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October 15, 1999

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

Re: Docket No. 990649-TP
Investigation into Pricing of Unbundled Network Elements

Dear Ms. Bayo:

Please find enclosed for filing in the above matter an original and 15 copies of the Surrebuttal Testimonies of Michael J. Doane, Dennis B. Trimble and David G. Tucek on behalf of GTE Florida Incorporated. Service has been made as indicated on the Certificate of Service. If there are any questions regarding this matter, please contact me at 813-483-2617.

Sincerely,

Anthony P. Gillman

Kimberly Caswell

KC:tas
Enclosures

AFA
APP
CAF
CMU
CTR
EAG
LEG
MAS
OPC
PAI
SEC
WAW
OTH

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that copies of the Surrebuttal Testimonies of Michael J. Doane, Dennis B. Trimble and David G. Tucek on behalf of GTE Florida Incorporated in Docket No. 990649-TP were sent via U. S. mail on October 15, 1999 to the parties on the attached list.

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ORIGINAL

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation into Pricing of Unbundled Network Elements	)))	Docket No. 990649-TP

SURREBUTTAL TESTIMONY OF

MICHAEL J. DOANE

ON BEHALF OF

GTE FLORIDA INCORPORATED

OCTOBER 15, 1999

GTE FLORIDA INCORPORATED

SURREBUTTAL TESTIMONY OF MICHAEL J. DOANE

DOCKET NO. 990649-TP

Q. **PLEASE STATE YOUR FULL NAME AND BUSINESS ADDRESS.**

A. My name is Michael J. Doane. My business address is 88 Kearny Street, Suite 1300, San Francisco, CA 94108.

Q. **DID YOU PREVIOUSLY PROVIDE DIRECT AND REBUTTAL TESTIMONY BEFORE THIS COMMISSION IN THE CURRENT DOCKET?**

A. Yes. I provided direct and rebuttal testimony on the approach the Commission should use if it proceeds with UNE deaveraging in the absence of retail rate rebalancing.

Q. **WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

A. My testimony responds to the Rebuttal Testimonies of AT&T and MCI witness Ankum, Rhythms Links witness Geis, Florida Digital Network witness Senatore, Sprint witness Sichter, and Covad and Rhythms Links witness Murray.

Q. **PLEASE SUMMARIZE THE POSITIONS EXPRESSED BY THESE WITNESSES.**

A. These witnesses advocate that in establishing deaveraged prices for unbundled network elements ("UNEs"), the Commission should not consider any factor other than a UNE's total element long run incremental cost ("TELRIC"), plus a "reasonable" allocation of forward-looking common costs. (Throughout my testimony, I refer to this approach as "TELRIC pricing.") They assert TELRIC pricing promotes competition and economic efficiency. The witnesses also contend that GTE's proposal to deaverage UNE rates is an attempt to needlessly limit and delay competitive entry.

Q. **PLEASE SUMMARIZE YOUR RESPONSE TO THESE CLAIMS.**

A. My testimony demonstrates that these witnesses' claims regarding the procompetitive effects of TELRIC pricing are both unsubstantiated and wrong from an economic standpoint. I also demonstrate that, contrary to their assertions, GTE's proposal is the *only* method that encourages--rather than limits--the entry of efficient providers.

In a constructive manner, GTE offered two methods by which to implement UNE deaveraging without undue delay. Under the first proposal, the Commission would rebalance retail rates to reflect the underlying costs of service, and UNE rates would be geographically deaveraged in conformance with the rebalanced retail rates. Simultaneous rebalancing of retail and wholesale rates would eliminate arbitrage opportunities that limit competition. However, if the Commission declines to adopt this approach, it could opt for GTE's alternative proposal, which maintains existing retail rates, while immediately deaveraging UNE rates. To bring the benefits of competition to consumers throughout Florida, this approach requires an adjustment charge on UNE prices to reflect the fact that retail rates do not correspond to their underlying costs. In the absence of such a charge, the provision of universal service would be threatened as new entrants would have the incentive to target high-margin (primarily business) customers and ignore residential customers generally, particularly those located in rural areas.

Q. HOW HAVE YOU ORGANIZED YOUR TESTIMONY?

A. I have organized my testimony around the witnesses' claims regarding: (1) the alleged benefits of TELRIC pricing and (2) the alleged problems concerning GTE's deaveraging adjustment charge ("DAC") proposal.

I. An Economic Analysis of the Witnesses' TELRIC Pricing Proposal

Q. ON WHAT GROUNDS DO THE WITNESSES ARGUE UNE PRICES SHOULD BE DEAVERAGED BASED SOLELY ON TELRIC?

A. In general, the witnesses allege TELRIC pricing will promote competition and economic efficiency. However, they draw this conclusion with no supporting economic analysis. For example, without analysis, Ms. Senatore alleges: "Pricing on the basis of TELRIC costs will encourage efficiency rather than monopolistic complacency, will enable market entry for competitive companies, and will send the right signals." (Senatore RT at 8; *see also* Sichter RT at 10; Geis RT at 9; Murray RT at 14.)

Q. HOW DO YOU RESPOND TO THE CLAIM THAT TELRIC PRICING PROMOTES COMPETITION AND ECONOMIC EFFICIENCY?

A. In response to this general claim, I analyze in detail the allegations put forward by Dr. August Ankum, as he sets forth a list of claims encompassing those of other witnesses. Dr. Ankum claims:

> Prices set at [TELRIC]:
>
> -- generate results consistent with competitive market outcomes;
>
> -- create the appropriate price signals that will promote overall economic welfare in Florida;
>
> -- induce efficient market entry by ALECs;
>
> -- are not discriminatory

(Ankum RT at 4.)

Q. PLEASE RESPOND TO DR. ANKUM'S CLAIM THAT TELRIC PRICES "GENERATE RESULTS CONSISTENT WITH COMPETITIVE MARKET OUTCOMES."

A. As a threshold matter, it should be recognized that Dr. Ankum offers literally no testimony supporting this claim. Instead, he takes on the straw man argument that UNE prices should not recover historic inefficiencies because that would be inconsistent with the results of competitive markets. This argument is a straw man because no party to this proceeding has put forward a methodology for establishing UNE prices that recover historic inefficiencies. Moreover, Dr. Ankum has failed to offer any evidence that such historic inefficiencies in local exchange carriers' costs exist. Indeed, the fact that GTE has operated under a price-cap plan since 1996 and made its last rate case filing in 1992 strongly suggests that it is operating efficiently, since cost inefficiencies reduce profits.

Dr. Ankum appears to take the position that TELRIC prices mimic those observed in competitive markets, which he observes generally produce prices that "gravitate toward economic costs." From this he concludes that the Commission can achieve the competitive market outcome by simply establishing UNE prices equal to TELRIC. This approach is misguided for several reasons.

First, the fallacy of Dr. Ankum's logic was explained coherently by Justice Stephen Breyer in his separate statement in *Iowa Utilities Board*. Commenting on the FCC's TELRIC pricing approach, Justice Breyer stated:

> For competition, according to the FCC, tends to produce prices that reflect forward-looking replacement costs, not actual historical costs. But this argument does not show that the Act

> compels the use of the FCC's system over any other. How could it? *The competition that the Act seeks is a process, not an end result*; and a regulatory system that imposes through administrative mandate a set of prices that tries to mimic those that competition would have set does not become any less a regulatory process, nor any more the competitive one.

AT&T Corp. v. Iowa Utils. Bd., 119 S. Ct. 721, 751 (1999) (Justice Breyer concurring in part and dissenting in part) [emphasis added].

As Justice Breyer observed, Dr. Ankum's standard is inherently circular and thoroughly regulatory. TELRIC prices are hypothetical constructs resulting from engineering cost models that do not and cannot reflect the dynamic nature of the competitive process. A prime example of why the TELRIC approach fails to capture this dynamic competitive process is vividly illustrated by the fact that TELRIC prices are calculated on the unrealistic assumption that local exchange carriers rebuild their capital from scratch (except for the location of their existing wire centers) at the end of each period. In the real world, firms economize by replacing capital when it is profitable to do so, i.e., when the operating cost savings exceed the capital investments for new plant on a present value basis.

For this reason, Professor Alfred Kahn has observed:

> In a world of continuous technological progress, it would be irrational for firms to constantly update their facilities in order *completely* to incorporate today's lowest-cost technology, as though starting from scratch, the moment those costs fell below prevailing market prices. Investments made today, totally embodying the most modern technology available currently, would instantaneously be outdated tomorrow and, in consequence, fail over their lifetime to earn a return sufficient to justify the investments in the first place.

(Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation*, Michigan State Utilities papers, 1998, at 91 [emphasis in original].)

Finally, while Dr. Ankum is correct that prices in competitive markets tend toward economic costs, he incorrectly asserts economic costs equal TELRIC. How can they? Economic costs include opportunity costs, *i.e.*, the value of the resource in its best alternatives use. Of course, the value of these alternative uses change constantly in competitive markets. But TELRIC prices by their nature are the end result of static engineering cost models and cannot reflect the realities of the competitive process.

Q. HOW DO YOU RESPOND TO DR. ANKUM'S CLAIM THAT PRICES SET AT TELRIC "CREATE THE APPROPRIATE PRICE SIGNALS THAT WILL PROMOTE OVERALL WELFARE IN FLORIDA"?

A. Dr. Ankum begins with the noncontroversial proposition that prices that reflect economic costs enable consumers and suppliers to make consumption decisions that lead to optimal results. He asserts that UNE prices based on retail rates will cause market participants to make buying decisions based on false information about the true costs produced by these services. He therefore concludes that such UNE prices will diminish overall economic welfare.

Dr. Ankum is correct in observing that retail rates are not based on economic costs. Instead, retail rates reflect this Commission's policy decisions regarding the trade-off between economic efficiency and equity goals, such as the provision of universal service. However, as demonstrated in my Direct Testimony, this does not imply UNE prices should fail to consider the retail rate structure. In fact, such a failure would reduce overall welfare in Florida. UNE prices should encourage efficient entry. That is, entry should be encouraged in all markets where the entrant can provide the "non-bottleneck" services at lower costs than the incumbent. TELRIC pricing, however, denies entry by efficient firms in some markets and permits entry of inefficient firms in others.

A simple numerical example demonstrates this point. Consider an ILEC that offers two services, residential and business local exchange service. For simplicity, assume each service requires an ILEC-provided UNE (*e.g.*, a loop) and a self-provisioned input (*e.g.*, retail marketing). Suppose the incremental costs of the loop and retail marketing are $12 and $3, respectively, and do not vary by type of customer. Further assume the retail price of residential service equals $14 and the retail price of business service equals $35. Now consider the economic consequences when the price of a loop is set equal to TELRIC. As shown in Table One below, an equally efficient entrant (*i.e.*, an entrant with the same marketing costs as the ILEC) would not find it profitable to serve residential customers.

TABLE ONE

TELRIC PRICING DENIES EFFICIENT ENTRY

Residential rate	$14
Less	
TELRIC UNE Rate	$12

Retail Marketing costs	$ 3
Equals	
Profit margin	-$ 1

In contrast, as shown in Table Two, a less efficient entrant (*i.e.*, an entrant with retail marketing costs double those of the ILEC) would find it profitable to serve business customers.

TABLE TWO

TELRIC PRICING ENCOURAGES INEFFICIENT ENTRY

Business rate	$35
Less	
TELRIC UNE Rate	$12
Retail Marketing costs	$ 6
Equals	
Profit margin	$17

These two examples demonstrate that the imposition of TELRIC prices distorts the CLEC's entry decision, contrary to Dr. Ankum's apparent belief.

Of course, economic efficiency would be enhanced if retail prices were rebalanced to reflect their underlying costs and UNE rates were adjusted accordingly to promote efficient entry. Indeed, this is GTE's primary proposal, as Mr. Trimble has explained.

Q. HOW DO YOU RESPOND TO DR. ANKUM'S CLAIM THAT PRICES SET AT TELRIC "INDUCE EFFICIENT MARKET ENTRY BY ALECS"?

A. The above examples clearly illustrate that this claim is without merit. TELRIC pricing (1) encourages CLECs to invest in their own facilities when it is more economical for the ILEC to provide the service and (2) destroys the incentive of CLECs to invest in their own facilities when it is more economical for them to provide the service than the ILEC.

Dr. Ankum appears to consider the case in which the resulting UNE price under GTE's proposal exceeds the stand-alone cost of the entrant, and the entrant's stand-alone cost is greater than GTE's TELRIC. (Ms. Murray takes a similar view at page 13 of her Rebuttal Testimony.) In this case, Dr. Ankum observes the entrant would have the incentive to construct its own (higher cost) facilities rather than lease them at TELRIC prices from the ILEC. However, this claim misconstrues GTE's pricing proposal. To ensure competitive neutrality, the DAC (equal to $17 in the above example for business customers) must be non-bypassable. When this is the case, the entrant will bypass GTE's facilities if and only if its stand-alone cost is lower than GTE's TELRIC, *i.e.*, it is a more efficient provider.

Q. HOW DO YOU RESPOND TO DR. ANKUM'S CLAIM THAT PRICES SET AT TELRIC ARE NOT DISCRIMINATORY?

A. As a threshold matter, Dr. Ankum provides no economic analysis to support this assertion. He simply asserts in a two-sentence answer that "any costs that deviate [from TELRIC], particularly those that are greater, are discriminatory." (Ankum RT at 6.) In contrast to Dr. Ankum's unsupported assertion, my Direct Testimony provides a detailed economic analysis demonstrating that, to the contrary, TELRIC prices are discriminatory whenever the retail rates contain implicit support, which is certainly the case in Florida. My testimony presented Professor Baumol's proof of this principle, which he calls the "Level-Playing Field Theorem." Not surprisingly, Dr. Ankum, as well as all other witnesses testifying on behalf of CLECs, did not even attempt to rebut this finding for the simple fact that it is correct.

TELRIC pricing is discriminatory because it creates subsidies for entrants at the expense of the ILECs. No competitive firm could offer services that contain subsidies for competitors, and thus encourage free-riding on its facilities, and still remain financially viable. By forcing the ILEC to accept prices that would never be agreed to by a competitive firm, TELRIC pricing places the ILEC at a competitive disadvantage relative to its competitors. The discriminatory impact on ILECs of TELRIC pricing is undeniable.

Q. DR. ANKUM ASSERTS THAT THE ACT APPEARS TO "PROHIBIT THE RECOVERY OF HISTORIC AND UNECONOMIC COSTS." PLEASE COMMENT.

A. First, Dr. Ankum appears to equate "historic" and "uneconomic" costs. However, he offers no evidence as to why any ILEC's historic costs are uneconomic. Dr. Ankum apparently believes that when the output of an engineering cost model produces "forward-looking costs" lower than the actual costs an ILEC incurred to build and maintain its local exchange network, the difference between "historic" and TELRIC costs should be deemed "uneconomic" and non-recoverable. An economic analysis of Dr. Ankum's position demonstrates the error in his logic.

As indicated above, firms in competitive markets do not replace their capital from scratch at the end of each period. Rather, firms economize by replacing capital when it is profitable to do so. Thus, the fact that there is a difference between an ILEC's actual costs and TELRIC does not mean that this difference is accounted for by "uneconomic" costs. That difference, rather, represents capital that was efficiently purchased and should not on economic grounds be replaced at the present time with new capital investments.

Second, Section 252(d)(1)(A) of the Act does not prohibit recovery of actual costs, as Dr. Ankum suggests. Because historic costs are evaluated in rate-of-return proceedings, Dr. Ankum assumes these costs cannot be included in UNE rates. Such a reading of the Act would violate the "reasonable profit" provision because a firm must recover all its costs before any profit can be earned. A more sensible reading of this section of the Act is that it simply requires that UNE prices be established without conducting a rate of return proceeding.

Q. DR. ANKUM ASSERTS THAT TELRIC PRICING PROVIDES ILECS WITH A NORMAL PROFIT BECAUSE THE METHODOLOGY INCLUDES THE COST OF CAPITAL. PLEASE COMMENT.

A. There are two problems with his assertion. First, Dr. Ankum implicitly assumes that CLECs will fail to maximize their profits by not utilizing both resale services and UNEs. However, when the retail structure is such that the resale rate for a service is less than the associated UNE cost, CLECs, of course, will choose to enter via resale. In contrast, when the UNE cost is less than the resale rate, CLECs will choose to enter via UNEs. There is evidence in this proceeding that precisely this entry pattern will be utilized by CLECs. Mr. Eric Geis, testifying on behalf of Rhythms Links, stated that in addition to leasing UNEs: "Through partnerships with other carriers and purchase of resold services, Rhythms will be able to provide the customer with a full suite of telecommunication services." (Geis RT at 3.) This pattern of entry (which was discussed in my Direct and Rebuttal Testimonies and in the articles attached to my Direct Testimony) ensures that TELRIC pricing will not allow the ILEC to earn a normal profit. In particular, when CLECs utilize resale entry in this example, the ILEC incurs costs not covered by the resale rate. Dr. Ankum's TELRIC pricing proposal includes no provision for recovering these costs and, as such, does not allow the ILEC to earn a normal profit.

Moreover, even if CLECs failed to maximize their profits by utilizing resold services in combination with UNEs, and instead only leased UNEs, Dr, Ankum's assertion would still be false when the output of an engineering cost model yields "forward-looking costs" less than the ILEC's actual total costs. Providing a firm a return on capital in the TELRICs hardly compensates it for the loss it incurs in this situation.

Q. DO ANY OF THE WITNESSES ARGUE THAT TELRIC PRICING PRODUCES AN OUTCOME DIFFERENT THAN A "LEVEL PLAYING FIELD"?

A. Yes. Ms. Senatore states: "The monopoly position of the ILEC warrants a different treatment than if a level playing field truly existed." (Senatore RT at 6.) Thus, Ms. Senatore advocates prices based on "forward-looking costs" which she freely admits are less than market prices. Ms. Senatore's statements can only be interpreted as a direct request for an entry subsidy. Obviously, if forward-looking costs are less than market prices, by definition they cannot be compensatory.

Q. MS MURRAY SATES THAT TELRIC PRICING WILL NOT UNDERMINE THE ILEC'S ABILITY TO PROVIDE UNIVERSAL SERVICE. PLEASE COMMENT.

A. On page 13 of her rebuttal testimony, Ms. Murray acknowledges that deaveraged prices that prevent uneconomic bypass "enhance the incumbent's ability to provide universal service." But having identified the correct objective, Ms. Murray nevertheless claims that deaveraging UNE prices on the basis of TELRIC deters uneconomic bypass. It can be easily demonstrated that her analysis is wrong.

Consider the example below in which a statewide average TELRIC price of $12 is established for a UNE. Further assume that the ILEC's deaveraged TELRIC equals $10..

TABLE THREE

TELRIC PRICING ENCOURAGES INEFFICIENT ENTRY

Business rate	$35
Less	
Statewide Average	
TELRIC UNE Rate	$12
ILEC's Retail Marketing Costs	$6
Equals	
Profit margin	$17

Ms. Murray's point is that an entrant having costs of $11 would engage in uneconomic bypass of the UNE. For this reason, she advocates a geographically deaveraged price to deter uneconomic bypass of this UNE.

However, Ms. Murray fails to consider the effect her proposal has on economic bypass generally. In particular, an entrant leasing the UNE at the geographically deaveraged price of $10 and facing the $35 retail rate can be substantially less efficient than the ILEC in the provision of the other inputs required for that service. In the example above, a CLEC would find it profitable to enter even if its retailing costs were as much as $25 (*i.e.*, approximately four times those of the incumbents). Thus, Ms. Murray's proposal exacerbates the incentive of the CLECs to engage in uneconomic bypass because it increases the profit margin or opportunity for arbitrage.

In sum, Ms. Murray recognizes the critical importance of preventing uneconomic bypass so as to enhance the incumbent's ability to provide universal service, but she advances a proposal that provides an even greater incentive for uneconomic bypass. Moreover, Ms. Murray offers no rebuttal of my Direct Testimony which demonstrated that the DAC is the only mechanism that prevents uneconomic bypass when the ILEC's retail rate structure contains implicit support for universal service.

Q. MS. MURRAY ASSERTS THAT TELRIC PRICING SATISFIES THE NONDISCRIMINATION STANDARD IN THE ACT. PLEASE COMMENT.

A. Ms. Murray correctly recognizes that the nondiscrimination standard is satisfied when competitors are treated in a competitively neutral manner. However, she states incorrectly that competitive neutrality is achieved by TELRIC pricing because, in her opinion, that is the implicit price the incumbent charges itself when it uses the same functionality to provide retail services.

As discussed in my Direct Testimony, competitive neutrality is achieved when incumbents are not favored in the final-product market over entrants or the reverse. Contrary to Ms. Murray's assertion, TELRIC pricing fails to satisfy this objective when the retail rate structure contains implicit support (see the Level Playing Field Theorem in Professor Baumol's article, attached to my Direct Testimony). Any so-called transfer price is irrelevant to the determination as to whether a UNE price is competitively neutral.

Using the above example, suppose the "retail division" of the ILEC pays a transfer price of $29 to the "wholesale division" for the UNE even if CLECs pay the $12 TELRIC price. Ms. Murray would conclude that the $29 transfer price discriminates against the ILEC since it exceeds the TELRIC. But this is incorrect since the transfer price simply shifts revenues from one "division" of the ILEC to another and does not competitively disadvantage the ILEC. Similarly, if the ILEC's so-called transfer price was $12 for the UNE and the CLEC's price was $29, this would not competitively disadvantage the CLEC because the retail price is $35. An equally efficient entrant would have the same profit margin as the ILEC, given the $17 of common costs allocated to the ILEC's retail rate.

II. An Economic Analysis of the Witnesses' Criticisms of the DAC

Q. DR. ANKUM STATES GTE'S DAC PROPOSAL SHOULD NOT BE ADOPTED BECAUSE IT (1) RESULTS IN PRICES FOR UNES THAT DEVIATE FROM ECONOMIC COSTS; (2) IGNORES CLECS' NON-RECURRING CHARGES; (3) DOES NOT TAKE INTO ACCOUNT ILECS' RETAIL PRICING FLEXIBILITY; AND (4) REINCARNATES OF THE EFFICIENT COMPONENT PRICING RULE. PLEASE COMMENT.

A. Dr. Ankum's response to the proposed DAC completely ignores the economic analysis provided in my Direct Testimony regarding the benefits of the proposal. In particular, he makes no attempt to rebut my evidence that the DAC is the only mechanism that ensures deaveraging of UNEs will achieve the Commission's goals of promoting competitive entry in all markets while preserving universal service.

Dr. Ankum's statement that the resulting UNE prices deviate from economic costs stems from his incorrect notion of economic costs. As noted above, TELRIC prices are simply hypothetical constructs resulting from the engineering cost models that are devoid of dynamic market conditions. Competitive prices will not tend to be equated to the lowest cost of duplicating service with the most recent technology. Thus, while Dr. Ankum correctly asserts that prices in competitive markets tend toward economic costs, he incorrectly asserts economic costs equal TELRIC.

Dr. Ankum is correct that the DAC ignores the CLEC's nonrecurring charges. This is entirely appropriate because these charges represent additional costs incurred by the ILEC that are caused by the CLEC's request for service. Economic efficiency requires that the CLEC generate cost savings sufficient to cover these additional costs. These costs should not be subtracted from the DAC because that would constitute an entry subsidy.

Dr. Ankum's criticism that the DAC ignores the potential consequences of GTE's retail pricing flexibility is based on a misunderstanding of the DAC mechanism. That mechanism takes into account GTE's retail price. If that price falls, commensurate reductions in the DAC are passed on to CLECs.

Finally, Dr. Ankum incorrectly asserts that GTE's DAC proposal a reincarnation of the ECPR rule rejected by FCC. The FCC's version of ECPR differs from the DAC in that it assumes the retail prices remain fixed, as do the corresponding UNE prices. As the FCC stated "the ECPR does not provide any mechanism for moving prices toward competitive levels; its simply takes prices as given." (FCC Local Competition Order, Docket 96-98, at para. 709 (1996).) This is not how the DAC works. As retail prices adjust over time in response to competitive forces, the DAC changes commensurately.

Q. MS. MURRAY ASSERTS THAT GTE'S DAC PROPOSAL IS UNDESIRABLE BECAUSE IT WOULD SEVERELY REDUCE THE PRESSURE ON AN ILEC TO REDUCE RETAIL PRICES TO COSTS. PLEASE COMMENT.

A. Ms. Murray fails to appreciate the full nature of GTE's deaveraging proposal. If this Commission chooses to move retail prices closer to cost to promote economic efficiency, it can accomplish that goal by rebalancing GTE's retail rates and aligning GTE's retail and wholesale rate structures. This approach would enhance the efficient allocation of resources at the retail level and ensure competitively neutral UNE prices. However, should the Commission choose to maintain the current retail rate structure, that choice would be undermined by Ms. Murray's deaveraging proposal. Ms. Murray is correct in her assessment that the arbitrage created by her proposal would force rates toward costs, but in doing so it would result in one of two possible outcomes: (1) the Commission's policy goal of promoting universal service would be adversely affected, given the need to increase basic rates or (2) the ILEC will be unable to remain solvent, given that price reductions will occur in some markets, but rates are not permitted to rise in others to cover the shortfall.

Q. **MS. MURRAY ASSERTS THAT GTE'S DAC PROPOSAL IS UNNECESSARY BECAUSE (1) GTE WILL HAVE AMPLE TIME TO RID ITSELF OF INEFFICIENT COSTS AND (2) GTE HAS THE OPTION TO REQUEST INTERIM UNIVERSAL SERVICE RELIEF. (MURRAY RT AT 26.) PLEASE COMMENT.**

A. Ms. Murray's first argument implicitly assumes that GTE has "inefficient costs." This statement, however, is offered without a scintilla of evidence. Moreover, as noted above, Ms. Murray ignores the fact that GTE has operated under a price cap mechanism since 1996 and, as she is aware, the company has the economic incentive to operate efficiently. Ms. Murray offers no evidence that ILECs have made imprudent investments or that the Commission has been derelict in its duty to protect ratepayers from such inefficient investments.

Ms. Murray's second argument ignores the fact that GTE has proposed a mechanism in this proceeding to remove the implicit support embodied in retail rates. This is GTE's first proposal which Ms. Murray and other witnesses have rejected as unnecessarily delaying competitive entry. The DAC proposal would not entail any delay or require the initiation of a new Commission hearing to establish support for universal service. The DAC could be initiated immediately. Moreover, as Mr. Trimble discusses, interim, company-specific measures cannot effect the kind of comprehensive, industry-wide solution that is necessary to achieve competitive neutrality.

Q. **FINALLY, MS. MURRAY ASSERTS THAT GTE'S DAC PROPOSAL IS UNWORKABLE BECAUSE IT LINKS UNE PRICES TO THE PRICES OF BUNDLED WHOLESALE SERVICES. PLEASE COMMENT.**

A. Ms. Murray is of the opinion that one should accept the negative consequences of uneconomic entry (which she admits elsewhere in her testimony is detrimental to universal service) because it is too cumbersome to prevent the problem. She provides a laundry list of possible complications without offering any constructive proposal for dealing with the problem. The Commission should recognize that the DAC is a valuable mitigation device. If implemented it will serve to broaden the scope of competition in Florida and lessen the adverse consequences of arbitrage. A workable DAC, as a practical matter, would specify separate charges for residential and business customers based on average purchase patterns and would vary geographically based on observed cost differences. Such an approach, while not perfectly tailored to the usage patterns of individual customers, will yield substantial competitive benefits.

Q. **HAS AT&T ARGUED ELSEWHERE THAT UNE PRICES SHOULD BE LINKED TO RETAIL RATES, AS YOU RECOMMEND?**

A. Yes. In a notice of *ex parte* communication before the California Public Utilities Commission ("CPUC"), AT&T stated that an adjustment to proposed TELRIC UNE prices was required if "Californians are ever to enjoy the innovative services and competitive prices that only competition can bring." (AT&T Letter to Commissioner Josiah L. Neeper, CPUC, Aug. 26, 1999.) AT&T stated that UNE-based competition would not happen unless proposed TELRIC UNE rates were adjusted to take into account the universal service support embodied in residential retail rates. AT&T's concern with the proposed TELRIC UNE rates was that they did not enable the company to profitably serve residential customers. Therefore, AT&T requested that the CPUC reduce the costs of the "UNE platform" to take into account retail rates. Moreover, AT&T stated that this adjustment would not violate Section 252(d)(1)(A) of the Act.

AT&T's proposal recognized explicitly the importance of taking the ILEC's retail rate structure into account when establishing rates for unbundled network elements. Their reason for doing so was straightforward: retail rates in California are not cost based. Instead, as is the case in Florida, they reflect that Commission's policy goals regarding affordability and the provision of universal service. As noted above, when this situation exists, TELRIC UNE rates will exceed retail prices in some markets (*e.g.*, residential) and will be below retail prices in other markets (*e.g.*, business). As AT&T correctly observed, this problem is corrected by adjusting TELRIC

UNE prices to account for universal service support implicit in retail rates. Of course, this adjustment must be applied symmetrically: it requires a downward adjustment when TELRIC exceeds the retail rate (less avoided retailing costs) and an upward adjustment when TELRIC is less than the retail rate (less avoided retailing costs). AT&T's *ex parte* communication with the CPUC reinforces this finding.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.