

1 REBUTTAL TESTIMONY OF DR. RICHARD D. EMMERSON
2 ON BEHALF OF BELLSOUTH TELECOMMUNICATIONS, INC.
3 BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION
4 DOCKET NO. 990649-TP
5 SEPTEMBER 10, 1999
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8 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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10 A. My name is Richard D. Emmerson. I am the President and CEO of INDETEC
11 International, Inc. My business address is 445 Marine View Avenue, Suite 310,
12 Del Mar, California.

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14 Q. ARE YOU THE SAME RICHARD D. EMMERSON WHO FILED DIRECT
15 TESTIMONY IN THIS CASE ON AUGUST 11?

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17 A. Yes. In that testimony I described my qualifications relevant to these
18 proceedings.

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20 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

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22 A. I respond to one issue in e.spire Witness James C. Falvey's direct testimony,
23 and to certain issues raised in the direct testimony of AT&T and
24 MCI/WorldCom Witness, Dr. August H. Ankum.

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1 Q. ON PAGE 3 OF HIS DIRECT TESTIMONY, MR. FALVEY DISCUSSES
2 ASPECTS OF GEOGRAPHIC DEAVERAGING THAT CAN BE
3 "ANTICOMPETTIVE." ARE THERE ASPECTS OF GEOGRAPHIC
4 DEAVERAGING THAT CAN NEGATIVELY AFFECT COMPETITION ON
5 THE MERITS?

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7 A. Yes. As I discussed in my direct testimony, deaveraged UNE rates in
8 combination with existing retail loop-based service rates is inconsistent with a
9 competitive result. Such a structure would create the wrong price signals for
10 ALECs in the process of choosing between making investments in facilities
11 and/or leasing an incumbent's facilities (via UNEs).

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13 If UNE rates are deaveraged without simultaneous retail rate rebalancing (and
14 the completion of universal service funding for high cost areas), then in high-
15 cost rural areas, retail rates would be too low and UNE rates would be too high
16 (relative to retail rates). In low-cost urban areas, retail rates would be too high
17 relative to UNE rates. In general, all prices of network capabilities available to
18 competitors should be related to retail prices in order to encourage the efficient
19 provision of end user services.

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21 Q. DR. ANKUM DISCUSSES (PAGE 18 OF HIS DIRECT TESTIMONY) THE
22 NOTION OF ESTIMATING COSTS THAT ASSUME "NEW AND
23 EFFICIENT CENTRAL OFFICE BUILDINGS" THAT PERMIT EFFICIENT,
24 LEAST COST, COLLOCATION ARRANGEMENTS. DO YOU HAVE
25 ANY COMMENTS?

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A. Yes. On pages 24-28 of my direct testimony, I discuss the proper application of least cost concepts. In particular, proper cost calculations must not be based on estimates of a hypothetical firm that starts anew from scratch each day. A hypothetical firm may have had a large building one day (to accommodate analog switching), a small building another day (to accommodate digital switching, but no collocation), and a medium-sized building at a still later time (to accommodate digital switching and collocation). Obviously real firms in competitive markets cannot make such transitions instantaneously and without incurring costs.

The costs that are caused in the real world reflect the resources that are used up to efficiently manage the transition from one circumstance to another. In order to emulate competitive markets real, rather than hypothetical, costs must be considered.

Q. DR. ANKUM DISCUSSES, AT PAGES 30 – 31 OF HIS DIRECT TESTIMONY, “ECONOMIC COSTS” AND THE TELECOMMUNICATIONS ACT. DOES THE TELECOMMUNICATIONS ACT REQUIRE THAT UNES BE PRICED AT TELRIC OR ECONOMIC COST?

A. No. While the Act uses the term “cost” over 30 times, it does not use the terms “economic cost,” “total element long-run incremental cost” (TELRIC), “total service long-run incremental cost” (TSLRIC), “long-run incremental cost,” or

1 "incremental cost." In his direct testimony, Dr. Ankum cites the relevant
2 section of the Act (252(d)(1)), which states that just and reasonable UNE rates
3 "shall be" "based on cost" and "may include a reasonable profit." Therefore,
4 the ACT does not state that UNE prices must equal TELRIC, economic cost or
5 some other measure of cost. Rather, the Act states that the UNE rates must be
6 based on cost, not equal to cost.

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8 The Act does state that the costs should be "determined without reference to a
9 rate-of-return or other rate-based proceeding." Other than this qualification
10 and the statement that the rate "may include a reasonable profit," the Act
11 provides no specific guidance as to the type of costs on which to base UNE
12 rates.

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14 Q. DOES A PRICE ABOVE INCREMENTAL COST FOR AN ELEMENT OR
15 A SERVICE INSURE A PROFIT FOR THE ILEC?

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17 A. No. As I discussed in my direct testimony, multiservice firms, such as ILECs,
18 have shared and common costs that are not directly attributable to individual
19 services or elements. It is the ability to share costs across multiple services that
20 creates economies of scope and lower overall costs. However, if every service
21 and element were priced equal to its incremental cost, the ILEC would not
22 recover its shared and common costs, and therefore would not earn a profit.

23

24 Profit (and loss) is, by its very nature, residual. That is, profit is what is left
25 over after all of the costs of the company have been recovered. Before a firm

1 can earn a profit, it must recover all of its incremental costs and all of its shared
2 and common costs as well. Setting prices at TSLRIC or TELRIC does not
3 provide for recovery of shared and common costs and therefore, does not yield
4 a reasonable profit.

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6 Q. DR. ANKUM USES THE TERMS "TELRIC" AND "ECONOMIC COSTS."
7 HOW DOES THE FCC USE THESE TERMS IN ITS INTERCONNECTION
8 ORDER WITH RESPECT TO PRICING UNES?
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10 A. At paragraph 672 of its First Report and Order in Docket No 96-98 (August
11 1996, Interconnection Order), the FCC states: "... we conclude here that prices
12 for interconnection and unbundled elements pursuant to sections 251(c)(2),
13 251(c)(3), and 252(d)(1), should be set at forward-looking long-run economic
14 cost. In practice, this will mean that prices are based on the TSLRIC of the
15 network element, which we will call Total Element Long Run Incremental Cost
16 (TELRIC), and will include a reasonable allocation of forward-looking joint
17 and common costs." At paragraph 675, the Order states: "Forward-looking
18 incremental costs, plus a portion of the forward-looking joint and common
19 costs, are sometimes referred to as 'economic costs.'"
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21 Unfortunately, the FCC has used the term TELRIC in some instances to refer
22 to the costing methodology (without an allocation of joint and common costs)
23 and in other instances to refer to its pricing methodology (including an
24 allocation of joint and common costs). This mixed usage of TELRIC as a
25 name for both a costing methodology and a pricing methodology (including a

1 reasonable allocation of joint and common costs) has led to confusion in
2 discussions of TELRIC.

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4 The FCC clearly intends for UNE prices to include an allocation of joint and
5 common costs. Any suggestion that UNE prices equal TELRIC alone (without
6 an allocation of joint and common costs), is inconsistent with the FCC's order,
7 sound public policy and sound economics.

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9 Q. ON PAGE 6 OF HIS DIRECT TESTIMONY, DR. ANKUM STATES: "FOR
10 EXAMPLE, IF PRICES FOR UNBUNDLED NETWORK ELEMENTS AND
11 INTERCONNECTION SERVICES ARE SET ABOVE ECONOMIC COST
12 THEN AN EFFICIENT CLEC MAY BE PRECLUDED FROM ENTERING
13 THE MARKET" (EMPHASIS IN THE ORIGINAL). DO YOU HAVE ANY
14 COMMENTS?

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16 A. Yes, I have two comments. First, whether an efficient alternate local exchange
17 carrier (ALEC) can enter the market, purchase UNEs from the ILEC, and
18 survive selling retail services to end users, does not depend on whether the
19 prices of UNEs are set equal to their economic costs (including an allocation of
20 joint and common costs). Rather, the success of an efficient ALEC will
21 depend on whether the differential, between the retail price (e.g., the ILEC's
22 basic local exchange price) and the UNE price, is great enough to allow the
23 ALEC to recover its other costs (i.e., its costs in addition to its purchase of
24 UNEs). If a retail rate is too low (e.g., a low rural residential basic local
25 exchange service rate), then a UNE price equal to its economic cost will not

1 allow an efficient ALEC to enter that market segment and survive, since the
2 differential between the UNE price and the retail price will be too small. In
3 contrast, if the retail rates are relatively high (e.g., a relatively high basic local
4 exchange rate for business in a central business district), then a UNE price
5 equal to its economic cost will offer the opportunity for even inefficient
6 ALECs to enter and survive in that segment.

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8 Therefore, in order to promote economic entry, as Dr. Ankum discusses at page
9 7 of his testimony, it is critical that UNE rates and retail rates be treated
10 consistently and simultaneously. Since it is the differential between retail rates
11 and UNE rates that determines whether efficient ALECs can enter a market
12 segment, if UNE rates are deaveraged, retail rates must be consistently and
13 simultaneously rebalanced (and universal service funding to high-cost areas
14 fully established). It is only through the consistent (and simultaneous)
15 treatment of retail rates (including universal service funding to high cost areas)
16 and UNE rates that efficient entry is encouraged, and inefficient entry
17 discouraged.

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19 Q. WHAT IS YOUR SECOND COMMENT WITH REGARD TO DR.
20 ANKUM'S DISCUSSION OF PRECLUDING EFFICIENT ENTRY?

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22 A. ALECs can enter a market segment by purchasing UNEs from ILECs and/or by
23 building their own facilities. Two types of pricing activities can discourage
24 efficient facilities-based entry by ALECs. First, retail rates that are too low
25 will discourage facilities-based entry by ALECs (e.g., if residential basic local

1 exchange service in rural areas is too low). If retail rates are too low, facilities-
2 based entrants will not be able to recover their costs through retail charges.

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4 Second, UNE prices that are too low discourages construction of facilities by
5 ALECs. Constructing facilities is a higher risk activity than leasing existing
6 ILEC facilities via UNEs. Therefore, there is a danger that UNE rates may not
7 be set high enough to reflect the risk of constructing facilities. If UNE rates are
8 set too low (e.g., by not reflecting the risk of constructing facilities), the
9 process will discriminate against the construction of facilities by efficient
10 providers. In such a case, efficient potential facilities-based entrants will tend
11 to purchase UNEs rather than construct their own facilities.

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Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.