

LAW OFFICES

McWHIRTER, REEVES, MCGLOTHLIN, DAVIDSON, RIEF & BAKAS, P.A.

LYNWOOD F. ARNOLD, JR.
JOHN W. BAKAS, JR.
C. THOMAS DAVIDSON
STEPHEN O. DECKER
LINDA E. JORGE
VICKI GORDON KAUFMAN
JOSEPH A. MCGLOTHLIN
JOHN W. McWHIRTER, JR.
RICHARD OLIVER
RICHARD W. REEVES
FRANK J. RIEF, III
DAVID W. STERN
PAUL A. STRASSE

100 NORTH TAMPA STREET, SUITE 2800
TAMPA, FLORIDA 33602-5126

MAILING ADDRESS: TAMPA

P.O. BOX 3350, TAMPA, FLORIDA 33601-3350

TELEPHONE (813) 224-0800

FAX (813) 221-1854

CABLE GRANDLAW

PLEASE REPLY TO:
TALLAHASSEE

TALLAHASSEE OFFICE
117 N. GADSDEN
TALLAHASSEE, FLORIDA 32301
TELEPHONE (850) 222-2525
FAX (850) 222-5600

September 2, 1998

VIA HAND DELIVERY

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

Re: Docket No. 980696-TP - In re: Determination of the Cost of Basic Local
Telecommunications Service, Pursuant to Section 364.025, Florida
Statutes

Dear Ms. Bayó:

Enclosed are the original and 15 copies of Joseph Gillan's Rebuttal Testimony
on behalf of FCCA to be filed in the above docket.

I have enclosed an extra copy of the above document for you to stamp and
return to me. Please contact me if you have any questions. Thank you for your

- ACK return to me.
- AFA 2 assistance.
- APP _____
- CAF _____
- CMU Key
- CTR _____
- EAG _____
- LEG 2 JAM/jg
- LIN 5 tags
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- SEC 1
- WAS _____
- OTH _____

Sincerely,

Joseph A. McGlothlin

Joseph A. McGlothlin

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DOCUMENT NUMBER-DATE
09608 SEP-28
FPSC-RECORDS/REPORTING

ORIGINAL

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

**In re: Determination of the Cost of
Basic Local Telecommunications
Service, Pursuant to Section 364.025,
Florida Statutes.**

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Docket No. 980696-TF

Filed: September 2, 1998

REBUTTAL TESTIMONY

OF

JOSEPH CILLAN

ON BEHALF OF

THE FLORIDA COMPETITIVE CARRIERS ASSOCIATION

DOCUMENT NUMBER-DATE

09608 SEP-28

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Determination of the Cost of)	
Basic Local Telecommunications)	Docket No. 980696-TP
Service, Pursuant to Section 364.025,)	
Florida Statutes.)	Filed: September 2, 1998
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**REBUTTAL TESTIMONY OF
JOSEPH GILLAN
ON BEHALF OF
THE FLORIDA COMPETITIVE CARRIERS ASSOCIATION**

1 Q. Please state your name and business address.

2

3 A. Joseph Gillan. My business address is PO Box 541038, Orlando, Florida, 32854.
4 I previously filed direct testimony in this proceeding on behalf of the Florida
5 Competitive Carriers Association.

6

7 Q. What is the purpose of your rebuttal testimony?

8

9 A. The purpose of my rebuttal testimony is to briefly explain how the testimony filed
10 by the incumbent local exchange carriers (ILECs) reinforces the most important
11 points in my direct testimony:

12

13 * First, the ILEC testimony confirmed my concern that the ILECs
14 would seek a potentially massive universal service subsidy fund to

1 shield their revenues from competition and to guarantee their
2 profits.

3
4 * Second, the ILEC testimony underscores the importance of
5 calculating the economic cost of the "family" of local exchange
6 services (i.e., the basket of services typically provided by a local
7 carrier to its subscriber.) in order to correctly determine whether
8 any external subsidy is appropriate or necessary.

9
10 * Third, the ILEC testimony provides additional support for the
11 critical need to develop universal service support and network
12 element prices using the same cost methodology and geographic
13 application.

14
15 Q. Did the ILEC testimony confirm your concerns that they would use this
16 proceeding to seek a massive subsidy fund?

17
18 A. Yes. The GTE testimony provides particular insight in this regard. GTE takes the
19 remarkable position that even its own cost study -- a cost study which it is
20 otherwise sponsoring as accurate and reliable -- should not be used because it
21 does not justify a sufficient subsidy. GTE's position is that a universal service
22 fund should guarantee the excess revenues that it receives today, and that its cost

1 study should be "adjusted" to produce this end result (Seaman, page 20, emphasis
2 added):

3
4 ... GTE believes that any explicit universal service fund or
5 mechanism must be sufficient to replace all of today's implicit
6 subsidies, and *the results of any cost model should be adjusted to*
7 *accommodate this goal.*

8
9 GTE's testimony exemplifies the corrupting influence of unjustified subsidization.
10 An unearned subsidy, once implemented, becomes a perpetual entitlement in the
11 eyes of its recipient. Even though the BCPM cost model (according to GTE)
12 indicates a subsidy of "only" \$366 million, GTE claims that it should actually be
13 provided a subsidy of \$487 million per year. Of course, every dollar of subsidy
14 provided GTE must first be collected from a consumer -- a consumer entitled to
15 a solid explanation for its contribution.

16
17 Q. What "logic" does GTE use to justify its claim that it is entitled to an annual
18 subsidy of nearly 1/2 billion dollars per year?

19
20 A. GTE's core argument is that because it *currently* overprices some of its services
21 by \$487 million dollars per year, it is entitled to these revenues in *perpetuity*
22 (Seaman, page 6). The point of a universal service fund, however, is not to
23 protect GTE's over-pricing (or profits), but rather to provide external support in
24 those limited instances where network costs are so high as to jeopardize network

1 subscription. GTE never explains, however, why such a massive subsidy is
2 needed to protect universal service in one of the more dense and prosperous parts
3 of the state. (As an aside, if GTE really required \$487 million in external subsidy
4 just to serve the Tampa/St. Petersburg area, one wonders why Bell Atlantic would
5 agree to its merger or how GTE could have seriously considered purchasing MCI).

6
7 **Q. Can you provide any statistics that place GTE's subsidy claim in perspective?**

8
9 **A. Yes.** Even before considering GTE's \$121 million "adjustment" to its cost
10 analysis, its threshold claim that it needs a "cost-justified" external subsidy of \$366
11 million is extraordinary in its own right. In 1997, GTE's total intrastate revenues
12 were roughly \$950 million per year (GTE Exhibit SAO-1). Thus, according to
13 GTE, it requires an external subsidy roughly equal to 40% to 50% of its intrastate
14 revenues.

15
16 Imagine the distorted incentives that would develop if nearly half the market's
17 revenues were controlled by a fund-administrator, instead of the individual
18 decisions of actual consumers. From a management perspective, the universal
19 service fund would become the make-it-or-break-it "customer" -- with GTE's (and
20 every other carrier's) resources devoted to fund-qualification, fund-analysis, fund-
21 litigation and (let's be honest) fund-manipulation. The fund GTE recommends

1 here seems a far cry from the position summarized in the Commission's 1996
2 legislative report (page 73):

3 GTE believes that the primary tool for ensuring reasonable rates in
4 a competitive market is the competitive market itself. A universal
5 service policy -- in conjunction with other policies and actions
6 regarding local exchange telephone competition -- should not
7 distort the effective operation of the market any more than is
8 necessary to carry out the public policy of maintaining universal
9 service at affordable rates in Florida.

10
11 **Q. Are there other summary-statistics which demonstrate the unreasonableness**
12 **of the ILEC position?**

13
14 **A. Yes. One measure of the reasonableness of the ILEC testimony is the extent to**
15 **which their policies target universal service support. Carefully targeting assistance**
16 **has been a key objective of universal service reform, as noted in the Commission's**
17 **1996 Report (page 38):**

18
19 Parties generally believe that support should be targeted to low
20 income households and to high cost areas.

21
22 We [the Commission] agree that targeted funding is an appropriate
23 means of providing support...

24
25 The GTE and BellSouth testimony provide data which can readily be used to
26 determine the "target efficiency" of their proposals (Sprint/United's data does not
27 easily permit this comparison). Remarkably, BellSouth and GTE claim that a

1 subsidy is needed for 100 percent of their residential lines (Seaman Exhibit MCS-
2 2, page 5; Martin Exhibit PFM-1). This subsidy claim stands in stark contrast to
3 the analysis provided by AT&T witness Guepe (pages 17-20) that shows that the
4 residential market is *profitable* for both of these ILECs.

5
6 **Q. How can the ILECs claim they need a subsidy to serve profitable customers?**

7
8 **A. The ILECs claim they deserve a subsidy if the local rate (including the SLC) does**
9 **not fully cover all local network costs, without regard to the other services a**
10 **customer purchases in connection with its local service. As I noted in my direct**
11 **testimony (page 13), however, such a "dial tone-only" spending pattern is rare.**
12 **The commercial attractiveness of a customer is decided by its total revenue**
13 **potential, and not just the revenues collected in the basic local rate.**

14
15 The only valid comparison to determine whether a legitimate subsidy need exists
16 is to compare the total cost to provide the typical package of local services
17 purchased by an average customer to the revenues from this package. So that the
18 legislature can reasonably evaluate whether an external fund is appropriate, I
19 recommend that the Commission calculate and report this family cost, even if it
20 also reports a "cost" of the "dial-tone only" option as well.

1 Q. In your opinion, do the ILECs actually believe that the entire residential
2 market requires subsidy?

3
4 A. No. Again, consider GTE's shifting positions on this issue. On the one hand,
5 GTE argues that the *entire* residential market in its territory requires support. Yet,
6 GTE has requested confidential treatment concerning the details of its analysis,
7 arguing:

8
9 These detailed, specific data would be useful for competitors in
10 discerning the size and composition of GTE's market on a
11 geographically disaggregated basis. The support information would
12 reveal to competitors GTE's costs of serving particular areas and
13 which areas would be most lucrative.

14
15 This request for confidential treatment exposes the absolute fallacy of GTE's
16 arguments. According to GTE, there are *no* lucrative areas (at least residential
17 areas) in its entire region -- *every* residential line requires a subsidy. Further, if
18 GTE's proposal were implemented, then the "lucrative" of each area would be
19 defined by the available subsidy, an amount (one would assume) that would never
20 be proprietary to GTE. GTE's confidentially request confirms that GTE's
21 management understands that its residential customers are profitable, even if its
22 subsidy proposal implies otherwise.

1 Q. Is there also support for your recommendation that network element prices
2 and universal service support (if any) should be developed consistently?

3
4 A. Yes. Although I disagree with the bulk of Mr. Seaman's testimony, we do agree
5 on one point: network element prices and universal service costs should be
6 developed consistently (Seaman, page 9). In addition, Sprint's testimony supports
7 the position in my direct testimony (Gillar, pages 22-24) that the "fixed wire
8 center" assumption renders irrelevant any theoretical distinction between a
9 universal-service and network-element cost study.

10
11 Q. Why is the "fixed wire center" assumption important to the question of
12 consistent universal-service and network-element cost studies?

13
14 A. The Commission (in a letter from Chairman Johnson to the FCC) had expressed
15 a view that a different cost study could be used to estimate the cost of universal
16 service than that used to establish network element prices. The basis for this
17 opinion was the view that a *universal-service* cost study should look at the cost of
18 a hypothetical entrant (i.e., an entrant with no facilities), while a *network-element*
19 cost study should consider the costs that would be incurred by the incumbent
20 (operating efficiently). Although this distinction may be theoretically accurate, it
21 is important to appreciate that both cost models sponsored in this proceeding are
22 constrained (by adopting the incumbent's wire center location) in a manner that

1 eliminates any meaningful difference. As a result, there is no valid theoretical
2 reason to use separate cost models to determine universal service support and
3 network element prices -- and, as explained in my direct testimony, there are
4 compelling economic, policy and pragmatic reasons why the same analysis should
5 be used.

6
7 **Q. How important is the "fixed wire center" assumption to the cost model and**
8 **its results?**

9
10 **A. The "fixed wire center" assumption is critical. Consider the basic logic explained**
11 **in the testimony of Sprint witness, Dr. Staihr (Staihr, page 10, emphasis in the**
12 **original):**

13
14 The cost of basic telephone service is primarily, and in rural areas,
15 almost completely, determined by the cost of the *loop*.

16
17 ***

18
19 The cost of the *loop* is determined primarily by two factors:
20 *distance and density*.

21
22 ***

23
24 Both of these, *distance and density*, in turn depend on where the
25 model assumes customers are located in relation to the central
26 office, and located in relation to each other.

27

1 Much of the debate in this proceeding concerns the first half of this basic
2 relationship (estimating the location of the customers). But equally important in
3 the analysis is the assumption defining the other end of the loop: the location of
4 the central office.

5
6 By adopting a methodology which accepts the *incumbent's* central office as the
7 terminal point of all loops, these "universal-service" cost models are structured to
8 calculate the *same* cost-object as a "network element" cost study: the forward-
9 looking cost of an efficient incumbent. (The observation that each model has the
10 same goal, however, does not diminish the importance of the larger issue -- i.e.,
11 which model estimates the cost most accurately).

12
13 The basic conclusion of my direct testimony remains. The cost of network
14 facilities used to determine universal service support (if any) should be the same
15 as the cost-based network element prices applicable to the facilities. The
16 Commission should establish geographic zones for each and report the cost results
17 accordingly. I note that the Commission has already established/approved
18 geographic zones for Sprint/United in the context of the MCI/Sprint
19 Interconnection Agreement. This framework can be used as the starting point for
20 determining universal service costs for each of the same areas.
21

1 Q. Does this conclude your rebuttal testimony?

2

3 A. Yes.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing Rebuttal Testimony of Joseph Gillan has been furnished by United States mail or hand delivery(*) this 2nd day of September, 1998, to the following:

Will Cox*
Division of Legal Services
Florida Public Service Commission
2450 Shumard Oak Boulevard
Room 370-M
Tallahassee, Florida 32399-0850

Charles Beck
Office of Public Counsel
111 West Madison Street, Room 812
Tallahassee, Florida 32399-1400

Michael Gross
Office of the Attorney General
Department of Legal Affairs
The Capitol, PL-01
Tallahassee, Florida 32399-1050

Harriet Eudy
ALLTELL Florida, Inc.
206 White Avenue
Live Oak, Florida 32060-0550

Rhonda Merritt
Tracy Hatch
AT&T Communications of the
Southern States, Inc.
101 North Monroe Street
Suite 700
Tallahassee, Florida 32301-1549

John Fons
Jeffrey Wahlen
Ausley Law Firm
Post Office Box 391
Tallahassee, Florida 32302

Nancy H. Sims
BellSouth Telecommunications, Inc.
150 South Monroe Street
Suite 400
Tallahassee, Florida 32301-1556

David B. Erwin
127 Riversink Road
Crawfordville, Florida 32327

Laura Gallagher
Florida Cable Telecommunications
Association, Inc.
310 North Monroe Street
Tallahassee, Florida 32301

Kelly Goodnight
Frontier Communications
International, Inc.
180 South Clinton Avenue
Rochester, New York 14646-0995

e.spire Communications, Inc.
131 National Business Parkway
No. 100
Annapolis Junction, Maryland 20701

Thomas M. McCabe
TDS Telecom/Quincy Telephone
Post Office Box 189
Quincy, Florida 32353-0189

Steven Brown
Intermedia Communications, Inc.
3625 Queen Palm Drive
Tampa, Florida 33619-1309

Jim McGinn
ITS Telecommunications Systems, Inc.
Post Office Box 277
Indiantown, Florida 34956

Susan Berlin
MCI Telecommunications Corp.
780 Johnson Ferry Road, Suite 700
Atlanta, Georgia 30342

Charles J. Rehwinkel
Sprint-Florida, Inc.
Post Office Box 2214
(MS: FLTH00107)
Tallahassee, Florida 32316

Suzanne F. Summerlin
1311-B Paul Russell Road
Suite 201
Tallahassee, Florida 32301

Supra Telecommunications
& Information Systems
12914 S.W. 133rd Court, Suite B
Miami, Florida 33186-5806

GTC, Inc.
c/o St. Joe Communications, Inc.
Post Office Box 220
Port St. Joe, Florida 324560-0220

Floyd Self
Messer Law Firm
Post Office Box 1876
Tallahassee, Florida 32302

Kimberly Caswell
GTE Florida Incorporated
Post Office Box 110
FLTC0007
Tampa, Florida 33601-0110

Lynne G. Brewer
Northeast Florida Telephone
Co., Inc.
Post Office Box 485
Macclenny, Florida 32063-0485

Barbara Auger
Peter Dunbar
Pennington Law Firm
Post Office Box 10095
Tallahassee, Florida 32301

Bill Huttenhower
Vista-United Telecommunications
Post Office Box 10180
Lake Buena Vista, Florida 32830-0180

Patrick Wiggins
Donna Canzano
Wiggins Law Firm
Post Office Drawer 1657
Tallahassee, Florida 32302

Kenneth Hoffman
TCG South Florida
Rutledge Law Firm
Post Office Box 551
Tallahassee, Florida 32302-0551

Richard Melson
Hopping Law Firm
Post Office Box 6526
Tallahassee, Florida 32314

Patrick L. Imhof
Legislative Research Director
Utilities and Communications
Florida House of Representatives
Room 428 HOB
402 South Monroe Street
Tallahassee, Florida 32399-1300


Joseph A. McGlothlin

Vicki Gordon Kaufman
McWhirter, Reeves, McGlothlin,
Davidson, Rief & Bakas, P.A.
117 South Gadsden Street
Tallahassee, Florida 32301
850/222-2525

Attorneys for Florida Competitive
Carriers Association