BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Investigation into pricing of unbundled network elements	))))	Docket No. 990649A-TP Filed: December 14th, 2001

(REVISED) REBUTTAL TESTIMONY

AND EXHIBIT

OF

DR. GEORGE S. FORD

ON BEHALF OF

Z-TEL COMMUNICATIONS, INC.

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is George S. Ford. I am the Chief Economist for Z-Tel Communications, Incorporated (Z-Tel). My business address is 601 South Harbour Island Boulevard, Suite 220, Tampa, Florida 33602.

Q. BRIEFLY DESCRIBE YOUR EDUCATIONAL BACKGROUND AND RELATED PROFESSIONAL EXPERIENCE.

A. I received a Ph.D. in Economics from Auburn University in 1994. My graduate work focused on the economics of industrial organization and regulation, with course work emphasizing applied price theory and statistics. In 1994, I became an Industry Economist for the Federal Communications Commission's Competition Division. The Competition Division of the FCC was tasked with ensuring that FCC policies were consistent with the goals of promoting competition and deregulation across the communications industries. In 1996, I left the FCC to become a Senior Economist at MCI WorldCom where I was employed for about four years. While at MCI WorldCom, I performed economic studies on a variety of topics related to federal and state regulatory proceedings. In May 2000, I became Z-Tel's Chief Economist.

In addition to my responsibilities at Z-Tel, I maintain an active research agenda on communications issues and have published research papers in a number of academic journals including the *Journal of Law and*

Economics, the *Journal of Regulatory Economics*, and the *Review of Industrial Organization*, among others. I am also a co-author of the chapter on local and long distance competition in the *International Handbook of Telecommunications Economics*. I often speak at conferences, both at home and abroad, on the economics of telecommunications markets and regulation.

Q. COULD YOU DESCRIBE Z-TEL'S SERVICE OFFERINGS?

A. Z-Tel is a Tampa-based, integrated service provider that presently provides competitive local, long distance, and enhanced services to residential consumers in thirty-five states, including New York, Pennsylvania, Massachusetts, Texas, Michigan, Georgia, Illinois, among others. Z-Tel plans to expand nationally as the unbundled network element platform ("UNE-P") becomes available at TELRIC rates. The company's goal is to offer a competitive service to the residential consumers of every state.

Z-Tel's service is not just a simple bundle of traditional telecommunications services. Z-Tel's service is unique in that it combines its local and long distance telecommunications services with Web-based software. This consideration enables each Z-Tel subscriber to organize his or her communications, including email, voicemail, fax, and even a Personal Digital Assistant ("PDA"), by accessing a personalized web-page

via the Internet. In addition, the personal Z-Line number can be programmed to follow the customer anywhere he or she goes, via the "Find Me" feature. Other service features include low long distance rates from home or on-the-road and message notification by phone, email, or pager. Customers can also initiate telephone calls (including conference calls in the near future) over the traditional phone network, using speed-dial numbers from their address book on their personalized web page.

Q. WHAT INTEREST DOES Z-TEL COMMUNICATIONS HAVE IN THIS PROCEEDING?

A. Z-Tel's service is a bundle of many different communications services including voicemail, email, fax, Internet, PDAs, and local and long distance telecommunications into an easy-to-use communications control center. An important element of that bundle is local exchange telecommunications service. To provide the local exchange portion of its service offering, Z-Tel must purchase unbundled network elements from incumbent local exchange carriers like BellSouth. At present, Z-Tel's primary means of providing local exchange service provision is UNE-P. Because Z-Tel is dependent upon the local exchange carrier's UNEs to provide service at this time, Z-Tel has a strong interest in ensuring the rates established for UNEs are TELRIC compliant and conducive to competitive entry.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I will address Issue 1(b), which states:

> Should BellSouth's loop rates or rate structure previously approved in Order No. PSC-01-1181-FOF-TP be modified? If so, to what extent, if any, should the rates or rate structure be modified?"

BellSouth witness Daonne Caldwell asserts that from a "cost perspective," BellSouth's approach has produced reasonable, accurate results, and there is no reason to disturb the currently approved loop rate (at page 18). In my testimony I will demonstrate that, to the contrary, the existing rates are questionable and warrant reexamination.

I will describe and perform a "sanity test" of BellSouth's loop rate that can assist the Commission in determining whether the rate meets the required TELRIC standard. The loop rate that BellSouth applies to UNEP customers fails the test. In my opinion, the results of this independent sanity test render the loop rates initially suspect, and indicate the need to scrutinize BellSouth's model and individual inputs. Witnesses Brian Pitkin and John Donovan, who will testify for WorldCom and AT&T, have performedsuch an analysis and have concluded that BellSouth has overstated its loop costs.

Q. PLEASE DESCRIBE THE "SANITY TEST" TO WHICH YOU REFER.

A. The test derives from the method that the FCC uses, for purposes of Section 271 applications, to assess the reasonableness of the UNE cost rates across the states in which in ILEC does business.

The FCC's methodology, which I refer to as the TELRIC Test, is laid out clearly in its Oklahoma-Kansas 271 Order at ¶84-5. It has since been applied in the subsequent 271 Orders including Massachusetts, Pennsylvania, and Arkansas and Missouri. In applying the method, the FCC uses its Hybrid Cost Proxy Model ("HCPM" or "USF cost model") to determine the relative cost of loops across the states of an ILEC. For example, according to the HCPM, the average cost of a loop is roughly 9% less in Florida than in Georgia. Loop costs are roughly 24% less in Florida than in Louisiana. The FCC then compares the relative UNE rates across states to determine if such differences are consistent with the estimated cost differentials as measured by the HCPM. To illustrate, if the loop rate in Georgia was, say, $10, then the loop rate in Florida should be about $9.10, or 9% less than in Georgia. The state that establishes the standard for a TELRIC compliant UNE rate, i.e., the reference state, is the state that has already received 271 authority from the FCC. In every case in which the FCC has applied its methodology, the state for each ILEC to first receive 271 authority serves as the standard (that is, Texas for all Southwestern Bell states and New York for all Verizon states).

Q. WHY DOES THE FCC USE THE HCPM TO COMPARE COSTS ACROSS STATES?

A. The operating principle underlying the FCC's analysis is that relative UNE rates between states should be consistent with relative cost differences, and that these relative cost differences are reasonably measured by the HCPM. As the FCC indicated:

> Our USF cost model provides a reasonable basis for comparing cost differences between states. We have previously noted that while the USF cost model should not be relied upon to set rates for UNEs, it accurately reflects the relative cost differences among states (emphasis added). [1]

When evaluating UNE rates within the context of a 271 application, the Commission employs its USF cost model to compare UNE rates in the applicant state with rates in other states which the Commission has found to comply with the TELRIC standard. If the difference in rates is roughly equal to the differences in costs, then the FCC declares the rates to be TELRIC compliant (or consistent with what a TELRIC analysis would produce).

Q. PLEASE PROVIDE EXAMPLES OF HOW THE TELRIC TEST IS APPLIED.

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[1] FCC KS-OK 271 Order, ¶ 84.

A. The FCC applied its "TELRIC Test" in the orders approving 271 applications in Oklahoma/Kansas and Massachusetts. In Oklahoma, the FCC evaluated the UNE loop rate, whereas in Massachusetts the loop and switching UNE rates were scrutinized with the TELRIC Test. For Oklahoma, the FCC expressed concern that the loop rate difference between Oklahoma and Texas was not cost justified:

> In taking a weighted average of loop rates in Oklahoma and Texas, we find that Oklahoma's rates are roughly one-third higher than those in Texas (ft. omitted). ... Using a weighted average of wire-center loop costs, the USF cost model indicates that loop costs in SWBT's Oklahoma study area are roughly 23 percent higher than loop costs in its Texas study area (ft. omitted). We therefore attribute this portion of the differential, roughly two-thirds of it, to differences in costs. The remainder of the differential, however, is not de minimus, and we cannot ignore its presence. [2]

In this statement, the FCC expressed concern that the difference in loop rates was not cost justified, where costs are measured with the HCPM. During the 271-review process, SBC "voluntarily" reduced its loop rates in Oklahoma. With respect to the reduced loop rates in Oklahoma, the FCC concluded:

> The weighted average of the Oklahoma discounted loop rates is roughly 11 percent higher than the weighted average of the loop rates in Texas. This differential between Oklahoma promotional and Texas rates is well within the 23 percent differential suggested by the USF cost model, and so

[2] FCC KS-OK 271 Order, ¶ 83-5.

> we conclude that the discounted rates meet the requirements of the Act.[3]

After the voluntary rate reduction in the Oklahoma loop rate, the 11% rate difference was below the 23% cost difference estimated by the HCPM. As a consequence, the FCC deemed the loop rate to be TELRIC compliant.

Q. HOW WAS THE TELRIC TEST APPLIED IN THE MASSACHUSETTS 271 ORDER?

A. During the review of the Massachusetts 271 application, Verizon "voluntarily" reduced its switching rates during the Massachusetts 271 proceeding to a level consistent with that of New York. The FCC concluded that the New York switching rates were appropriate for Massachusetts because:

> [a] weighted average of Verizon's voluntarily-discounted Massachusetts rates ... and corresponding rates in New York shows that rates in Massachusetts are roughly five percent lower than those in New York. A comparison based on the USF model of costs in Verizon's study area in Massachusetts and New York for these same elements indicates that the costs in Massachusetts are roughly the same as the costs in New York.[4]

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[3] FCC KS-OK 271 Order, ¶ 86.

[4] FCC Massachusetts 271 Order, ¶ 25.

Again, the relative cost difference as measured by the HCPM was used to evaluate the relative rate differences across states. The FCC also used the TELRIC test to evaluate the loop rates in Massachusetts.

Q. DID THE FCC USE THE TELRIC TEST TO EVALUATE THE RATES IN THE ARKANSAS AND MISSOURI 271 ORDER?

A. Yes. The FCC determined, for example, that the Missouri loop rate complied with TELRIC by performing the TELRIC Test with Texas as the reference state:

> We conclude that Missouri's recurring UNE rates fall within the range that TELRIC-based ratemaking would produce. With respect to loops, in taking a weighted average in Missouri and Texas, we find that Missouri's rates are slightly higher than those in Texas. The weighted average rates for a 2-wire analog loop in Missouri and Texas are $15.18 and $14.10, respectively. The Missouri loop rate is just under 8 percent higher than the Texas loop rate. The USF cost model, however, suggests that Missouri loop costs are nearly 20 percent higher than the Texas loop costs. Because the percentage difference between Missouri's rates and Texas' rates does not exceed the percentage difference between Missouri's costs and Texas' costs, SWBT has met its burden regarding the benchmark test using our USF cost model for recurring loop rates.[5]

Clearly, the TELRIC Test continues to be an important tool for the FCC's 271 evaluation.

Q. HOW IS THE TELRIC TEST PERFORMED?

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[5] ARMO Order, ¶59.

A. Put simply, the TELRIC Test simply compares the ratio of UNE rates to UNE costs between two states, where costs are measured by the HCPM. If there are two states, state X and Y, then the TELRIC Test is simply

$$\frac{\text{RATE\_X}}{\text{RATE\_Y}} \leq \frac{\text{COST\_X}}{\text{COST\_Y}}$$

where the ratio of UNE rates ("RATE") is less than or equal to the ratio of UNE costs ("COST"). For example, consider the Oklahoma and Texas loop comparison. The FCC determined that the UNE rates in Oklahoma were "roughly one-third higher than those in Texas," implying that the ratio of UNE rates was 1.33 (= RATE_OK/RATE_TX). The HCPM indicated, however, that loop costs are only "23 percent higher than loop costs" in Texas, implying that the ratio of costs was only 1.23 (= COST_OK/COST_TX). Obviously, 1.33 is not less than or equal to 1.23, leading the FCC to express concern over the initial Oklahoma loop rate. Once the Oklahoma loop rate was reduced "voluntarily", the ratio of UNE rates was only 1.11, which is below the cost ratio of 1.23. Thus, the reduced Oklahoma loop rate passed the TELRIC Test.

Q. HOW DOES THE FCC CHOOSE A REFERENCE STATE FOR ITS COMPARISON?

A. In the recent Arkansas-Missouri 271 Order, the FCC set forth the relevant criteria for choosing a reference state:

> A comparison is permitted when the two states have a common BOC; the two states have geographic similarities; the two states have similar, although not necessarily identical, rate structures for comparison purposes; and the Commission has already found the rates in the comparison state to be reasonable.[6]

Q. WHAT IS THE SIGNIFICANCE OF THESE EVALUATIONS BY THE FCC TO THIS CASE?

A. The significant point is that, where underlying costs have been measured by the HCPM and can be correlated, material disparities between or among the rates developed for different states are relevant to the consideration of whether a particular rate complies with the TELRIC standard.

Q. THE FCC HAS NOT APPROVED A BELLSOUTH 271 YET. HOW CAN YOU PERFORM THE TELRIC TEST FOR FLORIDA?

A. Even in the absence of a FCC-approved "reference state," and without indicating a view as to whether the rates in Georgia or Louisiana comply with the TELRIC standard, the same comparison employing HCPM data provides a useful tool with which to help gauge arguments concerning whether the Florida rate would comply with the FCC's TELRIC standard.

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[6] ARMO Order, ¶56.

Q. WHAT DOES THE TELRIC TEST SAY ABOUT THE LOOP RATE IN FLORIDA?

A. The current statewide average loop rate in Georgia for a UNE-P customer is $12.55. In Louisiana, the rate is $14.94. The current statewide average loop rate for Florida is $13.97. As previously mentioned, the HCPM indicates the cost of a loop in Florida is a maximum rate of about 9% less than in Georgia and 24% less than in Louisiana. Applying the test, the TELRIC Test ceiling standard for the loop rate in Florida is about $11.40 ($11.37 with Georgia as a reference and $11.30 with Louisiana as a reference). In other words, the loop rate would have to be at or below $11.40 to pass the sanity test. Thus, the current loop rate for BellSouth Florida is at least 23% too high (= 13.97/11.40). I have displayed these relationships in Exhibit __ (GSF-1).

Observe in Exhibit __ (GSF-1) that the loop cost in Georgia is about 83% of the loop cost in Louisiana, according to the HCPM. The ratio of loop rates in those states matches, almost identically, this cost difference (a ratio of 0.83). Only Florida is an outlier in the group.

Q. WHAT DO YOU CONCLUDE FROM THIS EXERCISE?

A. I believe the fact that BellSouth's loop rate fails this sanity test demonstrates the need to critically review BellSouth's rate. It is my

understanding that witness Brian Pitkin will address a number of specific flaws and questionable inputs in BellSouth's model.

Q. IF THE COMMISSION FAILS TO LOWER BELLSOUTH'S UNE LOOP RATE, WHAT EFFECT WILL THE INFLATED LOOP CHARGES HAVE ON Z-TEL'S ENTRY INTO FLORIDA?

A. I think most everyone thought that the Telecommunications Act was only about competition among telecommunications companies. Now, with the extremely limited human and financial resources of the CLEC industry, a form of competition between states for competitive entry is emerging. CLECs possess limited resources for marketing and selling their services. In the current capital market environment, CLECs have access to very limited resources that may be directed to typical market-entry tasks, such as marketing, sales, etc. For CLECs like Z-Tel, which has the ability to provide residential local service in over thirty states, the decision of which state to direct human and financial resources is a function of the potential margins in any particular state. States will relatively high UNE rates run the risk that entry will not happen, as CLECs devote resources to states with more attractive economics. In this proceeding, there is a danger that the Commission approve a relatively high loop rate that not only frustrates BellSouth's 271 prospects, but moves Florida down in the ranking of attractive markets. While I am not prepared to prognosticate

the future of competition in Florida, it does not take any leaps in logic to determine that Z-Tel would be more active in entering Florida at a loop rate of $11.40 or less than it will be at a loop rate of $13.97.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing (Revised) Rebuttal Testimony of Dr. George S. Ford on behalf of Z-Tel Communications, Inc. has been furnished by (*) hand delivery, or U.S. Mail this 14th day of December, 2001, to the following:

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