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REBUTTAL TESTIMONY OF
DAVID L. KASERMAN
ON BEHALF OF AT&T COMMUNICATIONS
OF THE SOUTHERN STATES, INC.
BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

Docket No. 960847-TP

Filed: September 24, 1996

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is David L. Kaserman. My business address is the Department of Economics, College of Business, 415 West Magnolia -- Room 203, Auburn University, Auburn, Alabama, 36849-5242.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes. I filed direct testimony on August 16, 1996.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to respond to economic arguments and analyses presented by Dr. David Sibley in his Direct Testimony, filed on behalf of GTE Florida Incorporated, Docket No. 960847-TP.

Q. DO YOU AGREE WITH THE BULK OF THE ANALYSIS PRESENTED BY DR. SIBLEY?

A. I do not.

1

2 **Q. WHAT IS THE BASIS OF YOUR DISAGREEMENTS WITH DR. SIBLEY?**

3 A. The bases of my disagreement are both fundamental and particular. Dr. Sibley and I
4 hold quite different views on the nature of competition in local exchange markets, and
5 on the prospects for, and policies to promote, future competition in these markets. As
6 a result of these fundamental disagreements, we further disagree on the proper
7 regulatory policies and pricing rules to promote competition and efficiency.

8

9 **Q. PLEASE EXPLAIN HOW YOUR VIEWS AND DR. SIBLEY'S VIEWS**
10 **DIFFER ON THESE FUNDAMENTALS.**

11 A. The first fundamental difference concerns the purposes and intent of the
12 Telecommunications Act of 1996 (hereafter, the "Act"). Dr. Sibley's testimony
13 suggests that he views the Act as having, as a primary goal, a guarantee that
14 incumbent local exchange carriers (hereafter ILECs) are indemnified against losses
15 arising out of competitive entry into local exchange markets. Numerous references
16 throughout Dr. Sibley's testimony attest to the primary importance he attaches to this
17 purposes. For example, he suggests that, "These arbitrations can affect the financial
18 viability of GET and every state's incumbent local exchange carriers. That issue, in
19 turn, will have profound ramifications for the consumers of the state."¹ Later, he
20 states, "...if prices are not appropriately set..., that will impair GTE's financial
21 integrity. This will starve the local telecommunications network of future
22 investments."² Dr. Sibley summarizes by stating that, "...many of the benefits that
23 should accrue to all citizens from robust, fair competition will be eroded if GTE and
24 other local exchange carriers are so weakened that they are unable to compete
25 effectively with those companies entering the marketplace."³ These sentiments

1 suggest that Dr. Sibley sees a close, causal connection between the financial well
2 being of the ILEC and the welfare of consumers. Any such connection, however, is
3 severed by competition.

4
5 Dr. Sibley's views on the importance of ILEC recovery of historic costs also illustrate
6 his assumption that incumbent firm welfare is a paramount purpose of the Act. Dr.
7 Sibley claims that, "...GTE should be reimbursed for all its costs and be allowed the
8 opportunity to earn a reasonable rate of return..."⁴ If GTE is reimbursed for "all its
9 costs," it doesn't need an "opportunity" to earn a reasonable return, it is guaranteed
10 one.

11
12 Protecting GTE's returns, which amounts to protecting GTE from competition, is
13 wholly inconsistent with protecting competition. In my view, the primary purpose of
14 the Act is the introduction of competition and the benefits it brings to local
15 telecommunications markets. The promotion of efficient and sustainable competition
16 in local exchange markets, however, requires control of the substantial monopoly
17 power enjoyed by ILECs. Entry will, and is intended to, erode this dominant
18 position. Introducing competition to eliminate monopoly is not consistent with
19 indemnifying the incumbent monopolist against competitive "harm."

20
21 Dr. Sibley and I also disagree over the current state of competition in local
22 telecommunications markets. Dr. Sibley's testimony repeatedly suggests that the
23 incumbent enjoys little or no market power, and that good alternatives available in
24 markets imply no bottleneck facilities. I do not agree with this characterization: the
25 ILEC has substantial market power in many areas and, barring some unforeseen

1 technological miracle, will continue in a dominant position for some years.

2

3 Dr. Sibley and I also disagree over the nature of costs of many local exchange
4 services. Dr. Sibley's discussion of the noncompensatory nature of TELRIC pricing
5 suggests that he believes that natural monopoly conditions arising, for example, from
6 common costs, obtain in these markets, even for the provision of unbundled network
7 elements (hereafter UNEs). This position is hard to understand given his frequent
8 assertions that local exchange markets already exhibit substantial competitive forces.
9 In effect, he is arguing that this market is both competitive and a natural monopoly.
10 He can't have it both ways.

11

12 Finally, Dr. Sibley and I do not agree on the role competition in local markets will
13 play in the future. Dr. Sibley suggests that competition, particularly the prices
14 available from competing suppliers, provide dynamic efficiency for applications of his
15 version of the Efficient Components Pricing Rule (hereafter ECPR, referred to by Dr.
16 Sibley as the M-ECPR) to pricing unbundled elements and wholesale services. I
17 believe that fostering competition is, itself, the main issue being addressed in this
18 arbitration. The amount of competition and the competitive benefits local markets in
19 Florida will exhibit in the future depends critically on the outcome of this arbitration.
20 The purpose of competition is not to improve flawed pricing rules, rather, the purpose
21 of pricing rules is to foster competition.

22

23 **Q. DO THESE FUNDAMENTAL DIFFERENCES LEAD YOU TO**
24 **RECOMMEND THAT THE COMMISSION ADOPT POLICIES**
25 **DIFFERENT FROM THOSE RECOMMENDED BY DR. SIBLEY?**

1 A. Yes. My understanding of the purpose of the Act, and my views on the nature of
2 costs and competition in local exchange markets in Florida, lead me to conclude that
3 prices for wholesale services and unbundled network elements (UNEs) should be
4 based on long run incremental costs in the manner outlined in my Direct testimony.
5 Dr. Sibley argues in favor of a version of the ECPR that is flawed due to a
6 misidentification of private with social costs.

7
8 This rule purports to efficiently price inputs sold to competitors using the ILEC rate
9 structure, as is, to assign common costs in much the same manner as Fully
10 Distributed Cost (hereafter FDC) pricing. Although Dr. Sibley acknowledges that the
11 current rate structure is not economically efficient, he proposes a rule to price inputs
12 based upon it. Pricing UNEs at TELRIC, in contrast, is economically efficient in the
13 strict sense.

14
15 As a result, of our fundamental disagreements, Dr. Sibley and I also differ over many
16 other specific policy issues discussed in his direct testimony. Due to the length and
17 complexity of Dr. Sibley's testimony and the included report, Exhibit No. DSS-2 by
18 Michael Duane, J. Gregory Sidak, Daniel F. Spulber, Michael A. Williams, and
19 David S. Sibley, I will address only the most important points of disagreement in my
20 testimony below.

21
22 **Q. TO WHAT EXTENT SHOULD GTE FLORIDA BE DEREGULATED**
23 **PRIOR TO FACING COMPETITION FROM NEW ENTRANTS INTO**
24 **LOCAL EXCHANGES MARKETS?**

25 A. Contrary to Dr. Sibley's suggestions, substantial deregulation of GTE prior to

1 meaningful competitive entry is a case of "putting the cart before the horse." The
2 purpose of the transitional regulation envisioned by the Act is to protect consumers
3 from monopoly prices while protecting competition from the very real threat of
4 exclusionary actions by GTE. These threats will ultimately be eliminated by
5 competition. Until that day arrives, however, continued regulation of ILEC prices
6 will be necessary in order to protect both consumers and competition. Thus,
7 obtaining some measure of competitive rivalry should be precondition to the
8 substantial deregulatory moves suggested by Dr. Sibley.

9
10 **Q. ARE THE PROPOSALS PUT FORTH BY AT&T IN THIS ARBITRATION**
11 **DESIGNED TO PROVIDE AT&T WITH A UNIQUELY FAVORABLE**
12 **COMPETITIVE POSITION?**

13 **A.** No, they cannot be. The non-discrimination provisions of the Act require that any
14 contractual terms obtained by AT&T by negotiation or arbitration must be available
15 to all firms entering the local exchange market. As a result, any favorable contractual
16 provisions obtained by AT&T will be available to its competitors in this market.
17 Such availability, in turn, ensures that the benefits of these provisions will flow
18 through to consumers as competing firms vie for their business.

19
20 **Q. IS THE VERSION OF THE EFFICIENT COMPONENTS PRICING RULE**
21 **PROPOSED BY DR. SIBLEY THE BEST METHODOLOGY FOR**
22 **ENCOURAGING COMPETITION IN LOCAL EXCHANGE MARKETS AS**
23 **OUTLINED IN THE ACT?**

24 **A.** No. Dr. Sibley proposes a slightly modified version of the ECPR which retains many
25 of the flaws of the formulation rejected by the FCC earlier. Dr. Sibley's proposal

1 modifies the previous version by capping the opportunity costs component by a
2 "market constraint" representing alternative competitive supply prices or stand alone
3 costs. This modification eliminates only the most egregious outcomes in the practical
4 application of this rule. The basic flaws still remain.

5

6 Dr. Sibley proposes that opportunity costs incurred by the ILEC be calculated as
7 foregone net revenue contributions from lost sales (in the absence of a market
8 alternative) given the current regulated pricing structure. Given the distortions
9 contained in that pricing structure, which are cited by Dr. Sibley, it seems incredible
10 to call the resulting prices "efficient." Certainly the prices calculated by this
11 methodology are not designed to foster competition in compliance with the Act.

12

13 The issues of which prices for network inputs are efficient versus which prices are
14 compensatory are entirely different. Marginal cost pricing is efficient whether it is
15 compensatory or not. Further, it is compensatory under the cost conditions at issue in
16 many cases here. The non-compensatory aspect of marginal cost (TELRIC or
17 TSLRIC) pricing arises only under natural monopoly conditions of substantial
18 economies of resale or scope.

19

20 **Q. WILL THE "MARKET" DERIVED LIMITATION PLACED ON THE**
21 **OPPORTUNITY COST COMPONENT OF NETWORK INPUT PRICES**
22 **EFFECTIVELY REDUCE THESE PRICES BELOW THOSE PREVIOUSLY**
23 **REJECTED BY CRITICS OF THE ECPR?**

24 **A.** No. Use of "competitive" market prices, when available, represents no restriction
25 beyond that inherent in the unwillingness of buyers to pay higher prices for goods

1 available elsewhere for less. The stand alone cost (SAC) limitation, previously
2 imposed by the FCC, would be rendered meaningless by the extraordinarily high
3 levels of allegedly forward looking common costs (FLCC) proposed by GTE Florida.
4 FLCC of \$769 millions, calculated based on GTE revenues, guarantee implied levels
5 of stand alone costs that will preclude competitive entry and perpetuate the GTE
6 monopoly.

7

8 **Q. IS THE METHOD FOR CALCULATING FORWARD LOOKING**
9 **COMMON COSTS PROPOSED BY DR. SIBLEY CORRECT?**

10 A. No, it is not. Dr. Sibley suggests that, as a consequence of regulation of GTEs' rates,
11 current GTE revenues can serve as a basis for inferring GTE's common costs. This
12 proposition has no support in economic theory. Firm costs arise from efficient
13 utilization of technologies used to deliver telecommunications services and the like.
14 Firm revenues reflect regulatory initiatives, lack competition, and blind chance.
15 Thus, revenues area totally incorrect basis for calculating costs.

16

17 **Q. IS DR. SIBLEY'S PROPOSAL TO USE THE BUNDLED RATE FOR TOLL**
18 **AND LOCAL SERVICE AS THE BASIS FOR CALCULATING THE**
19 **LOCAL SERVICE DISCOUNT CORRECT?**

20 A. No. This proposal well illustrates the defective application of Dr. Sibley's version of
21 ECPR for calculating discounts. Dr. Sibley suggests that the substantial margins
22 earned on intraLATA toll be applied as part of the ILEC's "opportunity cost" even
23 when the entrant self provides toll service. This proposal is indefensible on any
24 grounds (other than maintaining GTE's monopoly).

25

1 Q. DR. SIBLEY PROPOUNDS GTE'S CLAIM THAT THE COMMON COSTS
2 OF UNBUNDLED NETWORK ELEMENTS ARE "SUBSTANTIAL NOT
3 ONLY IN ABSOLUTE MAGNITUDE, BUT ALSO AS A PERCENTAGE OF
4 GTE'S TOTAL COSTS"⁵ IS THIS CORRECT?

5 A. Absolutely not. The common costs of UNEs are small, as recognized by the FCC and
6 many others. GTE's alleged "common costs" appear to be associated primarily with
7 vertical and other retail services, not unbundled elements. The claim of high common
8 costs for UNEs is designed to support monopoly pricing of these competitively crucial
9 elements to forestall entry in opposition to the intent of the Act.

10

11 Q. DO YOU PURPOSE COULD GTE HAVE IN PROPOSING PRICES FOR
12 UNES AND WHOLESALE SERVICES THAT EXCEED EFFICIENT
13 LEVELS?

14 A. Two purposes are evident. First, these inputs constitute monopoly-supplied products
15 creating a strong profit motive to inflate their prices. Second, higher prices reduce
16 competition by preventing entry and thus maintaining the dominant position of GTE.
17 Thus, GTE has very strong economic incentives to raise these prices above their
18 efficient levels.

19

20 Q. DR. SIBLEY SUGGESTS THAT HIS "COMPETITIVE CAPS" APPLIED
21 TO THE ECPR DUPLICATE MARKET PERFORMANCE WITH
22 VOLUNTARY EXCHANGE. IS THIS CORRECT?

23 A. GTE has a monopoly position. Is it reasonable to believe that voluntary exchanges
24 between a monopolist and a potential entrant will lead to competitive outcomes? Dr.
25 Sibley states that the emergence of competition will, under his proposed pricing rule,

1 bring some prices down. Can prices that competition will reduce be competitive to
2 begin with? This is actually an admission that the ECPR will not yield competitive
3 performance, but will instead, produce prices in excess of competitive levels.

4

5 **Q. IS THE ECPR, OR DR. SIBLEY'S PROPOSED VARIANT OF THIS RULE,**
6 **GENERALLY ACCEPTED BY ECONOMISTS?**

7 **A.** No. The rule on which Dr. Sibley's proposal is based has been rejected by its creators
8 and criticized by many leading economists. Drs. Economides and White point out
9 that, "[T]he ECPR also protects the monopolist from any competitive challenge by
10 these rivals and thus protects the monopolist's profits; and the ECPR preserves the
11 allocative or consumption inefficiency that results from the monopolist's excessively
12 high price for the through service."⁶ (p.564) Dr. Baumol's views on the applicability
13 of ECPR to pricing of telecommunications services are also well-documented.⁷

14

15 Although Dr. Sibley proposes a modified form of this rule, his suggestion does not
16 represent any improvement over the previously rejected version when one takes
17 account of the very large "common costs" he suggests apply in this case. Dr. Sibley
18 argues for over three quarters of a billion dollars in common costs and further
19 suggests that, due to competitive supply in switches, these costs will be assigned
20 primarily to loops. This renders competitive entry nearly impossible. Using Dr.
21 Sibley's methodology, the stand alone costs of loops and some other UNEs will be
22 prohibitive. Consequently, Dr. Sibley's application of the ECPR will amount to
23 monopoly pricing.

24

25 Although Dr. Sibley suggests that Professor Baumol did not repudiate Dr. Sibley's

1 version of ECPR, the record clearly indicates that Dr. Baumol is not in agreement
2 with Dr. Sibley's application here. In particular, Dr. Baumol states that,

3 "Intuition, and available forward-looking engineering costs
4 studies, indicate that for a logical aggregation of network elements,
5 SAC [stand-alone cost] does not differ significantly from long run
6 incremental cost because there are no significant common or shared
7 costs, among groups of network elements. This is because those
8 aggregative categories of network elements generally comprise
9 discrete physical facilities--e.g., loop, switching, transport and
10 signalling."⁸ [Emphasis added.]

11

12 Further, Dr. Baumol suggests that, "We understand that the costs incurred in common
13 between network elements and retail services are de minimis."⁹ Thus, I do not think
14 that Drs. Baumol and Willig would agree with Dr. Sibley's proposals.

15

16 **Q. IN ADDITION TO A VARIANT OF THE ECPR, DR. SIBLEY**
17 **RECOMMENDS END USER CHARGES TO FACILITATE RECOVERY OF**
18 **GTE COSTS THAT ARE NOT RECOVERED BY ECPR PRICING. IS THIS**
19 **ANALYSIS VALID?**

20 **A.** No. There are several problems with this proposal. First, the nature and application
21 of this fee are unclear. Second, some of the costs outlined by Dr. Sibley are included
22 under TELRIC based pricing. For example, the costs incurred by GTE to accomplish
23 unbundling of network elements or resale of network services are included in TELRIC
24 and avoided cost components. Dr. Sibley's proposal to compensate GTE for losses
25 incurred when "avoided costs are incorrectly overstated" raises the question of

1 whether GTE will be penalized when and if they gain from understated avoided costs.
2 Shared costs of network operation and common costs of network operation are
3 recoverable under the TELRIC + X formula, while Universal Service reform, now
4 under review will address the other "incumbent burdens" listed by Dr. Sibley.

5

6 **Q. DR. SIBLEY CRITICIZES TSLRIC OR TELRIC PRICING ON
7 NUMEROUS GROUNDS. DO YOU AGREE WITH THESE CRITICISMS?**

8 **A. No. TSLRIC pricing is unquestionably economically efficient. Rents earned on
9 services sold at supercompetitive prices are not a social opportunity cost, and the
10 preservation of these rents cannot provided the basis of efficient pricing. Cost
11 recovery per se is not the basis of efficiency.**

12

13 **Q. DR. SIBLEY ARGUES THAT TSLRIC PRICING WILL LEAD TO
14 EXCESSIVE UNBUNDLING AT THE CONTRIVANCE OF ENTRANTS.
15 DO YOU AGREE WITH THIS CLAIM?**

16 **A. No. Unbundling should occur in response to competitive market forces. Elements
17 should be unbundled when there is a demand for them on the part of potential
18 entrants. Since a TSLRIC pricing methodology would permit the ILEC to recover the
19 costs of unbundling, there is no scope for entrants to persecute the ILEC via this
20 device.**

21

22 **Q. DR. SIBLEY STATES THAT TSLRIC (OR TELRIC) PRICING IS UNLIKE
23 PRICING IN A COMPETITIVE MARKET. IS THIS TRUE?**

24 **A. No. Firms that lack market power price at marginal cost by necessity. Contrary to
25 Dr. Sibley's claims, this result does not reside only in simple textbook analyses: the**

1 analysis of Glenn MacDonald and Alan Slivinski provides an example.¹⁰

2

3 **Q. DR. SIBLEY STATES THAT A "REGULATORY CONTRACT" REQUIRES**
4 **THAT THE COMMISSION ALLOW GTE TO FULLY RECOVER ALL OF**
5 **THEIR COSTS, INCLUDING HISTORICAL COSTS. IS THIS AN**
6 **ECONOMIC ARGUMENT?**

7 **A.** No, it is a legal one. I am not a lawyer and offer no legal opinion on this claim.
8 However, the economic analyses of contracting theory offered by Dr. Sibley to
9 support this view is curious. Dr. Sibley suggests that the (possibly largely implicit)
10 contract between the regulator and regulated firm (ILEC) implies full cost recovery.
11 However, even if one accepts this regulatory contract framework, there is no evidence
12 presented, nor theoretical arguments offered, that full and complete indemnification of
13 the regulated firm is a property of the "optimal" regulatory contract. Typically,
14 optimality implies less than full "insurance" in any contract. The views expressed by
15 Dr. Sibley seem to plainly contradict the intentions of the Act, the emergence, at the
16 instigation of GTE, of price cap regulation, and the actual practice of even Rate-Of-
17 Return regulation.

18

19 **Q. CAN YOU BRIEFLY SUMMARIZE YOUR TESTIMONY?**

20 **A.** Dr. Sibley and I disagree on several fundamental grounds. I believe that the primary
21 purpose of the Telecommunications Act of 1996 is to foster efficient and sustainable
22 competition in local telecommunications markets, and that this purpose is served by
23 efficient pricing of wholesale services and unbundled network elements to potential
24 entrants. Dr. Sibley appears to regard the maintenance of the financial position of the
25 incumbent monopoly as both consistent with the objectives of the Act and legally

1 necessary. In pursuit of this objective, Dr. Sibley proposes a form of ECPR pricing
2 that is inconsistent with promoting efficient entry, combined with end user charges
3 designed to recover all of GTEs costs, including historical costs and costs that arise
4 from incumbent inefficiencies. I do not believe that Dr. Sibley's proposals are
5 consistent with either the intent of the Act, nor the welfare of the people of Florida.

6

7 **Q. DO THIS CONCLUDE YOUR TESTIMONY?**

8 **A. Yes.**

ENDNOTES

- ¹ Direct Testimony of Dr. David S. Sibley, Docket No. 960847-TP, p. 5
- ² Direct Testimony of Dr. David S. Sibley, p. 5, note 1, supra.
- ³ Direct Testimony of Dr. David S. Sibley, p.5, note 1, supra.
- ⁴ Direct Testimony of Dr. David S. Sibley, p.5, note 1, supra.
- ⁵ Direct Testimony of Dr. David S. Sibley, p.5, note 1, supra.
- ⁶ Nicholas Economides and Lawrence White, "Access and Interconnection Pricing: How Efficient is the 'Efficient Component Pricing Rule'?" Antitrust Bulletin, Vol. 40, Fall, 1995, pp. 557-579. See, also, William B. Tye and Carlos Lapuerta, "The Economics of Pricing of Network Interconnection: Theory and Application to the Market for Telecommunications in New Zealand." Yale Journal on Regulation, Vol. 13 (Summer 1996), pp. 419-500.
- ⁷ Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig, In the Matter of Implementations of the Local Competition Provisions on the Telecommunications Act of 1996, CC Docket No. 96-98, May 16, 1996.
- ⁸ Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig, p. 5, note 7, supra.
- ⁹ Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig, p. 12, note 7, supra.
- ¹⁰ Glenn MacDonald and Alan Slivinski, "The Simple Analytics of Competitive Equilibrium with Multiproduct Firms," American Economic Review, Vol. 77, No. 5, pp. 941-953.