DOCKET NO.: 990649-TP - Investigation into pricing of unbundled network elements (Sprint/Verizon track)

WITNESS: Direct Testimony of David J. Draper, Appearing on Behalf of Staff

DATE FILED: January 30, 2002

DIRECT TESTIMONY OF DAVID J. DRAPER

Q. Please state your name and business address.

A. My name is David J. Draper. My business address is 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0865.

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

A. I am employed by the Florida Public Service Commission, in the Finance and Tax Section of the Division of Economic Regulation, as a Regulatory Analyst III.

Q. Please outline your educational qualifications and work experience.

A. I graduated from Florida State University in 1994 with Bachelor of Science degrees in Accounting and Finance. After graduation, I was employed full-time at the Florida Department of Revenue where I reviewed and examined various tax forms for accuracy and completeness. In 1995, I accepted an auditing position with the Florida Public Service Commission in which I audited various regulated Florida utilities. In 1997, I took my present position with the Commission working in the Finance Section analyzing return on equity, cost of capital and capital structures of public utilities and companies regulated by the Commission. I am currently pursuing a Master of Business Administration degree at Florida State University.

Q. Have you previously testified before this commission?

A. Yes. I have previously provided testimony on the appropriate cost of equity for the Chesapeake Utilities Corporation rate case, Docket No. 000108-GU.

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

A. The purpose of my testimony is to recommend an appropriate forward-looking weighted average cost of capital for Sprint Florida and Verizon Florida for purposes of determining the appropriate cost of unbundled network elements (UNEs).

Q. What principles provided the framework for your determination of a fair rate of

return?

A. I have framed my testimony based on my understanding of The Communications Act of 1934 as amended by The Telecommunication Act of 1996, specifically Sections 251 and 252. In my opinion, the purpose of this Act was to develop competitive local markets by various means of entry, including the unbundling of network elements. Section 251 deals with interconnection between the incumbent telecommunication carrier and competing telecommunication carriers. Section 251 makes it the duty of the incumbent telecommunication carrier to offer its network elements to competing carriers and to provide all reasonable assistance in connecting and providing service to the competing carriers. Section 252 concerns the procedure by which carriers are required to negotiate; incumbent carriers are required to negotiate in good faith and any dispute may be taken to the state's public service commission for arbitration. I also framed my opinion based on Section 47 of the Code of Federal Regulations, specifically Subpart F - 51.505(b)(2). The rule in this subpart applies to the pricing of network elements, interconnection and methods of obtaining access to UNEs. Subpart F states: "The forward-looking cost of capital shall be used in calculating the total element long-run incremental cost of an element." In short, the cost rate of common equity and debt should reflect forward-looking cost rates, not a firm's embedded cost rates. Based upon my understanding of the rules and regulations stated above, I employed generally accepted financial models, objective market data and forecasted long-term and short-term debt cost rates in my analysis to determine the forward-looking cost of capital I am recommending in this proceeding.

Q. Please describe your general approach in determining Sprint Florida's and Verizon Florida's forward-looking weighted average cost of capital.

A. I began my analysis of the forward-looking weighted average cost of capital by estimating the appropriate cost of equity, cost of debt and relative capital structure weights for a well managed company in the business of providing UNEs. As a proxy for this line of business, I

analyzed the publicly traded telecommunication carriers listed in Value Line's "Investment Survey for Windows," November 2001 edition. I developed a set of financial criteria in order to determine an appropriate index of companies which I believe are comparable to the business and financial risks associated with the provision of UNEs. In Exhibit DJD-1, I have provided a schedule of my index of telecommunication companies. After determining an appropriate index of companies, I then performed a Discounted Cash Flow (DCF) analysis and a Capital Asset Price Model (CAPM) analysis on this index to estimate an appropriate return on equity (ROE). For the forward-looking cost of debt, I analyzed the December 1, 2001, Blue Chip Financial Forecasts and the December 17, 2001, Moody's Credit Perspectives to determine a forecasted forward-looking cost rate. Finally, I averaged the equity and debt ratios of the companies in my index as a proxy for a forward-looking capital structure and checked my results.

Q. Please describe how you selected the ratio of debt and equity used in your recommendation of the forward-looking weighted average cost of capital for both companies.

A. By using Value Line's "Investment Survey for Windows," November 2001 edition, I calculated the average equity ratio of the publicly traded telecommunication carriers included in my index. The average equity ratio for the index was 63.0%. To check this result, I reviewed C.A. Turner Utility Reports "Financial Statistics of Public Utilities, 2001" (C.A. Turner). C.A. Turner is a recognized financial publication used widely by financial analysts. In its report, C.A. Turner states that the average telecommunications company had an equity ratio of 57.6% in 2000. In addition, I reviewed several recent Commission Orders which approved UNE pricing for Sprint Florida, Verizon Florida and BellSouth in this and in other dockets. Based on this analysis, I am recommending a forward-looking capital structure consisting of 60% common equity and 40% debt.

Q. Do you believe that short-term debt should be reflected in the forward-looking cost

of debt?

A. Yes, short-term debt is used to finance day-to-day operations and allows for flexibility in paying short-term expenses. Almost all the companies included in my index have some form of short-term debt in their capital structures. C.A. Turner reports that the average amount of short-term debt for the companies in my index was 9.9% at the end of December 31, 2001, ranging from a low of 3.5% to a high of 20% of total capital. Furthermore, both Sprint Florida and Verizon Florida maintain a certain amount of short-term debt in their respective capital structures. Therefore, I believe it is appropriate to include short-term debt in the determiniation of the forward-looking cost of debt.

Q. What cost rate do you recommend for the forward-looking cost of Sprint Florida's and Verizon Florida's short-term debt?

A. I recommend a cost rate for Sprint Florida's and Verizon Florida's short-term debt of 5.36%.

Q. How did you determine the forward-looking cost rate for Sprint Florida's and Verizon Florida's short-term debt?

A. I calculated the cost rate for Sprint Florida's and Verizon Florida's short-term debt by averaging the five forecasted quarterly prime rates as reported in Blue Chip Financial Forecasts. The prime rate is the interest rate charged by banks to their most creditworthy customers. The forecasted average prime rate is 5.36%. Therefore, I recommend a cost rate of 5.36% for both Sprint Florida's and Verizon Florida's short-term debt included in their respective forward-looking cost of debt.

Q. What cost rate do you recommend for Verizon Florida's forward-looking cost of long-term debt?

A. I recommend a forward-looking cost rate for Verizon Florida's long-term debt of 7.84%.

Q. How did you determine the forward-looking cost rate for Verizon Florida's long-

term debt?

A. Verizon Florida is assigned a corporate credit rating of single A (A) by Standard & Poor's, Inc. (S&P). To estimate the forward-looking cost of long-term debt, I reviewed the average spread between yields on A rated utility bonds and 10-year Treasury bonds as reported by Moody's Investors Service, Inc. (Moody's). Due to the fact that the Federal Reserve has stopped issuing the 30-year Treasury bond, I have used the 10-year Treasury bond in calculating a forecasted cost for long-term debt. For the 12 month period ended November 2001, the average spread between the yields on A rated bonds and 10-year Treasury bonds has been as high as 309 basis points and as low as 258 basis points. Based on this range, I calculated an average spread between the yields on A rated utilities and 10-year Treasury bonds of 284 basis points. Using Blue Chip Financial Forecasts for December 2001, I calculated the forecasted interest rate for 10-year Treasury bonds by averaging the forecast for the next five quarters, which results in a rate of 5.0%. By adding the average spread of 2.84% to the average forecasted interest rate of 5.0% for 10-year Treasury bonds, I calculated a forward-looking cost rate for Verizon Florida's long-term debt of 7.84%.

Q. What cost rate do you recommend for Sprint Florida's forward-looking cost of long-term debt?

A. I recommend a forward-looking cost rate for Sprint Florida's long-term debt of 8.12%.

Q. How did you determine the forward-looking cost rate for Sprint Florida's long-term debt?

A. I performed the same analysis in forecasting Sprint Florida's cost rate for long-term debt as I did for Verizon Florida. Sprint Florida is assigned a corporate credit rating of triple B (BBB) by S&P. The spread between the yield on BBB rated utility bonds and 10-year Treasury bonds over the past twelve months ranges from a high of 348 basis points to a low of 275 basis points. Based on this range, I calculated an average spread of 312 basis points. By adding the average

spread of 3.12% to the average forecasted interest rate of 5.0% for 10-year Treasury bonds, I calculated a forward-looking cost rate for Sprint Florida's long-term debt to be 8.12%.

Q. What cost rate do you recommend for Sprint Florida and Verizon Florida overall cost of debt?

A. I recommend a weighted average forward-looking cost of debt which reflects a blend of 75% long-term debt and 25% short-term debt. For Sprint Florida, I recommend a weighted average forward-looking cost of debt of 7.43%. For Verizon Florida, I recommend a weighted average forward-looking cost of debt of 7.22%.

Q. Please describe your approach in analyzing the forward-looking cost of equity for both Sprint Florida and Verizon Florida.

A. In determining Sprint Florida's and Verizon Florida's respective forward-looking cost of equity, I first analyzed the publicly traded telecommunication carriers listed in Value Line's Investment Survey for Windows, November 2001 edition. I developed a set of financial criteria to determine an appropriate index of companies which I believe are comparable to the financial and business risks faced by Sprint Florida and Verizon Florida associated with the provision of UNEs. In developing this index, I eliminated any company that received less than 75% of its annual revenues from telecommunications operations. I also eliminated any company with insufficient financial data to perform a financial analysis. Finally, I eliminated any company that was the subject of an ongoing merger or acquisition. After I had determined the appropriate index of companies, I then performed a DCF analysis and CAPM analysis to determine an appropriate cost rate for common equity.

Q. What is the theory behind the Discounted Cash Flow Model?

A. The DCF model is based on two principles. First, investors value an asset based on the future cash flows they expect to receive. Second, investors value a dollar received today more than a dollar received in the future, meaning that they consider the time value of money.

Therefore, in a DCF analysis, the cost of equity is the discount rate that equates the present value of expected cash flows associated with a share of stock to the present market price of the stock. In Exhibit DJD-2, I have provided the basic DCF equation and defined the terms. The basic model has three simplifying assumptions: 1) dividends are paid annually and grow at a constant rate; 2) the price of the stock is determined on the dividend payment date; and 3) dividends increase once a year starting one year from the dividend payment date.

Q. Which Discounted Cash Flow model have you used in your analysis?

A. I have used a two-stage annually compounded DCF model. An assumption behind the basic DCF model is that dividends grow at a constant rate. However, growth in dividends can vary from period to period. A two-stage DCF model, also known as a non-constant growth model, allows for more specificity in the determination of dividend growth: a near term period during which dividends are specifically forecasted, and a subsequent period of sustainable growth. In Exhibit DJD-3, I have presented the equation for my two-stage annually compounded DCF model and defined the terms. This model is consistent with the valuation practices of institutional investors and financial analysts. An additional advantage of the two-stage model is that it can use the specific dividend forecast from Value Line and then incorporate a long-term sustainable growth rate. The two-stage model allows for more precision than the basic model.

Q. What are the inputs for your Discounted Cash Flow Model?

A. I used current stock prices for the companies in the Value Line index, specific dividend forecasts for the initial growth period, and a sustainable or long-term growth rate. For current stock prices, I first calculated the average of each company's high and low stock prices for the month of October 2001. From these computations, I then calculated an average stock price for the index, which is the input to my model. I used Value Line's forecasted dividends for the years 2002 and 2005. I assumed a constant growth rate between these years to estimate dividends for the initial growth period. I then calculated the long-term growth rate using the earnings retention

method, also known as the b x r approach. The inputs for my earnings retention method are Value Line's expected earned return on equity (r) and the expected retention rate (b) for 2005.

Q. Have you included an allowance for issuance costs in your Discounted Cash Flow model?

A. Yes. My DCF model includes an allowance for issuance costs, calculated as 3% of the stock price. The allowance for issuance costs added approximately 15 basis points to the overall cost of equity. An allowance for issuance costs enables the telecommunication carrier to recover the costs incurred when issuing common stock. Issuance costs include registration fees, legal fees, underwriting fees, and printing and mailing expenses. Investors could not earn the necessary return on their investment without an issuance cost adjustment. The sales price of the stock will exceed the net proceeds to the company because it will incur issuance costs. A company can incur these costs whether the stock is publicly traded or privately held. Conceptually, this situation with common stock is similar to that of bonds and preferred stock. With bonds, for example, the cost charged to ratepayers reflects issuance costs and is recovered over the life of the bond. The cost to the company for a specific bond issue is the interest expense plus the amortization of issuance costs divided by the principal value less the unamortized issuance costs. The result is that the cost to the company is greater than the return to the creditor. Unlike bonds, common stock does not have a finite life. Therefore, issuance costs cannot be amortized and must be recovered by an upward adjustment to the allowed return on equity. This adjustment reflects the fact that, due to the issuance costs, the company earns a return on an equity balance that is less than the actual amount paid by investors. Historically, underwriting expenses associated with issuing common stock have averaged 3% of gross proceeds.

Q. What are the results of your Discounted Cash Flow analysis?

A. The results of my DCF analysis shows that the forward-looking cost of equity for the comparable telecommunications index is 11.45%. Exhibit DJD-4 shows the inputs and results

of my analysis.

Q. What is the theory behind a Capital Asset Pricing Model?

A. The CAPM was first introduced by William Sharpe in 1964. It extended modern portfolio theory to introduce the notions of systematic and specific risk. CAPM divides the risk of holding assets into systematic and specific risk. Systematic risk is the risk of holding the market portfolio. This risk effects all securities and cannot be eliminated through diversification. Specific risk is the risk which is unique to an individual asset. It represents the component of an asset's return volatility which is not correlated with general market moves.

The theory underlying the CAPM is quite simple. The expected return on common equity depends on the beta of that company's equity. The beta is a measurement of stock price volatility relative to a broad market index. If a stock moves up or down twice as much as the market, it has a beta of 2. If it moves one half as much as the market, its beta is 0.5. The CAPM models the systematic risk of a particular asset.

Q. Please describe your Capital Asset Pricing Model.

A. In Exhibit DJD-5, I have listed the equation and the components of the CAPM. There are three basic components to the CAPM: 1) the expected risk-free rate of return, 2) the stock's expected relevant market risk called "beta," and 3) the expected return on the stock market taken as a whole. The risk-free rate (R_F) is derived from the average projected yield of the 30-year Treasury bond. Treasury bonds are a recognized bench mark for risk-free rates since there is little risk of the U.S. Government defaulting on its bonds. The required market return (R_m) was determined by using Value Line's database of listed companies and then screening those companies to remove anomalies. In my opinion, removing anomalies such as companies that do not pay dividends or have negative dividend growth, negative projected earnings growth or growth greater than 20%, results in an accurate representation of the market return. A basic DCF analysis was performed for each company in this broad market index. The result of the DCF

analysis was then used as the required market return. In my opinion, the average beta of the telecommunications firms in my index is a reasonable proxy for companies engaged in the provision of UNEs.

Q. What are the results of your Capital Asset Pricing Model analysis?

A. After using the CAPM to calculate an ROE, I made an adjustment for flotation costs by adding 15 basis points to the CAPM results. The 15 basis points for flotation costs were determined by calculating the difference between the DCF results using 3% flotation and the DCF results using no flotation costs. After calculating an ROE using the CAPM and adjusting for flotation costs, I calculated a cost of equity for the telecommunications index of 11.13%. Exhibit DJD-5 presents the results of my CAPM analysis.

Q. Given the results of your Discounted Cash Flow and Capital Asset Pricing Model analyses, what did you determine for the cost of equity?

A. Based on the results of my DCF and CAPM analyses, I calculated a range of return on equity from 11.13% to 11.45%. Averaging these results produces a truncated midpoint of 11.3%.

Q. What do you recommend as an appropriate ROE for both Sprint Florida and Verizon Florida?

A. The index of companies used to determine an appropriate ROE has an average bond rating of single A. S&P reports Verizon Florida as having a single A bond rating, therefore I recommend using the midpoint of 11.3% as its forward looking ROE. Sprint Florida has a bond rating of triple B. For this reason, I would recommend adding a 25 basis point adjustment to the calculated ROE mid point for Sprint Florida's forward looking ROE. This adjustment is similar to what was recommended for Sprint Florida's long-term debt. Therefore, I recommend a ROE for Sprint Florida of 11.55%. Ultimately, deciding the appropriate cost rate for common equity is a subjective process, estimating ROE has always been a forward-looking concept. Once a financial analysis is completed, a financial analyst must review the final calculation and decide

if it is a reasonable return when considering all the risks and rewards involved in the investment. Based on my analysis and the facts presented in this testimony, I believe that I have calculated the most equitable cost rates and the appropriate weighted ratios to be included in the forward-looking weighted average capital structure for both Sprint Florida and Verizon Florida.

Q. What forward-looking weighted average cost of capital do you recommend for both Sprint Florida and Verizon Florida?

A. I have calculated forward-looking cost rates for debt and common equity, and I have determined the proper weight for each component to be included in the capital structure. Based on my findings, I recommend a 9.90% return for Sprint Florida's forward-looking weighted average cost capital. In addition, I recommend a 9.67% return for Verizon Florida's forward-looking weighted average cost capital. In Exhibit DJD-6, I have provided a schedule of Sprint Florida's and Verizon Florida's recommended forecasted weighted average capital structure.

Q. Does this conclude your direct testimony?

A. Yes.

EXHIBIT DJD-1

DOCKET NO. 990649B-TP
INVESTIGATION INTO PRICING
UNBUNDLED NETWORK ELEMENTS
WITNESS: DAVID J. DRAPER

TELECOMMUNICATIONS INDEX

	Company Name	Bond Rating	% of Rev. From Tele Serv. (75% +)	Beta	Price to Book Value	Common Equity Ratio
1	AT&T Corp.	A-	100%		1.33	73%
2	BellSouth Corp.	A+	85%	0.85	4.82	58%
3	CenturyTel Inc.	BBB+	92%	1.00	2.29	40%
4	Qwest Communic.	BBB+	100%	1.55	1.87	73%
5	Sprint Corp.	BBB+	94%	0.85	2.93	78%
6	Telephone & Data	A-	100%	0.85	1.58	77%
7	Verizon Communic.	A+	100%		4.13	45%
	AVERAGE	A-		1.02	2.71	63%

Source: Value Line Investment Survey for Windows, November 2001 edition

C.A. Turner Utility Reports "Financial Statistics of Public Utilities, 2001"

BASIC DCF EQUATION

$$P_0 = \frac{D_1}{(1+K)} + \frac{D_2}{(1+K)^2} + \frac{D_3}{(1+K)^3} + \ldots + \frac{D_\infty}{(1+K)^\infty}$$

where: D_t = Dividends paid at the end of period t

K = Investors' required rate of return

P_0 = The current price of the stock this can also be written as

$$P_0 = \sum_{t=1}^{n} \frac{D_t}{(1+K)^t}, \text{ as n approaches } \infty$$

Assuming constant growth in dividends and g < K, these equations reduce to

$$K = \frac{D_1}{P_0} + g$$

where g is the constant growth rate in dividends.

EXHIBIT DJD-3

TWO-STAGE ANNUALLY COMPOUNDED DCF MODEL

$$P_0(1-FC) = \frac{D_1}{(1+K)} + \frac{D_2}{(1+K)^2} + \ldots + \frac{D_n}{(1+K)^n} + \frac{D_n(1+g)}{K-g}\frac{1}{(1+K)^n}$$

Where

P_0 = The current stock price

$D_1, D_2, \ldots D_n$ = Expected dividends each year

FC = Flotation costs

K = Investors' required rate of return

g = The constant growth rate after year n

DOCKET NO. 990649B-TP
INVESTIGATION INTO PRICING UNBUNDLED NETWORK ELEMENTS
WITNESS: DAVID J. DRAPER

EXHIBIT DJD-4

TELECOMMUNICATIONS INDEX

					Value Line Issue: Ed. 5 - 10/5/01					OCTOBER		
	DIV0	DIV1	DIV2	DIV3	DIV4	EPS4	ROE4	GR1-4	GR4+	HI-PR	LO-PR	AVER-PR
AT&T Corp.	0.15	0.15	0.15	0.15	0.15	1.15	5.50	1.0000	1.0478	20.000	15.170	17.585
BellSouth Corp.	0.76	0.80	0.81	0.83	0.84	4.15	22.00	1.0164	1.1755	42.470	36.260	39.365
CenturyTel Inc.	0.20	0.20	0.23	0.26	0.30	2.75	12.50	1.1447	1.1114	35.000	30.250	32.625
Qwest Communic.	0.05	0.05	0.05	0.05	0.05	2.25	8.50	1.0000	1.0831	19.950	12.500	16.225
Sprint Corp.	0.50	0.50	0.50	0.50	0.50	2.15	11.50	1.0000	1.0883	24.390	18.800	21.595
Telephone & Data	0.50	0.58	0.61	0.63	0.66	5.50	8.00	1.0440	1.0704	98.900	87.750	93.325
Verizon	1.54	1.60	1.64	1.68	1.72	4.95	22.00	1.0244	1.1436	55.990	49.000	52.495
Communications												
	0.529	0.554	0.57	0.586	0.603 0.665	3.27	12.86	1.033	1.103			39.03

COST OF EQUITY - NOVEMBER S&P STOCK GUIDE: NOV. 2001 with October Stock Prices

Annual **11.45%**

DATA SOURCES:

1. STOCK PRICES/S&P STOCK GUIDES
2. DIVIDENDS, EPS, ROE/VALUE LINE

EXHIBIT DJD-4

EXHIBIT DJD-5

CAPITAL ASSET PRICING MODEL COST OF EQUITY

CAPM Analysis Formula

K = RF + Beta(MR - RF) + FC

K = Investor's required rate of return

RF = Risk-free rate (Blue Chip forecast for 30-year Treasury bond)

Beta = Measure of systematic risk

MR = Market return

FC = Flotation cost adjustment

Telecommunications CAPM = 5.4% + 1.02(10.87% - 5.4%) +.15% = 11.13%

Source: Blue Chip Financial Forecasts, December 1, 2001

Value Line Investment Survey for Windows, November 2001 edition

DOCKET NO. 990649B-TP
INVESTIGATION INTO PRICING
UNBUNDLED NETWORK ELEMENTS
WITNESS: DAVID J. DRAPER

FORWARD-LOOKING WEIGHTED AVERAGE COST OF CAPITAL

SPRINT FLORIDA

	Ratio	Cost Rate	WACC
DEBT	40%	7.43%	2.97%
COMMON EQUITY	60%	11.55%	6.93%
			9.90%

VERIZON FLORIDA

	Ratio	Cost Rate	WACC
DEBT	40%	7.22%	2.89%
COMMON EQUITY	60%	11.30%	6.78%
			9.67%

CAPM Results:	11.13%
DCF Results:	11.45%
Average ROE Results:	11.29%

Verizon Florida Cost of Debt:

Long-term Debt: 5.00% + 2.84% = 7.84% x 75% = 5.88%

Short-term Debt: Forecasted Prime Rate= 5.36% x 25% = 1.34%

Weighted Average Cost of Debt: 7.22%

Sprint Florida Cost of Debt:

Long-term Debt: 5.00% + 3.12% = 8.12% x 75% = 6.09%

Short-term Debt: Forecasted Prime Rate= 5.36% x 25% = 1.34%

Weighted Average Cost of Debt: 7.43%

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation into pricing of unbundled network elements (Sprint/Verizon track).	DOCKET NO. 990649B-TP DATED: January 30, 2002

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the Direct Testimony and exhibits DJD-1 through DJD-6, of David J. Draper, has been served via U.S. MAIL and electronic mail to the following on this 30th day of January, 2002:

ACI Corp.
7337 S. Revere Pkwy.
Englewood, CO 80112

Ms. Virginia Tate
AT&T Communications of the Southern States, Inc.
101 N. Monroe Street
Suite 700
Tallahassee, FL 32301-1549

Ms. Nancy B. White
c/o Ms. Nancy H. Sims
BellSouth Telecommunications, Inc.
150 South Monroe Street
Tallahassee, FL 32301

Mr. Jeffrey Blumenfeld
Ms. Elise Kiely
Blumenfeld & Cohen
1625 Massachusetts Ave., NW
Suite 300
Washington, DC 20036

Ms. Kimberly Caswell
Verizon Select Services Inc.
P.O. Box 110, FLTC0007
Tampa, FL 33601-0110

Ms. Catherine F. Boone
c/o Covad Communications Company
10 Glenlake Parkway, Ste. 650
Atlanta, GA 30328

Mr. Matthew Feil
Florida Digital Network, Inc.
390 N. Orange Ave.
Suite 2000
Orlando, FL 32801

Mr. Scott Sapperstein
Intermedia Communications, Inc.
3625 Queen Palm Drive
Tampa, FL 33619-1309

Mr. Charles Rehwinkel
Sprint-Florida, Inc.
P.O. Box 2214
Tallahassee, FL 32316-2214

Mr. Richard Melson
Ms. Gabriel E. Nieto
Hopping Green Sams and Smith, P.A.
P.O. Box 6526
Tallahassee, FL 32314

Ms. Donna C. McNulty
MCI WorldCom
325 John Knox Road
Suite 105
Tallahassee, FL 32303

Mr. Brian Sulmonetti
MCI WorldCom
Concourse Corporate Center Six
Six Concourse Parkway
Suite 3200
Atlanta, GA 30328

Mr. Joseph McGlothlin
Ms. Vicki Kaufman
McWhirter, Reeves, McGlothlin, Davidson, Decker, Kaufman, Arnold, and Steen, P.A.
117 South Gadsden Street
Tallahassee, FL 32301

Mr. Rodney L. Joyce
Shook, Hardy & Bacon LLP
600 14th Street, N.W.
Suite 800
Washington, DC 20005-2004

Mr. Michael A. Gross
Florida Cable Telecommunications Assoc. Inc.
246 E. 6th Avenue, Suite 100
Tallahassee, FL 32303

Ms. Monica Barone
Sprint Communications Company Limited Partnership
3100 Cumberland Circle
Mailstop GAATLN0802
Atlanta, GA 30339

Mr. Jonathan Canis
Mr. Michael Hazzard
Kelley Drye and Warren, LLP
1200 19th St. NW, Fifth Floor
Washington, DC 20036

Mr. Peter Dunbar
Ms. Karen Camechis
Pennington, Moore, Wilkinson, Bell & Dunbar, P.A.
P.O. Box 10095
Tallahassee, FL 32302-2095

Mr. Eric J. Branfman
Mr. Morton Posner
Swidler Berlin Shereff
Friedman, LLP
3000 K Street NW, #300
Washington, DC 20007-5116

Ms. Carolyn Marek
Time Warner AxS of Florida, L.P.
233 Bramerton Court
Franklin, TN 37069

Mr. Gary Cohen
Blumenfeld & Cohen
16225 Massachusetts Ave., NW
Suite 320
Washington, DC 20036

Mr. Mark E. Buechele
Koger Center - Ellis Bldg.
1311 Executive Center Drive
Suite 200
Tallahassee, FL 32301-5027

Mr. Michael Sloan
Swidler Berlin Shereff Friedman, LLP
3000 K Street NW
Suite 300
Washington, DC 20007-5116

Floyd Self, Esquire
Norman Horton, Esquire
Tracy Hatch, Esquire
Messer, Caparello & Self
215 South Monroe St.
Suite 701
Tallahassee, FL 32302-1876

John P. Fons, Esquire
Ausley & Mcmullen
P.O. Box 391
Tallahassee, FL 32302

Ms. Kimberley Caswell
P.O. Box 110, FLTC0007
Tampa, Florida 33601-0110

JASON K. FUDGE, Senior Attorney

FLORIDA PUBLIC SERVICE COMMISSION
Gerald L. Gunter Building
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850
(850) 413-6199

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State of Florida

ORIGINAL

Public Service Commission

-M-E-M-O-R-A-N-D-U-M-

DATE: January 30, 2002
TO: Jason Fudge, Office of the General Counsel
Beth Keating, Office of the General Counsel
FROM: Tim Devlin, Director, Division of Economic Regulation
RE: Docket No. 990649B-TP - Investigation into pricing of unbundled network elements (Sprint/Verizon track)

Attached is the Direct Testimony of David J. Draper to be filed in the above-referenced docket.

TD:slc

AUS
CAF
CMP
COM
CTR
ECR
GCL
OPC
MMS
SEC 1
OTH