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September 16, 1996

BY HAND DELIVERY

Ms. Blanca S. Bayó
Director, Records & Reporting
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2540 Shumard Oak Boulevard
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Re: Docket No. 920260

Dear Ms. Bayó:

Enclosed for filing on behalf of MCI Telecommunications Corporation in the above referenced docket are the original and 15 copies of the rebuttal testimony of Don J. Wood.

By copy of this letter this document has been provided to the parties on the attached service list.

Very truly yours,

Richard D. Melson

RDM/cc
Enclosures
cc: Parties of Record

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REBUTTAL TESTIMONY OF DON J. WOOD

ON BEHALF OF MCI TELECOMMUNICATIONS CORPORATION

DOCKET NO. 920260-TL

SEPTEMBER 16, 1996

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Don J. Wood, and my business address is 914 Stream Valley Trail, Alpharetta, Georgia 30202. I provide consulting services to the ratepayers and regulators of telecommunications utilities.

Q. ARE YOU THE SAME DON J. WOOD WHO FILED DIRECT TESTIMONY ON BEHALF OF MCI IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to respond to BellSouth Telecommunications, Inc.'s ("BST's") proposal for rate reductions as described in the direct testimony of Alphonso J. Varner. I will describe the set of guiding principles against which proposals for rate reductions should be evaluated and explain why BST's proposal fails to comply with these principles and, as a result, is neither equitable nor in the best interest of Florida ratepayers.

Q. PLEASE DESCRIBE THE GUIDING PRINCIPLES THAT YOU BELIEVE SHOULD USED TO EVALUATE BST'S PROPOSED RATE REDUCTIONS.

A. Commission-ordered rate reductions of a given dollar magnitude can be implemented in many different ways through any number of services offered by BST. Not all such combinations are equally beneficial to end user ratepayers, however, and not all combinations have the same impact on BST's shareholders. I urge the Commission to adopt the following two general principles for use when evaluating rate reduction proposals.

First, the primary objective of rate reductions in this proceeding should be to provide the maximum benefit to ratepayers. Strategic rate changes designed primarily to provide present and future financial benefits to BST shareholders at the expense of existing ratepayers do not comply with this principle.

Second, to the extent possible, the benefits of rate reductions implemented as a result of this proceeding should accrue to the ratepayers whose payments represent the source of BST's overearnings. Clearly, it is important to recognize that BST's past overearnings were generated by payments from ratepayers during the period of time being studied. As a result, equity considerations dictate that going-forward rate reductions be targeted to existing ratepayers, or, at a minimum, *not* be specifically targeted toward future customers that BST wishes to attract.

Q. PLEASE DESCRIBE THE BASIS FOR BST'S PROPOSED RATE REDUCTIONS AS DESCRIBED BY BST WITNESS VARNER.

A. At p. 2 of his testimony, Mr. Varner states that the BST proposal was designed "to provide benefits to a broad base of Florida customers," and he goes on at p. 9 to suggest that BST is proposing certain rate reductions "to respond to customer requests." The nature of the specific rate reductions proposed by BST and other testimony in the record are simply at odds with these statements, however.

Q. PLEASE DESCRIBE THE REASONS WHY YOU BELIEVE BST'S PROPOSED RATE REDUCTIONS WERE NOT DESIGNED PRIMARILY TO "PROVIDE BENEFITS TO A BROAD BASE OF FLORIDA CUSTOMERS."

A. The strategic nature of BST's proposed reductions is made clear by a review of the implications of the proposed changes for existing ratepayers, existing/potential competitors, and BST shareholders. For example, BST is proposing to waive the Secondary Service Charge (a nonrecurring service initiation charge) when subscribers order any one of a number of vertical features, such as custom calling services or designer listings. Each of the services for which BST is proposing to waive this order processing charge is, without exception, priced to generate a significant margin (in other words, the tariffed recurring rates for these services are many multiples of the underlying incremental cost incurred by BST to provide the service). Clearly, BST shareholders will be better off if more end users subscribe to these services, and a decision to forego recovery of the nonrecurring costs associated with establishing service is one means of encouraging and increasing subscribership. Under the BST proposal, however, its shareholders need not forego anything; the lost nonrecurring costs will in effect be made up -- dollar for dollar -- with funds that have been collected from existing ratepayers through past rates that were excessively high. As a result, this component of the BST proposal represents an excellent example of what Mr. Metcalf refers to in his testimony as "badly misaligned costs and benefits:" Existing ratepayers have provided the funds and will receive no benefit, while BST shareholders will put no funds at risk but will receive all of the future benefits.

An additional example illustrates how BST intends to use the overearnings generated by existing ratepayers to gain an advantage over its competitors. BST proposes to eliminate the Secondary Service Charges (nonrecurring service initiation charges) for its WatsSaver service. Once again, only new subscribers will benefit; existing ratepayers who provided the funds for the reduction will not. Similarly, BST will gain an artificial advantage over its competitors for intraLATA toll services, purely as a result of its position as the historic monopoly (and rate of return regulated) provider. And once again, BST shareholders will be the recipients of potentially substantial future benefits, without the necessity of putting a single penny of their own at risk.

Q. PLEASE DESCRIBE THE REASONS WHY YOU BELIEVE BST'S PROPOSED RATE REDUCTIONS WERE NOT DESIGNED PRIMARILY TO "RESPOND TO CUSTOMER REQUESTS."

A. In order to determine what customers actually want, it is often most useful to ask the customers themselves. For example, BST is proposing certain reductions to the rates for PBX trunks, including new more favorable terms for PBX Term Contracts. Mr. Varner states at p. 9 that BST decided to propose these particular reductions based on "customer requests." As Ad Hoc Users' witness Metcalf points out at p. 4, however, the committee of end users that he represents "is the principal advocate of business customers appearing before the Commission in telecommunications matters," a fact well known to BST. Inexplicably, BST has proposed a rate reduction in order to "respond" to these customers, although, according to Mr. Metcalf, "Ad Hoc and its members have never communicated a desire to BST for this particular rate structure, and Mr. Varner has not discussed it with Ad Hoc or its members." Apparently, BST has adopted the spirit of an advertising slogan once used (albeit briefly) by its sister company, Bell Atlantic: "Its not what you think you want, its what we know you need." It is certainly clear that the proposed changes will benefit BST shareholders, even though they may not be responsive to the desires of the existing ratepayers who have provided the funds at issue in this proceeding.

Q. DON'T ALL MANAGERS OF PRIVATE CORPORATIONS MAKE DECISIONS, INCLUDING THOSE RELATED TO STRATEGIC PRICING, BASED ON THE OBJECTIVE OF MAXIMIZING THE WEALTH OF THEIR SHAREHOLDERS?

A. Of course. For example, the management of a firm may elect to forego today the costs associated with initiating service to a customer (especially for high margin services) in order to reap the financial benefits of higher subscribership in the future. Similarly, a decision may be made to reduce rates in those areas or for those specific rate elements where it is concerned that competitive entry may occur (such a pricing strategy can be targeted to specific geographic areas or other subdivisions of a market in which the perceived threat of competition exists, or can be used to offer incentives to new customers to subscribe to BST's service or to commit to a long term contract arrangement with BST). In each case, the firm's management is betting that this foregone current revenue will pay off in higher returns in the future. *In both scenarios, it is the shareholders who take the risk and shareholders who will be the recipients of the anticipated future gains.*

These scenarios are *not* representative of the opportunities currently available to BST, however. The transition from a rate of return environment to a more competitive environment with more relaxed regulation presents BST with an opportunity to eliminate the necessity of putting shareholder money at risk today in order to create anticipated future gains to those same shareholders. By using dollars available from overearnings to implement the strategic pricing strategies described above, BST management can utilize dollars obtained from Florida ratepayers as excess earnings during a period of earnings regulation to create future financial gains that will be retained by BST shareholders.

The ability to engage in such a strategy indicates a fundamental difference in the environment faced by BST and that faced by firms that have historically operated in competitive markets. As a result, pricing strategies that may be appropriate for other firms, including those strategies described above, may not be appropriate for BST. It is necessary for the Commission to continue to limit such strategic pricing by BST in order to protect ratepayers and to prevent BST shareholders from obtaining a "windfall" created by a change in form of regulation for BST.

Q. WON'T RATE REDUCTIONS DESIGNED TO ATTRACT NEW SUBSCRIBERS FOR BST'S SERVICES BENEFIT THOSE SUBSCRIBERS?

A. Yes. To adopt BST's proposed reductions on that basis would be a disservice to existing ratepayers for at least two reasons, however. First, such an approach ignores the source of the overearnings to be refunded, namely existing ratepayers. As Ad Hoc Users' witness Metcalf points out at p. 2 of his testimony, reductions should be targeted to "the parties who have paid the most in excessive contribution and rates over the years." A failure to do so, Mr. Metcalf correctly points out at p. 4, "badly misaligns costs and benefits," and would benefit new customers at the expense of current customers who have paid the excessive rates that led to the overearnings now being distributed. Second, BST's proposal, if adopted, would have adverse consequences for the development of competitive markets for telecommunications services within the state. If BST is permitted to use the funds from past overearnings to provide strategically targeted benefits to customers and potential customers for which BST either experiences or expects to experience some level of competition, BST will have a distinct advantage in the marketplace. Such an advantage will not have been gained because of the willingness of BST managers to work harder or by the willingness of BST shareholders to take additional business risks, but will instead be entirely a function of BST's position as the former monopoly provider of these services. New entrants into the market do not share BST's ability to fund strategic pricing initiatives using ratepayer dollars, however. In short, BST's proposal, if adopted, would permit BST to leverage its past monopoly power well into future at the expense of current ratepayers (who paid the excessive rates in the past but are now receiving no corresponding benefit) and future ratepayers (who will be denied the benefits of a competitive marketplace for those services for which effective competition would have otherwise developed).

Q. DOES MR. VARNER'S TESTIMONY PROVIDE SOME INSIGHT INTO THE LIKELY ACTUAL MOTIVES FOR THE RATE REDUCTIONS PROPOSED BY BST?

A. Yes. Throughout his testimony describing each of the proposed rate reductions, Mr. Varner states that the changes will make the service more attractive to new subscribers (pp. 10, 14), will "facilitate negotiations with customers and promotional activities for the service" (p. 11), and uses language such as "this proposed rate change is consistent with our current pricing strategy for the product (p. 13).

To be absolutely clear, I am not suggesting that it is inappropriate for a firm to engage in strategic pricing practices (constrained, of course, by applicable anti-trust laws) in order to entice new customers to buy its product. Under such a scenario, the firm's shareholders put their capital at risk in hopes of receiving the expected future reward. If the rate reductions proposed by

BST in this proceeding are adopted, however, BST shareholders will receive these benefits without incurring any corresponding risk, while the ratepayers who have unwillingly contributed the funding necessary for BST to implement its strategic pricing objectives will receive no direct benefit. Through this process, BST will also gain a competitive advantage over those firms who are currently competing or have plans to compete, purely as a result of its position as the former monopoly provider. BST's proposal represents an opportunity for BST to prevent the erosion of its monopoly power, and instead to leverage it forward into the future.

Q. WHAT IS YOUR RECOMMENDATION TO THE COMMISSION?

A. I am requesting that the Commission adopt the Joint Proposal of AT&T, MCI, Sprint Communications, FIXCA, Ad Hoc Users, and McCaw Communications. In direct contrast to the BST proposal, the rate reductions in the Joint Proposal do in fact "provide benefits to a broad base of Florida customers." In addition, since the parties to the Joint Proposal represent a group of BST's customers who have contributed much of the existing overearnings, implementation of the Joint Proposal would truly "respond to customer requests."

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.