October 1, 2003

BY HAND DELIVERY

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

Re: Docket No. 030868-TL: *In re: Sprint-Florida, Incorporated's Petition to Reduce Intrastate Switched Network Access Rates to Interstate Parity in a Revenue Neutral Manner*

Dear Ms. Bayo:

Pursuant to the Commission's decision at its September 30, 2003 Agenda Conference granting Citizens' Motion to Dismiss Sprint-Florida, Incorporated's Amended Petition to Reduce Intrastate Switched Network Access Rates to Interstate Parity in a Revenue Neutral Manner, but granting Sprint-Florida, Incorporated's leave to file an Amended Petition and associated amended testimony and exhibits, Sprint -Florida, Incorporated hereby files in the above matter the original and fifteen (15) copies of the following:

1. Sprint-Florida, Incorporated's ("Sprint's") Amended Petition to Reduce Intrastate Switched Network Access Rates to Interstate Parity in a Revenue Neutral Manner (highlighted and non-highlighted versions);
2. John M. Felz Amended Direct Testimony (redacted)(highlighted and non-highlighted versions) and Amended Exhibits JMF-11, JMF-12 and JMF-13(highlighted);
3. Dr. Kenneth Gordon Amended Direct Testimony (highlighted and non-highlighted versions); and
4. Sprint's Request for Confidential Classification and Protective Order pursuant to Section 364.183(1), Florida Statutes.

Sprint is not filing amended Direct Testimony or amended Exhibits of Kent W. Dickerson or amended Direct Testimony of Dr. Brian Staihr. Please see their original testimony and exhibits filed on August 27, 2003.

The confidential portions of the Amended Direct Testimony of John M. Felz are being filed under seal by separate letter.

There remains pending Sprint's Request for Confidential Classification and Protective Order regarding the confidential portions of the original Direct Testimony and exhibits of John M. Felz and the original exhibits of Kent W. Dickerson, filed on August 27, 2003. These documents were submitted to the Commission under seal. It is Sprint's intention that these documents, filed August 27, 2003, remain under seal and remain subject to Sprint's pending Request for Confidential Classification and Protective Order.

Please acknowledge receipt and filing of the above by stamping the duplicate copy of this letter and returning the same to this writer.

Thank you for your assistance in this matter.

Yours truly,

John P. Fons

Enclosures

cc: Certificate of Service List

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

IN RE: SPRINT-FLORIDA, INCORPORATED'S PETITION TO REDUCE INTRASTATE SWITCHED NETWORK ACCESS RATES TO INTERSTATE PARITY IN A REVENUE NEUTRAL MANNER PURSUANT TO SECTION 364.164(1), FLORIDA STATUTES

DOCKET NO.: 030868-TL
FILED: October 1, 2003

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SPRINT-FLORIDA, INCORPORATED'S AMENDED PETITION TO REDUCE INTRASTATE SWITCHED NETWORK ACCESS RATES TO INTERSTATE PARITY IN A REVENUE NEUTRAL MANNER

Sprint-Florida, Incorporated ("Sprint"), pursuant to Rule 28-106.104, Florida Administrative Code, Section 364.164(1), Florida Statutes, and pursuant to the directions of the Commission at its September 30, 2003 Agenda Conference, submits its Amended Petition to the Florida Public Service Commission ("Commission") to reduce its intrastate switched network access rates to interstate parity in a revenue neutral manner, stating as follows:

1. Petitioner is a local exchange telecommunications company ("ILEC") as that term is defined in Section 364.02, Florida Statutes. Petitioner's name, address and telephone number are:

Sprint-Florida, Incorporated
c/o Ben Poag
P. O. Box 2214
Tallahassee, FL 32316-2214
(850) 599-1029

2. All pleadings, filings and orders shall be directed on behalf of Sprint-Florida, Incorporated to:

John P. Fons, Esq.
Ausley & McMullen
P. O. Box 391
Tallahassee, FL 32302

Susan Masterton, Esq.
Sprint-Florida, Incorporated
P. O. Box 2214
Tallahassee, FL 32316

3. The Florida Tele-Competition Innovation and Infrastructure Enhancement Act ("2003 Act"), which became effective on May 23, 2003, authorizes the Commission to grant the reduction of intrastate switched network access rates charged by a local exchange telecommunications company in a revenue neutral manner upon the filing of a petition by a local exchange telecommunications company and upon consideration of whether granting the petition will:

(a) Remove current support for basic local telecommunications services that prevents the creation of a more attractive, competitive local exchange market for the benefit of residential consumers;

(b) Induce enhanced market entry;

(c) Require intrastate switched network access rate reductions to parity over a period of not less than 2 years or more than 4 years; and

(d) Be revenue neutral as defined in subsection (7) within the revenue category defined in subsection (2).

See Section 364.164(1), Florida Statutes 2003.

4. Sprint's Amended Petition, and associated amended testimony and exhibits accompanying this Amended Petition,[1] together with the associated testimony and exhibits accompanying Sprint's original Petition dated August 27, 2003, incorporated herein by this reference, address and fully satisfy each of the provisions of the 2003 Act to be considered by the Commission. The evidence presented by Sprint demonstrates that reducing intrastate switched

[1] This Amended Petition is supported by the amended testimony and amended exhibits sponsored by John M. Felz, and the amended testimony of Dr. Kenneth Gordon together with the testimony and exhibits of Kent W. Dickerson and Dr. Brian Staihr, and the exhibits of John M. Felz, not amended by this filing, filed August 27, 2003. Dr. Gordon has prepared revised direct testimony and exhibits on behalf of Sprint and BellSouth Telecommunications, Inc. ("BellSouth") and Verizon Florida, Inc. ("Verizon"). The citations will be to the witness' direct, or amended direct, testimony at a given page or to the exhibits referenced in that direct testimony; such as Felz Amended Direct Testimony at ___, or Dickerson Direct Testimony at Exhibit KWD-___.

access rates to interstate parity in a revenue neutral manner over a two-year period will achieve the goals of the 2003 Act by removing current support for basic local telecommunications services that prevents the creation of a more attractive, competitive local exchange market for the benefit of residential consumers, and by inducing enhanced market entry.

I. Introduction

5. The areas served by Sprint are predominantly non-urban, with lower customer density levels and higher costs per end user access line than its larger Florida ILEC neighbors, BellSouth Telecommunications, Inc. ("BellSouth") and Verizon Florida, Inc. ("Verizon"). Sprint offers subscribers within its service areas – many of which areas are non-contiguous areas – a variety of basic and non-basic telecommunications services, the prices or rates of which have been established by or approved by the Commission.

6. Until 1996, when Sprint elected price regulation, the prices for Sprint's residential basic local telecommunications service were set by the Commission using residual ratemaking principals which ignore the cost of provisioning as a factor in setting prices. Since 1996, any residential basic price increases have been made pursuant to a statutory index formula of inflation minus 1 percent. *See* Section 364.051(3), Florida Statutes. As reflected in cost studies approved by the Commission in 1998, the prices established by the Commission for Sprint's residential basic local telecommunications services do not, on average, cover the cost of providing residential basic local telecommunications service. *Report of the Florida Public Service Commission on the Relationships Among the Costs and Charges Associated with Providing Basic Local Service, Intrastate Access, and Other Services Provided by Local Exchange Companies, in Compliance with Chapter 98-277, Section 2(1), Laws of Florida*, Vol. 1, pp. 9-10, February 15, 1999 (Docket No. 980000A-SP). Similarly, using more current forward-looking economic cost analysis, the cost of providing residential basic local

telecommunications service still, on average, exceeds its price. Felz Direct Testimony at Exhibit JMF-3.

7. Sprint's intrastate switched network access rates in effect today are rates which were initially established by the Commission prior to the 1995 Florida Telecommunications Act ("1995 Act"), except for the reductions required by the 1995 Act and Chapter 98-277, Section 4, Laws of Florida. Sprint's intrastate switched network access rates were initially established by the Commission in 1983, without regard to cost, to replicate the significant contribution flowing to the local exchange companies from intrastate toll revenues through the division of revenues/toll settlements process. *See* Order No. 12765, Docket No. 820537-TP, issued December 9, 1983, at page 6. Intrastate switched network access charges were then, and have continued to be, the major source of interservices cross-subsidy. Even though intrastate switched network access rates were reduced through a series of devices on a LEC-by-LEC basis subsequent to 1983, but prior to the 1995 Act, rarely were the access rate reductions offset by increases in residential basic local service rates. In one situation in which the Commission was presented with an opportunity to reduce intrastate switched network rates, the Commission declined the opportunity and reduced residential basic local telecommunications service rates instead. *See In re: Investigation into Earnings of Central Telephone Company of Florida,* Docket No. 861361-TL, Order No. 17783, issued June 30, 1987.

8. The level of intrastate switched network access charges was designed by the Commission "to maintain the financial viability of the LECs while maintaining universal service." *Id.* page 7. "Maintaining Universal Service" means that residential basic local telecommunications service prices have been set as low as possible without regard to whether the prices cover cost. In other words, it has been standard regulatory policy that the contributions provided by intrastate switched network access rates and other non-basic services are to be used

to subsidize residential basic local telecommunications service prices. Gordon Amended Direct Testimony at 19-23. This policy of interservices cross-subsidies, while controversial, was marginally maintainable as long as the LECs maintained a local monopoly. Staihr Direct Testimony at 4. But, when the 1995 Act opened the LEC's local markets to competition, this policy of interservices cross-subsidies became a serious roadblock to the development of a competitive residential local market.

9. Consequently, Florida, today, finds itself in the difficult situation of trying to encourage residential local competition, but where the competitors have to compete against residential local service prices that are well below cost, are heavily subsidized by over-priced intrastate switched network access rates; and which provide insufficient margins to attract competition. The Florida Legislature, in recognition of this dilemma, enacted the 2003 Act to provide a mechanism for moving past these historical regulatory policies, thereby making the residential local service market more attractive to competitors. It is within the context of the 2003 Act that Sprint files this Amended Petition. The balance of this Amended Petition summarizes how the testimony and exhibits being proffered in support of the Amended Petition demonstrate that granting the Amended Petition meets the letter and spirit of the 2003 Act.

II. Granting Sprint's Amended Petition Will Remove Current Support for Basic Local Telecommunications Services that Prevents the Creation of a More Attractive, Competitive Local Exchange Market for the Benefit of Residential Consumers

A. Intrastate Switched Network Access Rates are Providing Support for Sprint's Residential Basic Local Telecommunications Services

10. It is without question that Sprint's intrastate switched network access rates have been set by the Commission and the Legislature at levels to support Sprint's below-cost residential basic local telecommunications services. Currently, Sprint's intrastate composite switched network access rate provides *over* $142 million per year in contribution to support

below-cost residential basic local telecommunications service rates. In passing the 1995 Act, the Florida Legislature went so far as to protect the ILECs' intrastate switched network access revenue stream by setting the switched network access rates in the statute and prohibiting CLECs from knowingly terminating toll calls over local interconnection facilities without paying the appropriate access charges. See Section 364.16(3), Florida Statutes. The Legislature's goal of preventing such arbitrage was to preserve the ILECs' ability to maintain universal service support. In 1995, the Commission ultimately determined that for the foreseeable future each ILEC should bear its own universal service support burden through its existing services and rate structure. *In re: Determination of Funding for Universal Service and Carrier of Last Resort Responsibilities*, Docket No. 950696, Order No. PSC-95-1592-FOF-TP, issued December 27, 1995, at page 20.

11. Sprint's *intrastate* switched network access rates (combined - originating and terminating) have been reduced from a high of approximately $0.24 per minute in 1984 to approximately $0.104 per minute today. Sprint's *interstate* switched network access rates, which are set by the Federal Communications Commission ("FCC"), have been reduced to approximately $0.013 per minute as of January 1, 2003. As defined in the 2003 Act, "parity" is the company's *intrastate* switched network access rate equal to its *interstate* switched network access rate in effect on January 1, 2003. See Section 364.164(5). In other words, by granting this Petition, Sprint's combined *intrastate* switched network access rate will decline from approximately $0.104 per minute to about $0.013 per minute. Even at this new price, Sprint's intrastate switched network rate will still exceed Sprint's forward-looking economic cost of $0.004475 per minute of use (Dickerson Direct Testimony at Exhibit KWD-2, page 4), and will continue to support below-cost residential basic local service.

12. Reducing Sprint's intrastate switched network access rates to interstate parity (from approximately $0.104 per minute to approximately $0.013 per minute) will result in the elimination of approximately $142 million per year in universal service support. Felz Amended Direct Testimony at Exhibit JMF-9. Based upon Sprint's forward-looking economic costs, Sprint's residential access lines are provided at a cost of $30.46 per month. Dickerson Direct Testimony at Exhibit KWD-2, page 2. Sprint's current residential basic service rate (weighted average) is $9.98 per month, per access line. Adding the Subscriber Line Charge (SLC) of $6.50 per line, per month, Sprint's residential basic access line revenue is $16.48 per month, versus the cost of $30.46. Felz Amended Direct Testimony at Exhibit JMF-3. This means that Sprint is experiencing a negative contribution amount of $13.98 per residential access line, per month, or a total annual shortfall from providing residential access lines at current rates well in access of $142 million per year.

B. Current Support for Residential Basic Local Telecommunications Services Prevents the Creation of a More Attractive, Competitive Residential Local Exchange Market

13. The Act makes it clear that it is level of support from intrastate switched network access rates which is to be addressed in any petition filed pursuant to the Act. This is because it is switched network access rates that are to be reduced in a revenue neutral manner. Section 364.164(1), Florida Statutes. The current level of support for residential basic local telecommunications services provided by Sprint's intrastate switched network access rates prevents the creation of a more attractive, competitive residential local market. That this is so is evident from a.) the level of competition in Florida for business customers compared to the level of competition for residential customers and b.) the level of residential competition in other states in which residential basic local telecommunications service rates are not so heavily supported. For example, in Florida, where business local services are priced well above cost, the

level of CLEC penetration is remarkable - approaching 30 percent of the business access lines. In comparison, the level of CLEC penetration in the residential local market is markedly lower - somewhere around 7 percent of the residential access lines. The difference in CLEC penetration levels can be attributed to the fact that Sprint's price for a business local access line is well above Sprint's cost to provide it - thereby creating attractive margins for CLECs - while Sprint's residential basic local access lines are saddled with historical regulatory prices that produce a negative contribution and a negative attractiveness to the CLECs. Staihr Direct Testimony at 4.

14. The CLECs' current lack of incentives for providing local service to Sprint's residential customers is further confirmed by comparing the residential basic local service rates in other states with the level of residential competition in those other states. In many of the other states in which residential basic local service competition is greater than what Sprint is experiencing in Florida, residential basic local services are priced closer to cost and, therefore, are not receiving the same high level of support from intrastate switched network access services as is occurring in Florida. Felz Amended Direct Testimony at 10; Gordon Amended Direct Testimony at 12-14. Competition is more likely where basic local service rates are more aligned with the cost of provisioning and less dependent upon interservice cross-subsidies. Staihr Direct Testimony at 5 and 7. It is worth noting that, upon the implementation of the reduction in intrastate switched network access rates to interstate parity in a revenue neutral manner, Sprint's residential basic local service prices will still be lower than the residential basic service prices in many other states. But, the movement in Sprint's Florida residential basic local service prices will send a clear signal to the CLECs that there are significant financial benefits available in serving the residential basic local service market. Staihr Direct Testimony at 6.

C. Removal of the Current Level of Support for Residential Basic Local Telecommunications Services Will Create a More Attractive, Competitive Local Exchange Market for the Benefit of Residential Customers

15. Those telecommunications consumers - both business and residential - who are experiencing robust local competition are the beneficiaries of that competition in the form of consumer choice of services, bundles of services, pricing packages and technologies. Staihr Direct Testimony at 15-16. The full benefits of residential local service competition will occur only when the residential local service market is not distorted by the presence of supported residential basic local service prices. Staihr Direct Testimony at 6; Gordon Amended Direct Testimony at 24-26.

16. More closely aligning residential basic local service prices with the forward-looking economic costs will serve to jump-start residential local competition in Florida. It can be expected that Sprint's residential local telecommunications service customers will thereby benefit from the availability of competitive local service providers offering a variety of services, packages of services, innovative pricing options and new technology. Gordon Amended Direct Testimony at 38-39. Although residential local competition will not happen overnight or come to all markets at the same time or in the same form, residential local competition will happen and will grow when the economics of competing are made more attractive to more competitors. As the process goes forward, more and more residential local service users will receive the benefits of competition. Staihr Direct Testimony at 8-10.

17. Because much of the territory served by Sprint is not a densely populated urban service territory, it is not certain that under current basic local service prices, the benefits of residential local service competition will immediately come to each of Sprint's customers. Yet, the evidence unquestionably demonstrates that residential competition will come as the result of granting Sprint's Amended Petition. Likewise, the evidence also demonstrates that competition in the less urban residential markets is not likely to ever materialize if Sprint's Amended Petition is not granted. Granting Sprint's Amended Petition will provide the impetus for CLECs and

other entrants to serve all Sprint's residential markets - wherever located - with new, different technologies, such as voice over internet protocol ("VOIP"), broadband over power lines ("BPL"), and fixed wireless services.

- The cable TV industry is currently conducting voice telephony trials using the VOIP transmission technology over cable TV lines and cable modems. Because of the extensive availability of cable TV networks, especially in residential areas, including rural areas, the cable TV infrastructure is readily available to provide voice telephony using VOIP transmission technologies. Staihr Direct Testimony at 9.
- The electrical power industry, including Florida electric utilities, are currently in trials using BPL technology to provide broadband services to consumers using the existing electrical grid. BPL technology is adaptable to also providing voice telephony. Again, because of the ubiquitous presence of the existing electric grid, BPL is a readily available alternative on a widespread basis to Sprint's local exchange telecommunications network and could be a significant competitive threat to its residential voice telephony, as well as data services. Staihr Direct Testimony at 9.
- There are a number of firms throughout the nation that are providing wireless services in less urban areas in competition with the ILECs. Given the proper financial incentives - including the ability to serve the less urban areas' profitability, these wireless firms can and will serve residential local customers in Sprint's rural areas as an alternative to wireline-based technologies. Staihr Direct Testimony at 9-10.

18. Infrastructure investment is contemplated by the federal 1996 Act and is an integral aspect of Florida's 2003 Act. With competition entering the residential local telecommunications service markets - urban, suburban and rural - on a large scale basis, there will be a substantial increase in infrastructure investment by the CLECs and by Sprint as well. In order to be able to compete successfully and efficiently in the residential market, Sprint will need to upgrade its network, including facilities and switches. Staihr Direct Testimony at 14. As just discussed, the competitors' infrastructure investment will come in several forms, including wireline, wireless, cable TV and electric power lines. As an additional benefit from stimulating local competition, the CLECs and Sprint's infrastructure investment activity will tend to create new, high-tech jobs and will tend to provide an infusion of capital-spending dollars into Florida's economy. Gordon Amended Direct Testimony at 32-34.

19. Making the residential local market more attractive to competitors is not the only benefit that Sprint's residential local service users will experience from granting Sprint's Amended Petition. Sprint's residential local service customers who subscribe to a major interexchange carrier (IXC) for their toll services will see a significant benefit from granting Sprint's Amended Petition. Felz Amended Direct Testimony at 27; Staihr Direct Testimony at 14. As required by the 2003 Act, each IXC that experiences expense savings from the reduction of intrastate switched network access rates must pass all of those savings on to their customers in the form of: a.) eliminating any "instate connection fee" by January 1, 2006; and b.) reducing intrastate toll rates. Section 364.163(2), Florida Statutes.

20. The "instate connection fee," which amounts to about $1.90 per month, is collected by several, major IXCs from many of their toll customers, regardless of the customers' level of toll usage. Thus, every residential toll customer paying the "instate connection fee" will see a reduction and eventual elimination of that $1.90 fee, regardless of how many or how few

toll calls the residential consumer makes each month. Felz Amended Direct Testimony at 26-27; Staihr Direct Testimony at 14. Thereafter, the IXCs' per-minute toll rates must be reduced to flow-through any residual intrastate switched network access rate reduction amounts.

21. Sprint will also provide its customers in outlying areas with additional benefits by reducing some extended calling service (ECS) charges, thereby effectively increasing those residential customers' flat-rate calling scope. These customers have long wanted the ability to have flat-rate calling opportunities with other Sprint customers with whom they have a community of interest. By bringing the residential basic local service prices more in line with costs, the past cost-disincentives will be greatly reduced, thereby making it more financially justifiable to provide these customers' with reduced charges in the form of a five (5)-free-call allowance. Felz Amended Direct Testimony at 26.

22. Also of importance in assessing the impact of granting Sprint's Amended Petition is the protection the 2003 Act provides for Florida's economically disadvantaged residential local service subscribers. Under the 2003 Act, any increases in residential basic local telecommunications service rates authorized by granting Sprint's Amended Petition will not apply to Sprint's Lifeline subscribers during the period that Sprint's intrastate switched network access rates are being reduced to interstate parity in a revenue neutral manner. Section 364.10(3)(c). Sprint is also committing, as part of its plan, to exempting its Lifeline subscribers from the effects of granting Sprint's Amended Petition for a period of three (3) years (at least through the first quarter, 2007). Felz Amended Direct Testimony at 27-28.

III. Granting Sprint's Amended Petition Will Induce Enhanced Market Entry

23. Granting Sprint's Amended Petition will induce enhanced market entry. Realigning access and basic local service prices closer to their costs will send a powerful signal to the CLECs who have otherwise been reluctant to serve the residential local service market.

Once the competitors are convinced that serving Sprint's residential local service markets is more in line with their economic interest, and once the entrants make the necessary infrastructure investment to serve the residential local service markets, residential local service consumers will see an array of enhanced services, bundles of services and technologies from which they can pick and choose at prices dictated by the marketplace. Gordon Amended Direct Testimony at 38-39; Staihr Direct Testimony at 8-10.

IV. Granting Sprint's Amended Petition Will Result in Intrastate Switched Network Access Rate Reductions to Parity Over a Period of Two Years

24. The 2003 Act provides that Sprint has the flexibility to determine the time period over which it may implement its intrastate switched network access rate reductions, so long as the reductions are revenue neutral to Sprint and are achieved between two (2) years and four (4) years. Sprint is designating three annual reductions over a two-year time period, beginning in the first quarter 2004, and concluding in the first quarter 2006, to accomplish the revenue neutral intrastate switched network access reductions. Felz Amended Direct Testimony at 17-19. By implementing the reductions over a two-year timeframe, Sprint will signal its competition that the residential local service market will be an attractive market sooner rather than later, and that the competitors can commence their infrastructure investment now rather than years from now. Gordon Amended Direct Testimony at 16-17; Felz Amended Direct Testimony at 26. In this way, residential local service users will receive the benefits of a competitive market in a relatively short timeframe, furthering the overarching purpose of the 2003 Act to promote competition.

25. Sprint recognizes that by implementing the intrastate switched network access reductions over a two-year period, as opposed to a longer period, the size of each annual basic local telecommunications service rate adjustment will therefore be larger each year. Consequently, as noted previously, in order to provide additional benefits to its residential

customers (especially those customers most likely to feel the impact of the basic local service price increases), Sprint will commit to the following steps:

a) eliminate/reduce the charge paid by basic local telecommunications service customers for certain extended calling service (ECS) and extended area service (EAS) routes by providing a five-free-call allowance; and

b) exempt Lifeline service subscribers from basic local telecommunication service price increases associated with the rate rebalancing for three (3) years from the grant of the Amended Petition (at least through the first quarter 2007). See Felz Amended Direct Testimony at 27-28.

V. Granting Sprint's Amended Petition Will Be Revenue Neutral

26. The 2003 Act mandates that Sprint must reduce its intrastate switched network access rates in a revenue neutral manner. The mechanism for achieving revenue neutrality is set forth in the statute. See Sections 364.164(4) and (7), Florida Statutes. Simply stated, the revenue neutrality requirement means that the intrastate switched network access rate reductions made by Sprint must be offset by increases in Sprint's basic local service rates.[2] In this regard, as stated previously, Sprint's reduction of its intrastate switched network access rate from a combined $0.104 per minute to parity with its interstate switched network access rate in effect on January 1, 2003, of $0.013 per minute, will, based upon current annual units, result in a reduction in Sprint's intrastate revenues by approximately $142 million.

27. Sprint will offset the annual $142 million shortfall by increasing its residential and single-line business basic local telecommunications service rates in three annual increments over a two year period concluding in the first quarter, 2006. Based upon current annual basic local service units, Sprint will increase residential basic local service rates by $2.95 per month in

[2] Basic local service rates include the monthly recurring rates for residential and single-line business basic local telecommunications service and non-recurring charges associated with the installation and connection of these services.

2004, by $2.75 per month in 2005, and by $1.16 per month in 2006. The exact date of the first and subsequent annual increases will be dependent upon when the Commission grants Sprint's Amended Petition. Even with these increases, the monthly price of residential basic local service will, on average, still be below the average monthly cost of $30.46 per access line. Dickerson Direct Testimony at Exhibit KWD-2, page 2. In addition, as required by the 2003 Act, Sprint will recover a portion of the revenue offset requirement from basic local service connection fees. Felz Amended Direct Testimony at 23.

28. Sprint will also increase its single-line business basic local service rates in three annual increments over a two-year period concluding in the first quarter, 2006; by an average of $2.70per month in 2004, $2.40 in 2005, and $.90 per month in 2006. Felz Amended Direct Testimony at 22. Sprint's current average single-line business access line revenue of $27.68 per month, including the $6.50 per month SLC, exceeds Sprint's average cost of providing single-line business basic local service. Felz Amended Direct Testimony at Exhibit JMF-4. By recovering a portion of Sprint's intrastate switched network access reduction amount from single-line business basic local telecommunications customers, even though those service rates already, on average, cover costs, Sprint is actually shifting away a portion of the access revenue reduction impact which otherwise would need to be recovered from Sprint's residential basic local telecommunications service customers.

29. Sprint has elected, in its Amended Petition, to increase its basic local services prices in a graduated manner over the two-year period because Sprint continues to believe that it is important to eliminate the non-cost-based component of its intrastate switched network access rate as quickly as possible. This principle drives, in part, the size of the resulting first of three annual basic local service price increases. The size of each of the remaining two annual switched access rate decreases and resulting basic local service price increases also reflects

Sprint's efforts to fulfill the underlying goal of the legislation to enhance the creation of a more competitive local market for the benefit of residential consumers as quickly as possible. Felz Amended Direct Testimony at 25.

30. Although the annual intrastate switched network access rate will be known, the actual amount of the basic local telecommunication service revenue annual offset will be dependent upon the size of the intrastate switched network access revenue reduction. This amount will be calculated by multiplying each annual intrastate switched network access per minute rate reduction by the number of intrastate switched network access minutes of use for the most recent, available 12-month period at the time the rate adjustments are made. Felz Amended Direct Testimony at Amended Exhibit JMF-11. Also, the amount of any annual rate increase to be applied to a given basic local telecommunications rate element will be dependent upon several factors, including the 2003 Act's provision that not all of the offset is to be recovered from the basic monthly recurring rate. Felz Amended Direct Testimony at Amended Exhibit JMF-12. Other factors impacting the amount of the adjustment might include the cost/revenue relationship of the basic service rate element and the most recent 12-month number of units of the basic service rate element. Felz Amended Direct Testimony at 24.

VI. Conclusion

31. The 2003 Act creates the mechanism by which residential local competition can become a reality in Florida. The key to that reality is the reduction of the considerable local residential service price support being provided by over-priced intrastate switched network access in a revenue neutral manner. By shifting the cost recovery to the cost-causers, namely, to basic local service customers, it follows that competitors will enter Sprint's local market to serve a broader number of residential customers with a variety of innovative technologies, services and pricing choices. Competition will allow the market, rather than regulation, to determine these

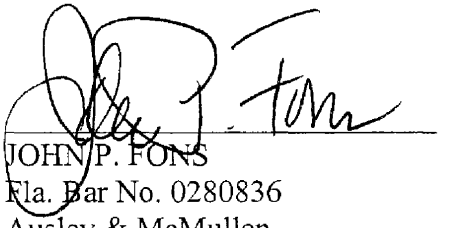
technologies, services and pricing choices. As noted by Governor Bush in his May 23, 2003, transmittal letter approving the 2003 Act:

> I am certain that this legislation will allow all Floridians to experience greater options, so that, ultimately, local phone customers will have the opportunity to access new technology and be offered the level of choice and quality that is now commonplace in long distance services and cellular phone plans.

As demonstrated by the accompanying testimony and exhibits, granting Sprint's Amended Petition will bring the full benefits of competition to Florida's residential consumers as contemplated by the 2003 Act.

WHEREFORE, having demonstrated, through this Amended Petition and the accompanying testimony and exhibits, that the criteria to be considered by the Commission, pursuant to Section 364.164(1)(a)-(d), Florida Statutes, have been fully addressed and satisfied, Sprint requests that the Commission grant this Amended Petition and authorize Sprint to reduce its intrastate switched network rates to interstate parity in a revenue neutral manner.

Respectfully submitted,



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ATTORNEYS FOR SPRINT-FLORIDA, INCORPORATED

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing has been furnished by e-mail and U.S. Mail this 1st day of October, 2003, to the following:

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

IN RE: SPRINT-FLORIDA, INCORPORATED'S PETITION TO REDUCE INTRASTATE SWITCHED NETWORK ACCESS RATES TO INTERSTATE PARITY IN A REVENUE NEUTRAL MANNER PURSUANT TO SECTION 364.164(1), FLORIDA STATUTES

DOCKET NO.: 030868-TL
FILED: October 1, 2003

SPRINT-FLORIDA, INCORPORATED'S AMENDED PETITION TO REDUCE INTRASTATE SWITCHED NETWORK ACCESS RATES TO INTERSTATE PARITY IN A REVENUE NEUTRAL MANNER

Sprint-Florida, Incorporated ("Sprint"), pursuant to Rule 28-106.104, Florida Administrative Code, ~~and~~ Section 364.164(1), Florida Statutes, and pursuant to the directions of the Commission at its September 30, 2003 Agenda Conference, submits its Amended ~~p~~Petitions to the Florida Public Service Commission ("Commission") to reduce its intrastate switched network access rates to interstate parity in a revenue neutral manner, stating as follows:

1. Petitioner is a local exchange telecommunications company ("ILEC") as that term is defined in Section 364.02, Florida Statutes. Petitioner's name, address and telephone number are:

Sprint-Florida, Incorporated
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Tallahassee, FL 32316-2214
(850) 599-1029

2. All pleadings, filings and orders shall be directed on behalf of Sprint-Florida, Incorporated to:

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3. The Florida Tele-Competition Innovation and Infrastructure Enhancement Act ("2003 Act"), which became effective on May 23, 2003, authorizes the Commission to grant the reduction of intrastate switched network access rates charged by a local exchange telecommunications company in a revenue neutral manner upon the filing of a petition by a local exchange telecommunications company and upon consideration of whether granting the petition will:

(a) Remove current support for basic local telecommunications services that prevents the creation of a more attractive, competitive local exchange market for the benefit of residential consumers;

(b) Induce enhanced market entry;

(c) Require intrastate switched network access rate reductions to parity over a period of not less than 2 years or more than 4 years; and

(d) Be revenue neutral as defined in subsection (7) within the revenue category defined in subsection (2).

See Section 364.164(1), Florida Statutes 2003.

4. Sprint's Amended Petition, and associated amended testimony and exhibits accompanying this Amended Petition,[1] together with the associated testimony and exhibits accompanying Sprint's original Petition dated August 27, 2003, incorporated herein by this reference, address and fully satisfy each of the provisions of the 2003 Act to be considered by the Commission. The evidence presented by Sprint demonstrates that reducing intrastate switched

[1] This Amended Petition is supported by the amended testimony and amended exhibits sponsored by John M. Felz, ~~Kent W. Dickerson, Dr. Brian K. Staihr~~ and the amended testimony of Dr. Kenneth Gordon together with the testimony and exhibits of Kent W. Dickerson and Dr. Brian Staihr, and the exhibits of John M. Felz, not amended by this filing, filed August 27, 2003. Dr. Gordon has prepared revised direct testimony and exhibits on behalf of Sprint and BellSouth Telecommunications, Inc. ("BellSouth") and Verizon Florida, Inc. ("Verizon"). The citations will be to the witness' direct, or amended direct, testimony at a given page or to the exhibits referenced in that direct testimony; such as Felz Amended Direct Testimony at ___, or Dickerson Direct Testimony at Exhibit KWD-___.

access rates to interstate parity in a revenue neutral manner over a two-year period will achieve the goals of the 2003 Act by removing current support for basic local telecommunications services that prevents the creation of a more attractive, competitive local exchange market for the benefit of residential consumers, and by inducing enhanced market entry.

I. Introduction

5. The areas served by Sprint are predominantly non-urban, with lower customer density levels and higher costs per end user access line than its larger Florida ILEC neighbors, BellSouth Telecommunications, Inc. ("BellSouth") and Verizon Florida, Inc. ("Verizon"). Sprint offers subscribers within its service areas – many of which areas are non-contiguous areas – a variety of basic and non-basic telecommunications services, the prices or rates of which have been established by or approved by the Commission.

6. Until 1996, when Sprint elected price regulation, the prices for Sprint's residential basic local telecommunications service were set by the Commission using residual ratemaking principals which ignore the cost of provisioning as a factor in setting prices. Since 1996, any residential basic price increases have been made pursuant to a statutory index formula of inflation minus 1 percent. *See* Section 364.051(3), Florida Statutes. As reflected in cost studies approved by the Commission in 1998, the prices established by the Commission for Sprint's residential basic local telecommunications services do not, on average, cover the cost of providing residential basic local telecommunications service. *Report of the Florida Public Service Commission on the Relationships Among the Costs and Charges Associated with Providing Basic Local Service, Intrastate Access, and Other Services Provided by Local Exchange Companies, in Compliance with Chapter 98-277, Section 2(1), Laws of Florida*, Vol. 1, pp. 9-10, February 15, 1999 (Docket No. 980000A-SP). Similarly, using more current forward-looking economic cost analysis, the cost of providing residential basic local

telecommunications service still, on average, exceeds its price. Felz Direct Testimony at Exhibit JMF-3.

7. Sprint's intrastate switched network access rates in effect today are rates which were initially established by the Commission prior to the 1995 Florida Telecommunications Act ("1995 Act"), except for the reductions required by the 1995 Act and Chapter 98-277, Section 4, Laws of Florida. Sprint's intrastate switched network access rates were initially established by the Commission in 1983, without regard to cost, to replicate the significant contribution flowing to the local exchange companies from intrastate toll revenues through the division of revenues/toll settlements process. *See* Order No. 12765, Docket No. 820537-TP, issued December 9, 1983, at page 6. Intrastate switched network access charges were then, and have continued to be, the major source of interservices cross-subsidy. Even though intrastate switched network access rates were reduced through a series of devices on a LEC-by-LEC basis subsequent to 1983, but prior to the 1995 Act, rarely were the access rate reductions offset by increases in residential basic local service rates. In one situation in which the Commission was presented with an opportunity to reduce intrastate switched network rates, the Commission declined the opportunity and reduced residential basic local telecommunications service rates instead. *See In re: Investigation into Earnings of Central Telephone Company of Florida,* Docket No. 861361-TL, Order No. 17783, issued June 30, 1987.

8. The level of intrastate switched network access charges was designed by the Commission "to maintain the financial viability of the LECs while maintaining universal service." *Id.* page 7. "Maintaining Universal Service" means that residential basic local telecommunications service prices have been set as low as possible without regard to whether the prices cover cost. In other words, it has been standard regulatory policy that the contributions provided by intrastate switched network access rates and other non-basic services are to be used

to subsidize residential basic local telecommunications service prices. Gordon Amended Direct Testimony at ~~18-21~~ 19-23. This policy of interservices cross-subsidies, while controversial, was marginally maintainable as long as the LECs maintained a local monopoly. Staihr Direct Testimony at 4. But, when the 1995 Act opened the LEC's local markets to competition, this policy of interservices cross-subsidies became a serious roadblock to the development of a competitive residential local market.

9. Consequently, Florida, today, finds itself in the difficult situation of trying to encourage residential local competition, but where the competitors have to compete against residential local service prices that are well below cost, are heavily subsidized by over-priced intrastate switched network access rates; and which provide insufficient margins to attract competition. The Florida Legislature, in recognition of this dilemma, enacted the 2003 Act to provide a mechanism for moving past these historical regulatory policies, thereby making the residential local service market more attractive to competitors. It is within the context of the 2003 Act that Sprint files this Amended Petition. The balance of this Amended Petition summarizes how the testimony and exhibits being proffered in support of the Amended Petition demonstrate that granting the Amended Petition meets the letter and spirit of the 2003 Act.

II. Granting Sprint's Amended Petition Will Remove Current Support ~~for~~ for Basic Local Telecommunications Services that Prevents the Creation of a More Attractive, Competitive Local Exchange Market for the Benefit of Residential Consumers

A. Intrastate Switched Network Access Rates are Providing Support for Sprint's Residential Basic Local Telecommunications Services

10. It is without question that Sprint's intrastate switched network access rates have been set by the Commission and the Legislature at levels to support Sprint's below-cost residential basic local telecommunications services. Currently, Sprint's intrastate composite switched network access rate provides *over* $142 million per year in contribution to support

below-cost residential basic local telecommunications service rates. In passing the 1995 Act, the Florida Legislature went so far as to protect the ILECs' intrastate switched network access revenue stream by setting the switched network access rates in the statute and prohibiting CLECs from knowingly terminating toll calls over local interconnection facilities without paying the appropriate access charges. See Section 364.16(3), Florida Statutes. The Legislature's goal of preventing such arbitrage was to preserve the ILECs' ability to maintain universal service support. In 1995, the Commission ultimately determined that for the foreseeable future each ILEC should bear its own universal service support burden through its existing services and rate structure. *In re: Determination of Funding for Universal Service and Carrier of Last Resort Responsibilities*, Docket No. 950696, Order No. PSC-95-1592-FOF-TP, issued December 27, 1995, at page 20.

11. Sprint's *intrastate* switched network access rates (combined - originating and terminating) have been reduced from a high of approximately $0.24 per minute in 1984 to approximately $0.104 per minute today. Sprint's *interstate* switched network access rates, which are set by the Federal Communications Commission ("FCC"), have been reduced to approximately $0.013 per minute as of January 1, 2003. As defined in the 2003 Act, "parity" is the company's *intrastate* switched network access rate equal to its *interstate* switched network access rate in effect on January 1, 2003. See Section 364.164(5). In other words, by granting this Petition, Sprint's combined *intrastate* switched network access rate will decline from approximately $0.104 per minute to about $0.013 per minute. Even at this new price, Sprint's intrastate switched network rate will still exceed Sprint's forward-looking economic cost of $0.004475 per minute of use (Dickerson Direct Testimony at Exhibit KWD-2, page 4), and will continue to support below-cost residential basic local service.

12. Reducing Sprint's intrastate switched network access rates to interstate parity (from approximately $0.104 per minute to approximately $0.013 per minute) will result in the elimination of approximately $142 million per year in universal service support. Felz Amended Direct Testimony at Exhibit JMF-9. Based upon Sprint's forward-looking economic costs, Sprint's residential access lines are provided at a cost of $30.46 per month. Dickerson Direct Testimony at Exhibit KWD-2, page 2. Sprint's current residential basic service rate (weighted average) is $9.98 per month, per access line. Adding the Subscriber Line Charge (SLC) of $6.50 per line, per month, Sprint's residential basic access line revenue is $16.48 per month, versus the cost of $30.46. Felz Amended Direct Testimony at Exhibit JMF-3. This means that Sprint is experiencing a negative contribution amount of $13.98 per residential access line, per month, or a total annual shortfall from providing residential access lines at current rates well in access of $142 million per year.

B. Current Support for Residential Basic Local Telecommunications Services Prevents the Creation of a More Attractive, Competitive Residential Local Exchange Market

13. The Act makes it clear that it is level of support from intrastate switched network access rates which is to be addressed in any petition filed pursuant to the Act. This is because it is switched network access rates that are to be reduced in a revenue neutral manner. Section 364.164(1), Florida Statutes. The current level of support for residential basic local telecommunications services provided by Sprint's intrastate switched network access rates prevents the creation of a more attractive, competitive residential local market. That this is so is evident from a.) the level of competition in Florida for business customers compared to the level of competition for residential customers and b.) the level of residential competition in other states in which residential basic local telecommunications service rates are not so heavily supported. For example, in Florida, where business local services are priced well above cost, the

level of CLEC penetration is remarkable - approaching 30 percent of the business access lines. In comparison, the level of CLEC penetration in the residential local market is markedly lower - somewhere around 7 percent of the residential access lines. The difference in CLEC penetration levels can be attributed to the fact that Sprint's price for a business local access line is well above Sprint's cost to provide it - thereby creating attractive margins for CLECs - while Sprint's residential basic local access lines are saddled with historical regulatory prices that produce a negative contribution and a negative attractiveness to the CLECs. Staihr Direct Testimony at 4.

14. The CLECs' current lack of incentives for providing local service to Sprint's residential customers is further confirmed by comparing the residential basic local service rates in other states with the level of residential competition in those other states. In many of the other states in which residential basic local service competition is greater than what Sprint is experiencing in Florida, residential basic local services are priced closer to cost and, therefore, are not receiving the same high level of support from intrastate switched network access services as is occurring in Florida. Felz Amended Direct Testimony at 10; Gordon Amended Direct Testimony at ~~11-12~~ 12-14. Competition is more likely where basic local service rates are more aligned with the cost of provisioning and less dependent upon interservice cross-subsidies. Staihr Direct Testimony at 5 and 7. It is worth noting that, upon the implementation of the reduction in intrastate switched network access rates to interstate parity in a revenue neutral manner, Sprint's residential basic local service prices will still be lower than the residential basic service prices in many other states. But, the movement in Sprint's Florida residential basic local service prices will send a clear signal to the CLECs that there are significant financial benefits available in serving the residential basic local service market. Staihr Direct Testimony at 6.

C. Removal of the Current Level of Support for Residential Basic Local Telecommunications Services Will Create a More Attractive, Competitive Local Exchange Market for the Benefit of Residential Customers

15. Those telecommunications consumers - both business and residential - who are experiencing robust local competition are the beneficiaries of that competition in the form of consumer choice of services, bundles of services, pricing packages and technologies. Staihr Direct Testimony at 15-16. The full benefits of residential local service competition will occur only when the residential local service market is not distorted by the presence of supported residential basic local service prices. Staihr Direct Testimony at 6; Gordon Amended Direct Testimony at ~~23-25~~ 24-26.

16. More closely aligning residential basic local service prices with the forward-looking economic costs will serve to jump-start residential local competition in Florida. It can be expected that Sprint's residential local telecommunications service customers will thereby benefit from the availability of competitive local service providers offering a variety of services, packages of services, innovative pricing options and new technology. Gordon Amended Direct Testimony at ~~37~~ 38-39. Although residential local competition will not happen overnight or come to all markets at the same time or in the same form, residential local competition will happen and will grow when the economics of competing are made more attractive to more competitors. As the process goes forward, more and more residential local service users will receive the benefits of competition. Staihr Direct Testimony at 8-10.

17. Because much of the territory served by Sprint is not a densely populated urban service territory, it is not certain that under current basic local service prices, the benefits of residential local service competition will immediately come to each of Sprint's customers. Yet, the evidence unquestionably demonstrates that residential competition will come as the result of granting Sprint's Amended Petition. Likewise, the evidence also demonstrates that competition in the less urban residential markets is not likely to ever materialize if Sprint's Amended Petition is not granted. Granting Sprint's Amended Petition will provide the impetus for CLECs and

other entrants to serve all Sprint's residential markets - wherever located - with new, different technologies, such as voice over internet protocol ("VOIP"), broadband over power lines ("BPL"), and fixed wireless services.

- The cable TV industry is currently conducting voice telephony trials using the VOIP transmission technology over cable TV lines and cable modems. Because of the extensive availability of cable TV networks, especially in residential areas, including rural areas, the cable TV infrastructure is readily available to provide voice telephony using VOIP transmission technologies. Staihr Direct Testimony at 9.
- The electrical power industry, including Florida electric utilities, are currently in trials using BPL technology to provide broadband services to consumers using the existing electrical grid. BPL technology is adaptable to also providing voice telephony. Again, because of the ubiquitous presence of the existing electric grid, BPL is a readily available alternative on a widespread basis to Sprint's local exchange telecommunications network and could be a significant competitive threat to its residential voice telephony, as well as data services. Staihr Direct Testimony at 9.
- There are a number of firms throughout the nation that are providing wireless services in less urban areas in competition with the ILECs. Given the proper financial incentives - including the ability to serve the less urban areas' profitability, these wireless firms can and will serve residential local customers in Sprint's rural areas as an alternative to wireline-based technologies. Staihr Direct Testimony at 9-10.

18. Infrastructure investment is contemplated by the federal 1996 Act and is an integral aspect of Florida's 2003 Act. With competition entering the residential local telecommunications service markets - urban, suburban and rural - on a large scale basis, there will be a substantial increase in infrastructure investment by the CLECs and by Sprint as well. In order to be able to compete successfully and efficiently in the residential market, Sprint will need to upgrade its network, including facilities and switches. Staihr Direct Testimony at 14. As just discussed, the competitors' infrastructure investment will come in several forms, including wireline, wireless, cable TV and electric power lines. As an additional benefit from stimulating local competition, the CLECs and Sprint's infrastructure investment activity will tend to create new, high-tech jobs and will tend to provide an infusion of capital-spending dollars into Florida's economy. Gordon Amended Direct Testimony at ~~31-33~~ 32-34.

19. Making the residential local market more attractive to competitors is not the only benefit that Sprint's residential local service users will experience from granting Sprint's Amended Petition. Sprint's residential local service customers who subscribe to a major interexchange carrier (IXC) for their toll services will see a significant benefit from granting Sprint's Amended Petition. Felz Amended Direct Testimony at ~~24-25~~ 27; Staihr Direct Testimony at 14. As required by the 2003 Act, each IXC that experiences expense savings from the reduction of intrastate switched network access rates must pass all of those savings on to their customers in the form of: a.) eliminating any "instate connection fee" by January 1, 2006; and b.) reducing intrastate toll rates. Section 364.163(2), Florida Statutes.

20. The "instate connection fee," which amounts to about $1.90 per month, is collected by several, major IXCs from many of their toll customers, regardless of the customers' level of toll usage. Thus, every residential toll customer paying the "instate connection fee" will see a reduction and eventual elimination of that $1.90 fee, regardless of how many or how few

toll calls the residential consumer makes each month. Felz Amended Direct Testimony at ~~24-25~~ 26-27; Staihr Direct Testimony at 14. Thereafter, the IXCs' per-minute toll rates must be reduced to flow-through any residual intrastate switched network access rate reduction amounts.

21. Sprint will also provide its customers in outlying areas with additional benefits by reducing some extended calling service (ECS) charges, thereby effectively increasing those residential customers' flat-rate calling scope. These customers have long wanted the ability to have flat-rate calling opportunities with other Sprint customers with whom they have a community of interest. By bringing the residential basic local service prices more in line with costs, the past cost-disincentives will be greatly reduced, thereby making it more financially justifiable to provide these customers' with reduced charges in the form of a five (5)-free-call allowance. Felz Amended Direct Testimony at ~~24~~ 26.

22. Also of importance in assessing the impact of granting Sprint's Amended Petition is the protection the 2003 Act provides for Florida's economically disadvantaged residential local service subscribers. Under the 2003 Act, any increases in residential basic local telecommunications service rates authorized by granting Sprint's Amended Petition will not apply to Sprint's Lifeline subscribers during the period that Sprint's intrastate switched network access rates are being reduced to interstate parity in a revenue neutral manner. Section 364.10(3)(c). Sprint is also committing, as part of its plan, to exempting its Lifeline subscribers from the effects of granting Sprint's Amended Petition for a period of three (3) years ~~time period~~ (at least through the first quarter, 2007). Felz Amended Direct Testimony at ~~25~~ 27-28.

III. Granting Sprint's Amended Petition Will Induce Enhanced Market Entry

23. Granting Sprint's Amended Petition will induce enhanced market entry. Realigning access and basic local service prices closer to their costs will send a powerful signal to the CLECs who have otherwise been reluctant to serve the residential local service market.

Once the competitors are convinced that serving Sprint's residential local service markets is more in line with their economic interest, and once the entrants make the necessary infrastructure investment to serve the residential local service markets, residential local service consumers will see an array of enhanced services, bundles of services and technologies from which they can pick and choose at prices dictated by the marketplace. Gordon Amended Direct Testimony at ~~37-38~~ 38-39; Staihr Direct Testimony at 8-10.

IV. Granting Sprint's Amended Petition Will Result in Intrastate Switched Network Access Rate Reductions to Parity Over a Period of Two Years

24. The 2003 Act provides that Sprint has the flexibility to determine the time period over which it may implement its intrastate switched network access rate reductions, so long as the reductions are revenue neutral to Sprint and are achieved between two (2) years and four (4) years. Sprint is designating three annual reductions over a two-year time period, beginning in the first quarter 2004, and concluding in the first quarter 2006, to accomplish the revenue neutral intrastate switched network access reductions. Felz Amended Direct Testimony at 17-19. By implementing the reductions over a two-year timeframe, Sprint will signal its competition that the residential local service market will be an attractive market sooner rather than later, and that the competitors can commence their infrastructure investment now rather than years from now. Gordon Amended Direct Testimony at ~~15-16~~ 16-17; Felz Amended Direct Testimony at ~~23-24~~ 26. In this way, residential local service users will receive the benefits of a competitive market in a relatively short timeframe, furthering the overarching purpose of the 2003 Act to promote competition.

25. Sprint recognizes that by implementing the intrastate switched network access reductions over a two-year period, as opposed to a longer period, the size of each annual basic local telecommunications service rate adjustment will therefore be larger each year. Consequently, as noted previously, in order to provide additional benefits to its residential

customers (especially those customers most likely to feel the impact of the basic local service price increases), Sprint will commit to the following steps:

a) eliminate/reduce the charge paid by basic local telecommunications service customers for certain extended calling service (ECS) and extended area service (EAS) routes by providing a five-free-call allowance; and

b) exempt Lifeline service subscribers from basic local telecommunication service price increases associated with the rate rebalancing for three (3) years from the grant of the Amended Petition (at least through the first quarter 2007). See Felz Amended Direct Testimony at ~~24-25~~ 27-28.

V. Granting Sprint's Amended Petition Will Be Revenue Neutral

26. The 2003 Act mandates that Sprint must reduce its intrastate switched network access rates in a revenue neutral manner. The mechanism for achieving revenue neutrality is set forth in the statute. See Sections 364.164(4) and (7), Florida Statutes. Simply stated, the revenue neutrality requirement means that the intrastate switched network access rate reductions made by Sprint must be offset by increases in Sprint's basic local service rates.[2] In this regard, as stated previously, Sprint's reduction of its intrastate switched network access rate from a combined $0.104 per minute to parity with its interstate switched network access rate in effect on January 1, 2003, of $0.013 per minute, will, based upon current annual units, result in a reduction in Sprint's intrastate revenues by approximately $142 million.

27. Sprint will offset the annual $142 million shortfall by increasing its residential and single-line business basic local telecommunications service rates in three annual increments over a two years period concluding in the first quarter, 2006. Based upon current annual basic local service units, Sprint will increase residential basic local service rates by $~~3.23~~2.95 per

[2] Basic local service rates include the monthly recurring rates for residential and single-line business basic local telecommunications service and non-recurring charges associated with the installation and connection of these services.

month in ~~in year one~~ 2004, ~~and~~ by ~~$3.63~~2.75 per month ~~in year two~~ in 2005, and by $1.16 per month in 2006. The exact date of the first and subsequent annual increases will be dependent upon when the Commission grants Sprint's Amended Petition. Even with these increases, the monthly price of residential basic local service will, on average, still be below the average monthly cost of $30.46 per access line. Dickerson Direct Testimony at Exhibit KWD-2, page 2. In addition, as required by the 2003 Act, Sprint will recover a portion of the revenue offset requirement from basic local service connection fees. Felz Amended Direct Testimony at ~~21~~ 23.

28. Sprint will also increase its single-line business basic local service rates in three annual increments over a two-year period concluding in the first quarter, 2006; by an average of $2.70~~2.87~~ per month ~~in year one and~~ in 2004, ~~by~~ $2.40 ~~3.13~~in 2005, and $.90 per month in 2006 ~~in year two~~. Felz Amended Direct Testimony at ~~21~~ 22. Sprint's current average single-line business access line revenue of $27.68 per month, including the $6.50 per month SLC, exceeds Sprint's average cost of providing single-line business basic local service. Felz Amended Direct Testimony at Exhibit JMF-4. By recovering a portion of Sprint's intrastate switched network access reduction amount from single-line business basic local telecommunications customers, even though those service rates already, on average, cover costs, Sprint is actually shifting away a portion of the access revenue reduction impact which otherwise would need to be recovered from Sprint's residential basic local telecommunications service customers.

29. Sprint has elected, in its Amended Petition, to increase its basic local services prices in a graduated manner over the two-year period because Sprint continues to believe that it is important to eliminate the non-cost-based component of its intrastate switched network access rate as quickly as possible. This principle drives, in part, the size of the resulting first of three annual basic local service price increases. The size of each of the remaining two annual switched access rate decreases and resulting basic local service price increases also reflects

Sprint's efforts to fulfill the underlying goal of the legislation to enhance the creation of a more competitive local market for the benefit of residential consumers as quickly as possible. Felz Amended Direct Testimony at 25.

~~29.~~30. Although the annual intrastate switched network access rate ~~adjustments~~ will be ~~fixed~~ known, the actual amount of the basic local telecommunication service revenue annual offset will be dependent upon the size of the intrastate switched network access revenue reduction. This amount will be calculated by multiplying each annual intrastate switched network access per minute rate reduction by the number of intrastate switched network access minutes of use for the most recent, available 12-month period at the time the rate adjustments are made. Felz Amended Direct Testimony at Amended Exhibit JMF-11. Also, the amount of any annual rate increase to be applied to a given basic local telecommunications rate element will be dependent upon several factors, including the 2003 Act's provision that not all of the offset is to be recovered from the basic monthly recurring rate. Felz Amended Direct Testimony at Amended Exhibit JMF-12. Other factors impacting the amount of the adjustment might include the cost/revenue relationship of the basic service rate element and the most recent 12-month number of units of the basic service rate element. Felz Amended Direct Testimony at ~~22-23~~ 24.

VI. Conclusion

~~30.~~31. The 2003 Act creates the mechanism by which residential local competition can become a reality in Florida. The key to that reality is the reduction of the considerable local residential service price support being provided by over-priced intrastate switched network access in a revenue neutral manner. By shifting the cost recovery to the cost-causers, namely, to basic local service customers, it follows that competitors will enter Sprint's local market to serve a broader number of residential customers with a variety of innovative technologies, services and pricing choices. Competition will allow the market, rather than regulation, to determine these

technologies, services and pricing choices. As noted by Governor Bush in his May 23, 2003, transmittal letter approving the 2003 Act:

> I am certain that this legislation will allow all Floridians to experience greater options, so that, ultimately, local phone customers will have the opportunity to access new technology and be offered the level of choice and quality that is now commonplace in long distance services and cellular phone plans.

As demonstrated by the accompanying testimony and exhibits, granting Sprint's Amended Petition will bring the full benefits of competition to Florida's residential consumers as contemplated by the 2003 Act.

WHEREFORE, having demonstrated, through this Amended Petition and the accompanying testimony and exhibits, that the criteria to be considered by the Commission, pursuant to Section 364.164(1)(a)-(d), Florida Statutes, have been fully addressed and satisfied, Sprint requests that the Commission grant this Amended Petition and authorize Sprint to reduce its intrastate switched network rates to interstate parity in a revenue neutral manner.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing has been furnished by e-mail and U.S. Mail this ____ day of _____, 2003, to the following:

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BEFORE THE PUBLIC SERVICE COMMISSION

AMENDED DIRECT TESTIMONY

OF

JOHN M. FELZ

I. INTRODUCTION

Q. Please state your name, occupation and business address.

A. My name is John M. Felz. I am employed as Director - State Regulatory for Sprint Corporation. My business address is 6450 Sprint Parkway, Overland Park, Kansas 66251.

Q. Please describe your educational background and business experience.

A. I received my Bachelor's degree in Accounting from Rockhurst University in Kansas City, Missouri in 1979. In 1989, I earned a Master's Degree in Business Administration with an emphasis in Finance from Rockhurst University. I began my career with Sprint as an internal auditor in 1979 and assumed increasing levels of responsibility in that department, including positions as Senior Auditor, Audit Manager and Assistant Director. From 1986 to 1988, I was Revenue Accounting Manager for Sprint's Midwest Group of local telephone companies with responsibility for billing approximately 500,000 customers in six states. In 1988, I was named to the position of Financial Budget Manager and had responsibility for preparing and managing the budget for Sprint's Midwest Group of local telephone companies. From 1991 to 1996, in the position of Revenue Planning Manager, I was responsible for regulatory and tariff issues for Sprint's local telephone operations in Kansas. From 1996 to 1998, I held the position of Senior Manager - Wholesale Markets with

responsibility for negotiating and implementing interconnection agreements with competitive local exchange carriers and wireless providers. I was named to my current position as Director - State Regulatory in January 1998 and have responsibility for development and implementation of regulatory policies for Sprint's operations in a number of states, including Florida.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to explain Sprint-Florida, Incorporated's (Sprint's) revised plan for reducing its intrastate switched network access rates in a revenue neutral manner as authorized in Section 364.164(1), Florida Statutes 2003. As a matter of introduction, I describe Sprint's service territory in Florida and its differences from BellSouth's and Verizon's territories in the state. I also provide a brief history of intrastate switched network access rates in Florida and how they were developed and modified over the years. In my testimony, I also explain and provide support for Sprint's revised plan for reducing intrastate access rates to parity with its January 1, 2003 interstate access rates on a revenue neutral basis. Finally, I describe the consumer benefits associated with Sprint's revised plan.

Q. Are there other witnesses who support Sprint's revised plan for reducing intrastate switched access rates to interstate levels in a revenue neutral manner?

A. Yes. Sprint is co-sponsoring (with BellSouth and Verizon) the testimony of Dr. Kenneth Gordon who addresses how the removal of implicit subsidies is consistent with the development of a healthy competitive market for basic local telecommunications services throughout the state of Florida. Sprint witness Dr. Brian Staihr demonstrates how Sprint's revised plan will remove current support for basic

local telecommunications services and create a more competitive local exchange market in Sprint's service area for the benefit of residential customers. Dr. Staihr will also describe how Sprint's revised plan for revenue neutral access rate reductions will induce enhanced market entry and create a more attractive residential competitive market. Sprint witness Kent Dickerson provides cost study results which demonstrate that Sprint's current intrastate switched network access rates are priced well above their costs and that Sprint's current residential basic local service rates are priced well below their costs. Through the testimony and supporting information of Sprint's witnesses, the evidence demonstrates that Sprint's revised plan for revenue neutral access rate reductions meets the criteria of section 364.164(1) and should therefore be approved by the Commission.

II. BACKGROUND

Q. Please describe Sprint's certificated local service market areas?

A. Sprint serves approximately 40 percent of the State's geographical area with 104 exchanges, but only 19.6 percent of the State's access lines, serving approximately 2.2 million total access lines out of a total of 11.2 million access lines.

Just over 70 percent of Sprint's access lines are residential. The exchanges vary in number of access lines from Tallahassee, the largest exchange, with 218,638 access lines, to Kingsley Lake, the smallest exchange, with only 332 access lines. Seventy-nine percent of Kingsley Lake's access lines are residential as compared to fifty percent for Tallahassee. Sprint has only five exchanges with more than 100,000 access lines, which are: Ocala with 108,052 access lines; Naples with 138,878 access

lines; Fort Myers with 167,238 access lines; Winter Park with 208,268 access lines; and Tallahassee with 218,638 access lines. Eighty-two (82) of Sprint's 104 exchanges have less than 25,000 access lines and 60 exchanges have less than 12,000 access lines.

Q. How does Sprint's service area compare with the areas served by BellSouth and Verizon in Florida?

A. As just noted, Sprint, with the exception of a few urban-type exchanges, has a less urban market area. In contrast, BellSouth and Verizon, which serve approximately 78 percent of the state's access lines, serve more urban and suburban areas and have a combined total of approximately 9 million access lines. When measured on the basis of access lines per square mile, Sprint's service territory exhibits significantly less customer density than that of either BellSouth or Verizon. Sprint's service territory encompasses over 22,000 square miles and exhibits a customer density of 94 lines per square mile. This is in stark contrast to BellSouth's density of 341 lines per square mile and Verizon's density of 465 lines per square mile. I have included Exhibit JMF-1 as an attachment to my testimony which provides a visual representation of the differences in customer density between Sprint and BellSouth and Verizon. In Docket Nos. 990649A & B – TP this Commission recognized the more diverse geographic Sprint service area and established four (4) UNE loop rate bands for Sprint as compared to three (3) rate bands each for the more urban BellSouth and Verizon service areas. Additionally, Sprint's basic local telecommunications service rates are lower on average than both BellSouth's and Verizon's.

Q. Why are the differences between the serving areas of Sprint, Verizon and

BellSouth important in the context of this proceeding?

A. The differences in the geographic density and customer mix are important factors that influence the magnitude of the revenue-neutral price changes that Sprint is requesting in its Petition. The unique characteristics of Sprint's service territory and customer mix, when compared to those of Verizon and BellSouth, means that Sprint's rate structure reflects a greater subsidy from intrastate switched network access charges than being experienced by the other companies. Hence, a greater increase in basic local service rates will be necessary for Sprint to achieve the interstate parity and revenue-neutral provisions of the legislation.

Q. Please explain how rates were established historically in a monopoly environment?

A. Under historical rate base, rate-of-return regulation, a total company revenue requirement was determined based on the company's total expenses, plus a return on its investments. After the overall revenue requirement was established, prices were set to optimize revenues from discretionary and non-basic services. To the extent the firm's revenue requirement could not be recovered from raising non-basic service rates, the residual amount would be recovered from access charges and residential and business local access line services. Because residential basic local service rates were set based on universal service and other objectives (well below cost), access charges and business services became the "plug" to provide the revenue to meet the revenue requirement. The principle underlying this "residual" pricing concept was the idea of maintaining the universal service objective of making residential basic local service widely available at "affordable" rates, regardless of cost/revenue relationships. The net effect was to set prices for non-basic and discretionary services above their costs to

support lower-priced, below-cost residential basic local service rates.

Historically, the largest contribution to the support for residential basic local service was long distance calling, which was viewed in a monopoly environment as a highly desirable, premium, discretionary service with a predictable, stable revenue stream. The significant contributions from both interstate and intrastate long distance toll were used to support below-cost residential basic local service rates through end user rate-setting proceedings including a division of revenue/settlements process overseen by the federal and state regulators. In the now intensively competitive long distance market, the regulator's maintenance of the historic contribution levels from long distance toll to subsidize below-cost residential basic local service is provided from access charges paid to the local exchange companies by the long distance carriers.

Q. What are Sprint's current intrastate switched access rates and what regulatory proceedings influenced the current rate levels?

A. Sprint's current intrastate switched network access rates are the product of several decisions and now average approximately $.104 per minute (originating and terminating). The current rates reflect a significant change from the structure and rates originally established by the Commission in 1983.

Rates were originally established in Docket 820537-TP which was initiated by Order No. 11551, issued January 26, 1983, on the eve of the impending AT&T divestiture. The purpose of the proceeding was to implement an intrastate access charge structure in Florida that would compensate local exchange companies for the use of their local facilities to originate and terminate long distance traffic by interexchange carriers. As

stated in Commission Order No. 12765, issued December 9, 1983, the primary goal ". . . was to set access charges that would adequately compensate the LECs for use of their local facilities for originating and terminating toll traffic and to provide incentives for competition, while maintaining universal telephone service." This policy goal resulted in the Commission setting intrastate switched network access charges for Sprint (then United Telephone) in the neighborhood of $0.25 per minute.

Thereafter, Docket No. 8609874-TL was initiated in mid-1986 to re-address the level of, and the mechanism for, recovering non-traffic sensitive costs associated with the local loop. The outcome of that docket was essentially a continuation of the historical regulatory policies of maintaining low basic local service rates through the support of revenues from other services, principally intrastate switched network access charges.

In 1989, in Docket No. 891239-TL, and again in 1991, in Docket No. 910980-TL, Sprint (United Telephone at the time) filed petitions that proposed increases in residential basic local service rates and reductions in switched network access charges. The $16 million access charge reduction and local service rate increase requested in the 1989 case was approved, however, the $8 million access reduction requested in the 1991 case was rejected since it would have increased residential basic local service rates. Specifically, the Commission stated:

> "We increased local rates by $15.9 million in United's last rate case and lowered the BHMOC [an intrastate access charge component]. But, we do not believe that local rates should again be raised in this proceeding in order to have a greater BHMOC reduction. Accordingly, we shall deny United's request." (Order No. PSC-92-0708-FOF-TL, Docket Nos.

910980-TL, 910529-TL.)

In 1995, the Florida Legislature passed the Florida Telecommunications Act ("1995 Act") which opened the local exchange carriers' local markets to competition and mandated reductions in access charges for any LEC who chose to become regulated under a price regulation plan and whose intrastate switched network access charges were not then at parity with its interstate switched network access charges. The 1995 Act established a target for intrastate switched access rates as the December 31, 1994 interstate switched network access rate levels and provided for a 5 percent annual reduction in access charges as the mechanism for achieving parity with a LEC's interstate switched network access rates. Sprint fulfilled the annual reductions mandated under this legislation in 1996 and 1997. In 1998, the Florida Legislature modified the provisions related to access charge reductions and required a 15 percent reduction to be made in 1998, while at the same time removing the 1994 interstate rate as the target. Since Sprint's 1998 access rate reductions of 5 percent ($9.3 million) in July and 10 percent ($17.6 million) in October, there have been no further changes to Sprint's intrastate switched network access rates.

Q. You have discussed generally how access charges have historically been set above cost and identified Sprint's current access rates and how they arrived at their current level. Does the cost study information supplied by Sprint witness Dickerson confirm that Sprint's current intrastate switched access rates reflect a substantial contribution?

A. Yes. Sprint's current intrastate access rates provide a substantial contribution when compared with the forward-looking cost of switched access services. I have prepared

exhibit JMF-2 to illustrate the current relationship between intrastate access rates and cost. The analysis demonstrates that Sprint's current average intrastate switched access rate of $.050392 per minute of use (per end) exceeds the cost for the service of $.004475, thereby providing a significant contribution of $.045917 per minute of use. It should be noted that this analysis of current intrastate access rates and costs is presented solely to demonstrate the existing subsidy to residential local service provided by intrastate access charges.

Q. Is cost the target for the intrastate access reductions?

A. No. The 2003 Act established parity with the January 2003 interstate access rates as the appropriate target for reducing intrastate access rates.

Q. What evidence do you have that the contributions from intrastate switched network access charges are subsidizing residential basic local service?

A. Exhibit JMF-3 to my testimony demonstrates the significant subsidy being provided to residential basic local service rates. The cost studies presented by Sprint witness Dickerson identify the forward-looking cost of residential basic local service as $30.46 and business basic local service as $XX.XX. A comparison of these costs to the current associated rates (including the subscriber line charge) for basic local service reveals that residential basic local service is currently priced well below its associated costs. The exhibit clearly demonstrates that the rates for residential basic local service are not recovering the associated costs of providing the service. Coupled with the previous analysis of intrastate access rates and its associated costs, it is clear that intrastate access charges are providing a subsidy to residential basic local service rates. Exhibit JMF-4 provides a comparison of the rates and costs for single-line business

service.

Q. How do intrastate switched access rate levels in Florida compare to those in other states?

A. Exhibit JMF-5 demonstrates the disproportionate contribution made by Sprint's intrastate switched network access charges to support residential basic local service rates in Florida, relative to seven other southeastern states. I have shown the access rates of BellSouth, the largest ILEC in each of these other states. Sprint's intrastate access charge rate is more than twice the intrastate access charge rate of the next highest rate and more than ten (10) times higher than four (4) of the other states' rates.

Q. How do Sprint's basic local service rates in Florida compare to the rates in other states?

A. Sprint's average monthly rate for residential basic local service, including TouchTone, is $9.98 in Florida, compared to a national average rate of $14.55, a difference of $4.57. The national average rate is from the FCC's 2003 Reference Book of Rates, Price Indices and Household Expenditures for Telephone Service, Table 1.1. Exhibit JMF-6 is a comparison of Sprint's rates with those of BellSouth's rates in other states in the southeast. BellSouth's rates were used for comparison as they are the largest ILEC in the subject states.

As can be seen from Exhibit JMF-6, Sprint's residential basic local rates are significantly lower than the comparable rates in its seven neighboring southeastern states. Sprint's rates in its lowest rate group are on average $4.47 per month lower than the comparable rates in the other states. In the highest rate group, Sprint's

Florida residential rates are on average $3.86 per month lower than the comparable rates in the other states.

Exhibit JMF-7 shows that Sprint's single-line business rates are also significantly below the rates for business lines in these neighboring states. Sprint's single-line business average rate of $21.18 is also well below the national average of $33.34 (FCC's 2003 Reference Book of Rates, Price Indices and Household Expenditures for Telephone Service, Table 1.8).

Q. Has Sprint's Local Telephone Division had experience in other states in transitioning subsidies from access charges to end user rates?

A. Yes. Sprint's experiences in Ohio and Pennsylvania with rate rebalancing between access charges and end user rates provides information which is insightful in evaluating a similar initiative here in Florida.

Q. Could you describe Sprint's access rebalancing experience in Ohio?

A. In June 2001, the Public Utilities Commission of Ohio approved Sprint's proposed plan to reduce intrastate switched access charges to interstate levels and increase certain end user rates to offset the access revenue reduction (Commission Opinion and Order in Case No. 00-127-TP-COI and Case No. 01-1266-TP-UNC, Issued June 28, 2001). The plan provided for a reduction of intrastate switched access rates to parity with the interstate switched access rates that resulted from the FCC's Coalition for Affordable Local and Long Distance Service ("CALLS") proceeding. To offset the access reduction, Sprint established an end user charge (called an "intrastate access fee") of $4.10 for residential customers, $6 for single-line business customers and

\$8.90 for multi-line customers. These local rate increases were implemented on a flash-cut basis.

Q. What has been Sprint's experience with switched network access rate rebalancing in Pennsylvania?

A. The Public Utility Commission of Pennsylvania has allowed residential basic local service rates to periodically increase up to a weighted average cap of \$16 per month to offset decreases in intrastate switched access rates. Rates for business local service were also allowed to increase, but by a smaller amount than residential rates. Intrastate traffic sensitive access charges were to be reduced to the July 1998 interstate rate levels. The carrier common line charge was restructured from a minute-based charge to a flat-rate carrier charge. Under this plan, Sprint has increased its residential basic local service rates by approximately \$4.41 to an average of \$15.88 and has offset these local rate increases with corresponding reductions to its traffic sensitive intrastate switched network access rates and the carrier charge.

Q. Have there been recent developments in Pennsylvania which will further reform the intrastate access rate structure for Sprint in Pennsylvania?

A. Yes. On July 10, 2003, the Pennsylvania Commission approved a joint proposal of Sprint, the Rural Telephone Company Coalition, the Office of Consumer Advocate, Office of Trial Staff and Office of Small Business Advocate that provides for further access charge reductions on a revenue-neutral basis. The approved plan allows Sprint to increase its residential basic local service rates to achieve a maximum weighted average of \$18 and to offset these increases with corresponding reductions to its traffic sensitive access rates and the carrier charge. Rates for business local service are

allowed to increase by the same amount as the residential rates.

Q. What was the Pennsylvania Commission's rationale in approving the local rate increases and corresponding access charge reductions?

A. The Pennsylvania Commission recognized the need to rationalize the pricing structure for both basic local service and access charges to foster a more competitive environment. The Pennsylvania Commission specifically found in its July 10, 2003, order that:

> "At this juncture, the Commission is persuaded that the proposed access charge reductions are in the public's interest and in accordance with the Commission's objective to reduce implicit subsidy charges such as access charges that impede competition in the telecommunications market. As implicit charges become explicit charges, competitors are better able to compete for local and long distance customers in an ILEC's service territory because IXCs are not hindered by paying ILECs excessive access charges in providing competitive toll services and CLECs are better able to compete with ILEC local service rates that have been kept artificially low as a result of the access charge subsidies." (Order at page 10).
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> ***
>
> "We further look to the Federal Communications Commission's (FCC) recent decisions in the CALLS and MAG orders for precedence in ordering implicit charges to become explicit, either through an increase in basic local telephone service rates, or through service line charges on customer bills. This enables other carriers to compete due to reduced

subsidies. While the Joint Proposal does not require a rural ILEC or Sprint/United to mirror interstate access charges, the fact that this is a step towards making the charges closer to cost and closer to the interstate access charges will help to avoid arbitrage and will help competition enter the ILEC territories." (Order at page 11).

III. ACCESS RATE REDUCTIONS

Q. What provisions of the Tele-Competition Innovation and Infrastructure Enhancement Act ("2003 Act") govern Sprint's filing of its petition to reduce its intrastate switched access rates?

A. The applicable provisions of the legislation associated with the access reductions include the following:

364.164 (1)

"Each local exchange telecommunications company may, after July 1, 2003 petition the Commission to reduce its intrastate switched network access rate in a revenue neutral manner."

364.164 (5)

"As used in this section, the term 'parity' means that the local exchange telecommunications company's intrastate switched network access rate is equal to its interstate switched network access rate in effect on January 1, 2003, if the company has more than 1 million access lines in service."

364.164 (6)

"As used in this section, the term 'intrastate switched network access rate' means the composite of the originating and terminating network access rate for carrier common line, local channel/entrance facility, switched common transport, access tandem switching, interconnection charge, signaling, information surcharge, and local switching."

Q. Please describe Sprint's interstate switched network access rate structure that will be used as the target for Sprint's intrastate access reductions.

A. Sprint's January 1, 2003 interstate switched network access rates are the result of the CALLS plan adopted by the Federal Communications Commission in June 2000 (Sixth Report and Order in CC Docket No. 96-262 and 94-1, Report and Order in CC Docket 99-249, Eleventh Report and Order in CC Docket 96-45, released May 31, 2000). The CALLS plan established a five-year timeframe for addressing issues with both the rate structure and rate levels for interstate switched network access service. Exhibit JMF-8 to my testimony identifies the rate elements reflected in Sprint's January 2003 interstate switched access rates.

Q. Are there any differences between Sprint's interstate and intrastate switched access rate structures?

A. Yes. Sprint's intrastate switched network access rates include rates for carrier common line and interconnection charge, however the interstate rates for these elements are set at zero. Also, the interstate switched transport rate category has sub-element rates for common and dedicated trunk ports, which are not disaggregated from the switched common transport rate element in the intrastate tariff.

Q. How will Sprint reduce intrastate switched access rates to be in parity with interstate switched access rates?

A. Because the 2003 Act specifically identifies the interstate switched access rate as the target for parity, Sprint will implement a very simple and straight-forward approach to achieve parity. Sprint will establish a rate structure for its intrastate switched network access rates that mirrors both the rate structure and rate levels for interstate switched network access service in effect on January 1, 2003. This approach ensures that the intrastate switched network access rates are in parity with their interstate counterpart since both the structure and rates will be exactly the same once the transition to parity is completed.

Q. Using this method of mirroring both the rate structure and rate levels for interstate switched network access rates, how did Sprint calculate the impact of the intrastate switched network access rate reduction?

A. As specified by the 2003 Act, Sprint will utilize the most recent 12 months' actual pricing units in developing the impact of the intrastate switched access reduction. For purposes of this filing, the most recent available 12 months information covers the period from June 2002 to May 2003. Sprint applied the current intrastate switched access rates to the actual pricing units to develop the current intrastate switched access revenues. Sprint then applied the January 1, 2003 interstate access rates to those same pricing units to develop the estimate of revenues to be received after implementation of the rate changes. Assuming – for illustration purposes only - a flash-cut, one-time reduction, the difference between the two revenue amounts represents the total value of the intrastate switched access rate reductions. For purposes of its Petition, Sprint has calculated this amount as $142,073,492. The detailed calculations of this amount

are included on Exhibit JMF-9 to my testimony.

Q. Does Sprint's approach result in parity between the intrastate composite switched network access rate and the interstate composite switched network access rate?

A. Yes. As noted earlier, Section 364.164 (6) provides a comprehensive description of what is included in the term "intrastate switched network access rate."

> "As used in this section, the term 'intrastate switched network access rate' means the composite of the originating and terminating network access rate for carrier common line, local channel/entrance facility, switched common transport, access tandem switching, interconnection charge, signaling, information surcharge, and local switching."

I have prepared Exhibit JMF-10 which demonstrates that Sprint's access rate reduction plan will produce a composite switched intrastate access rate that is equal to the composite January 1, 2003 interstate switched access rate. Sprint's calculation produces an intrastate switched access composite rate of $.012852 after the access rate reduction is completed. This composite rate is equivalent to the January 1, 2003 interstate switched access composite rate of $.012852.

Q. What is Sprint's revised plan for adjusting intrastate switched network access rates?

A. Sprint will reduce its intrastate switched network access rates to the target levels in three separate annual increments over a two-year period. ~~This means approximately~~

~~50 percent of the access reduction will occur in year 1 and the remainder in year 2.~~ The first annual access reductions ~~in year 1~~ are targeted to reducing the current intrastate switched network access charge elements which have no associated costs and are therefore providing a pure subsidy. Specifically, Sprint will target the reduction of ~~$71,035,981~~62,319,890 to the interconnection charge and the carrier common line rates. The first annual access reductions ~~amount in year 1~~ results in an elimination of the interconnection charge and a substantial reduction in the carrier common line rates. Amended Exhibit JMF-11 to my testimony provides the detailed calculations supporting the first annual ~~year 1~~ access reductions.

Q. What intrastate switched network access rate changes are planned for the second ~~increment~~year ~~2~~?

A. The ~~year 2~~ second annual intrastate switched network access rate reductions ~~will be~~are directed first towards elimination of the remaining carrier common line rates. The remainder of the second annual access rate reduction is directed at the end office local switching rate element. ~~establishing the rate elements and rates that fully mirror the January 1, 2003 interstate rates~~. Sprint has estimated the impact of the second ~~year~~ annual increment of the access reduction as ~~$71,037,512~~56,211,283 based on current pricing units (see Amended Exhibit JMF-11). ~~However, it is recognized that the actual reduction amount for year 2 will be based on the latest 12 months pricing units at that time. As a result, the impact of the access reduction for year 2 will likely vary from the $71,037,512 amount.~~

Q. What intrastate switched network access rate changes are planned for the third increment ?

A. The third annual intrastate switched network access rate reductions are directed first towards reducing the end office local switching rate element, which was partially reduced in the second increment, to the January 1, 2003 interstate level. The remainder of the third annual access rate adjustment is directed at establishing the rate elements and rates that fully mirror the January 1, 2003 interstate rates. Sprint has estimated the impact of the third annual increment of the access reduction as $23,541,741 based on current pricing units (see Amended Exhibit JMF-11).

Q. With these changes, does Sprint's revised plan comply with the provisions of the 2003 Act regarding intrastate switched access rate levels?

A. Yes. Based on this revised plan, ~~at the end of the second year,~~ Sprint~~'s~~ will reduce its intrastate switched access rates ~~will~~ to exactly match (in both structure and rate level) the January 2003 interstate switched network access rates over a two-year period utilizing three separate access reductions. Although Sprint has estimated the impact of each increment of the access reduction, it is recognized that the actual reduction amount for each increment will be based on the latest 12 months pricing units at that time. As a result, the impact of the access reduction for each of the three increments will likely vary from the estimated amounts.

IV. REVENUE NEUTRALITY

Q. You have described Sprint's revised plan for reducing its intrastate switched access rates to parity with interstate rates. What does the 2003 Act provide for in terms of revenue neutrality?

A. The 2003 Act specifies that, if intrastate access rates are to be reduced, they must be

reduced in a revenue-neutral manner. Section 364.164 (2) describes the specific methodology to be used for calculating revenue neutrality:

> "If the Commission grants the local exchange company's petition, the local exchange company is authorized, the requirements of section 364.051 (3) notwithstanding, to immediately implement a revenue category mechanism consisting of basic local telecommunications service revenues and intrastate switched network access revenues to achieve revenue neutrality. The local exchange company shall thereafter, on 45 days' notice, adjust the various prices and rates of the services within its revenue category authorized by this section once in any 12-month period in a revenue-neutral manner."

Q. What information did Sprint use to create the revenue category mechanism provided for in the provision quoted above?

A. The provisions of the 2003 Act related to calculation of the revenue category mechanism are contained in section 364.164 (7):

> "Calculation of revenue received from each service before the implementation of any rate adjustment must be made by multiplying the then-current rate from each service by the most recent 12 months' actual pricing units for each service within the category, without any adjustments to the number of pricing units. Calculation of revenue for each service to be received after implementation of rate adjustments must be made by multiplying the rate to be applicable for each service by the most recent 12 month's actual pricing units for each service within the category, without any adjustments to the number of pricing

units."

Based on these guidelines, Sprint extracted billing information for the most recent 12 months (June 2002 through May 2003) for intrastate switched network access services and basic local telecommunications services and created a model which documents the calculations necessary to achieve the revenue neutrality provisions of the 2003 Act. This information is summarized in Amended Exhibit JMF-12 to my testimony.

Q. What is Sprint's revised plan for achieving revenue neutrality?

A. As noted previously, Sprint will reduce its intrastate switched access rates to the target interstate levels over a two-year period using three separate annual increments (2004, 2005 and 2006). To achieve the revenue neutrality provided by the 2003 Act, Sprint will increase rates for basic local telecommunications services over that same two-year period, accomplishing the increase over three separate annual increments. I previously described how Sprint's calculation of the amount to achieve access rate parity produces a reduction of $142,073,492 in access revenues, assuming a one-time, flash-cut reduction. This $142,073,492 represents an estimate of the amount to be recovered through adjustments in the rates for basic telecommunications service, assuming the same one-time, flash-cut adjustment.

As noted previously, Sprint will reduce its intrastate switched access revenues in three annual increments as follows:

Increment 1 (2004) $62,319,890

Increment 2 (2005) $56,211,862

Increment 3 (2006) $23,541,711

Sprint will achieve revenue neutrality for these switched access revenue reductions by implementing increases in its rates for basic local telecommunications services over the same two-year period, accomplished in three annual increments.

~~implement 50 percent of the total switched network access rate reduction and corresponding revenue-neutral increases to basic telecommunications services in year 1. The remaining access rate reduction and revenue-neutral increases to basic local telecommunications service rates will be accomplished in year 2.~~

Q. What rate changes to basic local telecommunications services will be implemented to achieve revenue neutrality?

A. Amended Exhibit JMF-12 to my testimony summarizes Sprint's revised rate change plan for its basic residential and single-line business local service rates for the three annual increments. ~~both year 1 and year 2~~. Sprint will increase residential basic local service recurring rates by ~~$3.23~~2.95 in the first increment ~~year 1~~, ~~and $3.63~~ $2.75 in the second increment~~year 2~~ and $1.16 in the third increment. Rates for single-line business basic local service will increase by an average of ~~$2.87~~$2.70 in the first increment~~year 1~~, ~~and~~ ~~$2.40~~3.13 in the second increment~~year 2~~ and $.90 in the third increment. Sprint will also increase certain residential and business non-recurring service charges in each of the three annual increments of the plan. These rate changes will increase basic local service revenues by ~~$142,085,602~~142,084,461, an amount which is slightly different from the total access reduction amount due to rounding differences.

Upon the grant of Sprint's Revised Petition, Sprint, in compliance with Section 364.164(2), Florida Statutes, will commence the implementation of its first annual

intrastate switched network access and basic local service price adjustments. These adjustments should become effective in the first quarter of 2004. The subsequent annual adjustments will be scheduled to take place on the anniversary of the effective date of the first annual adjustment.

Q. How does Sprint's revised plan comply with the provision in 364.164 (2) regarding limiting the increases to the basic local service monthly recurring rate?

A. The 2003 Act provides that:

> "An adjustment in rates may not be offset entirely by the company's basic monthly recurring rate."

In compliance with this provision, Sprint's revised plan includes an estimated $7,638,900 of increases to certain non-recurring, service charges. As a result, Sprint's access charge reductions are not offset entirely by increases in the basic local service monthly recurring rate.

Q. How will Sprint comply with the provisions of the 2003 Act relating to Lifeline and pay telephone access lines?

A. The 2003 Act provides that:

> "Billing units associated with pay telephone access lines and Lifeline service may not be included in any calculation under this subsection."

Sprint has specifically identified the number of Lifeline and pay telephone lines in service during the 12-month period used in calculating the revenue neutrality provisions of its revised plan. The pay telephone lines were removed from the

calculation of revenue neutrality and the current rates will not be affected by rate changes associated with implementing the 2003 Act. For Lifeline customers, billing system limitations will preclude Sprint from continuing to display the current basic local service rate for Lifeline customers on the bill as the rate changes resulting from the revenue neutrality provisions are implemented. Sprint will, instead, reflect on these customers' bills, a Lifeline credit that is increased by the amount of the increases to recurring residential rates. This will insure that there is no net impact to the customer from the increases associated with implementing the 2003 Act. Sprint believes this approach is expressly consistent with the legislative provisions regarding Lifeline customers – namely, to ensure their bills are unaffected by the rate changes resulting from implementation of the revenue neutrality provisions of the 2003 Act.

Q. What are the factors that could change the actual basic local service rates in the Sprint revised plan?

A. The 2003 Act provides that the actual pricing changes to accomplish revenue neutrality must be based on the company's most recent 12 months' pricing units. As a result, changes to the pricing units for both switched access services and basic local telecommunications services are expected and will affect ~~both the year 1 and year 2~~all three increments of Sprint's planned price changes. Upon the granting of the Petition, Sprint will adjust the price changes to ensure revenue neutrality is achieved and the calculations remain in compliance with the provisions of the 2003 Act.

Q. Could you identify the specific rate changes planned for residential and single-line business basic local service rates?

A. Yes. I have prepared Amended Exhibit JMF-13 which identifies the current rates and

the specific rate changes for ~~both~~ the three annual increments of Sprint's revised plan ~~year 1 and year 2~~ for both residential and single-line business basic local service. The exhibit also identifies the current and planned rates for the service connection charge elements.

Q. Does Sprint's revised plan apply the basic local service increase equally across all rate groups?

A. For residential basic local service rates, Sprint will implement increases that are consistent across all rate groups. For single-line business basic local service rates, Sprint has taken into account competitive and calling scope considerations in its rate design. As a result, Sprint's revised plan for single-line business basic local service rates does reflect some variability in the increases across the rate groups.

Q. What is Sprint's rationale for the distribution of its revenue-neutral rate changes over the three increments?

A. Sprint has elected to increase its basic local services prices in a graduated manner over the two-year period because Sprint continues to believe that it is important to eliminate the non-cost-based component of its intrastate switched network access rate as quickly as possible. This principle drives, in part, the size of the resulting first of three annual basic local service price increases. The size of each of the remaining two annual switched access rate decreases and resulting basic local service price increases also reflects Sprint's efforts to fulfill the underlying goal of the legislation to enhance the creation of a more competitive local market for the benefit of residential consumers as quickly as possible.

V. CONSUMER IMPACTS

Q. Sprint includes a two-year timeframe for implementation of its revised revenue-neutral plan. Why is a two-year plan most appropriate?

A. As described in more detail in the testimony of Dr. Kenneth Gordon, the elimination of implicit subsidies in access rates and the establishment of pricing for local services which are more closely aligned with their costs, will make the residential local market more attractive to competitors and will bring about enhanced market entry. Additionally, as indicated by the access charge and local service rate differentials shown in my exhibits JMF-5 and JMF-6, Florida is already well behind other states in making these changes.

Q. Will Sprint introduce other consumer benefits in addition to those that accrue from a more competitive market?

A. Yes. In an effort to mitigate the impacts to customers from the increases in rates for basic local service, Sprint will reduce the amount residential customers pay for extended local calling services by providing a free allowance of five calls per month for routes which are charged on a per message basis. Currently, customers incur a charge of $.20 or $.25 per message for all calls made on these local calling plans. Under Sprint's plan, customers will receive the first five calls free, and will incur the tariff charges for calls over the allowance. Based on current rates, customers could experience savings of up to $1.00 or $1.25 per month in their charges for extended local calling. This plan has the potential for providing benefit to a large number of Sprint's residential customers as over 82 percent have extended local calling service available to them over 283 routes included in Sprint's proposal.

Q. Are there other consumer benefits provided by the legislation?

A. Yes. The interexchange carriers ("IXCs") are required to return to their residential and business customers the benefits of access reductions they realize from the ILEC rate reductions. The reductions that customers experience in the rates for long distance calling will serve to offset the increases they will experience for basic local services. This offset will consist of eliminating, by January 1, 2006, any "instate connection fee" which for the "big three" IXCs is currently approximately $1.90 per month, and flowing-through any residual switched network access charge reduction amount in the form of lower toll rates. Thus, IXC's residential customers currently being charged an instate connection fee will see a direct reduction in their monthly toll bill of about $1.90, regardless of the amount of their toll calling volume. Thereafter, long distance users will receive the benefits of additional IXC flow-through toll price reductions.

Q. What additional protections are there for those customers that are economically disadvantaged who might otherwise be impacted more significantly by the increases in basic local service?

A. As I stated previously, Section 364.10(3)(a) exempts Lifeline customers from the rate changes allowed by Section 364.164. Additionally, Section 364.10 (3) (a) enhances the Lifeline program effective September 1, 2003, to allow any customer who meets a stand-alone income eligibility test at 125% or less than the federal poverty level to subscribe to Lifeline service without having to apply to a low-income assistance program. Eligibility for these customers will be administered by the Office of Public Counsel. Sprint implemented this new criterion as of August 1, 2003. As further protection for Lifeline customers, Sprint will extend the Lifeline credit amount for an

additional year beyond the two-year rebalancing period through at least the first quarter of 2007.

Q. What about universal service objectives? Aren't you concerned that increasing residential local service rates will result in some subscribers dropping off the network?

A. No, for several reasons. First, the 2003 Act has increased Lifeline service availability to a greater number of Florida's economically disadvantaged. In fact, Lifeline is being expanded such that the requirement of participation in one of the six public assistance programs is not required. Customers that have household incomes up to 125% of the Federal Poverty Level can apply to the Office of Public Counsel for approval for subscription to Lifeline service. Additionally, as I stated previously, the rates for Lifeline service will not increase for a period of three years as a result of the rebalancing.

Second, the empirical data from the other states that have increased their local service rates demonstrates that subscribership has not been adversely affected. Exhibit JMF-14, shows that of the seven other southeastern states, all of which have higher local service rates than Florida, each has increased its residence subscribership more than Florida's subscribership, except for Georgia, where subscribership has remained unchanged. Exhibit JMF-15 shows the subscribership for 1988 and November of 2002 for each of the seven other southeastern states.

Finally, from an ability to pay perspective, Florida customers have higher average incomes than any of the other seven states. Exhibit JMF-16 shows the per capita

personal income for Florida as compared to the other states. Exhibit JMF-17 shows Florida's higher level of disposable personal income versus the seven other states. Nationally, Florida ranks 25th in per capita personal income, again higher than the other states as shown in Exhibit JMF-18, another indication of Florida's higher income relative to the other states.

Q. You previously described Sprint's access rebalancing experience in Ohio and Pennsylvania. How do the rates for basic residential local service in those states compare to the rates in the Sprint revised plan for Florida?

A. Sprint's rate for basic residential local service in Ohio averages $16.55. The $4.10 "intrastate access fee" authorized by the Ohio Commission brings the total charge for residential local service to $20.65. In Pennsylvania, Sprint's current average residential local service rate is $15.88 and based on the Pennsylvania Commission's recent order, it will move towards the cap of $18 in 2004. Sprint's revised revenue-neutral plan for Florida will result in a weighted-average residential local service rate of $16.84 (current average of $9.98 plus increase of $6.86 over Sprint's two-year plan). The resulting residential local service rate in Florida will be significantly below Sprint's rates in Pennsylvania and Ohio.

Q. Has Sprint experienced any significant changes in subscribership for residential basic local service as a result of the local rate increases in Pennsylvania or Ohio?

A. No, there was virtually no negative customer reaction to the increases in local rates in these two states, either in the form of complaints to the Commission or decreases in subscribership. In Ohio, primary residential access lines declined approximately 1% during the six months following the local rate increase. In Pennsylvania, primary

residential access lines declined less than ½ of 1 percent in the six months following the most recent local rate increase. Although minor declines in residential access lines were experienced in these states, there are many factors other than the local rate increases that influenced this trend, including the general state of the economy, wireless replacement and competition from other wireline carriers. As an illustration, Sprint's primary access lines for its entire 18 state local telephone division declined approximately .3 percent during 2001 and .5 percent in 2002, even though the other states were not experiencing the type of local rate increases that were ordered in Ohio and Pennsylvania.

Q. Do the changes in interstate access rates provide any evidence that the correct assignment for recovery of these costs to end users does not negatively impact universal service objectives?

A. The FCC, in recognition of the problems of continuing service cross-subsidies in a competitive telecommunications markets, has been transitioning the support for local services provided through interstate access charges from toll users to local service via the End User Common Line or Subscriber Line Charge. Local subscribership, measured by the FCC's Telephone Penetration Data as the percentage of households with telephone service, has steadily increased even though the subscriber line charge has increased to $6.50 for primary residential service as of July 2003. The subscriber line charge for residential and single-line business was initially implemented at a rate of $1.00 on June 1, 1985. At that time, the FCC reported subscribership nationally at 91.8%; as of November 2002, the latest available data, subscribership was at 95.3%. This is not surprising given that the increase in the recurring subscriber line charge rate has been offset by significant decreases in long distance rates and increases in

consumer income.

Q What is your conclusion regarding the significance of this data?

A. The data conclusively demonstrates that basic local service rates in Florida can be increased without negatively impacting universal service or subscribership levels. In fact, when basic local service rates are increased on a revenue neutral basis, with access charge rate reductions flowed through to end user customers, along with Sprint's plan to provide the first five extended local calls free, universal service will be positively impacted. This is particularly true given that under Section 364,164, those most economically disadvantaged consumers, Florida's Lifeline subscribers, will not be subject to rate increases in their recurring local service rates from the rate rebalancing for three years and will have the benefit of reduced toll charges.

It is also worth noting that even with the basic local service price increases being implemented by Sprint, the residential basic local service prices will still be below the cost of providing the basic local service. As noted by Dr. Staihr and Dr. Gordon, there are significant benefits to the residential marketplace that will result from moving prices towards cost in terms of making the residential market more attractive to competitors and inducing enhanced market entry.

VI. CONCLUSION

Q. Could you summarize Sprint's position in this proceeding?

A. Through its petition and the testimony and exhibits of its witnesses in this proceeding, Sprint demonstrates that its revised plan for reducing intrastate network access rates

in a revenue neutral manner meets all of the criteria established by the 2003 Act and should therefore be approved by the Commission. Specifically, granting Sprint's petition will:

- ***Remove current support for basic local telecommunications services that prevents the creation of a more attractive, competitive local exchange market for the benefit of residential customers.***

  My testimony, along with the cost study information supported by Sprint witness Dickerson, provides evidence that intrastate switched network access rates are providing support for Sprint's residential basic local telecommunications services. Sprint's witnesses Gordon and Staihr provide evidence that the removal of the current level of support for residential local services will create a more attractive, competitive local exchange market for the benefit of residential customers.

- ***Induce enhanced market entry.***

  Sprint witnesses Gordon and Staihr provide evidence demonstrating that approval of Sprint's petition will result in enhanced market entry by competitors.

- ***Result in intrastate switched access rate reductions to parity over a period of two years.***

  My testimony describes Sprint's revised plan for implementing its revenue neutral intrastate switched access reductions over a two-year period, which complies with the 2003 Act provisions of a period of not less than two years or more than four years.

- ***Will be revenue neutral.***

  My testimony describes Sprint's revised plan for decreasing intrastate network switched access rates to the January 2003 interstate levels and increasing basic local service rates to offset the access reductions. Sprint's revised plan fully complies with the provisions of the 2003 Act regarding revenue neutrality.

Q. Does this conclude your testimony?

A. Yes, it does.

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BEFORE THE PUBLIC SERVICE COMMISSION

AMENDED DIRECT TESTIMONY

OF

JOHN M. FELZ

I. INTRODUCTION

Q. Please state your name, occupation and business address.

A. My name is John M. Felz. I am employed as Director - State Regulatory for Sprint Corporation. My business address is 6450 Sprint Parkway, Overland Park, Kansas 66251.

Q. Please describe your educational background and business experience.

A. I received my Bachelor's degree in Accounting from Rockhurst University in Kansas City, Missouri in 1979. In 1989, I earned a Master's Degree in Business Administration with an emphasis in Finance from Rockhurst University. I began my career with Sprint as an internal auditor in 1979 and assumed increasing levels of responsibility in that department, including positions as Senior Auditor, Audit Manager and Assistant Director. From 1986 to 1988, I was Revenue Accounting Manager for Sprint's Midwest Group of local telephone companies with responsibility for billing approximately 500,000 customers in six states. In 1988, I was named to the position of Financial Budget Manager and had responsibility for preparing and managing the budget for Sprint's Midwest Group of local telephone companies. From 1991 to 1996, in the position of Revenue Planning Manager, I was responsible for regulatory and tariff issues for Sprint's local telephone operations in Kansas. From 1996 to 1998, I held the position of Senior Manager - Wholesale Markets with

responsibility for negotiating and implementing interconnection agreements with competitive local exchange carriers and wireless providers. I was named to my current position as Director - State Regulatory in January 1998 and have responsibility for development and implementation of regulatory policies for Sprint's operations in a number of states, including Florida.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to explain Sprint-Florida, Incorporated's (Sprint's) revised plan for reducing its intrastate switched network access rates in a revenue neutral manner as authorized in Section 364.164(1), Florida Statutes 2003. As a matter of introduction, I describe Sprint's service territory in Florida and its differences from BellSouth's and Verizon's territories in the state. I also provide a brief history of intrastate switched network access rates in Florida and how they were developed and modified over the years. In my testimony, I also explain and provide support for Sprint's revised plan for reducing intrastate access rates to parity with its January 1, 2003 interstate access rates on a revenue neutral basis. Finally, I describe the consumer benefits associated with Sprint's revised plan.

Q. Are there other witnesses who support Sprint's revised plan for reducing intrastate switched access rates to interstate levels in a revenue neutral manner?

A. Yes. Sprint is co-sponsoring (with BellSouth and Verizon) the testimony of Dr. Kenneth Gordon who addresses how the removal of implicit subsidies is consistent with the development of a healthy competitive market for basic local telecommunications services throughout the state of Florida. Sprint witness Dr. Brian Staihr demonstrates how Sprint's revised plan will remove current support for basic

local telecommunications services and create a more competitive local exchange market in Sprint's service area for the benefit of residential customers. Dr. Staihr will also describe how Sprint's revised plan for revenue neutral access rate reductions will induce enhanced market entry and create a more attractive residential competitive market. Sprint witness Kent Dickerson provides cost study results which demonstrate that Sprint's current intrastate switched network access rates are priced well above their costs and that Sprint's current residential basic local service rates are priced well below their costs. Through the testimony and supporting information of Sprint's witnesses, the evidence demonstrates that Sprint's revised plan for revenue neutral access rate reductions meets the criteria of section 364.164(1) and should therefore be approved by the Commission.

II. BACKGROUND

Q. Please describe Sprint's certificated local service market areas?

A. Sprint serves approximately 40 percent of the State's geographical area with 104 exchanges, but only 19.6 percent of the State's access lines, serving approximately 2.2 million total access lines out of a total of 11.2 million access lines.

Just over 70 percent of Sprint's access lines are residential. The exchanges vary in number of access lines from Tallahassee, the largest exchange, with 218,638 access lines, to Kingsley Lake, the smallest exchange, with only 332 access lines. Seventy-nine percent of Kingsley Lake's access lines are residential as compared to fifty percent for Tallahassee. Sprint has only five exchanges with more than 100,000 access lines, which are: Ocala with 108,052 access lines; Naples with 138,878 access

lines; Fort Myers with 167,238 access lines; Winter Park with 208,268 access lines; and Tallahassee with 218,638 access lines. Eighty-two (82) of Sprint's 104 exchanges have less than 25,000 access lines and 60 exchanges have less than 12,000 access lines.

Q. How does Sprint's service area compare with the areas served by BellSouth and Verizon in Florida?

A. As just noted, Sprint, with the exception of a few urban-type exchanges, has a less urban market area. In contrast, BellSouth and Verizon, which serve approximately 78 percent of the state's access lines, serve more urban and suburban areas and have a combined total of approximately 9 million access lines. When measured on the basis of access lines per square mile, Sprint's service territory exhibits significantly less customer density than that of either BellSouth or Verizon. Sprint's service territory encompasses over 22,000 square miles and exhibits a customer density of 94 lines per square mile. This is in stark contrast to BellSouth's density of 341 lines per square mile and Verizon's density of 465 lines per square mile. I have included Exhibit JMF-1 as an attachment to my testimony which provides a visual representation of the differences in customer density between Sprint and BellSouth and Verizon. In Docket Nos. 990649A & B – TP this Commission recognized the more diverse geographic Sprint service area and established four (4) UNE loop rate bands for Sprint as compared to three (3) rate bands each for the more urban BellSouth and Verizon service areas. Additionally, Sprint's basic local telecommunications service rates are lower on average than both BellSouth's and Verizon's.

Q. Why are the differences between the serving areas of Sprint, Verizon and

BellSouth important in the context of this proceeding?

A. The differences in the geographic density and customer mix are important factors that influence the magnitude of the revenue-neutral price changes that Sprint is requesting in its Petition. The unique characteristics of Sprint's service territory and customer mix, when compared to those of Verizon and BellSouth, means that Sprint's rate structure reflects a greater subsidy from intrastate switched network access charges than being experienced by the other companies. Hence, a greater increase in basic local service rates will be necessary for Sprint to achieve the interstate parity and revenue-neutral provisions of the legislation.

Q. Please explain how rates were established historically in a monopoly environment?

A. Under historical rate base, rate-of-return regulation, a total company revenue requirement was determined based on the company's total expenses, plus a return on its investments. After the overall revenue requirement was established, prices were set to optimize revenues from discretionary and non-basic services. To the extent the firm's revenue requirement could not be recovered from raising non-basic service rates, the residual amount would be recovered from access charges and residential and business local access line services. Because residential basic local service rates were set based on universal service and other objectives (well below cost), access charges and business services became the "plug" to provide the revenue to meet the revenue requirement. The principle underlying this "residual" pricing concept was the idea of maintaining the universal service objective of making residential basic local service widely available at "affordable" rates, regardless of cost/revenue relationships. The net effect was to set prices for non-basic and discretionary services above their costs to

support lower-priced, below-cost residential basic local service rates.

Historically, the largest contribution to the support for residential basic local service was long distance calling, which was viewed in a monopoly environment as a highly desirable, premium, discretionary service with a predictable, stable revenue stream. The significant contributions from both interstate and intrastate long distance toll were used to support below-cost residential basic local service rates through end user rate-setting proceedings including a division of revenue/settlements process overseen by the federal and state regulators. In the now intensively competitive long distance market, the regulator's maintenance of the historic contribution levels from long distance toll to subsidize below-cost residential basic local service is provided from access charges paid to the local exchange companies by the long distance carriers.

Q. What are Sprint's current intrastate switched access rates and what regulatory proceedings influenced the current rate levels?

A. Sprint's current intrastate switched network access rates are the product of several decisions and now average approximately $.104 per minute (originating and terminating). The current rates reflect a significant change from the structure and rates originally established by the Commission in 1983.

Rates were originally established in Docket 820537-TP which was initiated by Order No. 11551, issued January 26, 1983, on the eve of the impending AT&T divestiture. The purpose of the proceeding was to implement an intrastate access charge structure in Florida that would compensate local exchange companies for the use of their local facilities to originate and terminate long distance traffic by interexchange carriers. As

stated in Commission Order No. 12765, issued December 9, 1983, the primary goal ". . . was to set access charges that would adequately compensate the LECs for use of their local facilities for originating and terminating toll traffic and to provide incentives for competition, while maintaining universal telephone service." This policy goal resulted in the Commission setting intrastate switched network access charges for Sprint (then United Telephone) in the neighborhood of $0.25 per minute.

Thereafter, Docket No. 8609874-TL was initiated in mid-1986 to re-address the level of, and the mechanism for, recovering non-traffic sensitive costs associated with the local loop. The outcome of that docket was essentially a continuation of the historical regulatory policies of maintaining low basic local service rates through the support of revenues from other services, principally intrastate switched network access charges.

In 1989, in Docket No. 891239-TL, and again in 1991, in Docket No. 910980-TL, Sprint (United Telephone at the time) filed petitions that proposed increases in residential basic local service rates and reductions in switched network access charges. The $16 million access charge reduction and local service rate increase requested in the 1989 case was approved, however, the $8 million access reduction requested in the 1991 case was rejected since it would have increased residential basic local service rates. Specifically, the Commission stated:

> "We increased local rates by $15.9 million in United's last rate case and lowered the BHMOC [an intrastate access charge component]. But, we do not believe that local rates should again be raised in this proceeding in order to have a greater BHMOC reduction. Accordingly, we shall deny United's request." (Order No. PSC-92-0708-FOF-TL, Docket Nos.

910980-TL, 910529-TL.)

In 1995, the Florida Legislature passed the Florida Telecommunications Act ("1995 Act") which opened the local exchange carriers' local markets to competition and mandated reductions in access charges for any LEC who chose to become regulated under a price regulation plan and whose intrastate switched network access charges were not then at parity with its interstate switched network access charges. The 1995 Act established a target for intrastate switched access rates as the December 31, 1994 interstate switched network access rate levels and provided for a 5 percent annual reduction in access charges as the mechanism for achieving parity with a LEC's interstate switched network access rates. Sprint fulfilled the annual reductions mandated under this legislation in 1996 and 1997. In 1998, the Florida Legislature modified the provisions related to access charge reductions and required a 15 percent reduction to be made in 1998, while at the same time removing the 1994 interstate rate as the target. Since Sprint's 1998 access rate reductions of 5 percent ($9.3 million) in July and 10 percent ($17.6 million) in October, there have been no further changes to Sprint's intrastate switched network access rates.

Q. You have discussed generally how access charges have historically been set above cost and identified Sprint's current access rates and how they arrived at their current level. Does the cost study information supplied by Sprint witness Dickerson confirm that Sprint's current intrastate switched access rates reflect a substantial contribution?

A. Yes. Sprint's current intrastate access rates provide a substantial contribution when compared with the forward-looking cost of switched access services. I have prepared

exhibit JMF-2 to illustrate the current relationship between intrastate access rates and cost. The analysis demonstrates that Sprint's current average intrastate switched access rate of $.050392 per minute of use (per end) exceeds the cost for the service of $.004475, thereby providing a significant contribution of $.045917 per minute of use. It should be noted that this analysis of current intrastate access rates and costs is presented solely to demonstrate the existing subsidy to residential local service provided by intrastate access charges.

Q. Is cost the target for the intrastate access reductions?

A. No. The 2003 Act established parity with the January 2003 interstate access rates as the appropriate target for reducing intrastate access rates.

Q. What evidence do you have that the contributions from intrastate switched network access charges are subsidizing residential basic local service?

A. Exhibit JMF-3 to my testimony demonstrates the significant subsidy being provided to residential basic local service rates. The cost studies presented by Sprint witness Dickerson identify the forward-looking cost of residential basic local service as $30.46 and business basic local service as $XX.XX. A comparison of these costs to the current associated rates (including the subscriber line charge) for basic local service reveals that residential basic local service is currently priced well below its associated costs. The exhibit clearly demonstrates that the rates for residential basic local service are not recovering the associated costs of providing the service. Coupled with the previous analysis of intrastate access rates and its associated costs, it is clear that intrastate access charges are providing a subsidy to residential basic local service rates. Exhibit JMF-4 provides a comparison of the rates and costs for single-line business

service.

Q. How do intrastate switched access rate levels in Florida compare to those in other states?

A. Exhibit JMF-5 demonstrates the disproportionate contribution made by Sprint's intrastate switched network access charges to support residential basic local service rates in Florida, relative to seven other southeastern states. I have shown the access rates of BellSouth, the largest ILEC in each of these other states. Sprint's intrastate access charge rate is more than twice the intrastate access charge rate of the next highest rate and more than ten (10) times higher than four (4) of the other states' rates.

Q. How do Sprint's basic local service rates in Florida compare to the rates in other states?

A. Sprint's average monthly rate for residential basic local service, including TouchTone, is $9.98 in Florida, compared to a national average rate of $14.55, a difference of $4.57. The national average rate is from the FCC's 2003 Reference Book of Rates, Price Indices and Household Expenditures for Telephone Service, Table 1.1. Exhibit JMF-6 is a comparison of Sprint's rates with those of BellSouth's rates in other states in the southeast. BellSouth's rates were used for comparison as they are the largest ILEC in the subject states.

As can be seen from Exhibit JMF-6, Sprint's residential basic local rates are significantly lower than the comparable rates in its seven neighboring southeastern states. Sprint's rates in its lowest rate group are on average $4.47 per month lower than the comparable rates in the other states. In the highest rate group, Sprint's

Florida residential rates are on average $3.86 per month lower than the comparable rates in the other states.

Exhibit JMF-7 shows that Sprint's single-line business rates are also significantly below the rates for business lines in these neighboring states. Sprint's single-line business average rate of $21.18 is also well below the national average of $33.34 (FCC's 2003 Reference Book of Rates, Price Indices and Household Expenditures for Telephone Service, Table 1.8).

Q. Has Sprint's Local Telephone Division had experience in other states in transitioning subsidies from access charges to end user rates?

A. Yes. Sprint's experiences in Ohio and Pennsylvania with rate rebalancing between access charges and end user rates provides information which is insightful in evaluating a similar initiative here in Florida.

Q. Could you describe Sprint's access rebalancing experience in Ohio?

A. In June 2001, the Public Utilities Commission of Ohio approved Sprint's proposed plan to reduce intrastate switched access charges to interstate levels and increase certain end user rates to offset the access revenue reduction (Commission Opinion and Order in Case No. 00-127-TP-COI and Case No. 01-1266-TP-UNC, Issued June 28, 2001). The plan provided for a reduction of intrastate switched access rates to parity with the interstate switched access rates that resulted from the FCC's Coalition for Affordable Local and Long Distance Service ("CALLS") proceeding. To offset the access reduction, Sprint established an end user charge (called an "intrastate access fee") of $4.10 for residential customers, $6 for single-line business customers and

$8.90 for multi-line customers. These local rate increases were implemented on a flash-cut basis.

Q. What has been Sprint's experience with switched network access rate rebalancing in Pennsylvania?

A. The Public Utility Commission of Pennsylvania has allowed residential basic local service rates to periodically increase up to a weighted average cap of $16 per month to offset decreases in intrastate switched access rates. Rates for business local service were also allowed to increase, but by a smaller amount than residential rates. Intrastate traffic sensitive access charges were to be reduced to the July 1998 interstate rate levels. The carrier common line charge was restructured from a minute-based charge to a flat-rate carrier charge. Under this plan, Sprint has increased its residential basic local service rates by approximately $4.41 to an average of $15.88 and has offset these local rate increases with corresponding reductions to its traffic sensitive intrastate switched network access rates and the carrier charge.

Q. Have there been recent developments in Pennsylvania which will further reform the intrastate access rate structure for Sprint in Pennsylvania?

A. Yes. On July 10, 2003, the Pennsylvania Commission approved a joint proposal of Sprint, the Rural Telephone Company Coalition, the Office of Consumer Advocate, Office of Trial Staff and Office of Small Business Advocate that provides for further access charge reductions on a revenue-neutral basis. The approved plan allows Sprint to increase its residential basic local service rates to achieve a maximum weighted average of $18 and to offset these increases with corresponding reductions to its traffic sensitive access rates and the carrier charge. Rates for business local service are

allowed to increase by the same amount as the residential rates.

Q. What was the Pennsylvania Commission's rationale in approving the local rate increases and corresponding access charge reductions?

A. The Pennsylvania Commission recognized the need to rationalize the pricing structure for both basic local service and access charges to foster a more competitive environment. The Pennsylvania Commission specifically found in its July 10, 2003, order that:

> "At this juncture, the Commission is persuaded that the proposed access charge reductions are in the public's interest and in accordance with the Commission's objective to reduce implicit subsidy charges such as access charges that impede competition in the telecommunications market. As implicit charges become explicit charges, competitors are better able to compete for local and long distance customers in an ILEC's service territory because IXCs are not hindered by paying ILECs excessive access charges in providing competitive toll services and CLECs are better able to compete with ILEC local service rates that have been kept artificially low as a result of the access charge subsidies." (Order at page 10).
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> ***
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> "We further look to the Federal Communications Commission's (FCC) recent decisions in the CALLS and MAG orders for precedence in ordering implicit charges to become explicit, either through an increase in basic local telephone service rates, or through service line charges on customer bills. This enables other carriers to compete due to reduced

subsidies. While the Joint Proposal does not require a rural ILEC or Sprint/United to mirror interstate access charges, the fact that this is a step towards making the charges closer to cost and closer to the interstate access charges will help to avoid arbitrage and will help competition enter the ILEC territories." (Order at page 11).

III. ACCESS RATE REDUCTIONS

Q. What provisions of the Tele-Competition Innovation and Infrastructure Enhancement Act ("2003 Act") govern Sprint's filing of its petition to reduce its intrastate switched access rates?

A. The applicable provisions of the legislation associated with the access reductions include the following:

364.164 (1)

"Each local exchange telecommunications company may, after July 1, 2003 petition the Commission to reduce its intrastate switched network access rate in a revenue neutral manner."

364.164 (5)

"As used in this section, the term 'parity' means that the local exchange telecommunications company's intrastate switched network access rate is equal to its interstate switched network access rate in effect on January 1, 2003, if the company has more than 1 million access lines in service."

364.164 (6)

"As used in this section, the term 'intrastate switched network access rate' means the composite of the originating and terminating network access rate for carrier common line, local channel/entrance facility, switched common transport, access tandem switching, interconnection charge, signaling, information surcharge, and local switching."

Q. Please describe Sprint's interstate switched network access rate structure that will be used as the target for Sprint's intrastate access reductions.

A. Sprint's January 1, 2003 interstate switched network access rates are the result of the CALLS plan adopted by the Federal Communications Commission in June 2000 (Sixth Report and Order in CC Docket No. 96-262 and 94-1, Report and Order in CC Docket 99-249, Eleventh Report and Order in CC Docket 96-45, released May 31, 2000). The CALLS plan established a five-year timeframe for addressing issues with both the rate structure and rate levels for interstate switched network access service. Exhibit JMF-8 to my testimony identifies the rate elements reflected in Sprint's January 2003 interstate switched access rates.

Q. Are there any differences between Sprint's interstate and intrastate switched access rate structures?

A. Yes. Sprint's intrastate switched network access rates include rates for carrier common line and interconnection charge, however the interstate rates for these elements are set at zero. Also, the interstate switched transport rate category has sub-element rates for common and dedicated trunk ports, which are not disaggregated from the switched common transport rate element in the intrastate tariff.

Q. How will Sprint reduce intrastate switched access rates to be in parity with interstate switched access rates?

A. Because the 2003 Act specifically identifies the interstate switched access rate as the target for parity, Sprint will implement a very simple and straight-forward approach to achieve parity. Sprint will establish a rate structure for its intrastate switched network access rates that mirrors both the rate structure and rate levels for interstate switched network access service in effect on January 1, 2003. This approach ensures that the intrastate switched network access rates are in parity with their interstate counterpart since both the structure and rates will be exactly the same once the transition to parity is completed.

Q. Using this method of mirroring both the rate structure and rate levels for interstate switched network access rates, how did Sprint calculate the impact of the intrastate switched network access rate reduction?

A. As specified by the 2003 Act, Sprint will utilize the most recent 12 months' actual pricing units in developing the impact of the intrastate switched access reduction. For purposes of this filing, the most recent available 12 months information covers the period from June 2002 to May 2003. Sprint applied the current intrastate switched access rates to the actual pricing units to develop the current intrastate switched access revenues. Sprint then applied the January 1, 2003 interstate access rates to those same pricing units to develop the estimate of revenues to be received after implementation of the rate changes. Assuming – for illustration purposes only - a flash-cut, one-time reduction, the difference between the two revenue amounts represents the total value of the intrastate switched access rate reductions. For purposes of its Petition, Sprint has calculated this amount as $142,073,492. The detailed calculations of this amount

are included on Exhibit JMF-9 to my testimony.

Q. Does Sprint's approach result in parity between the intrastate composite switched network access rate and the interstate composite switched network access rate?

A. Yes. As noted earlier, Section 364.164 (6) provides a comprehensive description of what is included in the term "intrastate switched network access rate."

> "As used in this section, the term 'intrastate switched network access rate' means the composite of the originating and terminating network access rate for carrier common line, local channel/entrance facility, switched common transport, access tandem switching, interconnection charge, signaling, information surcharge, and local switching."

I have prepared Exhibit JMF-10 which demonstrates that Sprint's access rate reduction plan will produce a composite switched intrastate access rate that is equal to the composite January 1, 2003 interstate switched access rate. Sprint's calculation produces an intrastate switched access composite rate of $.012852 after the access rate reduction is completed. This composite rate is equivalent to the January 1, 2003 interstate switched access composite rate of $.012852.

Q. What is Sprint's revised plan for adjusting intrastate switched network access rates?

A. Sprint will reduce its intrastate switched network access rates to the target levels in three separate annual increments over a two-year period. The first annual access

reductions are targeted to reducing the current intrastate switched network access charge elements which have no associated costs and are therefore providing a pure subsidy. Specifically, Sprint will target the reduction of $62,319,890 to the interconnection charge and the carrier common line rates. The first annual access reductions result in an elimination of the interconnection charge and a substantial reduction in the carrier common line rates. Amended Exhibit JMF-11 to my testimony provides the detailed calculations supporting the first annual access reductions.

Q. What intrastate switched network access rate changes are planned for the second increment?

A. The second annual intrastate switched network access rate reductions are directed first towards elimination of the remaining carrier common line rates. The remainder of the second annual access rate reduction is directed at the end office local switching rate element. . Sprint has estimated the impact of the second annual increment of the access reduction as $56,211,283 based on current pricing units (see Amended Exhibit JMF-11).

Q. What intrastate switched network access rate changes are planned for the third increment ?

A. The third annual intrastate switched network access rate reductions are directed first towards reducing the end office local switching rate element, which was partially reduced in the second increment, to the January 1, 2003 interstate level. The remainder of the third annual access rate adjustment is directed at establishing the rate elements and rates that fully mirror the January 1, 2003 interstate rates. Sprint has estimated the impact of the third annual increment of the access reduction as $23,541,741 based on current pricing units (see Amended Exhibit JMF-11).

Q. With these changes, does Sprint's revised plan comply with the provisions of the 2003 Act regarding intrastate switched access rate levels?

A. Yes. Based on this revised plan Sprint will reduce its intrastate switched access rates to exactly match (in both structure and rate level) the January 2003 interstate switched network access rates over a two-year period utilizing three separate access reductions. Although Sprint has estimated the impact of each increment of the access reduction, it is recognized that the actual reduction amount for each increment will be based on the latest 12 months pricing units at that time. As a result, the impact of the access reduction for each of the three increments will likely vary from the estimated amounts.

IV. REVENUE NEUTRALITY

Q. You have described Sprint's revised plan for reducing its intrastate switched access rates to parity with interstate rates. What does the 2003 Act provide for in terms of revenue neutrality?

A. The 2003 Act specifies that, if intrastate access rates are to be reduced, they must be reduced in a revenue-neutral manner. Section 364.164 (2) describes the specific methodology to be used for calculating revenue neutrality:

> "If the Commission grants the local exchange company's petition, the local exchange company is authorized, the requirements of section 364.051 (3) notwithstanding, to immediately implement a revenue category mechanism consisting of basic local telecommunications service revenues and intrastate switched network access revenues to achieve revenue neutrality. The local exchange company shall

thereafter, on 45 days' notice, adjust the various prices and rates of the services within its revenue category authorized by this section once in any 12-month period in a revenue-neutral manner."

Q. What information did Sprint use to create the revenue category mechanism provided for in the provision quoted above?

A. The provisions of the 2003 Act related to calculation of the revenue category mechanism are contained in section 364.164 (7):

"Calculation of revenue received from each service before the implementation of any rate adjustment must be made by multiplying the then-current rate from each service by the most recent 12 months' actual pricing units for each service within the category, without any adjustments to the number of pricing units. Calculation of revenue for each service to be received after implementation of rate adjustments must be made by multiplying the rate to be applicable for each service by the most recent 12 month's actual pricing units for each service within the category, without any adjustments to the number of pricing units."

Based on these guidelines, Sprint extracted billing information for the most recent 12 months (June 2002 through May 2003) for intrastate switched network access services and basic local telecommunications services and created a model which documents the calculations necessary to achieve the revenue neutrality provisions of the 2003 Act. This information is summarized in Amended Exhibit JMF-12 to my testimony.

Q. What is Sprint's revised plan for achieving revenue neutrality?

A. As noted previously, Sprint will reduce its intrastate switched access rates to the target interstate levels over a two-year period using three separate annual increments (2004, 2005 and 2006). To achieve the revenue neutrality provided by the 2003 Act, Sprint will increase rates for basic local telecommunications services over that same two-year period, accomplishing the increase over three separate annual increments. I previously described how Sprint's calculation of the amount to achieve access rate parity produces a reduction of $142,073,492 in access revenues, assuming a one-time, flash-cut reduction. This $142,073,492 represents an estimate of the amount to be recovered through adjustments in the rates for basic telecommunications service, assuming the same one-time, flash-cut adjustment.

As noted previously, Sprint will reduce its intrastate switched access revenues in three annual increments as follows:

Increment 1 (2004)	$62,319,890
Increment 2 (2005)	$56,211,862
Increment 3 (2006)	$23,541,711

Sprint will achieve revenue neutrality for these switched access revenue reductions by implementing increases in its rates for basic local telecommunications services over the same two-year period, accomplished in three annual increments.

Q. What rate changes to basic local telecommunications services will be implemented to achieve revenue neutrality?

A. Amended Exhibit JMF-12 to my testimony summarizes Sprint's revised rate change plan for its basic residential and single-line business local service rates for the three

annual increments. . Sprint will increase residential basic local service recurring rates by $2.95 in the first increment , $2.75 in the second increment and $1.16 in the third increment. Rates for single-line business basic local service will increase by an average of $2.70 in the first increment , $2.40 in the second increment and $.90 in the third increment. Sprint will also increase certain residential and business non-recurring service charges in each of the three annual increments of the plan. These rate changes will increase basic local service revenues by $142,084,461, an amount which is slightly different from the total access reduction amount due to rounding differences.

Upon the grant of Sprint's Revised Petition, Sprint, in compliance with Section 364.164(2), Florida Statutes, will commence the implementation of its first annual intrastate switched network access and basic local service price adjustments. These adjustments should become effective in the first quarter of 2004. The subsequent annual adjustments will be scheduled to take place on the anniversary of the effective date of the first annual adjustment.

Q. How does Sprint's revised plan comply with the provision in 364.164 (2) regarding limiting the increases to the basic local service monthly recurring rate?

A. The 2003 Act provides that:

> "An adjustment in rates may not be offset entirely by the company's basic monthly recurring rate."

In compliance with this provision, Sprint's revised plan includes an estimated $7,638,900 of increases to certain non-recurring, service charges. As a result, Sprint's

access charge reductions are not offset entirely by increases in the basic local service monthly recurring rate.

Q. How will Sprint comply with the provisions of the 2003 Act relating to Lifeline and pay telephone access lines?

A. The 2003 Act provides that:

> "Billing units associated with pay telephone access lines and Lifeline service may not be included in any calculation under this subsection."

Sprint has specifically identified the number of Lifeline and pay telephone lines in service during the 12-month period used in calculating the revenue neutrality provisions of its revised plan. The pay telephone lines were removed from the calculation of revenue neutrality and the current rates will not be affected by rate changes associated with implementing the 2003 Act. For Lifeline customers, billing system limitations will preclude Sprint from continuing to display the current basic local service rate for Lifeline customers on the bill as the rate changes resulting from the revenue neutrality provisions are implemented. Sprint will, instead, reflect on these customers' bills, a Lifeline credit that is increased by the amount of the increases to recurring residential rates. This will insure that there is no net impact to the customer from the increases associated with implementing the 2003 Act. Sprint believes this approach is expressly consistent with the legislative provisions regarding Lifeline customers – namely, to ensure their bills are unaffected by the rate changes resulting from implementation of the revenue neutrality provisions of the 2003 Act.

Q. What are the factors that could change the actual basic local service rates in the

Sprint revised plan?

A. The 2003 Act provides that the actual pricing changes to accomplish revenue neutrality must be based on the company's most recent 12 months' pricing units. As a result, changes to the pricing units for both switched access services and basic local telecommunications services are expected and will affect all three increments of Sprint's planned price changes. Upon the granting of the Petition, Sprint will adjust the price changes to ensure revenue neutrality is achieved and the calculations remain in compliance with the provisions of the 2003 Act.

Q. Could you identify the specific rate changes planned for residential and single-line business basic local service rates?

A. Yes. I have prepared Amended Exhibit JMF-13 which identifies the current rates and the specific rate changes for the three annual increments of Sprint's revised plan for both residential and single-line business basic local service. The exhibit also identifies the current and planned rates for the service connection charge elements.

Q. Does Sprint's revised plan apply the basic local service increase equally across all rate groups?

A. For residential basic local service rates, Sprint will implement increases that are consistent across all rate groups. For single-line business basic local service rates, Sprint has taken into account competitive and calling scope considerations in its rate design. As a result, Sprint's revised plan for single-line business basic local service rates does reflect some variability in the increases across the rate groups.

Q. What is Sprint's rationale for the distribution of its revenue-neutral rate changes

over the three increments?

A. Sprint has elected to increase its basic local services prices in a graduated manner over the two-year period because Sprint continues to believe that it is important to eliminate the non-cost-based component of its intrastate switched network access rate as quickly as possible. This principle drives, in part, the size of the resulting first of three annual basic local service price increases. The size of each of the remaining two annual switched access rate decreases and resulting basic local service price increases also reflects Sprint's efforts to fulfill the underlying goal of the legislation to enhance the creation of a more competitive local market for the benefit of residential consumers as quickly as possible.

V. CONSUMER IMPACTS

Q. Sprint includes a two-year timeframe for implementation of its revised revenue-neutral plan. Why is a two-year plan most appropriate?

A. As described in more detail in the testimony of Dr. Kenneth Gordon, the elimination of implicit subsidies in access rates and the establishment of pricing for local services which are more closely aligned with their costs, will make the residential local market more attractive to competitors and will bring about enhanced market entry. Additionally, as indicated by the access charge and local service rate differentials shown in my exhibits JMF-5 and JMF-6, Florida is already well behind other states in making these changes.

Q. Will Sprint introduce other consumer benefits in addition to those that accrue from a more competitive market?

A. Yes. In an effort to mitigate the impacts to customers from the increases in rates for basic local service, Sprint will reduce the amount residential customers pay for extended local calling services by providing a free allowance of five calls per month for routes which are charged on a per message basis. Currently, customers incur a charge of $.20 or $.25 per message for all calls made on these local calling plans. Under Sprint's plan, customers will receive the first five calls free, and will incur the tariff charges for calls over the allowance. Based on current rates, customers could experience savings of up to $1.00 or $1.25 per month in their charges for extended local calling. This plan has the potential for providing benefit to a large number of Sprint's residential customers as over 82 percent have extended local calling service available to them over 283 routes included in Sprint's proposal.

Q. Are there other consumer benefits provided by the legislation?

A. Yes. The interexchange carriers ("IXCs") are required to return to their residential and business customers the benefits of access reductions they realize from the ILEC rate reductions. The reductions that customers experience in the rates for long distance calling will serve to offset the increases they will experience for basic local services. This offset will consist of eliminating, by January 1, 2006, any "instate connection fee" which for the "big three" IXCs is currently approximately $1.90 per month, and flowing-through any residual switched network access charge reduction amount in the form of lower toll rates. Thus, IXC's residential customers currently being charged an instate connection fee will see a direct reduction in their monthly toll bill of about $1.90, regardless of the amount of their toll calling volume. Thereafter, long distance users will receive the benefits of additional IXC flow-through toll price reductions.

Q. What additional protections are there for those customers that are economically disadvantaged who might otherwise be impacted more significantly by the increases in basic local service?

A. As I stated previously, Section 364.10(3)(a) exempts Lifeline customers from the rate changes allowed by Section 364.164. Additionally, Section 364.10 (3) (a) enhances the Lifeline program effective September 1, 2003, to allow any customer who meets a stand-alone income eligibility test at 125% or less than the federal poverty level to subscribe to Lifeline service without having to apply to a low-income assistance program. Eligibility for these customers will be administered by the Office of Public Counsel. Sprint implemented this new criterion as of August 1, 2003. As further protection for Lifeline customers, Sprint will extend the Lifeline credit amount for an additional year beyond the two-year rebalancing period through at least the first quarter of 2007.

Q. What about universal service objectives? Aren't you concerned that increasing residential local service rates will result in some subscribers dropping off the network?

A. No, for several reasons. First, the 2003 Act has increased Lifeline service availability to a greater number of Florida's economically disadvantaged. In fact, Lifeline is being expanded such that the requirement of participation in one of the six public assistance programs is not required. Customers that have household incomes up to 125% of the Federal Poverty Level can apply to the Office of Public Counsel for approval for subscription to Lifeline service. Additionally, as I stated previously, the rates for Lifeline service will not increase for a period of three years as a result of the rebalancing.

Second, the empirical data from the other states that have increased their local service rates demonstrates that subscribership has not been adversely affected. Exhibit JMF-14, shows that of the seven other southeastern states, all of which have higher local service rates than Florida, each has increased its residence subscribership more than Florida's subscribership, except for Georgia, where subscribership has remained unchanged. Exhibit JMF-15 shows the subscribership for 1988 and November of 2002 for each of the seven other southeastern states.

Finally, from an ability to pay perspective, Florida customers have higher average incomes than any of the other seven states. Exhibit JMF-16 shows the per capita personal income for Florida as compared to the other states. Exhibit JMF-17 shows Florida's higher level of disposable personal income versus the seven other states. Nationally, Florida ranks 25th in per capita personal income, again higher than the other states as shown in Exhibit JMF-18, another indication of Florida's higher income relative to the other states.

Q. You previously described Sprint's access rebalancing experience in Ohio and Pennsylvania. How do the rates for basic residential local service in those states compare to the rates in the Sprint revised plan for Florida?

A. Sprint's rate for basic residential local service in Ohio averages $16.55. The $4.10 "intrastate access fee" authorized by the Ohio Commission brings the total charge for residential local service to $20.65. In Pennsylvania, Sprint's current average residential local service rate is $15.88 and based on the Pennsylvania Commission's recent order, it will move towards the cap of $18 in 2004. Sprint's revised revenue-

neutral plan for Florida will result in a weighted-average residential local service rate of $16.84 (current average of $9.98 plus increase of $6.86 over Sprint's two-year plan). The resulting residential local service rate in Florida will be significantly below Sprint's rates in Pennsylvania and Ohio.

Q. Has Sprint experienced any significant changes in subscribership for residential basic local service as a result of the local rate increases in Pennsylvania or Ohio?

A. No, there was virtually no negative customer reaction to the increases in local rates in these two states, either in the form of complaints to the Commission or decreases in subscribership. In Ohio, primary residential access lines declined approximately 1% during the six months following the local rate increase. In Pennsylvania, primary residential access lines declined less than ½ of 1 percent in the six months following the most recent local rate increase. Although minor declines in residential access lines were experienced in these states, there are many factors other than the local rate increases that influenced this trend, including the general state of the economy, wireless replacement and competition from other wireline carriers. As an illustration, Sprint's primary access lines for its entire 18 state local telephone division declined approximately .3 percent during 2001 and .5 percent in 2002, even though the other states were not experiencing the type of local rate increases that were ordered in Ohio and Pennsylvania.

Q. Do the changes in interstate access rates provide any evidence that the correct assignment for recovery of these costs to end users does not negatively impact universal service objectives?

A. The FCC, in recognition of the problems of continuing service cross-subsidies in a

competitive telecommunications markets, has been transitioning the support for local services provided through interstate access charges from toll users to local service via the End User Common Line or Subscriber Line Charge. Local subscribership, measured by the FCC's Telephone Penetration Data as the percentage of households with telephone service, has steadily increased even though the subscriber line charge has increased to $6.50 for primary residential service as of July 2003. The subscriber line charge for residential and single-line business was initially implemented at a rate of $1.00 on June 1, 1985. At that time, the FCC reported subscribership nationally at 91.8%; as of November 2002, the latest available data, subscribership was at 95.3%. This is not surprising given that the increase in the recurring subscriber line charge rate has been offset by significant decreases in long distance rates and increases in consumer income.

Q What is your conclusion regarding the significance of this data?

A. The data conclusively demonstrates that basic local service rates in Florida can be increased without negatively impacting universal service or subscribership levels. In fact, when basic local service rates are increased on a revenue neutral basis, with access charge rate reductions flowed through to end user customers, along with Sprint's plan to provide the first five extended local calls free, universal service will be positively impacted. This is particularly true given that under Section 364,164, those most economically disadvantaged consumers, Florida's Lifeline subscribers, will not be subject to rate increases in their recurring local service rates from the rate rebalancing for three years and will have the benefit of reduced toll charges.

It is also worth noting that even with the basic local service price increases being

implemented by Sprint, the residential basic local service prices will still be below the cost of providing the basic local service. As noted by Dr. Staihr and Dr. Gordon, there are significant benefits to the residential marketplace that will result from moving prices towards cost in terms of making the residential market more attractive to competitors and inducing enhanced market entry.

VI. CONCLUSION

Q. Could you summarize Sprint's position in this proceeding?

A. Through its petition and the testimony and exhibits of its witnesses in this proceeding, Sprint demonstrates that its revised plan for reducing intrastate network access rates in a revenue neutral manner meets all of the criteria established by the 2003 Act and should therefore be approved by the Commission. Specifically, granting Sprint's petition will:

- ***Remove current support for basic local telecommunications services that prevents the creation of a more attractive, competitive local exchange market for the benefit of residential customers.***

  My testimony, along with the cost study information supported by Sprint witness Dickerson, provides evidence that intrastate switched network access rates are providing support for Sprint's residential basic local telecommunications services. Sprint's witnesses Gordon and Staihr provide evidence that the removal of the current level of support for residential local services will create a more attractive, competitive local exchange market for the benefit of residential customers.

- ***Induce enhanced market entry.***

  Sprint witnesses Gordon and Staihr provide evidence demonstrating that approval of Sprint's petition will result in enhanced market entry by competitors.

- ***Result in intrastate switched access rate reductions to parity over a period of two years.***

  My testimony describes Sprint's revised plan for implementing its revenue neutral intrastate switched access reductions over a two-year period, which complies with the 2003 Act provisions of a period of not less than two years or more than four years.

- ***Will be revenue neutral.***

  My testimony describes Sprint's revised plan for decreasing intrastate network switched access rates to the January 2003 interstate levels and increasing basic local service rates to offset the access reductions. Sprint's revised plan fully complies with the provisions of the 2003 Act regarding revenue neutrality.

Q. Does this conclude your testimony?

A. Yes, it does.

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SPRINT-FLORIDA, INCORPORATED
Intrastate Access Reductions

	Increment 1						
	Twelve Months Billing Units *	Current Intrastate Access Rate	Current Intrastate Access Revenue	Increment 1 Intrastate Access Rate	Increment 1 Intrastate Access Revenue	Increment 1 Annual Revenue Change
Carrier Common Line Access						
Originating Access Minute	1,137,803,229	$0.025800	$ 29,355,323	*$ 0.012443*	*$ 14,157,686*	*$ (15,197,638)*
Terminating Access Minute	1,950,818,429	$0.033633 **	$ 65,612,727	*$ 0.012443*	*$ 24,274,034*	*$ (41,338,693)*
Interconnection Charge						
Total Interconnection Charge-Per Access Minute	3,289,996,573	$0.001758 **	$ 5,783,559	$ -	$ -	$ (5,783,559)
Switched Transport-Local Channel/Entrance Facility						
Local Channel/Entrance Facility - Voice Grade	804.74	$ 80.00	$ 64,379	$ 80.00	$ 64,379	$ -
Local Channel/Entrance Facility - DDS - 56.0 kbps	168.00	$ 69.10	$ 11,609	$ 69.10	$ 11,609	$ -
Local Channel/Entrance Facility - DS1 - 1.544 kbps	985.44	$ 205.65	$ 202,657	$ 205.65	$ 202,657	$ -
Local Channel/Entrance Facility - DS3 - 44.736 mbps	319.99	$ 1,250.50	$ 400,149	$ 1,250.50	$ 400,149	$ -
Switched Transport-Direct Trunked Transport						
Voice Grade-Termination (Fixed)	575.46	$ 33.80	$ 19,451	$ 33.80	$ 19,451	$ -
Voice Grade-Facility (Per Mile)	13,113.08	$ 1.80	$ 23,604	$ 1.80	$ 23,604	$ -
DDS-Termination (Fixed)	48.00	$ 37.55	$ 1,802	$ 37.55	$ 1,802	$ -
DDS-Facility (Per Mile)	223.56	$ 3.80	$ 850	$ 3.80	$ 850	$ -
DS1-Termination (Fixed)	6,988.29	$ 72.57	$ 507,171	$ 72.57	$ 507,171	$ -
DS1-Facility (Per Mile)	135,414.48	$ 12.37	$ 1,675,122	$ 12.37	$ 1,675,122	$ -
DS3-Termination (Fixed)	176.69	$ 476.75	$ 84,237	$ 476.75	$ 84,237	$ -
DS3-Facility (Per Mile)	3,221.23	$ 244.96	$ 789,081	$ 244.96	$ 789,081	$ -
Switched Transport-Tandem Switched Transport						
Tandem Switched Transmission Termination	1,106,569,637.50	$0.000207	$ 229,263	$ 0.000207	$ 229,263	$ -
Tandem Switched Facility	24,977,040,255.96	$0.000042	$ 1,036,611	$ 0.000042	$ 1,036,611	$ -
Tandem Switching	970,994,904.00	$0.000899	$ 873,165	$ 0.000899	$ 873,165	$ -
Common Transport Multiplexing	1,319,493,579.64	$ -	$ -	$ -	$ -	$ -
Common Trunk Port	1,490,689,259.47	$ -	$ -	$ -	$ -	$ -
Dedicated Trunk Port-DS0	2,148.69	$ -	$ -	$ -	$ -	$ -
Dedicated Trunk Port-DS1	15,875.31	$ -	$ -	$ -	$ -	$ -
Switched Transport-Chargeable Optional Features						
Multiplexing-DS1 to Voice	4.09	$ 301.32	$ 1,232	$ 301.32	$ 1,232	$ -
Multiplexing-DS3 to DS1	498.30	$ 585.94	$ 291,972	$ 585.94	$ 291,972	$ -
STP Port Charge	120.00	$ 485.00	$ 58,200	$ 485.00	$ 58,200	$ -
End Office-Local Switching						
Local Switching-Per Access Minute	3,099,745,853.00	$0.017700	$ 54,865,502	$ 0.017700	$ 54,865,502	$ -
TOTAL SWITCHED ACCESS SERVICES			$ 161,887,665		*$ 99,567,775*	*$ (62,319,890)*

*** Unit information based on June 2002 thru May 2003**
**** Current rate is a composite of rates from sections E3, E6 and E16.**

Items in Italic represent amended numbers.

SPRINT-FLORIDA, INCORPORATED
Intrastate Access Reductions

		Increment 2				
	Twelve Months Billing Units	Increment 1 Intrastate Access Rate	Increment 1 Intrastate Access Revenue	Increment 2 Intrastate Access Rate	Increment 2 Intrastate Access Revenue	Increment 2 Annual Revenue Change
Carrier Common Line Access						
Originating Access Minute	1,137,803,229	*$ 0.012443*	*$ 14,157,686*	$ -	$ -	*$ (14,157,686)*
Terminating Access Minute	1,950,818,429	*$ 0.012443*	*$ 24,274,034*	$ -	$ -	*$ (24,274,034)*
Interconnection Charge						
Total Interconnection Charge-Per Access Minute	3,246,048,469	$ -	$ -	$ -	$ -	$ -
Switched Transport-Local Channel/Entrance Facility						
Local Channel/Entrance Facility - Voice Grade	804.74	$ 80.00	$ 64,379	*$ 80.00*	*$ 64,379*	$ -
Local Channel/Entrance Facility - DDS - 56.0 kbps	168.00	$ 69.10	$ 11,609	*$ 69.10*	*$ 11,609*	$ -
Local Channel/Entrance Facility - DS1 - 1.544 kbps	985.44	$ 205.65	$ 202,657	*$ 205.65*	*$ 202,657*	$ -
Local Channel/Entrance Facility - DS3 - 44.736 mbps	319.99	$ 1,250.50	$ 400,149	*$ 1,250.50*	*$ 400,149*	$ -
Switched Transport-Direct Trunked Transport						
Voice Grade-Termination (Fixed)	575.46	$ 33.80	$ 19,451	*$ 33.80*	*$ 19,451*	$ -
Voice Grade-Facility (Per Mile)	13,113.08	$ 1.80	$ 23,604	*$ 1.80*	*$ 23,604*	$ -
DDS-Termination (Fixed)	48.00	$ 37.55	$ 1,802	*$ 37.55*	*$ 1,802*	$ -
DDS-Facility (Per Mile)	223.56	$ 3.80	$ 850	*$ 3.80*	*$ 850*	$ -
DS1-Termination (Fixed)	6,988.29	$ 72.57	$ 507,171	*$ 72.57*	*$ 507,171*	$ -
DS1-Facility (Per Mile)	135,414.48	$ 12.37	$ 1,675,122	*$ 12.37*	*$ 1,675,122*	$ -
DS3-Termination (Fixed)	176.69	$ 476.75	$ 84,237	*$ 476.75*	*$ 84,237*	$ -
DS3-Facility (Per Mile)	3,221.23	$ 244.96	$ 789,081	*$ 244.96*	*$ 789,081*	$ -
Switched Transport-Tandem Switched Transport						
Tandem Switched Transmission Termination	1,106,569,637.50	$ 0.000207	$ 229,263	*$ 0.000207*	*$ 229,263*	$ -
Tandem Switched Facility	24,977,040,255.96	$ 0.000042	$ 1,036,611	*$ 0.000042*	*$ 1,036,611*	$ -
Tandem Switching	970,994,904.00	$ 0.000899	$ 873,165	*$ 0.000899*	*$ 873,165*	$ -
Common Transport Multiplexing	1,319,493,579.64	$ -	$ -	$ -	$ -	$ -
Common Trunk Port	1,490,689,259.47	$ -	$ -	$ -	$ -	$ -
Dedicated Trunk Port-DS0	2,148.69	$ -	$ -	$ -	$ -	$ -
Dedicated Trunk Port-DS1	15,875.31	$ -	$ -	$ -	$ -	$ -
Switched Transport-Chargeable Optional Features						
Multiplexing-DS1 to Voice	4.09	$ 301.32	$ 1,232	*$ 301.32*	*$ 1,232*	$ -
Multiplexing-DS3 to DS1	498.30	$ 585.94	$ 291,972	*$ 585.94*	*$ 291,972*	$ -
STP Port Charge	120.00	$ 485.00	$ 58,200	*$ 485.00*	*$ 58,200*	$ -
End Office-Local Switching						
Local Switching-Per Access Minute	3,099,745,853.00	$ 0.017700	$ 54,865,502	*$ 0.011964*	*$ 37,085,359*	*$ (17,780,142)*
TOTAL SWITCHED ACCESS SERVICES			*$ 99,567,775*		*$ 43,355,914*	*$ (56,211,862)*

* Unit information based on June 2002 thru May 2003
** Current rate is a composite of rates from sections E3, E6 and E16.

Items in Italic represent amended numbers.

SPRINT-FLORIDA, INCORPORATED
Intrastate Access Reductions

		Increment 3				
	Twelve Months Billing Units	Increment 2 Intrastate Access Rate	Increment 2 Intrastate Access Revenue	Increment 3 Intrastate Access Rate	Increment 3 Intrastate Access Revenue	Increment 3 Annual Revenue Change
Carrier Common Line Access						
Orginating Access Minute	1,137,803,229	$ -	$ -	$ -	$ -	$ -
Terminating Access Minute	1,950,818,429	$ -	$ -	$ -	$ -	$ -
Interconnection Charge						
Total Interconnection Charge-Per Access Minute	3,246,048,469	$ -	$ -	$ -	$ -	$ -
Switched Transport-Local Channel/Entrance Facility						
Local Channel/Entrance Facility - Voice Grade	804 74	$ *80.00*	$ *64,379*	$ *102.60*	$ *82,566*	$ *18,187*
Local Channel/Entrance Facility - DDS - 56.0 kbps	168.00	$ *69.10*	$ *11,609*	$ *160.00*	$ *26,880*	$ *15,271*
Local Channel/Entrance Facility - DS1 - 1.544 kbps	985.44	$ *205.65*	$ *202,657*	$ *110.81*	$ *109,195*	$ *(93,462)*
Local Channel/Entrance Facility - DS3 - 44.736 mbps	319.99	$ *1,250.50*	$ *400,149*	$ *670.42*	$ *214,526*	$ *(185,622)*
Switched Transport-Direct Trunked Transport						
Voice Grade-Termination (Fixed)	575.46	$ *33.80*	$ *19,451*	$ *60.00*	$ *34,528*	$ *15,077*
Voice Grade-Facility (Per Mile)	13,113.08	$ *1.80*	$ *23,604*	$ *2.23*	$ *29,242*	$ *5,639*
DDS-Termination (Fixed)	48.00	$ *37.55*	$ *1,802*	$ *85.00*	$ *4,080*	$ *2,278*
DDS-Facility (Per Mile)	223.56	$ *3.80*	$ *850*	$ *4.30*	$ *961*	$ *112*
DS1-Termination (Fixed)	6,988.29	$ *72.57*	$ *507,171*	$ *41.16*	$ *287,655*	$ *(219,516)*
DS1-Facility (Per Mile)	135,414.48	$ *12.37*	$ *1,675,122*	$ *4.96*	$ *671,232*	$ *(1,003,890)*
DS3-Termination (Fixed)	176.69	$ *476.75*	$ *84,237*	$ *482.70*	$ *85,288*	$ *1,052*
DS3-Facility (Per Mile)	3,221.23	$ *244.96*	$ *789,081*	$ *81.64*	$ *262,967*	$ *(526,114)*
Switched Transport-Tandem Switched Transport						
Tandem Switched Transmission Termination	1,106,569,637.50	$ *0.000207*	$ *229,263*	$ *0.000562*	$ *622,268*	$ *393,005*
Tandem Switched Facility	24,977,040,255.96	$ *0.000042*	$ *1,036,611*	$ *0.000075*	$ *1,868,218*	$ *831,607*
Tandem Switching	970,994,904.00	$ *0.000899*	$ *873,165*	$ *0.001525*	$ *1,481,069*	$ *607,904*
Common Transport Multiplexing	1,319,493,579.64	$ -	$ -	$ *0.000367*	$ *483,805*	$ *483,805*
Common Trunk Port	1,490,689,259.47	$ -	$ -	$ *0.000557*	$ *830,314*	$ *830,314*
Dedicated Trunk Port-DS0	2,148.69	$ -	$ -	$ *4.070000*	$ *8,745*	$ *8,745*
Dedicated Trunk Port-DS1	15,875.31	$ -	$ -	$ *93.58*	$ *1,485,612*	$ *1,485,612*
Switched Transport-Chargeable Optional Features						
Multiplexing-DS1 to Voice	4.09	$ *301.32*	$ *1,232*	$ *248.92*	$ *1,018*	$ *(214)*
Multiplexing-DS3 to DS1	498.30	$ *585.94*	$ *291,972*	$ *225.58*	$ *112,406*	$ *(179,565)*
STP Port Charge	120.00	$ *485.00*	$ *58,200*	$ *430.85*	$ *51,702*	$ *(6,498)*
End Office-Local Switching						
Local Switching-Per Access Minute	3,099,745,853.00	$ *0.011964*	$ *37,085,359*	$ *0.003568*	$ *11,059,893*	$ *(26,025,466)*
TOTAL SWITCHED ACCESS SERVICES			$ *43,355,914*		$ *19,814,173*	$ *(23,541,741)*

*** Unit Information based on June 2002 thru May 2003**
**** Current rate is a composite of rates from sections E3, E6 and E16.**

Items in Italic represent amended numbers.

Sprint-Florida, Inc.
Summary of Revenue-Neutral Rate Changes

	Increment 1 Annual Revenue Change	Increment 2 Annual Revenue Change	Increment 3 Annual Revenue Change	Total Annual Revenue Change
INTRASTATE SWITCHED ACCESS	*$ (62,319,890)*	*$ (56,211,862)*	*$ (23,541,741)*	**$ (142,073,493)**

BASIC LOCAL SERVICE	Increment 1 Rate Increase	Increment1 Annual Revenue Change	Increment 2 Rate Increase	Increment 2 Annual Revenue Change	Increment 3 Rate Increase	Increment 3 Annual Revenue Change	Total Annual Revenue Change
Residential Basic Local Service	*$ 2.95*	*$ 50,502,490*	*$ 2.75*	*$ 47,077,474*	*$ 1.16*	*$ 19,858,530*	$ 117,438,494
Business Basic Local Service	*$ 2.70*	*$ 7,655,312*	*$ 2.40*	*$ 6,804,127*	*$ 0.90*	*$ 2,547,548*	*$ 17,006,987*
Residential Service Connection Charges		*$ 3,204,165*		*$ 1,544,768*		*$ 760,747*	$ 5,509,680
Business Service Connection Charges		*$ 958,758*		*$ 784,914*		*$ 385,629*	$ 2,129,300
Total Basic Local Service Increases		*$ 62,320,724*		*$ 56,211,283*		*$ 23,552,454*	*$ 142,084,461*

Items in Italic represent amended numbers.

Sprint-Florida, Inc.
Amended Petition to Reduce Access Rates
Filed: October 1, 2003
Amended Exhibit JMF-13

Sprint-Florida, Inc.
Current and New Basic Rates

	Residential Current Rate	Residential Increment 1 Rate	Residential Increment 2 Rate	Residential Increment 3 Rate	Business Current Rate	Business Increment 1 Rate	Business Increment 2 Rate	Business Increment 3 Rate
Individual Access Line								
United Rate Group 1	$ 7.63	*$ 10.58*	*$ 13.33*	*$ 14.49*	$ 16 57	*$ 21.32*	*$ 25.54*	*$ 27.12*
United Rate Group 2	$ 8.39	*$ 11.34*	*$ 14.09*	*$ 15.25*	$ 18 37	*$ 22.43*	*$ 26.04*	*$ 27.39*
United Rate Group 3	$ 9.18	*$ 12.13*	*$ 14.88*	*$ 16.04*	$ 20.15	*$ 23.51*	*$ 26.50*	*$ 27.62*
United Rate Group 4	$ 9.94	*$ 12.89*	*$ 15.64*	*$ 16.80*	$ 21.94	*$ 24.62*	*$ 27.00*	*$ 27.89*
United Rate Group 5	$ 10.72	*$ 13.67*	*$ 16.42*	*$ 17.58*	$ 23.79	*$ 25.83*	*$ 27.64*	*$ 28.32*
United Rate Group 6	$ 11.48	*$ 14.43*	*$ 17.18*	*$ 18.34*	$ 25 57	*$ 27.39*	*$ 29.01*	*$ 29.61*
Centel Rate Group 1	$ 8.58	*$ 11.53*	*$ 14.28*	*$ 15.44*	$ 18 04	*$ 22.13*	*$ 25.76*	*$ 27.12*
Centel Rate Group 2	$ 9.05	*$ 12.00*	*$ 14.75*	*$ 15.91*	$ 19.07	*$ 22.69*	*$ 25.91*	*$ 27.12*
Centel Rate Group 3	$ 9.45	*$ 12.40*	*$ 15.15*	*$ 16.31*	$ 19.99	*$ 23.32*	*$ 26.28*	*$ 27.39*
Centel Rate Group 4	$ 9.91	*$ 12.86*	*$ 15.61*	*$ 16.77*	$ 21.06	*$ 24.01*	*$ 26.63*	*$ 27.62*
Centel Rate Group 5	$ 10.37	*$ 13.32*	*$ 16.07*	*$ 17.23*	$ 22.08	*$ 24.69*	*$ 27.01*	*$ 27.89*
Centel Rate Group 6	$ 10.89	*$ 13.84*	*$ 16.59*	*$ 17.75*	$ 23.25	*$ 25.53*	*$ 27.56*	*$ 28.32*
Service Charges								
Primary - United	$ 20.45	*$ 22.50*	*$ 24.20*	*$ 25.00*	$ 25.60	*$ 29.80*	*$ 33.25*	*$ 35.00*
Primary - Centel	$ 20.45	*$ 22.50*	*$ 24.20*	*$ 25.00*	$ 30.65	*$ 32.60*	*$ 34.20*	*$ 35.00*
Secondary - United	$ 9.70	*$ 12.10*	*$ 14.05*	*$ 15.00*	$ 16.35	*$ 20.25*	*$ 23.45*	*$ 25.00*
Secondary - Centel	$ 12.25	*$ 13.50*	*$ 14.50*	*$ 15.00*	$ 14.30	*$ 19.10*	*$ 23.05*	*$ 25.00*
Access Line Charge - United	$ 30.70	*$ 30.80*	*$ 30.90*	*$ 31.00*	$ 35.75	*$ 37.65*	*$ 39.25*	*$ 40.00*
Access Line Charge - Centel	$ 30.70	*$ 30.80*	*$ 30.90*	*$ 31.00*	$ 35.75	*$ 37.65*	*$ 39.25*	*$ 40.00*
Premise Visit - United	$ 10.20	*$ 28.10*	*$ 42.75*	*$ 50.00*	$ 10.24	*$ 28.10*	*$ 42.80*	*$ 50.00*
Premise Visit - Centel	$ 21.50	*$ 34.30*	*$ 44.80*	*$ 50.00*	$ 30.65	*$ 39.35*	*$ 46.50*	*$ 50.00*
Record Change - United	$ 5.10	*$ 10.00*	*$ 13.35*	*$ 15.00*	$ 5 10	*$ 10.00*	*$ 13.35*	*$ 15.00*
Record Change - Centel	N/A	*N/A*	*N/A*	*N/A*	$ 5.10	*$ 10.00*	*$ 13.35*	*$ 15.00*
Number Change - United	$ 9.70	*$ 12.10*	*$ 14.05*	*$ 15.00*	$ 11.75	*$ 15.45*	*$ 18.50*	*$ 20.00*
Number Change - Centel	$ 9.70	*$ 12.10*	*$ 14.05*	*$ 15.00*	$ 11.75	*$ 15.45*	*$ 18.50*	*$ 20.00*
Restore Service - United	$ 15.35	*$ 21.35*	*$ 23.80*	*$ 25.00*	$ 20.45	*$ 27.00*	*$ 32.35*	*$ 35.00*
Restore Service - Centel	$ 15.35	*$ 21.35*	*$ 23.80*	*$ 25.00*	$ 15.35	*$ 24.20*	*$ 31.45*	*$ 35.00*

Items in Italic represent amended numbers.

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AMENDED DIRECT TESTIMONY OF DR. KENNETH GORDON

On behalf of Verizon Florida Inc., BellSouth Telecommunications, Inc., and Sprint-Florida Inc.

~~August 27~~September 30, 2003

AMENDED AMENDED DIRECT TESTIMONY OF DR. KENNETH GORDON~~DIRECT TESTIMONY OF DR. KENNETH GORDON~~

I. PURPOSE & SUMMARY OF CONCLUSIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Dr. Kenneth Gordon. My business address is One Main Street, Cambridge, Massachusetts 02142. My C.V. is provided as Attachment A.

Q. WHAT IS YOUR CURRENT POSITION?

A. I am a Special Consultant of National Economic Research Associates, Inc. ("NERA"). Previously, I was Senior Vice President at NERA.

Q. WILL YOU PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS?

A. I am an economist and former Chairman of the Maine Public Utilities Commission ("Maine Commission") and the Massachusetts Department of Public Utilities ("Mass. DPU"). The Mass. DPU is now known as the Massachusetts Department of Telecommunications and Energy. I have been an economist since 1965, and I have been directly involved with developing and establishing regulatory policy at the federal and state levels since 1980, when I became an industry economist at the Federal Communications Commission ("FCC").

I received my A.B. degree from Dartmouth College in 1960. I received my M.A. degree in 1963 and my Ph.D. degree in 1973, both in economics, from the University of Chicago. I have taught applied microeconomics, industrial organization, and regulation (as well as

other subjects) at Georgetown University, Northwestern University, University of Massachusetts at Amherst, and Smith College.

From 1980 to 1988, I was an industry economist at the FCC's Office of Plans and Policy, where I worked on a full range of regulatory issues, including telecommunications, cable, broadcast, and intellectual property rights. At the FCC, one of the major focuses of my work was activity aimed at introducing competition into communications markets.

Prior to joining NERA in November 1995, I chaired the Maine Commission (1988 to December 1992) and the Mass. DPU (January 1993 to October 1995). During my term as Chairman of the Mass. DPU, the DPU investigated and approved a price cap incentive regulation plan for NYNEX and also undertook a proceeding to examine interconnection and other issues related to the development of competition at all levels of telecommunications, including basic local service.

While a regulator, I was active in the National Association of Regulatory Utility Commissioners ("NARUC"), serving on its Communications and Executive Committees. In 1992, I served as President of NARUC. I was also Chairman of the BellCore Advisory Committee and the New England Governor's Conference Power Planning Committee.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. Verizon Florida Inc., BellSouth Telecommunications, Inc., and Sprint-Florida Inc., ("the companies") are seeking to restructure their rates for intrastate network access services

("intrastate access") and basic local telecommunications services ("basic local") in accordance with recently passed legislation by the Florida Legislature.[1] The companies' revised plans—which must address the criteria established in the legislation—call for them to restructure their intrastate access and basic local rates in a revenue-neutral manner.

The companies have asked me to provide an economic and policy analysis of their revised rate plans and to testify on whether I believe those revised plans meet the criteria laid out in the legislation.

Q. WHAT ARE YOUR MAJOR CONCLUSIONS?

A. After reviewing the newly-enacted legislation, the evidence in this case—specifically the companies' revised plans and the cost evidence submitted by the companies' witnesses—and based on my general knowledge and expertise on telecommunications economic and regulatory matters, I conclude that the revised plans submitted by the companies meet the criteria contained in the legislation. Specifically, upon implementation, the revised plans will, *inter alia*:

- Reduce current support for basic local telecommunications services that prevents the creation of a more attractive competitive local exchange market for the benefit of residential consumers; and
- Induce enhanced market entry.

The companies' revised plans significantly decrease support for basic local service by reducing prices for a service that has historically and purposely been an important

[1] *See* Section II below.

source—but by no means the only source—of support for basic local services, namely intrastate access. In order to achieve revenue neutrality, the companies' revised plans increase residential basic local prices towards cost-based levels, thus creating a more attractive market for potential entrants, ultimately for the benefit of residential consumers. Both theory and empirical evidence show that low residential basic local prices have hindered the development of residential competition. By better aligning residential basic local prices with cost, competitors will have increased incentives to target a broader mix of residential consumers, which is the intent of the Florida legislature.

In addition, I conclude that the revised plans will enhance economic welfare in Florida by increasing economic activity. As described in the respective testimonies of the companies' cost witnesses, the cost evidence submitted in this proceeding demonstrates that rates for residential basic local service diverge significantly from their underlying costs. A movement toward costs—and, therefore toward more rational economic pricing—will bring with it several economic benefits. These benefits include providing market participants—i.e., customers, the companies and potential and actual competitors—with more cost-based price signals, which will improve economic decision making and lead to more economically rational utilization of telecommunications services. Economic activity in Florida will increase as a result of the companies' revised plans because rebalancing generates substantial consumer benefits. Telephone consumers are better off as a result of moving prices more in line with costs, and will likely increase their purchases of those services whose price has come down. Perhaps of even greater significance, competitive telephone service providers will be seeing better price signals for local service, and will be able to invest without having to face the level of subsidized competition they have faced in the past. New investment by these providers should, at the

margin, increase.

The cost evidence presented by the companies demonstrates that basic local prices are receiving an economic subsidy from other services. The companies submitted forward-looking direct cost evidence to demonstrate that their residential basic local services are priced below the costs the companies incur to provide the services. Forward-looking direct cost is the basis for determining whether a service is receiving an economic subsidy. Moreover, consistent with this Commission's ruling, the companies' cost witnesses, when measuring the economic subsidy flowing to basic local services, correctly assign the entire cost of the loop to basic local.

I also conclude that the companies' revised plans will not jeopardize universal service in the state of Florida. The companies' residential basic local prices are substantially below the national average and Florida is not a poor state. The Florida Public Service Commission ("Commission") has the flexibility to approve the companies' revised plans and still have residential basic local prices remain affordable. The Florida Legislation requires that any price increase in basic local service not apply to Lifeline consumers and also increased the income eligibility for Lifeline consumers to 125 percent, thus protecting those customers most likely to be sensitive to potential price increases from a rebalancing plan. Importantly, the companies' revised rebalancing plans will lead to lower intrastate toll prices for all consumers. At the end of the day, the mix of services that consumers purchase as a result of the companies' revised plans will make consumers better off overall.

Finally, the fact that some customers may experience unwanted rate changes should not be

an argument for the status quo. Good policy requires weighing and balancing the costs and benefits of particular actions. While it may seem that maintaining current prices is the least objectionable thing to do from a policy perspective, there is an implicit but very real cost to continuing the status quo. The deployment of next generation, advanced networks depends crucially on providing all market participants the sound economic signals that will encourage efficient investment and innovation. Cost-based prices provide the incentives needed to bring to market the new services that customers demand. This cannot be accomplished by distorted prices.

Q. YOU HAVE NOTED IN YOUR MAJOR CONCLUSIONS THAT VERIZON FLORIDA INC., BELLSOUTH TELECOMMUNICATIONS, INC., AND SPRINT-FLORIDA INC. HAVE REVISED THEIR RESPECTIVE RATE REBALANCING PLANS FILED ON AUGUST 27, 2003 TO EXTEND THE TIME OVER WHICH INTRASTATE NETWORK ACCESS AND BASIC LOCAL TELECOMMUNICATIONS RATES WILL BE REFORMED. HAVE YOU REVIEWED THESE COMPANIES' REVISED PLANS?

A. Yes, I have.

Q. DO THESE REVISIONS AFFECT YOUR ANALYSIS OF THE COMPANIES' PLANS OR YOUR TESTIMONY?

A. No. With the exception of the minor changes — changing "plans" to "revised plans" — as well as this and the previous question and answer, my testimony remains unchanged from the testimony that I filed on August 27, 2003.

II. BACKGROUND

Q. PLEASE DESCRIBE THE BASIS FOR THE COMPANIES' REQUEST TO INCREASE BASIC EXCHANGE PRICES.

A. From an economic perspective, the fact that the companies' current residential basic local prices are not fully recovering their forward-looking economic cost is, by itself, a good enough reason to begin the process of moving them to more economically rational levels. Both theoretical and empirical research have shown that rebalancing rates and moving them toward levels more commensurate with their underlying costs results in significant benefits to telecommunications consumers and, by so doing, benefits the economy as well.[2] Rebalancing rates has also been demonstrated to have a positive effect on competitive entry into the local exchange market.[3]

The immediate catalyst for the companies' revised plans is the recent changes in Florida laws. I have been informed by counsel that the legal authority for the companies' request arises from recent changes in the statutory framework in Florida. During the 2003 regular legislative session, the Legislature passed Senate Bill 654, the Tele-Competition Innovation and Infrastructure Enhancement Act ("Tele-Competition Act"). The Tele-Competition Act implements several important policies, but for our purposes the relevant Section of the Tele-Competition Act is § 364.164 "Competitive market enhancement."

Q. WHAT ARE THE IMPORTANT PROVISIONS OF § 364.164?

A. § 364.164 permits local exchange telecommunications companies to petition the

[2] See Section IV below.

[3] See Section III.

Commission to reduce their intrastate access rates in a revenue-neutral manner. In reaching its decision, § 364.164 (1) states that the Commission shall consider whether granting the petitions will:

a. Remove current support for basic local telecommunications services that prevents the creation of a more attractive competitive local exchange market for the benefit of residential consumers;

b. Induce enhanced market entry;

c. Require intrastate switched network access rate reductions to parity over a period of not less than 2 years or more than 4 years; and

d. Be revenue neutral as defined in subsection (7) within the revenue category defined in subsection (2).

Throughout my testimony, I will focus on whether the companies' revised plans are consistent with and meet the criteria provided in § 364.164 (1) (a) and (b). Other company witnesses discuss how the companies' revised plans would meet criteria (c) and (d).

Q. IN ORDER TO REDUCE INTRASTATE ACCESS RATES IN A REVENUE NEUTRAL MANNER, RATES FOR OTHER SERVICES NEED TO BE INCREASED. WHAT SERVICES DO YOU BELIEVE SHOULD BE INCREASED?

A. The first category of services that should be considered are those services whose current prices do not recover fully their underlying costs, such as residential basic local telecommunications services. Rates for these subsidized services should be increased in order to better reflect their real economic cost. This is confirmed in §364.164 (2), where the legislation calls for the creation of a revenue category mechanism consisting of basic

local telecommunications service revenues and intrastate switched network access revenues in order to achieve revenue neutrality. That is, the legislation states that in order to achieve revenue neutrality, if intrastate access prices are reduced, then basic local service prices need to be increased.

The current rate design for telephone services—where basic local services are priced below cost and other services, including intrastate access service, are priced in such a way so as to provide the support—while in the process of being reduced or eliminated in a number of states, continues to be encountered in state regulation of telephone services. However, as the Florida Legislature wisely recognized, whatever benefits such a rate design policy has arguably achieved in the past, such as helping the United States achieve universal telephone service—the continuation of such policies frustrates another important policy goal of Federal and state regulators, namely, the establishment of efficient competition to as broad a base of business and residential consumers as is economically feasible—not to mention the economic costs that arise from price-cost distortions, *per se*, as I discuss further below.

The current rate design policy as it pertains to residential basic local services, frustrates that policy goal and by enacting § 364.164, the Florida Legislature has provided the Commission with the direction it needs to make competition work better for all Florida consumers.

Q. ARE THE COMPANIES' REVISED PLANS CONSISTENT WITH § 364.164 (1) (a) and (b)?

A. Yes. The companies' revised plans are consistent with and meet the criterion of § 364.164(1)(a) and (b). Below in Section III, I fully describe why I believe that the

companies' revised plans are consistent with and meet those criteria.

Q. DR. GORDON, FROM A POLICY PERSPECTIVE DO YOU BELIEVE THAT IT IS APPROPRIATE TO ENGAGE IN THE TYPE OF REBALANCING THAT IS BEING CONTEMPLATED BY THE COMPANIES' PLANS?

A. Yes, I do. In this testimony, I describe fully why I believe that the companies' revised plans are consistent with the criteria of the Tele-Competition Act that the Commission shall consider and why the revised plans would likely result in increasing competitive activity in the state of Florida. Specifically, the revised plans will create a more attractive local exchange market for residential consumers and lead to enhanced market entry—two criteria that need to be considered by the Commission in addressing the companies' revised plans. By making the residential local exchange market more attractive, residential consumers will likely see more companies competing for their business, which will, in turn, result in more options for residential consumers, improved services and lower prices for their telecommunications services. From a policy perspective, it is appropriate to accomplish these tasks.

In addition, I describe below the history of rate design for basic local services in the United States and how the end result of these policies has been uneconomically low residential basic local prices; lower than what one would expect to find in undistorted competitive markets. Of course, states have differed in their implementation of these policies and, as a result, residential basic local service prices vary quite a bit from state to state. In Florida, residential basic local prices are quite low when compared to prices in other states. In Table I below, I list the flat-rate charges for each of the three companies' lowest and highest rate groups compared to the national average flat-rate charges. As can

be seen in the table, each of the companies' highest rate group is well below the national average of $14.55 per month.

Table I – Comparison of Verizon, BellSouth and Sprint's flat-rate residential basic local charges and National Average flat-rate charges

Company	Lowest Rate Group	Highest Rate Group	Unweighted Average	National Average (2002)
Verizon	$9.72	$12.06	$10.89	
BellSouth	$7. 57	$11.04	$9.31	
Sprint	$7.63	$11.48	$9.56	
National Average (2002)				$14.55

Source: Florida Senate Staff Analysis And Economic Impact Statement, p. 4. April 8, 2003; FCC *Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service*, Table 1.1 July 2003, rates exclude Federal and State subscriber line charges, touch tone charge and taxes, 911 and other charges.

Q. HOW DOES THE FACT THAT FLORIDA HAS LOW RESIDENTIAL BASIC LOCAL TELECOMMUNICATIONS PRICES RELATE TO THIS PROCEEDING?

A. It relates to this proceeding in two important ways. First, the Legislature has correctly perceived that low residential basic local prices have led the residential local exchange market to be less attractive to competitors than would be the case with more economically rational residential basic local prices. In Section III below, I describe fully why, from an economic perspective, I believe the Legislature is absolutely correct on this point. Put

simply, holding all other factors constant, the lower the residential basic local price (when set governmentally without regard to whether the prices cover cost), the more unattractive those customers are to actual and potential competitors. Since Florida residential basic local prices are lower than those in many other states, and in fact lower than the national average, the problem facing potential new entrants as a result of these low rates is likely to be even more severe and pronounced in Florida than in other states. For this reason, it is even more important that Florida policymakers tackle this problem sooner rather than later.

Q. IS THERE ANY SUPPORT FOR YOUR ASSERTION THAT THE PROBLEM OF AN UNATTRACTIVE RESIDENTIAL MARKET MAY BE WORSE IN FLORIDA THAN IN OTHER STATES?

A. Yes, there is some support for my assertion. The FCC compiles data on local telephone competition. Its most recent report, released June 12, 2003 included a table that lists, for each state available, the percentage of lines provided to residential and small business customers by ILECs and CLECs.[4] The FCC provided data on 40 states and of those 40 states Florida ranked 30th in the percent of CLEC lines that were sold to residential and small business customers. This means that in 29 out of 40 states, CLECs' served proportionately greater residential customers than in Florida (see Figure 1 at the end of this testimony). Florida ranks below states such as Georgia (58%), Alabama (52%), Louisiana (61%) and Virginia (70%) to name a few, all of which have higher residential prices. This provides some evidence that low residential basic local prices are having a

[4] *See, Local Telephone Competition: Status as of December 31, 2002*, Table 11, Industry Analysis and Technology Division Wireline Competition Bureau, Federal Communications Commission.

negative impact on residential competition in Florida.

Q. YOU MENTIONED THAT THERE WAS A SECOND REASON WHY YOU BELIEVE THAT FLORIDA'S LOW RESIDENTIAL BASIC LOCAL PRICES, IN COMPARISON WITH OTHER STATES, ARE RELEVANT IN THIS PROCEEDING. WHAT IS THAT SECOND REASON?

A. The second reason has to do with affordability considerations and the flexibility this Commission has in rebalancing rates while still maintaining basic residential local rates that are quite affordable for most Floridia consumers. As mentioned above, the companies' prices for residential basic local services are generally well below the national average. However, Florida is not a poor state. According to data from the U.S. Bureau of Economic Analysis, Florida is on par with the national average in personal income per capita.[5] Specifically, as of 2001, the data show that personal income per capita in Florida was $29,047 compared to the national average of $30,413. Thus, the Commission has the flexibility to increase residential basic local prices, which are currently well below the national average, to more economically reasonable levels without making the services unaffordable to Florida consumers.

At the same time, Florida consumers will pay less for intrastate toll calls. The companies' rebalancing plan will lower the access charge component of the cost of producing intrastate toll calls. IXCs are required to pass these cost savings through to consumers in the form of lower prices. Thus, even with the increase in basic residential local rates, telecommunications will be just as affordable to Florida consumers as before, yet

[5] Bureau of Economic Analysis, Regional Economic Information System, Table SA1-3.

consumers will be better off because they will be consuming a different mix of telecommunications services that provides more value than they are currently receiving.

In addition, the Tele-Competition Act also requires that any increase in basic local service rates not apply to Lifeline customers and that the ILECs increase Lifeline participation to 125 percent of federal poverty income level.[6] These requirements further protect low-income consumers—and it is low-income consumers who would be most prone to disconnections in the face of price increases—thus providing the Commission with even more flexibility to approve the companies' rate rebalancing request with minimal concern that such a rate restructuring would negatively affect subscribership. I discuss this point, and other reasons why I believe the companies' revised plans will not negatively affect subscribership in Florida, in more detail in Section VI below.

Q. VERIZON, BELLSOUTH AND SPRINT ARE FILING THEIR REVISED PLANS AT THE SAME TIME. IS THERE ANY PUBLIC POLICY BENEFIT TO HAVING THE COMMISSION REVIEW THE COMPANIES' REVISED PLANS AT THE SAME TIME?

A. Yes. The benefits are at least threefold. First, to the extent that basic local rates are simultaneously adjusted closer to their costs throughout the territory of the three companies serving 98 percent of the ILEC customers, the better competition will be benefited and market entry enhanced. Certain providers who might be positioned to provide facilities–based basic local service (e.g. cable telephony, electric and wireless providers) will not necessarily configure their coverage areas based on the ILECs service

[6] § 364.10(3)(a).

territories. For them the potential staggered implementation of the rebalancing could be an obstacle to competitive entry. There are several areas within Florida where at least two of the three major ILECs provide service where it may be economical for a new entrant to provide service regardless of the ILEC boundary. For example, the Orlando/Central Florida (BellSouth/Sprint) area, Southwest Florida (between Sarasota and Ft. Myers (Verizon/Sprint)) area and the Pensacola – Ft. Walton – Destin -- Panama City (BellSouth/Sprint/BellSouth) area are three relatively compact geographic areas served in part by at least two of the three companies. Each of these areas might appropriately comprise the service territory of a single facilities–based entrant. When the price increases contained in the company plans are implemented and signal to these entrants that pricing distortions are being reduced on a broad basis, the competitors may be able to more efficiently execute their business plans.

Second, it is also important to avoid unnecessary marketplace distortions that could affect the purchase decisions of end-users. End-users normally make their purchase decisions based in large part on relative price differences among providers. If the rate-rebalancing is not implemented across all companies simultaneously, end-users will make these decisions based on incomplete and imperfect information as they see some providers' rates increasing while other providers' rates remain the same (at least temporarily). The risk will be that regulatory scheduling rather than the relative costs and benefits of various service offerings becomes the driving force behind consumers' decisions. For example, it is easy to imagine a situation involving two or more of the ILECs —where a CLEC might be able to offer service at a legitimate cost savings to all customers, but if re-balancing is not done simultaneously perhaps only one firm's customers would respond to the competitive offer, because the other firm's rate increase had yet to be implemented.

Coordinated rate rebalancing across all companies will ensure that potential competitors are not artificially disadvantaged when introducing new service offers by artificial boundaries, and that customers are not disadvantaged by incorrect and incomplete information driving their purchase decisions.

Third, the magnitude and timing of the access charge price reductions for the three companies would also benefit end users statewide. IXCs will be able to implement more meaningful price reductions if they can aggregate their access cost reductions into a single round of pricing changes.

Q. THE LEGISLATION PERMITS A COMPANY TO RESTRUCTURE ITS RATES OVER A MINIMUM OF TWO YEARS AND A MAXIMUM OF FOUR. EACH OF THE COMPANIES PLANS TO HAVE INTRASTATE ACCESS RATES REACH PARITY WITH INTERSTATE RATES OVER A TWO-YEAR PERIOD. DO YOU BELIEVE THIS IS A GOOD IDEA?

A. Yes I do, for several reasons. First, it is clearly permitted by the Tele-Competition Act. Second, it is a matter of economic principle that economic welfare is at its highest when prices are based on their underlying forward-looking costs and are not distorted. As I discuss in greater detail in Section III, prices that are distorted provide inferior signals for market participants and result in losses in consumer welfare because investment and purchase decisions by firms and consumers do not reflect the true costs that society incurs to provide the services. The companies' revised plans reduce these pricing distortions in the Florida telecommunications markets sooner rather than later and, by so doing, achieve economic efficiency gains sooner as well.

Third, a possible reason why one would prefer a more gradual rate restructuring time frame has to do with avoiding consumer "rate shock". As the words imply, rate shock implies that the increase in price proposed by the company is so high, that consumers would be obviously and adversely affected. However, based upon my personal experience as a former commissioner, as well as what I have observed in other states, I do not believe that the yearly increase in basic local prices will result in rate shock.

Q. PLEASE EXPLAIN WHY YOU BELIEVE THAT THE COMPANIES' PLANS WILL NOT RESULT IN RATE SHOCK.

A. The companies' revised plans will result in relatively minor increases in a customer's basic local price. In addition, as I stated earlier, these price increases will not even apply to current Lifeline consumers and new Lifeline consumers who have become eligible as a result of the Tele-Competition Act raising the income threshold to 125% of the poverty level.

In addition, with the reduction and elimination of the in-state connection fees, many customers might not even experience a significant change in their total bill. If there is an increase in the customers' bill, it will likely result in large part from increased stimulation from lower long distance charges that represent real gains to consumers because they are now able to make more calls at the new lower prices.

Finally, the companies' revised plans compare favorably with other states that have approved rate-rebalancing plans that approved much larger increases than the companies' request Importantly, these states' price adjustments did not jeopardize universal service. In Section VI, I also discuss the experience of some of the states that have already

implemented serious rate rebalancing plans, including Massachusetts where I presided as Chairman through one such adjustment.

III. THE COMPANIES' REVISED PLANS WILL RESULT IN A "MORE ATTRACTIVE COMPETITIVE LOCAL EXCHANGE MARKET FOR THE BENEFIT OF RESIDENTIAL CONSUMERS" AND WILL INDUCE "ENHANCED MARKET ENTRY"

Q. HOW DO YOU JUDGE WHETHER THE COMPANIES' REVISED PLANS MEET THE CRITERIA OF § 364.164 (1) (a) AND (b)?

A. § 364.164 (1) (a) states that the companies' plans should remove the current support for basic local telecommunications services that is impeding the creation of a more attractive competitive local exchange market for the benefit of residential consumers. In order for the companies' revised plans to meet the first criterion, they must show that the revised plans remove—or at a minimum reduce—support for basic local telecommunications. By so doing, they create a more "attractive" competitive local exchange market, because the price to be competed against by new entrants is raised to more closely reflect the real economic costs of doing business. The second criterion for the Commission's consideration is § 364.164 (1) (b) which simply states that the plans should induce enhanced market entry and no distinction is made between residential or business consumers.[7]

[7] There are other criteria in § 364.164 (1) that I do not discuss but that are the subject of the companies' respective witnesses.

Therefore, in evaluating whether the companies' revised plans meet the criteria in these sections, I must ascertain whether the revised plans: (1) remove current support for basic local telecommunications services, and (2) will likely result in a more attractive competitive environment that would benefit residential consumers and induce enhanced market entry.

Q. DO THE COMPANIES' REVISED PLANS REMOVE CURRENT SUPPORT FOR BASIC LOCAL TELECOMMUNICATIONS SERVICES?

A. Yes, the companies' revised plans significantly decrease current support for basic local telecommunications services. The revised plans do this by reducing the prices of a service that has historically been set by regulators to provide an important source—but by no means the only source—of support for basic local services, namely, intrastate switched network access.

Q. WHY DO YOU BELIEVE THAT INTRASTATE SWITCHED NETWORK ACCESS CURRENTLY SUPPORTS BASIC LOCAL TELECOMMUNICATIONS SERVICES?

A. There are two reasons. The first is the historical rate design policy prevalent in telecommunications regulation in Florida and throughout the United States. As I mentioned earlier, historically, telecommunications rate design was premised on the policy goal—at times stated and sometimes left implicit—of keeping the price of basic local telecommunications low or as low as possible. This policy began early on in telecommunications regulation and was accomplished through the rate design mechanisms that were part and parcel of traditional regulation. Traditional regulation required two broad steps. The first was to determine a revenue requirement that was sufficient to meet

the prudently incurred operating expenses and a reasonable return on prudently invested capital. The second broad step was the rate design process, which determined the price of each regulated service to ensure that the regulated company had the opportunity to recover its revenue requirement from its regulated service.[8] Normally, a proper rate design process would require that the price of any service recover at least its underlying cost and, in addition, contribute to the firm's shared and common cost in some manner. At times that manner was consistent with economic efficiency goals—as when demand considerations were taken into account—and at other times it was more reflective of other policy considerations—as when an equal percentage markup was applied across the board to the different services.

For basic local services, however, in most instances the price was set on a residual basis without taking into consideration the underlying cost of providing basic local telecommunications. That is, the goal of residual pricing was to keep basic local prices low, or as low as possible, and to recover more revenue from other telecommunications services, constrained by what consumers were willing to pay for the non-basic telecommunications services and by—as competition began to become more prevalent in telecommunications markets—the threat of customers bypassing the public switched telecommunications network.

Prior to divestiture of AT&T in 1984, toll prices provided the bulk of support for basic local telecommunications services. As technological advances lowered the cost of

[8] I say opportunity to recover its revenue requirement because the regulatory process does not generally guarantee a regulated company a certain return, it only provides the regulated company the opportunity to earn a certain return.

providing toll services, toll prices did not decrease commensurately and were used as a means to support basic local telecommunications services—i.e., to keep the prices of basic local lower than would otherwise be the case. After divestiture of AT&T, interstate and intrastate switched network access services were substituted as a means of supporting basic local telecommunications services.

Notably, even after the substitution of price cap regulation for traditional regulation, the cross subsidies that were present under traditional regulation have been maintained.

The notion that intrastate switched network access services have been used as a source of support for basic local telecommunications is confirmed in the Florida *Senate Staff Analysis and Economic Impact Statement on the Tele-Competition Act*, where it states:

> According to the commission, intrastate network access service rates were set well above the incremental cost of providing the service in order to keep rates for basic local telecommunications service as low as possible and to encourage subscribership.[9]

The second reason why I believe that intrastate access services currently support basic local service is cost considerations. As described in the testimonies of their witnesses, the companies have established that the price of residential basic local telecommunications services is below forward-looking direct cost estimates. From an economic perspective, whenever the revenues from a service are insufficient to recover its forward-looking direct costs, that service is said to be in receipt of an economic subsidy. The source of the

[9] *See* Senate Staff Analysis and Economic Impact Statement on CS/SB 654, April 8, 2003.

subsidy—including that for residential basic local services—comes from all those services that are priced above their respective forward-looking direct costs. As a whole, these services contribute to the support of residential basic local. Because intrastate access services are priced significantly above their forward-looking direct costs, this means that intrastate switched network access services are supporting basic local service.

Q. DOES THIS IMPLY THAT THERE MAY BE OTHER SERVICES, BESIDE INTRASTATE ACCESS SERVICES, THAT MAY ALSO BE SUPPORTING BASIC LOCAL TELECOMMUNICATIONS SERVICES?

A. Yes, that is correct. In general, for multi-product firms, where there are significant amounts of shared and common costs, firms must, in the aggregate, price their services above forward-looking direct costs in order to earn sufficient revenues to remain viable. When one service is priced below its forward-looking direct costs, as is the case for residential basic local telecommunications services, other services that are priced above forward-looking direct costs are supporting the service that is priced below its own forward-looking direct costs.

The Florida Legislature, however, has specifically determined that it is the support provided by intrastate switched network access that is to be reduced. The Tele-Competition Act calls for rebalancing to take the form of lowering intrastate access rates to parity—over a 2 to 4 year period—with interstate switched network access rates and to simultaneously increase basic local telecommunications services by an amount sufficient to make up the revenue over the same time period. Under this approach, there is still no guarantee that residential basic local services recover at least their forward-looking direct costs once intrastate access rates are set to parity with interstate switched access rates. In

fact, according to the companies' evidence, residential rates will still be below forward-looking direct costs even when intrastate switched network access rates reach parity with the interstate rates.

Therefore, while the companies' revised plans are consistent with the criteria to be considered by the Commission, the plans do not result in the complete rebalancing of rates. Thus, there will still likely be some (lesser) distortions in prices even after the implementation of the plans.

Q. AS AN ECONOMIST, DO YOU BELIEVE THAT REBALANCING IS COMPLETED ONCE BASIC RESIDENTIAL PRICES ARE SET AT FORWARD-LOOKING DIRECT COSTS?

A. While having basic local services recover at least their underlying forward-looking direct costs is a good first step, it would not necessarily result in economically efficient prices. As I discuss in greater detail below in Section IV, economically efficient prices require that a multi-product firm's shared and common costs be recovered through markups on each service or product above forward-looking direct costs in a manner that least distorts economic efficiency. Therefore, to have economically efficient basic local prices would likely require that basic local services be priced above forward-looking direct costs. However, as markets become more competitive, markups will be limited by the need to be competitive with other firms in the market.

Q. HAVING ESTABLISHED THAT THE REVISED PLANS REMOVE CURRENT SUPPORT FOR BASIC LOCAL, § 364.164 (1) (a) PROVIDES THAT, AS A RESULT OF THE REMOVAL, THEY WILL RESULT IN A MORE

ATTRACTIVE COMPETITIVE LOCAL EXCHANGE MARKET FOR THE BENEFIT OF RESIDENTIAL CONSUMERS. WILL THE COMPANIES' REVISED PLANS MEET THIS CRITERION?

A. Yes, the companies' revised plans will create a more attractive competitive local exchange market for the benefit of residential consumers. Economic theory and empirical research both indicate that this will likely be the case. I discuss these two factors below.

Q. PLEASE DISCUSS WHY YOU BELIEVE THAT ECONOMIC THEORY SUGGESTS THAT THE COMPANIES' REVISED PLANS WILL LIKELY RESULT IN A MORE ATTRACTIVE COMPETITIVE LOCAL EXCHANGE MARKET FOR THE BENEFIT OF RESIDENTIAL CONSUMERS?

A. One of the key components of the companies' revised plans is that intrastate access revenues will be decreased in a revenue-neutral manner by increasing the price of (and revenue from) basic local telecommunications services for residential consumers. The cost information provided by the companies in this proceeding indicates that residential basic local telecommunications prices are currently below forward-looking direct costs. Increasing the price of a service, especially a service that is below forward-looking direct costs, will make for a more attractive market for actual and potential competitors. Competitors will not rationally try to compete against heavily subsidized prices.

Q. WOULD YOU PLEASE EXPLAIN WHY YOU BELIEVE THIS TO BE THE CASE?

A. In a market economy, prices are the essential tool that send signals to market participants that, in turn, determine market behavior and outcomes. For example, as prices increase or decrease, consumers alter their consumption decision because the value consumers place

on goods and services changes in relation to price. Producers alter their production, investment and research and development decisions as well, because as prices increase or decrease, profits change along with them. It is the search for profits that drives firms to enter or expand into new markets. As prices change, potential entrants into the market will be affected as well. Lower prices may act to keep new firms from entering the market and higher prices more reflective of cost will tend to attract new firms into the market.

Like any other firm, the investment decision of a telecommunications competitor is based on the present value of the cash flows that the investment project is likely to generate over the useful economic life of the project. Holding all other factors constant, when the price of a service increases, a cash flow analysis would show that the investment project becomes more profitable (or less of a loss) and thus more attractive. In the case before us, an increase in the price of basic local telecommunications service would increase the revenues from residential basic local services in a cash flow analysis, thus increasing the attractiveness of providing those residential services. As a result of rate rebalancing, where the companies plan to raise residential basic local prices, the residential local exchange market will look more attractive to all actual and potential telecommunications providers of residential services.

Q. WILL THE COMPANIES' REVISED PLANS ALSO PROVIDE INCREASED INCENTIVES FOR OTHER COMPETING TELEPHONY TECHNOLOGIES?

A. Yes. An important reason for opening local telecommunications markets to competition is the belief that technological change is proceeding so rapidly that competitive markets will do a much better job than monopoly of discovering which technologies can or cannot

succeed in the long run. For example, access to customers for their telecommunications needs comes in the form of fixed-wireline access, wireless access, cable telephony, Internet, and potentially satellite and even access via electric utilities. Of course, not all of these technologies will necessarily survive in the long run and competition will likely lead to a mix of technologies surviving and providing the lowest possible cost for each consumer's telecommunications needs.

However, in order for the lowest-cost mix of technologies to remain in the market, prices and the signals they send must not be distorted and must reflect the underlying cost of providing service. The companies' revised plans move positively in this direction and encourage new entrants—regardless of the chosen technology—to enter or expand in the marketplace because even competitors using lower-cost (or more attractive) technologies may not be able to compete against a subsidized ILEC price that does not fully reflect its own costs. This would be a loss for consumers and the Florida economy.

Q. IS THERE EVIDENCE THAT OTHER FORMS OF ACCESS ARE COMPETING WITH FIXED-WIRELINE ACCESS?

A. Yes. The Florida Commission has recognized the actual and potential substitution occurring between fixed-wireline and other forms of access, including wireless and emerging IP-telephony providers. As the Commission states:

> Regarding the substitution of technology and services, as they are being found to be close substitutes to traditional wireline services, both wireless and

emerging broadband IP-telephony providers must be included in the analysis.[10]

In the same report, the Florida Commission cites nation-wide data indicating that about 5% of U.S. wireless subscribers have disconnected wireline service and conclude that substituting wireless for wireline services appears to be a national trend.[11] Moreover, as the same report concludes, Florida may be especially susceptible to this phenomenon because of the large population in Florida that also has residences in other states. For many of these consumers, "it makes little sense to continue paying for telephone service that sits idle much of the year when wireless enables them to stay connected wherever they are."[12]

The Florida Commission has also concluded that cable providers are competing directly with fixed-wireline providers. The Commission cites to national data that shows that by second quarter of 2002, there were 2.5 million cable telephony subscribers and that cable companies expect to see one-third of their digital cable households take cable telephony service by 2005.[13]

There is evidence that the Tele-Competition Act is already having a positive impact on competitors' incentive to enter and expand in the Florida market. On July 18, 2003, Knology, a provider of broadband and voice telephony services, announced it has entered

[10] *See*, Florida Public Service Commission, *Telecommunications Market in Florida Annual Report on Competition As of June 30, 2002*, December 2002, p. 6.

[11] *Ibid*, at 7.

[12] *Ibid*, at 9.

[13] *Ibid*, at 10

into a definitive agreement to purchase certain assets from Verizon Media Ventures, Inc.[14] Knology offers local and long distance telephone service and its purchase of Verizon's Americast cable system will permit it to compete directly with Verizon. In its press release announcing its decision, Knology stated:

> In commenting on this transaction, Knology noted that the Tele-Competition Act recently enacted in Florida positively influenced its decision to expand operations in the state. This Act, as written by the Florida Legislature and supported by Governor Bush, laid the foundation for companies like Knology to enter the Florida market, and offer competitive services and products to consumers.

Q. IS THERE EMPIRICAL EVIDENCE THAT SUPPORTS YOUR VIEW THAT RATE REBALANCING WILL LIKELY MAKE THE RESIDENTIAL LOCAL EXCHANGE MARKET MORE ATTRACTIVE?

A. Yes, there is empirical evidence. Two of my colleagues at NERA investigated empirically whether low residential basic local rates were having any impact on competition in the states and, specifically, whether low rates were hindering the development of residential competition.[15] In that paper, the authors hypothesized that inefficient local exchange prices are having an impact on competition and that, specifically, low residential prices are inhibiting competition for residential customers. To test their hypotheses, the authors compared how local competition varied across the different states depending on how

[14] *See*, Knology Press Release July 18, 2003, *Knology Announces Agreement to Purchase Broadband Asset*.

[15] *See*, Agustin J. Ros and Karl McDermott, "Are Residential Local Exchange Prices Too Low? Drivers to Competition in the Local Exchange Market and the Impact of Inefficient Prices," in Michael Crew, *Expanding Competition in Regulated Industries*, Kluwer Academic Publishers, 2000.

"unbalanced" were local exchange prices. Specifically, the authors estimated several cross-section econometric models of facilities-based competition, controlling for things such as cost and demand considerations in the different states. The authors also included several policy variables, including one that measured the degree to which residential local exchange prices were "distorted" in each state. The authors summarized their results, as they pertained to residential competition, as follows:

> Using OLS and GLS estimates we found a significant and positive association between states that have more "balanced" tariffs and residential competition. For two measures of residential competition used in our data, we found that "rebalancing" tariffs by 10% leads to approximately a 9% and 13% increase, respectively, in residential competition.[16]

In addition, James Eisner (an FCC staff member) and Professor Dale E. Lehman performed a somewhat similar study.[17] Eisner and Lehman state in their conclusion:

> ...in some specifications, there appears to be less competitive entry (principally facilities-based) where residential rates are lower. These findings are generally statistically significant at the 90% level.[18]

Finally, another empirical study examined rate rebalancing in Latin America and found that rate rebalancing in some Latin American countries has led to increases in the supply

[16] *Ibid.*, at 167.

[17] *See*, James Eisner and Dale E. Lehman, *Regulatory Behavior and Competitive Entry*, presented at the 14th Annual Western Conference Center for Research in Regulated Industries, June 28, 2001. The authors' main motivation appears to have been ascertaining how regulatory behavior—as it pertains to unbundled loop prices and 271 entry—affects competitive entry. Nevertheless, they control for local exchange prices as well.

[18] *Ibid.*, p. 25.

of main telephone lines by providing better incentives to market participants.[19]

In summary, both economic theory and the empirical literature suggest that the companies' revised plans—by setting residential rates at more economically efficient levels—would likely make the residential local exchange marketplace more attractive to actual and potential competitors.

Q. BUT ISN'T IT THE CASE THAT CLECS ALREADY HAVE ENOUGH INCENTIVES TO SERVE LUCRATIVE RESIDENTIAL CUSTOMERS?

A. Yes, it is probably the case that CLECs have enough incentive to serve a subset of residential customers, namely those customers that are very profitable either because the cost of serving them is especially low or because their volumes are unusually high. But the promise of the Tele-Competition Act is to ensure that competition for residential customers is as broad and diffuse as is economically feasible, and by better aligning the prices of residential basic local services with their underlying costs, a broader base of residential customers will obtain the benefits of competition.

Q. § 364.164 (1) (b) PROVIDES THAT THE COMPANIES' PLANS CONSIDER THE EFFECT ON ENHANCED MARKET ENTRY. WILL THE COMPANIES' REVISED PLANS MEET THIS PROVISION?

A. Yes, the companies' revised plans will induce enhanced market entry. Above, I have discussed how the revised plans would likely create a more attractive competitive local

[19] *See*, Agustin J. Ros and Aniruddha Banerjee, "Telecommunications Privatization and Tariff Rebalancing: Evidence from Latin America," *Telecommunications Policy*. 24 (2000) 233-252.

exchange market for the benefit of residential consumers. This is an example of how the revised plans will induce enhanced market entry.

In general, the companies' revised plans will provide for improved entry signals into the local exchange market by diminishing distorted price signals that may encourage uneconomic entry into the overpriced markets. Prices that are free of distortions will lead to several economically-efficient outcomes known as allocative, technical and dynamic efficiencies. First, efficient pricing assumes that the marginal cost that society incurs to produce goods and services reflects the value that consumers place on the good or service consumed, (allocative efficiency). Second, optimal signals are provided to firms in the industry (e.g., whether to increase production or exit the industry) and to potential entrants contemplating entering the market. This ensures that it is the lowest cost firms that stay in the market and provide goods and services. In this way the use of society's scarce resources is minimized (technical efficiency). Third, prices that adequately cover costs ensure that appropriate incentives exist for improvement in technology, increased research and development and higher quality goods and services (dynamic efficiency).

Q. UNDER WHAT CONDITIONS CAN IT BE SAID THAT PRICES ARE FREE OF DISTORTION, AND ARE THE COMPANIES' CURRENT PRICES FOR BASIC LOCAL SERVICES FREE OF DISTORTIONS?

A. Prices are free of distortion when: (1) they recover at least the forward-looking incremental cost of production and (2) for multi-product firms, markups above incremental costs take into account demand characteristics in the market, subject, of course, to the need for the firm to meet competition. As described in the companies' cost testimonies, the companies' prices for basic local residential services are not recovering

the forward-looking direct cost of production. As such, prices for these services do not meet the economic criterion that prices should at a minimum recover the forward-looking direct cost of production.

By adopting the companies' revised plans, however, the Commission will be reducing significantly the distortions in the price of intrastate access and residential basic local services and achieving the economically efficient outcomes described above.

IV. OTHER ECONOMIC BENEFITS FROM THE COMPANIES' REVISED PLANS

Q. ARE THERE OTHER ECONOMIC BENEFITS THAT WILL LIKELY ARISE FROM THE COMPANIES' REVISED REBALANCING PROPOSAL?

A. Yes, there are other economic benefits that will likely arise from the companies' revised rebalancing proposals. Both economic theory and empirical research suggest that rate rebalancing will likely increase economic activity in Florida as increased competition brings benefits to Florida consumers of telecommunications services.

Q. WOULD YOU PLEASE DESCRIBE WHY ECONOMIC THEORY SUGGESTS THAT RATE REBALANCING WILL INCREASE ECONOMIC ACTIVITY IN FLORIDA?

A. Rate rebalancing consists of increasing the prices of services that are priced below forward-looking direct costs and reducing the prices of services that are priced significantly above forward-looking direct costs. As mentioned earlier in my testimony, the history of telecommunications rate design is such that residential basic local prices

were set low and usage services (such as toll and intrastate access services) were set high.

However, economic theory teaches that economic efficiency (and overall consumer welfare) is at its highest level when prices of goods and services in an economy are set at forward-looking direct cost. Of course, in industries where there are significant fixed costs—that give rise to economies of scale—and in multi-product firms where there are significant amounts of shared and common costs, pricing services at forward-looking direct cost does not permit the firm to earn sufficient revenues to recover all its costs. Under such conditions, markups above forward-looking direct costs are required. Specifically, as competition develops, those services that are more price elastic will likely receive a proportionately lower markup above cost than those services that are more price inelastic.

Q. PLEASE DESCRIBE HOW REBALANCING RESULTS IN INCREASED ECONOMIC ACTIVITY IN FLORIDA?

A. The companies' revised plans will lower intrastate access prices, which will in turn result in lower intrastate toll prices, as required by the Tele-Competition Act. As a result of the reduction in intrastate toll prices, Floridia consumers will use more toll services. This will create value for them that they are not now receiving. This, in turn, will reflect an increase in economic activity in Florida. In addition, and of more direct importance to this proceeding, more cost reflective prices for local service will send signals to competitors that will more efficiently guide their investment decisions, and in all likelihood, increase their investment beyond what it is in the face of today's artificially low prices. Thus, rebalancing will generate significant gains in economic activity in Florida. It is important to stress the point that demand for access to the network by consumers depends not only

on the price of network access but it also depends on the value that consumers obtain (consumers' surplus) from using the network. While higher network access prices may, in theory, decrease the quantity of access consumed, the concomitant decrease in long distance price will increase the quantity of access consumed. Empirical evidence suggests that, in net, we may well find that rebalancing leads to more consumers subscribing to the network.[20]

Q. IS THERE EMPIRICAL EVIDENCE THAT QUANTIFIES THE AMOUNT OF ECONOMIC BENEFIT THAT A REBALANCING PLAN CAN GENERATE?

A. Yes, there is empirical support. There have been several studies that have examined the welfare gains arising from rate rebalancing. One of the first studies found that, for the U.S. as a whole, the loss from overpricing long distance service to business and residential consumers in 1983 was around $10 billion, a finding that was confirmed in subsequent research.[21] More recent research confirms the significant gains in economic welfare that can be achieved from more economically rational prices. For example, a 2000 study by Robert Crandall and Leonard Waverman (a NERA colleague) found the total cost of the current rate design—i.e., lower basic local prices and higher long distance prices—to be anywhere between $2.5 to $7.0 billion per year, depending on the assumptions made.[22]

[20] *See*, Hausman, J, T. Tardiff, and A. Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *The American Economic Review*, Vol. 83, May 1993, pp. 178-184.

[21] *See*, John T. Wenders and Bruce L. Egan, "The Implications of Economic Efficiency for U.S. Telecommunications Policy." *Telecommunications Policy* 10 (1986): 33-40 and Lewis Perl, "Social Welfare and Distributional Consequences of Cost-Based Telephone Pricing." Paper presented at the Thirteenth Annual Telecommunications Policy Research Conference, Airlie, Va. April 23, 1985.

[22] *See*, Robert Crandall and Leonard Waverman, *Who Pays for Universal Service?: When Telephone Subsidies Become Transparent*, Brookings Institute, (2000), p. 119.

V. COST ISSUES

Q. WHAT IS THE CORRECT COST CONCEPT TO USE FOR DETERMINING WHETHER A SERVICE IS RECEIVING AN ECONOMIC SUBSIDY?

A. From an economic perspective, use of forward-looking direct costs (economic costs as opposed to embedded or historical costs) is the proper basis for determining whether a specific service is in receipt of an economic subsidy. The embedded cost or historical cost of an activity is a record of the costs a firm attributes to the pursuit of its activity in a given (past) accounting period. That cost reflects what the firm actually paid for capital equipment,[23] its actual costs of operating and maintaining that equipment, and other costs incurred in operating the enterprise. By contrast, the economic cost of an activity is the actual forward-looking cost of accomplishing that activity in an efficient manner. In contrast to embedded costs, forward-looking costs are those associated with present and future uses of the firm's (or society's) resources. Only these forward-looking costs are relevant for making present and future production and investment decisions, for placing resources in alternative uses, and for setting efficient prices for the services to be provided presently or in the future.

According to the evidence presented by the companies, their residential basic local rates are below forward-looking direct costs and I conclude, therefore, that those rates are in receipt of an economic subsidy.

[23] Embedded costs also include the annual depreciation expenses associated with the stock of equipment that (1) was purchased in the current and previous years and (2) is still in use.

Q. THE COMPANIES' REVISED PLANS ARE BASED UPON THE FACT THAT THE LOCAL LOOP IS NOT A SHARED OR COMMON COST AND THAT ITS COST IS CAUSED SIMPLY BY PROVIDING CUSTOMERS ACCESS TO THE TELEPHONE SYSTEM AND CANNOT APPROPRIATELY BE SPREAD AMONG THE REMAINING TELEPHONE SERVICES. DOES THE FLORIDA COMMISSION AGREE WITH THIS APPROACH REGARDING THE LOCAL LOOP?

A. Yes, it does. In a report to the Florida Legislature in 1999, the Commission explicitly rejected the notion that the cost of the loop should be recovered from non basic local telecommunications service.[24] In that report, the Commission stated:

> Is the cost of local loop facilities properly attributable to the provision of basic local telecommunications service? By definition, yes. Section 364.02(2), Florida Statutes, defines "basic local telecommunications service as"
>
> > Voice grade, flat-rate residential and flat-rate single-line business local exchange services which provide dial tone, local usage necessary to place unlimited calls within a local exchange area, dual tone multi-frequency dialing, and access to the following emergency services such as "911," all locally available interexchange companies, directory assistance, operator services, relay services, and an alphabetical directory listing.

[24] *See*, "Report of the Florida Public Service Commission on the Relationship Among the Costs and Charges Associated with Providing Basic Local Service, Intrastate Access, and Other Services Provided by Local Exchange Companies, in Compliance with Chapter 98-277, Section 2(1), Laws of Florida," Florida Public Service Commission Tallahassee, Florida February 15, 1999.

Given such an identification of the cost object to be studied, the principle of cost causation leads one to the unavoidable conclusion that the decision to have local service leads to the incurrence of loop costs.[25]

VI. UNIVERSAL SERVICE WOULD NOT BE PUT AT RISK AS A RESULT OF THE COMPANIES' REVISED PLANS

Q. SHOULD THE COMMISSION BE CONCERNED ABOUT UNIVERSAL SERVICE?

A. While it is true that, in theory, as the price of basic local service increases, some consumers may decide the new price is above the value he or she places on the service—and may, as a result, decide to do without telephone service—I do not believe that, in practice, this would occur, or occur to such an extent as to jeopardize universal service in Florida. There are several reasons why I believe this is the case.

First, although low-income subscribers may be more sensitive to price increases than are middle and higher income users, the Tele-Competition Act does two things to help low income consumers. It provides that, in the event of an increase in residential basic local service prices, low-income consumers who are Lifeline customers will be exempted from the price increase; and, it expands the number of Lifeline-eligible customers to 125 percent of the federal poverty level. These steps should go far to address any problems of affordability.

[25] *Ibid*, at 51.

Second, the price elasticity of demand for access to the network is quite low, meaning that the vast majority of consumers will continue to subscribe. Specifically, the price elasticity of demand measures the percentage impact on demand given a percentage change in price. Previous research has demonstrated that customers generally do not disconnect their phone service when prices for basic local service increase.[26]

Third, and very importantly, in addition to its own price, the demand for residential basic local service is determined by the amount of value consumers obtain from using the services produced by the network, i.e., local calling, intraLATA toll, interLATA toll, vertical services and newer services such as broadband Internet access. As prices for these services decrease over time due to competitive pressure and technological innovation, the value that consumers place on having access to the network increases and so, therefore, does their demand to stay on the network.[27] The companies' revised plans call for rate increases phased in over a two year period and to the extent that prices for complementary goods decrease so will consumers' desire to remain on the network increase. This helps reduce, or may even offset, the negative effect of the price increase.

Finally, as discussed above, less distorted prices should provide better incentives for competitors to compete for residential consumers. Competition brings with it improved quality, different selection of goods and services bundled together in a way that customers find attractive, and lower prices. These factors provide additional reasons why during the

[26] *See,* Lester D. Taylor, (1994), *op. cit.*

[27] Hausman, J., T. Tardiff, and A. Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *The American Economic Review*, Vol. 83, May 1993, pp. 178-184.

phase-in period, customers will likely place increased value on subscribing to the network, thus mitigating the effects of any local rate increase.

To the extent the Florida Commission is concerned with the few remaining users who may decide to drop off the network it is also important to be aware that alternatives to the fixed network are growing and at least some customers may be turning to alternative means of meeting their communications needs. For example, the extraordinary growth of wireless service, driven by lower wireless prices and pricing plans that include a "bucket" of minutes provides customers with more meaningful opportunities to use wireless service as a substitute to wireline service.

Q. SHOULD THE COMMISSION BE CONCERNED IF CUSTOMERS DROP OFF THE FIXED NETWORK BUT INSTEAD RELY PRIMARILY ON OTHER FORMS OF ACCESS?

A. No. An important goal for policymakers has been to ensure that as many consumers as possible have access to the public switched telecommunications network, irrespective of how that access is obtained. When a customer drops off the fixed-line network and accesses the public network via wireless access, this is simply a substitution effect caused by the customer choosing between fixed and wireless access. This is not a universal service concern for policymakers.

Q. DR. GORDON, HAVE OTHER STATES IMPLEMENTED RATE REBALANCING?

A. Yes, there are other states that have implemented rate rebalancing including California, Illinois, Ohio, and in Massachusetts where I served as Chairman. Even in Maine, where

by statute basic residential services are to be set as low as possible and where I also served as Chairman, they have recently approved a rebalancing plan.

Q. WOULD YOU PLEASE DESCRIBE THE RATE REBALANCING PROCESS IN MASSACHUSETTS?

A. The process for changing prices in Massachusetts began before I became Chairman of the Massachusetts Commission and continued during my tenure. In Massachusetts, residential fixed monthly charges were increased significantly, with offsetting decreases in business, toll, and carrier access prices. The Massachusetts Commission early on after divestiture recognized the problems that historic pricing policies were creating, as other (especially institutional) barriers to market entry were being eliminated, and thus ordered a change in price structure:

> "properly defined incremental costs should be used as the primary basis for pricing all services, including local exchange service ...to the extent that current rates do not reflect an appropriate allocation of costs, the [MDPU] will, consistent with the need to avoid major discontinuities in rate levels, move toward that goal." IntraLATA Competition, D.P.U. 1731 (1985), p. 36-38.

> "Traditionally, the pricing of telephone service was based on a method whereby residential monthly exchange rates were priced below cost in order to promote universal service; and long-distance, toll, and business rates were priced above cost in order to subsidize residential exchange rates. While this system succeeded in serving a social purpose, it was a pricing scheme not conducive to the development of a fully-competitive market, in which the benefits associated with competition would be realized by all customers."

NET, D.P.U. 93-125 (1994), pp. 10-11.

In Massachusetts, moving prices more in line with incremental costs required a significant shift in revenue recovery from usage-based prices, such as intraLATA toll and intrastate carrier access, to fixed monthly prices for all classes of customers. In addition, because the MDPU found that there were no significant cost differences in serving different classes of customers, the price-rebalancing process also entailed a further shift in revenue recovery from business customers to residential customers. Of course, the necessary changes were not made overnight. The MDPU established a series of annual, revenue-neutral, price-rebalancing investigations in order to achieve its goal over time.

When the Massachusetts price-rebalancing process ended in January of 1994 (with the adoption of a price cap plan), the price for basic residential dial-tone service (1MR) had risen from about $3.00 per month in 1990 to $9.91 per month in 1994 (net of the SLC).[28] Comparable increases also occurred for residential flat-rate service (1FR), which was the most popular service in Massachusetts, at that time. Flat rate residential prices had ranged from $9.95 in rural areas to $12.38 in urban areas. The rebalancing process moved flat rate residential prices to $16.85 state wide. During this period, the average increase for residential consumers was $2.18 per year over four years and, according to the DTE, record evidence shows virtually no impact on residential telephone subscriber penetration.[29] Because the price-rebalancings were revenue-neutral, these increases were

[28] I was Chairman of the MDPU for the last of these annual investigations.

[29] *See*, "Re Verizon New England, Inc. dba Verizon Massachusetts D.T.E. 01-31-Phase II," *Public Utilities Reports – 223 PUR4th*, p. 397.

completely offset by decreases in prices for other services, notably residential and business intraLATA toll and carrier switched access.

Massachusetts was one of the first states to open toll and local markets to competitive entry, and the price rebalancing helped to lessen opportunities for uneconomic bypass and thus promoted the development of an efficient competitive process.

More recently, Massachusetts has continued to better align prices with their underlying costs by reducing switched access and increasing residential dial-tone rates. Specifically, the DTE authorized the ILEC to implement a one-time increase of $2.44 to its residential dial-tone line charge. In commenting on its decision, the DTE stated:

> Moreover, the department finds that with the $2.44 increase in the dial-tone line charge, competitive local exchange carriers (CLECs) can profitably enter and serve the residential telephone market in Massachusetts.[30]

The DTE concluded that a $2.44 increase will not harm the Department's universal service goals, based on similarity to the several, annual $2.18 increase in the early 1990s rebalancing plans and comparable increases in several other states and in the Federal subscriber line charge since 2000. For example, the Maine PUC approved a $1.78 increase in Verizon's basic monthly per line rate in May 2001 and the New York Public Service Commission authorized a two-year Incentive Plan which permitted an increase of $1.85 on March 1, 2002 and another $0.65 on March 1, 2003 for a total increase of $2.50 in the space of a year. The FCC's Federal subscriber line charge has increase from $4.35

[30] *Ibid*, p. 361.

in July 2000 to $6.50 in July 2003.

Q. PLEASE DISCUSS MAINE'S EXPERIENCE WITH RATE REBALANCING?

A. Significant rate rebalancing has been achieved in Maine in recent years, with no noticeable impact on telephone subscribership levels. In 1997, the Maine legislature (M.R.S.A. 35-A, §7101-B) directed the Maine Public Utility Commission to establish, notwithstanding any other provision of state law, intrastate access rates that are less than or equal to interstate access rates established by the FCC (*i.e.*, parity with interstate access rates) by May 30, 1999. At the time, Bell Atlantic's intrastate access rates were $0.26 per minute, significantly higher than its then-current Federal interstate access rate of about $0.07 per minute.

Subsequently, on March 17, 1998, the Commission approved an Order (Docket No. 94-123 reopened) that approved a stipulation between Bell Atlantic-Maine (now known as Verizon-Maine) and a group of intervenors, including the Commission's Advocacy Staff and the Public Advocate. This stipulation allowed Bell Atlantic-Maine to increase its basic local exchange rates by a total of $3.50 by May 30, 1999, with steps of $1.50 in 1998 and $2.00 in 1999. This was followed by another increase of $1.78 in 2000.

Maine continues to have the highest telephone penetration rate in the country—about 98 percent of Maine's households have telephone service.[31] In addition, lower intrastate toll rates have benefited some customer classes, especially those customers in rural areas with relatively small toll-free calling areas.

[31] MPUC Annual Report 2002, pp. 43.

Q. WHAT OTHER STATE EXPERIENCES DO YOU BELIEVE ARE RELEVANT?

A. In California in 1994, the Commission approved a rebalancing plan for GTE and Pacific Bell. GTE's residential rates immediately went from $9.75 to $17.25 while Pacific's residential rates went from $8.35 to $11.25.[32] Recently, as part of a rebalancing plan for Sprint's local telephone company in Ohio where intrastate access fees were lowered to mirror Federal charges, the Commission approved the creation of an end user charge of $4.10 for residential customers and $6.00 for single-line business.[33]

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

[32] *See*, Decision 94-09-065, *et. al.*, September 15, 1994.

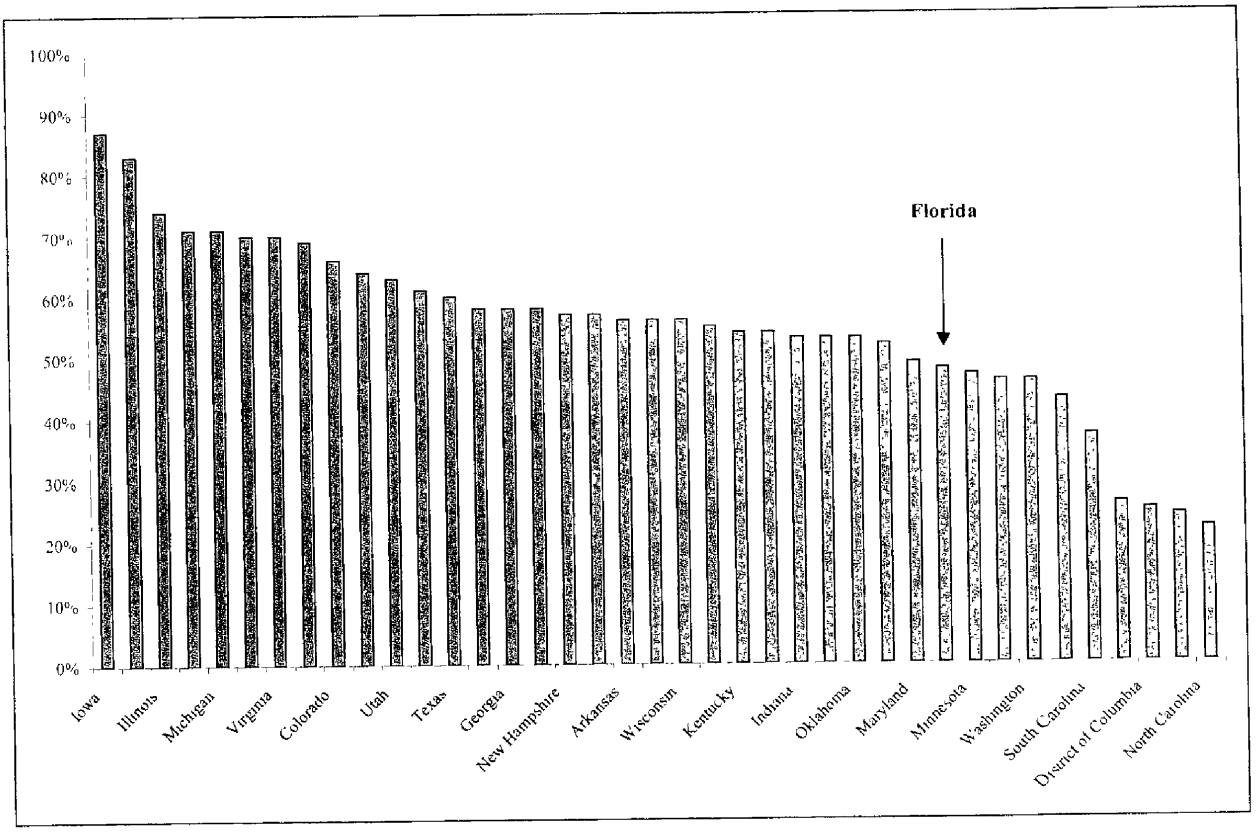
[33] *See*, The Public Utilities Commission of Ohio, Case No. 00-127-TP-COI and 01-1266-TP-UNC, June 28, 2001.

ATTACHMENT A

ATTACHMENT B

FIGURE 1 – PERCENT OF CLEC LINES SOLD TO RESIDENTIAL AND SMALL BUSINESS CUSTOMERS BY STATE, AS OF DECEMBER 31, 2002

SOURCE: FCC, *Local Telephone Competition: Status as of December 31, 2002*



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AMENDED DIRECT TESTIMONY OF DR. KENNETH GORDON

On behalf of Verizon Florida Inc., BellSouth Telecommunications, Inc., and Sprint-Florida Inc.

September 30, 2003

AMENDED DIRECT TESTIMONY OF DR. KENNETH GORDON

I. PURPOSE & SUMMARY OF CONCLUSIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Dr. Kenneth Gordon. My business address is One Main Street, Cambridge, Massachusetts 02142. My C.V. is provided as Attachment A.

Q. WHAT IS YOUR CURRENT POSITION?

A. I am a Special Consultant of National Economic Research Associates, Inc. ("NERA"). Previously, I was Senior Vice President at NERA.

Q. WILL YOU PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS?

A. I am an economist and former Chairman of the Maine Public Utilities Commission ("Maine Commission") and the Massachusetts Department of Public Utilities ("Mass. DPU"). The Mass. DPU is now known as the Massachusetts Department of Telecommunications and Energy. I have been an economist since 1965, and I have been directly involved with developing and establishing regulatory policy at the federal and state levels since 1980, when I became an industry economist at the Federal Communications Commission ("FCC").

I received my A.B. degree from Dartmouth College in 1960. I received my M.A. degree in 1963 and my Ph.D. degree in 1973, both in economics, from the University of Chicago. I have taught applied microeconomics, industrial organization, and regulation (as well as other subjects) at Georgetown University, Northwestern University, University of

Massachusetts at Amherst, and Smith College.

From 1980 to 1988, I was an industry economist at the FCC's Office of Plans and Policy, where I worked on a full range of regulatory issues, including telecommunications, cable, broadcast, and intellectual property rights. At the FCC, one of the major focuses of my work was activity aimed at introducing competition into communications markets.

Prior to joining NERA in November 1995, I chaired the Maine Commission (1988 to December 1992) and the Mass. DPU (January 1993 to October 1995). During my term as Chairman of the Mass. DPU, the DPU investigated and approved a price cap incentive regulation plan for NYNEX and also undertook a proceeding to examine interconnection and other issues related to the development of competition at all levels of telecommunications, including basic local service.

While a regulator, I was active in the National Association of Regulatory Utility Commissioners ("NARUC"), serving on its Communications and Executive Committees. In 1992, I served as President of NARUC. I was also Chairman of the BellCore Advisory Committee and the New England Governor's Conference Power Planning Committee.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. Verizon Florida Inc., BellSouth Telecommunications, Inc., and Sprint-Florida Inc., ("the companies") are seeking to restructure their rates for intrastate network access services ("intrastate access") and basic local telecommunications services ("basic local") in

accordance with recently passed legislation by the Florida Legislature.[1] The companies' revised plans—which must address the criteria established in the legislation—call for them to restructure their intrastate access and basic local rates in a revenue-neutral manner.

The companies have asked me to provide an economic and policy analysis of their revised rate plans and to testify on whether I believe those revised plans meet the criteria laid out in the legislation.

Q. WHAT ARE YOUR MAJOR CONCLUSIONS?

A. After reviewing the newly-enacted legislation, the evidence in this case—specifically the companies' revised plans and the cost evidence submitted by the companies' witnesses—and based on my general knowledge and expertise on telecommunications economic and regulatory matters, I conclude that the revised plans submitted by the companies meet the criteria contained in the legislation. Specifically, upon implementation, the revised plans will, *inter alia*:

- Reduce current support for basic local telecommunications services that prevents the creation of a more attractive competitive local exchange market for the benefit of residential consumers; and
- Induce enhanced market entry.

The companies' revised plans significantly decrease support for basic local service by reducing prices for a service that has historically and purposely been an important source—but by no means the only source—of support for basic local services, namely

[1] *See* Section II below.

intrastate access. In order to achieve revenue neutrality, the companies' revised plans increase residential basic local prices towards cost-based levels, thus creating a more attractive market for potential entrants, ultimately for the benefit of residential consumers. Both theory and empirical evidence show that low residential basic local prices have hindered the development of residential competition. By better aligning residential basic local prices with cost, competitors will have increased incentives to target a broader mix of residential consumers, which is the intent of the Florida legislature.

In addition, I conclude that the revised plans will enhance economic welfare in Florida by increasing economic activity. As described in the respective testimonies of the companies' cost witnesses, the cost evidence submitted in this proceeding demonstrates that rates for residential basic local service diverge significantly from their underlying costs. A movement toward costs—and, therefore toward more rational economic pricing—will bring with it several economic benefits. These benefits include providing market participants—i.e., customers, the companies and potential and actual competitors—with more cost-based price signals, which will improve economic decision making and lead to more economically rational utilization of telecommunications services. Economic activity in Florida will increase as a result of the companies' revised plans because rebalancing generates substantial consumer benefits. Telephone consumers are better off as a result of moving prices more in line with costs, and will likely increase their purchases of those services whose price has come down. Perhaps of even greater significance, competitive telephone service providers will be seeing better price signals for local service, and will be able to invest without having to face the level of subsidized competition they have faced in the past. New investment by these providers should, at the margin, increase.

The cost evidence presented by the companies demonstrates that basic local prices are receiving an economic subsidy from other services. The companies submitted forward-looking direct cost evidence to demonstrate that their residential basic local services are priced below the costs the companies incur to provide the services. Forward-looking direct cost is the basis for determining whether a service is receiving an economic subsidy. Moreover, consistent with this Commission's ruling, the companies' cost witnesses, when measuring the economic subsidy flowing to basic local services, correctly assign the entire cost of the loop to basic local.

I also conclude that the companies' revised plans will not jeopardize universal service in the state of Florida. The companies' residential basic local prices are substantially below the national average and Florida is not a poor state. The Florida Public Service Commission ("Commission") has the flexibility to approve the companies' revised plans and still have residential basic local prices remain affordable. The Florida Legislation requires that any price increase in basic local service not apply to Lifeline consumers and also increased the income eligibility for Lifeline consumers to 125 percent, thus protecting those customers most likely to be sensitive to potential price increases from a rebalancing plan. Importantly, the companies' revised rebalancing plans will lead to lower intrastate toll prices for all consumers. At the end of the day, the mix of services that consumers purchase as a result of the companies' revised plans will make consumers better off overall.

Finally, the fact that some customers may experience unwanted rate changes should not be an argument for the status quo. Good policy requires weighing and balancing the costs

and benefits of particular actions. While it may seem that maintaining current prices is the least objectionable thing to do from a policy perspective, there is an implicit but very real cost to continuing the status quo. The deployment of next generation, advanced networks depends crucially on providing all market participants the sound economic signals that will encourage efficient investment and innovation. Cost-based prices provide the incentives needed to bring to market the new services that customers demand. This cannot be accomplished by distorted prices.

Q. YOU HAVE NOTED IN YOUR MAJOR CONCLUSIONS THAT VERIZON FLORIDA INC., BELLSOUTH TELECOMMUNICATIONS, INC., AND SPRINT-FLORIDA INC. HAVE REVISED THEIR RESPECTIVE RATE REBALANCING PLANS FILED ON AUGUST 27, 2003 TO EXTEND THE TIME OVER WHICH INTRASTATE NETWORK ACCESS AND BASIC LOCAL TELECOMMUNICATIONS RATES WILL BE REFORMED. HAVE YOU REVIEWED THESE COMPANIES' REVISED PLANS?

A. Yes, I have.

Q. DO THESE REVISIONS AFFECT YOUR ANALYSIS OF THE COMPANIES' PLANS OR YOUR TESTIMONY?

A. No. With the exception of the minor changes — changing "plans" to "revised plans" — as well as this and the previous question and answer, my testimony remains unchanged from the testimony that I filed on August 27, 2003.

II. BACKGROUND

Q. PLEASE DESCRIBE THE BASIS FOR THE COMPANIES' REQUEST TO INCREASE BASIC EXCHANGE PRICES.

A. From an economic perspective, the fact that the companies' current residential basic local prices are not fully recovering their forward-looking economic cost is, by itself, a good enough reason to begin the process of moving them to more economically rational levels. Both theoretical and empirical research have shown that rebalancing rates and moving them toward levels more commensurate with their underlying costs results in significant benefits to telecommunications consumers and, by so doing, benefits the economy as well.[2] Rebalancing rates has also been demonstrated to have a positive effect on competitive entry into the local exchange market.[3]

The immediate catalyst for the companies' revised plans is the recent changes in Florida laws. I have been informed by counsel that the legal authority for the companies' request arises from recent changes in the statutory framework in Florida. During the 2003 regular legislative session, the Legislature passed Senate Bill 654, the Tele-Competition Innovation and Infrastructure Enhancement Act ("Tele-Competition Act"). The Tele-Competition Act implements several important policies, but for our purposes the relevant Section of the Tele-Competition Act is § 364.164 "Competitive market enhancement."

Q. WHAT ARE THE IMPORTANT PROVISIONS OF § 364.164?

A. § 364.164 permits local exchange telecommunications companies to petition the

[2] See Section IV below.

[3] See Section III.

Commission to reduce their intrastate access rates in a revenue-neutral manner. In reaching its decision, § 364.164 (1) states that the Commission shall consider whether granting the petitions will:

a. Remove current support for basic local telecommunications services that prevents the creation of a more attractive competitive local exchange market for the benefit of residential consumers;

b. Induce enhanced market entry;

c. Require intrastate switched network access rate reductions to parity over a period of not less than 2 years or more than 4 years; and

d. Be revenue neutral as defined in subsection (7) within the revenue category defined in subsection (2).

Throughout my testimony, I will focus on whether the companies' revised plans are consistent with and meet the criteria provided in § 364.164 (1) (a) and (b). Other company witnesses discuss how the companies' revised plans would meet criteria (c) and (d).

Q. IN ORDER TO REDUCE INTRASTATE ACCESS RATES IN A REVENUE NEUTRAL MANNER, RATES FOR OTHER SERVICES NEED TO BE INCREASED. WHAT SERVICES DO YOU BELIEVE SHOULD BE INCREASED?

A. The first category of services that should be considered are those services whose current prices do not recover fully their underlying costs, such as residential basic local telecommunications services. Rates for these subsidized services should be increased in order to better reflect their real economic cost. This is confirmed in §364.164 (2), where the legislation calls for the creation of a revenue category mechanism consisting of basic

local telecommunications service revenues and intrastate switched network access revenues in order to achieve revenue neutrality. That is, the legislation states that in order to achieve revenue neutrality, if intrastate access prices are reduced, then basic local service prices need to be increased.

The current rate design for telephone services—where basic local services are priced below cost and other services, including intrastate access service, are priced in such a way so as to provide the support—while in the process of being reduced or eliminated in a number of states, continues to be encountered in state regulation of telephone services. However, as the Florida Legislature wisely recognized, whatever benefits such a rate design policy has arguably achieved in the past, such as helping the United States achieve universal telephone service—the continuation of such policies frustrates another important policy goal of Federal and state regulators, namely, the establishment of efficient competition to as broad a base of business and residential consumers as is economically feasible—not to mention the economic costs that arise from price-cost distortions, *per se,* as I discuss further below.

The current rate design policy as it pertains to residential basic local services, frustrates that policy goal and by enacting § 364.164, the Florida Legislature has provided the Commission with the direction it needs to make competition work better for all Florida consumers.

Q. ARE THE COMPANIES' REVISED PLANS CONSISTENT WITH § 364.164 (1) (a) and (b)?

A. Yes. The companies' revised plans are consistent with and meet the criterion of § 364.164(1)(a) and (b). Below in Section III, I fully describe why I believe that the

companies' revised plans are consistent with and meet those criteria.

Q. DR. GORDON, FROM A POLICY PERSPECTIVE DO YOU BELIEVE THAT IT IS APPROPRIATE TO ENGAGE IN THE TYPE OF REBALANCING THAT IS BEING CONTEMPLATED BY THE COMPANIES' PLANS?

A. Yes, I do. In this testimony, I describe fully why I believe that the companies' revised plans are consistent with the criteria of the Tele-Competition Act that the Commission shall consider and why the revised plans would likely result in increasing competitive activity in the state of Florida. Specifically, the revised plans will create a more attractive local exchange market for residential consumers and lead to enhanced market entry—two criteria that need to be considered by the Commission in addressing the companies' revised plans. By making the residential local exchange market more attractive, residential consumers will likely see more companies competing for their business, which will, in turn, result in more options for residential consumers, improved services and lower prices for their telecommunications services. From a policy perspective, it is appropriate to accomplish these tasks.

In addition, I describe below the history of rate design for basic local services in the United States and how the end result of these policies has been uneconomically low residential basic local prices; lower than what one would expect to find in undistorted competitive markets. Of course, states have differed in their implementation of these policies and, as a result, residential basic local service prices vary quite a bit from state to state. In Florida, residential basic local prices are quite low when compared to prices in other states. In Table I below, I list the flat-rate charges for each of the three companies' lowest and highest rate groups compared to the national average flat-rate charges. As can

be seen in the table, each of the companies' highest rate group is well below the national average of $14.55 per month.

Table I – Comparison of Verizon, BellSouth and Sprint's flat-rate residential basic local charges and National Average flat-rate charges

Company	Lowest Rate Group	Highest Rate Group	Unweighted Average	National Average (2002)
Verizon	$9.72	$12.06	$10.89	
BellSouth	$7. 57	$11.04	$9.31	
Sprint	$7.63	$11.48	$9.56	
National Average (2002)				$14.55

Source: Florida Senate Staff Analysis And Economic Impact Statement, p. 4, April 8, 2003; FCC *Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service*, Table 1.1 July 2003, rates exclude Federal and State subscriber line charges, touch tone charge and taxes, 911 and other charges.

Q. HOW DOES THE FACT THAT FLORIDA HAS LOW RESIDENTIAL BASIC LOCAL TELECOMMUNICATIONS PRICES RELATE TO THIS PROCEEDING?

A. It relates to this proceeding in two important ways. First, the Legislature has correctly perceived that low residential basic local prices have led the residential local exchange market to be less attractive to competitors than would be the case with more economically rational residential basic local prices. In Section III below, I describe fully why, from an economic perspective, I believe the Legislature is absolutely correct on this point. Put

simply, holding all other factors constant, the lower the residential basic local price (when set governmentally without regard to whether the prices cover cost), the more unattractive those customers are to actual and potential competitors. Since Florida residential basic local prices are lower than those in many other states, and in fact lower than the national average, the problem facing potential new entrants as a result of these low rates is likely to be even more severe and pronounced in Florida than in other states. For this reason, it is even more important that Florida policymakers tackle this problem sooner rather than later.

Q. IS THERE ANY SUPPORT FOR YOUR ASSERTION THAT THE PROBLEM OF AN UNATTRACTIVE RESIDENTIAL MARKET MAY BE WORSE IN FLORIDA THAN IN OTHER STATES?

A. Yes, there is some support for my assertion. The FCC compiles data on local telephone competition. Its most recent report, released June 12, 2003 included a table that lists, for each state available, the percentage of lines provided to residential and small business customers by ILECs and CLECs.[4] The FCC provided data on 40 states and of those 40 states Florida ranked 30th in the percent of CLEC lines that were sold to residential and small business customers. This means that in 29 out of 40 states, CLECs' served proportionately greater residential customers than in Florida (see Figure 1 at the end of this testimony). Florida ranks below states such as Georgia (58%), Alabama (52%), Louisiana (61%) and Virginia (70%) to name a few, all of which have higher residential prices. This provides some evidence that low residential basic local prices are having a

[4] *See, Local Telephone Competition: Status as of December 31, 2002*, Table 11, Industry Analysis and Technology Division Wireline Competition Bureau, Federal Communications Commission.

negative impact on residential competition in Florida.

Q. YOU MENTIONED THAT THERE WAS A SECOND REASON WHY YOU BELIEVE THAT FLORIDA'S LOW RESIDENTIAL BASIC LOCAL PRICES, IN COMPARISON WITH OTHER STATES, ARE RELEVANT IN THIS PROCEEDING. WHAT IS THAT SECOND REASON?

A. The second reason has to do with affordability considerations and the flexibility this Commission has in rebalancing rates while still maintaining basic residential local rates that are quite affordable for most Floridia consumers. As mentioned above, the companies' prices for residential basic local services are generally well below the national average. However, Florida is not a poor state. According to data from the U.S. Bureau of Economic Analysis, Florida is on par with the national average in personal income per capita.[5] Specifically, as of 2001, the data show that personal income per capita in Florida was $29,047 compared to the national average of $30,413. Thus, the Commission has the flexibility to increase residential basic local prices, which are currently well below the national average, to more economically reasonable levels without making the services unaffordable to Florida consumers.

At the same time, Florida consumers will pay less for intrastate toll calls. The companies' rebalancing plan will lower the access charge component of the cost of producing intrastate toll calls. IXCs are required to pass these cost savings through to consumers in the form of lower prices. Thus, even with the increase in basic residential local rates, telecommunications will be just as affordable to Florida consumers as before, yet

[5] Bureau of Economic Analysis, Regional Economic Information System, Table SA1-3.

consumers will be better off because they will be consuming a different mix of telecommunications services that provides more value than they are currently receiving.

In addition, the Tele-Competition Act also requires that any increase in basic local service rates not apply to Lifeline customers and that the ILECs increase Lifeline participation to 125 percent of federal poverty income level.[6] These requirements further protect low-income consumers—and it is low-income consumers who would be most prone to disconnections in the face of price increases—thus providing the Commission with even more flexibility to approve the companies' rate rebalancing request with minimal concern that such a rate restructuring would negatively affect subscribership. I discuss this point, and other reasons why I believe the companies' revised plans will not negatively affect subscribership in Florida, in more detail in Section VI below.

Q. VERIZON, BELLSOUTH AND SPRINT ARE FILING THEIR REVISED PLANS AT THE SAME TIME. IS THERE ANY PUBLIC POLICY BENEFIT TO HAVING THE COMMISSION REVIEW THE COMPANIES' REVISED PLANS AT THE SAME TIME?

A. Yes. The benefits are at least threefold. First, to the extent that basic local rates are simultaneously adjusted closer to their costs throughout the territory of the three companies serving 98 percent of the ILEC customers, the better competition will be benefited and market entry enhanced. Certain providers who might be positioned to provide facilities-based basic local service (e.g. cable telephony, electric and wireless providers) will not necessarily configure their coverage areas based on the ILECs service

[6] § 364.10(3)(a).

territories. For them the potential staggered implementation of the rebalancing could be an obstacle to competitive entry. There are several areas within Florida where at least two of the three major ILECs provide service where it may be economical for a new entrant to provide service regardless of the ILEC boundary. For example, the Orlando/Central Florida (BellSouth/Sprint) area, Southwest Florida (between Sarasota and Ft. Myers (Verizon/Sprint)) area and the Pensacola – Ft. Walton – Destin -- Panama City (BellSouth/Sprint/BellSouth) area are three relatively compact geographic areas served in part by at least two of the three companies. Each of these areas might appropriately comprise the service territory of a single facilities–based entrant. When the price increases contained in the company plans are implemented and signal to these entrants that pricing distortions are being reduced on a broad basis, the competitors may be able to more efficiently execute their business plans.

Second, it is also important to avoid unnecessary marketplace distortions that could affect the purchase decisions of end-users. End-users normally make their purchase decisions based in large part on relative price differences among providers. If the rate-rebalancing is not implemented across all companies simultaneously, end-users will make these decisions based on incomplete and imperfect information as they see some providers' rates increasing while other providers' rates remain the same (at least temporarily). The risk will be that regulatory scheduling rather than the relative costs and benefits of various service offerings becomes the driving force behind consumers' decisions. For example, it is easy to imagine a situation involving two or more of the ILECs —where a CLEC might be able to offer service at a legitimate cost savings to all customers, but if re-balancing is not done simultaneously perhaps only one firm's customers would respond to the competitive offer, because the other firm's rate increase had yet to be implemented.

Coordinated rate rebalancing across all companies will ensure that potential competitors are not artificially disadvantaged when introducing new service offers by artificial boundaries, and that customers are not disadvantaged by incorrect and incomplete information driving their purchase decisions.

Third, the magnitude and timing of the access charge price reductions for the three companies would also benefit end users statewide. IXCs will be able to implement more meaningful price reductions if they can aggregate their access cost reductions into a single round of pricing changes.

Q. THE LEGISLATION PERMITS A COMPANY TO RESTRUCTURE ITS RATES OVER A MINIMUM OF TWO YEARS AND A MAXIMUM OF FOUR. EACH OF THE COMPANIES PLANS TO HAVE INTRASTATE ACCESS RATES REACH PARITY WITH INTERSTATE RATES OVER A TWO-YEAR PERIOD. DO YOU BELIEVE THIS IS A GOOD IDEA?

A. Yes I do, for several reasons. First, it is clearly permitted by the Tele-Competition Act. Second, it is a matter of economic principle that economic welfare is at its highest when prices are based on their underlying forward-looking costs and are not distorted. As I discuss in greater detail in Section III, prices that are distorted provide inferior signals for market participants and result in losses in consumer welfare because investment and purchase decisions by firms and consumers do not reflect the true costs that society incurs to provide the services. The companies' revised plans reduce these pricing distortions in the Florida telecommunications markets sooner rather than later and, by so doing, achieve economic efficiency gains sooner as well.

Third, a possible reason why one would prefer a more gradual rate restructuring time frame has to do with avoiding consumer "rate shock". As the words imply, rate shock implies that the increase in price proposed by the company is so high, that consumers would be obviously and adversely affected. However, based upon my personal experience as a former commissioner, as well as what I have observed in other states, I do not believe that the yearly increase in basic local prices will result in rate shock.

Q. PLEASE EXPLAIN WHY YOU BELIEVE THAT THE COMPANIES' PLANS WILL NOT RESULT IN RATE SHOCK.

A. The companies' revised plans will result in relatively minor increases in a customer's basic local price. In addition, as I stated earlier, these price increases will not even apply to current Lifeline consumers and new Lifeline consumers who have become eligible as a result of the Tele-Competition Act raising the income threshold to 125% of the poverty level.

In addition, with the reduction and elimination of the in-state connection fees, many customers might not even experience a significant change in their total bill. If there is an increase in the customers' bill, it will likely result in large part from increased stimulation from lower long distance charges that represent real gains to consumers because they are now able to make more calls at the new lower prices.

Finally, the companies' revised plans compare favorably with other states that have approved rate-rebalancing plans that approved much larger increases than the companies' request Importantly, these states' price adjustments did not jeopardize universal service. In Section VI, I also discuss the experience of some of the states that have already

implemented serious rate rebalancing plans, including Massachusetts where I presided as Chairman through one such adjustment.

III. THE COMPANIES' REVISED PLANS WILL RESULT IN A "MORE ATTRACTIVE COMPETITIVE LOCAL EXCHANGE MARKET FOR THE BENEFIT OF RESIDENTIAL CONSUMERS" AND WILL INDUCE "ENHANCED MARKET ENTRY"

Q. HOW DO YOU JUDGE WHETHER THE COMPANIES' REVISED PLANS MEET THE CRITERIA OF § 364.164 (1) (a) AND (b)?

A. § 364.164 (1) (a) states that the companies' plans should remove the current support for basic local telecommunications services that is impeding the creation of a more attractive competitive local exchange market for the benefit of residential consumers. In order for the companies' revised plans to meet the first criterion, they must show that the revised plans remove—or at a minimum reduce—support for basic local telecommunications. By so doing, they create a more "attractive" competitive local exchange market, because the price to be competed against by new entrants is raised to more closely reflect the real economic costs of doing business. The second criterion for the Commission's consideration is § 364.164 (1) (b) which simply states that the plans should induce enhanced market entry and no distinction is made between residential or business consumers.[7]

[7] There are other criteria in § 364.164 (1) that I do not discuss but that are the subject of the companies' respective witnesses.

Therefore, in evaluating whether the companies' revised plans meet the criteria in these sections, I must ascertain whether the revised plans: (1) remove current support for basic local telecommunications services, and (2) will likely result in a more attractive competitive environment that would benefit residential consumers and induce enhanced market entry.

Q. DO THE COMPANIES' REVISED PLANS REMOVE CURRENT SUPPORT FOR BASIC LOCAL TELECOMMUNICATIONS SERVICES?

A. Yes, the companies' revised plans significantly decrease current support for basic local telecommunications services. The revised plans do this by reducing the prices of a service that has historically been set by regulators to provide an important source—but by no means the only source—of support for basic local services, namely, intrastate switched network access.

Q. WHY DO YOU BELIEVE THAT INTRASTATE SWITCHED NETWORK ACCESS CURRENTLY SUPPORTS BASIC LOCAL TELECOMMUNICATIONS SERVICES?

A. There are two reasons. The first is the historical rate design policy prevalent in telecommunications regulation in Florida and throughout the United States. As I mentioned earlier, historically, telecommunications rate design was premised on the policy goal—at times stated and sometimes left implicit—of keeping the price of basic local telecommunications low or as low as possible. This policy began early on in telecommunications regulation and was accomplished through the rate design mechanisms that were part and parcel of traditional regulation. Traditional regulation required two broad steps. The first was to determine a revenue requirement that was sufficient to meet

the prudently incurred operating expenses and a reasonable return on prudently invested capital. The second broad step was the rate design process, which determined the price of each regulated service to ensure that the regulated company had the opportunity to recover its revenue requirement from its regulated service.[8] Normally, a proper rate design process would require that the price of any service recover at least its underlying cost and, in addition, contribute to the firm's shared and common cost in some manner. At times that manner was consistent with economic efficiency goals—as when demand considerations were taken into account—and at other times it was more reflective of other policy considerations—as when an equal percentage markup was applied across the board to the different services.

For basic local services, however, in most instances the price was set on a residual basis without taking into consideration the underlying cost of providing basic local telecommunications. That is, the goal of residual pricing was to keep basic local prices low, or as low as possible, and to recover more revenue from other telecommunications services, constrained by what consumers were willing to pay for the non-basic telecommunications services and by—as competition began to become more prevalent in telecommunications markets—the threat of customers bypassing the public switched telecommunications network.

Prior to divestiture of AT&T in 1984, toll prices provided the bulk of support for basic local telecommunications services. As technological advances lowered the cost of

[8] I say opportunity to recover its revenue requirement because the regulatory process does not generally guarantee a regulated company a certain return, it only provides the regulated company the opportunity to earn a certain return.

providing toll services, toll prices did not decrease commensurately and were used as a means to support basic local telecommunications services—i.e., to keep the prices of basic local lower than would otherwise be the case. After divestiture of AT&T, interstate and intrastate switched network access services were substituted as a means of supporting basic local telecommunications services.

Notably, even after the substitution of price cap regulation for traditional regulation, the cross subsidies that were present under traditional regulation have been maintained.

The notion that intrastate switched network access services have been used as a source of support for basic local telecommunications is confirmed in the Florida *Senate Staff Analysis and Economic Impact Statement on the Tele-Competition Act*, where it states:

> According to the commission, intrastate network access service rates were set well above the incremental cost of providing the service in order to keep rates for basic local telecommunications service as low as possible and to encourage subscribership.[9]

The second reason why I believe that intrastate access services currently support basic local service is cost considerations. As described in the testimonies of their witnesses, the companies have established that the price of residential basic local telecommunications services is below forward-looking direct cost estimates. From an economic perspective, whenever the revenues from a service are insufficient to recover its forward-looking direct costs, that service is said to be in receipt of an economic subsidy. The source of the

[9] *See* Senate Staff Analysis and Economic Impact Statement on CS/SB 654, April 8, 2003.

subsidy—including that for residential basic local services—comes from all those services that are priced above their respective forward-looking direct costs. As a whole, these services contribute to the support of residential basic local. Because intrastate access services are priced significantly above their forward-looking direct costs, this means that intrastate switched network access services are supporting basic local service.

Q. DOES THIS IMPLY THAT THERE MAY BE OTHER SERVICES, BESIDE INTRASTATE ACCESS SERVICES, THAT MAY ALSO BE SUPPORTING BASIC LOCAL TELECOMMUNICATIONS SERVICES?

A. Yes, that is correct. In general, for multi-product firms, where there are significant amounts of shared and common costs, firms must, in the aggregate, price their services above forward-looking direct costs in order to earn sufficient revenues to remain viable. When one service is priced below its forward-looking direct costs, as is the case for residential basic local telecommunications services, other services that are priced above forward-looking direct costs are supporting the service that is priced below its own forward-looking direct costs.

The Florida Legislature, however, has specifically determined that it is the support provided by intrastate switched network access that is to be reduced. The Tele-Competition Act calls for rebalancing to take the form of lowering intrastate access rates to parity—over a 2 to 4 year period—with interstate switched network access rates and to simultaneously increase basic local telecommunications services by an amount sufficient to make up the revenue over the same time period. Under this approach, there is still no guarantee that residential basic local services recover at least their forward-looking direct costs once intrastate access rates are set to parity with interstate switched access rates. In

fact, according to the companies' evidence, residential rates will still be below forward-looking direct costs even when intrastate switched network access rates reach parity with the interstate rates.

Therefore, while the companies' revised plans are consistent with the criteria to be considered by the Commission, the plans do not result in the complete rebalancing of rates. Thus, there will still likely be some (lesser) distortions in prices even after the implementation of the plans.

Q. AS AN ECONOMIST, DO YOU BELIEVE THAT REBALANCING IS COMPLETED ONCE BASIC RESIDENTIAL PRICES ARE SET AT FORWARD-LOOKING DIRECT COSTS?

A. While having basic local services recover at least their underlying forward-looking direct costs is a good first step, it would not necessarily result in economically efficient prices. As I discuss in greater detail below in Section IV, economically efficient prices require that a multi-product firm's shared and common costs be recovered through markups on each service or product above forward-looking direct costs in a manner that least distorts economic efficiency. Therefore, to have economically efficient basic local prices would likely require that basic local services be priced above forward-looking direct costs. However, as markets become more competitive, markups will be limited by the need to be competitive with other firms in the market.

Q. HAVING ESTABLISHED THAT THE REVISED PLANS REMOVE CURRENT SUPPORT FOR BASIC LOCAL, § 364.164 (1) (a) PROVIDES THAT, AS A RESULT OF THE REMOVAL, THEY WILL RESULT IN A MORE

ATTRACTIVE COMPETITIVE LOCAL EXCHANGE MARKET FOR THE BENEFIT OF RESIDENTIAL CONSUMERS. WILL THE COMPANIES' REVISED PLANS MEET THIS CRITERION?

A. Yes, the companies' revised plans will create a more attractive competitive local exchange market for the benefit of residential consumers. Economic theory and empirical research both indicate that this will likely be the case. I discuss these two factors below.

Q. PLEASE DISCUSS WHY YOU BELIEVE THAT ECONOMIC THEORY SUGGESTS THAT THE COMPANIES' REVISED PLANS WILL LIKELY RESULT IN A MORE ATTRACTIVE COMPETITIVE LOCAL EXCHANGE MARKET FOR THE BENEFIT OF RESIDENTIAL CONSUMERS?

A. One of the key components of the companies' revised plans is that intrastate access revenues will be decreased in a revenue-neutral manner by increasing the price of (and revenue from) basic local telecommunications services for residential consumers. The cost information provided by the companies in this proceeding indicates that residential basic local telecommunications prices are currently below forward-looking direct costs. Increasing the price of a service, especially a service that is below forward-looking direct costs, will make for a more attractive market for actual and potential competitors. Competitors will not rationally try to compete against heavily subsidized prices.

Q. WOULD YOU PLEASE EXPLAIN WHY YOU BELIEVE THIS TO BE THE CASE?

A. In a market economy, prices are the essential tool that send signals to market participants that, in turn, determine market behavior and outcomes. For example, as prices increase or decrease, consumers alter their consumption decision because the value consumers place

on goods and services changes in relation to price. Producers alter their production, investment and research and development decisions as well, because as prices increase or decrease, profits change along with them. It is the search for profits that drives firms to enter or expand into new markets. As prices change, potential entrants into the market will be affected as well. Lower prices may act to keep new firms from entering the market and higher prices more reflective of cost will tend to attract new firms into the market.

Like any other firm, the investment decision of a telecommunications competitor is based on the present value of the cash flows that the investment project is likely to generate over the useful economic life of the project. Holding all other factors constant, when the price of a service increases, a cash flow analysis would show that the investment project becomes more profitable (or less of a loss) and thus more attractive. In the case before us, an increase in the price of basic local telecommunications service would increase the revenues from residential basic local services in a cash flow analysis, thus increasing the attractiveness of providing those residential services. As a result of rate rebalancing, where the companies plan to raise residential basic local prices, the residential local exchange market will look more attractive to all actual and potential telecommunications providers of residential services.

Q. WILL THE COMPANIES' REVISED PLANS ALSO PROVIDE INCREASED INCENTIVES FOR OTHER COMPETING TELEPHONY TECHNOLOGIES?

A. Yes. An important reason for opening local telecommunications markets to competition is the belief that technological change is proceeding so rapidly that competitive markets will do a much better job than monopoly of discovering which technologies can or cannot

succeed in the long run. For example, access to customers for their telecommunications needs comes in the form of fixed-wireline access, wireless access, cable telephony, Internet, and potentially satellite and even access via electric utilities. Of course, not all of these technologies will necessarily survive in the long run and competition will likely lead to a mix of technologies surviving and providing the lowest possible cost for each consumer's telecommunications needs.

However, in order for the lowest-cost mix of technologies to remain in the market, prices and the signals they send must not be distorted and must reflect the underlying cost of providing service. The companies' revised plans move positively in this direction and encourage new entrants—regardless of the chosen technology—to enter or expand in the marketplace because even competitors using lower-cost (or more attractive) technologies may not be able to compete against a subsidized ILEC price that does not fully reflect its own costs. This would be a loss for consumers and the Florida economy.

Q. IS THERE EVIDENCE THAT OTHER FORMS OF ACCESS ARE COMPETING WITH FIXED-WIRELINE ACCESS?

A. Yes. The Florida Commission has recognized the actual and potential substitution occurring between fixed-wireline and other forms of access, including wireless and emerging IP-telephony providers. As the Commission states:

> Regarding the substitution of technology and services, as they are being found to be close substitutes to traditional wireline services, both wireless and

emerging broadband IP-telephony providers must be included in the analysis.[10]

In the same report, the Florida Commission cites nation-wide data indicating that about 5% of U.S. wireless subscribers have disconnected wireline service and conclude that substituting wireless for wireline services appears to be a national trend.[11] Moreover, as the same report concludes, Florida may be especially susceptible to this phenomenon because of the large population in Florida that also has residences in other states. For many of these consumers, "it makes little sense to continue paying for telephone service that sits idle much of the year when wireless enables them to stay connected wherever they are."[12]

The Florida Commission has also concluded that cable providers are competing directly with fixed-wireline providers. The Commission cites to national data that shows that by second quarter of 2002, there were 2.5 million cable telephony subscribers and that cable companies expect to see one-third of their digital cable households take cable telephony service by 2005.[13]

There is evidence that the Tele-Competition Act is already having a positive impact on competitors' incentive to enter and expand in the Florida market. On July 18, 2003, Knology, a provider of broadband and voice telephony services, announced it has entered

[10] *See*, Florida Public Service Commission, *Telecommunications Market in Florida Annual Report on Competition As of June 30, 2002*, December 2002, p. 6.

[11] *Ibid*, at 7.

[12] *Ibid*, at 9.

[13] *Ibid*, at 10.

into a definitive agreement to purchase certain assets from Verizon Media Ventures, Inc.[14] Knology offers local and long distance telephone service and its purchase of Verizon's Americast cable system will permit it to compete directly with Verizon. In its press release announcing its decision, Knology stated:

> In commenting on this transaction, Knology noted that the Tele-Competition Act recently enacted in Florida positively influenced its decision to expand operations in the state. This Act, as written by the Florida Legislature and supported by Governor Bush, laid the foundation for companies like Knology to enter the Florida market, and offer competitive services and products to consumers.

Q. IS THERE EMPIRICAL EVIDENCE THAT SUPPORTS YOUR VIEW THAT RATE REBALANCING WILL LIKELY MAKE THE RESIDENTIAL LOCAL EXCHANGE MARKET MORE ATTRACTIVE?

A. Yes, there is empirical evidence. Two of my colleagues at NERA investigated empirically whether low residential basic local rates were having any impact on competition in the states and, specifically, whether low rates were hindering the development of residential competition.[15] In that paper, the authors hypothesized that inefficient local exchange prices are having an impact on competition and that, specifically, low residential prices are inhibiting competition for residential customers. To test their hypotheses, the authors compared how local competition varied across the different states depending on how

[14] *See*, Knology Press Release July 18, 2003, *Knology Announces Agreement to Purchase Broadband Asset*.

[15] *See*, Agustin J. Ros and Karl McDermott, "Are Residential Local Exchange Prices Too Low? Drivers to Competition in the Local Exchange Market and the Impact of Inefficient Prices," in Michael Crew, *Expanding Competition in Regulated Industries*, Kluwer Academic Publishers, 2000.

"unbalanced" were local exchange prices. Specifically, the authors estimated several cross-section econometric models of facilities-based competition, controlling for things such as cost and demand considerations in the different states. The authors also included several policy variables, including one that measured the degree to which residential local exchange prices were "distorted" in each state. The authors summarized their results, as they pertained to residential competition, as follows:

> Using OLS and GLS estimates we found a significant and positive association between states that have more "balanced" tariffs and residential competition. For two measures of residential competition used in our data, we found that "rebalancing" tariffs by 10% leads to approximately a 9% and 13% increase, respectively, in residential competition.[16]

In addition, James Eisner (an FCC staff member) and Professor Dale E. Lehman performed a somewhat similar study.[17] Eisner and Lehman state in their conclusion:

> ...in some specifications, there appears to be less competitive entry (principally facilities-based) where residential rates are lower. These findings are generally statistically significant at the 90% level.[18]

Finally, another empirical study examined rate rebalancing in Latin America and found that rate rebalancing in some Latin American countries has led to increases in the supply

[16] *Ibid.*, at 167.

[17] *See*, James Eisner and Dale E. Lehman, *Regulatory Behavior and Competitive Entry*, presented at the 14th Annual Western Conference Center for Research in Regulated Industries, June 28, 2001. The authors' main motivation appears to have been ascertaining how regulatory behavior—as it pertains to unbundled loop prices and 271 entry—affects competitive entry. Nevertheless, they control for local exchange prices as well.

[18] *Ibid*, p. 25.

of main telephone lines by providing better incentives to market participants.[19]

In summary, both economic theory and the empirical literature suggest that the companies' revised plans—by setting residential rates at more economically efficient levels—would likely make the residential local exchange marketplace more attractive to actual and potential competitors.

Q. BUT ISN'T IT THE CASE THAT CLECS ALREADY HAVE ENOUGH INCENTIVES TO SERVE LUCRATIVE RESIDENTIAL CUSTOMERS?

A. Yes, it is probably the case that CLECs have enough incentive to serve a subset of residential customers, namely those customers that are very profitable either because the cost of serving them is especially low or because their volumes are unusually high. But the promise of the Tele-Competition Act is to ensure that competition for residential customers is as broad and diffuse as is economically feasible, and by better aligning the prices of residential basic local services with their underlying costs, a broader base of residential customers will obtain the benefits of competition.

Q. § 364.164 (1) (b) PROVIDES THAT THE COMPANIES' PLANS CONSIDER THE EFFECT ON ENHANCED MARKET ENTRY. WILL THE COMPANIES' REVISED PLANS MEET THIS PROVISION?

A. Yes, the companies' revised plans will induce enhanced market entry. Above, I have discussed how the revised plans would likely create a more attractive competitive local

[19] *See*, Agustin J. Ros and Aniruddha Banerjee, "Telecommunications Privatization and Tariff Rebalancing: Evidence from Latin America," *Telecommunications Policy*, 24 (2000) 233-252.

exchange market for the benefit of residential consumers. This is an example of how the revised plans will induce enhanced market entry.

In general, the companies' revised plans will provide for improved entry signals into the local exchange market by diminishing distorted price signals that may encourage uneconomic entry into the overpriced markets. Prices that are free of distortions will lead to several economically-efficient outcomes known as allocative, technical and dynamic efficiencies. First, efficient pricing assumes that the marginal cost that society incurs to produce goods and services reflects the value that consumers place on the good or service consumed, (allocative efficiency). Second, optimal signals are provided to firms in the industry (e.g., whether to increase production or exit the industry) and to potential entrants contemplating entering the market. This ensures that it is the lowest cost firms that stay in the market and provide goods and services. In this way the use of society's scarce resources is minimized (technical efficiency). Third, prices that adequately cover costs ensure that appropriate incentives exist for improvement in technology, increased research and development and higher quality goods and services (dynamic efficiency).

Q. UNDER WHAT CONDITIONS CAN IT BE SAID THAT PRICES ARE FREE OF DISTORTION, AND ARE THE COMPANIES' CURRENT PRICES FOR BASIC LOCAL SERVICES FREE OF DISTORTIONS?

A. Prices are free of distortion when: (1) they recover at least the forward-looking incremental cost of production and (2) for multi-product firms, markups above incremental costs take into account demand characteristics in the market, subject, of course, to the need for the firm to meet competition. As described in the companies' cost testimonies, the companies' prices for basic local residential services are not recovering

the forward-looking direct cost of production. As such, prices for these services do not meet the economic criterion that prices should at a minimum recover the forward-looking direct cost of production.

By adopting the companies' revised plans, however, the Commission will be reducing significantly the distortions in the price of intrastate access and residential basic local services and achieving the economically efficient outcomes described above.

IV. OTHER ECONOMIC BENEFITS FROM THE COMPANIES' REVISED PLANS

Q. ARE THERE OTHER ECONOMIC BENEFITS THAT WILL LIKELY ARISE FROM THE COMPANIES' REVISED REBALANCING PROPOSAL?

A. Yes, there are other economic benefits that will likely arise from the companies' revised rebalancing proposals. Both economic theory and empirical research suggest that rate rebalancing will likely increase economic activity in Florida as increased competition brings benefits to Florida consumers of telecommunications services.

Q. WOULD YOU PLEASE DESCRIBE WHY ECONOMIC THEORY SUGGESTS THAT RATE REBALANCING WILL INCREASE ECONOMIC ACTIVITY IN FLORIDA?

A. Rate rebalancing consists of increasing the prices of services that are priced below forward-looking direct costs and reducing the prices of services that are priced significantly above forward-looking direct costs. As mentioned earlier in my testimony, the history of telecommunications rate design is such that residential basic local prices

were set low and usage services (such as toll and intrastate access services) were set high.

However, economic theory teaches that economic efficiency (and overall consumer welfare) is at its highest level when prices of goods and services in an economy are set at forward-looking direct cost. Of course, in industries where there are significant fixed costs—that give rise to economies of scale—and in multi-product firms where there are significant amounts of shared and common costs, pricing services at forward-looking direct cost does not permit the firm to earn sufficient revenues to recover all its costs. Under such conditions, markups above forward-looking direct costs are required. Specifically, as competition develops, those services that are more price elastic will likely receive a proportionately lower markup above cost than those services that are more price inelastic.

Q. PLEASE DESCRIBE HOW REBALANCING RESULTS IN INCREASED ECONOMIC ACTIVITY IN FLORIDA?

A. The companies' revised plans will lower intrastate access prices, which will in turn result in lower intrastate toll prices, as required by the Tele-Competition Act. As a result of the reduction in intrastate toll prices, Floridia consumers will use more toll services. This will create value for them that they are not now receiving. This, in turn, will reflect an increase in economic activity in Florida. In addition, and of more direct importance to this proceeding, more cost reflective prices for local service will send signals to competitors that will more efficiently guide their investment decisions, and in all likelihood, increase their investment beyond what it is in the face of today's artificially low prices. Thus, rebalancing will generate significant gains in economic activity in Florida. It is important to stress the point that demand for access to the network by consumers depends not only

on the price of network access but it also depends on the value that consumers obtain (consumers' surplus) from using the network. While higher network access prices may, in theory, decrease the quantity of access consumed, the concomitant decrease in long distance price will increase the quantity of access consumed. Empirical evidence suggests that, in net, we may well find that rebalancing leads to more consumers subscribing to the network.[20]

Q. IS THERE EMPIRICAL EVIDENCE THAT QUANTIFIES THE AMOUNT OF ECONOMIC BENEFIT THAT A REBALANCING PLAN CAN GENERATE?

A. Yes, there is empirical support. There have been several studies that have examined the welfare gains arising from rate rebalancing. One of the first studies found that, for the U.S. as a whole, the loss from overpricing long distance service to business and residential consumers in 1983 was around $10 billion, a finding that was confirmed in subsequent research.[21] More recent research confirms the significant gains in economic welfare that can be achieved from more economically rational prices. For example, a 2000 study by Robert Crandall and Leonard Waverman (a NERA colleague) found the total cost of the current rate design—i.e., lower basic local prices and higher long distance prices—to be anywhere between $2.5 to $7.0 billion per year, depending on the assumptions made.[22]

[20] *See,* Hausman, J., T. Tardiff, and A. Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *The American Economic Review*, Vol. 83, May 1993, pp. 178-184.

[21] *See*, John T. Wenders and Bruce L. Egan, "The Implications of Economic Efficiency for U.S. Telecommunications Policy." *Telecommunications Policy* 10 (1986): 33-40 and Lewis Perl, "Social Welfare and Distributional Consequences of Cost-Based Telephone Pricing." Paper presented at the Thirteenth Annual Telecommunications Policy Research Conference, Airlie, Va. April 23, 1985

[22] *See*, Robert Crandall and Leonard Waverman, *Who Pays for Universal Service?: When Telephone Subsidies Become Transparent*, Brookings Institute, (2000), p. 119.

V. COST ISSUES

Q. WHAT IS THE CORRECT COST CONCEPT TO USE FOR DETERMINING WHETHER A SERVICE IS RECEIVING AN ECONOMIC SUBSIDY?

A. From an economic perspective, use of forward-looking direct costs (economic costs as opposed to embedded or historical costs) is the proper basis for determining whether a specific service is in receipt of an economic subsidy. The embedded cost or historical cost of an activity is a record of the costs a firm attributes to the pursuit of its activity in a given (past) accounting period. That cost reflects what the firm actually paid for capital equipment,[23] its actual costs of operating and maintaining that equipment, and other costs incurred in operating the enterprise. By contrast, the economic cost of an activity is the actual forward-looking cost of accomplishing that activity in an efficient manner. In contrast to embedded costs, forward-looking costs are those associated with present and future uses of the firm's (or society's) resources. Only these forward-looking costs are relevant for making present and future production and investment decisions, for placing resources in alternative uses, and for setting efficient prices for the services to be provided presently or in the future.

According to the evidence presented by the companies, their residential basic local rates are below forward-looking direct costs and I conclude, therefore, that those rates are in receipt of an economic subsidy.

[23] Embedded costs also include the annual depreciation expenses associated with the stock of equipment that (1) was purchased in the current and previous years and (2) is still in use.

Q. THE COMPANIES' REVISED PLANS ARE BASED UPON THE FACT THAT THE LOCAL LOOP IS NOT A SHARED OR COMMON COST AND THAT ITS COST IS CAUSED SIMPLY BY PROVIDING CUSTOMERS ACCESS TO THE TELEPHONE SYSTEM AND CANNOT APPROPRIATELY BE SPREAD AMONG THE REMAINING TELEPHONE SERVICES. DOES THE FLORIDA COMMISSION AGREE WITH THIS APPROACH REGARDING THE LOCAL LOOP?

A. Yes, it does. In a report to the Florida Legislature in 1999, the Commission explicitly rejected the notion that the cost of the loop should be recovered from non basic local telecommunications service.[24] In that report, the Commission stated:

> Is the cost of local loop facilities properly attributable to the provision of basic local telecommunications service? By definition, yes. Section 364.02(2), Florida Statutes, defines "basic local telecommunications service as"
>
> > Voice grade, flat-rate residential and flat-rate single-line business local exchange services which provide dial tone, local usage necessary to place unlimited calls within a local exchange area, dual tone multi-frequency dialing, and access to the following emergency services such as "911," all locally available interexchange companies, directory assistance, operator services, relay services, and an alphabetical directory listing.

[24] *See*, "Report of the Florida Public Service Commission on the Relationship Among the Costs and Charges Associated with Providing Basic Local Service, Intrastate Access, and Other Services Provided by Local Exchange Companies, in Compliance with Chapter 98-277, Section 2(1), Laws of Florida," Florida Public Service Commission Tallahassee, Florida February 15, 1999.

Given such an identification of the cost object to be studied, the principle of cost causation leads one to the unavoidable conclusion that the decision to have local service leads to the incurrence of loop costs.[25]

VI. UNIVERSAL SERVICE WOULD NOT BE PUT AT RISK AS A RESULT OF THE COMPANIES' REVISED PLANS

Q. SHOULD THE COMMISSION BE CONCERNED ABOUT UNIVERSAL SERVICE?

A. While it is true that, in theory, as the price of basic local service increases, some consumers may decide the new price is above the value he or she places on the service—and may, as a result, decide to do without telephone service—I do not believe that, in practice, this would occur, or occur to such an extent as to jeopardize universal service in Florida. There are several reasons why I believe this is the case.

First, although low-income subscribers may be more sensitive to price increases than are middle and higher income users, the Tele-Competition Act does two things to help low income consumers. It provides that, in the event of an increase in residential basic local service prices, low-income consumers who are Lifeline customers will be exempted from the price increase; and, it expands the number of Lifeline-eligible customers to 125 percent of the federal poverty level. These steps should go far to address any problems of affordability.

[25] *Ibid*, at 51.

Second, the price elasticity of demand for access to the network is quite low, meaning that the vast majority of consumers will continue to subscribe. Specifically, the price elasticity of demand measures the percentage impact on demand given a percentage change in price. Previous research has demonstrated that customers generally do not disconnect their phone service when prices for basic local service increase.[26]

Third, and very importantly, in addition to its own price, the demand for residential basic local service is determined by the amount of value consumers obtain from using the services produced by the network, i.e., local calling, intraLATA toll, interLATA toll, vertical services and newer services such as broadband Internet access. As prices for these services decrease over time due to competitive pressure and technological innovation, the value that consumers place on having access to the network increases and so, therefore, does their demand to stay on the network.[27] The companies' revised plans call for rate increases phased in over a two year period and to the extent that prices for complementary goods decrease so will consumers' desire to remain on the network increase. This helps reduce, or may even offset, the negative effect of the price increase.

Finally, as discussed above, less distorted prices should provide better incentives for competitors to compete for residential consumers. Competition brings with it improved quality, different selection of goods and services bundled together in a way that customers find attractive, and lower prices. These factors provide additional reasons why during the

[26] *See,* Lester D. Taylor, (1994), *op. cit.*

[27] Hausman, J., T. Tardiff, and A. Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *The American Economic Review*, Vol. 83, May 1993, pp 178-184.

phase-in period, customers will likely place increased value on subscribing to the network, thus mitigating the effects of any local rate increase.

To the extent the Florida Commission is concerned with the few remaining users who may decide to drop off the network it is also important to be aware that alternatives to the fixed network are growing and at least some customers may be turning to alternative means of meeting their communications needs. For example, the extraordinary growth of wireless service, driven by lower wireless prices and pricing plans that include a "bucket" of minutes provides customers with more meaningful opportunities to use wireless service as a substitute to wireline service.

Q. SHOULD THE COMMISSION BE CONCERNED IF CUSTOMERS DROP OFF THE FIXED NETWORK BUT INSTEAD RELY PRIMARILY ON OTHER FORMS OF ACCESS?

A. No. An important goal for policymakers has been to ensure that as many consumers as possible have access to the public switched telecommunications network, irrespective of how that access is obtained. When a customer drops off the fixed-line network and accesses the public network via wireless access, this is simply a substitution effect caused by the customer choosing between fixed and wireless access. This is not a universal service concern for policymakers.

Q. DR. GORDON, HAVE OTHER STATES IMPLEMENTED RATE REBALANCING?

A. Yes, there are other states that have implemented rate rebalancing including California, Illinois, Ohio, and in Massachusetts where I served as Chairman. Even in Maine, where

by statute basic residential services are to be set as low as possible and where I also served as Chairman, they have recently approved a rebalancing plan.

Q. WOULD YOU PLEASE DESCRIBE THE RATE REBALANCING PROCESS IN MASSACHUSETTS?

A. The process for changing prices in Massachusetts began before I became Chairman of the Massachusetts Commission and continued during my tenure. In Massachusetts, residential fixed monthly charges were increased significantly, with offsetting decreases in business, toll, and carrier access prices. The Massachusetts Commission early on after divestiture recognized the problems that historic pricing policies were creating, as other (especially institutional) barriers to market entry were being eliminated, and thus ordered a change in price structure:

> "properly defined incremental costs should be used as the primary basis for pricing all services, including local exchange service .. to the extent that current rates do not reflect an appropriate allocation of costs, the [MDPU] will, consistent with the need to avoid major discontinuities in rate levels, move toward that goal." IntraLATA Competition, D.P.U. 1731 (1985), p. 36-38.

> "Traditionally, the pricing of telephone service was based on a method whereby residential monthly exchange rates were priced below cost in order to promote universal service; and long-distance, toll, and business rates were priced above cost in order to subsidize residential exchange rates. While this system succeeded in serving a social purpose, it was a pricing scheme not conducive to the development of a fully-competitive market, in which the benefits associated with competition would be realized by all customers."

NET, D.P.U. 93-125 (1994), pp. 10-11.

In Massachusetts, moving prices more in line with incremental costs required a significant shift in revenue recovery from usage-based prices, such as intraLATA toll and intrastate carrier access, to fixed monthly prices for all classes of customers. In addition, because the MDPU found that there were no significant cost differences in serving different classes of customers, the price-rebalancing process also entailed a further shift in revenue recovery from business customers to residential customers. Of course, the necessary changes were not made overnight. The MDPU established a series of annual, revenue-neutral, price-rebalancing investigations in order to achieve its goal over time.

When the Massachusetts price-rebalancing process ended in January of 1994 (with the adoption of a price cap plan), the price for basic residential dial-tone service (1MR) had risen from about $3.00 per month in 1990 to $9.91 per month in 1994 (net of the SLC).[28] Comparable increases also occurred for residential flat-rate service (1FR), which was the most popular service in Massachusetts, at that time. Flat rate residential prices had ranged from $9.95 in rural areas to $12.38 in urban areas. The rebalancing process moved flat rate residential prices to $16.85 state wide. During this period, the average increase for residential consumers was $2.18 per year over four years and, according to the DTE, record evidence shows virtually no impact on residential telephone subscriber penetration.[29] Because the price-rebalancings were revenue-neutral, these increases were

[28] I was Chairman of the MDPU for the last of these annual investigations.

[29] *See*, "Re Verizon New England, Inc. dba Verizon Massachusetts D.T.E. 01-31-Phase II," *Public Utilities Reports – 223 PUR4th*, p. 397.

completely offset by decreases in prices for other services, notably residential and business intraLATA toll and carrier switched access.

Massachusetts was one of the first states to open toll and local markets to competitive entry, and the price rebalancing helped to lessen opportunities for uneconomic bypass and thus promoted the development of an efficient competitive process.

More recently, Massachusetts has continued to better align prices with their underlying costs by reducing switched access and increasing residential dial-tone rates. Specifically, the DTE authorized the ILEC to implement a one-time increase of $2.44 to its residential dial-tone line charge. In commenting on its decision, the DTE stated:

> Moreover, the department finds that with the $2.44 increase in the dial-tone line charge, competitive local exchange carriers (CLECs) can profitably enter and serve the residential telephone market in Massachusetts.[30]

The DTE concluded that a $2.44 increase will not harm the Department's universal service goals, based on similarity to the several, annual $2.18 increase in the early 1990s rebalancing plans and comparable increases in several other states and in the Federal subscriber line charge since 2000. For example, the Maine PUC approved a $1.78 increase in Verizon's basic monthly per line rate in May 2001 and the New York Public Service Commission authorized a two-year Incentive Plan which permitted an increase of $1.85 on March 1, 2002 and another $0.65 on March 1, 2003 for a total increase of $2.50 in the space of a year. The FCC's Federal subscriber line charge has increase from $4.35

[30] *Ibid*, p. 361.

in July 2000 to $6.50 in July 2003.

Q. PLEASE DISCUSS MAINE'S EXPERIENCE WITH RATE REBALANCING?

A. Significant rate rebalancing has been achieved in Maine in recent years, with no noticeable impact on telephone subscribership levels. In 1997, the Maine legislature (M.R.S.A. 35-A, §7101-B) directed the Maine Public Utility Commission to establish, notwithstanding any other provision of state law, intrastate access rates that are less than or equal to interstate access rates established by the FCC (*i.e.*, parity with interstate access rates) by May 30, 1999. At the time, Bell Atlantic's intrastate access rates were $0.26 per minute, significantly higher than its then-current Federal interstate access rate of about $0.07 per minute.

Subsequently, on March 17, 1998, the Commission approved an Order (Docket No. 94-123 reopened) that approved a stipulation between Bell Atlantic-Maine (now known as Verizon-Maine) and a group of intervenors, including the Commission's Advocacy Staff and the Public Advocate. This stipulation allowed Bell Atlantic-Maine to increase its basic local exchange rates by a total of $3.50 by May 30, 1999, with steps of $1.50 in 1998 and $2.00 in 1999. This was followed by another increase of $1.78 in 2000.

Maine continues to have the highest telephone penetration rate in the country—about 98 percent of Maine's households have telephone service.[31] In addition, lower intrastate toll rates have benefited some customer classes, especially those customers in rural areas with relatively small toll-free calling areas.

[31] MPUC Annual Report 2002, pp. 43.

Q. WHAT OTHER STATE EXPERIENCES DO YOU BELIEVE ARE RELEVANT?

A. In California in 1994, the Commission approved a rebalancing plan for GTE and Pacific Bell. GTE's residential rates immediately went from $9.75 to $17.25 while Pacific's residential rates went from $8.35 to $11.25.[32] Recently, as part of a rebalancing plan for Sprint's local telephone company in Ohio where intrastate access fees were lowered to mirror Federal charges, the Commission approved the creation of an end user charge of $4.10 for residential customers and $6.00 for single-line business.[33]

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

[32] *See*, Decision 94-09-065, *et. al.*, September 15, 1994.

[33] *See*, The Public Utilities Commission of Ohio, Case No. 00-127-TP-COI and 01-1266-TP-UNC, June 28, 2001.

ATTACHMENT A

ATTACHMENT B

FIGURE 1 – PERCENT OF CLEC LINES SOLD TO RESIDENTIAL AND SMALL BUSINESS CUSTOMERS BY STATE, AS OF DECEMBER 31, 2002

SOURCE: FCC, *Local Telephone Competition: Status as of December 31, 2002*