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September 10, 1999

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

Re: Docket No. 990649-TP
Investigation into Pricing of Unbundled Network Elements

Dear Ms. Bayo:

Please find enclosed for filing an original and 15 copies of the Rebuttal Testimonies of Michael J. Doane, Dennis B. Trimble and David G. Tucek on behalf of GTE Florida Incorporated in the above matter. Service has been made as indicated on the Certificate of Service. If there are any questions regarding this matter, please contact me at 813-483-2617.

Sincerely,

Anthony P. Gillman

Kimberly Caswell

KC:tas
Enclosures

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Doane
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Trimble
DOCUMENT NUMBER-DATE
10902 SEP 10 99
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Tucek
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10903 SEP 10 99
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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that copies of the Rebuttal Testimonies of Michael J. Doane, Dennis B. Trimble and David G. Tucek on behalf of GTE Florida Incorporated in Docket No. 990649-TP were sent via U. S. mail on September 10, 1999 to the parties on the attached list.

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ORIGINAL

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation into Pricing of Unbundled Network Elements	)))	Docket No. 990649-TP

REBUTTAL TESTIMONY OF

MICHAEL J. DOANE

ON BEHALF OF

GTE FLORIDA INCORPORATED

SEPTEMBER 10, 1999

GTE FLORIDA INCORPORATED

REBUTTAL TESTIMONY OF MICHAEL J. DOANE

DOCKET NO. 990649-TP

Q. PLEASE STATE YOUR FULL NAME AND BUSINESS ADDRESS.

A. My name is Michael J. Doane. My business address is 88 Kearny Street, Suite 1300, San Francisco, CA 94108.

Q. DID YOU PREVIOUSLY PROVIDE DIRECT TESTIMONY BEFORE THIS COMMISSION IN THE CURRENT DOCKET?

A. Yes. I provided Direct Testimony on the approach the Commission should use if it proceeds with UNE deaveraging in the absence of retail rate rebalancing. This approach, which relies on a deaveraging adjustment charge ("DAC"), recognizes that deveraging proposals based solely on TELRIC costs are inappropriate when the ILEC's retail rates contain implicit universal service support.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. This testimony responds to certain aspects of the Direct Testimonies of alternative local exchange carrier ("ALEC") witnesses Ankum, Barta, Falvey, Gillan, Murray, and Strow. I will show why their approach to UNE pricing fails to meet the competitive neutrality and efficiency goals that even they admit should guide the Commission's decision in this case.

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Q. PLEASE SUMMARIZE THESE WITNESSES' POSITIONS TO WHICH YOU REPLY IN THIS TESTIMONY.

A. Each of the witnesses believes that the Commission should deaverage UNE rates (in particular, the loop) when significant cost variations are present. But they define cost as total element long incremental cost ("TELRIC") and argue that the deaveraged rate for a network element should be based solely on TELRIC, inclusive of a "reasonable" allocation of forward-looking common costs.

The witnesses claim that TELRIC is the appropriate standard because: (1) the Telecommunications Act of 1996 ("Act) requires it; and (2) it is necessary to promote efficient entry and widespread competition.

Q. PLEASE SUMMARIZE YOUR RESPONSE TO THESE CLAIMS.

A. In my direct testimony, I showed that current retail prices for local exchange services in Florida contain significant implicit support for universal service. This is a simple but important observation that has been confirmed by this Commission. In this environment, it would be a mistake to ignore the ILEC's disoriented retail rate structure when establishing deaveraged UNE rates. TELRIC pricing is not required by the Act. In fact, pricing UNEs at TELRIC will undermine the Act's purpose of encouraging efficient competition in *all* markets, including rural and residential ones. It will threaten universal service, while denying the ILEC an opportunity to recover its total actual costs of providing service.

Q. AS YOU NOTED, SEVERAL ALEC WITNESSES ASSERT THAT DEVERAGING UNE RATES ON THE BASIS OF TELRIC IS CONSISTENT WITH REQUIREMENTS OF THE ACT. WHY DO YOU DISAGREE?

A. These witnesses fail to acknowledge or appreciate the economic importance of a key aspect of section 252(d)(1) of the Act, which provides that the prices of the UNEs "may include a reasonable profit." Obviously, a firm cannot earn a reasonable profit unless it first recovers all of its costs. The same ILEC network is used to provide both retail and wholesale services. If we assume that that network is used to provide wholesale services only, a profit must still be possible. Under the ALECs' TELRIC approach, however, UNE prices would be set equal to forward-looking costs, even if those costs are lower than the company's total actual costs. These UNE prices would, by design, prevent the firm from covering its total costs and earning a reasonable profit. If the ALECs' pricing proposal were adopted, the implication would be that Congress established a pricing methodology that mandated losses (*i.e.*, denied reasonable profits) for incumbent carriers whenever their current actual total costs exceed their forward-looking total costs.

Q. DR. ANKUM ALLEGES "ONLY IF PRICES FOR UNBUNDLED NETWORK ELEMENTS REFLECT TRUE FORWARD-LOOKING, ECONOMIC COSTS, WILL EFFICIENT, WIDESPREAD COMPETITIVE ENTRY BE POSSIBLE IN FLORIDA." (DT AT 5.) PLEASE COMMENT.

A. Dr. Ankum defines (incorrectly) forward-looking economic costs as "the total service long run incremental cost of the network element in question, plus a reasonable share of forward-looking efficient, shared and common costs." (Ankum DT at 4. Economic costs, properly defined, include opportunity costs -- that is, the value of a resource in its best alternative use. *See* Paul A. Samuelson and William D. Nordhaus, ECONOMICS, 14th ed., McGraw-Hill, Inc., N.Y., 1992, at 130-31.) Thus, according to Dr. Ankum and other ALEC witnesses (Ankum DT at 6; Barta DT at 6-7; Falvey DT at 1, 13; Gillan DT at 2, 5; Strow DT at 3), competitive entry will be possible only if UNE prices equal TELRIC plus an allocation of common costs.

The only support Dr. Ankum offers for this view is his own statement that "prices for essential inputs that are set at cost promote efficient entry." (Ankum DT 6.) While Dr. Ankum presents the correct economic standard, *i.e.*, UNE price should promote efficient entry and deter inefficient entry--his position that this is accomplished by TELRIC pricing is incorrect.

The proof of Dr. Ankum's error is found in a recent paper by Professor William Baumol. (See, e.g., William J. Baumol, *Having Your Cake: How to Preserve Universal-Service Cross Subsidies While Facilitating Competitive Entry*, YALE JOURNAL ON REGULATION, VOLUME 16:1, 1999; a copy of this article was attached as Exhibit MJD-2 to my direct testimony.) As I noted in my Direct Testimony, Professor Baumol co-authored an affidavit that the FCC relied upon to support the TELRIC pricing approach it adopted in 1996.

Now, three years later, Professor Baumol has clarified that input (*i.e.*, UNE) prices that fail to account for implicit support in existing retail rates are *not* competitively neutral and, if adopted, will undermine productivity efficiency by enabling less efficient firms to undercut suppliers that are more efficient in their use of resources. This is demonstrated using what he refers to as "The Level Playing Field Theorem."

A simple numerical example demonstrates this point. Suppose that the ILEC produces two services, "R" and "B." The price of "R" is $5 and the price of "B" is $15. To produce either service requires only a loop and retail marketing. Only an ILEC can install a loop, at a forward-looking cost of $5. The forward-looking retail marketing cost is also $5 for the incumbent, so that the cost of supplying both R and B is $10. Thus, R receives implicit support of $5 and B contributes support of $5.

Now suppose that Dr. Ankum's TELRIC pricing proposal was adopted: an entrant can buy a loop at $5 and provide its own retail marketing. If the entrant's marketing cost is also $5, it can earn a profit of nearly $5 by providing B at a price just below the ILEC's regulated price of $15. It would have no interest in providing R.

Dr. Ankum's assertion is wrong because this finding would hold even if the entrant were *less* efficient than the ILEC. For example, if the entrant's retail marketing costs were $6, instead of $5, it could still make a $4 profit on service B. However, society is made worse off because the total cost of supply would have increased, not decreased, as a result of entry. The error in Dr. Ankum's reasoning stems from his failure to consider the ILEC's retail rate structure when evaluating entry decisions.

Q. INTERMEDIA WITNESS STROW CONTENDS THAT THE PURPOSE OF HER TESTIMONY IS TO "PROVIDE INFORMATION TO ENABLE THE [COMMISSION] TO ESTABLISH COMPETITIVELY NEUTRAL LONG-TERM PRICING POLICIES FOR [UNES]." (STROW DT AT 3.) DOES HER TESTIMONY ACHIEVE THIS PURPOSE?

A. No. Ms. Strow provides no such information. She does not define the term "competitive neutrality," so I can only assume that she adopts the standard economic definition: competitive neutrality is achieved when input prices do not favor incumbents in the final-product market over entrants or the reverse. Again, this is the correct economic standard for the Commission to adopt when evaluating the merits of deaveraging. It is violated when UNE prices are based solely on TELRIC and the retail rates contain implicit support for universal service.

Q. WHAT WOULD BE THE CONSEQUENCES TO FLORIDA CONSUMERS IF THE COMPETITIVE NEUTRALITY STANDARD WAS VIOLATED AS A RESULT OF ADOPTING MS. STOW'S PROPOSAL?

A. As Mr. Trimble also points out, consumers here would be harmed because entrants would have no choice but to continue to selectively target high-margin customers (*e.g.,* businesses in high density urban areas) and ignore low margin customers (*e.g.*, residential customers in rural areas). In fact, Ms. Strow indicates that her company, Intermedia, has located its voice switches in precisely those areas considered to be high-margin (*e.g.*, Jacksonville, Orlando, Tampa, and Miami). (Strow DT at 2.) With retail rates substantially above TELRIC in those markets, deaveraged UNE prices based on TELRIC would provide a windfall gain to new entrants. Of course, if UNE rates permit selective, subsidized entry, current funding for universal service will be diminished (as margins previously targeted to the provision of universal services are transferred to entrants) and competition will not widely develop.

Q. HAS ANY WITNESS RECOGNIZED THE NEED TO ESTABLISH PARITY BETWEEN THE ILEC'S RETAIL PRICES AND THE STRUCTURE OF DEAVERAGED PRICES FOR UNES?

A. Yes. Covad witness Murray states the Commission should consider "parity issues in establishing deaveraged prices for unbundled network elements." (Murray DT at 3.) She contends that parity is consistent with the "non-discrimination requirements of the Telecommunications Act of 1996 in determining deaveraged rates" (Murray DT at 8.)

The problem with Ms. Murray's recommendation is that she appears to apply it selectively--that is, only for provision of the DSL-based services that are the focus of her own company's operations. Of course, there is no economic rationale for limiting application of this principle to DSL services. As demonstrated above, the competitive neutrality Ms. Murray claims to advocate demands parity between the retail and wholesale rate structures.

Q. IS MS. MURRAY'S POSITION ON PARITY CONSISTENT WITH HER ARGUMENTS REGARDING THE BASIS FOR DEAVERAGED UNE PRICES?

A. No. Her position on parity contradicts her advocacy of TELRIC-based pricing. With regard to the latter, Ms. Murray asserts: "The more closely forward-looking costs and prices for unbundled network elements are aligned, the more likely competitors will build facilities only if they can do so more efficiently than the incumbent." (Murray DT at 5.) Ms. Murray cannot have it both ways. Following the logic of her argument, she supports parity between retail and UNE rates only when it *lowers* the UNE rate (*i.e.*, when the application of the parity principle would reduce the UNE rate below TELRIC). When parity would necessitate an increase in the UNE rate above TELIC, she abandons the principle. This selective application of the competitive parity principle, as demonstrated above, does no more than subsidize inefficient entry at the expense of the consumer.

Q. DR. ANKUM OPINES THAT "TO THE EXTENT THE ILEC HAS REGULATORY-IMPOSED COSTS (SUCH AS ANY COSTS RELATED TO UNIVERSAL SERVICE OR CARRIER OF LAST RESORT 'OBLIGATIONS') IN ITS RATE STRUCTURE, THE ILEC SHOULD BE REQUIRED TO DEMONSTRATE THESE COSTS EXPLICITLY AND THE COMMISSION SHOULD--*IN A SEPARATE PROCEEDING*--FIGURE OUT HOW TO DEAL WITH THEM IN A COMPETITIVELY NEUTRAL MANNER." (ANKUM DT AT 33 [EMPHASIS IN ORIGINAL]). PLEASE COMMENT.

A. With this statement, Mr. Ankum admits that competitive neutrality is an economically relevant issue in establishing deaveraged UNE costs and rates. However, the Commission need not accept his suggestion of deferring treatment of regulatory costs to a separate proceeding. The evidence presented in this one will be sufficient to define and solve the problem, at least on an interim basis. First, the regulatory burden can be measured given available information on retail rates and long-run incremental costs. Second, I described in my direct testimony a proposal called the "Deaveraging Adjustment Charge" that can be implemented with the same information. This mechanism is an adjustment charge set so as to maintain the implicit support now in current rates. As shown in the articles attached to my Direct Testimony, it is competitively neutral. If an entrant is more efficient then GTE, it will be able to pay the adjustment charge and still earn a positive economic profit due to its superior efficiency. If it is less efficient, then it will necessarily lose money by paying the charge to acquire the customer.

Application of this deaveraging mechanism would establish UNE prices that promote competitive entry in all market segments while preserving affordable rates to preferred customer classes. Deferring the problem when the solution is known and available would be akin to practicing a costly "shell game" with the consumer at the losing end.

Q. DR. ANKUM STATES "SINCE MY RECOMMENDATION WOULD LEAVE THE ILEC'S RETAIL RATES IN PLACE, THERE SHOULD NOT BE ANY IMPACT FROM PRICING UNBUNDLED NETWORK ELEMENTS AT ECONOMIC COSTS ON THE ILEC'S REVENUE STREAM." (ANKUM DT AT 32-33.) IS THIS TRUE?

A. No. This statement illustrates the disconnect in Dr. Ankum's economic reasoning. He apparently is unaware of the concept of arbitrage. That is, if the ILEC's UNE prices are deaveraged, but its retail rates are not, then an entrant can simply undercut the ILEC's retail prices, even if it is less efficient than the ILEC.

Suppose, for example, that an ILEC serves two areas, urban and rural. Loop costs are $16 in the urban area and $30 in the rural area. The weighted average cost over the two areas combined is $23. If entry occurs and loop rates are deaveraged, but not the retail price, the entrant can buy loops at $16 and serve urban areas only, making a $7 profit. The ILEC will be left with the rural areas, able only to charge $23, thus losing $7 per loop. Furthermore, the entrant will succeed even if it is less efficient than the ILEC.

Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.

A. If the Commission wishes to proceed with UNE deaveraging while implicit support remains in retail rates, then its deaveraging plan must account for the disoriented retail rates. I offer the Commission an interim approach that does just that. The deaveraging adjustment charge will permit efficient competition in all market segments until retail rates can be rebalanced and/or an explicit universal service fund is established. In contrast, the ALECs' proposal for deaveraging at economic cost (as defined by Mr. Ankum) is economically unsound and will promote ever greater arbitrage opportunities. If the Commission's objectives are to promote competition (especially for those customers where local competition choices are lacking) and to preserve universal service, then it will not seriously consider the ALECs' pricing proposal.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.