ORIGINAL

BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

IN RE: PETITION FOR EXPEDITED REVIEW AND) CANCELLATION OF BELLSOUTH) TELECOMMUNICATIONS, INC.'S KEY CUSTOMER) PROMOTIONAL TARIFFS AND FOR) INVESTIGATION OF BELLSOUTH'S PROMOTIONAL) PRICING AND MARKETING PRACTICES, BY) FLORIDA DIGITAL NETWORK, INC.)	DOCKET NO. 020119-TP
IN RE: PETITION FOR EXPEDITED REVIEW AND) CANCELLATION OF BELLSOUTH) TELECOMMUNICATIONS, INC.'S KEY CUSTOMER) PROMOTIONAL TARIFFS BY FLORIDA) COMPETITIVE CARRIERS ASSOCIATION)	DOCKET NO. 020578-TP

REBUTTAL TESTIMONY

OF

WILLIAM E. TAYLOR, Ph.D.

ON BEHALF OF

BELLSOUTH TELECOMMUNICATIONS, INC.

NOVEMBER 25, 2002

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NOVEMBER 25, 2002

1 ## I. INTRODUCTION

2 **Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND CURRENT POSITION.**

3 A. My name is William E. Taylor. I am Senior Vice President of National Economic Research
4 Associates, Inc. ("NERA"), head of its Communications Practice, and head of its Cambridge
5 office located at One Main Street, Cambridge, Massachusetts 02142.

6 **Q. DID YOU TESTIFY PREVIOUSLY IN THESE DOCKETS?**

7 A. Yes. I filed direct testimony in this matter on October 23, 2002. That testimony lists my
8 qualifications.

9 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

10 A. I have been asked by BellSouth Telecommunications, Inc. ("BellSouth") to respond to
11 economic issues raised in the testimonies of Joseph Gillan and Danyelle Kennedy (on behalf
12 of the Florida Competitive Carriers Association) and Michael P. Gallagher (on behalf of
13 Florida Digital Network, Inc.) filed on October 23, 2002 in these Dockets. In general, these
14 witnesses urge the Commission to impose additional restrictions on BellSouth's ability to
15 compete through temporary promotions, targeted price reductions, bundling of services, and
16 term and volume discounts. Both price and non-price limitations on BellSouth's promotions
17 are proposed. Price limitations would take the form of excessive price floors—applying

1 only to BellSouth—to address alleged threats of price squeezes and cross-subsidies.

2 Proposed non-price limitations on BellSouth's behavior include

3 • a redefinition of what it means for customers to be "similarly-situated,"

4 • restrictions on the terms of volume and term discount plans,

5 • absolute limitations (unrelated to cost) on the size of allowable BellSouth discounts,
6 tied to BellSouth's loss of market share, and

7 • limits on the duration and frequency of BellSouth promotions.

8 In general, these proposed restrictions are anticompetitive and, if imposed, would
9 eviscerate the competitive process in Florida and deny both ALEC customers and BellSouth
10 customers the benefits of competition.

11 It is important to bear in mind that promoting competition to allow the free market to
12 function will generally serve the goal of lower prices, a wider array of better services, and
13 the more efficient allocation of resources than would otherwise be the case. Rules that limit
14 a firm's ability to lower its prices or structure its promotional offerings should be
15 approached with great caution, because lower prices are precisely what competition is
16 designed to promote. This Commission should be especially skeptical of a proposal
17 suggested by any company that would prevent its competitor from reducing prices, because
18 companies would always prefer that their competitors charge higher prices.

19 Restricting the incumbent by an excessive price floor immediately reduces consumer
20 welfare by holding prices up. Additionally, it reduces future consumer welfare by creating a
21 price umbrella for competitors, which not only protects inefficient competitors but also
22 relieves the more efficient competitors from constantly striving to maintain their competitive
23 edge by lowering prices. To the extent that price floors are necessary, Sections

1 364.051(5)(b-c) of the Florida Statutes clearly express the standards to be used to prevent
2 price squeezes and cross-subsidies, and no additional standards are necessary or
3 appropriate.

4 Although many consumers benefit from competition by switching to a new provider
5 that offers lower-priced or higher-quality services or more appealing packages of services,
6 other consumers also benefit from competition by receiving better services, or packages of
7 services, at lower prices from their incumbent supplier. In Florida, business customers are
8 increasingly switching to competitive suppliers, presumably because of additional benefits
9 that accrue to them from doing so. However, those who have not switched from—or have
10 chosen to stay with—BellSouth as the incumbent supplier can also benefit from competition
11 to the extent that BellSouth is able to respond to competitors' offerings.

12 I also want to emphasize the importance of allowing all firms flexibility to structure
13 their promotional offerings to respond to the varying market conditions that exist in the state.
14 Section 364.051(5)(a) of the Florida Statutes emphasizes this requirement. It endorses
15 pricing and product flexibility, including geographic and customer deaveraging, contracts,
16 packaging and bundling, and volume and term discounts, as long as the result is not
17 anticompetitive and does not unreasonably discriminate among similarly-situated
18 customers.[1] To balance these requirements, we need to know how to determine whether a
19 proposed promotion is procompetitive or anticompetitive.

[1] "Nothing contained in this section shall prevent the local exchange telecommunications company from meeting offerings by any competitive provider of the same, or functionally equivalent, nonbasic services in a specific geographic market or to a specific customer by deaveraging the price of any nonbasic service, packaging nonbasic services together or with basic services, using volume discounts and term discounts, and offering individual contracts. However, the local exchange telecommunications company shall not engage in any

(continued...)

1 An anticompetitive *price* is one that violates the standards provided by the Statutes,
2 as discussed above. A *non-price* anticompetitive act is one that diminishes the level of
3 competition in the market. As a general proposition, when a company with market power
4 acts without a valid business purpose—i.e., its conduct makes no business sense apart from
5 its tendency to exclude competition and thereby create or maintain market power—the
6 conduct can be deemed anticompetitive if it in fact diminishes competition. While a firm
7 may complain that a rival's conduct that harms it is a non-price anticompetitive act, that
8 complaint seldom will have merit because any action a rival takes to better serve and attract
9 more customers is likely to make life more difficult for its competitors and reduce their
10 profit. For this reason, economics distinguishes between conduct that is *anticompetitor*
11 from that which is *anticompetitive* largely by asking whether the conduct in question
12 increases or decreases consumer welfare. By these standards, restricting the degree,
13 frequency, and duration of BellSouth promotions would restrict procompetitive behavior and
14 harm consumers by reducing the vigor of competition in Florida. Term and volume
15 discounts expand consumer choice and ultimately expand demand, increasing consumer
16 welfare directly. In addition, because charging different prices to differently-situated
17 customers can expand demand and increase consumer welfare, artificially restricting price
18 flexibility by narrowing the definition of "similarly situated" customers would be
19 anticompetitive.
20 Finally, the fact that all of the restrictions proposed by ALECs would be imposed

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(...continued)

anticompetitive act of practice, nor unreasonable discriminate among similarly situated customers."

1 only on BellSouth would distort the process of competition in Florida and reduce the
2 benefits of that competition to Florida consumers.

3 II. RESTRICTIONS ON PRICE REDUCTIONS: PRICE FLOORS

4 A. Imputation

5 **Q. MR. GILLAN PROPOSES (AT 4) A UNE-BASED IMPUTATION TEST TO BE**
6 **APPLIED TO INDIVIDUAL SERVICES AND PROMOTIONS. IS SUCH AN**
7 **IMPUTATION TEST NECESSARY IN FLORIDA?**

8 A. No. Under the Section 364.051(5)(c) standard, the minimum retail price must cover the
9 direct cost of the service plus—to the extent not already included in the direct cost—the
10 price charged by the incumbent for any "monopoly service." For this purpose, I equate the
11 term "monopoly service" with "essential facility." The purpose of the Section
12 364.051(5)(c) standard is to ensure that competitors compete on an even footing with
13 BellSouth with respect the price they pay for the use of any BellSouth essential facility.
14 Because the Key Customer promotion is, and was, subject to resale at an avoided cost
15 discount, carriers can always purchase any telecommunications service that BellSouth sells
16 under the promotion (including any essential facility) at a regulated price designed to be
17 consistent with Florida's imputation price floor. That is, even if BellSouth were to offer a
18 service at a discount off the retail price (under the Key Customer promotion), an ALEC that
19 resells that promotional service would receive the full benefit of both that discount as well
20 as the avoided cost discount that applies to resold services.[2] The resale price the competitor

[2] For purposes of illustration, if the Key Customer retail price discount to end user customers were *x* percent,
(continued...)

1 pays BellSouth for any service (including any essential facility that is a component of that
2 service), therefore, will always be less than the price BellSouth charges its retail customers
3 for the same service (including any essential facility component). Moreover, the discount off
4 of BellSouth's promotional price will be sufficient for an efficient firm to compete
5 profitably against BellSouth in the retail market.

6 In particular, it is not necessary to require that BellSouth's retail price for a service
7 exceed the prices of the UNEs that could be used to replicate the same service. UNE
8 prices are based on TELRIC. Suppose, first, that TELRIC reasonably measures the
9 forward-looking incremental costs that BellSouth incurs to provide the UNE. Then even if
10 BellSouth's retail price is less than the TELRIC-based UNE price, both BellSouth and its
11 competitors are on a level playing field, in the sense that both firms face the same
12 incremental cost for the same facilities. It costs BellSouth TELRIC to use its UNE, and its
13 competitors pay the same TELRIC to use the UNE.[3] Both carriers, of course, expect to serve
14 customers profitably even if retail basic exchange service prices do not fully cover direct
15 costs by selling other higher-margin services to the customer.

16 Second, TELRIC-based UNE prices specifically include a markup to cover a portion
17 of shared fixed and common costs. Suppose BellSouth's incremental costs for providing the
18 UNE are the same as the incremental cost component of the TELRIC costs for the UNE. The

(...continued)

and the avoided cost discount for resold services were *y* percent, then an ALEC that resells BellSouth's Key Customer promotional service would get the benefit of both the *x* percent discount and the *y* percent discount.

[3] To the extent that BellSouth's actual costs exceed TELRIC costs, the ALEC is placed at an artificial competitive advantage, in the sense that it receives use of the essential facilities supplied by BellSouth at a lower cost than BellSouth incurs to provide them to itself for its retail service.

1 fact that TELRIC includes an allocation of shared fixed and common costs means that the
2 TELRIC-based UNE price would be too high for a price floor.

3 **Q. PLEASE COMMENT ON THE ARGUMENTS BY MS. KENNEDY (AT 14-16) AND**
4 **MR. GALLAGHER (AT 22) THAT A COMPETITOR'S ABILITY TO RESELL A**
5 **BELLSOUTH PROMOTION DOES NOT, BY ITSELF, MAKE THE PROMOTION**
6 **PROCOMPETITIVE.**

7 A. The fact that a competitor can resell a promotion ensures that an equally efficient competitor
8 will not be unfairly excluded from the market. To understand why, it is important to first
9 revisit the need for imputation itself and the price floor standard formulated in Section
10 364.051(5)(c). As I explained in my direct testimony in this proceeding (at 7-9),
11 imputation—and the specific price floor (such as that in Section 364.051(5)(c)) it
12 embodies—is a competitive safeguard against a price squeeze, i.e., it is intended to protect
13 dependent competitors who must purchase essential facilities from the incumbent. These
14 essential facilities are precisely the "monopoly component" to which Section 364.051(5)(c)
15 refers. Arguably, some UNE loops are such facilities that ALECs may find economically
16 infeasible to reproduce on their own. With that said, however, it also follows that a facility
17 that *can* be reproduced economically by ALECs, or can be obtained from alternative sources
18 or in an alternative manner, should no longer be considered an essential facility or a
19 monopoly component. Hence, for such a facility the imputation standard—and the price
20 floor standard in 364.051(5)(c)—cannot possibly apply.

21 In the present context, were ALECs not allowed to resell BellSouth's Key Customer
22 promotional service (which is not the case), it might be the case that ALECs cannot replicate

1 for themselves the essential facilities (*e.g.*, certain UNE loops) that are embodied in the
2 promotional service. However, the possibility of resale by ALECs changes this condition
3 fundamentally—a fact unambiguously recognized by the FCC.[4] Under resale, an ALEC can
4 gain access to *all* facilities and rate elements that make up the Key Customer promotional
5 service, including any that would be considered essential facilities or monopoly components
6 in the absence of resale. Therefore, in economic theory, the availability of resale (as one
7 possible alternative source of essential facilities) vitiates any argument for the application of
8 the imputation price floor (such as that in Section 364.051(5)(c)).

9 Now, both Ms. Kennedy and Mr. Gallagher claim that the ALEC's margin on a
10 resold service is too small to make resale a profitable proposition for the ALEC. It is
11 important to note that this is not an argument against the fundamental principle discussed
12 above of imputation itself. The resale (avoided cost) discount was calculated by the Florida
13 Public Service Commission precisely to give a firm that is at least as *efficient* in retailing
14 (the only function the ALEC is performing) as BellSouth the same margin that BellSouth has
15 between its retail price and its incremental cost. If that margin is too small for an ALEC to
16 succeed as a reseller, then all that proves is that BellSouth is more efficient than the ALEC
17 at providing the retail function. Other things being equal, there would then be no reason for
18 customers to benefit from having the ALEC provide that retail function rather than BellSouth.
19 The *sole* purpose of a retail price floor is to ensure that ALECs are not unfairly
20 disadvantaged whenever they have to purchase essential facilities or services from

[4] FCC, *In the Matter of Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc. for Provision of In-Region InterLATA Services in Georgia and Louisiana*, CC Docket No. 02-35, Memorandum Opinion and Order, released May 15, 2002, ¶287.

1 BellSouth; it is *not* to provide a crutch to less efficient ALECs or their faulty business plans.

2 **Q. TO SUMMARIZE, HOW SHOULD THE COMMISSION APPLY THE PRICE**
3 **FLOOR STANDARD IN SECTION 364.051(5)(C) WHEN RESALE OF**
4 **BELLSOUTH'S KEY CUSTOMER PROMOTIONAL SERVICES IS POSSIBLE?**

5 A. The Commission should recognize that the resale provisions of the federal
6 Telecommunications Act of 1996, as implemented by the FCC and this Commission, create a
7 situation in which BellSouth's competitors are not disadvantaged by BellSouth's control of
8 any "essential facilities" or "monopoly services" as those terms are contemplated in Florida
9 statutes. This is because, as explained above, the resale price the competitor pays BellSouth
10 for any service (including any monopoly component of that service) will always be less than
11 the price BellSouth charges its retail customers for the same service (including any
12 monopoly component thereof). Accordingly, competitors suffer no disadvantage and the
13 rationale for the price floor standard in Section 364.051(5)(c) disappears.

14 **Q. EVEN IF A UNE-BASED IMPUTATION PRICE FLOOR WERE THOUGHT TO BE**
15 **NECESSARY, WOULD MR. GILLAN'S PRICE FLOOR BE ECONOMICALLY**
16 **CORRECT?**

17 A. No. Even if it were necessary for BellSouth retail prices to pass a Section 364.051(5)(c)
18 price floor test based on UNE prices (and it is not), Mr. Gillan's proposed test (at 4) would
19 be incorrect. The Florida price floor standard begins with the direct cost of the retail
20 service as provisioned by BellSouth. The price floor additionally includes (as an imputed

1 cost) the UNE price BellSouth charges to competitors, *but only to the extent that such cost*
2 *is not already included in the direct cost of the retail service.*[5]

3 To see what this means consider two possible scenarios. First, suppose the
4 TELRIC of a given UNE (and thus the price of that UNE) is a reasonable approximation to
5 the network component of BellSouth's incremental costs for a given retail service. Under
6 this assumption, the Florida standard (and economic theory) would set the retail price floor
7 for basic exchange service *exactly* at the direct cost of the retail service. That is because,
8 by assumption, the UNE price would already be fully included as part of the direct cost of
9 the retail service.

10 Alternatively, suppose instead that the UNE price *exceeds* the direct cost of the
11 network elements involved in a given retail service.[6] In this case, the Florida standard (and
12 economic theory) would set the retail price floor at the sum of the direct cost of the retail
13 service and the *contribution* (i.e., the price of the UNE less the direct cost of the UNE) that
14 BellSouth would earn from selling the UNE to ALECs. This contribution is exactly what
15 Section 364.051(5)(c) refers to as the portion of "the price charged by the company for any
16 monopoly component..." that is "not included in the direct cost" of the retail service. It
17 follows then that the Florida standard would add this contribution to the direct cost of the
18 retail service. In economic theory, this imputation price floor would clearly exceed

[5] "The price charged to a consumer for a nonbasic service shall cover the direct costs of providing the service and shall, to the extent a cost is not included in the direct cost, include as an imputed cost the price charged by the company to competitors for any monopoly component used by a competitor in the provision of its same or functionally equivalent service."

[6] In theory, the UNE price based on TELRIC exceeds the direct cost of the network elements (as measured by the TELRIC method) because the UNE price includes an assignment of common overhead costs.

1 BellSouth's incremental cost of the retail service. The amount by which that price floor
2 would be higher is exactly the difference between the UNE price that competitors pay
3 BellSouth and the UNE direct cost that BellSouth incurs. This standard would ensure that
4 as long as the UNE is considered an essential facility, BellSouth's competitors would be
5 neither advantaged nor disadvantaged by having to purchase that essential facility from
6 BellSouth.[7]

7 These ideas can be illustrated with a simple example. Suppose the TELRIC price of
8 a given UNE is $20 and we have reason to believe that the direct cost of that UNE is also
9 $20. That is, BellSouth can earn no contribution from selling the UNE at a price equal to
10 cost. This corresponds to the first scenario considered above. If BellSouth's direct
11 incremental cost to provide the retail service is the sum of this network component cost and
12 the cost of direct retailing functions, say, $5, then the Florida imputation price floor in this
13 scenario would be simply $20 (the TELRIC of the UNE, which in this case is the same as the
14 direct cost of the UNE) + $5 (the direct costs of the retail service that are not included in the
15 TELRIC of the UNE) = $25.

16 Next, consider the second scenario in which the TELRIC price of the UNE remains
17 at $20, but we know that the true direct cost of UNE to BellSouth is only $17 (the remaining
18 $3 being the built-in assignment of overhead and common costs). Then, Section
19 364.051(5)(c) would start with the $22 direct costs of providing the service (which consists
20 of $17 for the UNE and $5 for retailing functions). The statute would then add the

[7] Of course, as explained earlier, the availability of resale means that the UNE loop is not an essential facility, and this entire discussion would become moot.

1 contribution that BellSouth earns from selling the UNE at a price above its direct cost. That
2 contribution is exactly the $3 that is built into the TELRIC of the UNE to cover overhead and
3 common costs. Thus, in the second scenario, the Florida imputation price floor would be
4 $17 (the direct cost of the UNE) + $5 (the direct costs of the retail service that are not
5 included in the TELRIC of the UNE) + $3 (the contribution that BellSouth earns from selling
6 the UNE at a price above its direct cost) = $25 (the same amount as in the first scenario).
7 The fact that the imputation price floor is the same in both scenarios is neither
8 surprising nor an accident. It is precisely what is implied by the wording of Section
9 364.051(5)(c), and is entirely consistent with economic theory.

10 **Q. PLEASE EXPLAIN SPECIFICALLY WHAT IS WRONG WITH MR. GILLAN'S**
11 **APPROACH TO IMPUTATION.**

12 A. Mr. Gillan takes a different approach from that discussed above. He assumes that the direct
13 cost of the retail service is equal to the sum of (i) network direct costs and (ii) retailing
14 direct costs. The former are approximated by the sum of the UNE prices and the latter by the
15 cost implied by the 16.81 percent avoided cost discount associated with supplying resold
16 services. Neither of these approximations is valid for the purposes to which Mr. Gillan
17 applies them. First, we know that TELRIC, in principle, overstates BellSouth's direct
18 network costs associated with a UNE because TELRIC includes an allocation of common
19 overhead costs which are not part of the direct cost of network services. Second, the
20 avoided cost discount is calculated as the percentage of total costs avoided by reselling *all*
21 services rather than supplying them through normal retail channels. That cost bears no
22 relationship to the incremental retail costs associated with supplying a particular retail

1 service to a customer while continuing to sell other services through normal retail channels.

2 **Q. MR. GILLAN PROPOSES THAT HIS PRICE FLOOR SHOULD APPLY TO**
3 **INDIVIDUAL SERVICES AND PROMOTIONS. DO YOU AGREE?**

4 A. No, there is no economic basis for such a requirement. Indeed, there would be a decrease in
5 economic efficiency if price floors and imputation standards were imposed at the level of,
6 say, individual rate elements. To achieve the economic goal of efficient competition in the
7 presence of essential facilities, an imputation test should apply its test at the level of the
8 relevant service market.

9 **Q. PLEASE EXPLAIN HOW APPLYING IMPUTATION AT THE SERVICE MARKET**
10 **LEVEL WILL FOSTER COMPETITIVE CONDITIONS.**

11 A. It would do so by ensuring that no equally efficient firm (including BellSouth) is denied the
12 ability to compete because of the prices that BellSouth charges for essential facilities. By
13 applying imputation at the level of the service market, the Commission can be assured that in
14 Florida, an equally efficient firm is able to recover its economic costs and to compete on the
15 basis of its economic advantages with BellSouth. Any competitor with lower average
16 incremental costs could enter and charge an average price lower than that of BellSouth. In
17 this aggregate sense, economic efficiency would be preserved because an efficient
18 competitor will have a cost-based competitive advantage in setting its price.

19 The business basic exchange service market, for example, includes all of BellSouth's
20 serving area, all types of tariffed service offerings, term and volume discount plans,
21 promotions, and contracts. If BellSouth passes an imputation test at this level of aggregation,
22 then an equally or more efficient competitor can purchase essential services from BellSouth

1 and design a set of retail prices that are equal to or lower overall than BellSouth's set of
2 prices.[8] The Commission would not be serving any procompetitive interest by requiring that
3 BellSouth's prices for components of a retail package equal or exceed an imputation price
4 floor because no potential competitor would be placed at a competitive disadvantage by
5 BellSouth's pricing some service components above an imputation standard and other
6 components—within the same service market—below an imputation standard. This is the
7 same logic that shows that drug stores are not guilty of predatory pricing when they sell the
8 second tube of toothpaste for a penny, despite the fact that its variable cost is somewhat
9 higher.

10 **Q. BUT ISN'T IT NECESSARY FOR FIRMS TO MAKE A PROFIT ON EVERY**
11 **COMPONENT OF A SERVICE THEY OFFER?**

12 A. No. Competition is not a process of replicating every aspect of other firms' services; it is a
13 process by which each firm seeks to exploit its own competitive advantage by offering one
14 or more services or bundles of services that customers will substitute for other competitors'
15 services. Thus, to compete effectively, it is not necessary for firms to be able to supply
16 profitably every component of a service.

17 **Q. MR. GILLAN (AT 4) WANTS THE COMMISSION TO APPLY HIS TEST**
18 **SEPARATELY TO RECURRING AND NON-RECURRING PRICES. DOES THIS**
19 **MAKE ECONOMIC SENSE?**

[8] And, irrespective of whether BellSouth passed an imputation test, a more efficient competitor could resell BellSouth's business basic exchange service profitably at a lower price than BellSouth's retail basic exchange price.

1 A. No. One generally cannot purchase retail basic exchange service without also purchasing
2 the non-recurring activities necessary to establish service. What matters for an efficient
3 price floor is whether the expected incremental revenue from offering the service (including
4 both recurring and non-recurring revenue) equals or exceeds the incremental cost of the
5 service (again, including both recurring and non-recurring costs). The relationship between
6 revenue associated with individual components of the package and the individual
7 incremental costs of the different components of the package is irrelevant. Thus, the common
8 practice across the industry of discounting or waiving non-recurring charges to attract new
9 customers is not—by itself—anticompetitive; so long as the package the consumer actually
10 purchases is priced at a compensatory level, consumers benefit from such promotions and
11 the competitive process is strengthened.

12 **Q. MR. GILLAN (AT 5) ILLUSTRATES HIS TEST WITH SOME BELLSOUTH**
13 **PRICES AND CLAIMS THAT BELLSOUTH'S DISCOUNTED RETAIL PRICE**
14 **FAILS THE APPLICABLE PRICE FLOOR TEST BY NEARLY $15. ASSUMING,**
15 **FOR THE SAKE OF ARGUMENT, THAT HIS NUMBERS ARE CORRECT, IS THE**
16 **DISCOUNTED RETAIL PRICE ANTICOMPETITIVE?**

17 A. No. The discounted retail price (assumed to be $98.84) is not anticompetitive for two
18 reasons. First, competitors can obtain the services necessary to provide 4-line business
19 basic exchange service by reselling BellSouth's Key Customer promotion at an avoided cost
20 discount. Instead of paying $93.68 for UNE-P facilities, an ALEC can purchase the same

1 services for $82.23 in the form of resale.[9] Second, even if an ALEC chooses to use the more
2 expensive UNE-P—no doubt because the ALEC receives the benefit of access charges from
3 long distance carriers (IXCs) when it uses UNE-P but not when it uses resale—the $98.84
4 discounted retail price is not anticompetitive because BellSouth and the ALEC are placed on
5 the same competitive footing. That is, assuming that the TELRIC-based price for the UNE-P
6 represents BellSouth's costs, both the ALEC and BellSouth experience the same costs for
7 use of the UNE-P facilities. Of course, as a business matter, it is possible that neither
8 carrier would find it profitable to supply 4-line service (and no other services) to the
9 customer at this price. But neither carrier intends to do that. Rather, by selling basic
10 exchange service to the customer, BellSouth and the ALEC each expect to provide additional
11 higher-margin services to the customer, including vertical services, toll and exchange access
12 services. On average, BellSouth and an equally-efficient ALEC would find it similarly
13 profitable to provide this bundle of services to the customer.

14 **B. Cross-Subsidization**

15 **Q. MR. GILLAN ASSERTS (AT 6) THAT AN ADDITIONAL TEST IS NECESSARY TO**
16 **GUARD AGAINST CROSS-SUBSIDIZATION OF NON-BASIC SERVICES. DO**
17 **YOU AGREE?**

18 A. No. In the first place, cross-subsidization of non-basic services is not likely to be a problem
19 in Florida for the reasons outlined in my direct testimony (at 9-10). Second, a proper
20 economic test for cross-subsidy is already part of the Florida Statutes in Section

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[9] That is, a 16.81 percent discount off the assumed discounted retail price of $98.84.

1 364.051(5)(b).

2 **Q. MR. GILLAN PROPOSES A TEST (AT 6-7) THAT BELLSOUTH SHOULD BE**
3 **REQUIRED TO USE ANNUALLY TO SHOW THAT NONBASIC SERVICES ARE**
4 **NOT CROSS-SUBSIDIZED BY BASIC SERVICES. IS THIS TEST CONSISTENT**
5 **WITH THE ECONOMIC TEST FOR CROSS-SUBSIDIZATION OR THE TEST IN**
6 **SECTION 364.051(5)(B)?**

7 A. No. While the Florida cost standard is consistent with the economic definition of cross-
8 subsidization, there are several differences between Mr. Gillan's proposed test and that
9 defined in the Florida statutes. Section 364.051(5)(b) states that

10 The cost standard for determining cross-subsidization is whether the total revenue
11 from a nonbasic service is less than the total long-run incremental cost of the
12 service. Total long-run incremental cost means service-specific volume and
13 nonvolume-sensitive costs.[10]

14 First, the statute literally applies to a single nonbasic service, while Mr. Gillan wishes to
15 test for cross-subsidy at the aggregate level to ensure that "all nonbasic services cover the
16 total cost of providing such services" (at 6). That difference presents no economic problem:
17 a valid test of cross-subsidy can be conducted for individual services or for any given group
18 of services taken together. Moreover, the Florida standard is readily interpreted in the
19 context of a group of services simply by substituting the phrase "service or group of
20 services" for the word "service."

21 Second, and more important, Mr. Gillan recommends that the test be based on "a
22 fully-allocated cost study." Mr. Gillan is not specific about the nature of the costs he has in

1 mind, but the phrase "fully-allocated costs" in telecommunications economics is generally
2 used to mean a top-down cost study based on embedded accounting costs in which total
3 (historical) accounting costs for the firm are first assigned to services on as cost-causal a
4 basis as possible, after which the remaining costs are assigned to services based on some
5 non-cost-causal algorithm. If that type of study is what Mr. Gillan is proposing, it would
6 violate both the Florida statute and established economic principles.

7 Cross-subsidization is measured using forward-looking incremental costs, not
8 historical accounting costs. What matters in determining whether a service is receiving a
9 subsidy is whether the costs incremental to the decision to provide the service are covered
10 by the incremental revenue from providing the service. Embedded costs play no role in such
11 an analysis.

12 In addition, fully-allocated costs—of any description—have no place in a cross-
13 subsidy test. The only costs that matter in a subsidy test are those that are causally
14 associated with supplying the service and that would be avoided if the service were
15 discontinued. Even reasonable allocations of fixed costs or common overhead costs to a
16 service have no role in a subsidy test because those costs would be incurred whether or not
17 the service were provided and would still be incurred if the service were discontinued.

18 **Q. MS. KENNEDY (AT 10) CLAIMS THAT WAIVING INSTALLATION CHARGES**
19 **"INSURES THAT EXISTING CUSTOMERS WILL SUBSIDIZE NEW**
20 **INSTALLATIONS." DO YOU AGREE?**

(...continued)

[10] This measure of cost is also frequently called total *service* long-run incremental cost ("TSLRIC").

1 A. No. Installation is not a separate service provided in a separate market from basic exchange
2 service. So long as the price of the package of services actually offered to customers (basic
3 exchange service bundled together with installation) meets the relevant price floor, there is
4 no danger of cross-subsidization. In particular, waiving installation charges for new
5 customers does not imply that existing customers are subsidizing new service installations,
6 as alleged by Ms. Kennedy (at 10). If the revenues from basic exchange service and
7 installation equal or exceed the cost of basic exchange service including installation, then no
8 customer or service is being subsidized.

9 **Q. MS. KENNEDY ADDITIONALLY CLAIMS (AT 11) THAT BELLSOUTH DOES**
10 **NOT WAIVE ITS NON-RECURRING CONNECTION CHARGE TO ALECS, AND**
11 **THIS FACT ALLEGEDLY "GIVES BELLSOUTH AN ANTICOMPETITIVE**
12 **ADVANTAGE TO WAIVE THESE CHARGES FOR END-USER CUSTOMERS..."**
13 **DO YOU AGREE?**

14 A. No. In principle, BellSouth's non-recurring installation charges to ALECs are based on the
15 TELRIC associated with the activity. In addition, as she points out, the ALEC will also
16 incur its own installation costs in establishing service for a customer. The sum of those two
17 costs is part of the incremental cost to the ALEC of providing basic exchange service.
18 BellSouth also incurs costs associated with establishing a retail account, and those costs are
19 part of its cost of providing basic exchange service. If BellSouth thinks new customers can
20 be attracted by reducing or waiving the non-recurring charge, there is nothing in economics
21 (or in the Florida Statutes) that would consider such a package to be anticompetitive,
22 provided the package as a whole passed the relevant price floor test. The ALEC, of course,

1 is also perfectly free to structure its basic exchange prices as it sees fit, charging up front for
2 installation costs or recovering them over the life of the service. Indeed, in the reasonably
3 competitive long distance market, we observe long distance carriers not merely waiving
4 installation or PIC-change fees but actively writing checks ($75 in my mailbox within the
5 past month in Massachusetts) to induce new customers to subscribe to their service.

6 III. OTHER RESTRICTIONS ON PROMOTIONS.

7 A. Discrimination Among Similarly-Situated Customers.

8 **Q. WHAT IS THE JUSTIFICATION IN ECONOMICS FOR CHARGING DIFFERENT**
9 **CUSTOMERS DIFFERENT PRICES FOR THE SAME SERVICE?**

10 A. Price discrimination in economics is important for at least two reasons. First, in industries
11 like telecommunications which have a high proportion of fixed costs, pricing services at
12 incremental cost will not recover the total cost of the firm. Pricing services differently to
13 differently-situated customers is a useful technique to recover the total cost of the firm while
14 minimizing the effect of pricing above incremental cost on customers' purchase decisions.
15 Second, in economic theory, charging different prices to customers in different groups can
16 increase aggregate economic welfare,[11] depending upon characteristics of demand and cost
17 functions. Circumstances where price discrimination is likely to increase welfare are where
18 total output increases (compared with the outcome when a single price is charged to all

[11] Economic welfare is defined as the sum of consumer surplus and producer surplus. Consumer surplus is the difference between what customers are willing to pay for a service and what they actually pay. Producer surplus is the aggregate profit of firms that produce the service.

1 customers) and where demand functions are relatively price-inelastic.[12]

2 Price discrimination is a pervasive feature of the economy and a powerful tool that
3 firms use to compete. One classic example is airline fares in which customers having a high
4 willingness to pay for flexibility (business travelers) are frequently charged much more than
5 vacation travelers who have a much lower willingness to pay. As a result of such price
6 discrimination, many more people fly than would occur if all passengers were charged the
7 same fare.

8 **Q. MR. GILLAN (AT 8-9) RECOMMENDS THAT THE COMMISSION PROHIBIT**
9 **BELLSOUTH FROM OFFERING PROMOTIONS TO PARTICULAR CUSTOMERS**
10 ***SOLELY* BECAUSE THEY HAVE CHOSEN TO TAKE SERVICE FROM ANOTHER**
11 **PROVIDER. ARE CUSTOMERS WHO DIFFER ONLY IN THE CARRIER THEY**
12 **CHOSE TO PROVIDE SERVICE "SIMILARLY-SITUATED" FROM AN**
13 **ECONOMIC PERSPECTIVE?**

14 A. Yes. A qualitative economic interpretation of "similarly situated" was given in my direct
15 testimony (at 20-21) which emphasized the importance of both cost and demand
16 characteristics in classifying customers as similarly or differently situated. On that basis, it
17 is not unreasonable to suppose that customers who have actually chosen to leave a supplier
18 have different demand characteristics from those customers who remain. In addition, Mr.
19 Gillan's specific concern applies to winback-type programs, not to the Key Customer

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[12] See, *e.g.*, H.R. Varian, "Price Discrimination and Social Welfare," *American Economic Review*, Vol. 75 (1985), 870-877. A general discussion of the welfare effects of price discrimination is found in D. Carlton and J. Perloff, *Modern Industrial Organization*, Second Edition, New York: Harper Collins (1994) Chapter 11.

1 promotions that concern us here.

2 **Q. MR. GALLAGHER OPINES (AT 13) THAT BELLSOUTH'S DISCOUNTS ARE**
3 **ANTICOMPETITIVE BECAUSE BELLSOUTH HAS NOT MADE THEM**
4 **AVAILABLE TO "ALL CUSTOMERS IN THE BUSINESS CLASS." ARE SUCH**
5 **PROMOTIONS NECESSARILY ANTICOMPETITIVE OR DISCRIMINATORY?**

6 A. No. Not all business customers in Florida face the same range of choices for services, and it
7 is perfectly reasonable to price and market differently to customers having comparatively
8 more competing alternatives. As Mr. Gillan observes,

> 9 If competitors offer service generally to an area, then BellSouth's competitive
> 10 responses should be available to the same customer segment, not only to those
> 11 customers that may have *chosen* an alternative. (at 8-9, emphasis in original).

12 While Mr. Gillan and I disagree about whether customers who actually choose a
13 competitor's service are similarly-situated to those who do not, apparently we do agree that
14 if ALECS offer a service in a particular geographic area or to a particular set of customers,
15 BellSouth should be allowed to respond by pricing services differently in that geographic
16 area or to that set of customers.

17 **Q. IN ADDITION, EVEN AMONG THE CUSTOMERS ELIGIBLE FOR A**
18 **BELLSOUTH PROMOTION, MR. GALLAGHER COMPLAINS (AT 14) THAT**
19 **BELLSOUTH DOES NOT "USE THE SAME MEANS, METHODS AND**
20 **MATERIALS TO OFFER THE KEY CUSTOMER PROGRAM TO ALL ELIGIBLE**
21 **CUSTOMERS." SHOULD BELLSOUTH BE REQUIRED TO MARKET ITS**
22 **PROMOTIONS IN THE SAME WAY TO ALL ELIGIBLE CUSTOMERS?**

1 A. No. In competitive, unregulated markets, efficient firms—large and small—target their
2 marketing efforts and budgets towards those customers from whom the expected return is
3 greatest. To do otherwise would be unprofitable and would waste valuable time and
4 resources. Efficient ALECs presumably do the same. To require BellSouth to market
5 *inefficiently*—to expend the same effort to attract each eligible customer to a promotion—
6 would be discriminatory and wasteful and amount to an anticompetitive strategy of using
7 regulation to raise a rival's costs. BellSouth's costs would be artificially increased since
8 for any level of marketing, BellSouth would have to spend resources where the expected
9 return would be negative. At the end of the day, Florida customers would pay more for the
10 services they receive.

11 **B. Long-Term Contracts**

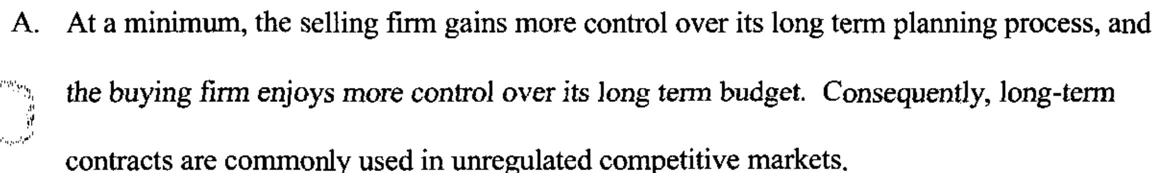
12 **Q. MR. GILLAN ASSERTS AT (9) THAT LONG-TERM CONTRACTS WORK**
13 **AGAINST THE OBJECTIVE OF EFFECTIVE COMPETITION. DO YOU AGREE?**
14 A. No. Long-term contracts can be beneficial to both contracting parties and consumers in
15 general. From an economic perspective, long term-contracts serve several important
16 functions. First, they can reduce the business risk to BellSouth so that an otherwise
17 unprofitable sunk investment in facilities or in a customer relationship might become
18 profitable. Such reductions in risk reduce service prices that customers ultimately pay.
19 Second, they reduce the business risk of BellSouth's customers, so that investment
20 in facilities or relationships that the customer may make in order to use BellSouth's services
21 might become profitable.
22 Third, the general public benefits from such contracts because they: (i) promote

continuity between the contracting parties, (ii) reduce transaction costs, and (iii) provide the parties an opportunity to reduce risk and manage their budgets more effectively. By providing both parties an opportunity to plan and reduce uncertainty more effectively, BellSouth's ability to negotiate long-term contracts benefits all Florida customers because reduced uncertainty reduces the overall cost of doing business.

Finally, competitors also offer long-term contracts at a discounted price, and some customers prefer them. The ability to offer similar contracts permits BellSouth to obtain *some* retail contribution from those customers who otherwise would choose a competitor's service and supply no contribution to BellSouth.[13] While the contribution is less than what BellSouth would receive if the customer simply purchased services out of the tariff, customers currently have a choice of suppliers, and the contribution BellSouth receives from its long-term contracts is more than it would receive if it did not offer those services.

Q. HOW DOES A REDUCTION IN UNCERTAINTY REDUCE COSTS?

A. At a minimum, the selling firm gains more control over its long term planning process, and the buying firm enjoys more control over its long term budget. Consequently, long-term contracts are commonly used in unregulated competitive markets.



Production decisions—such as how much and what kind of capital equipment is required to fulfill demand—are primarily responsible for the level of a firm's capital expenditures. For capital-intensive production processes such as telecommunications, capital costs generally constitute the majority of all costs incurred. The more certain

[13] Because of the fixed cost markup in the TELRIC rates, BellSouth would receive some contribution when it supplied UNEs to a competitor rather than the retail service to a customer.

1 managers can be about the likely demand for output, the more efficient they can be about
2 acquiring and deploying capital and designing plant to accommodate demand. In particular,
3 certainty regarding the facilities required at particular locations is valuable because, once
4 placed, important types of telecommunications equipment cannot economically be moved:
5 for example, high capacity distribution plant serving a particular customer might not be
6 reusable if that customer switched its service to another facilities-based supplier.
7 Alternatively, in the face of great uncertainty about future demand, a firm is left to take its
8 best guess, place capital accordingly and attempt to set prices to recover its costs. Anything
9 that reduces uncertainty for the selling firm (i.e., a long-term contract for the exchange of a
10 given amount of service over a specified period of time) increases the efficiency with which
11 managers can make decisions about the production process, reducing the firm's production
12 costs and, ultimately, its prices.

13 The buying firm also benefits from a reduction in uncertainty. The buying firm is
14 acquiring inputs (i.e., telephone services) to its production process and for reasons similar
15 to those above will benefit from the knowledge that services will be available at a known
16 prices for a given number of years. The buyer may have to purchase equipment and install
17 complex wiring whose design depends on the service provided by BellSouth, and its
18 business case for the service is very different if the terms and conditions of BellSouth's
19 service are known in advance for some period of time. Just like the selling firm, the buying
20 firm can more effectively plan its production costs and thus more able to reduce its cost of
21 production and increase its margin on each unit of output it provides to its customers.

22 **Q. IS THE EXTENDED-TERM NATURE OF THE CONTRACT NECESSARY TO**

1 **ACHIEVE THESE BENEFITS?**

2 A. Yes, in the example discussed above. Without a known term of service over which
3 BellSouth can be reasonably sure of providing service, there would be no reduction in its
4 risk and thus no associated reduction in its costs or prices. Additionally, reducing customer
5 churn through contracts can reduce sales and marketing costs. Similarly, from the customer's
6 perspective, an extended term contract reduces the risk and associated costs from market
7 changes.

8 **Q. DO LONG-TERM CONTRACTS HINDER THE DEVELOPMENT OF**
9 **COMPETITION, AS SUGGESTED BY MR. GILLAN (AT 9)?**

10 A. No. As discussed above, some buyers prefer having the option of signing an extended-term
11 contract in addition to purchasing services from the tariff. The availability of extended-term
12 contracts simply changes the nature of competition for business telecommunications users,
13 expanding the range of services available to customers to include a class of options that
14 some customers find attractive.

15 Thus, all competitors—ILECs and ALECs alike—should be free to offer the same
16 mix of spot and extended-term contracts. Going forward, BellSouth has no inherent
17 advantage in marketing extended-term contracts to such customers. Contracts expire and new
18 customers come into the market constantly. Extended-term contracts, by themselves, do not
19 reduce the degree of competitive rivalry in the market; they merely extend that rivalry to
20 include an option that many customers value—volume and term commitments in exchange for
21 lower prices.

22 Because markets have been opened to competition, business customers do not have

1 to wait for competition or sacrifice profits. Competitors provide contract services today to
2 such customers. If BellSouth is prevented or restricted from selling extended-term contracts
3 in this market, business customers may not receive the lower prices their demand and cost
4 structures would otherwise warrant, and BellSouth would be unable to serve such
5 customers. In addition, it would be poor public policy to require BellSouth to compete for
6 such customers by selling its tariffed services while competitors are free to write long-term
7 contracts. That type of competition is patently inefficient, and it is ultimately customers who
8 pay to support inefficient competitors through higher prices.

9 **C. Duration and Frequency of Promotional Offers.**

10 **Q. MR. GALLAGHER (AT 18-19) RECOMMENDS THAT THE KEY CUSTOMER**
11 **PROMOTION BE LIMITED TO 90 DAYS AND THAT BELLSOUTH BE**
12 **ENJOINED FROM REPEATING IT FOR AT LEAST A YEAR. ARE THESE**
13 **ECONOMICALLY REASONABLE RESTRICTIONS?**

14 A. No. As I stated in my direct testimony (at 17-18), as long as the promotional prices
15 proposed meet the Florida price floor standards, such prices are procompetitive, not
16 anticompetitive, and the more flexibility BellSouth has to propose them, the more vigorous
17 competition will be in Florida and the better off Florida customers.

18 The same point is recognized in the Florida statutes, which explicitly recognize the
19 importance to a firm of being able to respond to its competitors' offerings:

20 Nothing contained in this section shall prevent the local exchange
21 telecommunications company from meeting offerings by any competitive provider
22 of the same, or functionally equivalent, nonbasic services in a specific geographic
23 market or to a specific customer by deaveraging the price of any nonbasic service,
24 packaging nonbasic services together or with basic services, using volume

1 discounts and term discounts, and offering individual contracts. [Section
2 364.051(5)(A)]

3 Mr. Gallagher does not propose that comparable restrictions be imposed on the promotions
4 of ALECs, so each ALEC is free to choose the duration and frequency of its promotional
5 campaigns. If BellSouth is to be free to meet such offerings, it must have the same flexibility
6 to choose the duration and frequency of its promotions. Moreover, even if ALEC
7 promotions were restricted in duration and frequency, the fact that there are many
8 competitors in Florida local exchange markets means that restrictions on the duration and
9 frequency of any firm's promotions would be a serious competitive disadvantage, and if
10 applied widely would eviscerate the competitive process in Florida.

11 Finally, BellSouth makes promotions that extend beyond 90 days available for resale
12 at the Florida avoided cost discount, so that longer promotions are treated as effective price
13 reductions from the perspective of an ALEC competitor.

14 **D. Competitive Parity and Asymmetric Regulation**

15 **Q. MS. KENNEDY OBSERVES (AT 7) THAT "BELLSOUTH PROMOTIONS**
16 **SERIOUSLY HAMPERED NTC'S ABILITY TO COMPETE IN THE**
17 **MARKETPLACE." SHE GOES ON TO NOTE THAT NTC'S MARGINS WERE**
18 **REDUCED IN RESPONSE AND THAT "A NEWLY COMPETITIVE COMPANY IS**
19 **SEVERELY HAMPERED WHEN IT MUST CUT PROFIT MARGIN TO THE BONE**
20 **TO COMPETE WITH A MONOPOLY THAT HAS VASTLY GREATER**
21 **RESOURCES." ARE THESE GOOD ECONOMIC REASONS FOR CURTAILING**
22 **BELLSOUTH'S USE OF PROMOTIONS?**

1 A. No. On the contrary, as long as BellSouth's prices meet the appropriate Florida price floor
2 standards (discussed above), this sequence of events is precisely what competition is
3 intended to do to benefit Florida customers. There is no provision in the
4 Telecommunications Act of 1996 or the Florida statutes (as I read them as an economist) that
5 endows an entrant with any kind of temporary respite from competition until it can evolve
6 from "a newly competitive company" to "[a]n established company [that] may be able to
7 succeed with slim margins." (Kennedy at 7). History has not been kind to temporary "infant
8 industry" policies that favor new entrants until (some day) they can develop into fully
9 competitive adults: (i) they ossify into permanent policies and (ii) they allow inefficient
10 firms to persist in the market. Regulated competition of this sort is not a competitive process
11 from which customers in Florida are likely to benefit.

12 **Q. MR. GALLAGHER (AT 7-8) ALSO OBSERVES THAT "AT AN ALEC SPECIFIC**
13 **LEVEL, THE IMPACT OF BELLSOUTH'S DISCOUNTS CAN BE EXTREMELY**
14 **HARMFUL WHEN AN ALEC LOSES EXISTING CUSTOMERS." HE OBSERVES**
15 **(CORRECTLY) THAT SUCH PROMOTIONS CAN REDUCE ALEC GROWTH**
16 **RATES AND DISCOURAGE ALEC INVESTMENT. IS THIS A REASON TO**
17 **RESTRICT BELLSOUTH PROMOTIONS?**

18 A. No. Losing customers (or not) is the essence of the competitive process, and ALECs cannot
19 be inoculated against such outcomes without making a mockery of the competitive process.
20 In any event, BellSouth's promotions have not prevented the ALECs from doing quite
21 well in local telecommunications markets in Florida. In 2002, ALECs serve approximately
22 33 percent of business access lines in BellSouth's territory and, obviously, ILECs in Florida

1 have lost far more access lines in the urban wire centers where ALECs have concentrated
2 their efforts. Nothing in the overall record of growth in local competition in Florida
3 suggests that recent BellSouth promotions have impeded the ALECs ability to compete, much
4 less brought competition to a halt.

5 Moreover, Mr. Gallagher gets it right when he points out (at 9), that "the public
6 interest demands that ALECs at least be protected from...anticompetitive conduct."
7 However, public policy also demands that the regulator do no more than that. Provided
8 BellSouth's prices meet the established Florida standards, the competitive process is best
9 served by minimal regulatory intervention. It would be unthinkably disruptive and
10 counterproductive if the regulator in Florida were required to assure that BellSouth
11 marketed equally (whatever that might mean) to all Florida customers eligible for a
12 promotion, or to judge whether a promotion was new or simply a variant of an existing
13 promotion. Firms in unregulated, competitive markets come up with ingenious, inventive
14 ideas to package and price products to attract particular customer groups and encourage
15 them to use more services and spend more money. These promotions make consumers better
16 off, but if competitor complaints and regulatory hearings can be used to prevent or delay
17 their implementation, the competitive process and Florida consumers will suffer.

18 **Q. MR. GALLAGHER (AT 15) PROPOSES THAT BELLSOUTH PROMOTIONS BE**
19 **SHARPLY RESTRICTED UNTIL ALECS HAVE ACHIEVED "MEANINGFUL**
20 **MARKET SHARE IN BELLSOUTH TERRITORY." IS THIS AN ECONOMICALLY**
21 **SOUND PROPOSAL?**

22 A. Quite the contrary. First, by preventing discounts greater than 10 percent off of tariffed

1 rates, Mr. Gallagher would deny Florida consumers significant price competition. A
2 common characteristic of prices in unregulated, competitive markets—particularly where the
3 technology is characterized by a high proportion of fixed costs—is for list or tariffed prices
4 to remain comparatively high while firms compete on price by offering packages and
5 targeted discounts. This pattern was certainly observed in long distance telecommunications
6 markets in the U.S. where basic prices increased and long distance carriers competed by
7 moving customers to discount packages. If Mr. Gallagher's suggestion were adopted,
8 BellSouth's tariffed prices would become the price umbrella for Florida local exchange
9 markets under which inefficient ALECs could serve profitably (though at high cost) and
10 efficient ALECs could earn supranormal profits. Consumers would suffer.

11 Second, tying this pricing restriction to loss of market share would distort incentives
12 to compete in Florida. Market shares are supposed to be an *outcome* of the competitive
13 process: do well, satisfy customers, reduce costs and prices, and you will be rewarded by
14 attracting more customers and ultimately higher profits. Penalizing one firm based on its
15 market share confuses these incentives. Moreover, picking a critical market share (say 40
16 percent) implies that Florida believes such a distribution of the market would be desirable.
17 While unregulated, efficient competition could create a market with many competitors and no
18 firm with a dominant market share and solve many regulatory problems, that fact alone does
19 not mean that an *artificial* process that handicaps one firm until some desired division of the
20 market would also solve regulatory problems or serve the interests of consumers.

21 In short, specifying a desired outcome of the competitive process in which many
22 ALECs can successfully compete is the very opposite of competition. An unregulated
23 monopoly market would probably be better for consumers than regulated competition under

1 a market allocation scheme such as Mr. Gallagher proposes.

2 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

3 A. Yes.