BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of

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. 030867-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. 030868-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.	DOCKET NO. 030869-TL
FLOW-THROUGH OF LEC SWITCHED ACCESS REDUCTIONS BY IXCs, PURSUANT TO SECTION 364.163(2), FLORIDA STATUTES.	DOCKET NO. 030961-TI

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VOLUME 13

PAGES 1531 THROUGH 1670

PROCEEDINGS: HEARING

BEFORE:	CHAIRMAN LILA A. JABER COMMISSIONER J. TERRY DEASON COMMISSIONER BRAULIO L. BAEZ COMMISSIONER RUDOLPH "RUDY" BRADLEY COMMISSIONER CHARLES M. DAVIDSON
DATE:	Friday, December 12, 2003
TIME:	Commenced at
PLACE:	Betty Easley Conference Center Room 148 4075 Esplanade Way Tallahassee, Florida
REPORTED BY:	LINDA BOLES, RPR Official FPSC Reporter (850) 413-6734
APPEARANCES:	(As heretofore noted.)

I N D E X

WITNESSES

EXHIBITS

NUMBER:		ID.	ADMTD.
77	Gabel A-2 through Gabel A-4	1537	1669
78	(Confidential) Gabel A-1	1537	1669

PROCEEDINGS

(Transcript continues in sequence from Volume 12.)

CHAIRMAN JABER: Okay. All right.

Public Counsel, Mr. Gabel -- are your witnesses sworn?

MR. BECK: No, they're not, Madam Chairman.

CHAIRMAN JABER: Let me ask both to stand, and Mr. Cooper as well. Mr. Gabel, Mr. Ostrander and Mr. Cooper.

(Witnesses collectively sworn.)

CHAIRMAN JABER: Thank you.

DAVID J. GABEL

was called as a witness on behalf of the Office of Public Counsel and, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. BECK:

Q Dr. Gabel, would you please state your name.

A David Gabel.

Q By whom are you employed?

A The Office of Public Counsel.

Q Who are you employed by otherwise?

A Oh, Queens, Queens College.

Q Okay.

CHAIRMAN JABER: And your real job.

COMMISSIONER DAVIDSON: It's refreshing to see an honest expert. Not that all the other experts haven't been

honest, just for sake of clarity in the record.
BY MR. BECK:
Q Did you file direct testimony in this case?
A I did.
Q And do you have any additions, deletions or corrections to that testimony?
A I do not.
Q Does your direct testimony have attachments?
A They do.
Q And there are four appendices to your testimony; is that right?
A Yes.
MR. BECK: Madam Chair, could we have Dr. Gabel's appendixes labeled as an exhibit? And in that exhibit there are some numbers that BellSouth claims to be confidential.
CHAIRMAN JABER: Okay. Let's see. Mr. Beck, I have four exhibits for Mr. Gabel. Am I looking at the wrong thing?
MR. BECK: Yes. There's four appendices. If you'd like them to be combined or not --
CHAIRMAN JABER: I can consolidate them?
MR. BECK: Yes.
CHAIRMAN JABER: Okay. Gabel A-1 through Gabel A-4 will be identified as hearing Exhibit 77. And are you saying it's a confidential exhibit?
MR. BECK: Yes. Appendix 1 has information BellSouth

claims to be confidential.

CHAIRMAN JABER: Okay.

MR. BECK: I believe that is the only one of the appendices that has confidential information.

CHAIRMAN JABER: Appendix A-1?

MR. BECK: Yes.

CHAIRMAN JABER: Then let me clarify. Appendix A-2 through A-4 will be given Exhibit 77. Exhibit 78 will be reserved for confidential exhibit Gabel A-1. All right?

MR. BECK: Yes.

(Exhibits 77 and 78 marked for identification.)

BY MR. BECK:

Q Dr. Gabel, if I were to ask you the same questions contained in your prefiled testimony, if I were to ask you those questions today, would your answers be the same?

A Yes.

Q And did you also file rebuttal testimony in this case?

A Yes.

Q Do you have any additions, deletions or changes to that testimony?

A No.

Q If I were to ask you the questions contained in your rebuttal testimony today, would your answers be the same?

A Yes.

MR. BECK: Madam Chairman, I'd ask that Dr. Gabel's direct and rebuttal testimony be inserted into the record as though read.

CHAIRMAN JABER: Prefiled direct testimony and prefiled rebuttal testimony of Dr. David J. Gabel shall be inserted into the record as though read.

1 1 INTRODUCTION AND WITNESS BACKGROUND

2

3 **Q. Please state your name and business address.**

4 A. My name is David Gabel. My business address is 31 Stearns Street,

5 Newton, Massachusetts 02459-2441.

6

7 **Q. On whose behalf are you appearing.**

8 A. I am appearing on behalf of the Office of Public Counsel (OPC).

9

10 **Q. Could you please summarize your qualifications and work**

11 **experience?**

12 A. Since obtaining my PhD in economics from the University of Wisconsin in

13 1987, I have been a member of the Department of Economics at Queens

14 College. I am also a Visiting Scholar in the Massachusetts Institute of

15 Technology Internet and Telecommunications Convergence Consortium in

16 Cambridge, Massachusetts, and a research fellow of the National Regulatory

17 Research Institute at the Ohio State University. Prior to my job at Queens

18 College, I was employed in both the public and private sectors.

19

20 As an employee of the Massachusetts Department of Public Utilities and the

21 Wisconsin Public Service Commission, I was involved in cost and rate analysis.

22 At the American Telephone and Telegraph Company (AT&T) I was responsible

for developing interfaces between engineering simulation models and financial forecasting systems. While an employee of Dean Witter Reynolds, my primary area of responsibility was evaluating the economics of different telecommunications products. As an employee of the Yadkin Valley Telephone Membership Cooperative, I was involved in plant installation.

During the past seven years, I have been an advisor to the Washington, New Mexico, and Maine public utility commissions, as well as the Federal Communications Commission (FCC). I have assisted these Commissions with the resolution of various issues that have arisen due to the passage of the 1996 Telecommunications Act. I have also been a consultant to various foreign governments on telecommunications matters.

Q. What is your area of academic research?

A. I specialize in the field of telecommunications. I have conducted research on a number of topics. My dissertation focused on the evolution of the telephone market in Wisconsin between 1894 and 1917. Beginning with my tenure as a member of the Staff of the Massachusetts Department of Public Utilities, and continuing with subsequent jobs at the Wisconsin Public Service Commission and the American Telephone and Telegraph Company, I have had a strong interest in measuring the costs of providing telecommunication services. After I completed my doctoral dissertation, I conducted further study in this area. This

work was partially funded by the National Regulatory Research Institute (NRRI). My curriculum vitae is attached to this testimony as Appendix 4.

I continue to spend a large share of my time exploring issues related to the cost function of the telecommunications industry. I am also an instructor at the National Association of Regulatory Commissioners (NARUC) summer training course held at Michigan State University each year. In addition, I was a co-author of two reports commissioned by the National Regulatory Research Institute on the FCC's Triennial Review Order. The first report developed an overview of the economic issues of impairment under the *Telecommunications Act* 1996, and the second provided a database and the means for estimating the costs of UNE-L (Unbundled Network Element Loop) supply on a granular basis. The reports have been disseminated to the members of the National Association of Regulatory Utility Commissioners (NARUC).

Q. Have you ever testified in a regulatory proceeding before?

A. Yes. I have testified before the Wisconsin, Maine, New York, Indiana, Maryland, Massachusetts, Connecticut, and the Pennsylvania Public Service Commissions, as well as the Canadian Radio and Television Commission.

Q. Have you previously submitted testimony in a Florida proceeding.

A. Yes, in Docket Nos. 981834-TP and 990321-TP on pricing of collocation elements, I submitted rebuttal testimony on behalf of the Staff of the Florida Public Service Commission on April 18, 2003.

2 OVERVIEW OF THE TESTIMONY

Q. What is the purpose of your testimony?

A. The purpose of this testimony is to:

- identify the germane policy and economic issues pertaining to the implementation of telecommunications law in Florida under Section 364.164 of the Florida Statute; and

- review the petitions of the ILECs for rebalancing of rates under this section.

Q. Can you summarize the most important issues addressed in your testimony.

A. Yes. Under the Tele-Competition Innovation and Infrastructure Act of 2003 ("the Act"), ILECs may petition the Commission to reduce intrastate access charges provided that any rate reductions are "revenue-neutral" when rebalanced

against the other rates charged by the ILECs. The commission has 90 days to issue a decision on each petition.

As set forth in Section 364.164 (1), Florida Statutes, the Commission is to consider certain criteria in reviewing companies' petitions filed pursuant to this section. Inter alia, the Commission is to consider whether granting the petitions will:

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

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).

It is the view of the Florida Office of Public Counsel (OPC) that the Commission should:

1) determine whether current prices support any form of BLTS to be rebalanced, especially residential BLTS, where the proposed rebalancings are concentrated;

2) if so, then whether this support acts to prevent the creation of a more attractive market for the benefit of residential customers; and

3) if so, then whether removal of the quantified support as proposed by the petition of the ILEC would create a more attractive market for the benefit of residential customers or whether the proposal should be rejected.

Q. Can you summarize the most important conclusions and recommendations of your testimony?

A. Yes, I have reviewed the petitions filed by Verizon, Sprint, and BellSouth to reform their intrastate network access rates and BLTS rates, and it is the position of the OPC that these petitions should not be approved by the Commission. The petitions do not provide adequate empirical evidence to support the ILECs' claims. In particular:

- The ILECs have not shown that residential BLTS is supported and therefore there is no record to support the proposed rebalancing. Thus, a

substantial rebalancing by raising residential BLTS rates cannot be justified by any claim that such support exists. Indeed, the CPC demonstrates in this testimony that it is highly unlikely that such support exists.

- The ILECs have not made a showing that the proposed reform of these rates would create a more attractive competitive local exchange market for the benefit of residential customers or enhance market entry or that entry will be enhanced because they fail to demonstrate support of residential BLTS which underpins most of their arguments on entry, and, in any case, their analysis is based on a model that no entrant would ever use, so is irrelevant. Moreover, any claims of benefits to consumers based on the removal or reduction of support of residential BLTS are moot, since no such support exists.

- The ILECs have not demonstrated that the proposed rebalancing would benefit or protect consumers.[1] Again any claims of benefits brought by elimination or amelioration of support of residential BLTS are irrelevant (since residential rates are not supported), and ILEC evidence beyond this on the impacts of the rebalancing is very limited.

[1] On protect see Section 364.01 (3) and (4) (a) and (c).

The economic and policy environment in the telecommunications sector is undergoing rapid and fundamental change. The development of more competitive telecommunications markets in the area of mobile services has revealed what economically efficient prices are likely to look like in telecommunications markets generally. Relative pricing patterns in these markets are in sharp contrast to the prices recommended by the ILECs.

The OPC, therefore recommends that rebalancing, if it occurs, should result in prices that reflect the operations of a competitive market, rather than prices that are sustainable due to a lack of competition.

3 EXISTING RATES PROVIDE NO OR VERY LITTLE SUPPORT FOR BASIC LOCAL TELECOMMUNICATIONS SERVICES

Q. Do the ILECs demonstrate residential BLTS is supported.

A. No. The ILECs contend that a service is subsidized or supported if it is priced below the economic cost of providing the service. The ILECs' cost measures are inappropriate for use as a test of whether residential BLTS is supported since their methodology is based on TELRIC instead of TSLRIC estimates. Costs shared by residential BLTS and business and data services, which are captured in the TELRIC estimates used by the ILECs, are not part of the TSLRIC of residential BLTS. As I point out below, the ILECs contend that

TSLRIC is the appropriate test for subsidization.[2] In addition, the ILECs approach understates the revenue per line from BLTS as their analysis excludes revenues relevant to residential BLTS, the higher Subscriber Line Charge (SLC) for additional lines.

Taking these factors into account, it is highly probable that current retail prices for residential BLTS alone exceed the direct costs of providing these services, and consequently current total revenues from residential services gained through supply of residential exchange lines exceed the TSLRIC of residential services supplied over residential exchange lines by even more.

Q. Can you explain what are the key reasons why cost estimates used by the ILECs to form the basis for their rate rebalancing recommendations are inappropriate?

A. Yes. The ILECs' cost measures are not valid for evaluating subsidization of BLTS. The ILECs' estimates of TSLRIC for residential BLTS substantially exceed actual TSLRIC costs since they rely on TELRIC-based estimates that include costs of the loop shared by residential, business, and data services which should not appear in a TSLRIC estimate. For example, TELRIC estimates for a UNE loop include trenching, conduit, poles, cable placement and similar costs

[2] I explain the difference between TSLRIC and TELRIC on Page 16.

that are largely, but not entirely, *shared* by business and data services.[3] Such shared costs cannot be part of the TSLRIC of residential BLTS.[4]

3.1 TSLRIC AND NOT TELRIC SHOULD BE USED TO EVALUATE THE LEVEL OF SUPPORT, IF ANY, PROVIDED TO BASIC LOCAL TELECOMMUNICATION SERVICES (BLTS) SINCE TELRIC OVERSTATES THE CONTRIBUTION OF SHARED COSTS TO BLTS

Q. Why should TSLRIC be used instead of TELRIC to evaluate whether or not BLTS is being subsidized.

A. TSLRIC, and not TELRIC, should be used since TSLRIC excludes shared costs that are included In TELRIC. Consistent with this, the Commission has previously required TSLRIC to be the cost standard to be used when evaluating the reasonableness of a rate.[5]

[3] These costs are largely, but not completely, shared as the presence of residential service might lead to increased investments that otherwise would not have occurred. See discussion at Page 18 below.

[4] It is my view that the TELRIC costs of a UNE loop, including the costs of the copper pair are further shared by BLTS, long distance services, ADSL services and any other service that uses the copper pair. However, we do not press this point in these proceedings.

[5] Florida Public Service Commission, Commission Order PSC-96-1579-FOF-TP, Page 25 (as cited in D. Daonne Caldwell, Direct Testimony on Behalf of BellSouth Telecommunications, Inc. Before the Florida Public Service Commission, Petition of BellSouth Telecommunications, Inc. to Reform Its Intrastate Network Access and Basic Local Telecommunications Rates in Accordance with Florida Statutes, Section 364.164, August 27, 2003, Page 6, Lines 10-17).

The FCC takes a similar view. For example, the FCC has noted that if the level of analysis is an individual rate element, then the appropriate cost metric is the TSLRIC. The FCC made this distinction between costing methodologies because there are many shared costs that are not relevant to the incremental cost of an individual rate element. Shared costs are only appropriately included in the cost analysis when the revenue from the shared services is simultaneously considered.[6]

Q. Do any of the ILECs' witnesses support the use of TSLRIC in determining whether BLTS is supported.

A. Yes. BellSouth Telecommunications, Inc. witness William Taylor takes this same position in the present proceedings.[7] Taylor has also previously testified on this matter for Verizon on determining if a service is subsidized. In Massachusetts, Dr. Taylor took the position that TSLRIC, not TELRIC, should be used to determine if dial-tone was subsidized. He said: "If we are going to have a price floor for, say, dial-tone line, my own understanding is that, to avoid cross-

[6] Federal Communications Commission, FCC 96-325, The First Report and Order In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 (CC Docket No. 96-98) and Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers (CC Docket No. 95-185), August 8, 1996, Paragraph 676-682, 695.

[7] William E. Taylor, Direct Testimony on Behalf of BellSouth Telecommunications, Inc. Before the Florida Public Service Commission, Petition of Sprint Florida Inc. to Reduce Access Rates, August 27, 2003, Page 13, Lines 7-17.

subsidy, we'd like to have TSLRIC," and not TELRIC or TELRIC minus joint and common costs.[8]

BellSouth Telecommunications, Inc.'s witness D. Daonne Caldwell also supports Taylor's argument in this proceeding, noting that: "TSLRIC studies are the basis for testing for cross-subsidization." She properly asserts that shared costs should be excluded from a TSLRIC study because the costs persist if one service is eliminated and a second service still requires the shared facility.[9]

Dr. Kenneth Gordon, representing all three ILECs, views support as occurring when forward-looking direct [emphasis added] costs of the service [emphasis added], not network element, are not covered.[10] Direct costs, by definition, do not include shared costs.

In summary, the testimony of these witnesses on the behalf of the ILECs is consistent with the Commission's rules and my support for use of TSLRIC to identify the level of support. Nevertheless, the ILECs effectively contradict their

[8] Massachusetts Department of Telecommunications and Energy (DTE), Price Cap Regulation for Verizon, DTE 01-31, Phase II, Volume 1, 10/22/02, Page 23.

[9] Caldwell, Page 8, Lines 9, 16-22.

[10] Kenneth Gordon, Direct Testimony on Behalf of Verizon Florida, Inc.; BellSouth Telecommunications, Inc.; and Sprint Florida Inc. Before the Florida Public Service Commission, Petition of Sprint Florida Inc. to Reduce Access Rates, August 27, 2003, Page 20, Lines 20-23, Page 21, Lines 1-4, and Page 34, Lines 1-17.

own witnesses by using TELRIC methodology to ascertain what they believe is the level of support for BLTS.

Q. Can you explain why TSLRICs are often lower than TELRICs.

A. The TSLRIC of a service that uses particular network elements is often lower than the network element's TELRIC. Incremental cost measures the cost avoided when a *service* is eliminated, while maintaining all other services.[11] It does not include any costs shared by services.[12] A service's TSLRIC is equal to the difference between the total forward looking long run costs of offering all services and the total forward looking long run cost of offering all services *except* the service in question.[13] A network element's TELRIC is the difference between

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[11] Stephen J. Brown and David S. Sibley, The Theory of Public Utility Pricing (Cambridge: Cambridge University Press, 1986), Page53.

[12] Caldwell, in her testimony on behalf of Bell South Telecommunications, Inc. agrees that TSLRIC does not include shared and common costs (Caldwell, *Ibid.*, Page 8, Line 9); and also Gordon, see footnote 10.

[13] Bell South Telecommunications, Inc. witness, Taylor agrees in testimony provided in Massachusetts: TSLRIC is calculated by "loo[k]ing at the costs of the entire firm, with and without a particular service." Massachusetts Department of Telecommunications and Energy (DTE), Price Cap Regulation for Verizon, DTE 01-31, Phase II, Volume 1, 10/22/02, Page 35.

A similar definition of TSLRIC was offered by the Commission in "we find TSLRIC should be defined as the costs to the firm, both volume sensitive and volume insensitive, that will be avoided by discontinuing, or incurred by offering, an entire product or service, holding all other products or services offered by the firm constant." Florida Public Service Commission, Order PSC-96-1579-FOF-TP, Before The Florida Public Service Commission In Re: Petitions by AT&T Communications of the Southern States, Inc., MCI Telecommunications Corporation, MCI Metro Access Transmission Services, Inc., American Communications Services, Inc. and American Communications Services of Jacksonville, Inc. for Arbitration of Certain Terms and Conditions of a Proposed Agreement with BellSouth Telecommunications, Inc. Concerning Interconnection and Resale Under the Telecommunications Act of 1996 (Docket No. 960833-TP, Docket No. 960846-TP, Docket No. 960916-TP), December 31, 1996, Page 26.

the total forward looking long run costs of supplying all network elements and the total forward looking long run cost of offering all network elements *except* the network element in question. The TELRIC cost estimate will include costs that are excluded from TSLRIC because TELRIC includes shared cost that are incurred in the provision of any two or more services that may use the element. These shared costs would be excluded from the TSLRIC of an individual service. In such cases, the TSLRIC of those services is lower than TELRIC because TSLRIC excludes shared costs that are included in TELRIC.

As an example, suppose an ILEC digs a trench along a road and places a cable into the trench that is shared by loops serving business and residential customers that subscribe to BLTS, as well as customers of data services. To estimate the (average) TELRIC of the local loop one would take the total cost of the trenching and the material and installation cost of the cable and divide it by the total number of loops in use. In contrast, to evaluate the (average) total long run incremental cost of residential BLTS (i.e., the TSLRIC of residential BLTS), one would ascertain the costs avoided by eliminating residential service while maintaining business and data services. This difference would be divided by the number of in-service residential lines. The absence of residential BLTS would not have an impact on the ILEC's trenching costs, and therefore the trenching cost should not be part of the TSLRIC of the loops used to provide residential

BLTS. Rather trenching is a shared cost of all services that have facilities running through the trench.[14]

Q. I understand that later you will provide specific cost estimates for residential BLTS TSLRIC (see Page 28 and Appendix 2), but for the present can you provide any general support for the proposition that the TSLRIC of a residential loop is likely less than the TELRIC for a loop?

A. Yes. Cost data generated by the Benchmark Cost Model (BCM) model is suggestive that the TSLRIC of residential service is approximately one-half of the TELRIC value.[15] BCM was developed by two of the three ILECs in this proceeding—Verizon and Sprint.[16]

3.2 THE ILECS USE TELRIC METHODOLOGY INSTEAD OF TSLRIC METHODOLOGY WHEN DEVELOPING THEIR COSTS OF SERVICE, AND THUS OVERSTATE THE COSTS OF PROVIDING BASIC LOCAL TELECOMMUNICATIONS SERVICE

[14] BellSouth witness Caldwell makes the same conceptual point when she argues that a license fee paid to a vendor that supports two or more services should be treated as a shared cost, and not as a component of the TSLRIC of the services. Caldwell Direct, Page 8, Lines 20-22.

The cable installation costs are also largely shared costs, and to the extent that the installation costs are not avoided when residential service is eliminated, they too should be excluded from the TSLRIC of residential service.

[15] David Gabel, Improving Proxy Cost Models for Use in Funding Universal Service, National Regulatory Research Institute (1996), Page 5.

Q. Can you demonstrate that BellSouth essentially relies on TELRIC estimates to incorrectly estimate TSLRIC?

A. Yes. BellSouth witness Caldwell indicates that BellSouth used its TELRIC data to estimate the TSLRIC of the local loop.[17] Caldwell claims that BellSouth Telecommunications, Inc.'s approach provides TSLRIC estimates,[18] because loop costs should not be treated as common costs, but are directly attributable to BLTS.[19] However, as explained above (Page 15), it is incorrect to assume that all loop costs are direct costs.

Caldwell also avers that a range of "direct costs required to promote and support retail services, e.g. billing, collections, marketing, sales, advertising and product management" should be included.[20] I only accept this, to the extent that these costs are shown to be incurred only and solely due to residential BLTS and that they would not be incurred otherwise, for example, if BellSouth Telecommunications, Inc. were to supply business and data services. BellSouth Telecommunications, Inc. do not demonstrate this.

[16] MCI and U S WEST also sponsored the development of the model.

[17] See especially Caldwell, *Ibid.*, Page 3, Lines 12-25, Page 4, Lines 1-22, and Exhibit DDC-3. In addition, the material investment passed from BSTLM to the BellSouth Cost Calculator were calculated using the BSTLM TELRIC methodology, Caldwell, Exhibit DDC-1.

[18] *Ibid.*, Page 6, Lines 10-19.

[19] *Ibid.*, Page 9, Lines 7-25, Page 10, Lines 1-13.

[20] *Ibid.*, Page 11. Quote from Lines 8-9; general point, Lines 8-18.

Q. Can you demonstrate that Sprint essentially relies on TELRIC estimates to measure TSLRIC.

A. Yes, witness Kent W. Dickerson, in his testimony on behalf of Sprint, indicates the method taken by Sprint in estimating the TSLRIC of BLTS:

> "Sprint is using the same cost studies that the Florida Public Service Commission approved in Docket No. 990649B-TP for Sprint's unbundled network element (UNE) prices [citation omitted]. Using the Commission-approved cost studies, Sprint deaveraged the investments to match the investments associated with R1 and B1 services. Since UNEs are sold to wholesale carrier customers, the UNE cost studies do not include any costs associated with retail functions. To appropriately account for the costs Sprint incurs to provide these services on a retail basis, the cost of retail service was added to the TSLRIC studies for R1 and B1 services."[21]

In short, Sprint's measure of TSLRIC takes the TELRIC estimate of a UNE loop and adds costs allegedly incurred due to retailing. However, the UNE loop TELRIC is a cost incurred jointly by a range of services including business lines, special access, and data services. Therefore, the cost estimate is biased upward because it includes shared costs.

Furthermore, some or all of Sprint's retail marketing costs may also be incurred jointly with the supply of other services beyond BLTS. More troublesome is Sprint's apparent assumption that the marketing, sales and product develop expenses are the same for residential BLTS as it is for data, business, and special access lines.[22]

Q. Can you demonstrate that Verizon essentially relies on TELRIC estimates to measure TSLRIC.

A. Yes. The testimony of Orville D. Fulp on behalf of Verizon in this proceeding indicates at least two flaws in Verizon's calculation of TSLRIC.[23] First, Verizon used its UNE rates to establish the cost of BLTS, and it avers that these rates "are a conservative estimate of the cost of provisioning basic local residential services because they do not reflect true TSLRICs."[24]

[21] Kent W. Dickerson, Direct Testimony on Behalf of Sprint Florida Inc., Before the Florida Public Service Commission, Petition of Sprint Florida Inc. to Reduce Access Rates, August 27, 2003, Page 3, Lines 15-25.

[22] Ibid., Page 7 of 7.

[23] Orville D. Fulp, Direct Testimony on Behalf of Verizon Florida Inc., Before the Florida Public Service Commission, Petition of Verizon Florida Inc. to Reform Its Intrastate Network Access and Basic Local Telecommunications Rates in Accordance with Florida Statutes, Section 364.164, August 27, 2003.

[24] *Ibid.*, Page 19, Lines 7-9, Page 20, Lines 9-11.

Second, Verizon's cost estimates include joint and common costs based on a common cost allocator of 12.11%.[25] This allocator should be excluded from a TSLRIC study since TSLRIC excludes all joint costs from being attributable to one service, and only includes costs that can be directly attributable to a service.

Q. Did the ILECs explain why they were using TELRIC as a proxy for TSLRIC?

A. Not to any significant degree. Expediency appears to have been a major factor. Verizon witness Fulp notes that given the time constraints of these proceedings the Commission has only 90 days to issue an order, and that therefore these previously developed rates would be adequate for the Commission's purposes. Witness Fulp argues that it would be less resource intensive and time consuming to analyze these rates previously approved by the Commission than to develop a new cost study.[26]

Q. Are time constraints a good reason for using TELRIC-based estimates of TSLRIC?

A. It is true that TELRIC estimates are more readily available than TSLRIC estimates, but this is no reason for not seeking to adjust these given the availability of data to do so. It would be untenable to rely on unadjusted TELRIC

[25] *Ibid.*, Page 21, Lines 1-3.

[26] *Ibid.*, Page 19, Lines 18-21 and Page 20, Lines 18-21.

costs when, for example, I will demonstrate that the BellSouth state-wide TSLRIC of residential BLTS is approximately half of a TELRIC-based estimate.[27] This result is consistent with data generated by the ILECs' own Benchmark Cost Model (see Page 18). Even if my own conservative estimates, or those of the Benchmark Cost Model, contain errors, they are unlikely to be over 100% off, which would have to be the case for the TELRIC-based estimates to be more accurate.

Q. You stated that you would estimate the TSLRIC of residential BLTS using BellSouth's cost model. Would you explain how BellSouth's model works?

A. Yes. First, in my response I will only address the operation of BellSouth's loop model. I concentrate on that model because the overwhelming portion of the ILEC cost estimates for BLTS are associated with the loop.[28]

The BellSouth Model estimates the forward-looking economic cost of its loop network and then uses a series of fully distributed cost mechanisms to assign the loop network cost to each service. The loop network is designed to provide all of the services that BellSouth offers, including local residential, single line business,

[27] My conclusion is based on working with intermediate output data from BellSouth's loop model. Based upon my knowledge of the cost structure of the telephone industry, I conclude that the finding that TELRIC is much higher than TSLRIC applies equally to Verizon and Sprint.

[28] For example, Sprint witness Dr. Staihr states that "the cost of the loop accounts for over 90% of the cost of providing basic local service." Direct, Testimony Page 11, Lines 9-10.

multi-line business, Centrex, special access, and state private line services. Fully distributed allocators such as pair-feet for cable investment or DS0 (that is, a 64 kb/s channel circuit) equivalents for digital loop carrier investment are used to allocate the material investment in the network. Shared costs such as installation costs and poles and conduits are allocated across the various services through the use of in-plant factors and structure factors.

Q. Is BellSouth's methodology appropriate for estimating the TSLRIC of a service?

A. TSLRIC estimate should not use factors to estimate the portion of shared costs assigned to a service. Instead, the shared costs should be excluded from the TSLRIC estimate. For example, the TSLRIC estimate of residential BLTS equals the total cost of providing the combined services minus the stand-alone cost of providing all service with the exemption of residential BLTS. Costs shared by residential and all services would be included in the stand-alone cost of the other services and thus would be filtered out of the incremental cost of residential BLTS. This filtering process would remove, for example, the cost of the trench that contains any wires that serve customers other than residential customers. The BellSouth model, on the other hand, would allocate a share of that trench to the incremental cost of residential service, and because it allocates these and other shared costs to residential service, the BellSouth model does not properly estimate service incremental cost for any service. While BellSouth

characterizes its study as being true to the TSLRIC methodology, it is more appropriately characterized as a fully distributed cost study.

Q. Is it possible to use the BellSouth model to estimate the TSLRIC of a service?

A. Yes. It is possible to make a reasonable estimate of the TSLRIC of a service by removing the shared costs from the model. Because the model is set-up to allocate all shared costs, it is not always possible to remove the theoretically correct amount of shared costs. However, removing a reasonable amount of the shared costs will allow the Commission to base its decision on an estimate of TSLRIC that is approximately right. This approximate value is likely to be significantly closer to the correct TSLRIC value than BellSouth's fully distributed estimate.

Q. Were you able to determine a reasonable estimate of the TSLRIC for residential BLTS?

A. Yes. I estimated that statewide average loop portion of the TSLRIC is **begin proprietary** XXXXX **end proprietary.**[29] This value is significantly lower than BellSouth's **begin proprietary** xxxxxx **end proprietary** loop estimate. I did not estimate the cost of the port, switching, and transport. For the purposes of

[29] The OPC is filing a copy of the proprietary work papers associated with all of the proprietary calculations presented in this testimony with both the Commission and BellSouth. See Appendix 3 for the list of proprietary files.

this proceeding I will accept BellSouth's estimates of port, and switching and transport costs even though their estimates of **begin proprietary** xxxxx **end proprietary** and **begin proprietary** xxxxx **end proprietary** per line, respectively, are probably too high. The sum of my retail cost adder of **begin proprietary** xxxxx **end proprietary** per residential line, my loop estimate and BellSouth's port, transport and switching estimates equals **begin proprietary** xxxxx **end proprietary**. This value, **begin proprietary** xxxxx **end proprietary**, is a reasonable estimate of the statewide TSLRIC for residential BLTS. I recommend that the Commission use this value to determine whether residential customers are receiving a subsidy from access services.

Q. What changes did you make to the BellSouth model when you estimated the TSLRIC for residential BLTS?

A. I removed a portion of the shared costs of the digital loop carriers and I reduced the material in-plant factors that add installation costs to cable material costs.

Q. How did you remove a portion of the shared costs of the digital loop carriers (DLC)?

A. The output of the BSTLM model lists three general types of DLC equipment. These are common, hardwire, and plug-ins. The common equipment is used to transport messages from the DLC remote terminal to the

central office terminal. This equipment is shared by all services that use the DLC. I removed the common DLC material investment costs for the material investment costs that are passed from the BSTLM to the BellSouth cost calculator. The hardwire equipment includes the cabinets, shelves and batteries that are part of the remote and central office equipment. This is shared equipment. However, because I could not separate the amount of hardwire equipment that is truly incremental to residential service from the total hardwire investment, I did not reduce the material investment associated with hardwire equipment. The failure to remove the share cost associated with the hardwire equipment generates an upward bias to the TSLRIC estimate. Finally, because the plug-ins can be directly assigned to individual services, I did not change the BSTLM plug-in material investment estimated by BellSouth.

Appendices 1 and 2 of my testimony provide a description of the other adjustments that I made to the study.[30] The other adjustments were made with the objective of, as with the DLC equipment, to remove shared costs from BellSouth's loop cost estimate.

Q. Were you able to determine a reasonable estimate of the TSLRIC for business BLTS?

[30] I provide my own estimates of retail costs directly attributable to residential BLTS in Appendix 2.

A. Yes. Using the same method that I have just described when I estimated the TSLRIC for residential service, I estimated that BellSouth state-wide TSLRIC for business loops is **begin proprietary** xxxxx **end proprietary**. This value is significantly lower than BellSouth's **begin proprietary** xxxxxx **end proprietary** loop estimate. I did not estimate the cost of the port, switching and transport. For the purposes of this proceeding, I will accept BellSouth's estimates of port, switching and transport.

Q. What conclusion can be drawn from your analysis of TSLRIC?

A. I conclude that residential BLTS is not being subsidized by access service or any other service. This conclusion is based on the fact that the state-wide TSLRIC for residential BLTS is **begin proprietary** xxxxxx **end proprietary** and state-wide average revenue for residential BLTS is The **begin proprietary** xxxxxx **end proprietary**. The **begin proprietary** xxxxxx **end proprietary** state average was calculated by dividing the current residential BLTS revenue by the present statewide demand shown in BellSouth exhibit SB-1.[31] Business BLTS for single line business customers is also not being subsidized. For these customers the TSLRIC plus the retail adder is **begin proprietary** xxxxx **end**

[31] BellSouth Telecommunications, Inc., Direct Testimony of E. Steven Bigelow, Exhibit SB-1. For residential service, revenue equals the average revenue derived from SB-1 plus a $6.50 SLC. This value under-estimates the average revenue because a portion of the residential lines are non-primary and are charged a $7.00 SLC. For business service, because these customers are alleged to be single-line business customers, a $6.50 SLC was added to the average business revenue calculated using the data in Exhibit SB-1.

proprietary while average revenue is **begin proprietary** xxxxxx **end proprietary**.

Q. You have excluded shared costs from your estimate of the TSLRIC of a loop. But didn't Caldwell and Gordon argue that local loop costs are not shared over different services, but are directly attributable to BLTS, and claim the Commission has come to a similar conclusion? Does the Commission's earlier ruling invalidate your views?

A. No. As noted BellSouth Telecommunications, Inc.'s approach relies on TELRIC estimates.[32] Caldwell's testimony avers that these can be used to provide TSLRIC estimates for BLTS[33] because loop costs should not be treated as common costs, but are directly attributable to BLTS.[34] Caldwell quotes the Florida Commission as saying "the cost of local loop facilities [is] properly attributable to the provision of basic local telecommunications service."[35] The Commission in the same quote goes on to cite the Florida Statutes' definition of BLTS as including a wider range of services.[36] The services identified by the Commission were services that were are provided over a given loop. Caldwell

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[32] See discussion above at Page 19.

[33] Caldwell, Page 6, Lines 10-19.

[34] *Ibid.*, Page 9, Lines 7-25, Page 10, Lines 1-13.

[35] *Ibid.*, Page 10, Lines 2-12.

[36] *Id.*

asserts that this demonstrates the Commission "rejected the claim that the cost of the loop should be recovered from non-basic local telecommunications services." Gordon provides the same citation to the same effect.[37]

I do not dispute that any long run incremental costs attributable to BLTS as defined by the Commission must be part of that service's TSLRIC, but this has no bearing on whether *residential* BLTS shares costs with business BLTS, other business, special access, or data services. I am not challenging the Commission's determination that the cost of a given loop should only be assigned to BLTS.[38] Rather I am pointing out that when the cost of the residential BLTS loop is estimated, costs shared with other services, such as special access, data and business BLTS, shared costs should not be treated as a direct cost. The Commission should estimate the cost of a residential loop given that the residential loop shares facilities with other services. Residential BLTS does share costs with business, special access and data services and these shared costs should not be included as part of residential BLTS TSLRIC.

Q. Can you go into additional detail regarding your analysis of Caldwell's testimony on use of TELRIC estimates for residential BLTS costs?

[37] Gordon, *Ibid.*, Page 34, Lines 19-22, Page 35, Lines 1-20.

[38] As noted, I do not accept that local loop costs are solely attributable to BLTS. However, this is not material to my position in this proceeding.

A. Caldwell incorrectly argues that, "[t]reatment of loop costs as shared or common costs also violates the cost-causation principle inherent in TSLRIC methodology"[39] because "[a] cost is caused when an activity takes place; if BellSouth provisions the loop, the cost is incurred."[40] Treating the shared costs of a loop as a direct cost violates the definition of TSLRIC because the shared cost is incurred whether or not residential BLTS is supplied. It is not a cost directly attributable to the service, residential BLTS. If residential BLTS were eliminated, there would be little or no change in many structure costs, such as trenching, and so these cannot be considered a TSLRIC of residential BLTS.

Caldwell also argues that BLTS rates should exceed TSLRIC estimates however estimated to make a contribution to shared and common costs.[41] This is not relevant for the purpose of deciding whether BLTS is subsidized, since a service is only cross-subsidized if it recovers less than its TSLRIC.[42] Caldwell correctly points out in her testimony that (1) TSLRIC does not include shared and common

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[39] *Ibid.*, Page 9, Lines 20-21.

[40] *Ibid.*, Page 9, Lines 21-23.

[41] *Ibid.*, Page 10, Lines 14-21, Page 11, Lines 1-3.

[42] Faulhaber, G.R. (1975) "Cross-subsidization: Pricing in Public Enterprises," American Economic Review, 65 (5) December 966-77.

Furthermore, neither Caldwell nor any of the ILEC witnesses provide evidence regarding the degree to which the price of BLTS needs to be marked-up above TSLRIC or TELRIC to comply with the requirements of the governing statute. Therefore, her statement that there is a need to set prices in excess of TELRIC provides little if any instruction.

costs,[43] and (2) that, "TSLRIC studies are the basis for testing for cross-subsidization".[44] The view that TSLRIC is the relevant standard for testing for a subsidization is consistent with the Commission's ruling that TSLRIC is the appropriate cost standard,[45] as recognized by Caldwell,[46] another BellSouth witness (Taylor),[47] and the ILECs' joint witness (Gordon).[48]

Q. You stated that the ILECs used TELRIC cost estimates to test if residential service is subsidized. If TELRICs are used to measure support or subsidies, is it consistent to use BLTS only revenues in testing for support?

A. No. Costs must be matched with equivalent revenues when testing for support or seeking to align rates to costs. If TELRIC estimates for a network element over which many services are supplied are to be relied on (as the ILECs

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[43] Caldwell, *ibid.*, Page 8, Lines 16-25, Page 9, Lines 1-5.

[44] *Ibid.*, Page 8, Line 9.

[45] Florida Public Service Commission, Order PSC-96-1579-FOF-TP, Before The Florida Public Service Commission In Re: Petitions by AT&T Communications of the Southern States, Inc., MCI Telecommunications Corporation, MCI Metro Access Transmission Services, Inc., American Communications Services, Inc. and American Communications Services of Jacksonville, Inc. for Arbitration of Certain Terms and Conditions of a Proposed Agreement with BellSouth Telecommunications, Inc. Concerning Interconnection and Resale Under the Telecommunications Act of 1996 (Docket No. 960833-TP, Docket No. 960846-TP, Docket No. 960916-TP), December 31, 1996, Page 26.

[46] Caldwell, *ibid.*, Page 6, Lines 10-19.

[47] See footnotes 7 and 8 above.

[48] See Footnote 10 above.

advocate),[49] then these must be compared to revenues from all services that use that network element. Consequently, the average revenue from all users of the shared facility should also be used. It would be inappropriate to count shared costs on one side and residential BLTS revenues only on the other.

Another way to see this is to understand that when a firm evaluates an entry or expansion decision it compares the difference between expected total revenues and costs attributable to undertaking the activity in question (a position the ILECs have long advocated). Therefore, a hypothetical firm, LOOPCO, would compare its average revenue for all loops to the average cost of the loops. The average cost of a loop would include shared and direct costs of residential and business BLTS, as well as such costs from business, data and special services. This is essentially how the ILECs have calculated costs for this proceeding. The average revenue would include income derived from all products, residential, business, data, and special access loops.

Furthermore, if this type of analysis is conducted, the result of the test will only tell the Commission if the family of products that use loops are profitable and it will provide no meaningful economic information regarding the profitability of any one particular service, such as residential BLTS. No service specific conclusions

[49] For a general discussion see Section 4, pp. 46 ff below. Specifically on the ILECs' positions on this questions see Section 4.2, pp. 52 ff.

can be reached because it is a test for the family of products that require loops, and indicates nothing about the profitability of individual services. In order to determine the profitability of an individual service, the Commission must undertake the type of TSLRIC studies that I support in this testimony.

Q. If the Commission finds that residential BLTS prices do cover TSLRIC then are there any important implications for the claims by the ILECs and their witnesses about the benefits of adjusting these prices?

A. Yes. The ILECs and their witnesses have made a range of claims about benefits that would arise if BLTS prices currently fail to cover TSLRIC,[50] but

[50] Examples of these claims include:

1. regulatory policies that result in "uneconomically low residential basic local prices" imply lower [rates] than one would expect to find in undistorted competitive markets." (Gordon, *Ibid.*, Page 9, Lines 21-24).
2. if "the prices of residential basic local services [were better aligned] with their underlying costs, a broader base of residential customers will obtain the benefits of competition." (For Gordon's full position, see *Ibid.*, Page 29, Lines 11-13, and Page 30, Lines 15-18).
3. economic benefits would be generated if prices for residential BLTS prices were appropriately set. (Gordon, *Ibid.*, pp. 31 ff.).
4. "the lower the residential basic local price (when set governmentally without regard to whether the prices cover cost), the more unattractive those customers to actual and potential competitors". (Gordon, *Ibid.*, Page 11, Lines 4-6).
5. "If... incumbents rates are lowered artificially with the help of subsidy support, but their incremental costs do not change, potential competitive entrants that are not entitled to comparable subsidy support are likely to be deterred from entering the market." (Taylor, *Ibid.*, Page 5, Lines 19-22). I also do not accept that prior to rebalancing "subsidies" from intra-LATA access charges are not available to a CLEC provider of exchange lines. There is no competitive reason why CLECs cannot charge similar intra-LATA access charges.
6. that levels of CLEC provision to residential consumers are aggravated by prices being especially below TSLRIC as compared with other states (Gordon, *Ibid.*, Page 11, Lines 6-

through rebalancing were set so as to bring them closer to or achieve coverage of TSLRIC.[51] If the Commission finds that the ILECs have failed to show that residential BLTS prices are not so supported, as I have argued, then these assertions are moot.

It should also be noted that Dr. Gordon's claim that "the legislature has 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" is without basis.[52] The legislature came to no such conclusion, but rather directed the Commission to consider rebalancing more favorably if it were to "remove current support for basic local telecommunications services (BLTS) that prevents the creation of a more attractive competitive local exchange market for the benefit of residential customers; [and] [i]nduce enhanced market entry."[53]

Q. Does the ILEC analysis of BLTS take into account the correct level of BLTS revenue?

11). I also do not accept Gordon's comparison of Florida's residential BLTS rates to what he calls the national average, and nor that residential BLTS prices alone should be compared with TSLRIC. Instead, the comparison should be to total revenues earned through the supply of exchange lines.

[51] See Page 14 above.

[52] Gordon, *Ibid.*, Pages 10-11.

[53] Section 364.164 (1) (a) and (b).

A. No. The ILECs look at the profitability of residential service by adding in the Subscriber Line Charge (SLC) for the first line — $6.50 in the case of Verizon, Sprint, and BellSouth.[54] However, their analysis of profitability excludes the higher SLCs that are allowed for additional lines, and therefore understates the revenue per line earned from BLTS. This, in turn, results in an understatement of the margins earned on BLTS.

3.3 THERE IS LITTLE OR NO EVIDENCE TO SUPPORT THE ILECS' CONTENTION THAT REBALANCING WILL STIMULATE ENTRY

Q. The ILECs contend that rebalancing will stimulate competition in Florida, claiming the CLECs appear less interested in serving the residential market in Florida than in other states because current BLTS

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[54] Orville D. Fulp, Direct Testimony on Behalf of Verizon Florida Inc. Before the Florida Public Service Commission, Petition of Verizon Florida Inc. to Reform Its Intrastate Network Access and Basic Local Telecommunications Rates in Accordance with Florida Statutes, Section 364.164, August 27, 2003, Page 22, Line 6.

The primary residential rate for the SLC is the lesser of the Common Line, Marketing and Transport Interconnection Charge (CMT) per line or the capped rate of $6.50, while for non-primary residential lines the rate is the lessor of $7.00 or the greater of the rate as of June 30, 2000 or the average price cap CMT revenue per line and the multi-line business rate is the lessor of $9.20 or the greater of the rate as of June 30, 2000 or the average price cap CMT revenue per line.

	Primary Residential	Non-Primary Residential	Multiline Business	Subscriber Line Charge	CMT
BellSouth:	6.50	7.00	7.13	7.13	7.07
Sprint	6.50	7.00	8.51	8.51	7.61
Verizon	6.50	7.00	8.98	8.98	8.37

See FCC Rules Section 69.152.

rates are too low in Florida. Do they provide any empirical evidence for this line of reasoning?

A. Yes, Dr. Gordon provides data suggesting that that residential BLTS charges in Florida are sharply lower than the national average and argues that this is hindering competition.[55]

Q. Can you comment on this evidence?

A. Yes. At best, Dr. Gordon's evidence is highly misleading. Dr. Gordon cites an FCC statistic that shows the average residential BLTS rate for 95 U.S. cities on October 15, 2002 was $14.55.[56] He also cites Florida Senate Staff estimates of the average rates for BellSouth, Sprint, and Verizon. The lowest of these rates is $7.57—nearly $7 below the 95 city average, and the highest of these rates is $12.06—$2.49 less than the 95 city average. However, Dr. Gordon is comparing apples with oranges. His averages include many different cost areas that are not comparable to what is a sample of the largest 100 cities in America. He also ignores the fact that SLCs in Florida are more than 15% above the 95 city average.[57] Yet, Gordon could have chosen to cite the data in the same FCC report that would have allowed a comparison of apples with apples.

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[55] Gordon, *Ibid.*, Page 10-11.

[56] Gordon, *Ibid.*, Page 10. The original source is: http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ref03.pdf, Table 1.1.

[57] The 95-city average of federal and state SLCs was $5.64 (FCC, *ibid.*, Table 1.1.), Florida's SLC for residential lines is typically $6.50 -- see footnote 54.

FCC Table 1.3 includes three cities in Florida, Miami, Tampa and West Palm Beach. The cost of these lines including SLCs and State and Federal taxes, respectively, is $20.24, $22.45 and $19.41. These prices, respectively, are $3.14, $0.93 and $3.97 below the 95 city average -- a substantially different picture to the $2.49 to nearly $7 difference that Gordon portrays.

Q. You mentioned that the ILECs contend that there is comparatively less residential competition in Florida than in many other states. Do you agree with Dr. Gordon's arguments that the comparative lack of entry by CLECs into Florida's residential services market is due to residential retail rates in Florida being too low and that these rates should be raised as a consequence?

A. No, I do not. Dr. Gordon's chart identifies the States where a large share of the CLECs lines are residential and small business customers.[58] Dr. Gordon's chart illustrates that Florida's CLECs are far from the nation's leaders, Iowa, Illinois, and Michigan, in terms of successful entry into the residential and small business market (mass market).

Due to data and time limitations, I will focus my comments on two of the three states that have the highest ranking in terms of CLECs serving the residential

[58] Direct Testimony of Dr. Kenneth Gordon, Attachment B.

market -- Illinois and Michigan.[59] In Illinois and Florida, the mass market accounts for approximately 85% and 50% of the CLECs customers, respectively.

As the first row in Table 1 below illustrates, consistent with the 95 city data just discussed, that Florida's residential retail rates are not that much lower than what is reported for Illinois. What is considerably lower, however, are the gross margins achievable by CLECs in Florida vis-à-vis the margins obtainable in Michigan and Illinois (see Row 3 of Table 1).[60]

Table 1: Comparative UNE Rates and Retail Rates

	Florida	Illinois	Michigan[61]
Residential Retail Rates[62]	$20.70	$21.31	$26.91

[59] To be consistent with Gordon's analysis, I relied on FCC data for the price of basic residential service (Gordon, Page 10). Iowa was left out of this analysis as the FCC's *Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service* only contained retail rates for Frontier Communications, whose Iowa UNE rates could not be tracked down in the short time available for presenting testimony in this proceeding.

[60] The table reports the margin based on a comparison of the price of exchange service and cost of the UNEs. I present the data in this manner in order to illustrate the error in Gordon's analysis. Entry is, of course, determined not by the price of BLTS, but rather the margin earned on all services sold over a network.

[61] The residential rate of $26.91 is the average of the rates of $27.59 for Detroit, $24.97 for Grand Rapids, and $28.16 for Saginaw (from the FCC's Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service). However, a review of Michigan Bell Telephone Company Tariff M.P.S.C. No. 20r, Part 4 Section 2, 14th Revised Sheet No. 3 (Issued: June 7, 2002) shows a residence services rate of $14.31 for call plan unlimited in metro access area. Taking Saginaw as an example, we add to the $14.31 $5.35 for the federal SLC, $2.78 for the state SLC, $0.53 for Federal USF, $0.42 for number portability and $2.89 for 911 charges, which brings the total to $26.28. The remaining $1.88 is, presumably, state and federal taxes.

[62] Data in this row is from the FCC *Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service*,2003, at Table 1.3. These rates are inclusive of all surcharges, touch tone service charges, and taxes. Data is as of October 2002.

	Florida	Illinois	Michigan[61]
Nov 2002 UNE-P Price[63]	$20.59	$12.22	$14.50
Gross Margin	$0.11	$9.09	$12.41
UNE-L Rates[64]			
Metro	$9.77	$2.59	$8.47
Suburban	$13.88	$7.07	$8.73
Rural	$24.63	$11.40	$12.54

Q. What accounts for the difference in CLEC entry between Florida and Illinois?

A. Dr. Gordon suggests the difference in entry is attributable the unreasonable rate structure in Florida. It certainly can not be the rate of residential BLTS -- as Row 1 of Table 1 above demonstrates, the price of residential BLTS is essentially the same in the Illinois and Florida. The data in the table indicate that a more plausible explanation for the comparative lack of CLEC entry in Florida vis-à-vis Illinois is that Florida's UNE prices are not as conducive to profitable CLEC entry into the market as the UNE prices found in Illinois. The UNE platform in Florida costs $20.59, versus $12.22 in Illinois. This implies that the lack of CLEC entry could be addressed just as effectively by lowering UNE prices. While I am not advocating in this docket a reduction in UNE prices, the observed difference in entry is more easily explained by the differences in UNE rates found in the two states, not the price of BLTS.

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[63] Data in this row derived from: *Commerce Capital Markets, The Status of 271 and UNE-Platform in the Regional Bells' Territories* (November 2002) by Anna Maria Kovacs, Kristin L. Burns, and Gregory S. Vitale. (The UNE-P price used assumes Dial Equipment Minutes (DEM))

[64] *Id.*

Q. What accounts for the difference in CLEC entry between Florida and Michigan?

A. The data indicates that the price of residential BLTS is lower in Florida and the UNE prices are higher. These factors work together to explain why the pattern of entry is different between Florida and Michigan. Nevertheless, the Commission must be mindful that the decision of entry is based on a comparison of cost and revenues for the platform, not the margin from just one of the services sold over the platform.

Q. Can you provide any other evidence that the differences and CLEC entry between Florida and other states, such as Michigan and Illinois, is due to the margin of profitability of entry rather than residential BLTS rates *per se*?

A. Yes. In the fourth quarter of 2002 UNE prices in Florida were cut.[65] Using a weighted average of three density zones, the price fall was a substantial 11.6%.[66] A study found, as a result of this change, that "[r]esidential competition

[65] Consumer Federation of America, Competition at the crossroads: Can public utility commissions save local phone competition?, 7 October 2003, http://www.consumerfed.org/unep_200310.pdf, last paragraph of p. 9.

[66] B. Gregg 2002, 2003, (http://www.nrri.org/reports) the density zone weighted average monthly loop cost to be $15.81 in July 2002 falling by 11.8% to $13.95 by January 2003. Porting costs also fell from $1.40 to $1.17. With switching costs constant at $0.77, the total cost of UNE-P fell from $17.98 to $15.89.

increased sharply and has moved Florida much closer to the national average in terms of balance between residential and business in a short period of time."[67]

Q. Based on the analysis above, can you explain why the ILEC's analysis of entry into the Florida market is flawed?

A. Yes. The ILECs focus on the price of BLTS as the primary determinant of entry when elsewhere they contend that entry is based on the relationship between total revenue and total cost. The evidence provided by the ILECs has been superficial, in conflict with their positions on this issue before the FCC, and most importantly, it has failed to explain why rate rebalancing will induce new entry. Yes, some prices will be higher (BLTS), but others will be lower. Since entry decisions are based on total revenue, the ILECs have only offered speculation regarding the possibility that rebalancing will spur entry. This kind of superficial evidence would be given little weight in an impairment proceeding that addressed the economics of entry,[68] and neither should be accepted here. I will return to this point below (in Section 4).

[67] Consumer Federation of America, *id.* The change in share of residential CLEC lines is illustrated in Exhibit 4 on Page 11.

[68] (Federal Communications Commission, Triennial Review, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking in the Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers (Docket Number 01-338), Implementation of the Local Competition Provisions of the Telecommunications Act of 1996 (Docket Number 96-98), and Deployment of Wireline Services Offering Advanced Telecommunications Capability (Docket Number 98-147), August 21, 2003, Paragraph 485.

Q. Does Dr. Gordon cite any additional evidence that supports his proposition that entry is impeded due to the current rate structure?

A. Yes. Dr. Gordon, testifying on behalf of Sprint, Verizon, and BellSouth gives great weight to a study co-authored by two of his colleagues at his consulting firm, National Economics Research Associates (NERA).[69]

Q. Have you reviewed the study?

A. Yes.

Q. Do you believe that the study has any forensic value?

A. No. This study is severely flawed and therefore provides no useful insights on the issue of how rate rebalancing influences entry. I will briefly identify a few of the flaws. The authors, Ros and McDermott, used a few different econometric specifications to estimate how the ratio of business and residential rates affects competitive entry. Ros and McDermott contend that if the ratio of business to residential rates is high, residential rates are inefficiently low (Page 157 of the study). This conclusion, based solely on residential prices, and not underlying costs is unwarranted.

Ros and McDermott also make a range of modeling errors:

[69] Gordon, Page 27, footnote 15 and BellSouth's response to Citizens 2nd Set of Interrogatories, No.37. The study was provided in response to Citizens' 2nd Request for Production of Documents, Item No. 30.

- The authors attempt to explain the variation in the number of CLECs assigned numbering codes in each state through a number of explanatory variables (Page 163). The authors do not control for the size of the state.[70] Therefore they fail to take into account that the size of the market in California is many times greater than the size of the market in Wyoming. They repeat this error in their modeling of resold access lines. Such a misspecification would likely so bias their results as to render them without content.

- Two of the three facility based specifications involve trying to explain the variation in collocation at ILEC wire centers (Page163). The authors fail to control for 47 U.S.C. § 251 exemption to rural carriers of unbundling requirements. The statute establishes a barrier to entry that is highly relevant to explaining why different levels of observation are observed throughout the country. Therefore I am concerned that the researchers model specification leads to biased parameter estimates.

[70] Paradoxically, the authors suggested the need to control for the size of the market and indicated that they would include the total gross state product. Page 157, 162. However, this variable, or any proxy for it, was dropped by the authors (Pages 163 and 166).

- The authors effectively assume that the ratio of business to residential rates is uniform throughout a state (Footnote 19) or that the variance is of no relevance. Therefore the model fails to adequately measure the variable of interest.

- The study is based on aggregate state data and therefore fails to take into account the variation of profitable entry opportunities within a state.

- Variables are dropped from the different specifications without any adequate explanation of why it is appropriate to include a variable, such as per capita income, in one specification, but not another (Pages 163, 166). If a relevant variable has been dropped from the model, the coefficient estimates are likely biased. Additionally, such inclusions and omissions raise questions as to whether variable choices were made with an outcome in mind rather than allowing the data to speak for itself.

In summary, this paper suffers from omitted variable bias, measurement errors, and coefficient estimates that appear to be the result of a fishing expedition rather than the product of a sound research methodology.

4 ENTRY DECISIONS BY CLECS ARE NOT BASED ON A COMPARISON OF THE PRICE OF RESIDENTIAL BLTS TO THE TSLRIC OF BLTS – ENTRY DECISIONS ARE BASED ON A COMPARISON OF TOTAL REVENUES FROM ALL SERVICES WITH THE TOTAL TSLRIC OF ALL SERVICES

Q. The ILEC witnesses have testified that entry may be impeded by the allegedly supported residential BLTS rates.[71] Is it sensible to understand the economics of entry by looking at the price of BLTS only?

A. No. Entry decisions are not made on the basis of the price of an individual product. Rather a firm's entry is controlled by the relationship between expected total revenue and costs.

Q. Can you elaborate on this point?

A. Entry decisions are made on the basis of the expected total revenues and costs of all services an entrant can offer.

Traditional economic analysis points out that new firms enter a market with no entry barriers when economic profits are positive, and that entry will continue to occur until economic profits are driven to zero. Thus, it is not solely the price of one product or a number of products that determine the firm's entry decision –

[71] For some examples see footnote 50.

rather it is whether total expected revenues exceed total expected costs associated with entry.

More generally, a firm chooses to supply or extend supply of a service or services, or to enter a market or markets, when the net expected return from doing so, accounting for risk, is positive. It is completely irrelevant to a firm's decision, say, to supply local access lines, that it might make an expected loss on BLTS according to some measure, if total expected revenues, including those earned from retailing vertical and ADSL services, and wholesaling or retailing long distance services, cover the total expected cost of entry and the BLTS losses must be incurred to gain this overall position of profit.

Indeed, the fact that revenue neutrality is required under any rate rebalancing in these proceedings implicitly acknowledges that ILECs look at the entire revenue package and not each component in isolation. In requiring rebalancing, the section takes account of the <u>total</u> impact on the ILEC's revenues. The Legislature could have chosen to simply cut intra-state network access rates to interstate network access rates, but this would have been inconsistent with ensuring continued cost-coverage. Rebalancing provides a means of lowering intrastate network access rates while ensuring the ILEC's were able to continue recovering their costs. Indeed, as I will discuss below, given total revenues

earned by the ILECs (and hence potential earnings of new entrants) are rebalanced, it is unlikely that there will be a substantial change in the attractiveness of entry broadly in the supply of BLTS.

Q. Can you comment on how a typical CLEC might make an entry decision?

A. Yes. CLECs entry decisions will be based on total expected revenues and costs associated with all the services that can be sold given entry into the market, and would take account of whether entry would result in access to universal service support fund. An entry decision would not be based on the price of any particular service or product such as residential BLTS.

For example, assume that the cost of providing residential BLTS for a CLEC is $18, and that rates are rebalanced so that the price of this service increases from $15 to $20. According to the ILEC arguments presented in their petitions, the increase in the price will induce more competitive entry into the provision of BLTS since the profit will be $2 per customer. However, this is hardly the whole picture. A CLEC, by investing in a local loop, can also offer long distance services (either at the wholesale or retail level), and other non-basic services (for example, customer calling services and ADSL), just as the ILEC does. In considering the profitability of investing in the local loop, the CLEC would have to

take account of the fact that prices on some of these other services would fall on average by $5 due to rebalancing.

On these terms, net profitability would not change at all, and while it is true there would be other effects, these are hardly likely to be decisive. Demand would increase for those services for which prices were adjusted downwards just as it would fall for residential BLTS, and due to cross-product effects, demand for some of the other services the CLEC could sell might also vary slightly. The net impact might make entry slightly more or less profitable, but the effect is unlikely to significant and could be negative. In any case, the ILECs present no evidence at all as to how shifts in demand due to rebalancing might affect the profitability of entry. Instead, they naively argue CLECs will pay attention to the $5 price increase on residential BLTS and ignore the $5 price falls elsewhere.

4.1 THE FEDERAL COMMUNICATIONS COMMISSION HAS PREVIOUSLY ACKNOWLEDGED THAT ENTRY DECISIONS ARE BASED ON THE CONSIDERATION OF THE MARKET AS A WHOLE AND NOT ON THE CONSIDERATION OF ANY ONE PARTICULAR SERVICE

Q. You have advocated that the Commission consider total expected revenues when it considers the profitability of entry into the residential

market. Does the FCC's Triennial Review refer to how the profitability of entry is determined?

A. Yes. In assessing impairment, the FCC points out that "...in conducting our impairment analysis, we recognize that decisions on whether to enter are based not just on the cost of entry but also on the revenues to be gained."[72] The FCC goes on to emphasize that the analysis of impairment should "...consider all the revenue opportunities that a competitor can reasonably expect to gain over the facilities, from providing all possible services that an entrant could reasonably expect to sell."[73]

Furthermore, the FCC notes that:

> "...the impairment standard we adopt today considers whether all potential revenues from entering a market exceed the costs of entry, taking into account consideration of any advantages a new entrant may have ... we take into the account the fact that there are a number of services that can be provided over the stand-alone loop, including voice, voice over xDSL (i.e., VoDSL), data, and

[72] Federal Communications Commission, Triennial Review, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking in the Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers (Docket Number 01-338), Implementation of the Local Competition Provisions of the Telecommunications Act of 1996 (Docket Number 96-98), and Deployment of Wireline Services Offering Advanced Telecommunications Capability (Docket Number 98-147), August 21, 2003, Paragraph 100.

[73] *Ibid.*, Paragraph 100

video services. In so doing, we conclude that the increased operational and economic costs of a stand-alone loop (including costs associated with the development of marketing, billing, and customer care infrastructure) are offset by the increased revenue opportunities afforded by the whole loop."[74]

Q. Does the FCC take a position on the role of the state commissions in evaluating competitive entry issues?

A. Yes, the FCC has made it quite clear that the state commissions have a responsibility to examine all revenue sources when evaluating competitive entry issues, and that (implicitly) looking at the price and cost of BLTS in a vacuum is misguided:

"In determining the likely revenues available to a competing carrier in a given market, the state commission must consider all revenues that will derive from service to the mass market, based on the most efficient business model for entry."[75]

"...our analysis must take into consideration the full range of revenues that are likely to be obtained by an entrant providing voice

[74] *Ibid.*, Paragraph 258

[75] *Ibid.*, Paragraph 519

and related services, and the costs likely to be incurred. All factors affecting a competing carrier's likely revenues and costs must be examined to determine if they affect its ability to enter a market economically. Because economic entry depends on whether the sum total of all likely revenue sources exceeds the sum total of all likely costs of serving the market, any factor that limits or lowers the potential revenues available to a competing carrier, or raises the cost of serving a set of customers, is a potential barrier to entry. It is only by evaluating all the factors together that we may determine whether the likely revenues from entry will exceed the likely costs. Therefore, no factor should be examined in isolation."[76]

4.2 THE ILECS CONTEND IN OTHER PROCEEDINGS THAT ENTRY DECISIONS BY CLECS ARE BASED ON A CONSIDERATION OF TOTAL REVENUES, NOT THE PRICE OF AN INDIVIDUAL SERVICE

Q. Have the ILECs in other proceedings advocated the position that entry decisions are made based on a comparison of the total revenue and costs associated with serving a customer?

A. Yes. Elsewhere the ILECs argue that the attractiveness of a market is judged by the total revenue generated by a customer, not by the profitability of

any one service, and this is consistent with FCC requirements that the States take this into account when carrying out impairment analysis. As noted by the FCC, in its evaluation of BellSouth's discussion of what revenues should be considered in an impairment analysis, BellSouth avers that the entry decision into the mass market is based on the combined revenues of business and residential customers. And with respect to the residential customers, BellSouth advocates taking into account all revenue derived over the access line, such as moneys received for the provision of call-waiting.[77] I see no reason to disagree with this previously held position of BellSouth.

The reply comments of Verizon in the FCC's Triennial Review are also indicative that the ILECs are fully aware that entry decisions on the part of CLECs are made on the basis of the bundles of services and revenues that can be generated from its customers, and not solely on the basis of the profitability of residential BLTS:

> "... the CLECs likewise disregard the various sources of revenue, beyond local exchange service, that they can tap into

[76] *Ibid.*, Paragraph 484, Footnote 1497

[77] *Ibid.*, Paragraph 485, Footnote 1511

BellSouth Ex Parte Presentation to the FCC, Letter from Jon Banks to FCC Commission Kevin Martin, January 30, 2003, Page 2. In this filing, BellSouth encouraged the FCC to include in its impairment analysis the revenue derived from vertical and local services, not just local service.

once they deploy their own facilities. Unlike the ILECs (which in most states remain prohibited from providing interLATA services), CLECs can immediately offer the full range of services to their customers -- not just local exchange service, but also long distance voice, high-speed Internet access, and video distribution, for example. That is precisely the strategy pursued by successful overbuilders such as RCN. The Commission therefore must dismiss arguments that CLECs cannot deploy their own facilities because the local exchange revenues available from the vast majority of customers are insufficient to justify such investment. No CLEC competes solely for the local telephone service revenues of potential customers, and no ILEC would either, if it had a choice."[78]

Q. Is Verizon's testimony in this proceeding consistent with its advocacy before the FCC?

A. No. The testimony of Verizon in the Triennial Review that is noted above is inconsistent with its witness in this proceeding, Carl Danner. Dr. Danner asserts that "historical patterns of entry and competition show that the prices of

[78] Reply Comments of the Verizon Telephone Companies, In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers (Docket Number 01-338), Implementation of the Local Competition Provisions of the Telecommunications Act of 1996 (Docket Number 96-98), and Deployment of Wireline Services Offering Advanced Telecommunications Capability (Docket Number 98-147), July 17, 2002, Page 43.

individual services influence competition."[79] In addition, Danner goes on to state that entrants will be deterred by the low price of providing local service when he states that "competitors that have cost structures similar to Verizon's simply can not compete against Verizon's existing supported rates."[80] Yet, we have witnessed entry by CLECs in Florida and elsewhere with a variety of cost structures -- the reason being that entry decisions are based on revenues and costs as a whole and not on the costs or revenues of any one particular service such as residential BLTS.

In addition, previous testimony in Massachusetts on behalf of Verizon by Dr. William E. Taylor (one of BellSouth's expert witnesses in this Florida proceeding) clearly supports the argument that entry decisions are based on the total revenues available to the entrant, and not from any one particular service:

> "[S]ometimes we ask the question, can a LEC make money in residential service, for example? And for that, what matters is the full panoply of services that a CLEC or ILEC can expect to provide when it attracts a customer. So for that it

[79] Carl R. Danner, Direct Testimony on Behalf of Verizon Florida Inc. Before the Florida Public Service Commission, Petition of Verizon Florida Inc. to Reform Its Intrastate Network Access and Basic Local Telecommunications Rates in Accordance with Florida Statutes, Section 364.164, August 27, 2003, Page 8, Lines 22-23.

[80] *Ibid.*, Page 7, Lines 10-12.

makes...sense to include the revenues and the costs from vertical services in the calculation."[81]

Q. You have presented evidence that indicates the entry decisions are based on a comparison of the total revenue and costs associated with entry, not just the price of BLTS. Have CLECS in other proceedings at times taken the position that lowering access rates is not a sound public policy?

A. Yes. Testimony by Cox Communications in Connecticut indicates that some CLECs fully recognize that lowering access rates is just as likely to impede as enhance competition, and it further supports the argument that CLECs base their entry decisions on total revenues available. CLECS may be concerned that lowering access rates would harm their entry plans by reducing their potential to raise revenues, recover their costs, and attract capital -- and thus could impede competition rather than promote it.

In his testimony in Connecticut, William Lafferty states on behalf of Cox Communications that:

[81] Massachusetts Department of Telecommunications and Energy, Price Cap Regulation for Verizon, DTE 01-31, Phase II Order, April 11, 2003, Page 82.

". Access charges are a critical source of revenue to provide the financial resources for competitors to establish viable businesses themselves ... Absent the opportunity to generate the necessary revenue to finance their growth, CLECs will be constrained in their ability to provide customers the level of choices, quality and market based prices contemplated by the 1996 Act. Thus, the future of competition requires the Department to move slowly in making further adjustments to CLEC (and ILEC) access charges or risk the possibilities of less competition and higher local service rates for customers in Connecticut."[82]

In response to whether or not Cox reviews the profitability of individual services such as access charges and how it determine whether to enter a market or not, Mr. Lafferty replied:

"The potential revenues from all telecommunications services are compared to the total expected expenses and investments required to operate in the market. ...Cox looks at its total

[82] Pre-Filed Testimony of F. Wayne Lafferty on Behalf of Cox Connecticut Telecommunications, L.L.C., State Of Connecticut, Department Of Public Utility Control (DPUC), DPUC Investigation of Intrastate Carrier Access Charges (Docket 02-05-17), June 3, 2003, Page 4. http://www.dpuc.state.ct.us/DOCKCURR.NSF/22af672892a9d75b85256afe0059fc24/7d0914bc13f012dd85256d3c00449134/$FILE/TESTIMONY.DOC

telecommunications operations. The revenues, expenses, profitability and cash flow of all telephony services including basic local service, calling features, toll and access are reviewed in the aggregate."[83]

Q. Even if total revenues are considered and these rise making entry more profitable does this necessarily induce more entry?

A. No, most especially when prices are regulated to prevent abuse of market power. An unregulated incumbent with substantial market power can price well-above competitive levels without attracting entry that constrains their pricing power. In such a case, a rise in total revenues from regulated levels may not be sufficient to allow entrants to overcome existing entry barriers. Thus, price and indeed total revenues may rise above the regulated level toward monopoly levels without attracting entry.

Q. The ILECs have argued that rebalancing is also sensible in light of the pending entry by new suppliers of telecommunication services. Do you have any comments regarding the speculation of the ILECs?

[83] Ibid., Page 18.

A. Yes. Sprint witness Dr. Brian Staihr, for example, points out that power lines may be used to provide broadband services to residential customers.[84] In my view, the success or failure of broadband over power lines will have little to do with rate rebalancing. Rather broadband over power has to address such impediments as the sharing of electronic equipment with a small number of houses, say six.[85] By contrast, telephone companies are often able to spread the cost of the field electronics over a much larger number of households.

Moreover, while new technologies, such as power lines, are a potential threat, the potential entrants described by the ILECs do not currently constrain the pricing power of the ILECs because of economic and technical constraints. As recently pointed out by the former chair of the FCC's Technology Advisory Council's Broadband Access Working Group, Stagg Newman, "any new technology platform will be quite challenged in most markets to compete with the cable operators and incumbent telephone companies for the delivery of highspeed Internet access either on a stand-alone basis or in conjunction with other services."[86]

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[84] See, for example, Direct Testimony of Brian K. Staihr, Page 9.

[85] Six households being a reasonable estimate of the number of households that share a power transformer. The terminal electronics used in the provision of broadband over power are likely to be located on the secondary side of the transformer.

[86] Stagg Newman, "Broadband Access Platforms for the Mass Market An Assessment," http://intel.si.umich.edu/tprc/papers/2003/254/BbandAccessPlatforms.pdf. Newman's paper also

The ILECs also mention that wireless and cable telephony can constrain the pricing power of the incumbents. The FCC recently concluded that at this juncture these modes of communication (all commercially available in contrast to supply over power lines) do not impose a significant constraint on the incumbents pricing power. For example, with reference to wireless service, the FCC stated mobile providers are "not yet a suitable substitute for local circuit switching [footnote omitted]." The FCC added that mobile wireless connections "in general do not yet equal traditional landline facilities in their quality and their ability to handle data traffic[footnote omitted].[87]

Similarly, the FCC finds that the presence of cable and mobile telephony is not sufficient to reverse a general presumption of impairment of CLEC entry in residential markets.[88] Entry to supply residential BLTS, even where it can be said to have occurred on new technologies such as over pay-television cabling, remains, in the FCC's eyes, a very difficult proposition.

addresses some significant engineering limitations associated with using alternative technologies to provide voice services.

[87] Federal Communications Commission, Triennial Review, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking in the Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers (Docket Number 01-338), Implementation of the Local Competition Provisions of the Telecommunications Act of 1996 (Docket Number 96-98), and Deployment of Wireline Services Offering Advanced Telecommunications Capability (Docket Number 98-147), August 21, 2003, Paragraphs 444-445.

[88] FCC, *ibid.*, paragraph 198.

I recommend that the Commission not order rate rebalancing on the unsupported proposition that the deployment of new technologies will be enhanced if rates are rebalanced.

4.3 PRICING BEHAVIOR IN OTHER INDUSTRIES STRONGLY SUGGESTS THAT FIRMS SET PRICES TO GAIN AND RETAIN MARKET SHARES, AND NOT SIMPLISTICALLY ON THE BASIS OF THE PRICES AND COSTS OF INDIVIDUAL PRODUCTS

Q. The ILECs contend that prices should be market based.[89] Do you concur that market operations provide insights into how prices should be set by regulators?

A. Yes and therefore, in this section, my testimony points out how unregulated competitive firms set prices for products, which, like the loop, provide complementary benefit to other products. I will show that in unregulated markets, these complementary goods are often sold below cost to induce demand for complementary products.

Q. Does the experience of pricing behavior in other industries that offer complementary products indicate that entrants often set prices to attract

[89] William E. Taylor, Direct Testimony on Behalf of BellSouth Telecommunications, Inc. Before the Florida Public Service Commission, Petition of Sprint Florida Inc. to Reduce Access Rates, August 27, 2003, Page 16, Lines 7-8

market share, and that existing firms also set prices to retain market shares rather than focus on a simple comparison of prices and costs of individual products?

A. Yes. Based on economic theory, it is clear that a firm may have an incentive to set its price for the complementary good at a level below the marginal cost of production in order to stimulate demand for a complementary product. As pointed out by Tirole, "An interesting phenomenon that may arise with complements is that one or several of the goods may be sold below marginal cost...so as to raise the demand for other goods sufficiently".[90] This is the case in the telecommunications industry, and in a number of other industries as will be illustrated below.

In the case of the telecommunications industry, pricing products below their marginal costs occurs in the competitive, unregulated wireless segment of the market. In wireless service, cell phones are often given away for "free" as part of a package offering the consumer a bundle of minutes and other services. In addition, wireless companies also now offer a number of packaged pricing plans for multiple cell phones to a family under which mobile-to-mobile calls within a family might be free -- presumably to induce increased use of the cell phones for other calls and services for which prices are non-zero or because the total

[90] Jean Tirole, The Theory of Industrial Organization, MIT Press, 1988, Page 70.

business attracted with this special justifies the 'loss' made on family-to-family calls.

Research has shown that in competitive markets firms' strategic pricing decisions are much more complex than the simplistic notion of prices being driven towards marginal cost.[91] Recognizing that "...people do not make purchases by evaluating the products alone but by evaluating the entire purchase opportunity"[92] firms in competitive markets typically take a more nuanced approach to pricing, considering it as much a function of strategic positioning and marketing as it is of cost recovery.

Price discriminating behavior and market segmentation in other industries confirms that such pricing behavior in the telecommunications industry is hardly an aberration. For example, Vietor summarizes the impact of deregulation in six industries and notes that pricing mechanisms, in fact, became more complex once government controls were reduced.[93] Rather than moving to cost-based pricing, as had been predicted, many of the markets exhibited an increased level

[91] See, for example, Thomas T. Nagle and Reed K. Holden, The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making, Prentice-Hall, Inc., 1987 (Nagle 1987).

[92] *Id.*, at Page 168.

[93] Richard Vietor, Contrived Competition: Regulation and Deregulation in America, Cambridge, Harvard University Press, 1994.

of price discrimination, because firms used pricing to segment customers and establish customer loyalty.

Q. Can you provide some examples of pricing behavior for complementary products in other industries?

A. Yes. The case of pricing of razor blades is germane here since it illustrates pricing behavior when complementary products are provided together (as is also the case in telecommunication services). Gillette has chosen to focus on a "shaving systems" approach to take full advantage of "the principle of complementary products under which the relative prices of products can be exploited because they must be used together. The razor, a quite substantial product, is sold at a low price to get it into the consumer's hands. This facilitates the sales of profitable, replacement blades which fit only the systems for which they have been designed."[94]

Another component of the Company's strategy has been:

> "to continually add features to the basic razors, and hence make more profit per blade as consumers buy up in features. This started with the Trac II twin blade system, and continued with the

[94] Thomsen, Kenneth A. "The Global Strategy of the Gillette Corporation", MIT MS Thesis 1987, Page 44.

pivot headfirst on the Atra, and then later on the Good News disposable. Following this introduction was the addition of a lubricating strip on the blade that would release a lubricant when wet. This feature was first put on the Atra Plus, and later added to the Good News Plus.

What Gillette has been effectively doing is hooking the consumer with a low priced razor and blade, and then having him buy upscale a little each time. With a fixed market size, this is almost the only way to increase profits."[95]

A final example is the printer business. The printer may be inexpensive with some inkjet printers currently available for as little as $99. However, the expensive part is buying the ink cartridges, which can cost up to 66% of the $99 printer price. So, printer manufacturers use low upfront prices for the printers to attract customers that then become locked into having to purchase cartridges that only fit the specific printer purchased.[96]

Q. What lessons do you draw from observations regarding the pricing practices of the wireless, razor, and computer printing industries?

[95] Ibid., Page 29.

[96] Walter S. Mossberg, "How Good Could a $99 Printer Be" The Wall Street Journal, August 7, 2002, Page D5.

A. The largest cost component of BLTS is the loop. However, the loop is used to provide more than BLTS. In unregulated competitive markets, we observe complementary goods being priced below cost to induce use of other products. Currently, BLTS is already priced above TSLRIC, and the ILECs have not provided a compelling case as to why non-market based pricing should be imposed by the commission.

5 THE ILECS' HAVE FAILED TO SHOW THAT REBALANCING WILL BE BENEFICIAL TO RESIDENTIAL CUSTOMERS

Q. The Commission is obligated to consider if the proposed rebalancing will be beneficial to,[97] and indeed protects,[98] residential customers. What type of evidence have the ILECs provided in terms of the benefits and costs associated with rebalancing?

A. I have already noted that the bulk of the evidence the ILECs introduced on benefits to consumers is based on the proposition that there is support for residential BLTS. As this is not so, this evidence is not relevant to the case. The ILECs also contend, based in large part on their understanding of rebalancing

[97] S. 364.164 (1) (a) of the Act.

[98] S. 364.01 (3), and (4) (a) and (c) of the Act.

undertaken in other states, that rebalancing will improve efficiency because it will stimulate toll usage and will not adversely effect universal service.[99]

Q. What is your view of the empirical evidence presented by the ILECs on the impact of rebalancing from experiences in other states?

A. The ILECs devote many pages of testimony to this question. Sprint states that rebalancing has occurred in Pennsylvania and Ohio but provides no evidence of how consumers benefited. Rather it provides evidence that is suggestive that a substantial number of people may have disconnected service.[100] Danner talks about the success of the California rebalancing.[101] Dr. Gordon mentions Illinois, discusses Massachusetts and Maine, and very briefly California and Ohio.[102]

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[99] See, for example, Direct Testimony of Dr. Carl Danner, Page 11, Line 12 to Page 12 Line 4; Direct Testimony of Dr. Brian Staihr, Page 16; Direct Testimony of Dr. William Taylor, Page 4, Lines 5-12. None of the ILEC witnesses quantify these alleged efficiency gains. Quantification is important because while it is true that rebalancing will increase toll usage, this benefit must be weighed against the cost of some people disconnecting service.

[100] Felz, *Ibid.*, Page 27, Lines 18-23. Declines respectively of "approximately 1%" and lest than 1/2 of 1 percent" occurred in Ohio and Pennsylvania within a six month period of rebalancing. It is likely additional losses occurred subsequently, that is, the long run effect was greater than this. However, Felz provides no indication as to what other factors may have played a role in determining penetration.

[101] Danner, *Ibid.*, pp. 25 ff.

[102] Gordon, *Ibid.*, pp. 39 ff.

In addition, it is worth pointing out that in BellSouth's response to Second Interrogatories on the benefits of reduced access rates in a number of states that have reduced access rates, Dr. Gordon states in Supplemental Response Item Number 34 (Florida Docket No. 030869-TL, September 5, 2003) that:

What is striking about all the ILEC testimony on rebalancing, is a failure to provide the results of any statistical analysis of the effect of rebalancing. Indeed, in some cases there is no discussion at all of what happened (for example, the already mentioned case of Illinois in Dr. Gordon's evidence) and there is no analysis of the impact of rebalancing on consumers (for example, in Felz's evidence, except for the claim that there will be little subscriber loss[103]; and in Dr. Gordon's discussion of California and Ohio[104]). Moreover, there is no mention of other states where substantial rebalancing occurred (for example, Wyoming).[105] This is all the more curious given the following response from Dr. Gordon to a request from Citizens' to provide evidence on rebalanced rate changes in the States he mentions in his testimony:[106]

> "BellSouth has not drawn any conclusions on such [rebalancing] effects on a state specific basis. To do so would require a substantial and detail investigation, and even then the conclusions

"BellSouth has not drawn any conclusions on such effects on a state specific basis... the conclusions would be subject to serious doubt. The reason is that competitive activities of firms are driven by many factors; separating out the effects of any one factor is extremely difficult."

[103] Felz, *Ibid.*, Pages 26-29.

[104] Gordon, *Ibid.*, Page 42, Line 23 and Page 43, Lines 1-5.

[105] Wyoming Public Service Commission, 2000 Annual Telecommunications Report, http://psc.state.wy.us/htdocs/telco/telco00/2000TelcoRpt.htm#INTRO.

would be subject to serious doubt. The reason is competitive activities of firms are driven by many factors; separating out the effects of any one is extremely difficult. However, comparisons across states, using appropriate statistical techniques (multiple regression analysis), can 'hold constant' other influences on competitive behavior, and isolate the influence of the variable of interest (rebalancing in this case)"[107]

I agree with Dr. Gordon on the difficulty in translating evidence on rebalancing from one State to another without rigorous statistical analysis. Indeed, in my view, all the ILEC evidence on rebalancing is rendered invalid by this shortcoming.

Q. Can you provide any evidence on the impact of lower intra-LATA toll charges?

Yes. I am aware of two published articles on this topic — one done by an academic, Armando Levy, and the other done by a colleague of Dr. William

[106] Citizens' 2nd Set of Interrogatories, Item Number 37.

[107] BellSouth Telecommunications, Inc.'s Responses to the Office of Public Counsel's Second Set of Interrogatories (Numbers 23-48). Dr. Gordon's answer goes on to say, "on competition. The McDermott-Ros paper, cited in Dr. Gordon's testimony, represents such an approach." I note that: the Citizen's request Number 37 did not mention the impact of rebalancing on competition; and I have shown the McDermott-Ros paper (which is concerned about with the development of local

Taylor and Dr. Ken Gordon of NERA.[108] Both papers seem to suggest that there is not a significant increase in the volume of toll traffic when rates are rebalanced. This implies the efficiency and welfare impacts of moving toll rates towards marginal cost (to the extent that they currently exceed these) will be limited.

Levy's study, based on 27 states, finds that the demand elasticities from rate rebalancing to be in the range of -0.2 to –0.3.[109] His explanation of the lower price elasticities was that "as rates fall so does consumer sensitivity to prices."[110] In particular, Levy concluded, "From a behavioral perspective, as price drops below about fifteen cents, households make as many intra-LATA calls as they wish and further discounts do little to stimulate demand."[111] That is, as per minute rates fall the impact between even a large reduction in call rates has on consumer well-being and hence behavior is limited. For example, assume the average intra-LATA call price is 7¢/minute call. If you spend an average of 10 minutes on any

competition as explained by local service prices, not about rebalancing *per se*) to be seriously flawed

[108] Both papers appear in The Future of the Telecommunications Industry: Forecasting and Demand Analysis, edited by David G. Loomis and Lester D. Taylor, Kluwer Academic Publishers (1999). The first is, Armando Levy, "Semi-Parametric Estimates of INTRALATA Demand Elasticities", Pages 115-124; the second, Timonthy J. Tardiff, "Effects of Large Price Reductions on Toll and Carrier Access Demand in California," Pages 97-114.

[109] For example, a retail toll price elasticity of –0.32 is found for a 10% price drop (from 15¢); and -0.21 for a 40% drop (Levy, *Ibid.*, Page 121).

[110] Levy, *Ibid.*, Page 116.

[111] Levy, *Ibid.*, Page 123. Elsewhere he says, "We find a decidedly nonlinear relationship with households becoming insensitive to price below fifteen cents per minute." Page 116.

given intra-LATA call, a 1¢ or 14.3% price fall only saves you 10¢ per call. This may not have much of an impact on your decision to make an additional call or stay on the phone longer. However, the time cost of an additional or longer call to many consumers would be substantial in comparison to the call's total price (70¢ plus), let along the 10¢ savings. The net result is calling responses to such price changes are likely to be limited.

Levy concludes:

> "[R]egulatory policy which anticipates a large increase in consumer surplus due to lower intra-LATA toll tariffs (at the expense of local rates) may be ill founded, since the evidence here suggests residential household demand for toll is much small at low tariffs than previous research may indicate."

On toll elasticities, Tardiff's paper comes to similar conclusions to Levy's: that in California the long-run retail toll price elasticity of demand is -0.2.[112] Tardiff also estimated the California long-run access price elasticity to be –0.24. That is, if access prices fall in California by 10% demand for access services is only

[112] Tardiff, *Ibid.*, Page 109.

stimulated by an unresponsive 2.4%.[113] The impact of toll and access price changes registered over the course of a approximately one year.[114]

In summary, the paper by Levy and Tardiff indicate that lowering toll prices has a limited impact on expanding demand. The implication is that consumers would gain little from such price reductions and any efficiency gains due to such changes moving price closer to marginal cost (if price is above marginal cost) would be minimal.

5.1 RATE RECOMMENDATIONS

Q. Would you recommend that the Commission adopt the ILECs rebalancing plans?

A. No. The ILECs' petitions should be rejected because they have failed to show that BLTS is supported or that their plans would be beneficial to residential customers or would induce entry or even that residential consumers are appropriately protected under the ILECs' proposals.

Q. Are there any reasons why you would suggest the commission adopt a rebalancing plan in the future?

[113] Tardiff, *Ibid.*, Page 112.

[114] Tardiff, *Ibid.*, Page 106.

A. Yes, I agree with the ILECs that rates need to be rebalanced, but disagree on the form of the required rebalancing.

Beyond the legislative direction provided on this issue, there are at least two good reasons for changes to intrastate network access charges:

- Consumers find confusing the proposition that intrastate rates for a short-distance call are priced at a higher rate than a long-distance toll call; and

- Asymmetrically high intrastate access rates encourage carriers to pretend that intrastate calls are actually interstate calls.

Rate rebalancing would partly address these anomalies, though the extent of the problem is reduced as consumers increasingly subscribe to bundled packages with one fixed price for a combined amount of both intrastate and interstate minutes. While the asymmetric rates do provide an economic incentive to misrepresent the nature of the calls, this is not a controlling reason to change access rates. If a firm misrepresents the nature of its traffic, it may be sued for racketeering.[115]

[115] Washington Post, "AT&T Sues Worldcom Over Call-Routing Methods", September 3, 2003, Page E1.

Q. What kind of rebalancing might be beneficial to residential consumers while enhancing, or at least not reducing competitive entry?

A. In my view, rebalancing that would be beneficial to residential customers and would not be an obstacle to competitive entry would involve setting rates that are more reflective of what would emerge in a competitive market. In particular, in a competitive market both recurring and non-recurring BLTS charges would be kept relatively low and some increases would be imposed on other services.[116] I would not rule out moderate increases in residential BLTS prices, that is, increases materially lower than in the ILECs' current proposals.

6 CONCLUSION AND RECOMMENDATIONS

Q. Do you have any concluding remarks and can you please summarize your recommendations?

A. The petitions filed by Verizon, Sprint, and BellSouth to reform their intrastate network access rates and BLTS rates should not be approved by the Commission. The petitions do not provide adequate empirical evidence to support the ILECs' claims. In particular:

[116] I recognize that the Commission's ability to raise other rates may be proscribed by the Act.

- The ILECs have not made a showing that residential BLTS is supported and therefore there is no record to support the proposed rebalancing. Thus, a substantial rebalancing by raising residential BLTS rates cannot be justified by any claim that such support exists.

- The ILECs have not made a showing that the proposed reform of these rates would create a more attractive competitive local exchange market for the benefit of residential customers or enhance market entry or that entry will be enhanced because their analysis is based on a model that no entrant would ever use. Moreover, any claims of benefits to consumers based on the removal or reduction of support of residential BLTS are moot, since no such support exists

- The ILECs have not demonstrated that the proposed rebalancing would benefit or protect consumers. Again any claims of benefits brought by elimination or amelioration of support of residential BLTS are irrelevant (since residential rates are not supported), and ILEC evidence beyond this on the impacts of the rebalancing is very limited.

1 Introduction And Witness Background

Q. Please state your name and business address.

A. My name is David Gabel. My business address is 31 Stearns Street, Newton, Massachusetts 02459-2441.

Q. On whose behalf are you appearing?

A. I am appearing on behalf of the Florida Office of Public Counsel (OPC).

Q. Are you the same individual that submitted direct testimony in this proceeding on behalf of the Florida Office of Public Counsel (OPC)?

A. Yes.

Q. What is the purpose of your testimony?

A. The purpose of my rebuttal testimony is to address the direct testimony of: Dr. Mayo,[1] on behalf of AT&T Communications of the Southern States, LLC ("AT&T") and MCI Worldcom Telecommunications, Inc. ("MCI"); Mr. Fonteix,[2] on behalf of AT&T; Mr. Shafer,[3] and Ms. Ollila,[4] on behalf of staff for the Florida

[1] Direct Testimony of Dr. John W. Mayo on behalf of AT&T Communications of the Southern States, LLC and MCI Worldcom Communications, Inc., October 31, 2003.

[2] Direct Testimony of Mr. Wayne Fonteix on behalf of AT&T Communications of the Southern States, LLC, October 31, 2003.

[3] Direct Testimony of Mr. Gregory L. Shafer on behalf of Staff for the Florida Public Service Commission, October 31, 2003.

Public Service Commission ("the Commission"); and Mr. Boccucci, Jr., on behalf of Knology of Florida, Inc. ("Knology").[5] I will address several issues in my rebuttal testimony, referring to the testimony of: Dr. Mayo on competitive pricing; Dr. Mayo and Mr. Fonteix on residential basic local telephone service (BLTS), support and entry; Mr. Shafer on legislative intent, entry and bundled and long distance rates; Ms. Ollila on the "Competition Report";[6] and Mr. Boccucci, Jr. on BLTS support and competitive entry.

Q. Can you succinctly summarize the positions of AT&T, MCI, Staff and Knology as stated in the testimony of their expert witnesses and your responses to these positions?

A. Yes. AT&T and MCI:

- assert that BLTS rates are subsidized;
- are concerned that existing access prices prevent competitive local exchange carriers (CLECs) from competing retail long distance prices down toward costs, and from competing through the supply of bundles;

[4] Direct Testimony of Ms. Suzanne M. Ollila on behalf of Staff for the Florida Public Service Commission, October 31, 2003.

[5] Direct Testimony of Mr. Felix L. Boccucci Jr. on behalf of Knology, Inc., October 31, 2003.

[6] Florida Public Service Commission's, Office of Market Monitoring and Strategic Analysis, "Telecommunications markets in Florida: Annual Report on Competition as of June 30, 2002" December 2002.

- recommend that regulation should emulate prices that would emerge in a competitive market, a position consistent with that of the OPC, but that the proposed BLTS prices are correct, and that access services should be priced at incremental cost.

It is the OPC's view that:

- AT&T and MCI present no evidence that BLTS is subsidized or that the proposed rate rebalancing is consistent with competitive prices (and note, Staff do not present any evidence or findings on whether BLTS or residential BLTS is subsidized); and
- AT&T's and MCI's view on what they believe constitute correct BLTS and access service prices is inconsistent with competitive practice.

Mr. Shafer argues that if residential BLTS is subsidized, then entry would be difficult, but this conclusion does not hold if BLTS is an important complement to other services (as Mr. Shafer points out in his testimony) or is supplied as part of a bundle.

Knology claims that the rebalancing will generate competitive entry, but in no way demonstrates this, and indeed its testimony appears to contradict its position in a filing with the Securities and Exchange Commission.

2 Rebuttal Of The Testimonies Of Dr. Mayo, A Witness For AT&T And MCI, And Mr. Fonteix, A Witness For AT&T

2.1 Dr. Mayo And Mr. Fonteix Provide No Evidence On Whether Residential BLTS Is Subsidized Or Supported

Q. What are your views of Dr. Mayo's and Mr. Fonteix's statements about whether residential BLTS is subsidized or supported?

A. Mr. Fonteix asserts, without providing any supporting evidence, that BLTS is subsidized.[7] Dr. Mayo claims, again absent evidence, that BLTS is supported.[8]

Q. Why is it important to provide evidence?

[7] Fonteix Direct, p. 2, lines 15-18, p. 4, lines 2-4. Mr. Fonteix does not define subsidized and cites Mayo ibid. as supplying evidence of this without providing a specific location in that testimony. Mayo only once uses the language of subsidy in this context (Mayo, p. 15, lines 3-10), arguing that cross-subsidies prevent entry, but providing no evidence of a cross-subsidy—see also footnote 8 below. Moreover, the view that cross-subsidies prevent entry is in general incorrect—see my discussion on entry below on pp. 8 ff. (Section 2.2).

[8] Mayo Direct, p. 11. Mayo provides no definition of support or evidence that BLTS rates are supported or subsidized, but does argue that BLTS rates are inefficient because of the history of regulatory development (p. 8, lines 6-17, p. 9, lines 1-16). His only evidence to this effect is a paper published 7 years ago (p. 5, footnote 5), presumably written even earlier and based on evidence collected at least a year earlier, so hardly applicable to Florida in 2003. In any case, inefficient rates do not imply supported rates. On Dr. Mayo on "cross-subsidy", see footnote 7 above. Dr. Mayo also provides no support for his view that the proposed rebalancing "unequivocally 'removes support for basic local telecommunications services' in Florida... Thus, it is quite clear that the statutory requirement of removing support for basic local services will be met by the plan described in the ILECs' petitions" (Mayo Direct, p. 11, lines 11-12 and lines 16-17).

A. As a general matter, the Commission should not rely on the unsubstantiated opinion of an expert. An expert should provide a foundation for his/her conclusion.[9] Neither Mr. Fonteix nor Dr. Mayo have provided any evidence to support a finding that residential BLTS is subsidized or supported.[10] The material presented by Dr. Mayo and Mr. Fonteix on these points adds nothing to what was said by the ILECs' witnesses. In particular, their testimony does not show residential BLTS rates are currently priced below total service long run incremental cost.

Q. You say that Dr. Mayo and Mr. Fonteix provide no evidence for their positions on whether BLTS is subsidized or supported. Is it possible that Dr. Mayo and Mr. Fonteix relied on the results submitted by the ILECs?

A. It is possible but would contradict AT&T's view of the relevant economic costs. AT&T has routinely asserted, for example, in unbundled network element (UNE) dockets, that ILEC evidence overstates costs and have argued that the true economic cost of service is lower than the costs estimated by regulatory Commissions. AT&T has also contended that the same cost estimates should be used for determining the cost of basic telephone service.[11] In this case, the

[9] *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 113 S.Ct. 2786 (1993).

[10] I have shown the residential BLTS is not subsidized: Direct Testimony of Dr. David J. Gabel on behalf of the Office of Public Counsel for the Florida Public Service Commission, October 31, 2003, *passim*.

ILECs used UNE prices to estimate the cost of BLTS. If AT&T was to rely on the ILECs' total element long run incremental cost (TELRIC) estimates it would imply to me that either it is reversing its position regarding what is the economic cost of service or that AT&T will select a number that rationalizes its position in a particular case. In any case, AT&T should not rely on TELRIC studies since they include shared costs (as pointed out in my direct testimony).[12]

Q. Has AT&T provided the Commission with its estimate of the economic cost of the loop?

A. Yes. for example in docket PSC-01-1181-FOF-TP, AT&T estimated the costs as ranging from $5.25 to $34.24 for BellSouth's service level 2 loops. If we take AT&T's loop estimate for the lowest cost zone, $5.25, and add on the cost of switching, transport, and retail incremental costs (approximately $3.00) we get a cost estimate of $8.25 that is significantly less than the ILECs' TELRIC-based

[11] AT&T sponsored the Hatfield Model in DOCKET NO. 960833-TP, order released December 31, 1996. The Commission order in that proceeding notes that the proponents of the Hatfield Model "purport that the model develops forward-looking network investments and costs for unbundled network elements and basic local exchange service." *Id.* Furthermore, AT&T has regularly argued that the economic cost of service is lower than the rates proposed by the ILECs and established by the Commission. See, for example, in docket PSC-01-1181-FOF-TP, AT&T contended that the economic cost of a loop was in the range of $6.76 to $8.00, or approximately one-half the rate established by the Commission. Table A, May 25, 2001 If a subsidy analysis was done by AT&T using what it has represented is the correct economic cost of service, it would have estimated that the cost of providing BLTS that was lower than the values identified by the ILECs. This, in turn, would have reduced the likelihood of a finding that residential service is supported or subsidized.

[12] Gabel Direct, at p. 11, lines 8-10.

estimate for the lowest cost zone of (approximately) $20.[13] This is also less than residential BLTS charges of $20.24. Therefore, it is unclear how Dr. Mayo concludes that BLTS is supported.

Q. Perhaps Dr. Mayo's endorsement of raising BLTS rates is based on his belief that it is appropriate to raise residential rates to make up for any ILEC access revenue loss?

A. I would be surprised if that was his view. In a recent Massachusetts proceeding, Dr. Mayo stated that it would be "unjust and unreasonable" to link access price reductions with an offsetting increase in the price of basic residential service.[14]

Q. Perhaps AT&T believes that when testing for the existence of a subsidy or the degree of support it is appropriate to use UNE rates to prevent a price squeeze?

A. AT&T's witnesses claim that BLTS is subsidized or supported. The economic test for determining if BLTS is subsidized involves comparing the ILEC's BLTS price with the ILEC's total service long-run incremental cost for BLTS. A price squeeze test is irrelevant to determining the existence of a

[13] The difference between the BellSouth cost estimate and the $8.25 value is only partially attributable to retail costs.

[14] *Verizon – Massachusetts, Price-Cap Regulation*, Massachusetts Department of Telecommunications and Energy, DTE 01-31, Phase II, Department of Telecommunications and Energy, October 24, 2002, Vol. 3, pp. 290-293.

subsidy because the price squeeze test involves consideration of the CLEC's costs, rather than the ILEC's costs. It is the ILEC's costs that are of relevance in this proceeding because of the legislative requirement to consider the degree to which ILEC rates are subsidized or supported.

2.2 Dr. Mayo And Mr. Fontiex Do Not Provide A Coherent Explanation Or Evidence As To Why The Proposed Rebalancing Would Induce CLEC Entry

Q. Please summarize Dr. Mayo and Mr. Fonteix views on the impact of current and rebalanced prices on entry. What is your view of their positions?

A. Both Dr. Mayo and Mr. Fonteix contend that current prices prevent entry,[15] and that the proposed rebalancing will lead to more entry.[16] However, their arguments are moot to the extent that they rely on the rebalancing moving BLTS rates from below TSLRIC to above it (since there is no record evidence that BLTS is priced below TSLRIC).

[15] Mayo Direct, p. 12, lines 4-6; pp. Fonteix Direct, p. 2, lines 19-23, p. 3, lines 1-11.

[16] Mayo Direct, p. 11, lines 19-23, p. 12, lines 1-8, p. 14, lines 1-4, and p. 18, lines 3-5; Fonteix Direct, p. 5, lines 8-13, p. 7 lines 4-9 (note the provided example in this last case shows entry prior to, rather than caused by, access rate reductions), and p. 7, lines 14-16; implicit in p. 2, lines 19-23, p. 3, lines 1-11.

Further, despite arguing that retail telecommunications firms increasingly, and indeed necessarily, must compete through the supply of bundles,[17] neither Dr. Mayo nor Mr. Fonteix discuss the impact of rebalancing on revenues a CLEC might earn in bundling local long distance service and any other services, let alone total revenues a CLEC could expect to earn, including revenues from intra-LATA access charges.

Yet, such revenues, most importantly, total revenues from the broad range of a CLEC's operations would not be significantly changed because the proposed rebalancing is required to be revenue neutral and intra-LATA access charge savings must be passed on in retail long distance prices.[18] Consequently, from the perspective of expected total profitability, the proposed rebalancing will not have a substantial impact on entry incentives.[19]

I also note that Mr. Fonteix's presents evidence from other states that he claims shows that the proposed rebalancing would lead to more entry.[20] However, the evidence he presents has little if any bearing on this question. No meaningful conclusions can be drawn by comparing different states and/or time periods

[17] For example, see Mayo Direct, p. 12, lines 18-22; Fonteix Direct, p. 2, line 23, p. 3, line 1; p. 5, lines 17-21, p. 6, line 1; p. 8, lines 12-13; and implicitly at p. 12, lines 18-20. Staff also take this view, for example, see footnote 63 below.

[18] For example, see Gabel Direct, Section 4.

[19] These comments apply specifically to Mayo Direct, p. 11, lines 19-23, p. 12, lines 1-8 and lines 18-21, p. 15, lines 1-14; references for Fonteix are as in footnote 17 above.

without an adequate statistical analysis that controls for the factors that differ from state to state and from one period of time to the next.[21]

It is also odd that AT&T would represent that high access fees are harmful to the CLECs when the CLECs have typically supported high access fees,[22] and the FCC has had to issue orders requiring the CLECs to lower their access fees.[23]

Q. Have Dr. Mayo and Mr. Fonteix added any arguments on entry not adduced by the ILECs' witnesses? If so, please indicate your view of these.

A. Yes, Dr. Mayo and Mr. Fonteix raise some lines of reasoning not made by the ILECs' witnesses, in particular that:

- efficient entry may be precluded due the difference between the ILECs' physical cost of supply of intra-LATA calls and its access prices for the same; and
- the prospect of anti-competitive behavior on the part of the ILECs.

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[20] Fonteix Direct, pp. 12-13.

[21] See Gabel Direct, Section 5, especially pp. 67-69.

[22] Discussed below, on pp. 8 and also footnotes 103 and 104.

[23] FCC 01-146 (CC docket Number 96-262), Seventh Report And Order And Further Notice Of Proposed Rulemaking, Adopted: April 26, 2001 (Released: April 27, 2001).

On the first matter, Dr. Mayo makes two points. First, he thinks that high intra-LATA access rates mean CLECs "face asymmetrically higher costs" than the ILEC,[24] making it impossible for CLECs to press price to actual cost, but only to their perceived cost, the intra-LATA access rate.[25] Secondly, Dr. Mayo argues that high intra-LATA access rates make it impossible for the CLEC to bundle retail services, and in particular offer very low priced retail intra-LATA calls competitively with the ILEC, since the CLECs are said to face intra-LATA access prices that exceed the incremental cost of supplying intra-LATA calls, so the ILEC's costs are lower than the CLEC's.[26] Mr. Fontiex expresses a similar view.[27]

Both of these arguments are wrong for two reasons:

1. CLECs earn as well as pay termination charges.[28] Moreover, the intra-LATA termination charge incurred by the CLEC will on average net out—

[24] Mayo Direct, p. 13, line 2.

[25] Mayo Direct, p. 12, lines 22-23, p. 13, line 1-10.

[26] Mayo Direct, p. 13, lines 11-23 and p. 14, line 1.

[27] "[E]xcess access charges further depress competition by limiting competitors' ability to compete across the full range of service categories," Fonteix Direct, p. 2, lines 21-22 (but see also 19-20). As with Dr. Mayo, Mr. Fonteix's argument is that higher intra-LATA access charges force competitors to charge higher retail rates for such calls, but that the ILECs do not incur such costs, so can compete at much lower prices, especially through bundles (Fonteix Direct, p. 2, line 23, p. 3, lines 1-11; on how undoing this alleged source of a price squeeze is said to improve outcomes see p. 5, lines 8-13, and p. 7, lines 14-16).

[28] The argument here also applies to origination charges for recipient pays calls.

so long as calls are reasonably random, even a very small network's outbound traffic will match in bound traffic—but even if they do not, net payments will be substantially less than gross payments and a very small proportion of the CLEC's total costs. As a result, moderately high termination charges do not represent a high total cost, most especially one that could prevent make bundling, even with very low or even zero rates on retail calls, unprofitable.

2. While the termination rate, being a real marginal cost to the CLEC, is relevant to the CLEC's retail pricing decision, this will not prevent the CLEC from bundling with low rates on retail calls, if this is what the market demands (as both Mayo and Fonteix suggest).[29] Competitive markets often set rates above or below marginal cost as is necessary, most especially (but not necessarily) on "gateway" goods, such as retail line rentals,[30] and on items supplied as part of a bundle (for example, BLTS as part of a bundle with long distance service).[31] In these circumstances, the relevant cost to the supplier is, respectively, the cost of the gateway and the expected cost of products bought through the gateway ("such as caller

[29] See footnote 17 above.

[30] Shafer uses the term (Shafer Direct, p. 8, line 10) and defines at lines 11-15. The relevant quote is reproduced below on p. 8, where I also discuss pricing in this context.

ID, long distance service, or dial-up Internet access"),[32] or the bundle. In short, the cost of the bundle should be compared with its revenues.

2.3 AT&T's Position On Price Setting In This Case Is Inconsistent With Dr. Mayo's Own Testimony As Well As How AT&T Sets Its Own Prices In Competitive Markets

Q. Dr. Mayo argues regulated prices should be reflective of prices in competitive markets.[33] What are your views on this?

A. An important aspect of my earlier testimony was the view, "that rebalancing, if it occurs, should result in prices that reflect the operations of a competitive market, rather than prices that are sustainable due to a lack of competition."[34] Dr. Mayo takes a very similar stand:

> "it is important to note that price regulation is a substitute for rates set by competitive market forces. That is, economists commonly recommend that the rate setting exercise should, insofar as

[31] For a more general discussion on goods that complement others, see Gabel Direct, Section 4.3, pp. 61 ff. Note such bundles typically rendered profitable by a hefty monthly charge and high marginal prices for call minutes beyond a certain level.

[32] Shafer Direct, p. 8, lines 13-14.

[33] Mayo Direct, at p. 7, lines 14-17.

[34] Gabel Direct, at p. 11, lines 8-10.

possible, try to establish rates that mimic the rates that would be set by competitive market forces."[35]

Q. In your view are Dr. Mayo's recommendations—that residential BLTS prices should not be subsidized[36] (recognizing you have shown that residential BLTS is not subsidized) and that usage prices, such as intra-LATA access charges, should be set to exactly cover their LRIC[37]—consistent with prices that would emerge due to competitive market forces?

A. No. As I noted in my testimony, it is common in competitive markets for prices, such as those for residential BLTS, to be kept low, sometimes even below their long run incremental cost (LRIC), and for usage charges to be set above LRIC to recover subsidies, where they occurred, and make any necessary contribution to fixed costs.[38]

This is well evidenced by AT&T's own pricing behavior in competitive mobile telecommunications markets. For example, AT&T typically offers free and

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[35] Mayo Direct, at p. 7, lines 14-17.

[36] See, for example, Mayo Direct, p. 14, lines 17-19, p. 15, lines 1-14.

[37] Mayo Direct, p. 20, lines 8-11: "The relevant target, however, for the establishment of competition-enabling intrastate switched access charges in Florida is the economically efficient rate as approximated by incremental cost."

[38] For example, because of the gateway nature of the service—see footnote 30 above, and more generally footnote 31.

heavily subsidized mobile telephone handsets to new subscribers, thereby pricing handsets below their incremental cost. On 9 November 2003, AT&T offered three different handsets for free to new subscribers.[39] Mobile firms also typically offer handsets at below cost prices, even when a price is charged. For example, the AT&T cited web page that offers the Nokia 3560 handset for free indicates its normal price is $99.99. However, if bought directly from Nokia, the handset is priced at $139.99.[40] In either case, it is likely that AT&T prices the handset well below its LRIC.[41] Of course, AT&T expects, on average, to recover the cost of such discounts through subsequent usage charges which exceed the incremental cost of supplying that usage.

Q. Please comment on Dr. Mayo's views on the right level for intra-LATA and inter-LATA access rates.

A. Dr. Mayo concludes his testimony:

> "My understanding is that interstate access charge rates continue be set at rates that exceed the economic cost of providing access. The relevant target, however, for the establishment of competition-

[39] http://www.attwireless.com/personal/products/phones.jhtml;dsessionid=KOY5BO1NV4SB3B4R0GZSFFA?titleNumber=2&_requestid=75073.

[40] http://www.nokiausa.com/phones/3560.

enabling intrastate switched access charges in Florida is the economically efficient rate as approximated by incremental cost."[42]

Such a conclusion cannot be reached, as Dr. Mayo does, by merely comparing price to incremental cost. Rather, total earnings of the ILEC must be considered, as well as evidence on demand elasticities. A competitive carrier, to be successful in the long run, must cover its costs. In telecommunications, costs include a substantial fixed component,[43] which pricing at incremental costs would not cover. Consequently, service prices typically must exceed their long run incremental cost. In a competitive market, carriers would be pressured to ensure the necessary mark-up over long run incremental cost minimizes harm to their consumers. In particular, mark-ups would be made taking account of firm level demand elasticities. As I have indicated,[44] this typically implies, for example, low prices on "gateway" services such as line rentals.

[41] Since the retail price is $139.99, this is the opportunity cost to AT&T, which does not manufacture the handset, but could resell it at the retail rate.

[42] Mayo Direct, p. 20, lines 7-11.

[43] See, for example, on loop costs, FCC, 03-36 (Triennial Review Order), Report And Order And Order On Remand And Further Notice Of Proposed Rulemaking, February 20, 2003 (released August 21, 2003), paragraph 205.

[44] See footnote 30 above, and more generally, including the case of bundling, see footnote 31.

3 Staff Witness Mr. Shafer On Legislative Intent, Entry And Bundled And Long Distance Rates

3.1 The Legislation In No Way Presumes BLTS Is Supported

Q. Can you comment on Mr. Shafer's views on the theoretical underpinnings/premises of the Act?

A. Yes. Mr. Shafer claims, without evidence, that:

> "the theoretical underpinnings of the statute are that the cost/price relationships for intrastate access charges and basic local service rates are seriously misaligned. More simply put, the Legislature subscribed to the notion that access charges subsidize basic local rates, or that access charge rates far exceed cost and basic local service rates are on average below cost."[45]

and that:

[45] Shafer Direct, p. 7, lines 5-11.

"The premise under which the Legislature passed the Tele-competition Act is that basic local service rates are subsidized by intrastate access charges."[46]

The Act, however, appears agnostic on this, directing the Commission to consider rebalancing more favorably if it were to "remove current support for basic local telecommunications services (BLTS) that prevents the creation of a more attractive competitive local exchange market for the benefit of residential customers; [and] [i]nduce enhanced market entry."[47]

3.2 Mr. Shafer Takes No View As To Whether BLTS Or Residential BLTS Is Supported

Q. What are Mr. Shafer's views on whether BLTS is priced below cost or otherwise supported and does he provide any evidence on the question?

A. Mr. Shafer does not directly say that BLTS is priced below cost or otherwise supported and supplies no evidence that this is the case. He makes no

[46] Shafer Direct, p. 16, lines 6-8.

[47] Section 364.164 (1) (a) and (b).

direct or implied comments on whether residential BLTS is subsidized. My direct testimony demonstrates that the available evidence indicates that residential BLTS is not cross-subsidized.[48]

3.3 Mr. Shafer Is Incorrect In Asserting That If BLTS Was Priced Below Cost This Would Necessarily Discourage Entry

Q. What are Mr. Shafer's views on entry if BLTS was priced below cost and do you agree with these views?

A. Mr. Shafer incorrectly believes that:

> "To the degree that basic local service rates are below cost, that is a significant deterrent to market entry for that particular service."[49]

And that:

> "The challenge of making a profit in a market in which a key product is priced below cost is clearly a deterrent to entry."[50]

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[48] Gabel Direct, *passim.*

[49] Shafer Direct, p. 6, lines 11-14.

[50] Shafer Direct, p. 6, lines 23-24. Shafer repeats these views in many places—see p. 6, lines 18-21, and lines 23-25, continued on p. 8, line 1, p. 9, lines 5-12, p. 10, lines 2-5, and p. 11, lines 13-17.

Mr. Shafer is not correct that prices in a competitive market cannot be below cost, most especially on, in Shafer's words, a "gateway good".[51] As Mr. Shafer points out:

> "Many products cannot be viewed in isolation, and I believe basic local exchange access is one of those services. Basic local exchange service is a gateway product... it provides access to an array of other products or services that cannot stand alone or have no value without local exchange access. For example, services such as caller ID, long distance service, or dial-up Internet access are unavailable to consumers without local exchange service."[52]

In such cases, it is common for prices to be below cost without discouraging entry.[53] As Shafer puts it:

> "The profitability of these other services ['such as caller ID, long distance service, or dial-up Internet access'] also plays a role in the market entry decision. This phenomenon also explains why some

[51] Shafer Direct, p. 8, line 10.

[52] Shafer Direct, p. 8, lines 8-15.

[53] As per discussion above associated with footnotes 30 and 31 (at p. 14).

residential competition persists even in light of the evidence that basic local exchange service on its own is priced below cost on average."[54]

I add that residential BLTS is not subsidized based on my review of the data presented by the ILECs.[55] Consequently, even if Mr. Shafer were right that a subsidy prevents entry (and he is not), entry into residential BLTS would not be discouraged in present day Florida based upon the record evidence.

Moreover, on the question of entry, in Shafer's words, "the primary factor for a competitor to consider is whether they will be profitable in the foreseeable future in any particular market".[56] Yet, profitability of entry is not significantly changed by a revenue neutral price adjustment, thus the proposed rebalancing provides little or no incentive for increased entry.

Finally, even if the proposed rebalancing increased the profitability of entry, it does not automatically follow that new entry will occur. Given

[54] Shafer Direct, p. 8, lines 23-25, continued on p. 9, lines 1-2. The quote in square brackets is from p. 8, lines 13-14.

[55] Gabel Direct, *passim*.

sunk costs and other entry barriers, even higher profits may still be too low to result in significant new entry.

Q. Did Mr. Shafer present evidence to support proposition that current rates are a significant deterrent to market entry?

A. No, he did not. However, as I discuss below (1) Knology, Inc. in its SEC filings, does not list this as an impediment of entry or expansion;[57] (2) as is also the case for CLECs in a survey conducted by Staff;[58] and (3) CLECs generally consider lower access rates, even in return for higher BLTS charges, as having a negative impact on their profits.[59]

Q. Does any other evidence from Staff provide insights into the drivers of CLEC entry?

A. Yes, the 2002 "Competition Report" sponsored by Staff witness, Ms. Ollila, is relevant, and even more so, the "2003 Competition Report,"[60] containing similar, but more recent evidence.

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[56] Shafer Direct, p. 7, lines 1-3. Note the question asked was, "What would be the basis for competitors choosing to enter markets they had previously elected not to enter?" (p. 6, lines 24-25).

[57] See below pp. 8 ff. and footnotes 94 and 95.

[58] See below pp. 8 ff. and footnote 96.

[59] See below pp. 8 ff. and footnotes 103 and 104.

[60] Florida Public Service Commission's, Office of Market Monitoring and Strategic Analysis, "Telecommunications markets in Florida: Annual Report on Competition as of June 30, 2003", revised draft, October 27, 2003; http://www.psc.state.fl.us/general/publications/reports.cfm.

Q. Please summarize the 2002 Competition Report discussion of drivers of CLEC entry.

A. The report's section on entry begins with the views of the regulatory commissions from the two states with the most CLEC entry, New York and Texas:

> "The New York Commission stated that its ALEC market share may have been the result of the introduction of the UNE Platform... and the FCC's decision to allow Verizon to operate as a long distance carrier in New York (271 approval)...
>
> "The Texas Commission provided several reasons for its relatively high ALEC market share: prevalence of UNE-P, 271 approval..., existence of a standard, 4-year interconnection agreement..., performance measures, uniform state-wide municipal right-of-way compensation, and building access regulation."[61]

[61] Competition Report, p. 25.

These are the only reasons given by the New York and Texas Commissions that the Report cites. In particular, neither Commission is cited as mentioning low BLTS rates.

The authors of the Florida Competition Report conclude that CLEC entry tends to rise with 271 approval, larger margins between UNE prices and retail prices, and lower differences in UNE rates across zones.[62]

It is the view of the OPC that these factors are important, but with an important caveat on the margin between retail and UNE rates: the appropriate margin should be measured by a comparison of total revenues with the total cost of entry.[63] For example, retail supply through purchase of UNE-P entitles the supplying carrier to access charges and these must be accounted for. Consequently, a fall in access charges accompanied by a revenue neutral rise in BLTS rates is unlikely to have a substantial positive impact on the profitability of UNE-P entry.[64]

[62] Competition Report, pp. 25-26. Discussion is provided in pp. 26 ff. The 2003 Competition Report provides lists 10 factors that impact on CLEC entry decisions, including most of those already mentioned (pp. 13-14).

[63] This is recognized in the Report—"This analysis also does not include any additional margins that competitors could obtain by selling long distance and ancillary services such as voice mail, caller ID, call waiting, etc." (p. 29)—but not discussed in further detail, and is recognized more explicitly in the 2003 Competition Report—"Both ILEC and CLEC business plans depend on the average subscriber purchasing more than basic local service" (p. 18). For more on OPC's view that a broad view of entry decisions must be taken, see pp. 8 ff. (Section 2.2) above.

[64] See below pp. 8 ff. and footnotes 103 and 104.

Q. Does the Competition Report present any evidence about actual CLEC entry in Florida?

A. Yes, and this evidence strongly suggests that 271 approval and the availability of UNEs at affordable rate are central to CLEC entry decisions. The Report indicates that important reductions in UNE rates occurred in May and October 2001, and then in September 2002.[65] At the time of writing the Report, only pre-September 2002 data was available, but on that basis, the Report concludes:

> "the May and October 2001 rate changes have had a dramatic effect on the Florida market. The number of UNE-P lines in service in BellSouth's territory grew more than 259%."[66]

Q. You indicated evidence that is more recent was available in the 2003 Competition Report. Please summarize that evidence as it is relevant to the level of entry.

[65] Competition Report, p. 34, especially Table 8; the change in May see p. 35.

[66] Competition Report, pp. 35-36, including Figures 14-16. My direct testimony also concluded that recent line growth had surged, and also attributed this to lower UNE prices (Gabel direct, pp. 41-42).

A. Substantial CLEC entry in Florida continued—"switched based lines... grew 34%... in the 2002-2003 reporting period."[67] In BellSouth's six major markets, CLEC penetration rates were 18%, 24%, 26%, 27%, 28%, and 28%.[68]

Q. Please comment on these rates.

A. Several comments are relevant here. First, rapid growth in entry is hardly evidence of entry failure. Second, this rapid growth is no doubt in part explained by the September 2003 UNE rate reductions which left UNE-P prices at levels less than BLTS rates alone, that is, before accounting for other revenue sources.[69] Third, entry and market expansion decisions in telecommunications take substantial time. As a result, increased entry due to the September 2002 changes will continue well beyond the impact reported at June 2003.

Q. You have indicated the 2003 Competition Report showed rapid rates of growth in entry levels. Did it contain any relevant evidence on the mix of entry?

A. Yes. Even more striking than the rapid levels of entry, were three aspects of the mix of entry:

[67] 2003 Competition Report, p. 20; more generally see pp. 20 ff.

[68] 2003 Competition Report, p. 23, Table 9.

[69] 2003 Competition Report, p. 18.

(1) "[F]acility-base carriers have mainly targeted metropolitan areas,"[70] a trend unlikely to be significantly impacted by the proposed rebalancing.[71]

(2) Entry occurred to a much greater extent in BellSouth territory than in areas serviced by Verizon and Sprint.[72] For example, whereas CLECs have penetration rates 18-28% in the major markets served by BellSouth's exchanges, they only have 6-18% of Verizon's markets, and 11% of Sprint's.[73]

(3) "UNE-P only comprises 3% of CLEC lines in Verizon's territory and only 5% in Sprint's," but 48% of BellSouth lines.[74]

Q. Is it likely that the ILECs' petitions, on their own, would change the mix of entry?

A. No, not at all. The petitions are intended to be revenue neutral, so they would have a very limited impact on the relative attractiveness of entry into one

[70] 2003 Competition Report, p. 21; see also p. 15.

[71] David Gabel, "Why is There So Little Competition in the Provision of Local Telecommunications Services? An Examination of Alternative Approaches to End-User Access," MSU-DCL Law Review, 2002, 651-670.

[72] 2003 Competition Report, pp. 22 ff.

[73] 2003 Competition Report, p. 23, Table 9.

[74] 2003 Competition Report, p. 16.

ILEC's market over another's. They would also have little impact on the choice of UNE-P over other means of entry.

Q. Does the 2003 Competition Report suggest any likely causes of the sharply different rates entry into different ILEC territories?

A. Yes. The 2003 Competition Report explains the difference in CLEC entry rates in a manner similar to the New York Commission:[75] the availability UNEs at reasonable prices and the 271 process appear to be crucial to CLEC entry.[76] For example, the Florida Commission has only recently set UNE prices for Sprint and Verizon, and the Verizon rates have been stayed by a court order, while the Sprint rates only just came into effect, so have not yet affected penetration rates,[77] though ten new entrants now operate in Sprint territory.[78]

Q. What is the OPC's view of this question?

A. The OPC concurs that the chief causes of CLEC entry in Florida have likely been the 271 process,[79] and the availability of permanent cost-based UNE prices at levels that make profitable entry feasible. As a consequence, it is likely

[75] See p. 8 above.

[76] 2003 Competition Report, pp. 14-16.

[77] 2003 Competition Report, p. 16.

[78] 2003 Competition Report, p. 18.

[79] In part because it forces inter-exchange carriers to compete through bundles, and in part because the ILEC, in seeking the right to retail long distance services in its own territory, provides a range of competitive guarantees, including UNE availability.

that entry will continue in the BellSouth territories, and likely will grow in Sprint's areas of operation. Entry in Verizon's territory, however, may remain stalled while UNE prices are a matter of court proceedings.

Q. Can you discuss Mr. Shafer's views on bundled service offerings, and pricing of long distance services, especially by wireless carriers?

A. Yes. Mr. Shafer claims:

> "achieving parity between intrastate access charges and interstate access charges will lead to more competitively priced bundled service offerings for residential consumers, which will provide benefits to those consumers whose calling patterns match those offerings."[80]

And later that:

> "it is likely that there will be a significant number of residential consumers that will see benefits in expanded choice and new and innovative services."[81]

[80] Shafer Direct, p. 13, lines 5-9.

[81] Shafer Direct, p. 14, lines 11-14.

He also says that "a *significant number* of residential consumers... will see benefits in expanded choice and new and innovative services."[82]

Q. In your view, does Mr. Shafer support these strong claims?

A. The only explanation Mr. Shafer offers for these claims seem related to wireless competition in long distance supply pressing down long distance rates and leading to lower wireline bundle prices.[83] Two points should be made here:

1. The statute requires that retail long distance suppliers pass on any reductions in intra-LATA access rates implemented in the proposed rebalancing. Therefore, assuming the law is appropriately implemented, no competitive pressure from wireless carriers is necessary for long distance rates to be lowered.

2. It may be that competition among wireless providers provides some link between total wireless firm revenues and costs. But the impact of Florida's rebalancing on long distance prices, or bundled telephony prices in wireless, let along for the somewhat more distant substitute, wireline services, is likely to be quite small. Wireless pricing plans apply to wide

[82] Emphasis added. Shafer Direct, p. 14, lines 11-14.

[83] Shafer Direct, p. 13, lines 10-25, continued on p. 14, lines 1-6, and 15-24.

geographic areas, often at the national level. Consequently, lowering intra-LATA access rates in Florida are likely to have only a limited impact on prices of such plans.

Similarly, the price of wireless service is for a bundle of products—for example, as per Shafer, "the pricing strategy employed by wireless carriers... treats long distance minutes the same as local minutes"—so the effect would be further diluted.[84]

In this light, Mr. Shafer provides no evidence for proposing that "a *significant number* of residential consumers... will see benefits in expanded choice and new and innovative services,"[85] and indeed, admits that he doubts "that all residential consumers affected by the proposed rate changes will experience the benefits of increased competition and additional service offerings"[86] It is OPC's view that better evidence than this is required to show consumers will benefit from the proposed rebalancing.

[84] Shafer Direct, p. 14, lines 4-6.

[85] Emphasis added. Shafer Direct, p. 14, lines 11-14.

[86] Shafer Direct, p. 14, lines 9-11.

4 A Rebuttal Of The Testimony Of Mr. Boccucci, Jr.

4.1 Mr. Boccucci, Jr. Claims The ILECs' Petitions Will Increase Competitive Entry, But Provides No Material Evidence For This, And What He Says Is Inconsistent With Public Statements From Knology, Inc.

Q. Can you summarize Mr. Boccucci, Jr.'s testimony?

A. Yes, Mr. Boccucci, Jr., in his own words, presents "the position of Knology of Florida, ("Knology"), a competitive local exchange carrier, in support of the petitions subject to this proceeding."[87] He concludes:

> "Knology believes that the grant of these petitions 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, will induce enhanced market entry and will create more capital investment and provide more employment in the State of Florida."[88]

[87] Boccucci Jr. Direct, p. 1, lines 7-9.

[88] Boccucci Jr. Direct, p. 11, lines 7-11.

Q. Does Mr. Boccucci, Jr. show that that BLTS or residential BLTS are supported?

A. No. Mr. Boccucci, Jr. nowhere demonstrates that BLTS or residential BLTS are supported. Moreover, I have shown that the record evidence indicates that residential BLTS is not subsidized.[89] Consequently, Mr. Boccucci, Jr. conclusions, which I quote in my answer to the preceding question, not only are not demonstrated, but do not follow as a matter fact.

Q. Can you please highlight what you think is the central reason why you found no support of residential BLTS in contrast to the ILECs that found support (as also claimed by Mr. Boccucci, Jr.)?

A. Yes. The basic reason for the difference between my estimates and those of the ILECs was the treatment of shared costs. The ILECs inappropriately included, in their BLTS costs estimates, costs shared by business and data services.

Q. Does Knology, Inc. provide any insights into the treatment of shared costs and hence of the proper way to test for support or subsidy?

A. Yes, it does. For example, the following quote is consistent with economic theory (and my position), but not the ILECS' cost studies; nor does it

[89] Gabel Direct, *passim.*

support Knology's claims that BLTS is supported. It states that shared costs should not be allocated when evaluating the profitability of a service:

> "While management of the Company monitors the revenue generated from each of the various broadband services, operations are managed and financial performance is evaluated based upon the delivery of multiple services to customers over a single network. As a result of multiple services being provided over a single network, many expenses and assets are shared related to providing the various broadband services to customers. Management believes that any allocation of the shared expenses or assets to the broadband services would be subjective and impractical."[90]

Q. What else did Mr. Boccucci, Jr. have to say on what would induce entry?

A. Mr. Boccucci, Jr. testified that "Knology believes that Florida Statue 364.164 creates the framework to promote facility-based local exchange competition";[91] that Knology, Inc. invests where the regulatory environment is

[90] Knology, Inc., 10-Q report, September 30, 2003, p. 8, http://www.sec.gov/Archives/edgar/data/1096788/000119312503070040/d10q.htm.

[91] Boccucci Jr. Direct, p. 2, lines 16-17.

favorable (which given its prior investment in Panama City,[92] presumably included the State of Florida) and that "[i]f these petitions are granted, Knology will be able to attract and deploy new capital investment in Florida, thereby offering consumers a choice in facilities-based providers for new and advanced high-tech services."[93]

Q. Is Mr. Boccucci, Jr.'s testimony on entry consistent with the information Knology, Inc. supplies to investors in its 10-K reports?

A. No. In discussing impediments to entry, Knology, Inc. provided a range of difficulties that would adversely affect its operations.[94] None of these include too high access rates, too low BLTS rates, or existing legislation in any state. Similarly, none of these matters were raised in discussing difficulties in growing

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[92] Boccucci Jr. Direct, p. 2, lines 21-23, this investment was made prior to June 2001 (see http://www.knology.com/news/index.details.cfm?pkey=128).

[93] Boccucci Jr. Direct, p. 9, lines 17-19.

[94] Knology, Inc., 10-K report, December 31st, 2002, p. 23. http://www.sec.gov/Archives/edgar/data/1096788/000093176303000824/d10k.htm:

"We may encounter difficulties expanding into additional markets, which could adversely affect our results of operations.

"To expand into additional cities we will have to obtain pole attachment agreements, construction permits, franchises and other regulatory approvals. Delays in entering into pole attachment agreements and in receiving the necessary construction permits and in conducting the construction itself have adversely affected our schedule in the past and could do so again in the future. Further, as we are currently experiencing in Louisville, we may face legal or similar resistance from competitors who are already in these markets. For example, a competitor may oppose or delay our franchise application or our request for pole attachment space. These difficulties could significantly harm or delay the development of our business in new markets."

the company that would harm its operations.[95] Nor were these matters raised in Staff discussion of a survey of CLECs on impediments to entry. The top four concerns of CLECs, ranked starting with the often cited, were UNE rates, interconnection agreements, service outages and billing.[96]

Q. Does Mr. Boccucci, Jr. provide any evidence for his assertions on entry that you cite?

A. Knology claims it was motivated by the Act to invest in Florida through the purchase of "Cable and Data Asset (Verizon Media) in Pinellas County,"[97] but provides no evidence to this effect, except for the timing of that purchase.

Q. Mr. Boccucci, Jr. testified that on entry by Knology "incumbent providers upgrade their networks... implement new products and price reductions and increase the level of customer service and marketing to

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[95] Knology, Inc., 10-K report, December 31st, 2002, p. 25. http://www.sec.gov/Archives/edgar/data/1096788/000093176303000824/d10k.htm.:

"Our ability to grow will depend, in part, upon our ability to:

- successfully implement our strategy;
- evaluate markets;
- secure financing;
- construct facilities;
- obtain any required government authorizations; and
- hire and retain qualified personnel."

[96] 2003 Competition Report, p. 56-57, including Figure 26.

[97] Boccucci Jr. Direct, p. 3, lines 9-11.

compete with Knology." Does this indicate that the proposed rebalancing will lead to CLEC entry?

A. No, it does not. This is a standard result of competitive entry, but provides no indication of whether the proposed rebalancing encourages entry.

Q. Mr. Boccucci, Jr. testified that Knology actively bundles "voice, video and data services"[98] and provides "advanced or new services."[99] Does this indicate that the proposed rebalancing promotes bundling and advanced or new services?

A. No. According to Mr. Boccucci, Knology currently bundles and offers such services in Panama City, Florida[100] where it has been operating since at least June 2001,[101] so these decisions can hardly have been a result of the Act. Similarly, Knology's parent, Knology, Inc. provides these kinds of services in number of other locations outside of Florida,[102] that is, in jurisdictions where the Act does not apply.

[98] Boccucci Jr. Direct, p. 5, lines 13-15.

[99] Boccucci Jr. Direct, p. 5, lines 19-23, continued on p. 6, lines 1-10.

[100] Boccucci Jr. Direct, p.5, lines 13-23, continued on p. 6, lines 1-10.

[101] http://www.knology.com/news/index.details.cfm?pkey=128

[102] Boccucci Jr. Direct, p. 4, lines 10-12.

Q. You indicated that Mr. Boccucci, Jr. claims that rebalancing will be helpful to facility-based entrants. Were you surprised by Mr. Boccucci, Jr. testimony and if so why?

A. Yes, I was surprised. Access rate reductions have been perceived to be not in the best financial interest of many CLECs.[103] Indeed, this is Knology's own position in its 10-K report to the Securities and Exchange Commission:

> "*Access Charge Reform.* The FCC is in the process of reducing access charges imposed by local telephone companies for origination and termination of interstate long distance traffic. Overall decreases in local telephone carriers' access charges as contemplated by the FCC's access reform policies would likely put downward pricing pressure on our charges to domestic interstate and international long-distance carriers for comparable access. Changes to the federal access charge regime could adversely affect us by reducing the revenues that we generate from charges to domestic interstate and international long-distance carriers for originating and terminating interstate traffic over our telecommunications facilities."[104]

[103] FCC 01-146, paragraph 27; Gabel Direct, p. 57-58, which cites Pre-Filed Testimony of F. Wayne Lafferty on Behalf of Cox Connecticut Telecommunications, L.L.C. given on June 3, 2003.

[104] Knology, Inc., 10-K report, December 31st, 2002, p. 19, http://www.sec.gov/Archives/edgar/data/1096788/000093176303000824/d10k.htm.

Q. Does this conclude your testimony?

A. Yes.

BY MR. BECK:

Q Dr. Gabel, have you prepared a summary of your testimony?

A Yes.

Q Would you please provide that?

A Good afternoon, Commissioners. In my testimony I address two issues. I address the issue of the degree to which the proposal made by the ILECs will enhance market entry. Secondly, I address the issue, the degree to which there has been evidence presented in this hearing which shows that residential service is supported. Let me address each of those issues briefly.

The degree to which a market is going to experience greater competition, if someone makes such a claim, it needs to be supported with some evidence. And what I state in my testimony is what I find striking in the submissions of the ILEC petitions is any support, substantive support for their claims that the rebalancing will result in enhanced market entry. In my testimony I point out the difference between what you have received in this proceeding and what you will see in the TRO proceeding.

The Federal Communications Commission would not allow you to make a decision in the switching UNE impairment case based upon a mere claim that if you remove the UNE switching element, that it will result in no impairment. Instead there

has to be a showing about how the actual markets operate. And contrast that to the testimony that you have here. As opposed to having factual information about these are the kinds of entry costs that parties incur, you're just presented with platitudes; that if you rebalance, even though it's going to be revenue neutral, it's going to result in additional entry.

Now not only would that not be sufficient for the FCC, but let me just offer another analogy for you. Suppose I had entered testimony in this proceeding and I'd say to you, Commissioners, I don't think you should rebalance the rates because if you raise those residential rates, it's going to cause some people to fall off the network, and that's going to lead to some severe harm, people won't be able to call 911 that need to, and the cost to society of people falling off the network exceeds the benefits from rebalancing.

Now other parties would have said to me, well, where is your support for that? Can you identify how many people are going to fall off? It isn't sufficient to say that one is going to fall off. We need to know, is it going to be one, 12,000 or 24,000? And how do you identify what's the cost of somebody dropping off the network?

And so I suspect, knowing what I know of how administrative processes work, that if I had entered testimony that was just opinion without any way for you to independently validate my claims, you would probably have given little weight

to that evidence. And that's what one of my two sections of my testimony address, that the ILECs have just done nothing more than say, if you rebalance, that's going to improve things. And that should not be sufficient. They have failed to meet their burden of proof.

The second issue I address is the degree to which residential services receive support. Now support is different than a subsidy. I think myself and other economic experts are in agreement about what's the difference between a subsidy and a support. A subsidy involves a rate below the total service long-run incremental cost. Support is a rate that departs from what would emerge in a competitive market.

Now at the outset no one has introduced -- or let me say the ILECs in their direct case introduced no evidence about what kind of rates would emerge if the market was competitive. So, so my first presentation to you is that it's difficult to find that rates are supported when there's no evidence on what kind of rates would emerge in a competitive market.

My second point is, well, let's look at the studies that were submitted. These were characterized by the ILECs as total service long-run incremental costs, but they were not this. What the ILECs did is they said let's take the total cost of the loop and pretend that there's only one service access, we'll divide costs by the number of access lines and we'll get an average cost, and we'll compare that to the price

of residential service. Well, doing that conflicts with everything that I know Commissioners are taught when they go to Camp NARUC. You are now comparing a family product cost to a service price. And so the appropriate comparison that I pointed out in an NRR in Monograph in 1996, you have to do one of two things: You either have to compare the service price to the service incremental cost or you compare the family revenues to the family cost.

The ILECs are inconsistent. What they have done with the acquiescence of the interexchange carriers is they said, well, when it comes to cost, we're going to look at family cost, but when it comes to price or revenue, we're going to look at service price. That is illogical, it's inconsistent with anything that you would have been taught at Camp NARUC or anything that you would have read in an economics textbook.

CHAIRMAN JABER: Dr. Gabel, just for the record, I want you to know I was too busy to go to Camp NARUC. I think we could all say that.

COMMISSIONER DAVIDSON: I've not yet tasted that Kool-Aid.

THE WITNESS: Okay. All right. Okay. Well, in the end of my direct testimony I point out I think there should be rebalancing. I do. I'm struck by the access rates here. I do think there should be rebalancing. But when rebalancing occurs, it should be done in a way that's consistent with a

mandate that the Legislature has provided you. And the ILECs have not satisfied that mandate, so I encourage you to deny this petition and ask the ILECs to come in with a filing that is consistent with what you expect to see in an impairment proceeding, and that is show how a competitive market would work, show that the rebalancing will be beneficial to customers, and address the issue of, well, what kind of prices would emerge in a competitive market so that you don't have the kind of whipsawing of prices where you raise prices by regulatory fiat and then you later observe that those aren't prices that would be sustainable in a competitive market. Thank you.

CHAIRMAN JABER: Thank you, sir. Let's see. We should start with -- well, do you tender the witness for cross?

MR. BECK: Yes, I do.

CHAIRMAN JABER: Thank you. Ms. Bradley.

MS. BRADLEY: No questions.

CHAIRMAN JABER: Mr. Twomey. Okay. Ms. McNulty.

MS. McNULTY: No questions.

CHAIRMAN JABER: Mr. Hatch.

MR. HATCH: No questions.

MR. MEROS: No questions.

CHAIRMAN JABER: Mr. Lackey.

MR. LACKEY: Thank you, ma'am.

CROSS EXAMINATION

BY MR. LACKEY:

Q Dr. Gabel, my name is Doug Lackey. I'm an attorney with BellSouth. I have a few questions for you.

In your summary you said that you agreed with the ILECs that rates in Florida need to be rebalanced; is that correct?

A That is correct, and it's stated in my direct testimony.

Q And in doing this rebalancing, you would not rule out moderate increases in residential basic local telecommunications service prices; correct?

A That is correct.

Q Okay. Now I didn't see you in the hearing room yesterday. Were you here?

A I was watching most of the proceedings on television.

Q Okay. And did you see the testimony of the witness from Knology?

A I did.

Q Okay. Now you're a professor, I think, at Queens College; is that right?

A Yes, sir.

Q Okay. Have you ever run a CLEC?

A No.

Q Did you hear the witness from Knology testify that the price of local service was a factor that he considered in

making decisions about where to expand his service?

A I heard that testimony.

Q Did you hear him say that when he was comparing a $9 average rate in Florida to a $15 rate in Tennessee, that he went to Tennessee?

A I heard that testimony, but I certainly did not find it, the story credible because an investment decision by a firm is based upon looking at total revenues and costs, and the entry isn't going to be determined by the component price of basic exchange service. Rather, it's going to be based upon all the revenues that are generated by the firm.

And so if you look at the 10-K, 10-Q filings of firms like Knology or RCN, when they describe how they base their entry decisions, you don't see in their reports to investors a statement that, well, we're going into this market because of rebalancing. They look at total revenues.

Q All right. I want to make sure I understood your answer. You did not find the Knology witness's testimony yesterday credible; is that what you said?

A Maybe compelling I should have -- that is the word that I used, and I think a better selection of words would have been compelling.

MR. LACKEY: I don't have anything further, Madam Chairman. Thank you.

CHAIRMAN JABER: Thank you, Mr. Lackey. Mr. Chapkis.

MR. CHAPKIS: No question.

CHAIRMAN JABER: Mr. Fons.

MR. FONS: No questions.

CHAIRMAN JABER: Staff.

MS. CHRISTENSEN: Just a few questions.

CROSS EXAMINATION

BY MS. CHRISTENSEN:

Q In the deposition that you gave you provided an estimate of a UNE-P provider's other costs beyond the cost of the platform. Do you recall that?

A I do.

Q Okay. Do you recall the estimate that you had provided?

A $10, and --

Q Okay.

A After the deposition -- I was going by memory there.

Q Uh-huh.

A I was asked what costs I thought, or at least I had testified to what internal costs a CLEC would incur if they entered the market as a retail provider, and I suggested a price of $10 based upon a report that I recently did with Eric Ralph and Scott Kennedy for NRRI's part of the impairment proceeding. And I presented this estimate because the states need to look at what's the profitability of entry.

I looked up the number after my deposition. The true

number is $12.28.

Q What would be a high-end estimate? Is there a range for that? And if there is, could you give us the high-end estimate and a low-end estimate for those costs?

A There is a range, but at this moment I don't have a range in mind. What drives the range, I can tell what you drives the range is the estimate of the customer acquisition costs, and I can tell you that the customer acquisitions costs range -- the estimate is from $100 to $400. But then that needs to be converted to a monthly cost, and I don't, I can't do that off the top of my head.

Q A monthly cost. Can you explain the methodology you would use to come to the monthly cost?

A Sure.

Q We can figure out the mathematics later.

A All right. You identify, well, how much time does the CLEC have for recovering its customer acquisition costs? The customer acquisition costs are significant for an entrant. You estimate how much time the CLEC has to do that. I believe the report uses a number of 30 months, but I could be wrong about that. And then also you have to say, well, what's the cost of money to the CLEC, because you need to discount that cost over the 30-month period. And I believe the cost of money that was used in the study was 15 percent.

Q Okay. And is that the best -- I'm sorry. Was that

the basis for your estimate of the CLEC entrant costs?

A Yes. The $10 number that I used during my deposition was based upon what I remembered was in the NRRI report, and afterwards I looked it up and the true value is $12.28.

Q We just want to confirm one thing. Is the 30-month the expected service life?

A Yes, for the customer. When the customer signs up for service with the CLEC, that was the -- I believe -- it could have been 30 months, it could have been -- I know we played with numbers between 24 and 36 months.

Q Okay. So the range would be 24 to 36 months at the outset, but you believe 30 is probably the correct number?

A To the best of my recollection, yes.

MS. CHRISTENSEN: Okay. No further questions.

CHAIRMAN JABER: Commissioner Davidson.

COMMISSIONER DAVIDSON: Thank you, Chairman.

Welcome, Dr. Gabel.

THE WITNESS: Thank you.

COMMISSIONER DAVIDSON: Your bio at the Columbia Institute of Tele-Information states in part that your current research concerns the origin and the continued need to regulate the telephone industry. Could you elaborate on what you mean by "continued need to regulate the telephone industry"? Does that need encompass in your opinion economic regulation or is it limited to public policy type of regulation such as E-911,

universal service, et cetera?

THE WITNESS: No. My belief is that there continues to be a need for economic regulation in the telecommunications industry because at this point in time there isn't a sufficient amount of competition in the retail market where the Public Service Commission or any other equivalent state regulatory commission can just rely on the market to provide sufficient protection to retail customers. And so my focus of my research is thinking about, in part about where should regulatory commissions be focusing their effort.

COMMISSIONER DAVIDSON: At what point in your opinion would that continued need no longer exist from an economic regulation perspective?

THE WITNESS: Well, I think that you will continue to have a role in the foreseeable future. I can't imagine that role ending as long as there's interconnection between competing networks. So you could migrate from having a primary responsibility of providing safeguards to retail customers to just ensuring that when networks interconnect, that the terms of interconnection are reasonable.

COMMISSIONER DAVIDSON: Let's assume for a moment that the population of potential retail customers were all -- none of that population were economically disadvantaged, your average consumer. If at some point in time that batch of consumers, in fact, considered wireless, VOIP, wireline

telephony substitutes, would you agree that in that scenario there would be no need for economic regulation of the service?

THE WITNESS: Of the retail service? Yes.

COMMISSIONER DAVIDSON: Of the retail service.

THE WITNESS: Yes, I would agree with that.

COMMISSIONER DAVIDSON: Thank you. If you would, please, turn to Page 12 of your direct -- yes, of your direct (sic.) testimony. You state that, at Lines 4 and 5, "It is also odd that AT&T would represent that high access fees are harmful to the CLECs when the CLECs have typically supported high access fees."

That statement somewhat surprised me because numerous CLECs have indicated to my office prior to this docket that they are vehemently opposed to access fees, that it hurts their business model. And my question is, are you aware of any CLECs in Florida that have typically supported high access fees?

THE WITNESS: Commissioner, if you would turn to my rebuttal testimony at Page 40, I'll read to you from a document submitted by Knology on December, well, for the 10-K report from December 31st, 2002. In this section of Knology's report to the Securities and Exchange Commission, they identify risks to their business, and one of the risks to their business is access charge reform.

I quote, "The FCC is in the process of reducing access charges imposed by local telephone companies for

origination and termination of interstate long distance traffic. Overall decreases in local telephone carriers' access charges as contemplated by the FCC's access reform policies would likely put downward pressure on our charges to domestic interstate and international long distance carriers for comparable access."

COMMISSIONER DAVIDSON: I'm familiar with that passage. And I apologize, I've directed, I think, the witness and perhaps the parties to the wrong page. I was actually in the rebuttal testimony at Page 12. And let me clarify my question. I read that provision by Knology and that was useful.

To your knowledge are there any Florida-based CLECs that have typically supported high intrastate access fees? And I'm curious, I ask that -- it's not a trick question. I'm just trying to reconcile that statement with what has been my information here in the market. There's a -- we have a number of CLECs here: AT&T, Florida Digital Network, WorldCom, Allegiance Telecom, Intermedia and others. And I personally have received no indication from any of those CLECs that they support high intrastate access fees.

THE WITNESS: Well, Knology's report to its investors is the only piece of evidence that I have that speaks specifically to this issue. But the reason I went looking at Knology's Web site is because, as I state in my testimony, I'm

aware of in other jurisdictions the, including before the Federal Communications Commission, CLECs have generally opposed efforts by commissions to lower access rates because they see it as an important source of revenue. Because I --

COMMISSIONER DAVIDSON: If you would, Dr. Gabel, let me -- I want to walk through a scenario with you. If BellSouth Telecom, this is a hypothetical only, not based on any actual, not based on the actual facts. If BellSouth Telephone reduces access charges in 2004 by $10 million, it, under the statute, would be entitled to increase local rates by $10 million. Is that your understanding?

THE WITNESS: Yes.

COMMISSIONER DAVIDSON: In that sense from BellSouth Telecom's perspective, the rebalancing is revenue neutral at that point in time.

THE WITNESS: In that limited sense it is.

COMMISSIONER DAVIDSON: If a particular IXC such as AT&T receives an access charge reduction of, say, $1 million, the law requires that AT&T pass that $1 million reduction on to customers for some amount of time, which is, has been discussed here, but it has to be passed on initially. Would you agree with that?

THE WITNESS: I do agree.

COMMISSIONER DAVIDSON: So that reduction at that point in time is revenue neutral to AT&T.

THE WITNESS: Yes.

COMMISSIONER DAVIDSON: Assume for this hypothetical that the petitions are granted. If a competitive local exchange company seeks to enter the local service territory of BellSouth Telecom to provide local service, but it will not be providing long distance service, after these petitions are granted and after the local rate increases would take effect and controlling for other variables such as economic conditions before and after the granting of the petitions, is it true that the CLEC could on these hypothetical facts secure a better margin after the petitions than it could before the petitions with regard to providing basic local telephone service?

THE WITNESS: No. And the reason for that is because concurrent with the increase in the price of basic local telephone service, the stream of revenues that they receive from access charges have been reduced. What's the net effect? We don't know because the ILECs really haven't put together any model that quantifies what's the net effect of all of this. We really don't have in this record evidence on what's the net effect. You know, overall for BellSouth --

COMMISSIONER DAVIDSON: But is there -- let me ask a follow-up question. Is there some financial benefit from access charges in this market? I mean, those are -- access charges are costs that are associated with access to the network, so it's not as if the switch would not be being used.

For example, in the, in the pre-petition market the switch would be used, it would receive access charge for use of that switch. In the, in the post-market it would receive a higher, a higher rate. It wouldn't be, it wouldn't be receiving the access charge revenue. You basically would be billing under some bill-and-keep where a minute is a minute is a minute. So I'm having trouble understanding how the margin for entering the local exchange market would not be greater with this.

THE WITNESS: Okay.

COMMISSIONER DAVIDSON: Because if that's true, then everything, everything these, the long distance companies are saying would not be true. And I can't imagine that they're just going to waste their time if the access charge issue has absolutely no impact on, on their provision of service.

THE WITNESS: The long distance companies -- I think I can answer and identify the source of confusion. The long distance companies have two hats here: One is a CLEC and one is an interexchange carrier. There's no doubt that the interexchange carriers are going to experience a reduction in the bills that they receive from the local carriers, and they're happy about that.

But that is different than who you started to ask me about, which was the CLEC. The CLEC has two streams of revenues in the scenario that you present to me. One scenario is the charge to the retail customer. The second charge is the

charge to the interexchange carrier. So your scenario correctly identifies that the price to the retail customer goes up, but what your scenario doesn't seem to, or what I'm trying to convey to you is that simultaneously the access revenues of the CLEC goes down.

Now what I'm conveying to you is precisely what's in each of the impairment models that were developed by the ILECs that are in this room or that I developed for NRRI. And that's the kind of sensible economic analysis that you should be considering, but you don't have it before you.

COMMISSIONER DAVIDSON: Thank you. One final set of questions. At Page 16 of your rebuttal testimony, Dr. Gabel, you state in part at Lines 10 to 13, "It is common in competitive markets for prices to be kept low, sometimes even below their long-run incremental cost, and for usage charges to be set above LRIC to recover subsidies."

Could you please provide me with some of the common occurrences outside of this market in those competitive markets where regulation would keep prices low, sometimes even below the long-run incremental costs? Again, some examples outside of the telecommunications field.

THE WITNESS: Let me make sure I understand your question. Would I identify for you markets where a provider offers something at a price below cost?

COMMISSIONER DAVIDSON: No, not where a provider

does. I would like you to identify some competitive markets where regulation does that. I understand providers may make a competitive choice to do something, but I'm focused on where regulation would keep prices low.

THE WITNESS: The best example that I can think of would be access to telephony in rural areas; that as a federal policy, we have a policy of ensuring that rates in rural areas are comparable to rates in urban areas, it's part of our federal statute, and most states have comparable legislation requiring the creation of the Universal Service Fund. And in creating that statutory requirement, there's an explicit recognition to have a regulated price that was below cost.

COMMISSIONER DAVIDSON: Are there any examples that are common in competitive markets where the competitive -- are there any examples outside of telephone markets, telephony that you can point to? I'm trying to get to the meaning of its common and competitive markets. I'm trying to discern exactly how common and in what markets regulation would keep prices low.

THE WITNESS: Commissioner, if I understand your question, you're asking me for examples in regulated markets where competitive prices are set, or maybe I'm misunderstanding your question.

COMMISSIONER DAVIDSON: Well, it's -- the issue before us here is whether or not the, the Commission should

allow this rate rebalancing or whether it should conversely maintain the current price structure. You state that it's common in competitive markets for prices to be kept low, sometimes even below their long-run incremental cost. And my question is what are some of the other competitive markets where regulation keeps prices low, sometimes even below their long-run incremental cost?

THE WITNESS: Well, by -- in my mind, sir, just as you pointed out in your earlier questioning to me, if a market becomes competitive, you no longer regulate it. So it's hard for me to identify a competitive market where regulation requires prices to be below cost because it's almost -- it's hard -- right now I can't think of a case where because we have a competitive market we still regulate the prices.

COMMISSIONER DAVIDSON: Thank you, Chairman. Those are all my questions.

CHAIRMAN JABER: Commissioners, do you have any other questions? Okay. Redirect.

MR. MEROS: Madam Chair, may I ask, Commissioner Davidson asked a question that I would like to follow up on. The answer related to Knology, and it was not, it was not raised below, but it was raised as a part of an answer that Commissioner Davidson asked. And I'd like to ask just a very brief follow-up on it.

CHAIRMAN JABER: Mr. Meros, let me tell you, I never

in our proceedings open that door. It is very common for Commissioners to ask questions, and we don't allow recross because that, that unfairly starts the process all over again. Saying that, I recognize you have an opportunity for closing arguments.

MR. MEROS: Thank you.

CHAIRMAN JABER: Redirect.

MR. BECK: No redirect.

CHAIRMAN JABER: I've lost my train of thought. Thank you, Dr. Gabel, for your testimony. And there were no exhibits, so you may be excused. Oh, actually there were.

Mr. Beck, we had Exhibits 77 and 78.

MR. BECK: Yes. I'd move them into evidence.

CHAIRMAN JABER: Without objection, Exhibits 77 and 78 are admitted into the record.

(Exhibits 77 and 78 admitted into the record.)

(Transcript continues in sequence with Volume 14.)

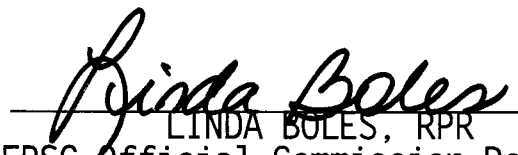
STATE OF FLORIDA)
: CERTIFICATE OF REPORTER
COUNTY OF LEON)

I, LINDA BOLES, RPR, Official Commission Reporter, do hereby certify that the foregoing proceeding was heard at the time and place herein stated.

IT IS FURTHER CERTIFIED that I stenographically reported the said proceedings; that the same has been transcribed under my direct supervision; and that this transcript constitutes a true transcription of my notes of said proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor am I a relative or employee of any of the parties' attorneys or counsel connected with the action, nor am I financially interested in the action.

DATED THIS 12th DAY OF DECEMBER, 2003.



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