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February 27, 1998

VIA HAND DELIVERY

Ms. Blanca Bayó
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

Re: Docket No. 971056-TX - In re: Application for certificate to provide alternative local exchange telecommunications service by BellSouth BSE, Inc.

Dear Ms. Bayó:

ADCK _____ Enclosed are the original and 15 copies of the Direct Testimony of Joseph Gillan
AFPA 1 to be filed in the above docket.

ARPP _____
GARF _____ I have enclosed an extra copy of the above documents for you to stamp and
CMU 1 return to me. Please contact me if you have any questions. Thank you for your
_____ assistance.

CTR _____

EAG _____

LEG 2

LIN 54124

OPC _____

RON _____ JAM/jg

SEC 1

WAS _____ Enclosures

OTH _____

Sincerely,

Joseph A. McGlothlin

DOCUMENT NUMBER - DATE

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FPSC-RECORDS/REPORTING

ORIGINAL

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Application for certificate)
to provide alternative local)
exchange telecommunications)
service by BellSouth BSE, Inc.)

Docket No. 971056-TX

DIRECT TESTIMONY

OF

JOSEPH GILLAN

ON BEHALF OF

**FLORIDA COMPETITIVE CARRIERS ASSOCIATION,
AT&T COMMUNICATIONS OF THE SOUTHERN STATES, INC.,
AND
MCI TELECOMMUNICATIONS CORPORATION**

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Direct Testimony of
Joseph Gillan
on behalf of the
Florida Competitive Carriers Association,
AT&T Communications of the Southern States, Inc.,
and
MCI Telecommunications Corporation

1 **Q. Please state your name, business address and occupation.**

2

3 **A. My name is Joseph Gillan. My business address is P.O. Box 541038, Orlando,**
4 **Florida 32854. I am an economist with a consulting practice specializing in**
5 **telecommunications.**

6

7 **Q. Please briefly outline your educational background and related experience.**

8

9 **A. I am a graduate of the University of Wyoming where I received B.A. and M.A.**
10 **degrees in economics. From 1980 to 1985, I was on the staff of the Illinois**
11 **Commerce Commission where I had responsibility for the policy analysis of**
12 **issues created by the emergence of competition in regulated markets, in**
13 **particular the telecommunications industry. While at the Commission, I served**
14 **on the staff subcommittee for the NARUC Communications Committee and**
15 **was appointed to the Research Advisory Council overseeing NARUC's research**
16 **arm, the National Regulatory Research Institute.**

17

18 **In 1985, I left the Commission to join U.S. Switch, a venture firm organized to**
19 **develop interexchange access networks in partnership with independent local**

1 telephone companies. At the end of 1986, I resigned my position of Vice
2 President-Marketing/Strategic Planning to begin a consulting practice.

3
4 Over the past decade, I have provided testimony before more than 25 state
5 commissions, four state legislatures, the Commerce Committee of the United
6 States Senate, and the Federal/State Joint Board on Separations Reform. I
7 currently serve on the Advisory Council to New Mexico State University's
8 Center for Regulation.

9
10 **Q. On whose behalf are you testifying?**

11
12 **A.** I am testifying on behalf of AT&T Communications of the Southern States Inc.
13 (AT&T), MCI Telecommunications Corporation (MCI), and the Florida
14 Competitive Carriers Association (FCCA). The FCCA is an association with a
15 broad membership, committed to the development of competition across all
16 services and all areas of Florida.

17
18 **Q. Please explain the fundamental issue in this proceeding.**

19
20 **A.** There is really a single issue of importance to this proceeding: just how many
21 BellSouths does it take to provide local service in its own territory? In the
22 testimony which follows, I explain that because *consumers* will discern only

1 Q. Please summarize the purpose of your testimony.

2

3 A. The purpose of my testimony is to explain why the Commission should deny
4 BellSouth a certificate to "compete against itself" through the legal artifice of
5 BellSouth-BSE. By requesting a certificate as an Alternate Local Exchange
6 Carrier (ALEC), BellSouth is seeking a form of back-door deregulation that
7 would be every bit as effective as if the company had directly requested that
8 the Commission repeal the Telecommunications Act of 1996, Chapter 364, and
9 rewrite its rules to eliminate the distinction between BellSouth and legitimate
10 entrant-competitors.

11

12 I want to make clear at the outset, however, that the carriers sponsoring my
13 testimony have no objection to BellSouth's entry and participation as an ALEC
14 outside its own territory. As BellSouth-BSE seeks to win and serve the
15 customers of GTE and Sprint, BellSouth-BSE will exist as a distinct competitor
16 to these incumbent LECs, with a unique market presence and an economic
17 relationship no different than any other entrant.

18

19 Within BellSouth-T's territory, however, BellSouth-BSE is a sham entrant, a
20 second BellSouth indistinct from the incumbent LEC. In every meaningful
21 way, BellSouth-BSE is BellSouth-T. The sole purpose for BellSouth-BSE is to
22 engage in market behavior that BellSouth-T is not, for good reason, allowed --

1 with the collateral effect of diluting (if not avoiding) BellSouth's obligations
2 under the federal Act intended to promote local competition.

3
4 **Q. What is an Alternate Local Exchange Carrier?**

5
6 **A** The Florida regulatory structure is founded on a fundamental distinction
7 between new entrant local companies (authorized to enter the market no sooner
8 than January 1, 1996) and incumbent local telephone companies, including
9 BellSouth-T. The statute makes clear that it is the policy of the State of
10 Florida to respect the very real differences between entrant and incumbent local
11 carriers (see, for instance, FS 364.01(4)(c) which directs the Commission to
12 promote competition by subjecting new entrants to a lesser level of regulatory
13 oversight than incumbent local carriers).

14
15 For the state statute to have meaning, the AL EC designation is intended for a
16 fundamentally different *economic* unit than the incumbent local exchange
17 carrier. Similarly, the federal Act is premised on a clear distinction between an
18 incumbent LEC and its entrant-competitors. The central point of my testimony
19 is that no such economic distinction can or will exist between BellSouth-BSE
20 and BellSouth-T, even if a superficial legal distinction applies.

21
22 **Q. Is it reasonable to consider BellSouth-BSE as an "alternative" to**

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BellSouth-T?

A. No, not within BellSouth-T's territory. BellSouth-BSE has a market and economic relationship to BellSouth-T which eliminates any meaningful distinction between these entities.

First, BellSouth-BSE will not occupy a unique position in the market. Within BellSouth's region, BellSouth-BSE will trade on the same name recognition as BellSouth. The legal distinction in its name will have no practical market significance in the eyes of consumers.

Second, the Commission should place no faith in the superficial claim that BellSouth-BSE will interact with BellSouth-T on an arms-length basis.

BellSouth-BSE and BellSouth-T only exist - in the eyes of investors -- as a single economic entity (BellSouth). There are no financial or market incentives for these companies to do anything other than maximize shareholder value -- a single objective inconsistent with an "arms-length" relationship.

The Fallacy of the Separate Identity

Q. Is it reasonable to expect consumers will distinguish between BellSouth-T and BellSouth-BSE?

1 A. No. In exchanges served by BellSouth-T, BellSouth-BSE's application is not
2 a request to *enter* a new market as an ALEC. Rather, this application
3 represents BellSouth's *reentry* to its *own* markets through a *second* distribution
4 channel (i.e., BellSouth-BSE) with lower regulatory obligations.

5
6 First, it is clear that BellSouth has chosen to name BellSouth-BSE with the
7 intention of capitalizing on the BellSouth name. Mr. Scheye testified in South
8 Carolina that BellSouth-BSE will trade on the BellSouth name, logo and
9 reputation (Docket 97-361-C):

10
11 ... [w]hile there has not been an explicit discussion, it's been,
12 generally, that we would market under the BellSouth name ...
13 [Tr. 24]

14 ...

15 Q. Is BellSouth-BSE going to use the little bell logo?

16
17 A. I would certainly hope so. Yes. [Tr. 25]

18 ...

19 Q. You indicate ... that one of the reasons why you wanted to do this, ...
20 was to get in business and not be restricted by your BellSouth territory
21 ... why not start there?

22 ...

1 A. Why not start in the 41 other states?

2

3 Q. Instead of starting where you have a presence already?

4

5 A. Two reasons. One, is clearly the BellSouth name is not as well
6 known there. Secondly, in the business market the idea would
7 be, a company that might have a founding already here in one of
8 our 9 states but has branches in other states. We would try to
9 attract all that business. Conversely, if I started in California
10 and Utah and I don't have a presence there, I don't have a
11 reputation there, I don't have a name there and probably have
12 little basis for going into business. [Tr. 76].

13

14 Even if consumers could discern a clear difference between BellSouth-BSE and
15 BellSouth-T, there is no reason why BellSouth would want consumers to do so.
16 The very fact that BellSouth has chosen to name its new affiliate BellSouth
17 (albeit with a BSE on the end) reveals its intent to blur any distinction between
18 these companies.

19

20 Q. Why is consumer-perception important?

21

22 A. The problem stems from BellSouth's position as an exchange monopolist. This

1 position of incumbency provides BellSouth certain market advantages (like
2 already serving *all* of the local customers in its territory). Both the state and
3 federal statutes have imposed specific obligations on BellSouth -- from price-
4 cap regulation, tariffs to avoid discrimination, and the requirement to open the
5 network to others -- to curb BellSouth's ability to exploit the advantages of this
6 incumbency.

7
8 By creating a legal entity that is imperceptibly different in the market -- but
9 which is subject to none of the obligations of an incumbent carrier -- BellSouth
10 is able to retain all the market advantages of incumbency while gaining all the
11 flexibility of non-dominance. This strategy provides BellSouth its desired
12 deregulatory freedom, without the inconvenience of actually losing any market-
13 control.

14
15 **Q. What would be the effect of BellSouth being able to compete in the same**
16 **market through two legal entities, but one market presence?**

17
18 **A.** It is impossible to predict with certainty *every* problem that would be created
19 by authorizing BellSouth to offer the same set of services through two entities -
20 - each subject to different rules and obligations -- in the same market.

21 However, there are three adverse consequences from their proposal that are
22 immediately apparent.

1 First, BellSouth will have gained an ability to improperly benefit its
2 unregulated affiliate through costs incurred by its regulated twin. For instance,
3 BellSouth has recently announced a \$20 million advertising campaign intended
4 to promote "BellSouth's" technological skills. Like all product non-specific
5 advertising, these adds will promote BellSouth-BSE and BellSouth-T without
6 differentiation. (In fact, it is difficult to conceive of any advertisement that
7 includes the BellSouth name and logo that would not benefit BellSouth-BSE.)
8

9 Second, BellSouth-BSE would provide BellSouth the ability to discriminate in
10 favor of select customers by offering targeted products through BellSouth-BSE
11 that are not generally available to other BellSouth customers. BellSouth-BSE
12 would (according to BellSouth) be treated like any other ALEC, with the
13 ability to contract with customers outside of BellSouth's tariffs and otherwise
14 applicable rules.
15

16 Third, BellSouth could use BellSouth-BSE to avoid its obligations under the
17 federal Act, in particular its obligation to permit the unrestricted resale of its
18 services at wholesale rates.
19

20 **Q. How would granting BellSouth-BSE local service authority in BellSouth-**
21 **T's territory enable BellSouth-T to evade its wholesale obligation?**
22

1 A. The federal Act establishes a number of tools to accelerate the entry of
2 competitors to the exchange market, including the resale of local exchange
3 service. The viability of the resale entry option is dependent upon the margin
4 between the retail rates available to consumers and the wholesale prices paid by
5 entrants.

6
7 The premise of the wholesale pricing option is that the relevant "retail" price is
8 the tariffed rate of the incumbent local exchange carrier, in this case BellSouth-
9 T. Approving BellSouth-BSE would violate this principle by providing
10 BellSouth *two* legal entities -- yet a *single* market presence -- to offer its local
11 services. BellSouth would be able to reprice existing services and introduce
12 new ones through BellSouth-BSE without any obligation to offer a wholesale
13 equivalent subject to the appropriate discount. In effect, the "retail" price
14 *relevant* to the wholesale entry option would be different than BellSouth-T's
15 list price to which the wholesale-discount obligation applies.

16
17 For instance, BellSouth-T's local rate today (Rate Group 12) is \$10.65, to
18 which the Commission-approved discount of 19% applies. As a result, the
19 wholesale margin is \$2.02. BellSouth-BSE, however, could offer the identical
20 service, to the same customers, for \$8.65 -- which, from the customer's
21 perspective, is equivalent to "BellSouth" reducing its rates by \$2.00. Because
22 the lower rate is offered by BellSouth-BSE, however, the wholesale discount

1 would not apply, the margin available to the competing reseller to cover its
2 own costs would be eliminated, and legitimate resale based competitors would
3 be driven from the market.
4

5 **Q. Do you have any other concerns with respect to BellSouth-BSE's request?**

6
7 **A.** Yes. Although I have focused solely on the most obvious abuse, BellSouth's
8 request for its BellSouth-BSE affiliate can be viewed more fundamentally as
9 effort to obtain the regulatory flexibility of non-dominant regulatory status
10 without first losing (and, as a consequence, perhaps *never* losing) its dominant
11 market position. The point of my testimony relates to how this structure will
12 impact rivals and the potential for local competition. But the Commission
13 should also consider, as a separate matter, whether it *ever* makes sense to
14 permit BellSouth to approach the same set of customers, with effectively the
15 same set of services, marketed under a single corporate identity, but using twin-
16 providers subject to different regulatory rules.
17

18 **The Fallacy of Arm's-Length Independence**

19
20 **Q. Does BellSouth-BSE have the same economic relationship to BellSouth-T as**
21 **other entrants?**
22

1 A. No. Only BellSouth-BSE enjoys an identity of ownership with BellSouth-T.
2 As such, there is shareholder-indifference within BellSouth as to whether a
3 service is sold by BellSouth-T or BellSouth-BSE: the effect on BellSouth's
4 investments, expenses, revenues and, ultimately, profits is identical. When you
5 own the pants, it does not matter in which pocket you keep your money.

6
7 Of course, this same calculus does not apply to any other competitor. If the
8 Commission were to grant this certificate, any price paid by BellSouth-BSE to
9 BellSouth-T would be no more than a transfer from one BellSouth pocket to
10 another. By contrast, the prices that entrants pay BellSouth-T are a real
11 economic cost they incur. Similarly, any shifts of customers from BellSouth-T
12 to BellSouth-BSE would be all in the family. On the other hand, if a bona fide
13 new entrant loses a customer to BellSouth-T, a real market loss occurs. Only
14 BellSouth-BSE can view BellSouth-T as a partner and not a competitor.

15
16 Q. **Is there any evidence that BellSouth-BSE will operate independently of**
17 **BellSouth-T (and, for that matter, BellSouth)?**

18
19 A. No. Testimony in other states confirms the obvious -- BellSouth-BSE is simply
20 not an independent economic unit. For instance, Mr. Scheye acknowledges that
21 his primary mission (as well as that of other BellSouth management) is to
22 maximize shareholder value (Docket 26192, Alabama PSC, Tr. 40):

1 BellSouth-T's deregulated twin.

2

3 **Q. Are there other examples which demonstrate that BellSouth-BSE is not an**
4 **independent economic unit?**

5

6 **A. Yes. BellSouth-BSE has indicated that it intends to operate primarily by**
7 **reselling BellSouth-T's retail services (South Carolina Docket 97-361-C, Tr.**
8 **59). Service-resale is only financially viable, however, if the entrant can**
9 **provide marketing and customer support more efficiently than the incumbent --**
10 **and not just modestly so, but by at least an amount necessary to offset any**
11 **price discount needed to attract the customer.**

12

13 Apply this equation to the operations of BellSouth-BSE. Is there any reason to
14 expect that BellSouth-BSE can provide marketing and customer service more
15 efficiently than BellSouth-T? Will BellSouth-BSE have greater skills than
16 BellSouth-T? If so, how -- BellSouth-BSE is staffed primarily by former
17 BellSouth-T employees.

18

19 *The only reason that service-resale is attractive to BellSouth-BSE is because*
20 *the fundamental economics of service resale do not apply to BellSouth-BSE.*

21 Each dollar BellSouth-BSE pays for the services it resells it pays to a sister
22 company; its marketing costs are reduced because it benefits from each

1 advertisement run by its sister company; and the price discounts it must offer to
2 attract customers from BellSouth are reduced because it will be perceived as
3 the incumbent. BellSouth-BSE is an accounting fiction, immune from the
4 standard financial constraints of its chosen entry strategy.

5
6 **Q. The Texas Public Service Commission recently addressed a similar issue**
7 **with respect to GTE. How did the Texas Commission respond?**

8
9 **A. The Texas PUC rejected a similar twin-provider request with the legal-rationale**
10 **that its state statute did not contemplate issuing two types of certificates in the**
11 **same territory to the same company or an affiliate. The Commission's press**
12 **release expounded on its reasoning as follows:**

13
14 "If we allow regulated companies to use an affiliate in their own
15 territory to avoid their responsibilities and to enter the
16 competitive market, we make a mockery of the whole regulatory
17 and legal scheme," said Commissioner Judy Walsh. Both Walsh
18 and Chairman Pat Wood, III, said that letting GTE's affiliate
19 compete in GTE's service area would be counter productive to
20 the competitive local telephone market the PUC is working to
21 establish in Texas.

22

1 Q. Should the Commission approve BellSouth BSE's certificate and just wait
2 to address any problems that arise?

3
4 A. No. The problems created by BellSouth-BSE's certification within BellSouth-
5 T's franchised area are structural and systemic to its proposal. The concerns
6 identified are not idle speculation, but are the easily predictable consequences
7 of creating the incentives that lie at the heart of its request. For instance,
8 BellSouth-BSE's resale of BellSouth-T's services provides a clear example of
9 BellSouth-BSE achieving a market-posture that is possible only because
10 BellSouth-BSE's affiliate relationship.

11
12 The fact of the matter is that BellSouth-BSE *is* BellSouth in the eyes of both
13 consumers and investors -- and, as such, is not an independent economic unit in
14 any meaningful way. The Commission should not allow BellSouth to use the
15 legal pretense of a separate BellSouth-BSE to accomplish through the back-
16 door a level of regulation that its rules, the Florida statute, and federal Act
17 would not grant directly.

18
19 At the outset of my testimony, I asked (somewhat rhetorically) just how many
20 BellSouths does it take to provide local service in its franchised areas? The
21 answer is one. The Commission should deny BellSouth-BSE's request to
22 operate as an "alternate" local carrier within BellSouth-T's operating region.

1 Q. If the Commission grants BellSouth-BSE an ALEC certificate to compete
2 in the territory served by BellSouth-T, what conditions or modifications
3 should the Commission impose?
4

5 A. If the Commission grants BellSouth-BSE a certificate to compete as an ALEC
6 in BellSouth-T's serving territory, it should make as a condition of BellSouth-
7 BSE certification BellSouth-BSE's acceptance of all the obligations applicable
8 to an incumbent LEC in the Federal Act, as well as the requirements of
9 Chapter 364 and the Commission's rules applicable to non-ALEC local carriers.
10

11 If BellSouth-BSE's purpose in applying for the certificate is to be able to
12 package certain products together and to "follow" certain customers who move
13 or add locations, as described in Mr. Scelvey's testimony, then such conditions
14 would not present any impediment to BellSouth-BSE's stated goals.
15

16 Q. Does this conclude your direct testimony?
17

18 A. Yes.

CERTIFICATE OF SERVICE

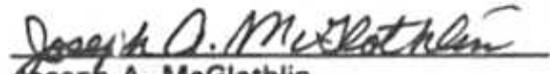
I HEREBY CERTIFY that a true and correct copy of the foregoing Direct Testimony of Joseph Gillan has been furnished by United States mail or hand delivery(*) this 27th day of February, 1998, to the following:

Martha Carter Brown*
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971056 -TX

CERTIFICATE OF SERVICE

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