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REBUTTAL TESTIMONY OF DR. KENNETH GORDON

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

November 19, 2003

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1 **REBUTTAL TESTIMONY OF DR. KENNETH GORDON**

2

3 **I. PURPOSE & SUMMARY OF CONCLUSIONS**

4

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

6 A. My name is Dr. Kenneth Gordon. My business address is One Main Street, Cambridge,
7 Massachusetts 02142.

8

9 **Q. ARE YOU THE SAME DR. GORDON THAT FILED TESTIMONY IN THIS**
10 **PROCEEDING ON SEPTEMBER 30, 2003?**

11 A. Yes, I am.

12

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

14 A. Verizon Florida Inc., BellSouth Telecommunications, Inc., and Sprint-Florida Inc., (“the
15 companies”) have asked me to review the direct testimonies of Dr. David J. Gabel and Dr.
16 Mark N. Cooper and to provide rebuttal testimony.

17

18 **Q. WHAT ARE YOUR GENERAL OBSERVATIONS FROM REVIEWING THESE**
19 **WITNESSES TESTIMONIES?**

20 A. These witnesses share an outdated view of the telecommunications market, one that sees
21 incumbent local exchange carriers (“ILECs”) as monopoly providers that face little
22 competition and that are constrained only by the fist of regulators. These witnesses
23 ignore the importance of the type of pricing reform to better reflect industry conditions
24 being proposed by the companies and advance old arguments using the same type of
25 pricing policy (e.g. residual telephone pricing) that prevailed in the industry at the time

1 when there was only one provider of telecommunication services that operated in an
2 exclusive franchise territory.

3 These views and positions are simply inconsistent with the current market environment.
4 ILECs operate in increasingly competitive markets where they are not the only providers
5 of telecommunication services. CLECs are able to provide telecommunications services
6 without regulatory intervention and competitors are using alternative technologies to
7 provide traditional telephony service—be it through coaxial cable, wireless or increasingly
8 Internet-based voice services. Nevertheless, these competitors face a serious problem in
9 competing with firms whose prices are set at artificially low levels. In spite of this, many
10 customers have choices and are increasingly exercising those choices.

11 The companies' rebalancing proposals recognize this new environment, as does the
12 TeleCompetition and Innovation Act of 2003 ("The Act") passed by the Florida
13 Legislature. Competition can only succeed and be as broad based as economically
14 feasible if the old vestiges of telecommunications pricing are done away with.
15 Specifically, the historic policy of pricing residential network access as low as possible
16 (residual telephone pricing) and of supporting companies through a complex set of
17 implicit support mechanisms is reducing the amount of competition for residential
18 consumers and is providing reduced incentives for CLECs to enter the market and serve
19 these customers.

20 The opinions of CLECs in this proceeding are particularly revealing since they are putting
21 their shareholders' money at risk by providing competitive telecommunications services
22 in Florida. They are in the best position to state whether the companies' plan would have
23 any impact on their incentive to enter new markets. Contrary to the position of Dr. Gabel,
24 Knology, a competitive local and long distance telephone company, believes the

1 companies' plan should be granted because it will "enhance the competitive choices
2 available to Florida citizens."¹ AT&T and its witnesses make the same point.²

3

4 **Q. WOULD YOU PLEASE SUMMARIZE YOUR MORE SPECIFIC**
5 **DISAGREEMENTS WITH DR. GABEL AND DR. COOPER?**

6 A. Yes. There are two major disagreements that I have with these witnesses. The first deals
7 with their position or implication that basic residential service is not receiving a subsidy;
8 while the second deals with the argument that the companies' plan will not result in a
9 more attractive market for the benefit of residential consumers.

10 Both positions are erroneous. Dr. Cooper uses the same old argument that he has
11 previously used in Florida, that is the cost of the local loop is a common cost of providing
12 telecommunications services and the pricing of other services, such as intraLATA toll or
13 exchange access services, should be set so as to recover a portion of loop costs. I describe
14 below why this is economically incorrect and remind the Commission of its own report
15 where it specifically (and correctly) rejected this way of viewing the costs of the local
16 loop.³

17 Dr. Gabel uses a somewhat different approach to achieve his goal of removing many of
18 the loop costs from the direct cost of residential network access. As described below, Dr.

¹ Testimony of Felix L. Boccucci, Jr. on Behalf of Knology of Florida, Inc. p.3.

² Direct Testimony of John W. Mayo on Behalf of AT&T Communications and MCI Worldcom Communications, October 31, 2003, p. 12.

³ 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.

1 Gabel begins with the economic definition of TSLRIC but then misapplies it to basic
2 residential service. Dr. Gabel's approach incorrectly defines the service in question by the
3 nature of the customer rather than correctly defining it according to the nature of its
4 production. The service that is being "costed" for purposes of this proceeding is network
5 access—i.e., the service that consists of all the costs associated with providing a customer
6 with dial tone service, irrespective of the type of customer. Network access most certainly
7 has a direct cost associated with it and that direct cost appropriately includes all the costs
8 of achieving it, including the support structures mentioned in Dr. Gabel's testimony—i.e.,
9 telephone poles, trenches, ducts, conduits, etc. They are all direct costs of network access.

10 The second major disagreement I have with Dr. Gabel is his contention that the
11 rebalancing plans will not enhance market entry. I have already mentioned that perhaps
12 the most important parties in this proceeding that can attest to what the plans are likely to
13 mean for actual and potential market entrants are the competitors who believe that the
14 companies' plans to rebalance rates will lower an important barrier to market entry.

15 Moreover, I do not think it is necessary for this Commission to resolve the debate about
16 what changes in telecommunications regulation will do more for local competition,
17 reforming pricing as the companies' plans do, or other actions that Dr. Gabel seems to
18 suggest—such as reducing UNE prices. The Legislature specifically mentioned the role
19 of retail pricing as a tool to enhance market entry and that is the tool that the Commission
20 should examine irrespective of whether other reforms might also have an impact on
21 residential competition.

22 Finally, I also discuss why it is perfectly consistent to say that the companies' plans will
23 enhance market entry while at the same time acknowledging that the investment decision
24 of a firm is based on comparing total revenues and total costs. Holding all other factors

1 constant, a rebalancing plan that better aligns prices with costs and lowers the support
2 needed from other services will reduce the risk of providing telecommunications service
3 and this will make the cash flow equation more positive for CLECs interested in targeting
4 residential consumers.

5

6 **II. THE LOCAL LOOP IS NOT A SHARED COST OF RESIDENTIAL**
7 **BASIC SERVICE OR A COMMON COST OF**
8 **TELECOMMUNICATIONS SERVICES**

9

10 **Q. DR. GABEL (SECTION 3) ARGUES THAT THE COMPANIES' POSITION**
11 **THAT THERE IS A SUBSIDY IN THE PROVISION OF LOCAL SERVICE IS**
12 **FLAWED BECAUSE THE COMPANIES INCORRECTLY USE TELRIC AS THE**
13 **COST STANDARD AND ASSUME THAT THE ENTIRE COST OF THE LOCAL**
14 **LOOP IS A DIRECT COST OF BASIC RESIDENTIAL SERVICE. DR. COOPER**
15 **(AT 3) ARGUES THAT THE LOOP IS A COMMON COST OF BASIC**
16 **RESIDENTIAL LOCAL SERVICE. HOW DO YOU RESPOND?**

17 A. The intervenors are incorrect. Economic theory and this Commission's own position
18 contradict their position that the local loop is anything other than a direct cost of providing
19 network access to consumers, irrespective of whether that customer is a residential or
20 business customer. Once it is established that the local loop is not a shared cost of basic
21 service it becomes evident that basic residential services are not recovering fully their
22 forward-looking direct costs.

23

1 Q. HAS THIS COMMISSION STATED PREVIOUSLY THAT THE LOCAL LOOP
2 IS NOT A SHARED COST OF BASIC SERVICE AND THAT ALL THE COSTS
3 ASSOCIATED WITH PROVIDING BASIC SERVICE SHOULD BE
4 RECOVERED FROM BASIC SERVICE?

5 A. Yes. As stated in my Amended Direct Testimony (at 36), in a report to the Florida
6 Legislature in 1999, the Commission explicitly rejected the notion that the cost of the loop
7 should be recovered from non-basic local telecommunications service.⁴ In that report, the
8 Commission stated:

9 Is the cost of local loop facilities properly attributable to the provision of basic
10 local telecommunications service? By definition, yes. Section 364.02(2),
11 Florida Statutes, defines “basic local telecommunications service as”

12 Voice grade, flat-rate residential and flat-rate single-line business local
13 exchange services which provide dial tone, local usage necessary to
14 place unlimited calls within a local exchange area, dual tone multi-
15 frequency dialing, and access to the following emergency services such
16 as “911,” all locally available interexchange companies, directory
17 assistance, operator services, relay services, and an alphabetical
18 directory listing.

19

⁴ 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.

1 Given such an identification of the cost object to be studied, the principle of cost causation
2 leads one to the unavoidable conclusion that the decision to have local service leads to the
3 incurrence of loop costs.⁵

4
5 **Q. BUT DR. GABEL (AT 30) STATES THAT HIS APPROACH IS CONSISTENT**
6 **WITH THE COMMISSION'S DETERMINATION BECAUSE "WHEN THE**
7 **COST OF THE RESIDENTIAL BLTS LOOP IS ESTIMATED, COSTS SHARED**
8 **WITH OTHER SERVICES, SUCH AS SPECIAL ACCESS, DATA AND**
9 **BUSINESS BLTS, SHARED COSTS SHOULD NOT BE TREATED AS A DIRECT**
10 **COST." HOW DO YOU RESPOND?**

11 A. Dr. Gabel argues that the companies have performed their cost studies for basic residential
12 incorrectly because they consider the costs of equipment such as ducts, trenches and poles
13 as incremental to basic service when in reality in many instances they are shared between
14 residential, business, DSL and ISDN. Dr. Gabel begins with the economic definition of
15 TSLRIC but then misapplies it to basic residential service. He states that TSLRIC is
16 determined by examining the change in the total cost of producing telecommunications
17 when a service is added (or discontinued). He further states that if basic residential
18 service were no longer provided the company would still need to incur the costs of ducts,
19 trenches, poles, cabinets, etc. From this he concludes that these costs would not be
20 included in a theoretically pure TSLRIC study.

⁵ *Ibid*, at 51.

1 The problem with Dr. Gabel's approach is that it is based on an unrealistic implementation
2 of TSLRIC. It is dependent on conducting a thought experiment that bears no
3 resemblance to what a real world incumbent telephone company would ever conceive of
4 doing. In order to be useful and relevant for business decision-making and for regulatory
5 purposes, TSLRIC calculations should be consistent with realistic business practices and
6 decisions. They should not be based on hypothetical situations that are unlikely to arise.

7 According to Dr. Gabel's TSLRIC interpretation, if the incumbent telephone company no
8 longer provides residential service—presumably because the residential population just
9 disappeared—this means that there would be little reason for businesses to locate to where
10 they are because there would be much less demand for business services. In fact, the
11 location of businesses is tied to the location of residential customers in a given serving
12 territory. It is then illogical to assume that if residential customers vanished there would
13 still be the same number of businesses or that they would locate in the same geographic
14 area.

15 Even if we were to carry this argument out a bit further, one would have to reach the
16 conclusion that the network built for serving only business customers would likely be
17 significantly different from the current network. Not only because business locations
18 would likely change but technology choices may change as well. But this invalidates the
19 thought experiment that is Dr. Gabel's basis for measuring TSLRIC. This is the case
20 because when one examines the impact of ceasing to offer residential service, the change
21 in total costs resulting from Gabel's thought experiment is not meaningful; the network
22 would have to be vastly re-engineered and re-configured.

23 Fortunately, it is not necessary to engage in this type of hypothetical analysis, as there is a
24 more straightforward and practical way of implementing the TSLRIC standard.

1

2 **Q. PLEASE DESCRIBE THE CORRECT WAY OF IMPLEMENTING THE TSLRIC**
3 **STANDARD IN THIS PROCEEDING?**

4 A. Dr. Gabel's approach incorrectly defines the service in question by the nature of the
5 customer rather than by the correct way of defining it according to the nature of its
6 production. The service that is being "costed" for purposes of this proceeding is network
7 access, i.e., the service that consists of all the costs associated with providing a customer
8 with dial tone service—irrespective of the type of customer. Network access most
9 certainly has a direct cost associated with it and that direct cost appropriately includes all
10 the costs of support structures mentioned in Dr. Gabel's testimony—i.e., telephone poles,
11 trenches, ducts, conduits, etc. They are direct costs of network access. In order to arrive
12 at the average direct cost of residential or business basic service one would take the direct
13 cost of network access and add other direct cost (if any) that are specific to business or
14 residential customers.

15

16 **Q. DR. COOPER (AT 17) ARGUES THAT THE LOOP IS A COMMON COST OF**
17 **TELECOMMUNICATIONS SERVICE. PLEASE EXPLAIN WHY YOU**
18 **BELIEVE THAT LOOP COSTS ARE NOT A COMMON OR SHARED COSTS?**

19 A. First, it is important to note that Dr. Cooper's arguments are the same arguments that he
20 has been making for years before this Commission. As I mentioned above, this
21 Commission has clearly rejected Dr. Cooper's view that the loop is a common cost of
22 telecommunications service.

1 Nevertheless, I will repeat, briefly, the arguments against Dr. Cooper's position. While it
2 is correct that the local loop is necessary in order to provide various telecommunications
3 services—such as network access (dialtone), intraLATA and interLATA usage and
4 vertical services—the cost of the local loop only varies in relation to changes in the
5 demand for network access and not in relation to changes in the demand for other
6 telecommunications services. Thus, it stands as a separate service. For example, when
7 the demand for toll services increase, a telephone company may need to augment capacity
8 on its switches and transmission routes but this would not increase the number of local
9 loops that it serves or the costs of operating those loops. Because of this fact, in a
10 forward-looking direct cost study for toll services—the investment and expenses
11 associated with the local loop would be excluded. On the other hand, when the demand
12 for network access increases (i.e., dialtone), a telephone company would need to incur the
13 costs associated with adding additional local loops, and these costs would be part of a
14 forward-looking direct cost study for network access.

15 This concept is best captured in the following quote by Alfred E. Kahn and William B.
16 Shew:

17 ...does subscriber access have a separate identifiable incremental cost
18 associated causally with providing it? The answer is, unquestionably, yes.
19 Connecting a customer to the network uses scarce resources, even if he or she
20 never uses the connection. The customer who subscribes to two access lines

1 imposes a greater cost on the system than the customer who subscribes to one,
2 even if they make the same number of calls, at the same times and places.⁶

3

4 **III. THE REBALANCING PLAN WILL PROVIDE INCREASED**
5 **INCENTIVES TO ENTER RESIDENTIAL MARKETS**

6

7 **Q. DR. GABEL SPENDS A GOOD PORTION OF HIS TESTIMONY (SECTION 3.3)**
8 **ARGUING THAT THE REBLANCING PLAN WILL NOT LIKELY STIMULATE**
9 **ENTRY. DR. COOPER (AT 12) MAKES A SIMILAR POINT. HOW DO YOU**
10 **RESPOND?**

11 A. I describe below some of the economic flaws in Dr. Gabel's arguments. I would like to
12 start off, however, by pointing to the testimony of CLECs in this proceeding which argue
13 —contrary to the view of Dr. Gabel or Dr. Cooper—that less support for basic
14 telecommunications service will in fact provide increased entry incentives. The
15 importance of these testimonies is that they present the viewpoint of the parties in this
16 proceeding who are actually putting shareholder money on the table.

17 For example, Knology of Florida, Inc. through the Testimony of Felix L. Boccucci, Jr.
18 believes that the companies' plans will have a positive impact on Knology's ability to
19 provide services in Florida. Mr. Boccucci states:

⁶ See, Alfred E. Kahn and William B. Shew, "Current Issues in Telecommunications Regulation: Pricing," *Yale Journal on Regulation*, Vol. 4(2) Spring 1987.

1 If these petitions are granted, Knology will be able to attract and deploy new
2 capital investment in Florida, thereby offering consumers a choice in facilities-
3 based providers for new and advanced high-tech services.⁷

4 Moreover, Mr. Boccucci states:

5 Knology believes that the petitions filed in these dockets should be granted,
6 because that decision will help to implement the policy underlying 364.14, and
7 it will enhance the competitive choices available to Florida citizens.⁸

8 In addition, Professor John W. Mayo on behalf of AT&T and MCI Worldcom
9 Communications states:

10 Higher prices relative to cost provide greater inducements for entry. In this
11 regard, the historical practice of residual pricing of local exchange services in
12 Florida has contributed to an environment that is relatively unattractive for
13 market entry.⁹

14

15 **Q. DR. GABEL (AT 34-35) DISPUTES YOUR CLAIM THAT “THE LEGISLATURE**
16 **HAS PERCIEVED THAT LOW RESIDENTIAL BASIC LOCAL PRICES HAVE**
17 **LED THE RESIDENTIAL LOCAL EXCHANGE MARKET TO BE LESS**
18 **ATTRACTIVE TO COMPETITORS THAN WOULD BE THE CASE WITH**

⁷ Testimony of Felix L. Boccucci, Jr. on Behalf of Knology of Florida, Inc. p.9.

⁸ *Id.* At 3.

⁹ Direct Testimony of John W. Mayo on Behalf of AT&T Communications and MCI Worldcom Communications, October 31, 2003, p. 12.

1 MORE ECONOMICALLY RATIONAL RESIDENTIAL BASIC LOCAL
2 PRICES.”¹⁰ HOW DO YOU RESPOND?

3 A. My assertion comes from a fair reading of the Act. While the Legislature was free to
4 consider all the reasons that may impact competition—including some of the reasons
5 mentioned by Dr. Gabel—it chose to include the following: “current support for basic
6 local telecommunications services that prevents the creation of a more attractive
7 competitive local exchange market for the benefit of residential customers.” This leads
8 me to conclude that the Legislature was persuaded that the current system of support for
9 basic local services is preventing the creation of a more attractive residential competitive
10 market as directly reflected in the Act.

11

12 Q. DR. GABEL (AT 37-38) POINTS OUT THAT YOUR COMPARISON OF
13 FLORIDA RATES VS. THE NATIONAL AVERAGE IS MISLEADING AND IS
14 COMPARING APPLES TO ORANGES; AND THAT WHEN THE THREE
15 MAJOR CITIES IN FLORIDA (MIAMI, TAMPA AND WEST PALM BEACH)
16 ARE COMPARED TO THE NATIONAL AVERAGE, FLORIDA’S RATES ARE
17 NOT AS LOW AS YOU IMPLY. HOW DO YOU RESPOND?

18 A. Even if Dr. Gabel’s methodology of comparing residential prices in Florida urban cities
19 with residential prices in U.S. urban cities is accepted, it still leads to the conclusion that
20 Florida prices are below the national average. For example, the average residential flat-
21 rate price for the 95 cities is \$23.38 while the same rates in West Palm Beach, Miami and

¹⁰ Direct Testimony of Dr. Kenneth Gordon on Behalf of Verizon Florida, Inc; BellSouth Telecommunications, Inc; and Sprint Florida Inc. Before the Florida Public Service Commission, August 27, 2003, pages 10-11.

1 Tampa are \$19.41, \$20.24 and \$22.45, respectively.¹¹ Every one of the Florida cities has
2 rates below the national average. This is true even though, based on Dr. Gabel's own data
3 (discussed below), it seems that Florida is a more costly state to serve than states such as
4 Michigan and Illinois which have higher residential rates.

5

6 **Q. DR. GABEL DISPUTES YOUR SUGGESTION THAT THE DIFFERENCE IN**
7 **ENTRY IS ATTRIBUTABLE TO THE UNREASONABLE RATE STRUCTURE**
8 **IN FLORIDA. WHEN COMPARING ILLINOIS TO FLORIDA HE STATES, "IT**
9 **CERTAINLY CAN NOT BE THE RATE OF RESIDENTIAL BLTS...THE PRICE**
10 **OF RESIDENTIAL BLTS IS ESSENTIALLY THE SAME IN THE [SIC]**
11 **ILLINOIS AND FLORIDA." HOW DO YOU RESPOND?**

12 A. Dr. Gabel is incorrect and his own data should have led him to the correct conclusion.
13 Dr. Gabel's Table 1 compares Florida, Illinois and Michigan in terms of residential rates
14 and UNE prices. From that he concludes that a more "plausible explanation for the
15 comparative lack of CLEC entry in Florida vis-à-vis Illinois is that Florida's UNE prices
16 are not as conducive to profitable CLEC entry into the market as the UNE prices found in
17 Illinois."

18 What Dr. Gable fails to note, however, is that average costs in Illinois and Michigan are
19 significantly lower than costs in Florida, according to the UNE prices set by the different
20 Commissions. That is, in principle UNE prices reflect the underlying cost of providing

¹¹ FCC Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service, Table 1.1 July 2003, rates include Federal and State subscriber line charges, touch tone charge and taxes, 911 and other charges.

1 service and Dr. Gabel's data show that Florida is a more costly environment in which to
2 operate than the other states he chose to look at. According to Dr. Gabel's Table 1, costs
3 in the metro area are only \$2.59 in Illinois compared to \$9.77 in Florida and \$8.47 in
4 Michigan. Florida is the more costly state to serve yet Dr. Gabel's own data show that
5 prices in Florida are below those in Illinois and Michigan.

6 Table A in Exhibit I reproduces Dr. Gabel's Table and shows the margins available to
7 CLECs in Florida, Illinois and Michigan in the metro areas using UNE-L, assuming that
8 the remaining usage costs to provide service are comparable among the three states. As
9 can be seen, Table A indicates that—contrary to Dr. Gabel's assertion—the rate structure
10 in Florida can be impacting entry in Florida vis-à-vis other states such as Illinois and
11 Michigan. The margins available to CLECs in Florida in the metro areas are significantly
12 less than the margins available to CLECs in Illinois and Michigan due to a higher cost
13 structure in Florida and a lower rate structure.

14

15 **Q. DR. GABEL (AT 39-40) ARGUES THAT THE REASON THAT FLORIDA**
16 **RANKS LOWER THAN OTHER STATES IN LOCAL COMPETITION MAY**
17 **HAVE MORE TO DO WITH THE PRICING OF UNES AND UNE-P THAN**
18 **RETAIL RATES. HOW DO YOU RESPOND?**

19 A. Dr. Gabel has not conducted a study to demonstrate that the reduction of UNE-P or UNE-
20 Ls has an impact on local competition or that it has a greater impact than establishing
21 more efficient retail rate structure. The point is a red herring because even if it were to be
22 shown that reductions in UNEs favorably impact competitors that does not take away
23 from the fact that a more efficient rate structure can also spur competition. The

1 Legislature specifically identified the inefficient retail rate structure as a tool to use in
2 enhancing market entry. It did not—although it was free to do so—identify the issues
3 mentioned by Dr. Gabel. The issue of whether artificially low UNE-P has more or less of
4 an impact on enhancing market entry is not relevant to the Commission’s decision. It is
5 simply a red herring meant to distract from the issue at hand.

6 Moreover, relying too heavily on UNE-P to enhance market entry is bad public policy if
7 one ever hopes to achieve facilities based competition. Finally, such changes should not
8 be made at a time when the states are in the process of implementing the Triennial Review
9 Process, which may lead to the eventual elimination of unbundled switching.

10

11 **Q. DR. GABEL (AT 46) ARGUES THAT THE ENTRY DECISIONS OF CLECS ARE**
12 **BASED ON A COMPARISON OF TOTAL REVENUE FROM ALL SERVICES**
13 **WITH THE TOTAL TSLRIC OF ALL SERVICES AND THAT THE**
14 **COMPANIES’ APPROACH OF EXAMINING JUST THE COST AND REVENUE**
15 **OF BASIC SERVICE IS FLAWED. IS HE CORRECT?**

16 A. The correct entry decision for a firm deciding whether to enter a given market is an
17 examination of total costs and total revenues achievable from the investment and
18 calculation of the present value of the cash flows generated by the investment. However,
19 Dr. Gabel is incorrect in suggesting that the companies’ examination of one component of
20 that equation—the price of residential BLTS—is flawed or irrelevant. It is certainly not
21 irrelevant for the following reasons.

22 The entry decision of any firm is based on an evaluation of the net cash flows generated
23 by the investment; naturally this includes all costs and all revenues associated with the

1 investment. This is basic economics so in that sense it is hard to disagree with Dr. Gabel's
2 assertion. However, this has no bearing on the issue before the Commission in this
3 proceeding: whether removing support will make for a **more** attractive marketplace for
4 residential consumers. Holding all other factors constant, a rebalancing plan that better
5 aligns prices with costs and lowers the support needed from other services will reduce the
6 risk of providing telecommunications service and will make the cash flow equation more
7 positive for CLECs interested in targeting residential consumers. A cash flow analysis
8 requires a risk-adjusted cost of capital in order to discount cash flows over time and a
9 lower cost of capital makes investment projects more attractive compared to a higher cost
10 of capital.

11 Given that residential basic service is being supported by other services—as the
12 Legislature correctly noted—the support provided by those other services can continue
13 only to the extent that competitive alternatives are not sufficiently robust to drive those
14 service prices to their underlying costs. That is, if rates are not rebalanced and driven to
15 more cost-based levels it will be other service's revenues that are used to support
16 residential basic services. But those revenues are only an uncertain and temporary tool,
17 and as competition and other technologies advance, the ability to use them to support
18 basic residential services is likely to become limited. The risk of providing
19 telecommunications services is higher when a firm is dependent on support from other
20 services than when all prices are more reflective of underlying costs.

21 A rate structure that more adequately aligns prices with costs and reduces the amount of
22 support from other services should be more attractive to CLECs—as CLECs have attested
23 to in this proceeding. CLECs would not be dependent on the proliferation of other
24 services as a source to support basic residential services, thus lowering the risks of

1 providing telecommunications services. These factors would be reflected in a properly
2 conducted cash flow analysis.

3

4 **Q. DR. GABEL (AT 49) ARGUES THAT REBALANCING MAY NOT LEAD TO**
5 **ANY INCREASE IN CLEC INCENTIVE TO ENTER BECAUSE WHILE THE**
6 **PRICE OF ONE SERVICE INCREASES, THE PRICE OF OTHER SERVICES**
7 **WILL DECREASE. HOW DO YOU RESPOND?**

8 A. For the reason discussed above, even if there were no net change in revenue, the risk of
9 providing telecommunications services would decrease, thus positively impacting a CLEC
10 entry-decision model.

11 In addition, it is correct that in a cash flow analysis, a CLEC would want to include the
12 revenues and costs (profits) that are earned from selling intrastate access services and a
13 reduction in intrastate access rates would, holding other factors constant, lower the
14 attractiveness of the local market. However, the CLEC's intrastate access prices are not
15 directly affected by the companies' plan. CLEC intrastate access charges are not
16 regulated. In fact, terminating intrastate access services are the services whose prices are
17 being reduced by the companies' plan because originating rates are much lower. And it is
18 on the terminating side that CLECs arguably are less constrained by the incumbent
19 companies' terminating rates.

20 While the companies' intrastate access prices are being reduced significantly, no such
21 requirement exists for the CLECs. The CLECs will now be able to charge higher
22 residential basic local prices but not have a concomitant reduction in their intrastate access

1 prices. This will have a positive impact on CLECs' incentive to target residential
2 customers.

3

4 **Q. DR. GABEL (AT 43) CRITICIZES A PAPER THAT YOU CITE THAT SHOWED**
5 **A POSITIVE RELATION BETWEEN RATE REBALANCING AND**
6 **RESIDENTIAL COMPETITION. HOW DO YOU RESPOND?**

7 A. Dr. Gabel questions the paper because it does not use cost information but rather attempts
8 to rank the differences in the level of rate distortion by examining the ratio of business to
9 residential prices. As with any empirical study, when the ideal variable is not available (in
10 this instance cost information) proxies must be used, and the use of a ratio between
11 business and residential prices can reveal useful information about the extent that prices
12 are distorted in the different states. The history of residual residential telephone pricing in
13 the U.S. reveals that several sources have been used to support residential services and
14 that one of those sources has been business service. Businesses tend to be located closer
15 to the central office than residential customers yet business prices tend to be higher than
16 residential. In fact, in the paper the authors found that the average ratio of monthly
17 business to residential prices was approximately 2.89.¹² So the use of examining this ratio
18 across the different states to determine how the states rank in terms of one component of
19 the distorted rate structure is justified.

¹² Agustin J. Ros and Karl McDermott, "Are Residential Local Exchange Prices Too Low? Drives to Competition in the Local Exchange Market and the Impact of Inefficient Prices," p. 160, in Michael A. Crew Ed., *Expanding Competition in Regulated Industries*.

1 Moreover, some of Dr. Gabel's criticisms of the paper are off point. For example, Dr.
2 Gabel states that when explaining the variation in the number of CLECs assigned
3 numbering codes in each state, the authors do not control for the size of the state. But an
4 examination of the equation shows that the authors used Gross State Product for the
5 industries finance, insurance and real estate. Surely, this variable is highly related to "size
6 of the state." Dr. Gabel continues by stating that the authors fail to control for 47 U.S.C. §
7 251 exemption to rural carriers of unbundling requirements. However, the authors used
8 data from the RBOCs, GTE and Sprint, none of which received a rural exemption. Dr.
9 Gabel also incorrectly assumes that the business and residential price ratio was uniform
10 throughout the state and that the study is based on aggregate state data when in fact the
11 rate data and other data were based on a weighted average for the RBOC, GTE and Sprint
12 in each state.

13 In summary, Dr. Gabel's criticisms of the study are off point. The paper was peer
14 reviewed and published in a book on competition in regulated industries that included a
15 range of academic and professional economists.

16 Finally, it is interesting that Dr. Gabel does not comment on the other paper I mentioned
17 in my testimony co-written by James Eisner (an FCC staff member) and Professor Dale E.
18 Lehman which supports the hypothesis that residential rates do matter for competition.¹³
19 Eisner and Lehman state in their conclusion:

¹³ 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.

1 ...in some specifications, there appears to be less competitive entry
2 (principally facilities-based) where residential rates are lower. These findings
3 are generally statistically significant at the 90% level.¹⁴

4
5 **Q. DR. GABEL (SECTION 4.3) SUGGESTS THAT PRICING BEHAVIOR IN OTHER**
6 **MARKETS SHOWS THAT FIRMS CAN PRICE COMPLEMENTARY**
7 **SERVICES LOW IN ORDER TO ATTRACT ADDITIONAL USAGE AND HE**
8 **CITES TO RAZOR BLADES AND TO WIRELESS PHONES AS EXAMPLES.**
9 **HOW DO YOU RESPOND?**

10 A. There are some differences between wireline telephony and the razor blade example.
11 While it is true that network access and usage are complementary services, it is also true
12 that they are separate standalone services that are demanded in their own right. For
13 example, a wireline customer could demand network access services on a stand-alone
14 basis without ever having an interest in usage. That is not the case with razor blades and
15 razors because both are required in order to be of use to customers; without the blade the
16 razor is of no value, and vice versa. The service in question is the razor **and** the razor
17 blade and one would expect that in competitive markets a razor company would recover
18 fully the incremental costs of the razor and razor blade through the sales of both.
19 Moreover, both the wireless and razor example that Dr. Gabel uses involve a form of
20 locking customers into a set technology that makes it costly to switch to competitors. For
21 example, once a consumer obtains a certain razor or cellular phone, they cannot be used

¹⁴ *Ibid.*, p. 25.

1 with other competitors services. That is, I cannot use my Gillette Mach 3 razor with the
2 Schick Quattro razor blades. Nor can I use my VoiceStream cell phone with Verizon's
3 wireless service. The same does not apply with wireline service. I can use the same loop
4 to access a different long distance company or, in the case of UNE-L and UNE-P, I can
5 use the same loop to access a different LEC.

6 This lock-in of technology permits a company like Gillette to price the razor below cost
7 (at times giving the razor away) and recover that loss by pricing the razor blade above
8 incremental cost. There is no standalone competition that would force the price of the
9 razor blade down to incremental cost. If there were, this pricing strategy would not be
10 sustainable. In telephone, one cannot price network access below incremental cost in the
11 hope of recovering the loss through higher usage prices because there is standalone
12 competition for usage—and other services that support network access—that drives usage
13 prices down to incremental costs. Therefore, there are significant differences in the
14 examples that Dr. Gable mentioned and wireline telephony service.

15 Finally, Dr. Gabel fails to mention that razor or wireless companies choose to market their
16 product in such a manner; they are not required to do so. In this proceeding, Dr. Gabel
17 presumably would force the companies to pursue a pricing strategy rather than permit
18 them to implement such a strategy only if it makes commercial sense to them. As
19 telecommunications markets continue to become increasingly competitive, this type of
20 micromanaging of pricing decisions is counterproductive.

21

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

23 A. Yes.

Exhibit I

Table A	Florida	Illinois	Michigan
Metro Residential Rates	\$20.70	\$21.31	\$26.91
Cost of service (UNE-L) Metro	\$9.77	\$2.59	\$8.47
Margin available	\$10.93	\$18.72	\$18.44

Source: Direct Testimony of Dr. David J. Gabel, Table 1