this approach
18 can't be used because it would cause local rates to go
19 up.

20
21 Let me first expand on the concept of imputation.
22 Imputation means that a local exchange carrier would
23 "impute" the price it charges competitors for performing
24 bottleneck functions into the price floor for the prices
25 it charges for its own competing retail services that use

1 these same bottleneck functions. Imputation results in
2 competitive equity because the owner of the bottleneck
3 and its competitors both effectively pay the same price
4 for using the bottleneck. It replicates behavior in
5 competitive markets.

6
7 Dr. Cornell is not correct when she states that imputing
8 the interexchange access rates which Sprint-
9 United/Centel proposes to charge into the company's local
10 exchange service rates would cause an upward spiral in
11 rates for the company's services. Imputation would not
12 increase the company's costs and so it would not increase
13 the revenues which the company needs to generate in the
14 marketplace. Imputation might cause some rates to
15 increase, but, at the same time, would allow other rates
16 to be decreased. Thus, the "worst case" is not that
17 local exchange rates in the aggregate rise, but that a
18 revenue neutral rate restructuring of local exchange
19 rates is necessary.

20
21 Let me illustrate the concept of imputation and the
22 potential rate restructuring that may result with its
23 adoption by describing a highly simplified example, which
24 is shown as Document 1 of Exhibit GEM-1. Suppose that a
25 local exchange company provides only two services, basic

1 local exchange service and an optional custom calling
2 feature package. (Obviously, the Company provides more
3 than two services. Clearly, the restructuring I discuss
4 could be applied to any and all of these services and not
5 just the two presented here.) Also, suppose that basic
6 local exchange service costs the company \$15 per month to
7 provide and it charges \$10, pursuant to regulation, while
8 the custom calling feature package costs \$1 per month to
9 provide and that the company charges \$10 per month for
10 it. Further, assume that in the aggregate these prices
11 cover the total costs of the firm (including a fair rate
12 of return and all fixed costs), not just the service
13 incremental costs of the two services.

14
15 Now, if local exchange competition is introduced, the
16 company must then impute the cost of local termination
17 into the price floor for basic exchange service. Since
18 the company must set its prices above incremental cost in
19 order to recover its total costs, the price floor for
20 basic exchange service becomes, say, \$16, the original
21 cost of \$15 plus a competitively equitable contribution
22 to fixed costs of \$1 for bottleneck local termination
23 functions. An imputation requirement would cause the
24 basic exchange rate to increase from \$10 to \$16, but,
25 since the company's total cost is unchanged, the custom

1 calling charge could be decreased. If everyone
2 subscribed to custom calling features, that price could
3 be decreased from \$10 to \$4 and the subscribers' total
4 bills would be unchanged. Imputation results in a
5 redistribution of charges, but does not cause an increase
6 in overall charges.

7
8 The problem, of course, is that everyone subscribes to
9 basic local exchange service, but not everyone subscribes
10 to custom calling features, so, while imputation does not
11 change the average bill for local exchange services, it
12 changes the bills of particular customers depending on
13 what services they subscribe to. If, for example, only
14 one-half of all subscribers take custom calling features,
15 the price of custom calling features would have to
16 increase to \$19 in order to recover the firm's total
17 cost, holding the price for basic service constant. This
18 is shown on Document 2 of GEM-1. After imputation, the
19 result would be that subscribers who do not subscribe to
20 custom calling features would experience a 60% rate
21 increase (from \$10 to \$16) while subscribers who
22 subscribe to basic service and custom calling features
23 would experience a 21% decrease (from \$29 to \$23) due to
24 the reduction in custom calling allowed by imputation.
25 The average local exchange bill would not change from the

1 original \$19.50.

2

3 This example demonstrates the shift from a regulated rate
4 structure designed to promote universal service to a
5 competitive market rate structure. Note that the
6 regulated rate structure creates a tremendous opportunity
7 for competitive entry. The entrant can choose to only
8 serve the portion of the market that subscribes to basic
9 local exchange service and custom calling features,
10 leaving those who only subscribe to subsidized basic
11 service to be served by the local telephone company. The
12 entrant might very well be able to offer a lower price
13 and earn excess profits even if it were less efficient
14 than the incumbent local exchange carrier, because it
15 would be free of the regulatory obligation to subsidize
16 basic ratepayers. This follows from a well established
17 theorem in contemporary economics which holds that, if a
18 company is earning normal profits and serving some
19 customers at less than incremental cost, it must
20 necessarily be serving other customers at more than the
21 stand-alone cost of serving the latter alone. By
22 avoiding service to the subsidized customers, new
23 entrants can compete for the other customers who are
24 being served at more than stand-alone cost.

25

1 Q. Do you then advocate abandoning imputation in this
2 proceeding?

3

4 A. No, I do not. In the long run, competition will force
5 local exchange carriers to revise their local exchange
6 rate structures so as to pass an imputation test for each
7 and every service. Dr. Edward C. Beauvais has presented
8 a cogent description of these trends in his testimony in
9 this proceeding. As the Commission reconsiders the
10 mechanisms for achieving its universal service and
11 carrier of last resort goals, there is a strong potential
12 to reduce the conflict between these goals and those of
13 the competitive entrants. Universal service funding,
14 derived in a competitively neutral manner, could be used
15 to reduce the price and price floor of basic service for
16 specific customer classes. This environment would make
17 it possible to restructure local exchange rates without
18 fear of jeopardizing important social policy goals.

19

20 Prior to the time that the Commission revises its
21 universal service and carrier of last resort policies,
22 and during the period that local exchange rates are
23 frozen, a simplified form of imputation can serve to
24 protect the interests of new entrants, even though it
25 will leave incumbent local exchange carriers vulnerable

1 to inefficient opportunistic niche entry. There is,
2 unfortunately, no way to avoid this without giving local
3 exchange carriers an opportunity to restructure their
4 rates.

5
6 My proposal is as follows: Prior to the time at which
7 local exchange carriers are given the opportunity to
8 restructure their local exchange rates, the imputation
9 test should be applied to the revenues, service
10 incremental costs, and imputed local termination charges
11 associated with serving a particular customer class in a
12 particular exchange, and to all customer classes in the
13 aggregate in a particular exchange. As a practical
14 matter, this would mean applying the imputation test for
15 business customers in the exchange, for residence
16 customers in the exchange, and for all customers in the
17 exchange.

18
19 Considering the example I presented previously, it is
20 apparent that the two services together passed the
21 imputation test, but the individual services did not
22 prior to rate restructuring. For the reasons I
23 previously stated, this outcome, if anything, is more
24 beneficial to the new entrant than a requirement to pass
25 the imputation test separately for the individual services.

1 Q. Do you propose that all local exchange companies be
2 required to conduct business and residential imputation
3 studies for each of their exchanges at this time?

4
5 A. No, I do not. A requirement that imputation tests be
6 conducted up front for each customer class in each
7 exchange would impose unreasonably burdensome demands on
8 incumbent local exchange carriers without offsetting
9 benefits for the new entrants. I suggest that the
10 imputation test be conducted when a potential entrant
11 specifically identifies business or residence service
12 classes in exchanges that they serve or have the
13 realistic potential to serve and where a credible
14 imputation issue exists. The Commission would order the
15 incumbent local exchange carrier to conduct the
16 imputation test in particular exchanges based upon an
17 acceptable petition from an entrant. As competition
18 develops and repricing is permitted and the Commission
19 addresses universal service and carrier of last resort
20 issues, imputation tests could be extended to classes of
21 services other than business as a whole or residence as
22 a whole, if the benefits appear to outweigh the costs.

23
24 Q. Do you agree with Dr. Cornell's testimony, beginning on
25 line 25, page 26, that, if the Commission determines that

1 compensation for terminating the local calls of
2 competitors is appropriate, rates should be set at
3 "direct economic cost" so they will fall to the "social
4 cost" of providing them?

5

6 **A.** No, I do not. I have read Dr. Cornell's testimony
7 regarding this issue many times and I cannot discern its
8 meaning or its relationship to anything in the
9 contemporary economics literature. The terms "direct
10 economic cost" and "social cost" are not ordinarily used
11 in economic analysis of access prices. As I read her
12 testimony, both terms are the same and correspond to the
13 industry's marginal cost. She appears to be defining
14 economic cost as the marginal cost of the least cost
15 firms in the industry when operating efficiently. If
16 this is what she means, then this is the "cost of the
17 resources that society must give up to produce that good
18 or service," her definition of social cost. Accordingly,
19 I understand social cost and economic cost to be
20 identical and to be equal to the industry long run
21 marginal cost. Given her definitions, I do not
22 understand how the social cost can be above the economic
23 cost, as she says is the case for interexchange services.
24 I believe that her argument here is simply the
25 traditional case for marginal cost pricing cloaked in

1 novel terms. As I understand her argument, she is saying
2 that setting the price of interexchange access above
3 marginal cost causes the price of toll services to be
4 above marginal cost (or "social cost" or "economic
5 cost"), resulting in inefficient resource allocation in
6 the economy. This is an issue which has been addressed
7 exhaustively in the economics literature for decades and
8 which is well understood.

9
10 I have written a paper that discusses the cost concepts
11 applicable here. It is presented as Document 3 of my
12 composite exhibit to this testimony [GEM-1]. I use
13 incremental costs in these discussions, which is standard
14 telecommunications industry practice, instead of marginal
15 costs. All necessary definitions are contained in my
16 paper.

17
18 Most of us remember the standard diagram in our beginning
19 economics textbook which shows the price for a good set
20 equal to its marginal cost, the firm earning normal
21 profits, etc. This happy, "first best" result comes
22 about because of assumptions about the shape of the cost
23 function. While useful in a pedantic context, this
24 description doesn't fit the modern telecommunications
25 industry. If a telecommunications firm were to set all

1 of its prices at marginal, or unit incremental cost, the
2 firm would quickly go bankrupt because it would not
3 recover its total cost. Not surprisingly, the textbook
4 first best, socially optimal result cannot be achieved in
5 the real world. Contemporary economic theory recognizes
6 the reality that not all cost curves fit the naïve
7 textbook example. It recognizes that firms must cover
8 their total costs and that incremental costs at several
9 levels set floors on prices. In my paper, I illustrate
10 this concept. The firm's prices must be set above the
11 applicable incremental cost floors, and, in the
12 aggregate, recover the firm's total cost. This is
13 exactly how unregulated firms in real-world competitive
14 markets or, contestable markets as they are sometimes
15 called, set their prices.

16
17 It is absolutely true that the resulting prices are above
18 the first-best theoretical level. This is not unique to
19 local exchange carriers, however. Even if interexchange
20 access charges were set at marginal cost, MCI would not
21 set its retail service prices at marginal cost of
22 interexchange access plus its own marginal cost, because
23 it would go bankrupt if it did. Toll prices today are
24 well above marginal cost because access charges are above
25 marginal cost and the interexchange carriers, as they

1 must, price their retail services to recover their own
2 total costs. This is as it must be. The issue is how
3 much each of the services of a multi-service firm will be
4 raised in order for the firm to recover its total costs.
5 As has been recognized for decades, the pattern of prices
6 depends on market conditions, with more elastic service
7 prices being raised above cost relatively less than less
8 elastic services. This is as true of MCI as it is of
9 Sprint-United/Centel or any other telecommunications
10 services provider in the same situation.

11
12 Dr. Cornell apparently feels that it is unfair for
13 competing carriers to contribute to the recovery of what
14 she calls "the indirect costs of the incumbent local
15 exchange carriers" because it has its own indirect costs
16 to recover. Dr. William Baumol, a long-time expert
17 witness for AT&T has eloquently responded to this
18 argument:

19
20 "Closer inspection, however, confirms that these
21 impressions are mistaken. As we have shown, the
22 efficient component-pricing rule offers the prospect of
23 success to entrants who can add efficiency to the supply
24 of the final product, while it ensures that inefficient
25 entrants are not made profitable by an implicit cross-

1 subsidy extracted from the incumbent. An entrant may
2 have to replicate some of the incumbent's activities or
3 facilities, and the costs of such duplication can render
4 an entrant unprofitable. But, if that is the case under
5 efficient component pricing, then the requisite
6 replication of cost correspondingly renders the entry
7 inefficient and, ultimately, harmful to consumers and to
8 society." See William J. Baumol and J. Gregory Sidak,
9 Toward Competition in Local Telephony, (Cambridge: The
10 MIT Press, 1994), p. 115.

11
12 **Q.** What about Dr. Cornell's contention that firms should
13 look only to their retail customers for recovery of their
14 "indirect costs" as a way of benefiting those customers?

15
16 **A.** I cannot understand this position. First, how can it
17 benefit Sprint-United/Centel's customers to recover all
18 "indirect" costs only from them and not from access and
19 interconnection services provided to its competitors?
20 What standard of fairness or efficiency justifies such an
21 approach? To the best of my knowledge, there is none.
22 Obviously, if Sprint-United/Centel's own retail customers
23 are implicitly paying more for terminating local calls
24 than its competitors pay to terminate calls on the same
25 network, competitive losses will lead to a death spiral

1 in which these indirect costs are recovered from ever
2 fewer customers. As is recognized in the literature, and
3 stated in the quote from Dr. Baumol, Dr. Cornell's
4 argument amounts to a request for a cross-subsidy to the
5 new entrant from the incumbent local exchange carrier.

6
7 Dr. Cornell's primary argument in support of her position
8 appears to be that "interconnection rates cannot be
9 competed down." She belatedly reveals that this
10 justifies pricing interconnection services to recover
11 "the total service long run incremental cost" of
12 interconnection, which she later equates to "direct
13 economic cost." She testifies that this "could be
14 expressed in tenths of a cent per minute." This is an
15 extraordinary position. This docket is about local
16 exchange competition. New entrants will be providing
17 interconnection and access services. Given that MCI is
18 an interexchange carrier, one may reasonably assume that
19 this is its principal incentive to enter the market. Dr.
20 Cornell is asking for a cross-subsidy precisely so she
21 can compete down the cost of access and local termination
22 unfairly. MCI will do this by attracting away customers
23 from Sprint-United/Centel's network. If you have the
24 customer, you provide the access and termination services
25 to him or her. Not only is it incorrect to say that

1 access and termination service prices cannot be competed
2 down, this is the principal reason that local exchange
3 competition exists.

4

5 Q. Do you agree with Dr. Cornell's assertion beginning on
6 line 20 of page 34 of her testimony that new entrants
7 will want to minimize costs but that Sprint-United/Centel
8 will not?

9

10 A. No. Both incumbents and entrants will want to minimize
11 costs because they will be competing with each other.
12 Their incentives are no different. If the Commission
13 adopts the proposal outlined in my testimony, Sprint-
14 United/Centel will impute interconnection prices into the
15 price floors of its retail services, so it cannot achieve
16 a competitive advantage by maintaining interconnection
17 costs and prices artificially high. Thus, contrary to
18 Dr. Cornell's testimony, the percentage of
19 interconnecting traffic is irrelevant, because both firms
20 will be paying the same price for local termination on
21 Sprint-United/Centel's network. If new entrants have
22 lower termination costs, this will give them a
23 significant competitive advantage.

24

25 Q. I take it, therefore, that you agree with Sprint-

1 United/Centel's proposal to apply interexchange access
2 charges to local interconnection services provided to
3 competitors?

4
5 **A.** Yes, I do. As I have testified, and as Dr. Beauvais has
6 testified, the time has long since passed in which it is
7 either possible or desirable to discriminate among
8 classes of customers based on the identity of the
9 customer or the type of traffic, such as exchange or
10 interexchange. The opportunities for arbitrage are
11 simply too great in a competitive environment. Consider
12 the fact that MCI Metro's parent is one of the largest
13 interexchange carriers and is currently paying nearly
14 half of its toll revenues to local exchange carriers for
15 access services. Sprint United/Centel will not be able
16 to determine whether traffic terminating to it from MCI
17 Metro's switch is intraexchange or interexchange. Those
18 of us who remember the years of discussion associated
19 with establishing interstate rates for exchange access
20 have unlimited respect for MCI's ability to develop
21 sophisticated arguments for why its traffic should be
22 carried at the lowest possible rate. I can imagine, for
23 example, an argument that it has a single exchange
24 covering the entire state so all intrastate traffic
25 terminating from its network should be consider exchange

1 traffic.

2

3 Even if arbitrage of the resulting discriminatory rate
4 structure were preventable, I would still argue against
5 charging different prices for exchange access and
6 interexchange access. There is general recognition that
7 access charges are priced ^{well} ~~will~~ above cost and need to be
8 reduced. It is also generally recognized that access
9 rates are too high because regulators are trying to keep
10 the price of basic service low. To the extent that rate
11 restructuring becomes feasible, it is appropriate to
12 reduce both interexchange and exchange access prices. It
13 makes no sense to maintain interexchange access prices
14 too high and to set exchange access prices at zero, as
15 Dr. Cornell proposes. Rather, both need to come down in
16 tandem. Ultimately, the goal should be a price structure
17 that treats all usage of exchange networks in a non-
18 discriminatory way. Dr. Beauvais' testimony provides an
19 excellent illustration of such a rate structure.

20

21 Q. Does this conclude your rebuttal testimony?

22

23 A. Yes, it does.

24

25

1 BY MR. WAHLEN:

2 Q Mr. Michaelson, do you have a summary of your
3 testimony and could you please give it?

4 A Yes, I do, and I would be happy to provide the
5 summary.

6 Good late afternoon, Commissioners. I understand
7 we are getting very late in the day. I will try to be
8 brief. I was asked by Sprint-United/Centel of Florida to
9 submit rebuttal testimony in this proceeding in order to
10 address certain issues raised in the testimony of MCI Metro
11 witness Doctor Nina Cornell. My testimony can be summarized
12 as follows: First, I disagree with Doctor Cornell's stated
13 policy goal for this proceeding. Her sole goal is to
14 promote the development of effective competition in local
15 exchange carrier markets, which she equates with making sure
16 enough consumers choose the services of one of a number of
17 new entrants. Doctor Cornell is confusing a means with an
18 end.

19 I believe that there should be two policy goals
20 that guide this proceeding. First, the promotion of a
21 modern, efficient telecommunications industry in Florida,
22 and, second, the promotion of universal service. If the
23 appropriate ground rules are established, local exchange
24 competition can be introduced as a means to achieving these
25 ends.

1 Second of all, and the rest of my comments deal
2 with this, I disagree with the principles Doctor Cornell
3 recommends that should govern compensation agreements for
4 terminating local exchange traffic. She advocates that new
5 entrants be treated as quote, unquote, co-carriers, not
6 customers, such as interexchange carriers. This would
7 involve price discrimination between the two types of
8 customers and this simply is not possible in a competitive
9 environment.

10 Next, Doctor Cornell advocates that compensation
11 must be reciprocal, but then goes on to recommend that there
12 be no compensation for terminating local calls. She calls
13 this "mutual traffic exchange," but defines the compensation
14 as, "in kind," rather than, "in cash." Certainly charging
15 nothing for a service minimizes the cost, but this is not an
16 appropriate justification for such a policy goal. In
17 addition, I am unaware of any economic rationale for this
18 element of Doctor Cornell's plan.

19 In spite of her recommendation that there be no
20 compensation for mutual traffic exchange, Doctor Cornell
21 admits in her testimony that entry would be possible if
22 Sprint were able to reset their rates in order to pass an
23 imputation test, but warns of a significant and unnecessary
24 spiral in local exchange rates.

25 I provide a rather lengthy discussion of

1 imputation, along with examples, in my testimony, and I will
2 not repete them here in the interest of time. But I think
3 it's important to define imputation and what I am proposing
4 in this case. Imputation requires that local exchange
5 carriers include the price it charges competitors for
6 performing bottleneck functions into the price floor for the
7 prices it charges for its own competing retail services that
8 use the same bottleneck functions. Imputation results in
9 competitive equity because the owner of the bottleneck and
10 its competitors both effectively pay the same price for
11 using the bottleneck facility. It replicates behavior in
12 competitive markets.

13 In my example, I show that imputation would not
14 necessarily in the aggregate cause local exchange rates to
15 rise, but would rather result in revenue neutral rate
16 rebalancing or restructuring. Even though local exchange
17 rates are frozen in Florida, imputation can still be used.
18 I describe in my testimony a way in which imputation tests
19 can be done in light of the local exchange freeze. This
20 approach will not only promote economic efficiency, but will
21 also be beneficial to new entrants. When restructuring is
22 allowed, imputation could then be done on a
23 service-by-service basis.

24 Doctor Cornell argues that if compensation for
25 local termination is required, then the appropriate basis

1 for rates should be set at "direct economic costs," a term I
2 can't find in the economic literature, but appears to be
3 equivalent to marginal costs. Setting interconnection rates
4 at marginal cost is unfair, inefficient, and
5 anti-competitive. It would require the incumbent to set
6 rates above marginal cost in order to recover its total
7 cost, which is required of all telecommunications companies,
8 including MCI, but to charge entrants a rate that is less
9 than that. If telecommunications firms were to set all
10 of its prices at marginal cost, it would quickly go
11 bankrupt. This is true not only of LECs, but also of
12 interexchange carriers. Doctor Cornell, however, believes
13 it is unfair for competing carriers to contribute to the
14 recovery of what she calls, "the indirect costs of the
15 incumbent local exchange carriers," because it has its own
16 indirect costs to recover.

17 The imputation test that I propose in this proceeding
18 includes not only the direct incremental cost of the
19 bottleneck facility, but also a contribution to these
20 indirect costs. This concept, which is known as the
21 efficient component pricing rule, I think is fair and
22 represents what would happen in a competitive market. In
23 this case, if the entrant as well as the incumbent pay the
24 same price for the bottleneck facility, then the company
25 that can be the most efficient in the supply of the final

1 service will win the business. If the entrant is less
2 efficient then the incumbent, it will be kept out of the
3 marketplace, which is the proper reaction in competitive
4 markets and good for society.

5 The proposal made by Doctor Cornell, however, will
6 result in an interfirm cross-subsidy because she will
7 require that the bottleneck facility be provided only at the
8 incremental cost of the bottleneck and include no
9 opportunity cost or loss contribution that would result as a
10 loss -- as a result of the loss of the business by the
11 incumbent.

12 Doctor Cornell argues that LECs should look only
13 to their retail customers for recovery of their, "indirect
14 costs." I don't understand how it benefits Sprint's
15 customers to recover all indirect costs only from them and
16 not from access and interconnection services provided to its
17 competitors. What standard of fairness or efficiency
18 justifies such an approach? To the best of my knowledge
19 there is none.

20 Doctor Cornell supports this position by stating
21 that interconnection rates cannot be competed down. I
22 believe this is an extraordinary position. This docket is
23 about local exchange competition. MCI will compete for
24 subscriber access at the expense of the incumbent. In doing
25 so, MCI will not only compete down the interconnection

1 rates, but in some cases will eliminate interconnection
2 charges altogether if it is successful in attracting
3 customers to its service. Competing down interconnection
4 prices is the principal reason that local exchange
5 competition exists.

6 Lastly, I agree with --

7 COMMISSIONER DEASON: Excuse me just a second.
8 How is an ALEC attracting new customers going to eliminate
9 the need for interconnection?

10 THE WITNESS: They will not eliminate the need
11 for interconnection, but what they can do is attract
12 business to the degree that they would pay less in
13 interconnection charges than they would before they entered
14 the marketplace. In other words, if they provide a direct
15 connection as they do today with special access for a
16 customer that terminates a significant amount of traffic
17 into their facilities, they would forego paying those costs
18 to the incumbent provider. Over time, as the entrants gain
19 more business, and can adjust -- use the proceeds that they
20 would have normally paid in interconnection to support its
21 activities in the marketplace, if they believe that the
22 margin is too high for interconnection, they will be able to
23 force it down by offering customers lower prices than the
24 incumbent could.

25 COMMISSIONER DEASON: But isn't that what

1 competition is all about?

2 THE WITNESS: That's right. That's what
3 competition is all about. And I don't understand how costs
4 cannot be competed down in the marketplace. That's what
5 competition will do. It will drive prices down to a level
6 where the most efficient firm can make money.

7 COMMISSIONER DEASON: I'm sorry for interrupting.

8 A (Continuing) Lastly, I agree with Sprint's
9 proposal to apply access charges to local interconnection
10 services provided to competitors. It is not possible to
11 price discriminate among classes of customers, in this case
12 IXCs and ALECs. There is a general recognition that access
13 charges are priced well above cost and need to be reduced,
14 but it makes no sense to maintain high access rates and set
15 local exchange access prices at zero, as Doctor Cornell
16 proposes. I recommend that prices be restructured so that
17 access and local exchange interconnection rates be set in a
18 nondiscriminatory way. That concludes my summary.

19 MR. WAHLEN: Mr. Michaelson is available for
20 cross examination.

21 MS. WILSON: Good evening, Mr. Michaelson.
22 I'm Laura Wilson.

23 CHAIRMAN CLARK: No, wait a minute.
24 Mr. Edgington.

25 MR. EDGINGTON: No cross.

1 CHAIRMAN CLARK: Thank you. Ms. Wilson,
2 Commissioner Johnson wants to ask a question.

3 COMMISSIONER JOHNSON: Let me -- and perhaps I
4 didn't understand something that you said a little earlier.
5 But you suggested that competition would drive the cost
6 down, or did you say that?

7 THE WITNESS: Competition can drive prices down.

8 COMMISSIONER JOHNSON: But if the cost is set by
9 the LEC, and it is outside of the control of the ALEC, what
10 affect will competition have on that?

11 THE WITNESS: The ALEC will, through whatever
12 mechanism it chooses, whether it is building its own
13 facilities, or reselling facilities, or providing wireless
14 services, will begin to provide direct connections to
15 customers, which will allow it to charge interconnection
16 rates to the incumbent provider.

17 COMMISSIONER JOHNSON: So they would get off of
18 your network, in other words.

19 THE WITNESS: Right. And if they were able to
20 connect -- if they had customers that both originated and
21 terminated calls in your network, then they wouldn't pay
22 interconnection charges to the incumbent provider. By doing
23 this, by gaining market share and gaining customers, they
24 will be able to effectively reduce their prices in a
25 competitive way with the incumbent provider. This happens

1 in most competitive markets. So I don't believe it's true
2 that the incumbent provider is going to control forever the
3 price of interconnections, because I think that competition
4 will force prices to be reduced if indeed they are well
5 above the incremental costs that the entrant could maintain
6 in its own network.

7 COMMISSIONER JOHNSON: I think I understand your
8 position. I will think about it a little while.

9 THE WITNESS: Okay.

10 CHAIRMAN CLARK: Ms. Wilson.

11 MS. WILSON: Thank you.

12 CROSS EXAMINATION

13 BY MS. WILSON:

14 Q Good evening, I'm Laura Wilson representing the
15 Florida Cable Telecommunications Association. I have just a
16 few questions for you. Did I understand you to say in your
17 summary that the two goals that should guide this Commission
18 would be the promotion of a modern, efficient
19 telecommunications system and the promotion of universal
20 service?

21 A Yes. I think I said telecommunications industry
22 instead of system, but essentially that's correct.

23 Q Okay. And in your summary did you express some
24 concern over maintaining the financial viability of
25 Sprint-United/Centel?

1 A I mentioned in my summary that if the incumbent
2 provider is forced to charge all of its services at equal to
3 incremental cost, they would quickly go bankrupt. But I was
4 speaking generically about incumbent providers.

5 Q And would it be your position that we need to be
6 concerned about Sprint-United/Centel's financial viability
7 because of its obligation to provide universal service?

8 A Well, I don't specifically address universal
9 service, per se, in my testimony, but I think it's fair to
10 say that if Sprint-United is forced to charge prices to its
11 customers which are implicitly higher than those that could
12 be charged by entrants that are also multi-billion dollar
13 companies, then I think it's fair to say that they face a
14 significant financial risk in the marketplace.

15 Q Okay. And aren't you also testifying in support
16 of an interconnection price whereby the ALECs will
17 contribute to United/Centel's ability to maintain universal
18 service through the interconnection rate?

19 A The interconnection charge that I propose, which
20 is based on the imputation principle described in my
21 testimony, would include a contribution element in the price
22 charged to the entrant. That contribution is not solely or
23 perhaps at all related to universal service. That would
24 depend on the cost of the company that is providing the
25 service, and in this case Sprint-United is the company. I

1 don't know what their universal obligations are or how they
2 are currently being recovered. I was speaking generically
3 about an imputation principle.

4 MS. WILSON: Okay. I have no further questions.

5 CHAIRMAN CLARK: Mr. Michaelson, just so I'm
6 clear, I realize you're a consultant with Ernst & Ernst.
7 What is your -- are you an economist?

8 THE WITNESS: The firm is now Ernst and Young.
9 It used to be Ernst & Ernst when I started years ago. I am
10 a partner in the firm, and I am a certified public
11 accountant.

12 CHAIRMAN CLARK: Okay. You're not an economist?

13 THE WITNESS: I am not an economist, although I
14 have studied economics, and in the course of nearly 19 years
15 of consulting primarily doing cost studies and setting
16 prices and so forth, I have studied the economic literature
17 and written about it and spoken about it. So I have, I
18 think, an in-depth knowledge of economics as it applies to
19 the subject matter that I'm testifying to today.

20 CHAIRMAN CLARK: Okay. Thank you. Mr. Crosby.

21 MR. CROSBY: No questions.

22 CHAIRMAN CLARK: Mr. Melson.

23 MR. MELSON: A few.

24 CROSS EXAMINATION

25 BY MR. MELSON:

1 Q Mr. Michaelson, I'm Rick Melson representing MCI
2 Metro. I would like to walk you through a numerical example
3 to try to understand some of the things you have said in
4 your summary. If you have got a pencil and a piece of paper
5 it might help to take a note or two to follow along. And
6 I'm going to use Sprint to refer to both United and Centel.
7 Assume for me that Sprint's cost of terminating a minute of
8 local traffic was half-a-cent per minute, and assume that
9 when Sprint completed a local call on its own network, the
10 other costs beyond the termination were another half-cent a
11 minute. So that, in effect, the total cost to Sprint of
12 handling the local call from one Sprint customer to another
13 would be a penny a minute.

14 COMMISSIONER JOHNSON: What are the other costs?

15 MR. MELSON: It would be originating, billing and
16 collecting, directory listing, all of the other things that
17 go into the cost of the service.

18 BY MR. MELSON:

19 Q Now, also assume for me that --

20 COMMISSIONER JOHNSON: Mr. Melson, not to cut you
21 off, but I just want to make sure I have the costs. The
22 cost of terminating, were you talking about the total
23 service long-run incremental costs? Are you including
24 contribution or --

25 MR. MELSON: I would mean total service long-run

1 incremental costs, including a return on investment, but not
2 including any contribution at this point to shared costs.

3 COMMISSIONER JOHNSON: Okay.

4 BY MR. MELSON:

5 Q And, Mr. Michaelson, every time I use cost, unless
6 I say something different, that is what I'm referring to, is
7 an average total service long-run incremental cost.

8 Now, assume that the price that Sprint charges,
9 say, MCI Metro for that local termination piece is a penny a
10 minute. In that situation, assuming that local service were
11 provided strictly on a charge per minute of use basis, what
12 would be the price floor under your imputation test for a
13 local company, for Sprint handling a call within its
14 network?

15 A In order for me to understand it, the price for
16 the final service or for the termination of the --

17 Q The price floor for the final service.

18 A Okay. And just so that I understand your cost
19 elements properly, the cost of the company to terminate a
20 call to its own customer is a half-a-cent a minute?

21 Q Correct.

22 A And then there is some kind of switching cost or
23 something else that's involved that is half-a-cent a minute?

24 Q Say cost of originating the call, the originating
25 piece of it as opposed to the terminating piece.

1 A Okay. And would that cost include the cost of
2 the, let's say, local loop facilities and the switching and
3 all of that, or is it simply the cost to terminate the call
4 on the switch? There are a lot of cost elements involved in
5 determining local services and I'm trying to understand what
6 you have included.

7 Q Right. And I'm trying to keep this simple, and
8 the other cost is intended to include all other total
9 service long-run incremental costs of completing a minute of
10 local traffic.

11 A Okay. And just so I understand, your definition
12 of TSLRIC is simply the direct capital outlays and operating
13 expenses, and it does not include any opportunity costs?

14 Q That's correct.

15 A So, the total cost, the total TSLRIC cost that you
16 mentioned to me is a penny a minute for those two elements?

17 Q That's correct.

18 A And just so -- I'm asking a lot of questions --
19 just so I understand your question, are you asking what the
20 price should be?

21 Q No. I also gave you the piece of information that
22 the price that Sprint charges to MCI Metro for the
23 termination is a penny per minute.

24 A Okay.

25 Q I'm asking you, given those three numbers, can you

1 tell me under your imputation test what the price floor
2 would be for a minute of local service provided by Sprint to
3 its own customer?

4 A Okay. The answer to the question would be a penny
5 and a half a minute, which would be composed of the
6 originating TSLRIC cost of half-a-cent a minute plus the one
7 cent a minute price charged to the entrants for the
8 bottleneck termination of the call.

9 Q Okay. Now assume that the price that Sprint
10 charges its customer for that minute is set at 3 cents?

11 A Okay.

12 Q In that situation, how much contribution to shared
13 costs or to profit is Sprint getting when it sells a minute
14 of use to its own customer?

15 A It gets, if I did my math right, 2-1/2 cents a
16 minute contribution.

17 Q All right. You're going to need to explain that
18 to me, because I would have thought two cents.

19 A Maybe I got the numbers wrong. You're telling me
20 now that the price is 3 cents a minute?

21 Q Correct.

22 A And the cost remains at half-a-cent a minute?

23 Q No. The total service long-run incremental cost
24 remains at a penny per minute, which was the half-cent of
25 termination plus the half-cent of origination.

1 A Maybe I misunderstood your question. I thought
2 you asked me what the contribution was for terminating the
3 local call on the network.

4 Q What is the contribution for providing a minute of
5 local service to a Sprint customer?

6 A Okay. That's different than what I understood
7 your question to be. The contribution for the bottleneck
8 facility is 2-1/2 cents a minute, and the cost of the final
9 service is -- the additional cost of originating the call
10 for the final service is another half-a-cent a minute. So,
11 in effect, you're correct, it would be a 2 cent per minute
12 contribution to its shared and common cost.

13 Q All right. Now, I would like you to assume for
14 me, again, just for purposes of example, that MCI Metro is
15 just slightly more efficient than Sprint, and that its costs
16 of originating a call rather than being five-tenths of a
17 cents per minute are four-tenths of a cent per minute.

18 Would you agree with me that the cost to MCI Metro
19 of originating a call under that circumstance and
20 terminating to a Sprint customer on the Sprint network would
21 be 1.4 cents per minute?

22 A If you would, Mr. Melson, clarify for me again,
23 are we back to the original price of the penny a minute for
24 the bottleneck facility or are we at 3 cents?

25 Q No. The 3 cents is the price to the end use

1 customer for an end-to-end service. The one cent is the
2 price to a competitor for the local termination, the
3 essential monopoly input into its competitive service.

4 A Okay. So if the price of the bottleneck service
5 to MCI Metro is a penny a minute from Sprint, and they have
6 an additional cost to originate the call of .004, then their
7 total cost or total price floor, if you will, for offering
8 their service to their customer is 1.4 cents a minute.

9 Q All right. Now, assume that they have got great
10 name recognition and are able to command the same price in
11 the marketplace as Sprint, and they provide that service to
12 their customer for a price of 3 cents per call.

13 A Okay.

14 Q In that situation, how much contribution is MCI
15 Metro earning toward its shared costs and its profit?

16 A They would make a contribution to their shared and
17 common costs of 1.6 cents a minute.

18 Q And that is less than the 2 cents that Sprint has
19 as a contribution to its shared and common costs when it
20 sells a comparable minute to its customer, is that correct?

21 A In real numbers, it is less because of two
22 reasons. First, MCI is more efficient in the origination of
23 its call by .001 per your stylized example. And, second,
24 the remaining 5 cents is the contribution, the so-called
25 opportunity cost that the company, is a real cost the

1 company would forego if MCI were to take its customer. So,
2 in effect, the contribution for MCI is different for those
3 two reasons.

4 Q And in that example where MCI has less
5 contribution to its own shared costs and it's own profit, it
6 is making a contribution of half a penny per minute towards
7 Sprint's shared costs, is that correct?

8 A It is paying Sprint a penny a minute per your
9 example, and thus providing Sprint with compensation for its
10 direct incremental cost of providing the bottleneck facility
11 plus its opportunity costs of a half-a-cent a minute.

12 Q And in this example, is it fair to equate
13 opportunity cost with contribution?

14 A Yes.

15 Q I believe in your summary you indicate --

16 COMMISSIONER DEASON: Mr. Melson, are you leaving
17 that example?

18 MR. MELSON: Yes, I was going to.

19 COMMISSIONER DEASON: Let me ask a question. If
20 the roles were reversed, and it was Sprint who was
21 terminating the call on MCI's network, what would be the
22 contribution that Sprint would earn, assuming their
23 terminating costs are the same as Sprint's terminating
24 costs?

25 THE WITNESS: That would depend, Commissioner, on

1 the price of termination charged by MCI.

2 COMMISSIONER DEASON: I assume it would be
3 reciprocal, that the same rate would apply in either
4 direction.

5 THE WITNESS: Assuming, again, Mr. Melson's
6 numbers, and assuming, therefore, that the price for
7 originating the call is still a half-a-cent a minute, they
8 would make a contribution of a penny and a half a minute to
9 their shared and common costs, assuming a 3 cent per minute
10 rate to their end user.

11 COMMISSIONER DEASON: And how did you calculate
12 that? You take the 3-cent rate, and what do you deduct from
13 that?

14 THE WITNESS: Subtracting out the price of the
15 bottleneck termination that they would pay to MCI of a penny
16 a minute, and subtracting from that the one-half-a-cent per
17 minute for originating the call that was assumed in the
18 example. In effect, if Sprint's cost structure for
19 termination was exactly the same as Sprint, then they would
20 be making -- Sprint would be making a contribution to the
21 opportunity costs which would be foregone by MCI of
22 providing the service to -- instead of MCI.

23 COMMISSIONER DEASON: Now, you took the 3 cents
24 and you deducted one cent, which was the price of
25 termination, is that correct?

1 THE WITNESS: I'm sorry, someone coughed, I
2 couldn't hear, Commissioner.

3 COMMISSIONER DEASON: Okay. I'm just trying to
4 understand how you -- what does the 1.5 cents represent?
5 That represents contribution to whom?

6 THE WITNESS: I believe, if I understood your
7 question properly, you were asking me what contribution
8 Sprint would make to its shared and common costs, assuming
9 that they charged a price of 3 cents per minute, they paid a
10 price of one cent per minute to MCI to terminate their call,
11 and they incurred a price of half-a-cent a minute to
12 originate the call. Those factors, 3 cents minus 1 cent
13 minus a half-a-cent would give a cent-and-a-half
14 contribution to its shared and common costs.

15 COMMISSIONER DEASON: And what would be MCI's
16 contribution from terminating that call from Sprint?

17 THE WITNESS: MCI would receive from Sprint one
18 cent per minute, which is the price that they would charge
19 for interconnection. If their cost is a half-a-cent a
20 minute, then they would recover not only the cost, but also
21 recover the contribution or opportunity cost of half-a-cent
22 per minute.

23 BY MR. MELSON:

24 Q Mr. Michaelson, in your testimony you state that
25 presumably the PSC is interested in promoting universal

1 service, is that correct?

2 A That's correct.

3 Q It's true, though, isn't it, that you're not
4 familiar with the activities this Commission has taken with
5 regard to universal service?

6 A That's correct.

7 Q And, in fact, you're not familiar with what type
8 of regulatory regime the Florida Public Service Commission
9 applies to Sprint today, is that correct?

10 A Not entirely, Mr. Melson. During my deposition I
11 was unaware of the regulatory regime which governs Sprint in
12 the State of Florida. But since that time I have had some
13 general discussions with Sprint about that, and while not an
14 expert in the details of the regulation, I'm generally
15 familiar with it.

16 Q But at the time you filed your testimony in
17 February you did not know that Sprint was subject to price
18 regulation in Florida, is that correct?

19 A That's correct.

20 Q Now, you testify that if some customers are served
21 by a firm at prices below incremental cost, that other
22 customers by definition will be served above the stand-alone
23 cost of serving them, is that correct?

24 A Assuming that the firm overall is earning normal
25 profits, yes.

1 Q Isn't it true that you have done no investigation
2 to determine whether Sprint is serving any customers below
3 incremental cost?

4 A That is correct.

5 Q And conversely, you have done no investigation to
6 determine whether Sprint is serving any customers at prices
7 above the stand-alone cost, is that correct?

8 A That's correct.

9 Q So would it be fair to say that in this regard you
10 don't know whether the principle that you enunciate in your
11 testimony has any application at all to the facts that are
12 before the Commission in this docket?

13 A No, I wouldn't agree with that at all. The
14 principle that I state in my testimony, which is on Page 14,
15 is a general theorem which has been proven by many
16 economists. I raised that example here simply as part of my
17 discussion of my own stylized example contained in my
18 exhibit. The theorem is certainly true. To the degree that
19 services are priced above stand-alone cost or below
20 incremental cost by Sprint or anybody else in this
21 proceeding, I don't have any direct knowledge of that.

22 But suffice it to say if Sprint were subject to
23 earning only normal profits, which I assume it is because
24 it's under price cap regulation, and assuming as I stated in
25 my deposition that some of their services or one of them, in

1 fact, were provided below its incremental cost, then at
2 least one other service or subset of services must be
3 provided at above stand-alone cost. That theorem is
4 absolutely true.

5 Q And I'm asking you if you don't know whether
6 Sprint has got any services priced below incremental cost,
7 and you don't know if they have got any services priced
8 above stand-alone costs, then you don't know whether that
9 theorem has any actual application to the facts of this
10 case, is that correct?

11 A The theorem is true. Whether or not any of the
12 services are provided at below incremental cost or above
13 stand-alone cost, I do not know.

14 Q I don't think that answered my question. Let me
15 try one more time. For purposes of this question, assume
16 that I accept your theorem.

17 A Okay.

18 Q If you don't know anything about Sprint's -- the
19 incremental cost of services provided by Sprint or their
20 stand-alone costs, then you don't know whether that theorem
21 has any application to the facts before the Commission at
22 this time, is that correct?

23 A Since you accepted my theorem, I would say yes.
24 Although I wasn't aware that the Commission was evaluating
25 the compensatory levels of rates during this proceeding, but

1 rather trying to establish general policies regarding
2 interconnection.

3 Q You endorse in your testimony the use of the
4 efficient component pricing rule, is that correct?

5 A That's correct.

6 Q Is it true that you don't know whether or not the
7 prices proposed by Sprint in this proceeding conform to that
8 rule?

9 A The efficient component pricing rule is equivalent
10 to imputation. If the company is recommending to impute its
11 interconnection charges to itself, then it is adhering to
12 the efficient component pricing rule that I recommend. But
13 I'm not the company's witness on the specific rates proposed
14 for interconnection in this proceeding.

15 Q All right. Turn if you would, please, to Page 18
16 of your testimony at Lines 21 through 22. You say there
17 that you do not understand how the social cost can be above
18 the economic cost as Doctor Cornell says is the case for
19 interexchange services, is that your testimony?

20 A Yes.

21 Q Would you point me to where in Doctor Cornell's
22 testimony she says that the social cost of interexchange
23 services is above their economic costs?

24 A On Page 27 of Doctor Cornell's testimony beginning
25 on Line 6, she makes the following statement, "If, however,

1 some intermediate goods or services, that is, goods or
2 services used as inputs in the production of other goods and
3 services are priced above their social cost, the economic
4 costs of the goods or services that use them will be higher
5 than their social costs."

6 Q So, Doctor Cornell says economic cost is higher
7 than social cost, is that correct?

8 A Yes. It appears that I have switched those terms
9 around in my testimony, so that's my error. Quite frankly,
10 I was somewhat confused in reading this section of her
11 testimony, and economic cost and social cost, as I
12 testified, I think are the same thing. But in this case, I
13 think I have misquoted her, and for that I apologize to the
14 Commission.

15 Q And you are not an economist, that's correct?

16 A That is correct.

17 Q And, finally, I believe it's your opinion that
18 local competition is not a goal in and of itself that this
19 Commission should be concerned with, is that correct?

20 A I'm sorry, could you repeat the question one more
21 time for me.

22 Q Yes. Is it fair to say that it's your opinion
23 that local competition in and of itself is not a goal that
24 that this Commission should be concerned with?

25 A Yes. I have stated in my testimony that that may

1 be a means to an end of achieving a modern, efficient
2 communications system or network in Florida, but I don't
3 believe that simply promoting competition is an appropriate
4 goal, because it could be done in a way which would harm
5 consumers rather than benefit them.

6 Q And so it's fair to say, then, that your
7 recommendations in this proceeding were not made with the
8 goal in mind of promoting competition?

9 A My recommendations were made --

10 Q Could you answer that yes or no and then explain,
11 please.

12 A Could you repeat the question one more time.

13 Q Sure. Is it fair to say, then, that your
14 recommendations in this proceeding were not made with the
15 goal in mind of promoting competition?

16 A No, I would not say that. I have tried to explain
17 in my testimony how I think competition can be accommodated
18 in Florida and at the same time meet the two policy goals
19 that I stated in my summary and in my testimony.

20 Q So I guess I'm confused. In your mind is
21 promoting competition a goal or is it not a goal?

22 A Competition can definitely contribute to a modern,
23 efficient telecommunications network and can contribute to
24 universal service for all subscribers in Florida.
25 Competition, however, can be introduced in such a way that

1 if that was the only goal, it might be harmful to consumers.
2 What I have tried to propose in my testimony is a way in
3 which competition can be accommodated, and, in fact,
4 encouraged in such a way that it would not harm consumers
5 and would not harm the entrant, for that matter.

6 Q And I guess I feel like I still haven't gotten an
7 answer to my question. In your opinion, is promoting
8 competition a goal or is it not a goal?

9 A It is a means to an end. It's not -- in my view,
10 it should not be an overriding goal with everything else the
11 Commission does secondary. I think that competition can be
12 used as a way to benefit -- could be used to benefit
13 consumers in the marketplace, but it should not be the
14 primary or sole goal of this proceeding in my view.

15 Q Should it be a goal?

16 A Yes, I believe it could be a goal, but it should
17 be taken into context with the other goals that I have
18 stated in my testimony.

19 Q And are you aware that the Florida Legislature in
20 Section 364.014(d) of the Florida Statutes has said that the
21 Commission shall exercise its exclusive jurisdiction in
22 order to, "promote competition by encouraging new entrants
23 into telecommunications markets"?

24 A I am aware of it now.

25 MR. MELSON: Thank you. No further questions.

1 CHAIRMAN CLARK: Ms. Dunson.

2 MS. DUNSON: No questions.

3 CHAIRMAN CLARK: Mr. Horton. Mr. Rindler.

4 MR. RINDLER: No questions.

5 CHAIRMAN CLARK: Ms. Wyske?

6 MS. WYSKE: No questions.

7 CHAIRMAN CLARK: Staff.

8 MS. CANZANO: No questions.

9 CHAIRMAN CLARK: Commissioners.

10 MS. CANZANO: Can we take that back?

11 COMMISSIONER KIESLING: Yes, what are you going to
12 do about your exhibit?

13 MS. CANZANO: Sorry about that.

14 CROSS EXAMINATION

15 BY MS. CANZANO:

16 Q Mr. Michaelson, do you have in front of you a copy
17 of a deposition transcript that was taken on March 7th?

18 A Yes, I do.

19 Q Have you had a chance to review it?

20 A Yes, I have.

21 Q Do you have any corrections to make to that?

22 A I have two minor corrections.

23 Q And what are they?

24 A At Page 17, Line 13, the first word was misspelled
25 in transcription. It should be the word will, W-I-L-L. And

1 on Page 31, Line 8 --

2 COMMISSIONER KIESLING: Wait a minute, I'm
3 confused. Could you go back to Line 13 on Page 17.

4 THE WITNESS: Yes.

5 COMMISSIONER KIESLING: And it should say --
6 shouldn't it be well, W-E-L-L?

7 THE WITNESS: Yes.

8 COMMISSIONER KIESLING: Access charges are priced
9 well above cost.

10 THE WITNESS: Right. And right after that
11 quotation, Commissioner -- I was trying to correct that in
12 my testimony. The word should be well. In my original
13 testimony it was will, which I corrected at the beginning.
14 So she transcribed wrong the first word I had used, which
15 was incorrect. This is kind of confusing, but just for the
16 record I wanted to correct that.

17 So just to be clear, Page 17, Line 13, the first
18 word should be "will." And then on Page 31, Line 8, in the
19 middle of that sentence there is a word "parody," it should
20 be parity, P-A-R-I-T-Y.

21 BY MS. CANZANO:

22 Q Thank you. And is this document now true and
23 correct to the best of your knowledge?

24 A Yes.

25 MS. CANZANO: Staff would like to have this marked

1 for identification as an exhibit at this time.

2 CHAIRMAN CLARK: It will be marked as Exhibit 36.

3 MS. CANZANO: Thank you.

4 COMMISSIONER DEASON: Madam Chairman, I think at
5 this hour we probably do need a parody principle.

6 CHAIRMAN CLARK: Exhibits 35 and 36 will be
7 entered in the record without objection.

8 (Exhibits 35 and 36 marked for identification and
9 received into evidence.)

10 CHAIRMAN CLARK: I'm sorry, do you have redirect?

11 MR. WAHLEN: No.

12 CHAIRMAN CLARK: I dare you. I didn't mean that.
13 I just got ahead of myself. Please feel free to
14 conduct redirect.

15 MR. WAHLEN: No, we don't have any redirect.
16 Thank you very much.

17 CHAIRMAN CLARK: Thank you. Mr. Michaelson, you
18 are excused.

19 I would like to take inventory about how much time
20 Mr. Poag is going to take.

21 MS. WILSON: I have about 20 minutes.

22 MR. CROSBY: At least a half hour to 45 minutes.

23 CHAIRMAN CLARK: Mr. Melson.

24 MR. MELSON: If he answers as concisely as Ms.
25 Menard, 15 minutes.

1 MS. DUNSON: Probably about 45 minutes.

2 MR. HORTON: I doubt that I will have any.

3 MR. RINDLER: Maybe five minutes.

4 MS. CANZANO: About an half hour to 45 minutes.

5 CHAIRMAN CLARK: It does not appear that we are
6 going to finish at eight or soon thereafter, so we will
7 come back tomorrow. And we will start the proceeding
8 half an hour after we conclude the FPL proceeding.
9 It's my understanding FPL has -- we have a stipulation
10 to consider. I don't think that will take more than an
11 hour. Why don't we do this, why don't we say we will
12 start at 11:00 a.m.

13 COMMISSIONER GARCIA: I have a flight tomorrow.

14 CHAIRMAN CLARK: We will start tomorrow at 10:30
15 or as soon thereafter as we conclude with the FP&L
16 matter. Does everyone understand that?

17 CHAIRMAN CLARK: Okay. We will start at 10:30, or
18 as soon thereafter as we finish the FPL matter.

19 Thank you.

20 (Transcript continues in sequence with Volume 11.)

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