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Sprint

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September 2, 1998

Ms. Blanca S. Bayo, Director
Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

Re: Docket No. 980696-TP

Dear Ms. Bayo:

Enclosed for filing in the above docket are the original and fifteen (15) copies of the Direct Testimonies of Carl H. Laemmli, Kent W. Dickerson, Brian K. Staihr and James W. Sichter on behalf of Sprint-Florida, Incorporated.

Please acknowledge receipt and filing of the above by stamping the duplicate copy of this letter and returning the same to this writer.

Thank you for your assistance in this matter.

Sincerely,

Charles J. Rehwinkel

CJR/th

Enclosures

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ORIGINAL

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

REBUTTAL TESTIMONY OF JAMES W. SICHTER

ON BEHALF OF SPRINT-FLORIDA, INCORPORATED

DOCKET 980696-TP

SEPTEMBER 3, 1998

Q. Please state your name and business address.

A. My name is James W. Sichter. I am Vice President-Regulatory Policy, for Sprint Corporation. My business address is 4220 Shawnee Mission Parkway, Fairway, Kansas.

Q. Please describe your educational background and work experience.

A. I hold a B.A. in Economics from the University of Kentucky (1968), a Masters in Economics from Wright State University (1972), and a Masters in Public Administration from University of Missouri-Kansas City (1979). I have worked for Sprint since 1973. Prior to my current position, I have held several positions with Sprint in the areas of costing and regulatory policy, including cost analyst, revenue analyst, corporate strategic planning analyst, staff economist, manager-policy research, director-regulatory and industry planning, director-service costs, director-access planning, and assistant vice president-regulatory and industry planning.

In my current position I have responsibility for developing state and federal regulatory and legislative policy for Sprint's Local Telecommunications Division. I also serve on the Executive and the Advisory Committees of the Michigan State University Institute of Public

Utilities. In addition, I have been a member of the faculty of the Michigan State University-NARUC Annual Studies Program since 1985, where I have taught course segments on a variety of areas, including access charges, jurisdictional separations, competition, the Telecommunications Act of 1996, and most recently, Universal Service and Access Charge Reform. In the past, I served on a number of United States Telephone Association committees, including chairing the USTA Policy Analysis Committee (1986-1989), Price Cap Team (1987-1989), and Part 69 Concepts Committee (1989-1991).

Q. Have you testified in other states?

A. Yes. I have previously testified before the Iowa, Kansas, Missouri, and Nevada state commissions.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to rebut Mr. Gillan's and Mr. Gueppe's recommendations that average revenues be used in the calculation of the amount of universal service support that is required, and Mr. Gueppe's proposal that a LEC's universal service support be determined by "netting" revenue shortfalls against revenue surpluses. I will also offer some comments on the geographic unit that should be used to determine universal service costs and support, and the relationship between the geographic area used to determine universal service support and the geographic area used to calculate unbundled network element prices.

Q. How do Mr. Gillan and Mr. Gueppe recommend that the amount of required universal service support be calculated?

A. Under their proposal, each company would calculate its average revenue per residential customer. This average revenue benchmark would include all revenues generated by residential customers, including, for example, intraLATA toll, features, and access revenues in addition to the basic service rate. The average revenue would then be compared to forward-looking costs of providing this family of services in each wire center to determine the need for universal service funding.

Q. Is the comparison between average revenues and costs an appropriate measure of the need for universal service funding?

A. No. All that such a comparison can tell us is whether the revenues generated by existing rate structures are, on average, covering costs. The issue of universal service, however, is not an issue of revenue sufficiency. Although there may be some exceptions, ILECs today generate sufficient total revenues to maintain the current level of telephone service penetration. The issue, rather, is how the revenues needed to support universal service are collected. The issue is one of rate structure—specifically, whether the existing practice of promoting universal service by charging above cost rates for some services in order to charge below cost rates for basic service is appropriate and sustainable in a competitive environment. Using a revenue benchmark to determine the need for universal service subsidies masks, if not completely defines away, the very issue—that of supporting universal service goals through implicit subsidies—that needs to be directly confronted by the legislature and the Commission. Adopting the approach recommended by Mr. Gillan and Mr. Gueppe would result in policies that would be inconsistent with the Telecommunications Act of 1996. In addition, the failure to replace implicit subsidies with an explicit, competitively neutral universal service fund will

inhibit, if not thwart altogether, the development of a fully competitive local exchange market for most residential customers in the State of Florida.

Q. How is Mr. Gillan's and Mr. Gueppe's proposal to use average revenues inconsistent with the Telecommunications Act of 1996?

A. The fundamental goal of the Telecommunications Act of 1996 is to promote competition in all telecommunications markets, and particularly the local exchange service market. It was equally recognized that competition will drive prices to costs, and that the historic practice of supporting universal service through implicit subsidies built into non-basic services was not sustainable in a competitive market. In order to preserve the policy goal of universal service in a competitive environment, the Act requires that existing implicit subsidies be replaced by an explicit universal service fund.

Mr. Gillan and Mr. Gueppe essentially ignore that requirement. At the heart of their approach is the assumption that the existing rates for all services are both economically appropriate and sustainable in a competitive environment. That assumption is simply wrong. The average revenue benchmark that is the foundation of their proposals is the product of monopoly era pricing practices wherein some services have been priced above cost and basic residential services have been priced below cost.

What Mr. Gillan and Mr. Gueppe fail to consider is how that rate structure translates into consumer telephone bills. Under the existing rate structure, the profitability of a customer is a direct function of the mix of services used by that customer. A consumer who uses only basic

service would be unprofitable to serve; conversely, heavy users of toll and vertical features—services that are priced substantially above cost—would be very profitable to serve. And the reality is that consumers do, in fact, vary widely in their use of telephone services. While most residential customers don't generate total revenues sufficient to cover the costs of serving them, others are highly profitable to serve. The latter customers, of course, are very attractive to new entrants; and indeed, competition can be expected to drive the prices to this set of customers down towards cost, thereby eroding the source of subsidies for those customers who do not generate enough revenues to cover the cost of serving them. Looking only at average revenues masks or ignores what is the core issue: the wide variance in revenues and profitability of individual customers—a variance that is the direct product of the wide variance in profitability of individual services that is produced by the existing rate structure.

Q. Do you have evidence as to the variances in revenues generated by Sprint residential customers in Florida?

A. Yes. Sprint conducted an analysis of the revenues generated by a sample of 2,750 of its residential customers in the service areas of what was then United of Florida from September 1996. The revenues included in the analysis were local service charges (including the interstate SLC), features, intraLATA toll, and state and interstate access (originating and terminating). The toll and access revenues were updated using July 1997 intraLATA toll and access rates. The results of the study are summarized in the following table.

RESIDENTIAL CUSTOMER REVENUE DISTRIBUTION

(monthly, per access line)

Total Revenue Category	Percent of Total Residential Customers	Local Revenue	Feature Revenue	Access Revenue	IntraLATA Toll Revenue	Total Revenue
<$15	15%	$12.62	$ .06	$ .59	$.05	$13.32
$15-$20	20%	13.1[illegible]	.81	3.32	.23	17.47
$20-$25	17%	13.27	2.05	6.58	.50	22.40
$25-$30	13%	13.20	3.83	9.52	.80	27.36
$30-$35	11%	13.18	3.90	13.94	1.35	32.36
$35-$40	7%	13.38	4.35	17.52	2.17	37.42
$40-$45	5%	13.03	5.41	22.81	1.21	42.46
>$45	12%	13.29	6.96	38.93	5.23	64.41
Average	100%	$13.13	$2.88	$11.82	$1.25	$29.08

As clearly indicated by these results, all residential customers are not the same. While the average local revenues don't vary much over the distribution, average local revenues ($13.13) constitute only 45% of the average total revenues ($29.08) of residential customers. Consumption of vertical features and toll/access, however, varies significantly. The 12% of residential customers in the highest revenue category generate $51.12 monthly in revenues from services other than local service, as compared to only $.70 a month from the 15% of customers in the lowest revenue category. Since it is the toll/access and feature services that

are today the source of subsidies to support universal service, the inequities of the current rate structure, and its unsustainability in a competitive market, are made readily apparent by the revenue distribution data contained in the table above.

Q. How would Mr. Gillan's and Mr. Gueppe's proposals thwart the development of a fully competitive local exchange market for residential customers in Florida?

A. As discussed above, some subset of residential customers are heavy users of toll and vertical features, and would represent an attractive market to a facility based competitor. However, the vast majority of residential customers yield revenues that would make them unprofitable or marginally profitable for a new entrant to serve. This is clearly demonstrated in the following table, which is based on a comparison of the total revenues generated by a customer with the costs of serving that customer. For this analysis, I used the BCPM costs, averaged at the wire center level, filed by Sprint in this proceeding to determine local service costs. Since the BCPM costs used in this study do not include any of the additional costs associated with toll/access and features, I used conservative estimates of the forward-looking costs for each of these discretionary features.

RESIDENTIAL CONTRIBUTION (PROFITABILITY) DISTRIBUTION

(monthly, per access line)

Contribution Level	Percent of Residential Customers	Local Revenue	Feature Revenue	Access Revenue	IntraLATA Toll Revenue	Total Revenue	BCPM Local Costs	Average Contribution *
>$30	3%	$13.51	$8.15	$62.34	$10.88	$94.88	$27.64	$51.89
$20-$30	3%	13.53	6.67	36.83	3.00	60.04	26.65	24.25
$10-$20	7%	13.51	6.07	26.34	2.06	47.99	26.98	14.34
$0-$10	16%	13.59	5.08	15.99	1.43	36.09	27.11	4.46
($10)-$0	32%	13.42	2.60	8.38	.91	25.32	28.33	(5.41)
($20)-($10)	26%	12.84	.94	4.95	.42	19.15	32.52	(14.63)
($30)-($20)	9%	12.21	.92	3.94	.31	17.37	40.14	(23.78)
<($30)	4%	11.66	1.42	4.09	.54	17.71	54.66	(38.10)
Average	100%	$13.13	$2.88	$11.82	$1.25	$29.08	$31.19	($5.26)

* Based on an estimated TELRIC of $.006684 per minute for intraLATA toll and access, and feature costs estimated at 22% of feature prices

As shown in the above table, 71% of Sprint's residential customers are not profitable—that is they do not generate revenues sufficient to cover the cost of providing their service. The results clearly demonstrate that the profitability of a residential customer is a direct function of that customer's use of vertical features and toll/access services. In no case does local service revenue alone cover costs. In fact, the current pricing structure for local services somewhat exacerbates the problem, since local rates in rural, higher cost areas are actually lower than the local rates in more urban, lower cost exchanges.

Certainly, there are a relatively small number of residential customers that would be attractive

to a facility-based competitor. However, the primary conclusion to be drawn from this evidence is that the residential segment of the market is, under existing rate structures, simply not attractive to a facility-based entrant. In light of this data, the almost total absence of facility-based competition in the residential segment in this country should come as no surprise. And unless the legislature and the Commission take steps to restructure rates and/or universal service funding to make the residential marketplace economically attractive to serve, there will never be vibrant facility-based competition in this segment of the market.

Q. What is Sprint's recommended approach?

A. Sprint would recommend, first, that the Commission quantify the existing level of subsidy to residential local exchange service, calculated as the difference between the residential basic service rate and the cost of providing the service. Second, Sprint advocates the elimination of existing implicit subsidies, and particularly the subsidy contributions embedded in access charges. To some degree, this could be accomplished though rate rebalancing—i.e., increasing residential local service rates to cost levels. However, Sprint also recognizes that full cost-based rates for residential basic service, especially in high cost areas, could jeopardize the goal of universal service. Therefore, Sprint recommends that the Commission determine a maximum affordable rate standard for basic residential service; to the extent that the cost of providing that service in a particular area exceeds that rate, the difference would be funded through an explicit, competitively neutral universal service fund. Sprint's plan would be revenue neutral. Any revenues generated by local service rate increases or new universal service funding would be offset, dollar for dollar, in reductions in existing implicit subsidies. Any subsidies provided through the new universal service fund would be portable, thereby increasing the incentives of new entrants to serve residential customers in higher cost areas.

Q. Mr. Gillan points out (pages 8-9 of his testimony) that if you compare only the local service rate to total local service costs, it might appear that a customer is being subsidized or needs to be subsidized when, in reality, that customer is highly profitable, considering the additional revenues generated by that customer's use of other services. Why should we provide a subsidy to LECs for serving customers who are already profitable?

A. Mr. Gillan's observation is based on the assumption that implicit subsidies would remain intact at the same time a new universal plan is implemented. That is certainly not Sprint's proposal. The flaw in Mr. Gillan's logic is best demonstrated in terms of his own example. Mr. Gillan uses the example of a customer who generates $15 in local service revenues and $10 in optional service revenue. Correspondingly, the cost of local service is $20 and the cost of the optional services is $1. Mr. Gillan argues that if we compare the local service rate of $15 to the local service costs of $20, it appears that the customer needs a subsidy in the amount of $5, whereas in reality the customer's total revenues of $25 exceed the total costs of $21—i.e., the customer is already profitable to serve and the service provider doesn't need a subsidy to serve that customer.

What Mr. Gillan misses is the dynamics of universal service reform. Under Sprint's proposal, at least, universal service funding would not increase a LEC's total revenues. Rather, it would be used to replace implicit subsidies on a revenue neutral basis. In terms of Mr. Gillan's example, the customer is profitable today only because the below cost rate paid by that customer for local service is more than offset by the above cost rate paid by that customer for optional services. What would happen under universal service reform is that the implicit

subsidy built into the optional service rates would be eliminated. Consequently, the revenues generated by the customer in the example would decrease by $9 (the difference between the existing rate of $10 and the cost of $1). If nothing else happened, that customer would now be unprofitable, yielding revenues of $16 compared to costs of $21. Thus, a universal subsidy in the amount of $5 (or, alternatively, an increase in the local rate) would not only be warranted, it would be absolutely necessary in order to provide LECs with the incentive to serve that customer.

The only other alternative to keep that customer profitable to serve is to maintain the high rate for optional services. Apparently, this is the situation envisioned by Mr. Gillan. It is a result that most certainly would not obtain under Sprint's universal service proposal.

Q. Mr. Gillan asserts (page 12) that it is not an unusual commercial practice to price some products high and others low when they are all part of a family of services. Why couldn't the same approach be taken for telephone services?

A. In the examples cited by Mr. Gillan, the provider has a reasonable expectation that the consumer will purchase the high priced items in addition to the low priced item. That is, one would expect that a customer who buys a razor handle will also purchase razor blades, since the razor handle would have no usefulness without them. That is not the case with the product set of telephone services. Local service is a valuable and useful service in and of itself; consumers don't have to purchase any additional services for their local service to be fully functional and valuable. The discretionary nature of these additional services, and the degree of independence of demand for these services from the demand for basic service, is evidenced by the revenue distribution data provided above; a substantial proportion of

customers make little or limited use of services beyond basic local service. At least at today's level of rates for non-basic services, a pricing strategy that presumes most customers will purchase enough high priced discretionary services to offset the below cost price for basic service would be ill-founded.

Q. Mr. Gueppe argues (page 16 of his testimony) that if all revenues are not included in the benchmark, "...the universal service fund would be sized too large..." and "...an inflated universal service fund would mean that consumers would face prices for telecommunications services that are too high." Do you agree?

A. No. To begin with, it is important to recognize that the "universal service fund" that exists today in the form of implicit subsidies is already "large". The only way to reduce or eliminate universal service funding needs is to increase local service rates to cost. Absent that, all that would happen is that the large subsidies built into existing rates would be replaced by an equally large universal service fund that would be explicit, specific, and predictable, as required by the Telecommunications Act, as well as being portable and available equally to all eligible telecommunications carriers.

Mr. Gueppe's assertion that universal service funding would increase prices for consumers is simply wrong. Mr. Gueppe makes the same erroneous assumption made by Mr. Gillan that universal service reform would keep existing rate structures intact. That, again, is certainly not Sprint's proposal. ILECs don't require any additional revenues to maintain the level of universal service that exists today. All that is required is that existing implicit subsidies be replaced by explicit universal service funding. Overall industry prices do not need to increase to maintain the current level of universal service, and would not increase under Sprint's

proposal.

Q. Mr. Gueppe also argues (page 19 of his testimony) that revenue shortfalls (where the costs at a wire center level exceed revenues) should be netted against revenue surpluses (where the revenues exceed the costs at the wire center level) in determining whether or not a LEC needs universal service support. Do you agree?

A. No. To reiterate, universal service reform is an issue of rate restructuring, not of revenue levels. As discussed previously, the existing level of revenues of ILECs is sufficient to maintain the current level of universal service. What is needed is not additional revenues, but a restructuring of how universal service funding is collected.

Most disturbing about Mr. Gueppe's proposal, however, is the assumption that it is not necessary to construct a universal service fund that is portable and available equally to all eligible telecommunications carriers. Under his proposal, a wire center that was clearly unprofitable would not be eligible for universal service funding if the ILEC currently providing service in that wire center was generating revenues in excess of its costs in other geographic areas. In those circumstances, there would be no incentive for a new entrant to provide service in that wire center, since it could not expect to earn a profit in doing so. The result is directly contrary to the fundamental goal of the Telecommunications Act of 1996—the goal of bringing competitive alternatives to all consumers.

Q. Mr. Gillan argues that the geographic unit used to determine universal service costs and unbundled network element cost should be the same. Do you agree?

A. Yes. Unless these two costs are determined on a reasonably consistent basis, there will be opportunities for uneconomic arbitrage. Take, for example, a wire center where the average cost is $50, and where universal service funding of $20 is available. If a CLEC can obtain unbundled elements at $40, because they were based on more broadly averaged costs, then the CLEC would obtain an unfair advantage over the ILEC, since the ILEC would have to recover $30 (i.e., the difference between its costs of $50 and its support receipts of $20) through its retail charges while the CLEC would have to recover only $20 (the difference between its unbundled network element costs of $40 of its support receipts of $ 20). Obviously, if the unbundled network element rates were above the costs used for universal service purposes, it would be the CLEC that would be disadvantaged.

However, there are ways to adjust for differences in the computation of universal service costs and unbundled network element costs. Essentially, universal support payments to a CLEC could be adjusted down (or up) by the difference between unbundled network element and universal service costs. In terms of the above example, the CLEC's universal service support would be reduced by $10, reflecting the fact that its costs for unbundled elements ($40) were that much less than the costs used for universal service purposes ($50). Obviously, this would be administratively cumbersome, and developing unbundled network element costs and universal service costs on the same basis would be far more preferable. My reason for pointing out this option is to demonstrate that the appropriate level of geographic disaggregation of costs for universal service purposes should be determined on its own merits, not on the basis of the current level of deaveraging of unbundled network element prices. To the extent that universal service funding is based on a geographic unit different from that used for unbundled network elements, the Commission could use an adjustment mechanism such as I described above to reconcile the differences for the duration

of whatever transition period is required to make unbundled network element prices consistent with the development of universal service costs.

Q. What is the appropriate geographic unit for the calculation of universal service costs?

A. As a general principle, the geographic unit used for universal service (and unbundled network elements) should be one in which the costs of service within that geographic area are relatively homogeneous. Basing universal service funding on the average costs in a geographic area that encompasses both very low cost and very high cost areas is undesirable for several reasons.

First, high cost areas with exactly the same level of costs would not necessarily receive the same level of universal service support, since that support would be calculated based on the average costs of some broader geographic area of which the high cost area is only a part. That is, the support received by any particular high cost area would be primarily a function of the cost characteristics of those other areas included in the same geographic area used for the determination of universal service support. In fact, a truly high cost area might receive no universal service support if the geographic area, as defined for universal service purposes, in which it happens to be located is comprised of low cost as well as high cost areas such that the average cost within that area is below the level needed to qualify for universal service support.

Second, basing both universal service support and unbundled network element prices on highly averaged costs distorts the competitive marketplace. New entry would be deterred in low cost areas to the extent that the averaged unbundled network prices greatly exceeded the

actual costs of providing the facilities in those areas. Conversely, averaging can produce artificial arbitrage opportunities. For instance, a facility-based entrant could choose to construct facilities in only lower cost areas—and receive universal service support for doing so—and, to meet its eligible telecommunications carrier obligation, serve high cost customers through resale.

Q. What empirical evidence to you have as to the proper level of disaggregation of costs for universal service purposes?

A. Sprint's cost study filed in this proceeding calculates costs at the wire center level. However, in order to analyze the appropriateness of using wire center level costs, we have also looked at costs disaggregated to the Census Block Group (CBG) level. The wire center maps, included as part of my testimony in Exhibit JWS-1, provide CBG level cost estimates, based on the BCPM costs submitted by Sprint in this proceeding, for each CBG in that wire center. What the data demonstrates is that even within a wire center, there can be significant cost variances. For example, the average cost in the Tallahassee wire center is $28.45, but costs in specific CBGs within that wire center range from a low of $17.99 (37% below the average) to a high of $144 (over five times the average).

Q. Does Sprint advocate that universal service be based on CBGs?

A. Not at this time. Basing universal service support on CBGs or similar levels of geographic disaggregation would pose formidable, although not insuperable, administrative issues. Sprint recommends, therefore, that universal service support initially be based on wire center average costs. However, Sprint equally believes that the Commission should reevaluate the

level of disaggregation in two to three years, to determine whether market circumstances warrant or necessitate basing universal service support on a more disaggregated basis.

Q. Does this conclude your testimony?

A. Yes.

IMMOKALEE FL
$45.00
IMMOKALEE MONTHLY COST
BLOCK GROUPS
$20 to $30 (2)
$30 to $40 (6)
$40 to $50 (2)
> $50 (2)
35.21
37.47
28.07
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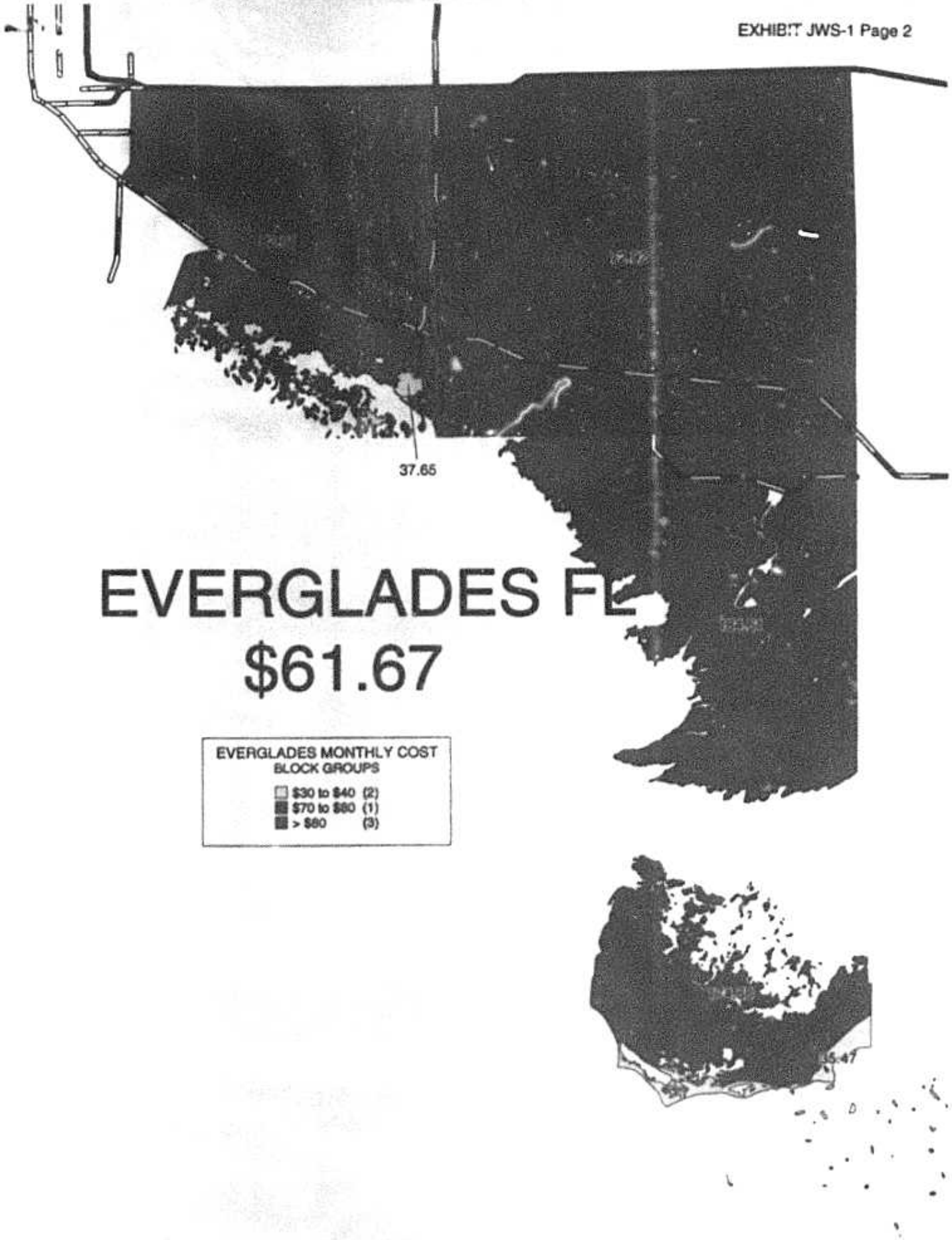
37.65
EVERGLADES FL
$61.67
EVERGLADES MONTHLY COST
BLOCK GROUPS
$30 to $40 (2)
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TALLAHASSEE FL
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