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REBUTTAL TESTIMONY OF WILLIAM E. TAYLOR

Prepared on Behalf of Verizon New England Inc.,

d/b/a

Verizon Rhode Island

Before The

State of Rhode Island

And Providence Plantations Public Utilities Commission

Docket No. 3445

October 22, 2002

REBUTTAL TESTIMONY OF WILLIAM E. TAYLOR

I. INTRODUCTION AND SUMMARY

Q. What is your name, business address and current position?

A. My name is William E. Taylor. I am Senior Vice President at National Economic Research Associates, Inc. (NERA), head of its telecommunications practice and of its Cambridge office, located at One Main Street, Cambridge, Massachusetts 02142.

Q. Have you testified previously in this Docket?

A. Yes. I filed direct testimony in this proceeding on July 1, 2002. My professional qualifications were attached as Exhibit 1 to that testimony.

Q. What is the purpose of your rebuttal testimony?

A. Verizon Rhode Island ("Verizon RI") has asked me to comment on selected economic issues raised in the testimonies of August H. Ankum on behalf of Conversent Communications of Rhode Island, L.L.C. ("Conversent"), Cindy Z. Schonhaut on behalf of Cox Rhode Island Telcom, L.L.C. ("Cox") and Thomas H. Weiss on behalf of the Division of Public Utilities and Carriers ("DPUC").

Q. Please summarize your primary conclusions.

A. My primary conclusions are summarized as follows.

- Competition is prevalent throughout Rhode Island, Verizon has no market power, and there is no economic basis to the assertion that granting Verizon pricing flexibility will harm competition.

- There is no economic basis to the assertion that Verizon could impair the development of competition by implementing a price squeeze.

- Imputation should not be used as a policy tool to address the needs of any one particular competitor. The purpose of imputation is to assure that the goal of efficient competition is not frustrated by anticompetitive pricing. The competitive process in Rhode Island will be efficient so long as Verizon's retail prices do not disadvantage an efficient competitor.

- If imputation were inappropriately used to advantage one particular competitor, consumers in Rhode Island would be harmed because prices would ultimately be higher than if competition were efficient.

- A UNE-based floor for retail prices would make no sense and serve no good purpose in Rhode Island. The Commission has already established a wholesale discount applicable to all of Verizon's retail telecommunications services. Using those discounted services, any efficient entrant is able to compete against Verizon's retail offerings.

- Because Cox is a full facilities-based competitor with a near ubiquitous presence currently offering telephone services to residence and business customers throughout the state, the Commission should question the need for any imputation standard.

- Verizon should not be the only telecommunications carrier in Rhode Island with a responsibility to fund the provision of Internet services to schools and libraries. The funding process should be competitively neutral.

- There is no economic basis to support the notion that Verizon should be required to absorb the first $2 million of exogenous costs.

- The assertion that competitive market forces are deteriorating and will leave Verizon with market power in Rhode Island is vacuous. Recent reductions in CLEC market capitalization and failures of some CLECs are normal outcomes of competitive market processes. They do not imply that competition cannot survive in local exchange markets or that Verizon is somehow responsible for its demise. Moreover, significant investment by entrants in local exchange markets remains, and those facilities are used to compete in the market regardless of the name of the firm that owns the assets.

II. GRANTING VERIZON PRICING FLEXIBILITY WILL NOT HARM COMPETITION

A. Verizon Does Not Have Market Power

Q. Dr. Ankum asserts (at 10) that because of “Verizon’s dominant position” the Commission should be concerned that it could increase and/or decrease its retail rates to impair the development of local competition. Ms. Schonhaut raises a similar concern and (at 9) characterizes the Plan’s pricing flexibility provision as “premature.” Please comment.

A. I disagree. While Dr. Ankum chooses to characterize Verizon as “dominant,” the relevant issue for pricing flexibility is whether Verizon has market power.[1] If a regulated firm with market power had pricing flexibility, it would presumably act to increase profits by holding the market price above the competitive level. Conversely, a regulated firm without market power would be unable to use pricing flexibility to raise prices above the competitive level.

It’s not clear what Dr. Ankum means by “dominant” other than perhaps that one firm has a large market share. In economics, it is well understood that a firm can have a large market share without having market power. For example, according to recent figures, Intel supplies about 80 percent of the computer chip market, but a more competitive market would be difficult to find. If Intel raised its prices, it would lose customers to AMD or other suppliers so that the price increase would ultimately prove to be unprofitable. Similarly, if Verizon raised the price of retail telephone service above the competitive level, consumers in Rhode Island would simply migrate to Cox, Conversent, or one of the many other reseller, UNE or facilities-based competitors currently in operation. Verizon could not impair the development of local competition as Dr. Ankum suggests unless it had market power.

Importantly, and contrary to Ms. Schonhaut’s opinion that Verizon’s proposal is premature, the fact is that Verizon does not currently possess market power in Rhode Island. As I testified in my direct testimony, implementation of the Telecommunications Act of 1996,

[1] A firm has *market power* if it can control the market price: for example, raising the price of a service above the competitive level and sustaining a profit for a significant period of time.

along with changes in regulation and technology have changed the structure of telecommunications markets in Rhode Island. Telecom markets are open to competition in Rhode Island from a variety of different providers using a variety of different entry strategies. All legal and regulatory barriers to entry into telecommunications markets are gone. Indeed, contrary to Dr. Ankum's assertions (at 12) that competition in Rhode Island is "feeble," Mr. Silvia's testimony shows that Verizon faces substantial, actual competition in all its retail markets. From an economic perspective, the presence of actual competition and the absence of barriers to entry effectively constrain Verizon's ability to raise retail prices above the competitive level. Thus there is no economic basis for either Dr. Ankum or Ms. Schonhaut to believe that Verizon holds market power in Rhode Island.

B. Verizon Has Neither The Incentive Nor The Ability To Engage In Anticompetitive Pricing Strategies

Q. You have explained that Verizon does not have market power and cannot raise retail telephone service prices above the competitive level in Rhode Island. Dr. Ankum asserts (at 10-11), however, that Verizon could *lower* retail rates in select circumstances to defeat competitors and then raise them to the detriment of ratepayers. Similarly, Ms Schonhaut asserts (at 7 and 14) that granting Verizon "unfettered flexibility" to *lower* rates will result in Verizon engaging in a strategy of anticompetitive predatory pricing to the detriment of Rhode Island consumers and pro-competitive public policies. Does anything prevent Verizon from lowering rates to defeat its competitors?

A. Yes. As I will explain below, it is literally impossible for Verizon to engage in anticompetitive pricing in Rhode Island. First, to be successful at predatory pricing a firm must be able to *permanently* force its competitors out of the market. This would be particularly difficult for Verizon in Rhode Island because Cox, a near ubiquitous facilities-based provider of cable and telephone services, has a committed presence based on substantial investment in facilities. Other UNE-based competitors also have switching and transmission facilities in Rhode Island. Such firms are not easily forced to abandon their investment. If they do, or if a UNE-based competitor goes out of business for any reason, their facilities remain in place and are available for other providers to use. The presence of such facilities makes it virtually impossible for Verizon to expect it could permanently force competitors out of the market. Second, the Commission in Rhode Island has approved a wholesale resale discount with which any efficient telephone service provider can always obtain Verizon's retail services to resell to its own customers at a cost sufficiently below Verizon's retail service price so that an efficient entrant could compete profitably.

Q. What is anticompetitive pricing?

A. Economists generally consider two related types of anticompetitive pricing practices: predatory pricing and vertical price squeezes. *Predatory pricing* entails pricing a service below the marginal cost of supplying the service (i.e., purposefully losing profit for a period) with the intention of permanently driving a rival from the market and then raising prices to recoup losses and earn supracompetitve profits going forward. This would be like Coke reducing its price in Rhode Island below its marginal cost with the expectation that it could force Pepsi to exit—and stay out of—the Rhode Island soft drink market. This is unlikely to happen because even if Coke was willing to lower its price (i.e., earn lower profit) in its attempt to force Pepsi out of the market, Pepsi's facilities (i.e., production facilities, distribution facilities, long-term contracts with supply sources) would remain in place. Thus, when Coke then raised its price to recoup its losses, customers would switch to Pepsi, or some other company using its facilities, which would prevent Coke from achieving its objective. That is, since Pepsi (or another firm using the facilities that Pepsi abandoned) would undercut Coke's supracompetitive price, Coke would be kept from recouping its losses and from earning supracompetitive profits going forward. The bottom line is that it would make no sense for Coke to engage in a strategy where it loses money and is unable to gain it (and more) back in the future.

Similarly, it would make no sense for Verizon Rhode Island to engage in such a strategy. Dr. Ankum is concerned that Verizon could *lower* retail rates in select circumstances to defeat competitors and then raise them to the detriment of ratepayers, but attempting to do so would (i) certainly and immediately reduce Verizon's profits and (ii) leave little or no opportunity to gain those lost profits back. Verizon would immediately lose profits because it would have to charge a price that did not recover its costs. Verizon would have little or no opportunity to recoup those lost profits because it could not expect to force Cox and others out of the market. As soon as Verizon began to raise its prices (above the competitive level to make up for lost profits) customers would turn to other service providers leaving Verizon at a loss.[2]

Indeed, recoupment is especially difficult in telecommunications because of the sunk-cost characteristics of competitors' underlying network facilities. Notwithstanding Ms. Schonhaut's belief (at 5) that Cox's presence in Rhode Island is not yet sufficient to forestall anticompetitive pricing, when a predator raises prices in the future to recover its lost profits, the rival's network remains in place and <u>can</u> be used to discipline prices. In the words of the Supreme Court:

> the success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain...For this reason, there is a consensus among commentators that predatory pricing schemes are rarely tried and even more rarely successful.[3]

The ability to recoup profits lost to predatory pricing or other tactics that cost Verizon profits would be blocked because networks are long-lived, immobile investments.

Q. What is a vertical price squeeze and what prevents Verizon from engaging in such a strategy?

A. Suppose a firm provides retail services in competition with other firms and is also the only supplier of some wholesale service that its competitors need to compete in the retail market.[4] A *vertical price squeeze* would occur if the integrated firm set its retail price so low that an efficient competitor couldn't pay for the wholesale service and still make a profit selling at the retail market price. The classic example of a vertical price squeeze involves a monopolist charging dependent competitors a high price for raw aluminum but

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[2] In addition, because of the time value of money, future gains would have to be much greater to make up for the initial losses to profit.

[3] *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986) emphasis in original.

[4] The classic example is a railroad that happens to own the only bridge over a river. To compete in the retail shipping business, other railroads must either wastefully duplicate the bridge or pay the owner to use it.

then selling its own retail aluminum products at a very low price. The result is that competitors are "squeezed" between their high costs and a low retail market price.

Q. It is clear why Verizon would lose money if it attempted to engage in predatory pricing. Please explain why Verizon would lose money if it attempted to engage in a vertical price squeeze.

A. Let's begin by describing a vertical price squeeze, using the case of switched access and toll service as an example. Assume, for the purpose of the example, that the wholesale service is switched access, that the retail service is toll and that toll competitors must purchase switched access from Verizon. Assume it cost Verizon 2¢ per minute to provide switched access to an IXC and 3¢ per minute to supply retail toll service. A vertical price squeeze would occur if Verizon charged an IXC 10¢ per minute for switched access (the wholesale service) but then only charged 6¢ per minute for its own retail toll service. Under these circumstances, an IXC could not effectively compete—it would be "squeezed" between its high cost and Verizon's low retail price. However, if Verizon attempted such a strategy, it would lose money that it could never expect to recoup. Thus, Verizon has no incentive or ability to engage in this strategy in the first place.

Essentially, Verizon would lose money on each minute of retail toll service it sold because every minute of toll service it sells represents one fewer minute of access service. Thus, Verizon loses 5¢ for every minute of toll service it supplies: by assumption, it could have sold access service for 10¢ (at a cost of 2¢) but chose instead to sell toll service for 6¢ (at a cost of 3¢). Like for predatory pricing discussed above, Verizon is now in a position where it has to make up lost profit and, is unable to do so. As soon as Verizon began to raise its retail price (above the competitive level to make up for lost profits) customers would turn to other service providers like Cox, Conversent, and others, leaving Verizon at a loss. No successful business makes strategic decisions to operate at a loss—Verizon has no incentive or ability to undertake such strategies.

Q. You mentioned that the advent of resale also prevented Verizon from engaging in anticompetitive pricing strategies. Please comment.

A. The Telecommunications Act of 1996 and subsequent Commission orders in Rhode Island establish a wholesale (resale) discount applicable to any Verizon retail telecommunications service a competitor wants to resell. This prevents any efficient service provider from ever being squeezed between a high wholesale cost and low retail market price or being forced to exit the market because of Verizon's below-cost pricing. The resale discount guarantees that any efficient telephone service provider can obtain Verizon's retail services to resell to its own customers at a cost sufficiently below Verizon's retail service price so it can compete profitably. Again, it is literally impossible for Verizon to engage in the anticompetitive pricing that Dr. Ankum and Ms. Schonhaut are concerned about.

C. Head-to-Head Competition On A Per Customer And Per Location Basis Is Not Something The Commission Should Avoid

Q. Dr. Ankum asserts (at 14) that with the pricing flexibility embodied in the company's proposed plan Verizon could "control the strength and viability of its competitors" by engaging in anticompetitive pricing practices for business services on "*a per customer and per location basis.*" Do you agree?

A. No. In addition to the reasons discussed above, Dr. Ankum's claim ignores the fact that Verizon already has such pricing flexibility on a per customer and per location basis. Verizon has long been able to compete head-to-head for contracts to provide telecommunications services to individual business customers. In so doing, Verizon has always been bound by rules that prohibit the kind of anticompetitive behavior about which Dr. Ankum is concerned. Indeed, the evidence in Ms. O'Brien's testimony regarding how competitors often win such contracts further diminishes the importance of Dr. Ankum's concerns in this regard.

Q. Dr Ankum further asserts (at 19-20) that Verizon's scope of operations enables it to engage in short-run marginal cost pricing for services supplied to select customers—i.e., those that CLECs are competing for—and still remain profitable, but that CLECs (already in a precarious financial position) are unable to match Verizon's prices. Please comment.

A. Dr. Ankum's concern is but another variant of his belief that Verizon has an incentive and the ability to engage in some form of anticompetitive pricing. The belief that Verizon would launch a "full-scale assault on a CLEC's customers in a particular location" by setting prices equal to short-run marginal cost ignores (i) the fact that Verizon cannot sustain a pricing policy that loses money—i.e., does not recover its fixed costs, and (ii) that the facilities of any facilities-based competitor would remain in the ground available for use the moment that Verizon attempted to raise its price back to levels high enough to sustain its operations (i.e., recover its forward-looking variable and fixed costs), recover its losses, and return a supracompetitive profit (without which there would be no point to Verizon engaging in such behavior in the first place) going forward. In addition, Dr. Ankum's concern about CLECs being forced to abandon collocation cages in wire-centers ignores the fact that those same CLECs have switches in place to serve those same wire centers and such facilities would remain available to that CLEC or another that took over its facilities. In short, Verizon has no incentive to engage in a pricing strategy that would result in losses (i.e., not recovering its substantial fixed costs of operations) when the presence of Cox and other facilities and UNE-based providers would leave it little or no hope of ever making up for that loss.

D. Cost Based Geographic Price Deaveraging Is Both Practical And Efficient

Q. Ms. Schonhaut asserts (at 8-9) that adopting Verizon's proposal would "thwart competition" because it would allow geographic rate deaveraging for local service in Rhode Island. Ms. Schonhaut goes on to say that geographic deaveraging based on varying cost characteristics "may sound good in a purely academic or theoretical context, but would have disastrous consequences for consumers in Rhode Island." Do you agree?

A. No. Rhode Island already has geographic variations in prices. They are not, however, cost-based price variations. Currently, 'value of service' prices for exchange service prevail—that is, subscribers in more densely populated geographic areas are charged more for exchange service on the basis that there are more local subscribers they can reach without a toll call. Under rate-of-return regulation when Verizon (then New England Telephone ("NET")) was the <u>only</u> (monopoly) provider of telephone service in Rhode Island, the regulator could set rates in this way and also provide a means for NET to have sufficient earnings to run the business.

Any price changes that move prices closer to cost (geographically or otherwise) will enhance consumer welfare and foster more widespread competition throughout all of Rhode Island. Ms. Schonhaut's characterization of cost-based deaveraged prices as only theoretically attractive exposes a misunderstanding of basic economic principles. When ever prices and costs are misaligned, too much of some goods and too little of other goods are produced and consumed. Prices are signals to consumers about what goods cost to produce—i.e., how much of society's scarce resources are needed to fulfill their demand—and when prices deviate from cost consumers end up paying too much for some goods and too little for others. While Ms. Schonhaut may believe it is beneficial for consumers in high-cost-to-serve areas of Rhode Island not to pay prices commensurate with the cost to bring them service, she ignores an important consequence. Namely, that the misalignment of prices and cost will discourage competitors from supplying services to those areas. So, while Ms. Schonhaut claims it is only an academic or theoretical issue, she ignores a *real* and *practical* consequence of her position—i.e., diminished competitive activity throughout all of Rhode Island.

E. The Needs Of Any One Particular Competitor Should Not Determine Policy Decisions

Q. Dr. Ankum asserts (at 14-15) that carriers that are dependent on Verizon's unbundled network elements—such as Conversent—would be "most vulnerable" if Verizon is granted pricing flexibility. Please comment.

A. The issue of whether Verizon should be granted pricing flexibility is a public policy issue that should be informed by considerations of the general economic well-being of consumers in Rhode Island. It would be inappropriate for public policy decisions to take account of the needs of any particular competitor. Thus, while the choices Conversent (or any other CLEC) made about how to enter and conduct business in Rhode Island's telecommunications markets might not be as profitable as other firms' business plans, that should not be the concern of the Commission. Indeed, if any LEC's business plan is too narrowly focused and/or otherwise does not allow it to successfully compete with other more efficient service providers, then the economic welfare of Rhode Island consumers would benefit by that LECs demise.

Indeed, if the Commission were to (in my opinion) err and make a public policy decision based on the need to support any individual CLEC, there would unambiguously be a detrimental (i.e., unnecessary and inefficient) increase in the ultimate prices for telecom services paid by consumers in Rhode Island. By definition, efficient prices will be obtained only if the competitive process is allowed to weed out inefficient firms. Each time an inefficient firm is given some artificial means by which to remain in the market—e.g., raising Verizon's price floor by improperly imputing UNE TELRIC rates (an issue I will discuss in more detail below)—prices are held higher than they otherwise should be and consumer welfare is diminished.

III. A UNE-BASED PRICE FLOOR IS UNNECESSARY

Q. Dr. Ankum asserts (at 7 and 31-32) that Verizon's retail price floor should be based on UNE TELRIC rates. He asserts that Verizon's price floor for any given service should include the imputed costs of all the UNEs used to provide the service and a measure of Verizon's retailing costs which he asserts are adequately accounted for by using the Commission's approved resale discount rate. Similarly, Ms. Schonhaut (at 15-17) asserts that the Commission must enforce a TELRIC-based price floor to ensure that Verizon treats competitors fairly, or facilities based competitors such as Cox would be squeezed out of the market. Do you agree?

A. No. A UNE-based price floor would make no sense and serve no good purpose in Rhode Island. The entire purpose of an imputation standard is to assure that an ILEC (i.e., Verizon) cannot set retail prices below the cost it imposes on a dependent competitor—i.e., place that dependent competitor in a price squeeze. For one prominent competitor in Rhode Island--Cox--there is no need for the Commission to impute UNE TELRIC rates to a price floor. Cox is not in any sense a dependent competitor: it is a full facilities-based competitor with a near-ubiquitous presence and currently offers telephone services to residence and business customers throughout the state. As a facilities-based competitor, Cox offers its services without relying on Verizon's facilities. This fact implies that Verizon does not control an essential facility in Rhode Island. If Verizon does not control an essential facility then there is no economic basis to impose any imputation standard.

Second, the purpose of a price floor is to prevent anticompetitive pricing, and I have explained above that Verizon has no incentive or ability to carry out a successful anticompetitive pricing strategy. The Commission has established a wholesale discount applicable to all of Verizon's retail telecommunications services. Thus no efficient competitor will ever be competitively disadvantaged by the UNE prices charged by Verizon. That is, regardless of the relationship between the retail prices and the wholesale UNE prices charged by Verizon, there is always a lower wholesale price that an efficient competitor can use to obtain the means by which to successfully compete with Verizon.

Finally, even if a price floor were deemed necessary by the Commission in Rhode Island, a UNE TELRIC-based price floor would be unnecessarily stringent and would result in inefficiently high service prices, because such a price floor would include recovery of a portion of the firm's shared fixed and common costs. From an economic perspective, such a UNE-based price floor would send the wrong price signal, unambiguously harm competition, and ultimately cost Rhode Island consumers more.

Q. Suppose the Commission disagrees with your reasoning and insists upon implementing a UNE-based price floor for retail services. What would be the correct imputation formula?

A. If the Commission mandates that Verizon must adhere to a retail price floor based on the assumption that it controls essential facilities required to provide basic exchange service, then the economically correct standard would set Verizon's retail price to be above its own marginal cost to provide the service plus any contribution (i.e., price less marginal cost) from the UNEs that competitors must purchase from Verizon in order to compete. That is, the economically appropriate imputation standard requires that Verizon's retail prices recover at least all direct cost incurred to provide its retail service plus any contribution from providing the relevant forms of unbundled elements to its competitors that are required to obtain essential facilities to compete with Verizon.

To understand this standard, suppose there were no essential facilities that competitors had to purchase from Verizon. A reasonable floor on Verizon's retail price would be just the incremental cost it incurs to supply the service. If there are essential facilities that competitors require and Verizon were to make them available at its own incremental cost, efficient competition would still allow Verizon to price its retail service all the way down to its retail incremental cost. However, if Verizon were to price its essential facilities above their costs, equally efficient competitors could not compete against Verizon's retail price. To offset that advantage, imputation adds to Verizon's incremental cost price floor, the contribution (price less incremental cost) that competitors provide to Verizon for use of its essential facilities.

In symbols:

$$P_R \geq MC_R + (P_W - MC_W)$$

where P and MC represent price and marginal cost respectively and R and W represent retail and wholesale respectively.[5] The difference between the price and marginal cost of the wholesale element ($P_W - MC_W$) represents the contribution toward recovery of fixed costs Verizon would receive if it provided the essential facility to its competitor. Under these circumstances, when there is an essential facility, there will be no opportunity for Verizon to impose an anti-competitive price squeeze—*i.e.*, supply an essential facility and require its competitor to pay more for the essential facility than it effectively charges its own customers for use of that facility. A more detailed derivation and discussion of this standard is contained in Attachment I to this testimony.

Q. Your exposition of the correct imputation standard began with the presumption that there was an essential facility used to provide *basic service*. Do CLECs generally limit their business to the supply of basic service and how would that effect your assessment of the correct imputation standard?

A. CLECs do not generally limit their business to the supply of basic service. A casual inspection of Conversent's web site reveals that its Basic Business Line service includes touch-tone, 900/976 blocking and multi-line hunting. Conversent's Basic Business Value

[5] The retail cost here is the entire incremental cost of supplying the increment of retail demand, not just the incremental cost of the retailing functions.

Package goes on to include call forwarding/variable, call forwarding/busy, call forwarding/no answer, cancel call waiting, three-way conference calling and speed dialing (30 numbers); the Basic Business Line Security Package goes on to include Distinctive Ring, Caller ID, Call Trace, Call Blocking and Deny Termination. The point is that plain old telephone service (POTS) is not a mainstay of the business done by CLECs.

This is important because in addition to applying the correct imputation price floor standard, it is important to assess that formula using all the prices and costs of all the retail services and wholesale elements a competitor uses to supply service packages to consumers. When the elements of these service packages are considered, the imputation standard I described above based on just basic service is very conservative. Unlike for basic service where Verizon's retail price is arguably lower or just slightly above the cost it incurs to provide the service, virtually everybody agrees that the price to cost margin for vertical services is high. That is, when we take into account that fact that CLECs compete to provide service packages (not just POTS) it is highly unlikely that Verizon's retail prices would ever fail an appropriate price floor test.

IV. OTHER ISSUES

A. Access Charge Imputation

Q. Ms. Schonhaut expresses a concern (at 17-18) about the imputation of the access charge component of toll rates. Please comment.

A. Ms. Schonhaut appears to be out of touch with telecommunications law and regulation. In particular, Section 272(e)(3) of the Act requires BOCs to purchase carrier access out of the same tariffs as their competitors and to impute those carrier access charges into their long distance prices, so that all competitors effectively pay the same price for the same carrier access services. Federal and state regulations prevent anticompetitive pricing of toll services through price floors and by imputing access charges in toll rates. From an economic perspective, even absent an imputation requirement, Verizon must recognize the access charges that competitors pay as an opportunity cost of supplying long distance itself.

If Verizon serves the long distance customer, it gives up carrier access charges that an IXC would have paid to it if it won the customer.

B. Verizon Should Not Be The Only Telecommunications Carrier In Rhode Island With A Responsibility To Fund the Provision Of Services To Schools And Libraries

Q. Ms. Schonhaut (at 34) raised the issue of the appropriate way to fund Internet access for Rhode Island schools and libraries. Please comment.

A. Funding for Internet access for schools and libraries should be equitable, nondiscriminatory and competitively neutral. That is, all suppliers of telecommunications services in Rhode Island should be required to make a proportionate contribution. This adheres to both economic principles and to the spirit of Section 254 (d) of the Act in regards to Universal Service.

> Every telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service.

Like the Universal Service fund discussed in the Act, funding for Internet access to schools and libraries in Rhode Island should place a proportionate burden on all firms supplying telecommunications services in the state. It is not equitable or competitively neutral to raise only Verizon's cost of doing business to accommodate Internet access.

C. Price Changes For Verizon's "Other" Services Should Not Be Capped

Q. Mr. Weiss recommends (at 16) that the Commission should restrain increases to the prices of "Other" products and services to a maximum of fifteen percent annually over the term of the plan. Do you agree?

A. No. Mr. Weiss himself testified that most all products and services in the "Other" category are offered in competitive environments or are discretionary services. There is no reason for the Commission to limit the price increases for any service offered in a competitive environment because market forces will act to hold prices to the competitive level. The purpose of regulation is to act in situations when market forces cannot be relied upon. This is not such a case. Discretionary services are, by definition, not *necessary* and as such the Commission should refrain from placing any limits on their price.

It is particularly disturbing that Mr. Weiss's proposal would limit Verizon's incentive and ability to innovate new services. Suppose, for example, that Verizon introduces a new service at $7, then learns that consumers are not responding favorably and reduces its price to $5. Based on strong consumer response to the $5 price, Verizon may want to increase the price to $6 but could not under Mr. Weiss's proposal.[6] Limiting Verizon's ability to test new products at various prices will have deleterious effects on new product innovation and introduction.

D. Verizon Should Not Be Required To Absorb The First $2 Million Of Exogenous Costs

Q. Mr. Weiss recommends (at 18) that Verizon be required to absorb the first $2.0 million of the intrastate revenue effects for exogenous events. Do you agree?

A. No. Economic principles require that changes in a regulated firm's costs should lead to changes in its prices because economic efficiency is enhanced when prices are kept close to incremental costs. Indeed, in competitive markets, price moves with incremental cost, and any event that changes incremental cost will change the market price by the same amount. Limiting the amount of exogenous adjustment in the way Mr. Weiss suggests departs from that objective.

E. There Is No Economic Basis For A Claim That Competitive Market Forces Are Deteriorating And Will Leave Verizon With Market Power

Q. Dr. Ankum makes a number of assertions (at 33-37 and Attachment II) regarding the financial health of competitive carriers and how it affects their ability to compete. He concludes (at 35) that "competitive carriers have suffered serious financial setbacks over the last two and one-half years" and asserts (at 37) that "if the Commission approves VZ's

[6] The limit would be $5.75 (5 x 1.15 = 5.75).

proposal, then the long-term viability of CLECs that use VZ's UNEs is seriously impaired." Do you agree?

A. No. This line of argument is unpersuasive for several reasons. First, while it is true that several entrants into the local exchange markets have not survived the past several months or even a few years, competition is "far from dead or dying" as two telecommunications analysts put it.[7] In a recent quarterly report on competition in the telecommunications industry, analysts at Eastern Management explained why a decreasing number of CLECs is not harmful to competition:

> CLECs are decreasing in total numbers as any pundit will tell you, but their power is growing by leaps and bounds. Despite bankruptcies and burnouts that we read about, the fact is that competitive service providers continue to grow their share of the business and residential markets. Industry consolidation is in many ways desirable for established carriers such as Allegiance, Cogent, and Time Warner Telecom. As their peers exit markets or the space altogether, companies can leverage their position to capture customers who have grown fond of alternative service. Acquisition of infrastructure, networks and customers with minimal capital expenditure is also a clear benefit to remaining carriers during this current period of fiscal conservatism.[8]

Consider Conversent, one of the leading CLECs in Rhode Island. Conversent was formed in June 1998 and currently employs over 500 sales, engineering, marketing and support staff.[9] The Company has, in fact, used the current environment to its benefit. For example, in November, 2001, it used the fall of Teligent to offer a special program to Teligent customers allowing them to maintain an uninterrupted local telephone and Internet service.[10] Three months later Conversent offered the same type of program to Network Plus customers after Network Plus filed for Chapter 11.[11] More recently, in August, Conversent acquired REON Broadband, Inc., a leading provider of in-building broadband

[7] Robert A. Saunders and Alina Bankowski, "Competition in the Telecom Sector: CLECs, Cable and Wireless are Making Waves Despite the Downturn," Eastern Management, April 1, 2002.

[8] *Ibid.*

[9] http://www.conversent.com/about/history.html

[10] http://www.conversent.com/about/news/teligent.html

[11] http://www.conversent.com/about/news/networkplus.html

solutions for businesses throughout New England.[12] Clearly, the current environment affects carriers differently, and it would be wrong to assume that the financial health of a particular set of carriers reflects the entire industry.

Second, several unsuccessful CLECs have been victims of their own business errors or the vagaries of the business cycle. Those that entered the market in pursuit of regulatory arbitrage profits alone—for example, from carrying Internet-bound traffic to Internet service providers—found themselves without a business when the FCC clarified the rules. Other unsuccessful CLECs have failed to attract sufficient capital or customers to compete and stay viable even in niche market segments:

> On the other hand, another entrant, ICG, expanded too quickly by adding markets before its initial network operating problems were eliminated. Ultimately, it filed for bankruptcy protection, citing service problems and revenue shortfalls. Another entrant, NorthPoint, sold digital subscriber line (DSL) service to Internet Service Providers (ISPs) rather than provide Internet access itself. With the recent financial crunch claiming many Internet firms, many of its customers defaulted on their payments, resulting in NorthPoint's filing for bankruptcy protection. Yet another entrant, Focal, relied too heavily on a gimmick -- collecting reciprocal compensation payments from established carriers for simply placing itself between these established carriers and Internet service providers. When this gambit was revealed and ultimately phased out by regulators, Focal's inefficient network design was exposed, placing it in substantial financial difficulty.[13]

Despite Verizon compliance with the duties and responsibilities imposed upon it by the 1996 Act, there can never be a guarantee that *every* competitor that enters the market will survive and thrive. Nor should the Commission act as a guarantor of the survival of any and every competitor. The 1996 Act contains no provisions—beyond allowing for fair competition—to ensure the survival of every new entrant.

Finally, Dr. Ankum would apparently have the Commission believe that non-incumbent carriers are about to go out of business and that their demise would, in large part, be the

[12] http://www.conversent.com/about/news/reon.html

[13] See Robert W. Crandall, "An Assessment of the Competitive Local Exchange Carriers Five Years After the Passage of the Telecommunications Act," Criterion Economics LLC, June 2001: 5.

Commission's fault if Verizon were granted pricing flexibility. I disagree. First, Dr. Ankum's exhibits highlighting the changes in market capitalization show that the CLECs and Wholesale Providers category has an August 28, 2001 capitalization in excess of $16 billion. This is hardly a trivial amount; indeed it is larger than the Gross Domestic Product of a number of nations in the world today. Importantly, Dr. Ankum's much-touted decline in market capitalization for the CLECs and Wholesale Providers category ($271 billion) is not so different from the market capitalization decline of *individual* companies such as Lucent ($237.6 billion decline), Microsoft ($248.3 billion decline) and Intel ($215.9 billion decline). Dr. Ankum's CLEC and Wholesale Provider category decline pales by comparison to the total market capitalization decline of just these four companies (more than $821 billion) over roughly the same period he analyzed.[14]

Furthermore, with the declining economy and tightening capital markets, CLECs are in a relatively advantageous investment position. Verizon is compelled to continue its investment program to meet retail service requirements, thereby ensuring that UNE, UNE-P and resale offerings continue to be available to CLECs in Rhode Island. The local exchange telecommunications market is unique in that respect—i.e., in the short run, entrants can survive and grow without expending a great deal of their own capital because the ILEC network can be relied upon to meet both wholesale and retail demand.

Q. Dr. Ankum points to the recent financial woes of some CLECs to suggest that local competition may not occur or be permanent. Do you agree?

A. No. There is virtually no chance that *competition* will disappear or even significantly recede in the local exchange even if particular competitors exit the market. First, the number of lines served by competitors has been growing vigorously, and the results are reflected in the FCC's most recent report on local competition. In that report, Rhode Island ranked as one of the most competitive states in the US, with CLECs capturing 16 percent of

[14] http://biz.yahoo.com/p/i/(intc, lu, mfst, and ibm).html and The Value Line Investment Survey, Edition 13 dated March 3, 2000 and Editions 5 and 7 dated January 21, 2000.

the local market.[15] Only New York had CLECs with a higher share of the local market (25 percent). Additionally, CLECs have made substantial sunk investments between 1997 and 2001,[16] which clearly demonstrate that competition is permanent. Local competitors, as a whole, will not walk away from this substantial sunk investment.

Second, the current travails of some CLECs are a normal part of the competitive process. This fact was made evident at the Competitive Telecommunications Association's ("CompTel") fall meeting recently. For example, in describing the success and failure of different CLECs, CompTel Chairman Richard E. Burk, president and chief executive officer of nii Communications, Inc., said

> it's also true that some of the business models and some of the executions have been better than others…the people who are here feel that they've really accomplished something significant to still be here."[17]

The president of CompTel, H. Russell Frisby Jr. said:

> it's very interesting that the people here were doing deals and in fact there was much more deal-making here than we had [at the last meeting in Miami]. In Miami people were looking and taking leads. Here people were actually doing the deals, which I think is significant…the people here think that they're the ones who will survive and will be the ones acquiring other companies."

Finally, and most importantly, even if some individual CLECs exit the local market, the remaining competitors are likely to purchase their assets (in the case of a facilities-based CLEC) and/or take over their customer bases. This process strengthens the purchaser's network and product mix and, ultimately, strengthens competition. The following table lists some of the instances in which this has happened over the past year:

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[15] Federal Communications Commission, "Local Telephone Competition: Status as of December 31, 2001," July, 2002.

[16] According to an analysis by New Paradigm Resources Group, the total investment by facilities-based CLECs between 1996 and 2001 is $64.3 billion. Competitive Telecommunications Association, "Measuring the Economic Impact of the Telecommunications Act of 1996: Telecommunications Expenditures (1996-2001), October 2002, p 11.

[17] TR Daily, "Despite Troubles, CLEC Representatives Upbeat as ComTel Conference Ends," October 9, 2002.

Date	Purchaser	Assets Purchased	Assets Purchased From
Sep 2002	Primus	Retail switched voice services customer base	Cable & Wireless USA
Sep 2002	Cogent	Customer base and building access agreements	FiberCity Networks
Jun 2002	Conversant	Customer base & other assets	REOn Broadband
Jun 2002	SureWest Communications	N/A	Western Integrated Network
Feb 2002	DSL.net	Customer base	Broadslate Networks
Feb 2002	New Edge Networks	Business customers and broadband access assets	AtHome
Feb 2002	Cogent	Customer base, backbone network	PSINet, Inc
Feb 2002	Cogent	In-building fiber optic facilities	Allied Riser Communications Corporation
Mar 2002	Broadview Networks	Customer base (including over 200,000 local lines), and an extensive fiber network	Network Plus
Mar 2002	Broadview Networks	Customer base and network equipment	Net2000 Communications
Oct 2001	Williams Communications	Fiber-optic network, intellectual property, and Internet protocol capabilities	CoreExpress
Oct 2001	ATSI Communcations	Telecommunications equipment, multinational customer base and accounts receivable	Telescape

This list does not reflect, however, the companies that have filed for Chapter 11 protection, only to emerge from reorganization stronger and healthier. For example, Teligent, a fixed wireless provider, emerged from bankruptcy on September 16, 2002, entirely debt-free and with all of its existing fixed-wireless assets intact, including spectrum licensees in 74 markets.[18] Another company to file for Chapter 11, McLeodUSA, also completed a reorganization. McLeod completed its Plan of Reorganization on April 16, 2002, and recently had revenues of $254 million for the second quarter of 2002.[19]

[18] Roy Mark, “Teligent to Emerge from Bankruptcy,” Internet.com, September 9, 2002.

[19] McLeodUSA Quarterly Releases, “McLeod Reports Second Quarter 2002 Results,” July 31, 2002.

Q. Is it likely that the apparent shakeout among CLECs will lead to stronger competition?

A. Yes. The current apparent shakeout, including consolidations and acquisitions, will result in robust, viable competition. Although a few competitors are struggling and might even go out of business, there is little chance that the competition faced by Verizon will become ineffective or anything less than permanent. Indeed competitors have been becoming larger in terms of revenue, geographic reach, and service lines, better able to take advantage of economies of scale and scope, and more credible with customers (allowing them to experience lower churn rates). Thus, there can be no lasting long-term negative effect even if a number of the smaller competitors do not survive as separate entities. One industry source accurately summarized the situation this way:

> The sheer economics prohibit the continued success of all the service providers…Over time it is certain that the more successful players will consolidate other carriers or leverage their exodus from this hyper-competitive market…Every startup industry from the railroad to the computer software sector has experienced boom, bust and plateau phases. Why should the CLEC market be any different?[20]

Q. Does this conclude your testimony.

A. Yes.

[20] Saunders and Bankowski at 2.

Attachment I

Imputation Standard

To fix ideas, it is useful to first note that the ILEC's incremental cost of retail service is the sum of its incremental cost to provide the wholesale service to itself and its incremental cost of retail-stage functions. That is,

$$IC_R^{ILEC} = IC_W^{ILEC} + IC_{RS}^{ILEC}$$

Next, consider that a profit-maximizing ILEC can obtain contribution from one of two sources: (1) the margin between the price of its retail service and the incremental cost of that retail service (if it won the customer), or (2) the margin between the price it charges the CLEC for the wholesale service and its incremental cost to supply the wholesale service to the CLEC (if the CLEC won the customer). In order that providing retail service increase the firm's profits, it must be the case that the retail margin equal or exceed the wholesale margin on an increment of service. Thus, $P_R - IC_R^{ILEC} \geq P_W - IC_W^{CLEC}$

Or, rearranging terms, we obtain the retail price floor:

$$P_R \geq IC_R^{ILEC} + (P_W - IC_W^{CLEC}).$$

In words, this price floor says that, if there is an essential facility, the ILEC's retail price must be above its retail incremental cost (IC_R^{ILEC}) by at least the margin the ILEC earns from selling the wholesale input to the CLEC ($P_W - IC_W^{CLEC}$).

Note that this is different from the imputation standard proposed by Dr. Ankum and Ms. Schonhaut. Their proposal is that Verizon's retail price equal or exceed the UNE prices plus Verizon's incremental cost of performing the retail functions:

$$P_R \geq IC_{RS}^{ILEC} + P_W$$

where P_W would be the UNE TELRIC price.

To see the importance of the difference consider the following re-arrangement of the correct imputation retail price floor rule:

$$\begin{aligned} P_R &\geq P_W + (IC_R^{ILEC} - IC_W^{CLEC}) \\ &= P_W + (IC_W^{ILEC} + IC_{RS}^{ILEC} - IC_W^{CLEC}) \\ &= P_W + IC_{RS}^{ILEC} + (IC_W^{ILEC} - IC_W^{CLEC}) \\ &= P_W + IC_{RS}^{ILEC} \quad \text{only if} \quad IC_W^{ILEC} = IC_W^{CLEC} \end{aligned}$$

This equation shows that the retail price floor is the sum of three items: (1) the price the ILEC charges the CLEC for the wholesale input, (2) the ILEC's incremental cost of its retail-stage functions, and (3) the *difference* between ILEC's incremental costs to supply the wholesale input to itself and to the CLEC. Only if the third component is zero—i.e., the ILEC incurs the same incremental cost for the wholesale input regardless of whether it is used by the ILEC itself or by the CLEC—will the last line of the condition above yield the retail price floor proposed by Dr. Ankum and Ms. Schonhaut.