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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation into pricing of)
unbundled network elements)
_____)

Docket No. 990649-TP
Filed: July 31, 2000

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REBUTTAL TESTIMONY

OF

GEORGE S. FORD

ON BEHALF OF

Z-TEL COMMUNICATIONS, INCORPORATED

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6 **Z-TEL COMMUNICATIONS, INCORPORATED**

7 **DOCKET NO. 990649-TP**

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

9 A. My name is George S. Ford. I am the Chief Economist for Z-Tel Communications,
10 Incorporated ("Z-Tel"). My business address is 601 South Harbour Island Boulevard, Suite
11 220, Tampa, Florida 33602.

12 **Q. BRIEFLY DESCRIBE YOUR EDUCATION EDUCATIONAL BACKGROUND**
13 **AND RELATED PROFESSIONAL EXPERIENCE.**

14 A. I received a Ph.D. in Economics from Auburn University in 1994. My graduate work
15 focused on the economics of industrial organization and regulation with course work
16 emphasizing applied price theory and statistics. After graduate school I spend two years at
17 the Federal Communications Commission in the Competition Division of the Office of the
18 General Counsel. The Competition Division of the FCC was tasked with ensuring that FCC
19 policies were consistent with the goals of promoting competition and deregulation across the
20 communications industries. I left the FCC to become a Senior Economist in the Law and

1 Public Policy group at MCI Worldcom where I was employed for three years. MCI
2 Worldcom's Law and Public Policy group is responsible for developing MCI Worldcom's
3 public policy positions for both federal and state regulatory proceedings. While at MCI
4 Worldcom, I filed declarations and economic studies on a variety of topics with both federal
5 and state regulatory agencies. In addition to my professional experience, I am an Affiliated
6 Scholar with the Auburn Policy Research Center at Auburn University in Alabama. Through
7 this professional relationship, I have maintained an active research agenda on
8 communications issues and have published research papers in a number of academic journals
9 *Journal of Law and Economics*, the *Journal of Regulatory Economics*, the *Review of*
10 *Industrial Organization*, among others. I regularly speak at conferences, both at home and
11 abroad, on the economics of telecommunications markets and regulation.

12 **Q. COULD YOU DESCRIBE Z-TEL'S SERVICE OFFERINGS?**

13 A. Z-Tel is a Tampa-based, integrated service provider that presently provides competitive
14 local, long distance, and enhanced services to residential consumers in New York,
15 Pennsylvania, Massachusetts, and Texas, with plans to expand nationally as the unbundled
16 network element platform ("UNE-P") becomes available at reasonable rates. At present, Z-
17 Tel serves nearly 200,000 *residential* customers ("Z-Tel Increases Subscribers by 97%
18 During the Second Quarter to Reach a Total of 170,000," Company Press Release, Monday
19 July 10).

1 Z-Tel's service is not just a simple bundle of traditional telecommunications services, but
2 is unique in that it combines its local and long distance telecommunications services with
3 Web-based software that enables each Z-Tel subscriber to organize his or her
4 communications, including email, voicemail, fax, and even a Personal Digital Assistant
5 ("PDA"), by accessing a personalized web-page via the Internet. In addition, the personal
6 Z-Line number can be programmed to follow the customer anywhere he or she goes via the
7 "Find Me" feature. Other service features include low long distance rates from home or on-
8 the-road and message notification by phone, email, or pager. Customers can also initiate
9 telephone calls (including conference calls in the near future) over the traditional phone
10 network, using speed-dial numbers from their address book on their personalized web page.

11 **Q. WHAT INTEREST DOES Z-TEL COMMUNICATIONS HAVE IN THIS**
12 **PROCEEDING?**

13 A. The Z-Tel service bundles many different communications services – voicemail, email,
14 fax, Internet, PDAs, local and long distance telecommunications – into an easy-to-use
15 communications control center. One element of that bundle is local exchange
16 telecommunications service. To provide the local exchange portion of its service offering,
17 Z-Tel must purchase unbundled network elements from incumbent local exchange carriers.
18 At present, the primary means of local exchange service provision is UNE-P. Because Z-Tel
19 is dependent upon the local exchange carrier's UNEs to provide service at this time, Z-Tel's
20 interest in this and related proceedings where the cost of UNEs will be determined is
21 apparent. The recurring and non-recurring costs for UNEs are a substantial percentage of Z-

1 Tel's costs. Further, Z-Tel is based in Tampa, Florida. Consequently, Z-Tel has a sincere
2 interest in offering its services to residential consumers in the State of Florida.

3 **Q. WHAT ELEMENTS OF THIS PROCEEDING ARE IMPORTANT TO A ALEC'S**
4 **ABILITY TO OFFER SERVICE IN THE STATE OF FLORIDA?**

5 A. A ALEC's decision to offer service in Florida's local exchange market – or any other
6 market for that matter - depends critically on the expected relationship between the revenues
7 and costs. Revenues must be sufficiently large to cover all expenses including the cost of
8 UNEs and the ALEC's own internal cost. The cost of UNEs can be a substantial share of per-
9 customer cost and this is particularly true for a ALEC offering competitive service to the
10 residential market with UNE-P.

11 **Q. WILL THE RATES DETERMINED IN THIS PROCEEDING EFFECT THE**
12 **PROSPECTS FOR COMPETITION IN THE STATE OF FLORIDA?**

13 A. Absolutely. The prospect for competition is inversely related to the prices for UNEs – the
14 higher the rates, the less likely competition will develop. Inflated non-recurring charges
15 (NRCs), in particular, are potent entry barriers. In setting the rates for UNEs, the FLPSC will
16 determine whether or not the residents of Florida will reap the full benefits of a competitive
17 local exchange telecommunications market. In fact, because all three of Florida's ILECs
18 (BellSouth, GTE, and Sprint) have proposed their own rates, and these rates differ
19 substantially, the FLPSC will determine *which* Floridians reap the benefits of a competitive
20 local exchange market. It is possible that the benefits of competition will be restricted to

1 regions served by particular carriers whose UNE rates are reasonable while the monopoly
2 status-quo remains in other regions where UNE rates are in excess of cost.

3 **Q. HAVE YOU REVIEWED THE UNE COST MODELS SUBMITTED IN THIS**
4 **PROCEEDING BY BELLSOUTH?**

5 A. Yes. I have reviewed the testimony related to and the manuals of the cost models
6 submitted on behalf of BellSouth – Florida ("BS-FL").

7 **Q. AS AN ECONOMIST, WHAT IS YOUR VIEW OF THE BS-FL MODELS?**

8 A. With a few relatively minor changes -- some of which are described in my testimony and
9 other in the testimony sponsored by other ALECs -- I believe the BS-FL cost model can
10 produce reasonable estimates of UNE costs. UNE rates that incorporate these and other
11 recommended changes may make it possible for the citizens of Florida, at least those located
12 in BS service areas, to begin experiencing the benefits of competition in the local exchange
13 market. These benefits are already accruing to residential consumers in New York as
14 discussed in the testimony of Mr. Gillan.

15 **Q. GIVEN THE 8TH CIRCUIT DECISION, DO YOU BELIEVE ALTERATIONS TO**
16 **THE COST MODELS ARE REQUIRED?**

17 A. I have reviewed the decision of the 8th Circuit. However, I am not prepared to make any
18 firm recommendations as to its interpretation at this point. The testimony of Mr. Gillan does
19 consider the impact of the Court's decision and, in general, I concur with his analysis.

1 However, I am not prepared at this time to recommend specific changes to the models to
2 bring them into compliance with the decision. Even if the models need to be changed in the
3 future to become more compatible with the 8th Circuit's decision, there is no reason to put
4 off the prospect for competition in Florida during the interim period by delaying this
5 proceeding.

6 **Q. WILL YOU PLEASE SUMMARIZE YOUR RECOMMENDED CHANGES?**

7 A. Yes. First, some of the changes I recommend were covered in Phase 1 of this proceeding.
8 In particular, Phase 1 included testimony related to the cost of capital and depreciation lives.
9 Both of these inputs have a meaningful effect on UNE rates, so I encourage the Commission
10 to carefully consider the testimony filed on these issues in Phase I. Generally, I support the
11 testimony and conclusions reached by John Hirshliefer regarding the cost of capital and
12 Michael Majoros regarding depreciation. The cost of capital, in particular, has a substantial
13 effect on UNE rates and, therefore, a substantial effect on the prospect for competition.
14 Because those issues have been covered in detail earlier in this proceeding, my current
15 testimony does not address either the cost of capital or depreciation.

16 **Q. WHAT RECOMMENDATIONS ARE COVERED IN YOUR TESTIMONY?**

17 A. I believe the BS-FL model uses the inappropriate discounts to estimate switching
18 investments. Specifically, I believe the computation of the "replacement" discount is flawed.

1 **Q. WHAT DISCOUNTS DOES BS-FL APPLY TO SWITCH INVESTMENTS?**

2 A. According to the testimony of Joseph Page, switch vendors offer a bi-furcated discount
3 structure in which the purchase of a new switch is subject to a larger discount (the
4 "replacement" discount) than the purchase of an upgrade to an existing switch (i.e., the
5 "growth" discount). For growth discounts, the BS-FL model uses those discounts "[s]tated
6 in BellSouth's contracts with the switch vendors (Page Testimony, p. 23)." However, for
7 replacement discounts, BS-FL does not use contracted discounts but computes discounts
8 based on a comparison of historical contract prices to the current (non-discounted) output of
9 SCIS/MO. No reason is given why the contracted "replacement" discounts are not employed.

10 **Q. DOES THIS APPROACH TO CALCULATING DISCOUNTS UNDERSTATE**
11 **THE DISCOUNT?**

12 A. Possibly, yes. From the testimony of Joseph Page (p. 23), it appears as if the
13 "replacement" discount is computed using the following formula:

14 $d = 1 - P_h/P_c$

15 where *d* is the discount, *P_h* is the historical price paid for replacement offices, and *P_c* is the
16 current (non-discounted) price estimated by SCIS/MO. For example, if the historical price
17 is \$1M and SCIS/MO estimates the price as \$2M, then the discount is 50%.

18 In a world of declining switch prices (as described in Mr. Page's Testimony, p. 10), BS-FL's
19 computation of the replacement discount potentially is understated. To illustrate, assume the

1 historical, undiscounted price was the switch investment was \$3M. At this price, the discount
2 received at the time of purchase was 66% ($= 1 - \$1M/\$3M$) not the 50% calculated in the
3 numerical example above. Thus, using the BS-FL approach to calculate the replacement
4 discount, rather than using contract discounts as in the case of growth discounts, may deflate
5 the replacement discount and raise switching costs. Switching cost are an important cost
6 element of UNE-P, so inflated switching costs may impede competition.

7 **Q. WERE YOU ABLE TO MEASURE THE IMPACT OF THE BS-FL**
8 **COMPUTATION ON THE REPLACEMENT DISCOUNT?**

9 A. No. It is unclear what effect this approach actually has on the discount, since the specifics
10 regarding the calculations were not provided in Mr. Page's testimony. Nor have I personally
11 reviewed any switch contracts between BS-FL and its switch vendors.

12 **Q. WHAT DO YOU RECOMMEND?**

13 A. If possible, the "replacement" and "growth" discounts should both equal the stated
14 discounts in BellSouth's contracts. I see no reason (other than to reduce the discount) why
15 the replacement discount should be treated differently than the "growth" discount. If there
16 is a valid reason the "replacement" discounts cannot be obtained directly from contracts, then
17 the historical contract prices and the non-discount prices from SCIS/MO must be from the
18 same time period to avoid discount deflation. If prices change frequently, the time periods
19 chosen for price comparisons are most relevant.

1 **Q. DOES THAT CONCLUDE YOUR TESTIMONY?**

2 **A. Yes.**

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the Rebuttal Testimony of George Ford on behalf of Z-Tel Communications, Incorporated has been furnished by Hand Delivery to * and by overnight delivery and E-mail this 31st day of July 2000, to:

*Beth Keating

Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

*Nancy B. White

c/o Nancy H. Sims
BellSouth Telecommunications, Inc.
150 South Monroe Street, Suite 400
Tallahassee, FL 32301-1556

Eric J. Branfman and Morton J. Posner
Swidler Berlin Shereff Friedman, LLP
3000 K. Street, NW, Suite 300
Washington, D.C. 20007-5116

James Falvey

e.spire Communications
133 National Business Parkway
Suite 200
Annapolis Junction, MD 20701

*Michael A. Gross

Vice President, Regulatory Affairs
& Regulatory Counsel
Florida Cable
Telecommunications Assoc.
310 North Monroe Street
Tallahassee, FL 32301

*Richard Melson

Hopping, Green, Sams & Smith, PA
P.O. Box 6526
Tallahassee, FL 32314

*Marsha Rule

AT&T
101 North Monroe Street, Suite 700
Tallahassee, Florida 32301-1549

Jeremy Marcus

Blumenfeld & Cohen
1615 M. Street, N.W., Suite 700
Washington, DC 20036

Catherine Boone

Covad Communications Company
Ten Glenlake Parkway
Suite 650
Atlanta, Georgia 30328

*Norman H. Horton, Jr.

Messer, Caparello & Self, P.A.
215 South Monroe Street, Suite 701
Tallahassee, Florida 32302-1876

Kimberly Caswell

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

Scott A. Sapperstein

Senior Policy Counsel
Intermedia Communications, Inc.
3625 Queen Palm Drive
Tampa, Florida 33619-1309

*Donna Canzano McNulty
MCI WorldCom, Inc.
325 John Knox Road
The Atrium Building, Suite 105
Tallahassee, Florida 32303

*TCG South Florida
c/o Kenneth Hoffman
Rutledge Law Firm
Post Office Box 551
Tallahassee, Florida 32302

Andrew Isar
Telecommunications Resellers Assoc.
4312 92nd Avenue, N.W.
Gig Harbor, WA 98335

*Charles J. Rehwinkel
Sprint-Florida, Incorporated
P.O. Box 2214
Tallahassee, FL 32316-2214

John Kerkorian
5607 Glenridge Drive
Suite 310
Atlanta, Georgia 30342

*Mark E. Buechele
Koger Center
Ellis Building
Suite 200
1311 Executive Center Drive
Tallahassee, Florida 32301-5027

Rodney L. Joyce
Shook, Hardy & Bacon, LLP.
600 14th Street, N.W.
Suite 800
Washington, D.C. 20005-2005

Stephen P. Bowen
Blumfield & Cohen
4 Embarcadero Center, Suite 1170
San Francisco, CA 94111

Glenn Harris
North Point Communications, Inc.
222 Sutter Street, 7th Floor
San Francisco, CA 94108

*Peter Dunbar
Pennington, Moore, Wilkinson, Bell &
Dunbar, P.A.
Post Office Box 10095
Tallahassee, Florida 32302

*Laura L. Gallagher
Laura L. Gallagher, P.A.
101 East College Avenue, Suite 302
Tallahassee, Florida 32301

*Angela Green, General Counsel
Florida Public Telecommunications Assoc.
125 S. Gadsden Street, Suite 200
Tallahassee, Florida 32301-1525

*Bruce May
Holland Law Firm
Post Office Drawer 810
Tallahassee, Florida 32302

Jonathan E. Canis
Michael B. Hazzard
Kelly Drye & Warren, LLP
1200 19th Street, NW, Fifth Floor
Washington, D.C. 20036

Jim Lamoureux, Senior Attorney
1200 Peachtree Street, Suite 1200
Atlanta, GA 30309

*Jeffrey Wahlen
Ausley Law Firm
Post Office Box 391
Tallahassee, Florida 32301

*Norman Horton, Jr.
Post Office Box 1876
Tallahassee, Florida 32302


Joseph A. McGlothlin