

DOCKET NO.: 030867-TL - [Petition by Verizon Florida Inc. to reform intrastate network access and basic local telecommunications rates in accordance with Section 364.164, Florida Statutes]

DOCKET NO.: 030868-TL - [Petition by Sprint-Florida, Incorporated to reduce intrastate switched network access rates to interstate parity in revenue-neutral manner pursuant to Section 364.164(1), Florida Statutes]

DOCKET NO.: 030869-TL - [Petition for implementation of Section 364.164, Florida Statutes, by rebalancing rates in a revenue-neutral manner through decreases in intrastate switched access charges with offsetting rate adjustments for basic services, by BellSouth Telecommunications, Inc.]

WITNESS: **Direct Testimony of Gregory L. Shafer,**
Appearing on Behalf of Staff

DATE FILED: October 31, 2003

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DIRECT TESTIMONY OF GREGORY L. SHAFER

1 |
2 | Q. Would you please state your name and address?

3 | A. Gregory L. Shafer, 2540 Shumard Oak Blvd., Tallahassee, Florida 32399-
4 | 0850.

5 | Q. By whom are you employed and in what capacity?

6 | A. I am employed by the Florida Public Service Commission, Division of
7 | External Affairs, as a Senior Analyst in the Office of Federal and Legislative
8 | Liaison.

9 | Q. What are your current responsibilities as a Senior Analyst?

10 | A. I presently function as a legislative analyst on telecommunications
11 | matters preparing bill analyses and representing the Florida Public Service
12 | Commission before the Florida Legislature on telecommunications matters. I
13 | also prepare and present analyses on various federal issues including national
14 | legislation as needed and Federal Communications Commission issues.

15 | Q. Please summarize your educational and professional background.

16 | A. I have a Bachelors degree in Economics from the University of South
17 | Florida and a Masters degree in Economics from Florida State University.

18 | My professional experience includes two years as a Field Economist with
19 | the U.S. Department of Labor, Bureau of Labor Statistics. I have been
20 | employed by the Florida Public Service Commission since September 1983. I
21 | spent five plus years in the Division of Communications in various capacities,
22 | the final two years as Supervisor of the Economics Section. My
23 | responsibilities primarily focused on policy development in the areas of
24 | Access Charges, Long Distance Service, Cellular telephone interconnection, and
25 | Shared Tenant Services. While working in the Division of Communications, I

1 testified in the Interexchange Carrier Rules docket and in the A.T. & T.
2 Waiver Request (forbearance) docket.

3 I spent approximately 10 years as Bureau Chief of the Bureau of Special
4 Assistance in the Division of Water and Wastewater and have testified in
5 several water and wastewater cases on the calculation of margin reserve. I
6 also testified on ratesetting policy in the Southern States (now known as
7 Florida Water Services, Inc.) rate case, Docket No. 950495-WS.

8 For the last four and a half years I have worked primarily on
9 telecommunications issues, first in the Division of Policy Analysis and
10 Intergovernmental Liaison and currently in the Division of External Affairs.

11 Q. What is the purpose of your testimony in this proceeding?

12 A. The purpose of my testimony is to provide the Commission with additional
13 information and perspectives on petitions filed by BellSouth, Sprint, and
14 Verizon (the Companies) in relation to the criteria established in Section
15 364.164, subsection (1)(a-c), Florida Statutes.

16 Q. Please describe the proposed implementation schedule of intrastate access
17 charge reductions and revenue neutral basic local service increases.

18 A. As proposed, all three companies elected to file simultaneously and their
19 implementation schedules are identical. Each company has proposed to
20 implement the intrastate access charge reductions and basic local service rate
21 increases in three steps over a 24 month period from the first change to the
22 final change. This will make it substantially easier for long distance
23 carriers in Florida to develop rate reductions that will apply to all of their
24 respective Florida customers served by BellSouth, Sprint and Verizon
25 simultaneously. While the statute addresses some aspects of required rate

1 | reductions by long distance carriers, it lacks specificity on timing,
2 | frequency and scope. By implementing access charge reductions simultaneously
3 | for Sprint, Verizon and BellSouth, it will be easier for long distance
4 | carriers to pass along those savings through rate reductions in fewer
5 | installments, across a broader geographic area.

6 | Q. What are the proposed incremental rate increases for basic local exchange
7 | service for each of the companies?

8 | A. BellSouth has two different methods to implement the proposed increases.
9 | The first method implements the increase in two equal increments of \$1.25 in
10 | the first quarters of 2004 and 2005 and a final increment estimated at \$1.00
11 | in the first quarter of 2006. The second method would implement an increase
12 | of \$1.39 in the first quarter of 2004, \$1.38 in 2005 and the estimated
13 | remainder of \$1.09 in 2006.

14 | Verizon proposes two equal increments during the same time frame in 2004
15 | and 2005 of \$1.58 and a final increment of \$1.57 in 2006.

16 | In conjunction with BellSouth and Verizon, Sprint proposes increases of
17 | \$2.95 in 2004, \$2.75 in 2005 and a lesser increase of \$1.16 in 2006.

18 | Q. How do the basic local service increases for Sprint compare to those for
19 | BellSouth and Verizon?

20 | A. As proposed, Sprint's total increase in residential flat-rate basic local
21 | service rates as a result of reducing intrastate access charge rates to parity
22 | with interstate access rates is \$6.86 compared to \$3.50 or \$3.86 for BellSouth
23 | and \$4.73 for Verizon. The incremental increases proposed by Sprint of \$2.95
24 | for 2004 and \$2.75 for 2005, are approximately 86% and 75% greater
25 | respectively, than those proposed by Verizon over the same period. The

1 primary reason for this disparity is that Sprint's intrastate access charge
2 rates are significantly higher than those of BellSouth. Consequently, the
3 impact of reducing these rates to parity with interstate access rates is
4 greater on the local service rates for Sprint's customers than either
5 BellSouth's customers. While Verizon's intrastate access rates are comparable
6 to Sprint's they have a greater number of access lines over which to spread
7 recovery. In addition, Sprint has elected to place a greater percentage of
8 the total revenue impact in the first two stages of the rate changes than in
9 the third, while BellSouth and Verizon have distributed the rate changes more
10 evenly over the transition period. Solely from a consumer equity perspective,
11 I would argue that Sprint's rate adjustments should be implemented through at
12 least one more step than those for BellSouth and Verizon. While this will add
13 additional administrative costs for Sprint and for the long distance carriers
14 in Sprint's territory, it will put Sprint's residential customers more on par
15 with those of BellSouth and Verizon in terms of the amount of the increase
16 they receive at any one time.

17 Q. Does the statute address rate shock mitigation or define reasonable rate
18 impact?

19 A. No, the statute does not directly address or define reasonable rates or
20 rate shock. However, the statute provides for a transition period for the
21 access charge and basic local service rate adjustments of not less than 2
22 years and not more than 4 years. One can reasonably infer that by providing
23 a transition period for implementation of the access charge reductions and
24 basic local service rate increases, the Legislature recognized the need to
25 mitigate the impact to consumers via a transition period rather than a one-

1 | time change in rates. Therefore, I believe the statute recognizes the concept
2 | of rate shock or rate reasonableness. Along those lines, had the Legislature
3 | envisioned that it was necessary to achieve access parity in thirteen months
4 | or 24 months or some other finite period, they could easily have established
5 | those time frames in the statutory language. By providing the range of not
6 | less than 2 and not more than 4 years as an implementation schedule, I believe
7 | the Legislature recognized the need to provide a transition path to temper
8 | rate impacts on consumers. It also seems reasonable that the determination
9 | of the appropriate implementation schedule for each company would not rest
10 | solely at the discretion of the Companies.

11 | Q. If Sprint were to extend its access reductions and basic local service
12 | increases by an additional step beyond those of BellSouth and Verizon, do you
13 | believe it would be appropriate for Sprint to extend its implementation
14 | timetable to 36 months?

15 | A. Yes. In addition, I believe it would be appropriate for Sprint to time
16 | its reductions in concert with BellSouth and Verizon for the first 24 months.
17 | Then Sprint would implement one more incremental rate adjustment 36 months
18 | after the initial adjustment in order to complete its transition to parity.

19 | Q. Please describe the characteristics that you believe might address the
20 | statutory criteria of inducing enhanced market entry.

21 | A. While no specific statutory guidance is provided for that particular
22 | criterion, I believe there are a number of ways to evaluate whether the
23 | petitions filed by BellSouth, Sprint, and Verizon will lead to enhanced market
24 | entry. The obvious first indication of induced market entry would be an
25 | increase in the number of market participants in any given market area.

1 | Another possible standard would be an expansion of consumer choice. That
2 | expanded choice may take the form of new competitors but may also be reflected
3 | in the form of new bundled service offerings by existing providers and/or
4 | nontraditional choices such as wireless or VoIP.

5 | Q. What would be the basis for competitors choosing to enter markets they had
6 | previously elected not to enter?

7 | A. I think the primary factor for a competitor to consider is whether they
8 | will be profitable in the foreseeable future in any particular market.
9 | However, many other factors influence market entry decisions other than the
10 | cost/price relationship for a particular service. In this case, the
11 | theoretical underpinnings of the statute are that the cost/price relationships
12 | for intrastate access charges and basic local service rates are seriously
13 | misaligned. More simply put, the Legislature subscribed to the notion that
14 | access charges subsidize basic local rates, or that access charge rates far
15 | exceed cost and basic local service rates are on average below cost. To the
16 | degree that basic local service rates are below cost, that is a significant
17 | deterrent to market entry for that particular service.

18 | Q. Is the removal of the alleged subsidy flowing from access charges to basic
19 | local service rates sufficient to induce more market participants for basic
20 | local service?

21 | A. There are strong theoretical reasons to believe that the proposed changes
22 | to intrastate access charges and basic local service rates will improve the
23 | level of competition in many markets. As noted previously, profitability is
24 | the main determinant of market entry to provide an individual product. The
25 | challenge of making a profit in a market in which a key product is priced

1 | below cost is clearly a deterrent to entry. Removing or reducing the degree
2 | of any subsidy will also remove or reduce the significance of that deterrent.

3 | Q. Testimony in this case suggests that the subsidy flowing from intrastate
4 | access charges to basic local service rates does not comprise the total amount
5 | of subsidy of basic local service rates. If this is true, does this mean that
6 | removing the alleged intrastate access charge subsidy will not be effective
7 | in inducing enhanced market entry?

8 | A. Not necessarily. Many products cannot be viewed in isolation, and I
9 | believe basic local exchange access is one of those services. Basic local
10 | exchange service is a gateway product, if you will. By that I mean it
11 | provides access to an array of other products or services that cannot stand
12 | alone or have no value without local exchange access. For example, services
13 | such as caller ID, long distance service, or dial-up Internet access are
14 | unavailable to consumers without local exchange service. In addition, these
15 | types of services are discretionary: that is, one particular customer may base
16 | his purchase decision solely on the price of local exchange service while
17 | another customer may base her decision on the price of a group of services
18 | together, including local exchange service. Thus, the price of local exchange
19 | service is a critical element for competitors to consider when choosing
20 | whether to enter a particular market but is not the only factor. The
21 | profitability of these other services also plays a role in the market entry
22 | decision. This phenomenon also explains why some residential competition
23 | persists even in light of the evidence that basic local exchange service on
24 | its own is priced below cost on average. Since telecommunications competitors
25 | rarely compete only for basic local exchange service, and since some

1 | competitors are already in the market. I believe the improvement of the
2 | cost/price relationship for basic local exchange service as reflected in the
3 | Companies' petitions will be a signal to competitors that the potential for
4 | profitability is improved. As a result of the proposed changes, one can
5 | reasonably expect that there will be additional market entry, particularly in
6 | markets that may have previously been only marginally profitable or slightly
7 | unprofitable. I would not view the petitions as deficient or necessarily
8 | ineffective on the basis that the entire alleged subsidy of basic local
9 | service has not been eliminated by the proposals.

10 | Q. Will the improved cost/price relationships for intrastate access charges
11 | and basic local exchange service induce enhanced market entry across all
12 | markets in Florida?

13 | A. There may be many ways to identify markets within each of the petitioning
14 | companies' service territories. However, for the sake of discussion I will
15 | assume that the local exchange is the relevant market area. Under that
16 | assumption, I do not believe that the proposed changes will induce additional
17 | market entry in all markets if by that you mean additional competitors. This
18 | is true primarily because the cost of providing basic local exchange service
19 | can vary dramatically between exchange areas. There will very likely be
20 | exchange areas in each company's service territory where the cost to provide
21 | basic local service is still significantly above its price and this will
22 | remain a barrier to entry in those exchange areas. I would expect this to be
23 | true in the least densely populated exchanges in particular.

24 | Q. Previously you mentioned that a variety of factors besides profitability
25 | would impact the decision of competitors to enter a particular market. What

1 | might some of those factors be?

2 | A. Business plans vary among providers of like products or services, and
3 | businesses adapt and adjust their plans to changing circumstances including
4 | technological changes, capital market factors, and short and long term profit
5 | horizons. There is more for a competitor to consider than the prices another
6 | competitor can charge for a particular service.

7 | Telecommunications service is costly to provide on a facilities basis
8 | due to the required investment in infrastructure. A facilities-based carrier
9 | must consider economies of scope and scale or the ability to attain enough
10 | customers in the relevant market to support the investment in infrastructure.
11 | The cost of customer acquisition is also significant when you are attempting
12 | to challenge a long-time sole provider of a product or service.

13 | In the case of providers that resell service or lease facilities from
14 | underlying carriers, the cost structure may differ but the cost of customer
15 | acquisition remains significant. Even in that case there are administrative
16 | costs for billing, customer service, management, etc.

17 | Competitive local exchange carriers also have the luxury and ability to
18 | be selective in the markets they serve in order to maximize their opportunity
19 | for profitability.

20 | Finally, demographics play a role in a decision to enter the market.
21 | Factors such as population density, age, and income in a particular market
22 | influence whether competitors will choose to provide goods and services.

23 | Q. Do the petitions as proposed address any of the factors you mention?

24 | A. The petitions focus exclusively on correcting inefficiencies in the
25 | cost/price relationships of intrastate access charges and basic local exchange

1 | service. While this is a significant factor in determining whether
2 | competitors will enter the exchange access market, it is by no means the only
3 | factor.

4 | I should note that the petitions are limited to what the incumbent local
5 | exchange companies are permitted to do by the statute in terms of the tools
6 | at their disposal. I would not view the petitions as deficient on the basis
7 | that they do not address factors other than the cost/price relationships of
8 | intrastate access charges and basic local exchange service. These issues and
9 | factors lie outside the statutory framework and petitioners are not required
10 | by the statute to address them.

11 | Q. You previously mentioned expanded customer choice as a way to view
12 | enhanced market entry. Please explain what you are referring to.

13 | A. One of the characteristics of a competitive market is that consumers are
14 | presented a variety of choices for a particular product. Products may not be
15 | identical but are essentially the same. Each competitor attempts to gain a
16 | portion of the market by differentiating its product in some way. Automobiles
17 | are a good example of product differentiation. You can distinguish your
18 | automobile purchase through seemingly endless variations in color, size,
19 | upholstery type, transmission type, horsepower, fuel efficiency, etc. Each
20 | year it seems, some automaker dreams up a new option in an attempt to attract
21 | new customers.

22 | The telecommunications market exhibits similar characteristics albeit
23 | to a lesser degree. In recent years, wireless communications carriers have
24 | developed a method of product differentiation based on pricing. Wireless
25 | carriers have provided calling options that treat local, intrastate long

1 distance, and interstate long distance minutes as identical depending on the
2 rate plan that is most attractive to individual consumers. In so doing they
3 have revolutionized telecommunications pricing and created a product desirable
4 to wireline and wireless customers alike. The response by wireline
5 telecommunications providers such as BellSouth, Sprint, and Verizon is that
6 they have each developed calling plans along similar lines as the wireless
7 companies.

8 Q. Is approval of the Companies' petitions likely to provide benefits to
9 residential consumers regardless of whether more competitors enter the market?

10 A. In my opinion achieving parity between intrastate access charges and
11 interstate access charges will lead to more competitively priced bundled
12 service offerings for residential consumers, which will provide benefits to
13 those consumers whose calling patterns match those offerings.

14 It should be noted that most wireless companies, through their
15 interconnection agreements, pay both inter- and intrastate access charges on
16 the relevant traffic. Since bundled service offerings are the mainstay of
17 wireless pricing and a competitive influence on wireline pricing, I would
18 expect that wireless pricing offerings will incorporate this cost reduction
19 and BellSouth, Sprint, and Verizon and IXCs will respond in a like manner.

20 Q. Do you believe that wireless is a significant substitute for wireline
21 service?

22 A. While I would not argue that wireless service is a perfect substitute for
23 wireline service, evidence suggests that a significant number of consumers use
24 wireless service to substitute for wireline long distance service. The FPSC
25 has for some time, commissioned consumer surveys through the University of

1 | Florida, Bureau of Economic and Business Research. That survey data for the
2 | period January 2003 through September 2003, indicates that more than 30% of
3 | residential consumers surveyed in that period most often used a wireless phone
4 | for long distance service. I believe this is because of the pricing strategy
5 | employed by wireless carriers that treats long distance minutes the same as
6 | local minutes.

7 | Q. Do you believe that all residential consumers will benefit from the
8 | changes proposed in the Companies' petitions?

9 | A. I doubt that all residential consumers affected by the proposed rate
10 | changes will experience the benefits of increased competition and additional
11 | service offerings. However, it is likely that there will be a significant
12 | number of residential consumers that will see benefits in expanded choice and
13 | new and innovative services.

14 | The survey data noted above also indicated that 88% of residential
15 | consumers surveyed had sought some type of lower cost long distance
16 | alternative (dial around, prepaid calling card, time of day, etc.). I believe
17 | the survey data, at a minimum, demonstrates that residential consumers will
18 | shop around for lower long distance prices. Armed with that knowledge, it is
19 | hard to imagine that Sprint, BellSouth and Verizon, along with the IXC's that
20 | serve in their territories, will not respond in some manner in an attempt to
21 | lure residential long distance consumers back to their networks.

22 | However, there will also be a segment of the residential customer base
23 | that will most likely see only rate increases and little or no benefit due to
24 | their individual calling patterns and location.

25 | Q. The prefiled testimony of Mr. Carl Danner (Verizon, page 21, lines 8-18)

1 suggests that the proposed rate changes will make the use of broadband
2 services more ubiquitous. Do you agree with Mr. Danner?

3 A. I do not see a direct impact of the proposed petitions on the broadband
4 market. However, if and when basic local service rates are increased, the
5 relative attractiveness of high speed data service improves as an alternative
6 for those consumers that are Internet users already. This would be
7 particularly true for consumers currently devoting a second basic local access
8 line to Internet use. Digital Subscriber Line service permits use of a single
9 access line for both voice and data service. BellSouth, Sprint, and Verizon
10 charge for each service individually or combined into bundled service
11 offerings which offer modest discounts if a consumer also accepts a variety
12 of add-on services (such as caller ID, three-way calling, call forwarding and
13 discounted long distance service). Only those consumers that have a demand
14 for data service will likely be incented to migrate to the higher priced
15 product. I do not really view a result that leads to some consumers migrating
16 to a higher priced service as a positive competitive outcome for consumers,
17 even if that service has the advantage of greater versatility. In the long
18 run, that may create a more vigorous battle for broadband customers, but I can
19 not reach that conclusion with any degree of certainty at this time.

20 Q. Do you believe increased competition will ultimately lead to lower
21 residential basic local service rates?

22 A. The premise under which the Legislature passed the Tele-competition Act
23 is that basic local service rates are subsidized by intrastate access charges.
24 To the degree that competition leads to prices that reflect true cost, it is
25 hard to envision competition leading to local service rates that are as low

1 | as the current, allegedly subsidized, rates. The only possible scenario that
2 | could produce that outcome is a reduction in the cost of providing basic local
3 | service due to new or improved technology for local loops or "last mile"
4 | interconnection. I do not believe that innovation will be driven by the
5 | desire to provide plain old telephone service. Rather, as telecommunications
6 | technology becomes more data oriented, I believe competitors will focus on
7 | providing high speed data service that will in turn provide access to
8 | desirable services such as streaming audio and video, as well as voice. Voice
9 | will become a single component of a range of possible services that the
10 | infrastructure will support. If that is the case, it seems unlikely that
11 | rates for traditional wireline basic local service, as a stand alone service,
12 | will be forced back to current levels through increased competition.

13 | Q. Does this conclude your testimony?

14 | A. Yes.

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