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| Witness: | Aron |
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| Sponsoring Party: | Southwestern Bell Telephone Company |
| Case No: | TO-2001-467 |

SOUTHWESTERN BELL TELEPHONE COMPANY

CASE NO. TO-2001-467



# SURREBUTTAL TESTIMONY

OF

DR. DEBRA J. ARON

Evanston, Illinois
September, 2001

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

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| In the Matter of the Investigation of the State of Competition in the Exchanges of Southwestern Bell Telephone Company. | ) | Case No. TO-2001-467 |

AFFIDAVIT OF DEBRA J. ARON

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| STATE OF ILLINOIS | ) | |
| | ) | SS |
| CITY OF EVANSTON | ) | |

I, Debra J. Aron, of lawful age, being duly sworn, depose and state:

1. My name is Debra J. Aron. I am presently a Director of LECG, LLC.
2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony.
3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Debra J. Aron

Subscribed and sworn to before this 6th day of September, 2001

Notary Public

My Commission Expires: 8/4/02

"OFFICIAL SEAL"
JOYCE M. KING
Notary Public, State of Illinois
My Commission Exp. 08/04/2002

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# SURREBUTTAL TESTIMONY OF DR. DEBRA J. ARON

## I. QUALIFICATIONS AND ORGANIZATION OF TESTIMONY

**Q.1 Please state your name and position.**

A.1 My name is Debra J. Aron. I am the Director of the Evanston offices of LECG, LLC, ("LECG") and Adjunct Associate Professor at Northwestern University. My business address is 1603 Orrington Avenue, Suite 1500, Evanston, IL, 60201.

**Q.2 Are you the same Debra J. Aron who submitted direct testimony in this proceeding?**

A.2 Yes.

**Q.3 Please explain the purpose and organization of your surrebuttal testimony.**

A.3 The purpose of my testimony is to respond to the economic issues raised in the rebuttal testimony of Staff witness William Voight (Section II) and Intervenors Barbara Meisenheimer of the Office of the Public Counsel (Section III), Matthew Kohly of AT&T (Sections III and IV), Donald Price of WorldCom (Section V), and Dawn Rippentrop of Sprint (Section VI).

## II. RESPONSE TO STAFF WITNESS WILLIAM VOIGHT

**Q.4 Staff witness William Voight contends that resale local exchange service is not a "viable alternative for customers."[1] How does Staff support this position?**

A.4 Several parties to this proceeding, including Mr. Voight, state their opposition to resale as contributing to effective competition.[2] However, Mr. Voight – unlike Intervenors that simply state their position regarding resale – identifies the particular aspects of resale competition that, in his view, diminish its efficacy as a competitive alternative and, allegedly, render resale a nonviable alternative for customers. According to Mr. Voight:

> [1] As a practical matter, resellers of basic local service are locked into SWBT's existing retail service structures. For example, resellers are limited to the feature packages currently offered by SWBT as well as the existing local calling scopes of SWBT. [2] Resale also places very little competitive pressure on prices offered to end users because the wholesale prices resellers must pay SWBT are based on SWBT's retail rates. [3] Resale also denies a competitor the opportunity to provide innovative services through the use of new technology.[3]

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1 Rebuttal Testimony of William L. Voight before the Missouri Public Service Commission, Case No. TO-2001-467 ("*Voight Rebuttal*"), p. 5.

2 See Rebuttal Testimony of Barbara A. Meisenheimer, submitted on behalf of the Office of the Public Council, before the Missouri Public Service Commission, Case No. TO-2001-467 ("*Meisenheimer Rebuttal*"), p. 10; and Rebuttal Testimony of R. Matthew Kohly on behalf of AT&T before the Missouri Public Service Commission, Case No. TO-2001-467 ("*Kohly Rebuttal*"), pp. 7-8.

3 *Voight Rebuttal*, p. 19.

**Q.5 With regard to the first of Mr. Voight's three criticisms of resale competition, is Mr. Voight correct that resellers are "locked into SWBT's existing retail service structures"?**

A.5 No. It is my understanding that CLECs, whether they resell SWBT's service, lease a UNE loop, or bypass SWBT's network, are free to offer their customers any type of rate structure they wish. Just because a reseller's *costs* are, in part, based on SWBT's retail price structure does not mean that the rates or rate structures that they charge end users are predetermined. They aren't. SWBT offers both flat rate and time sensitive local exchange calling plans in Missouri. While a reseller can replicate SWBT's rate structure if it desires, the reseller is also free to offer a different rate structure, such as per call rates, "buckets of minutes" plans, menus of pricing options, volume discounts, or bundled pricing.

Resellers are also free to differentiate their customer service operations from those of the incumbent. As I discussed in my direct testimony, resale promotes competition in the provision of retailing functions. Any entrant that is a better provider of retailing functions than SWBT, or that can implement innovative ideas in the provision of retailing functions, not only can attract customers away from SWBT, but confers a benefit to society by improving the efficiency and/or desirability of the retailing functions that the reseller is providing.

**Q.6 Mr. Voight's second complaint is that resale places "very little competitive pressure on prices offered to end users because the wholesale prices resellers must pay SWBT are based on SWBT's retail rates." Please respond.**

A.6 Mr. Voight underestimates the competitive pressure that resale offers. Resale can provide significant competitive pressure in at least three ways. First, because the resale discount

is based on a percentage of the retail price, rather than a fixed dollar discount, any increase in retail rates increases the profit margin available to CLECs that use resale.[4] This increases the CLEC's opportunities to provide additional demand-enhancing retailing services, opportunities to undercut the incumbent's price, and additional profit opportunities.[5]

Second, because many CLECs use resale in a portfolio of provisioning strategies along with UNEs and self-provision, any increase in retail prices opens a more substantial profit margin than occurs with the pure resale strategy. In fact, resale tends not to be a stand-alone business strategy for CLECs in Missouri. Instead, successful CLECs in many cases adopt a hybrid strategy, by which I mean that they install their own facilities where that is most effective, use UNEs where that is most economic, and use resale where and when resale is their best option. CLECs have the ability to "pick and choose" their service platform depending on the cost conditions and revenue opportunities in each geographic area. In this way, CLECs can broaden their geographic coverage using the combination of platforms that is most profitable. Indeed, the Commission should recognize that the majority of resold lines in Missouri are not utilized by carriers that are only resellers.[6]

For instance, the two largest resellers in the state compete in a hybrid manner, provisioning service over their own facilities and via UNE loops, as well as via resale Likewise, several other important CLECs in Missouri are hybrid competitors What Mr

[4] For example, suppose the retail price of a service is $30, and the resale discount is 20%. The wholesale price would be $24, and the CLEC would have a $6 margin to cover the costs of retailing and provide a profit. If SWBT were to increase the retail price by 10% to $33, the resale price would increase to $26.40. The margin available to the CLEC would, therefore, *increase* by 10% to $6.60.

[5] In the limiting case where the firms engage in "Bertrand" (price) competition and have perfectly homogenous products, the incumbent would be unable to increase the retail price at all in the presence of a reseller

[6] Based on resale and interconnection trunk data as of July 31, 2001 (provided by SWBT), approximately 2/3rds of all resold lines in Missouri are provided by CLECs with interconnection trunks in Missouri.

Voight's second point fails to address is why, for example, a hybrid-CLEC customer who happens to be served from a resold line should be considered to have fewer alternatives than a customer of the very same CLEC who happens to be served from that CLEC's own facilities. Both customers receive their service from the same CLEC, and are generally unlikely to know or care how the line is provisioned.

To understand the implications of a CLEC hybrid strategy, consider an example. Suppose the retail price of local exchange service is $30.00 per month, UNEs cost $20.00 per month, and the resale discount is 20 percent. For simplicity, assume that the CLEC incurs no other costs.[7] Suppose the CLEC serves half of its customers using UNEs and half using resale. On average, the CLEC earns a net of $8.00 per line.[8]

Now suppose the ILEC increases its retail price to $33.00. The cost of UNEs is unchanged but the resale price increases to $26.40 (i.e. $33.00 x (1-20%)). The reader can verify that the CLEC could increase its retail price to $31.20 and still maintain the average profit of $8.00 per line on existing customers, while simultaneously undercutting the incumbent's price by 5.5 percent, and thereby attracting new customers to earn even greater profits.[9] This ability to profitably undercut any price increase is the force that, in any market, creates pricing discipline.

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7 This is an innocuous assumption. If, for example, the CLEC incurred retailing costs of $6.00 per line, so that it earned no profits on any resale lines at the initial price, the same qualitative results would hold. In particular, increasing the retail price would give CLECs the opportunity to undercut the incumbent's price and still profit on each line.

8 $8.00 = ($30.00 - $20.00) x 50% + ($30.00 - $24.00) x 50%.

9 The CLEC could also maintain its original price and still profit, even at the higher wholesale price.

**Q.7 Mr. Voight's third complaint is that resale "denies a competitor the opportunity to provide innovative services through the use of new technology." Is this correct?**

A.7 No, it is not. It is not factually correct that resellers have no opportunities for innovation through new technology. Resellers are certainly limited in the extent to which they can innovate at the network level and this fact presumably underlies the preference in the Telecommunications Act of 1996 ("TA96") for facilities-based competition.[10] In the long run, facilities-based competition provides the greatest consumer benefits, for that reason. But it is incorrect to assert that resellers have no meaningful innovation opportunities. For example, new technologies are enabling third parties to provide sophisticated, integrated voice mail platforms on a wholesale basis to telecom providers, including resellers. These voice mail platforms provide integrated messaging over the consumer's phone line, pager, and other devices. I am aware of carriers in other states offering this service as part of their local exchange offering, and touting it as a substantial market innovation. While these carriers are offering this service over UNE-P, it is my understanding that there is no technical barrier to offering the same integrated voice mail service on a resale platform.

**Q.8 Are there any other reasons why it would be poor policy to dismiss resale as a competitive alternative?**

A.8 Yes. It is my understanding that, in Missouri, prices for UNE loops exceed SWBT's retail rates for residential services in some areas. As every knowledgeable observer of the industry is aware, it is not uncommon across the country for residential rates to be below the cost of providing the service. In my opinion, it is in view of this fact that Congress

[10] *Notice of Proposed Rulemaking and Notice of Inquiry* in WT Docket No. 99-217 and *Third Further Notice of Proposed Rulemaking* in CC Docket No. 96-98, FEDERAL COMMUNICATIONS COMMISSION, 14 FCC Rcd 12673 (1999), ¶ 4.

established resale rates to be based on retail rates, rather than on costs. The retail-minus-discount methodology ensures that competitors would have at least one entry strategy that would be robust to below-cost regulated retail prices that otherwise would be hostile to competition. By instituting this entry method, Congress created a path whereby carriers could establish a foothold and competition could begin. The next step, however, must be for retail price constraints to be relieved so that prices can respond to cost and competitive conditions, and facilities-based entry can take root.

Mr. Voight's theory that resale is not a viable alternative for customers, should be seen to be contrary to a fundamental, deliberate feature of TA96. This feature, which establishes the resale pricing methodology anticipates that, in some areas resale may be the only viable avenue for competitive entry as long as retail prices are artificially constrained below competitive levels.

**Q.9 Dr. Aron, do you have any other comments about Mr. Voight's argument regarding resale as competition?**

A.9 Yes. I would like to make the general comment that resale competition is a means by which CLECs can offer bundled local, intraLATA, and interLATA services, perhaps bundled with cellular, paging, and Internet services as well. Consumers often prefer that their telecommunications services be provided by one supplier, on one bill, all else being equal. This effect is sometimes called the preference for "one-stop-shopping." Customer surveys confirm that business and residential customers desire the ability to purchase most, or all, of their telecommunications services from one provider.[11]

[11] See, for example, Rebecca Blumenstein, *Package Plan: AT&T sees wireless as the key to its broader strategy of bundling its services*, in THE WALL STREET JOURNAL, Telecommunications supplement, September 20, 1999, p. R26 ("Study after study has shown that customers are confused by the myriad wireless, long-distance and Internet offers, and actually crave simplicity. In one recent survey [conducted by Yankee Group consulting firm], 69% of consumer households said they wanted one company to provide all their communications and entertainment needs.") See, also, *Home Communications Services Survey*,

Under the provisions of TA96, SWBT cannot jointly market (bundle, or offer one-stop-shopping of) in-region local service with interLATA services provided by its interLATA affiliate until the interLATA affiliate receives Section 271 authority.[12] However, carriers competing against SWBT are permitted to bundle, and, for them, bundling represents a powerful business strategy. For example, Global Crossing offers business customers "customized telecommunications package[s]," which can "save money over current local services ... when service is used in conjunction with Global Crossing long distance services."[13] Likewise, Intermedia Communications –a subsidiary of Worldcom—offers a local and long distance (plus features) bundle to business customers called Intermedia*One*SM. It claims that customers can create a "custom plan," and that "by combining long distance with local phone service, Intermedia*One* helps make money-saving, dedicated -line rates feasible for most businesses."[14]

Resale can be used to provide carriers an avenue for bundled offerings without requiring a carrier to make risky investments in network infrastructure. Looked at from the provider's perspective, the profitability of a bundling strategy depends on the overall return to serving the customer and the price that the market will bear for the bundle, and not on the profitability of local resale as a stand-alone service. Indeed, even an entrant that is less efficient than SWBT in retailing can potentially make a profit and exert competitive pressure on SWBT by reselling SWBT's local service in a bundle of other telecommunications services. The reason is that, first, a bundled offering may be able to

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ARTHUR ANDERSEN; downloaded September 12, 2001 from <http://www.arthurandersen.com/website.nsf/content/MarketOfferingseBusinessResourcesOnlineUserPanelHomeCommunications> (According to Andersen, in June 2001, more than 56 percent of those surveyed were "interested" or "somewhat interested" in buying multiple services from a single provider.)

12 TA96, §272(g)(2).

13 *Global Crossing® Local Services*; downloaded September 12, 2001 from <http://www.globalcrossing.com/services/ps_local_services.htm?bc=Products%20>.

14 *Intermedia*One*SM Voice Services*; downloaded September 12, 2001 from <http://www.intermedia.com/products/voice/intermediaone-voice.html> .

bear a higher retail price in the market than the sum of the stand-alone services (because of the extra value consumers receive from one-stop-shopping); second, there is the potential for profitability from other components of the bundle, such as long distance and vertical features; and third, when retailing a bundled service, the retailing costs can be shared among all products in the bundle, resulting in economies of scope.

Another role of resale competition, consistent with the CLEC's hybrid resale/facilities-based strategy, is that resale provides an entry alternative into the local exchange market that is less costly and less risky than facilities-based entry, and which permits entrants to get a foothold in the market before investing in facilities. That is, resale can be a short-run or temporary strategy used as a stepping stone to facilities-based provision of services. Potential competitors are able to enter the market through resale without having to lay out the large sums for network investments, or to incur the risks of building, owning and operating facilities. Over time, as a reseller's market position becomes established and it can make a more accurate assessment of the optimal size and location of its network investments, a reseller can invest in its own infrastructure and become a facilities-based provider.

Finally, some carriers are in fact pursuing and succeeding in a pure-play resale strategy, particularly in the business market. In the business segment, carriers can capture relatively high revenues per customer by combining multiple services, including local and long distance and also system design and other high-involvement customer services. In the current economic downturn, some of these resellers are better positioned to weather the storm than their facilities-based competitors, because the resellers may not be saddled with highly leveraged capital structures, as are many facilities-based carriers.

**Q.10 Have the benefits of resale competition been recognized by others in the telecommunications industry?**

A.10 Yes. The FCC, consistent with the intent of Congress in drafting TA96, has made clear that it views resale as competition, characterizing resale and UNE competition as "powerful tools to dismantle the legal, operational and economic barriers that frustrated competitive entry in the past."[15] Moreover, other of SWBT's competitors have indicated to their investors that they consider resale to be a component of their strategy that allows them to compete "aggressively" and "comprehensively."[16]

**Q.11 Mr. Voight points to the number of long-distance resellers as evidence that the long-distance market is effectively competitive.[17] How does he justify this contradictory treatment of long-distance and local exchange resale?**

A.11 Mr. Voight identifies two structural characteristics of the long-distance marketplace that supposedly facilitate resale competition there. First, he contends that the number of

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15 *Memorandum Opinion and Order*, FEDERAL COMMUNICATIONS COMMISSION, FCC No. 97-346, September 26, 1997, ¶ 2. See also *Trends in Telephone Service*, FEDERAL COMMUNICATIONS COMMISSION, September 1999 edition; *Local Competition: August 1999*, FEDERAL COMMUNICATIONS COMMISSION, INDUSTRY ANALYSIS DIVISION; *Progress Report: Growth and Competition in U.S. Telecommunications 1993-1998*, UNITED STATES COUNCIL OF ECONOMIC ADVISORS, February 8, 1999; Separate Statement of Commissioner Susan Ness, *Re: Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98*, September 15, 1999.

16 McLeodUSA's 2000 Form 10-K (filed 3/30/01) states that "In certain locations, we enter the market by reselling standard retail business services. This strategy allows us to aggressively capture customer share and generate revenue in a market with little up-front cost in comparison to establishing Centrex or other resold service, while we complete our own communications network. We will move relatively quickly from a resale mode to providing facilities-based services. In many other markets we have installed facilities and are aggressively capturing customer share utilizing our own switching facilities." (p. 7).

Similarly, Allegiance Telecom's 10-Q for March 31, 2000 states that, although Allegiance primarily focuses on providing facilities-based service, resold ILEC services have been used in order to "provide a comprehensive telecommunications solution to a customer that has a need for local services both within and outside [their] markets," as well as to provide services that are not available on their own facilities. (p. 11).

17 *Voight Rebuttal*, p. 67.

facilities-based long-distance carriers somehow influences the benefits of long-distance resale. Mr. Voight concludes that "[t]his diversity alone makes reselling substantially different in the long distance business as compared to the local exchange market where there is only one network – that of the incumbent monopolist – being resold."[18]

Second, Mr. Voight contends that the long-distance wholesale pricing structure (i.e., volume discounts) endows long-distance resellers with greater control over their cost structure, which facilitates effective competition. In contrast, "local service resellers can only resell based on some predetermined avoidable wholesale discount off the incumbent's tariffed rate for a particular service. Consequently, local service resellers are forced into providing the exact same service as SWBT."[19]

**Q.12 Dr. Aron, please respond to Mr. Voight's first point that the "diversity [of facilities-based IXCs] alone makes reselling substantially different in the long distance business as compared to the local exchange market where there is only one network – that of the incumbent monopolist – being resold."**

A.12 The logic of this statement is not self-evident. Mr. Voight does not offer an explanation of how the extent of facilities-based competition influences the incremental benefits of resale competition. I suppose he is arguing that the extent of facilities-based competition influences a reseller's bargaining power. In particular, he may be arguing that long-distance resale is legitimate competition, while local resale is not, because SWBT is often the only facilities-based provider available, leaving CLECs with virtually no bargaining power when negotiating with SWBT.

[18] *Voight Rebuttal*, p. 68.

[19] *Voight Rebuttal*, p. 68.

**Q.13 Is this a valid concern?**

A.13 No, it is not. Pursuant to the provisions of TA96, the Commission has established applicable resale discounts, which are available to all certificated CLEC resellers in Missouri pursuant to Section 252(i) and pursuant to the M2A. No bargaining power – indeed no bargaining – is necessary.

**Q.14 What about Mr. Voight's second point that the resale price structure in the long-distance market engenders competition between resale and facilities-based carriers?**

A.14 Mr. Voight fails to point out that facility-based IXCs are not required to provide *any* wholesale discounts to resellers, and therefore resellers of long distance have functioned primarily by aggregating traffic to take advantage of retail volume discounts. Hence, that market favors large resellers and disfavors small players. The fact that all local service carriers receive a discount on each resold line levels the playing field between small and large resellers, relative to the advantages enjoyed by large resellers in long distance.

**Q.15 Mr. Voight contends that under existing regulations he "simply cannot accept that SWBT is restrained from reacting to changing customer demands."[20] Accordingly, he concludes, "it should be clearly understood that the call for deregulation of prices is little more than a euphemism to raise prices."[21] Is this an accurate explanation for what SWBT gains by reclassifying its local exchange services?**

A.15 No. Mr. Voight seems to believe that the only freedom gained by a competitive reclassification is the ability to raise price above the cap, and that, in competitive markets, firms never raise prices. Both of these premises are simply incorrect. The logical conclusion of this erroneous argument is that Missouri consumers would be better of if *all* products and services were forever subject to price cap regulation. This is a conclusion I find objectionable.

First, it is incorrect to characterize competitive reclassification as simply permitting price increases. This caricature of the competitive process ignores, first, the fact that pricing is not a one-dimensional exercise in which prices simply go up or down. Pricing strategy in a competitive market involves the choice of – or invention of – new pricing structures, bundles, and service offerings. Telecommunications pricing in unregulated sectors is complex, often involving menus of pricing options from which one can choose, and where each option is tailored to particular user preferences. Carriers seek to offer plans that appeal to users in new and different ways. This form of innovation is a legitimate, socially valuable form of competition. Pricing flexibility permits more opportunities to restructure rates in innovative ways.

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[20] *Voight Rebuttal*, p. 45 ("I simply cannot accept that SWBT is restrained from reacting to changing customer demand. From my perspective, such allegations are a red herring designed to draw attention away from SWBT's desire to have unregulated prices in areas of limited or non-existent competition such as the situation in predominately rural areas of Missouri.")

[21] *Voight Rebuttal*, p. 9.

Moreover, a critical component of pricing that Mr. Voight misses is that price changes entail risk. A price decrease, for example, puts the carrier at risk that the desired effects – retaining customers, attracting new customers, and/or stimulating usage – might not come to pass, while the loss in revenue on existing customers certainly does. Pricing is almost always, in any industry, a matter of trial and error. A firm is more likely to attempt a price decrease if it knows it can limit its risk by restoring the original price later if the decrease does not work out.

With respect to Mr. Voight's premise that prices never rise in competitive markets, this is incorrect both in theory and in practice. Prices rise and fall in response to demand and supply conditions, new information in the market, and, again, trial and error efforts to find the "right" price. As AT&T witness Kohly correctly recognizes, "[t]he fact that SWBT may be able to increase rates does not, in and of itself, mean there is not sufficient competition."[22]

It is clearly the intent of Missouri telecommunications policy to promote competition. When there is competition in a market, it is both unnecessary and undesirable to impose artificial regulatory requirements on participants in the market. It is unnecessary because markets function more effectively than can regulations to protect customers. It is undesirable because artificial regulatory restrictions are not innocuous in competitive markets. By artificially preventing or hindering providers from quickly raising, lowering, restructuring, targeting, bundling, or otherwise changing prices, providers are impeded in their ability to respond to competition, to differential cost conditions, to customer-specific demands and preferences, and to changing market conditions. Moreover, SWBT is prevented from correcting prices that have been distorted by years of regulatory oversight. If SWBT cannot price in response to these

[22] *Kohly Rebuttal*, pp. 11-12.

legitimate market factors, it is restricted in its ability effectively to meet customer demand, and customers suffer.

**Q.16 Mr. Voight recognizes that "SWBT's data on the number of competitors in each exchange may not always be totally accurate because SWBT does not know the full extent of facility-based competition in its exchanges."[23] As a proxy for facility-based competition, Mr. Voight proposes using E911 database listings. Mr. Voight contends that such data are "a generally reliable and somewhat conservative means of estimating the presence of competition."[24] What is your response to this proposal?**

A.16 First of all, it is unclear to me why there is a need for a proxy to begin with. One solution is for each carrier to identify the quantity of voice-grade equivalent lines it has in SWBT's service territory and report these figures to Staff as requested in Data Request 2501. To the extent that CLECs are incapable of identifying their own voice-grade equivalent lines by exchange, they could at least offer some geographic area to which each line is associated.

Secondly, I concur with Mr. Voight that the use of E911 data listings as a proxy for competition is a conservative measure; the data contain potential shortcomings that can significantly underreport a CLEC's geographic presence and/or the magnitude of its geographic presence. As I understand it, virtually every *voice-grade* landline served by a CLEC or an ILEC that is capable of *dialing out* is registered in an E911 database. That, however, does not mean that every CLEC landline relevant to this proceeding is reported

[23] *Voight Rebuttal*, p. 13.

[24] *Voight Rebuttal*, p. 14.

in SWBT's E911 database. For example, in the E911 database, the underlying carrier is identified as the provider. Hence, a SWBT line that is resold by a CLEC would be reported as a SWBT line.[25]

The reporting requirements introduce other potential sources of error as well. First, complex voice services such as a PBX may be only partially represented in the E911 database. In particular, it is my understanding that carriers typically report only the telephone numbers of one-way outbound and two-way PBX trunks or direct outward dial (DOD) lines. Carriers do not generally report telephone numbers associated with one-way inbound lines because an emergency call cannot be placed on them. For example, in my office at LECG in Evanston, Illinois, we have 16 PBX trunks, consisting of 8 one-way outbound and 8 one-way inbound trunks. Therefore, we have 16 lines to our office serving approximately 40 telephones. However, because only 8 of these trunks have outward dialing capability, we would have only eight 911 numbers listed in the E911 database. Under this scenario, an estimate of lines based on E911 data undercount the total trunks to and from my office by a factor of 2.

Second, data lines, such as DSL and cable modem lines, may not be reported in the E911 database. For instance, a customer purchasing voice local exchange service from SWBT and data services (e.g., DSL or cable modem services) from a competing carrier would not be identified as a CLEC customer. CLECs are not required to report DSL or cable modem lines to the E911 administrator. These lines are, nevertheless, relevant to this proceeding because they substitute, to some extent, for second lines in residences and some businesses.

**Q.17 Mr. Voight argues that alternative service platforms, such as Internet and mobile wireless and "services" of "cable TV companies," cannot be considered as**

[25] UNE lines, however, are reported by CLECs, as are CLEC self-provisioned lines.

**substitutes in this proceeding for SWBT's landline local exchange service because they are not telecommunications services as defined by the Missouri statutes.[26] What is your response to this argument?**

A.17 While I am not a lawyer, I do not interpret the Missouri statute as does Mr. Voight (who, likewise, is not a lawyer). I will explain why, in my opinion, his interpretation is flawed, but first consider its policy implications. Mr. Voight's interpretation requires the Commission to ignore the substitutability between "alternative" services and "telecommunications" services regardless of economic evidence to the contrary. Under Staff's proposed interpretation, the Commission is precluded from reclassifying a telecommunications service that faces effective competition if the services that engender this competition are deemed "alternative." It is absurd economic policy. Artificial regulatory distinctions between services do not determine which services are viewed by consumers as reasonable alternatives for SWBT's services, and should not artificially exclude such services from consideration by the Commission. Mr. Voight offers no theory – as indeed, there is no such theory – of how consumers benefit from his flawed interpretation of the law.

**Q.18 How has Mr. Voight misinterpreted the Missouri statute in your opinion?**

A.18 The criteria for evaluating whether a telecommunications service faces "effective competition" are found in RSMo, §386.020.13. Nowhere in my reading of this section of the statute does it state that the scope of the analysis is to be limited to

[26] *Voight Rebuttal*, p. 22 ("The 'services' offered by 'non-regulated' wireless carriers, Internet providers, satellite providers, Cable TV companies, and private telecommunications systems are specifically exempted from the Missouri statutes as constituting telecommunications service and cannot possibly be relied upon as an available service from an alternative provider, as required by the statute. The Missouri statutes specifically define these alternative forms of communications as not constituting telecommunications *service*. Hence, SWBT cannot rely on non-regulated services of any sort as a means of escaping price cap regulation.")

"telecommunications" services. In fact, §386.020.13 twice references "services" – in parts (a)[27] and (b)[28] – and does not once mention "telecommunications service." This distinction is relevant in that the Missouri statute applies separate and differing definitions to a "service" and a "telecommunications service." The statute specifies a "service" as including "any product or commodity" furnished by "any corporation, person or public utility and the plant, equipment, apparatus, appliances, property and facilities employed by any corporation, person or public utility."[29]

Second, even if one were to infer that the reference to "services" in §386.020.13 is limited to "telecommunications services," this restriction does not preclude the Commission from considering "alternative" services. In fact, §386.020.13(e) explicitly directs the Commission to consider "[a]ny other factors deemed relevant by the commission and necessary to implement the purposes and policies of chapter 392, RSMo."[30] Ironically, it is Staff that cogently articulates the premise that the Missouri statutes are technology neutral. In responding to SWBT witness Sandra Douglas, Mr. Voight says:

> Ms. Douglas appears to confuse telecommunications services with the delivery mechanism used to provide the services. For example, it makes no difference if a service is delivered via copper wires, coaxial cables, fiber optic cables, microwave towers, satellites, SONET rings or some combination of all these technologies... For regulatory purposes (and consequently for the purposes of the price cap statute), the technological

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27 "The extent to which ***services*** are available from alternative providers in the relevant market" (RSMo, §386.020.13(a); emphasis added).

28 "The extent to which the ***services*** of alternative providers are functionally equivalent or substitutable at comparable rates, terms and conditions" (RSMo, § 386.020.13(b); emphasis added).

29 RSMo, §386.020(47) ("'Service' includes not only the use and accommodations afforded consumers or patrons, but also any product or commodity furnished by any corporation, person or public utility and the plant, equipment, apparatus, appliances, property and facilities employed by any corporation, person or public utility in performing any service or in furnishing any product or commodity and devoted to the public purposes of such corporation, person or public utility, and to the use and accommodation of consumers or patrons.")

30 RSMo, § 386.020.13(e).

delivery mechanism for a particular service does not matter. In this regard, it is said that the Missouri statutes are technology neutral.[31]

Thus, whether voice service is delivered by radio wave (e.g., wireless), by packet (DSL, cable), or by traditional circuit-switching over copper wires, each is properly seen to be a potential "alternative" that should be considered.

**Q.19 Mr. Voight contends that "[i]n [Staff's] view there is no relevance between the SWBT Section 271 proceeding and the instant case."[32] Do you agree with this statement?**

A.19 No, I do not. A necessary criterion in evaluating "effective competition" under §386.020.13(d) of the Missouri statute and as a matter of economic principle is whether there exist "economic or regulatory barriers to entry."[33] Section 271 approval under TA96 is premised on a showing of conclusive evidence that "barriers to competitive entry in the local market have been removed and the local exchange market today is open to competition."[34] I explained in my direct testimony that evaluation of barriers to entry is critical to a determination of effective competition.

The FCC's *First Report and Order*, which implemented the local competition provisions of TA96, cogently articulates the central import of §271 to this proceeding.[35] In this Order the FCC said:

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31 *Voight Rebuttal*, p. 40.

32 *Voight Rebuttal*, p. 25.

33 RSMo, §386.020.13(d).

34 *Memorandum Opinion and Order*, FEDERAL COMMUNICATIONS COMMISSION, FCC 99-404, December 22, 1999 ("*Bell Atlantic New York 271 Order*"), ¶ 426.

35 *First Report and Order*, FEDERAL COMMUNICATIONS COMMISSION, FCC 96-325, August 8, 1996 ("*First Report and Order*").

> Three principal goals established by the telephony provisions of the 1996 Act are: (1) opening the local exchange and exchange access markets to competitive entry; (2) promoting increased competition in telecommunications markets that are already open to competition, including the long distance services market; and (3) reforming our system of universal service so that universal service is preserved and advanced as the local exchange and exchange access markets move from monopoly to competition...
>
> These three goals are integrally related. Indeed, the relationship between fostering competition in local telecommunications markets and promoting greater competition in the long distance market is fundamental to the 1996 Act. Competition in local exchange and exchange access markets is desirable, not only because of the social and economic benefits competition will bring to consumers of *local* services, but also because competition eventually will eliminate the ability of an incumbent local exchange carrier to use its control of bottleneck local facilities to impede free market competition. Under section 251, incumbent local exchange carriers (LECs), including the Bell Operating Companies (BOCs), are mandated to take several steps to open their networks to competition, including providing interconnection, offering access to unbundled elements of their networks, and making their retail services available at wholesale rates so that they can be resold. Under section 271, once the BOCs have taken the necessary steps, they are allowed to offer long distance service in areas where they provide local telephone service, if we find that entry meets the specific statutory requirements and is consistent with the public interest. Thus, under the 1996 Act, the opening of one of the last monopoly bottleneck strongholds in telecommunications -- the local exchange and exchange access markets -- to competition is intended to pave the way for enhanced competition in *all* telecommunications markets, by allowing all providers to enter all markets. The opening of all telecommunications markets to all providers will blur traditional industry distinctions and bring new packages of services, lower prices and increased innovation to American consumers. The world envisioned by the 1996 Act is one in which all providers will have new competitive opportunities as well as new competitive challenges.[36]

Therefore, this Commission's support for SWBT's 271 application, and its conclusion that "SWBT's interLATA entry would serve the public interest"[37] is evidence that

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[36] *First Report and Order*, ¶¶ 3-4.

[37] *Order Regarding Recommendation on 271 Application Pursuant to the Telecommunications Act of 1996 and Approving the Missouri Interconnection Agreement (M2A)*, PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI, Case No. TO-99-227, issued March 15, 2001 ("*Missouri § 271 Order*"), p. 89. The

barriers to competitive entry in the local market in Missouri have been dismantled. Such evidence clearly is relevant, is called for in §386.020.13(d), and supports a showing of "effective" local exchange competition in Missouri.

**Q.20 Mr. Voight contends that SWBT's allegations of discriminatory regulatory treatment are ill-founded. Mr. Voight argues:**

> **SWBT is a major national wireless competitor free to price its services up or down as market forces establish. Any contention that competitors have an unfair advantage over SWBT is in my opinion, completely inaccurate. SWBT is fully free to compete in any market it chooses.[38]**

**Do you concur with Staff on this point?**

A.20 No. First, Mr. Voight's argument is inconsistent. SWBT is not "free to compete in any market it chooses." Unless Staff is willing to accept that wireless and wireline services are in the same market, then it must posit a wireline long distance market. And, until SWBT acquires §271 approval from the FCC, it cannot offer wireline interLATA long distance services in Missouri.

Second, SWBT is subject to an assortment of regulations that are not imposed on its competitors. For instance, SWBT is not free *not* to serve customers. Under its "carrier of last resort" obligations, SWBT is required to serve all customers that request an existing service in its territory. For example, SWBT cannot decide unilaterally, as can CLECs, not to serve residential customers in high cost or low average-revenue areas.

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Commission has subsequently affirmed its support for SWBT's application and that SBC's entry into the InterLATA market is in the public interest; see *Written Consultation by the Missouri Public Service Commission*, FEDERAL COMMUNICATIONS COMMISSION, CC Docket No. 01-194, August 20, 2001 ("*MPSC Written Consultation*").

38 *Voight Rebuttal*, p. 62.

Third, Mr. Voight misunderstands the nature of local exchange competition. Landline service providers compete not only with one another (intra-service competition), but certainly to some extent, also against alternative non-regulated services, such as mobile wireless (inter-service competition). It is the inter-service regulatory asymmetry that impedes SWBT's landline service from effectively competing against non-regulated mobile wireless services.

## III. RESPONSE TO OPC WITNESS BARBARA MEISENHEIMER AND AT&T WITNESS R. MATTHEW KOHLY ON MARKET SHARE

**Q.21 Witness Meisenheimer of OPC and Witness Kohly of AT&T argue that market share figures are "the most significant criteria"[39] or "the best way"[40] to determine if a market faces "effective competition." Does either party explain how such data might be collected?**

A.21 No. For example, AT&T's Mr. Kohly offers the following statement:

> While AT&T believes that market share data by provisioning method is extremely relevant to this case, AT&T does not have that type of data nor did SWBT present such data in its direct case. SWBT is in the best position to determine and reveal to the Commission its market share relative to its competitors - - an individual competitor's market share, even some data on multiple competitors, would still not provide a complete picture. At this time, AT&T cannot put forth a market share analysis. The fact that SWBT has not proffered such data suggests to me that SWBT does not believe it would be favorable to their application. If another party presents such data in rebuttal testimony, AT&T will provide comments in surrebuttal testimony. If this type of data is presented in SWBT's

[39] *Meisenheimer Rebuttal*, p. 13.

[40] *Kohly Rebuttal*, p. 5.

surrebuttal testimony, AT&T may request another round of testimony in order to be able to respond.[41]

In sum, AT&T contends that does not have access to data from other carriers that would be necessary to provide a "complete picture." Yet, Mr. Kohly chastises SWBT simply for sharing AT&T's lack of omniscience.

**Q.22 What is your response to this allegation?**

A.22 It is a convoluted and illogical statement. Any firm's market share is the ratio of its activity in the market (be it output, revenue, capacity, etc.) to the total activity of *all* firms in the market. Hence, the compilation of market share data is a collective undertaking. SWBT cannot unilaterally compile complete market share data, just as AT&T cannot compile such data. It requires data from *all* producers in the market.

SWBT is providing wholesale data in Mr. Hughes' surrebuttal testimony on the number of CLEC resale lines, UNE platforms, 911 listings, and CLEC interconnection trunks. However, missing from such data may be a significant number of facilities-based lines served by CLECs. As Staff points out in its rebuttal testimony, SWBT does not have this data[42] – only individual providers have complete data on the quantity of lines they are provisioning over their own facilities. Therefore, just as AT&T argues that "an individual competitor's market share, even some data on multiple competitors, would still not provide a complete picture," so would a market share that omitted a significant number of CLEC facilities-based lines. Coincidentally, it is this very data that SWBT is unable to offer that Staff and Intervenors argue is the most important in evaluating "effective competition."

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41 *Kohly Rebuttal*, p. 6.

42 *Voight Rebuttal*, p. 13.

**Q.23 Dr. Aron, do you have other concerns about how "market share" may be improperly computed?**

A.23 Yes, primarily as they relate to Mr. Kohly's recommendations. The proper computation of market share is not, nor should it be, a trivial undertaking. Such an undertaking has at least three major steps. First, one must determine the scope of the market at issue – which products count and which do not. Then, one must identify the measure that will most reasonably provide an indication of competition – such as revenue, capacity, lines, or some other variable. Finally, one must obtain data to quantify the measure.

As I described in my direct testimony,[43] a proper market analysis takes into account products that are reasonably interchangeable in use from the consumer's perspective, though the products may not be identical. Mr. Kohly's proposed examination of market share appears to fail on this ground. For example, Mr. Kohly concludes that, on the basis of §386.020.13(b), the only substitute for SWBT facilities-based service is another facilities-based service.[44] This is far too narrow a criterion to provide information from which the Commission could make pro-consumer decisions, and the proposal illustrates how easy it is to err in the construction of a relevant indicator. A valid economic analysis of a market requires that consumers' substitutes are the relevant standard to determining the scope of the market. Although I am not an attorney, I see nothing in the RSMo that is inconsistent with the basic economic approach to evaluating effective competition.[45] Similarly, the Commission should understand that

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43 *Aron Direct*, p. 8-14.

44 *Kohly Rebuttal*, p. 7. Mr. Voight makes a similar error by saying that alternatives that may be economic substitutes for telecommunications services are proscribed (by law, he says) from being counted in the analysis (*Voight Rebuttal*, p. 8).

45 I certainly see no inconsistency, as does Mr. Voight, in the use of non-traditional services that would pass the consumer-centric test of being reasonably interchangeable in use, or, in other words, substitutes.

market share estimates that combine distinct market segments provide little useful information about any relevant market.

**Q.24 Assuming that the Commission resolved these data collection and measurement problems, is market share, accurately measured, an appropriate metric of competition in the local exchange market?**

A.24 While market share information has its place in competition analysis, it can be both misleading and unreliable, particularly in a market with a regulated history. Measures of market share, if available, can be a starting point for a competitive analysis but are not an ending point. Market share data can mask the true competitive situation for several reasons, all of which apply to the local exchange markets in Missouri.

The first and most fundamental reason that market shares can be a misleading measure of competition is that they are a static picture of the market that do not reflect the presence or absence of entry barriers into the market. Economists, the courts, and the federal antitrust agencies recognize that barriers to entry are critical to determining the ability of any firm in a market to exercise market power. As I indicated in my direct testimony, if there are no significant barriers to entry, then market share is essentially irrelevant; no firm, no matter how large its market share, could exert significant market power for any length of time. Ease of entry, therefore, trumps market share.[46]

[46] *Department of Justice and Federal Trade Commission Horizontal Merger Guidelines* ("*Merger Guidelines*"), April 2, 1992, §3.0. See also ABA Section of Antitrust Law, *Antitrust Law Developments* (4th ed. 1997), pp. 328-332, citing: United States v. Baker Hughes Inc., 908 F.2d 981, 987 (D.C. Cir. 1990) ("In the absence of significant [entry] barriers, a company probably cannot maintain supracompetitive pricing for any length of time"); California v. American Stores Co., 872 F.2d 837, 842-43 (9th Cir. 1989) (recognizing that "[a]n absence of entry barriers into a market constrains anticompetitive conduct, irrespective of the market's degree of concentration," but finding that district court could properly have concluded, based on conflicting evidence, that defendant's proof of ease of entry was not sufficient to overcome plaintiff's prima facie case), *rev'd on other grounds*, 495 U.S. 271 (1990); Oahu Gas Serv. v. Pacific Resources, Inc., 838 F.2d 360, 366 (9th Cir.) ("A high market share, though it may ordinarily raise an inference of monopoly power, ... will not do so in a market with low entry barriers or other evidence of a defendant's inability to control prices or exclude competitors."), *cert. denied*, 488 U.S. 870 (1988); United

Second, market share is a particularly inappropriate measure of competition in a market that is emerging from regulated monopoly environment, because an incumbent's market share tends to understate the degree of competition during a transition to competition, and tends to underestimate a competitor's future competitive significance.[47] A market that was, in recent history, a protected monopoly, may well be much more concentrated than an equally competitive market without a regulated history. Market shares are "path-dependent;" i.e., they depend upon past market shares, even if the market is now highly competitive. An incumbent that prices competitively need not lose customers to competitors; if the incumbent prices so as to reflect the competitive threat, there is no incentive for its existing customers to move. Customers nonetheless receive the benefits of competition even if the incumbent's market share does not change.

When a firm's market share reflects its regulatory legacy, it is often more informative to look at the trend or change in market share over time than to look at the level of market share. If a firm's market share is being eroded by competitors, that is typically viewed as evidence of decline of that incumbent's market power and evidence of

States v. Waste Mgmt., Inc., 743 F.2d 976, 981-83 (2d. Cir. 1984) (prima facie illegality of 48.8% postmerger market share rebutted by ease of entry into Dallas County commercial trash collection market); United States v. Gillette Co., 828 F. Supp. 78m 84 (D.D.C. 1993) ("there is ample evidence that the mechanics of fountain pen design are readily available, thus leaving no technological barriers to [new] entry [and there] ... are also no legal or regulatory barriers"); Pennsylvania v. Russell Stover Candies, Inc., 1993-1 Trade Cas. (CCH) ¶ 70,224, at 70,093-94 (E.D. Pa. 1993) ("defendant can rebut the evidence [of a prima facie violation] by showing that barriers to entry are not significant"); United States v. Syufy Enters., 712 F. Supp. 1386, 1401 (N.D. Cal. 1989) (showing of absence of entry barriers "undermines any claim of monopoly power"), *aff'd*, 903 F.2d 659 (9th Cir. 1990); United States v. Calmar Inc., 612 F. Supp. 1298, 1306-07 (D.N.J. 1985) (ease of entry ensured that merger would not injure competition, despite the fact that it resulted in leading firm with 50% of market and HHI of 3000); Echlin Mfg. Co., 105 F.T.C. 410, 485-92 (1985) (Lack of entry barriers into the assembly and sale of carburetor kits eliminates any possibility of a substantial anticompetitive effect); Frank Saltz & Sons v. Hart Schaffner & Marx, 1985-2 Trade Cas. (CCH) ¶ 66,768 at 63,724 (S.D.N.Y. 1985) (dictum) (noting that even if concentration had been high, relative ease of adapting a factory from lower quality clothing to better quality men's suits would have precluded finding an antitrust violation); United States v. Tracinda Inv. Corp., 477 F. Supp. 1093, 1108 (C.D. Cal. 1979) (no barriers to entry into motion picture market); United States v. M.P.M., Inc., 397 F. Supp. 78, 92, 94 (D. Colo. 1975) (entry barriers relatively low in ready-mix cement business).

[47] The *Merger Guidelines* state that "recent or ongoing changes in the market may indicate that the current market share of a particular firm either understates or overstates the firm's future competitive significance." (§ 1.521)

lively competition. Even this conclusion has exceptions, however, because, again, market share cannot capture the market characteristics that directly determine its competitiveness, namely, entry conditions.

**Q.25 Ms. Meisenheimer relies on the Herfindahl-Hirschman Index (HHI) as an "indicator of market dominance (and in turn, the absence of effective competition)"[48] Is the HHI an accurate indicator of market dominance?**

A.25 Not necessarily. The HHI is another way of presenting and summarizing market share statistics; it is a measure of market concentration, calculated as the sum of each firm's squared market share. Thus, the HHI suffers from the same shortcomings as a measure of market share. As I have already explained in detail the shortcomings of market share as a measure of market power, I will not repeat them.

In addition to these shortcomings, it makes even less sense to present HHI measures that combine carrier activity in both the business and residential markets, as has Ms. Meisenheimer.[49] In particular, Ms. Meisenheimer's HHI estimates, which combine all customer lines from residential to large business lines, do not measure the concentration either the residential or the large business market.

**Q.26 Do competition authorities recognize that market share is not a definitive measure of market power or competition?**

A.26 Yes. As I indicated earlier, the fact that market share is fundamentally flawed as a measure of competition is well accepted among economists and antitrust authorities and

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48 *Meisenheimer Rebuttal*, p. 16.

49 *Meisenheimer Rebuttal*, p. 17. ("In total, an estimate of SWBT's share of statewide access lines is **__% ** dwarfing the combined total of its CLEC competitors including prepaid, regular resale, UNE-P, and CLEC switched service as estimated based on the number of E-911 listings.")

is reflected in the U.S. Merger Guidelines and in numerous court decisions (See Footnote 46).

I also note that the RSMo does not require the use of market share, at least by my lay reading of the statute. AT&T's witness, Mr. Kohly, admits that "Section 386.020(14)(a) [sic] does not explicitly impose a market share threshold ...."[50] I would go further than that. Section 386.020.13(a) simply does not use the term "market share." There is simply no basis for saying that the Section imposes a threshold, either explicitly or implicitly.

**Q.27 Do other telecommunications providers recognize that market share is not a definitive measure of competition?**

A.27 Yes. In a different venue, AT&T itself said that market share is a non-essential ingredient in demonstrating a market's competitiveness:

> The expert submissions made in this proceeding ... further acknowledge that market share statistics, standing alone, do not demonstrate the presence or absence of market power, and that other factors must therefore be examined to assess whether any carrier has market power [footnote omitted]...These are not controversial assertions; to the contrary, there is a broad economic and legal consensus supporting each [footnote omitted].[51]
>
> ***
>
> Economists have known for a long time that the link between market concentration and market competitiveness is a tenuous one [footnote omitted], and that measuring concentration is not a substitute for analyzing the factors that determine market performance. Salop, Brenner, and Roberts observe that '...market share, standing alone, does not determine

[50] *Kohly Rebuttal*, p. 5.

[51] *Reply Comments of American Telephone and Telegraph Company*, FEDERAL COMMUNICATIONS COMMISSION, CC Docket No. 90-132, September 18, 1990, p.3.

the extent to which competition effectively constrains the exercise of market power [footnote omitted].' [52]

**Q.28 Does the FCC recognize that market share is not a definitive measure of competition?**

A.28 Yes, the FCC itself recognizes the significant shortcomings of market share as a measure of competition. In its 1996 order declaring AT&T non-dominant, the FCC wrote:

> It is well-established that market share, by itself, is not the sole determining factor of whether a firm possesses market power. Other factors, such as demand and supply elasticities, conditions of entry and other market conditions, must be examined to determine whether a particular firm exercises market power in the relevant market [footnote omitted]. As we noted in the First Interexchange Competition Order, "[m]arket share alone is not necessarily a reliable measure of competition, particularly in markets with high supply and demand elasticities [footnote omitted]." [53]

**Q.29 Would variations in market share from one exchange to another indicate variations in the competitiveness in those exchanges?**

A.29 No, not necessarily. Unlike the incumbent, CLECs have the ability to pick and choose among the exchanges, to penetrate those areas first that are likely to produce the most profits. Exchanges with the greatest revenue potential (relative to costs) or lowest costs (relative to revenues) would likely be the most attractive areas to pursue, and one would expect them to show the greatest competitive penetration. However, as those areas become more populated with competitors, other areas with less competitive activity

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52 *Statement of Stanley M. Besen, Appendix B to Reply Comments of American Telephone and Telegraph Company*, FEDERAL COMMUNICATIONS COMMISSION, CC Docket No. 90-132, September 18, 1990, p.2.

53 Order *In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, FEDERAL COMMUNICATIONS COMMISSION, FCC 95-427, October 12, 1995 (*"AT&T Reclassification Order"*), ¶ 68.

therefore become more attractive. Hence, the fact that competitive activity, and market shares, are likely to vary across exchanges, is not evidence that *all* exchanges are not open to competition. Instead, it is consistent with the fact that competitors can and, rationally do, engage in cherry picking. Nevertheless, if the incumbent wanted to raise prices in only a particular exchange (and was able, from an administrative and billing standpoint to do so), that exchange would then become more attractive and invite cherry picking – the prospect of which, in turn, serves to discipline price there.

## IV. RESPONSE TO AT&T WITNESS R. MATTHEW KOHLY

**Q.30 Please summarize your conclusions regarding Mr. Kohly's Rebuttal Testimony.**

A.30 Mr. Kohly's Rebuttal Testimony addresses the issue of what constitutes "effective competition."[54] He applies his analysis of "effective competition" to access services,[55] intraLATA toll services,[56] and local services.[57] Mr. Kohly's arguments and characterization of the contemporary telecommunications marketplace are long on theory, most of which is incorrect,[58] if not incoherent. His recommendations should be recognized for what they are: the self-interested pleadings of AT&T for the Commission to establish a profit cushion for the benefit of AT&T and at the expense of consumers in

54 *Kohly Rebuttal*, pp. 5-16, and a discussion of competition on pages 16-20.

55 *Kohly Rebuttal*, pp. 23-28.

56 *Kohly Rebuttal*, pp. 28-32.

57 *Kohly Rebuttal*, pp. 32-33.

58 For instance, Mr. Kohly characterizes Ramsey pricing as a predatory pricing mechanism (*Kohly Rebuttal*, p. 3). First, Mr. Kohly is to be reminded that the Ramsey rule is the solution to the mathematical problem of maximizing *consumer* welfare subject to a revenue constraint. It follows immediately that prices that deviate from Ramsey prices do not maximize consumer welfare, and moving prices toward the Ramsey solution will improve consumer surplus. Second, the Ramsey rule is not predatory. Observation of the Ramsey formula confirms this point: $(P_i - MC_i)/P_i = R(1/e_i)$, where R is the Ramsey number with values from 0 to 1 and $e_i \geq 0$ is the (absolute value) price elasticity of demand in the $i^{th}$ market segment. Since R and $e_i$ equal or exceed 0, price necessarily equals or exceeds marginal cost.

Missouri. In particular, Mr. Kohly is asking that the Commission establish a policy whereby the prices of network elements or services that AT&T elects to *buy* from SWBT are regulated and low; and the prices of services that AT&T sells in competition with SWBT are regulated at umbrella levels to *preclude* lower prices.[59]

Mr. Kohly's recommendations are not pro-competition, but instead would result in a market that is managed by the Commission for the benefit of individual competitors, such as AT&T, at the expense of other competitors, the full and fair competition requirements of the RSMo, and consumers themselves. Moreover, Mr. Kohly offers no transition path to free-market competition, and therefore no transition for the elimination of the regulation-supported profit cushion for AT&T except perhaps through SWBT's loss of local market share that Mr. Kohly fails to specify.

I will describe some of Mr. Kohly's economic errors that are the foundation for his analysis. I will illustrate how these errors in economics lead to his inappropriate policy recommendations.

**Q.31 Please comment on Mr. Kohly's discussion of "effective competition."[60]**

A.31 Mr. Kohly's discussion of "effective competition" considers each of the four factors provided for in §386.020.13,[61] but his interpretations of these factors are inconsistent with basic economics. I will comment first on Mr. Kohly's discussion of §386.020.13(a), which directs the Commission to consider the "extent to which services are available from alternative providers in the relevant market." Mr. Kohly suggests that the

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59 *Kohly Rebuttal*, pp. 2-3.

60 *Kohly Rebuttal*, p. 5.

61 Mr. Kohly mistakenly refers to §386.020.14 rather than §386.020.13.

Commission use market share and an investigation into the manner by which the service is provisioned as two ways of evaluating availability.[62]

**Q.32 You have explained why market shares are not determinative of a market's competitiveness. Please explain why "availability" is substantially different from a market share measure.**

A.32 "Availability" measures the extent to which customers could choose to switch to competitors if, for example, their current provider attempted to increase prices significantly. Market share is an inappropriate indicator of "availability" because it fails to incorporate a producer's ability to *expand* output, be it through utilization of excess capacity, the expansion of existing capacity, or new entry. Output or revenue market shares are based on data that reflect how many customers a carrier serves, while availability refers to the ability of customers to find another provider if the customers so chose. For example, based an output market share, if I buy a Ford, I would not appear in Toyota's market share. Nevertheless, there is no question that Toyotas are readily available to me (and that certain Fords and certain Toyotas are, of course, economic substitutes).

Even market share as measured by carriers' capacity is not necessarily an accurate measure of "availability." This is obviously true when measuring the availability of resale services; the "capacity" of resellers is not a meaningful concept because resellers have the entire capacity of SWBT's network available to them with which to provide service. Similarly, the "capacity" of a collocated provider to serve customers in the collocated wire center is not well-defined, because the carrier can use unbundled loops from SWBT to serve each customer there, even without any loop capacity of its own.

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62 *Kohly Rebuttal*, p. 5.

Market share is not only distinct from the concept of "availability," but market share can be a very poor indicator of availability of substitute services. Simply put, typical measures of market share calculate the extent to which competitors are actually providing services to customers. A high level of availability of substitutes offered by competitors may well be accompanied by a low market share for those competitors.

**Q.33 Dr. Aron, you make several points about the deficiencies of market share in this proceeding, but isn't it true, as Mr. Kohly argues, that SBC Affiants Drs. Richard L. Schmalensee and Paul S. Brandon concluded that market share is relevant to analyzing the competitiveness of the long-distance marketplace?[63]**

A.33 Drs. Schmalensee and Brandon use market share in their analysis of the social benefits from permitting SBC to enter the in-region interLATA long-distance business in Missouri,[64] but their conclusions are quite contrary to those of Mr. Kohly.

**Q.34 How are market shares applied in the affidavit of Drs. Schmalensee and Brandon?**

A.34 *Schmalensee & Brandon* demonstrates an instance where residential toll revenue market share declined since 1984[65] – for AT&T and for the big-3 suppliers (AT&T, WorldCom, and Sprint) – but where (they conclude) market power increased, as demonstrated by AT&T's price increases even as access charges and other fees declined.[66] Thus, Mr.

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63 *Kohly Rebuttal*, p. 6-7.

64 *Affidavit of Richard L. Schmalensee and Paul S. Brandon In the Matter of Application of SBC Communications, Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc., d/b/a Southwestern Bell Long Distance, for Provision of In-Region InterLATA Services in Missouri*, FEDERAL COMMUNICATIONS COMMISSION, CC Docket No. ___, June 2001 ("*Schmalensee & Brandon*").

65 *Schmalensee & Brandon*, Figure 1, p. 7.

66 *Schmalensee & Brandon*, pp. 12-13.

Kohly's attempt to provide a good-for-the-goose example of the use of market share actually demonstrates a real-life pitfall in the use of market share as a reliable indicator of "availability" *or* "effective competition." Mr. Kohly's testimony implies that there is a positive relationship between market share and market power. If this were true, the decline in AT&T's long-distance market share would be accompanied by a corresponding decline in the carrier's market power. However, *Schmalensee & Brandon* conclude that the opposite is the case in the long distance market. They show that as the market shares of AT&T and the aggregate share of big-3 carriers (WorldCom and Sprint) declined, their pricing power increased. In other words, they argue, even as the market for long distance service has been getting less concentrated, pricing power of the big three providers (AT&T, WorldCom, and Sprint) increased, to the detriment of many long-distance consumers. Accordingly, *Schmalensee & Brandon* demonstrate a point completely contrary to the one that Mr. Kohly and Ms. Meisenheimer advocate. Not only is market share *not* the "best way" to determine effective competition, it can be a misleading way.

**Q.35 Please comment on Mr. Kohly's definition of "functional equivalence."[67]**

A.35 Mr. Kohly errs by characterizing "functional equivalence" as something to do with the technology used to provide services. He says, "the services must be functionally equivalent *in the manner in which they are provisioned.*"[68] Such a definition is totally in error and miles from the mark. Nowhere in the statute – and certainly not in economics – is there any indication that functional equivalency has anything whatsoever to do with the way services are provisioned. Rather, as I described in my direct testimony, the term "functionally equivalent" has to do with how the services are viewed by the consumer, i.e., how they function in use. The statute reads "functionally equivalent or substitutable

67 *Kohly Rebuttal*, p. 7.

68 *Kohly Rebuttal*, p. 7 (emphasis added).

at comparable rates, terms, and conditions,"[69] a construction that makes sense only when viewed from the consumer's viewpoint. The term "functionally equivalent" means that the competitor offers service that satisfies the same consumer desires in about the same way. Functional equivalence, therefore is more stringent than substitutability. Two services may be substitutes if they satisfy a similar consumer demand, even if they do so differently.

However, for purposes of assessing "effective competition" the distinction between "functionally equivalent" and "substitute" services is not a central element to the analysis; the conceptual framework that unifies all these concepts, as I said in my direct testimony, is whether services are in the same product market. If services are determined to be in the same product market, they compete with one another and contribute to "effective competition."

In an economic analysis of effective competition, consumer sovereignty is the gold standard for defining the relevant scope of the market, for assessing what products are substitutes, and for determining the degree of price discipline that various substitutes exert. The technology by which a service is provisioned is relevant in such an analysis to the extent that it bears on how rapidly a provider could enter the market and provide an alternative (substitute) to the consumer, or if it bears on how consumers perceive the products' attributes; but, in itself, technology or provisioning are not the criteria by which one determines competitive alternatives.

[69] RSMo, §386.020.13(b).

**Q.36 Does Mr. Kohly's error in interpreting "functional equivalence" have any effect on his arguments?**

A.36 Yes. His arguments are rendered meaningless, as his own logic illustrates. For example, Mr. Kohly says, "the only substitute for SWBT's facilities-based service is another facilities-based service."[70] The flaw in this statement is that it may matter little to consumers how a particular product is provisioned. Indeed, in some cases, including telecommunications, consumers may not even know, let alone understand, how their service is provisioned. Whether a call is transported via microwave tower, fiber optics, or coaxial cable is totally irrelevant to a consumer who experiences functional equivalence in the service that he or she is offered. Moreover, if a customer orders local exchange service from a CLEC, the customer may not have any idea and, to my knowledge is typically not offered a choice, of whether the service to his home is on a resale line, UNE, or self-provisioned. Hence, Mr. Kohly's definition is improper because it rules out as competitive two services that serve the similar or identical function from the consumer's viewpoint, but which are provisioned in different ways.

[70] *Kohly Rebuttal*, p. 7.

**Q.37 Mr. Kohly says that AT&T's Digital Link[71] service is not functionally equivalent to basic local service because Digital Link lacks some functionalities such as the ability to make operator-assisted calls, or 911.[72] Please comment.**

A.37 I defer to SWBT witness Hughes to deal with the specifics of this issue, but I will note that Mr. Kohly is being disingenuous in his testimony when he says that Digital Link is not functionally equivalent to "basic local service." AT&T itself markets Digital Link as a local service to those customers who have high-capacity (e.g., T-1) lines with AT&T.[73] The relevant market for Digital Link is not the residential or small business market because such customers rarely have T-1 links. Nevertheless, that does not mean that Digital Link does not exert competitive pressure on local service prices in the larger business market where the service is offered. As the table below (copied from AT&T's web site) illustrates, AT&T's own market materials clearly place Digital Link as a competitor to local service such as "local calls." Digital Link may not be a substitute for most mass-market customers, but to represent Digital Link as not being in competition with SWBT's local service to larger business customers is misleading at best.

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71 Digital Link is a service offered to business customers with access to T1 speed or greater. It allows the customer to combine local, intra-LATA, long-distance and international calls over AT&T's digital dedicated access facilities. See <www.att.com/local/services/dlinkp.html>, <www.att.com/local/products/diglink.html>, downloaded September 10, 2001. See also the "AT&T Digital Link Brochure", downloaded from <www.att.com/local/products/diglink.html>, September 10, 2001.

72 *Kohly Rebuttal*, p. 8.

73 See: <www.att.com/local/services/dlinkp.html>, downloaded September 10, 2001.

**What services does AT&T Digital Link provide my business?**
AT&T Digital Link is a Local offer that rides on a digital, dedicated DS-1 facility supporting these types of call types:

- Direct Outward Dialing (DOD)
- Direct Inward Dialing (DID)
- Originating 800 (8YY)
- Local calls
- Combo Trunks

The AT&T Digital Link offers support for the following call types:

- ISDN
- Universal T-1 Access (UTA)
- Directory Listings - basic single line yellow and white page directory listings

Source: <http://www.att.com/local/services/dlinkp.html>, downloaded September 10, 2001

**Q.38 Mr. Kohly also says that AT&T does not compete with SWBT for intraLATA toll service because the companies' products are not functionally equivalent.[74] Please comment.**

A.38 The gist of Mr. Kohly's response is that AT&T's intraLATA service is not functionally equivalent to SWBT's intraLATA toll service because AT&T pays switched access charges to SWBT when it is a SWBT local customer that originates and terminates the call. Mr. Kohly once again uses his incorrect definition of "functional equivalency" when the appropriate standard is one that is based on consumer preferences, not the provisioning choices of the providers. Later in my testimony I will specifically address Mr. Kohly's erroneous analysis of intraLATA toll competition. But, for purposes here, I will say that end-user customers would reasonably see AT&T's intraLATA toll service as being functionally equivalent or substitutable with SWBT's intraLATA toll service. Mr. Kohly admits that "an end-user may view the two services as similar,"[75] which is

74 *Kohly Rebuttal*, pp. 8-9.

75 *Kohly Rebuttal*, p. 9.

precisely the kind of indicator of substitutability in products that he should consider, not his idiosyncratic definition based on AT&T's costs. Any assessment of competition in the intraLATA toll service marketplace at a minimum should include both SWBT's and AT&T's intraLATA toll services. Mr. Kohly's erroneous conclusions are based on a definition of "functional equivalence" that is determined through the eyes of AT&T, not the eyes of the consumer, as it should be.

**Q.39 Mr. Kohly claims that AT&T offers no optional intraLATA calling plans that are substitutable for SWBT's Local Plus, Designated Number or other flat-rated intraLATA toll calling plans.[76] Does this mean that Local Plus, Designated Number and other flat-rated intraLATA toll calling plans offered by SWBT have no competition from AT&T?**

A.39 Of course not. Mr. Kohly is making a fundamental error. He is confusing the product with the price structure or price level that is paid for the product. Calls that originate and terminate within the LATA but which are more distant than the local calling area are interexchange calls in Missouri.[77] I cannot imagine that Mr. Kohly would deny that AT&T offers intraLATA interexchange toll calls.[78] How AT&T combines intraLATA toll calls with other calling services, or how it charges for such calls (e.g., flat-rate, per minute, or by the "bucket" of minutes) is a pricing issue, not a product definition issue.

When assessing competition, the relevant issue is to investigate how consumers would react to a small but significant and non-transitory increase in the price of SWBT's

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[76] *Kohly Rebuttal*, p. 8.

[77] See, for example, "Local Toll Calls" on the MPSC web site, at <http://168.166.4.147/teleco-terms.asp>.

[78] By my brief investigation, AT&T's web site offers local toll service in St. Louis (if not more areas) for $0.09 per minute. See also, *AT&T raises rates for Missouri customers*, JEFFERSON CITY (MISSOURI) NEWS TRIBUNE (ONLINE EDITION), December 1, 2000. Downloaded on September 14, 2001 from <http://www.newstribune.com/stories/120100/bus_1201000903.asp>.

interexchange services. It seems self-evident that some, and perhaps many, would consider moving to one or another of AT&T's plans. If that is the case, then the two products are substitutes for one another and belong in the same product market for purposes of a competitive assessment. This is an empirical question that is certainly not answered by a blanket denial that competition exists on the grounds that the price plans differ. Secondly, even if it were the case that AT&T did not offer intraLATA toll service in competition with SWBT in Missouri, this does not necessarily mean that *no* carrier offers such a service in competition with SWBT. Certainly, AT&T's presence or absence in a market is not the gauge of whether a market is competitive.[79]

**Q.40 Mr. Kohly says that wireless telephones are not substitutes for landline local telephones because only 3 percent of wireless customers do not purchase a wireline phone.[80] Please comment.**

A.40 In assessing whether wireless is a substitute for wireline local exchange service, the framework that I laid out in my direct testimony requires asking whether an alternative disciplines a product's price. It does not require that a certain number of customers actually pull their landlines in favor of wireless service. The method I propose asks whether a small but significant and non-transitory increase in the price of residential wireline service would induce sufficient numbers of customers to opt for alternatives, such as wireless, as to render the price increase unprofitable. I note here that one complicating factor in this framework is that the price of residential basic local service historically has been regulated below the competitive price, and in some cases even below cost. Accordingly, regulation itself has helped ensure that substitute services are few

79 For example, Qwest offers local toll calls in Missouri. See <http://residential.qwest.com/ld/oneplus/6cent_plan.jsp>, downloaded September 14, 2001.

80 *Kohly Rebuttal*, p. 10.

because few can compete with a sub-optimally priced (or even subsidized) service. I would expect that a consequence of removing local subsidies and creating a more rational local rate structure would be an increase in the effective competition and price discipline exerted by such alternatives as wireless and cable telephony/Internet.

**Q.41 Mr. Kohly also says that in addition to looking at market share, "Section §386.020(14)(c) [sic] also requires the Commission to consider whether the respective markets are 'irreversibly competitive.'"[81] Please comment.**

A.41 Nowhere in my reading of §386.020.13(c) or §392.185 or in my reading (and computer word search) of Chapter 392 did I find the term "irreversibly competitive," let alone a requirement that the Commission consider it. I conclude that this is something that Mr. Kohly himself believes is useful; but it is a misrepresentation of the RSMo to say that the statute itself requires it. Nevertheless, I will address the merits of Mr. Kohly's proposal. Mr. Kohly appears to base his concerns about reversibility of competition on the fact that many CLECs have run into substantial financial difficulties, with numerous bankruptcies and even cessation of operations.[82] While such reversals are lamentable to the owners and employees of the firm, and their inconvenienced customers, the policy issue is whether the industry's woes signal some generalized problem that bears on the effectiveness of the competitive process itself.

To a certain extent, the current trial-by-ordeal is hardening the surviving competitors. One of the firms that Mr. Kohly cited as having gone bankrupt, Northpoint Communications, Inc., has sold substantially all of its assets to Mr. Kohly's own employer, AT&T. AT&T paid about $135 million for Northpoint, which worked out to

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81 *Kohly Rebuttal*, p. 12.

82 *Kohly Rebuttal*, pp. 17-18.

approximately 26¢ per dollar of Northpoint's gross Property Plant & Equipment (PP&E),[83] or about one-quarter their original cost. Such opportunistic acquisitions reduce the cost basis of AT&T as a competitor to SWBT and other ILECs and improve the chances that AT&T can earn a positive, compensatory return on its investments in a market where Northpoint could not.

Many of the hard assets (as well as the talent and know-how, or "human capital," of many of the employees) remain in the market for others to use. Indeed, another CLEC, Time Warner Telecom, said that the current situation has a silver lining in that the exiting from the marketplace of some CLECs: (1) provides the opportunity for Time Warner to pick up customers formerly served by the CLECs; (2) will increase some of the "artificially low" prices on for certain telecommunications services; and (3) improves the availability of experienced telecommunications personnel.[84]

Finally, it is worth noting that, according to the data presented by Mr. Hughes, total CLEC lines continue to grow in Missouri. According to Mr. Hughes, not only is SWBT's share of the market declining, but its absolute number of lines is declining as well. This means that CLECs are not only capturing all of the growth in the market, but are eating into SWBT's existing base customers.

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83 As of September 30, 2000, Northpoint's gross PP&E was $526.6 million. AT&T's purchase price of $135 million therefore was about $0.26 per dollar of PP&E. MULTEX INVESTOR REPORTS (NORTHPOINT), Downloaded on July 16, 2001 from <www.multexinvestor.com/MGI/mg.asp?target=%2Fstocks%2Fcompanyinformation%2Fbalancesheet%2Fqbalancestd&Ticker=NPNTQ>.

84 *Time Warner Telecom Inc.*, EDGAR ONLINE GLIMPSE (Management's Discussion and Analysis section in the full 10-K/10-Q Report, Filed on May 14, 2001). Downloaded on July 12, 2001 from <www.edgar-online.com/lycos/quotecom/glimpse/glimpse.pl?sym=TWTC>.

**Q.42 Is the inability of some CLECs to attract additional outside financing itself an entry barrier?[85]**

A.42 No. Difficulties in attracting capital are a symptom, not a cause, of CLEC distress. There can be any number of reasons besides entry barriers why investors shy away from providing capital to CLECs, or, for that matter, to other telecommunications service providers in the US and elsewhere that have seen their stock prices decline substantially in the past two years. I will discuss several of these reasons below. I think it is fair to say that , for the most part, investment analysts do not generally describe, and certainly do not dwell on, any supposed ILEC intransigence or other such "entry barriers" as being among the reasons why some CLECs have had difficulties or why they find external funding difficult to come by.

**Q.43 Why have CLECs had trouble attracting capital over the past two or so years?[86]**

A.43 Based on my research and review of analyst reports and industry publications, I think it is fair to say that there are six main reasons for the investor disfavor of CLECs:

- Investors now have a clearer understanding that demand for new services, especially services related to the Internet, had been overestimated. Compounding the overestimation is a concurrent deceleration of growth rates of many telecommunications and data communications services;
- Firms that used substantial leverage created for themselves cost structures that turned what otherwise would be mere distress into financial catastrophe;
- Investors have a maturing understanding that not every telecommunications business model will prove to be successful;
- Investor support for arbitrage-based businesses has eroded;
- Investor support for inefficient businesses has eroded;

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85 *Kohly Rebuttal*, p. 16.

86 *Kohly Rebuttal*, pp. 17-18; and *Price Rebuttal*, p. 8.

- Investors better understand that economies of scale and scope are important in telecommunications, both in production and in marketing.

**Q.44 Please elaborate.**

A.44 With regard to the first point, I believe that the explosive growth in demand for telecommunications services, especially those services related to the Internet, was unsustainable. Growth may have hit an inflection point, which means that growth was positive but not explosively so.[87] The arithmetic of discounting shows that firms whose values are based on payoffs far in the future suffer most when growth rates ratchet downward.

The distressing impacts of the growth slowdown were magnified many times over by the fact that many CLECs were highly leveraged. This means that the firms used a lot of fixed-obligation debt relative to equity. The use of debt, or "high-yield heroin" as it has been called by Allegiance's CFO, contributed to liquidity crises for some CLECs.[88] Excessive leverage changed what might have been mere growing pains into a catastrophe for some CLECs.

My third observation is that since 1996 there have been a huge number of business plans regarding telecommunications services. Indeed, there seemed to be as many strategies as there were firms.[89] As Allegiance's CEO Royce Holland said, a CLEC shakeout was to be expected:

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87 There is considerable industry disagreement with estimated growth rates, which itself contributes to uncertainty and willingness of investors to provide capital.

88 Pacelle, Mitchell, *Busy Telecom Upstart Goes Cold Turkey on More 'Junk'*, THE WALL STREET JOURNAL ("Heard on the Street"), June 8, 2001. Downloaded on July 13, 2001 from <http://webreprints.djreprints.com /00000000000000000022186001.html>.

89 *Broadband 2001:A Comprehensive Analysis of Demand, Supply, Economics, and Industry Dynamics in the U.S. Broadband Market,* JP MORGAN SECURITIES INC. EQUITY RESEARCH AND MCKINSEY & COMPANY, April 2, 2001, p. 17 ("*Broadband 2001*").

> [Mr. Holland] described the CLEC shakeout as "only natural" -- the result of the overheated capital markets of 1999 and early 2000. In those days, there was "no business plan too weak or management team too inexperienced to get funded."[90]

My fourth point is that arbitrage-based business plans are finally falling by the wayside. Business plans such as maximizing reciprocal compensation traffic destined for the Internet or increasing terminating access rates are based primarily on flawed regulation that is in the process of being corrected. Companies that fail to transition away from these windfalls and toward providing real services are being dealt with harshly by investors.

Inefficient firms that cannot execute are being abandoned by investors as well. For example, some CLECs face substantial staffing issues. The turnover of employees, such as sales and service personnel, has been estimated to be 200% per year, meaning that the tenure of the average employee is 6 months.[91] Moreover, some CLEC managers have been more concerned with technology and their own perquisites than in the services that customers want:

> CLECs sold everything from regular service to high-speed digital subscriber lines. Most liked technology, but weren't good enough at customer service to really bother the Bells. ICG Communications, which filed for Chapter 11 in December, specialized in its own fancy offices and selling advanced optical-transport capacity. DSL providers like Covad and Northpoint Communications compounded the problem by selling their expensive technology to Internet service providers. These turned into deadbeat accounts; Northpoint filed for bankruptcy in January, and Covad is on the ropes.[92]

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90 *CLEC Representatives Have Doubts about FCC's 'Recip Comp' Order*, TR DAILY, May 15, 2001.

91 *Testimony of John Malone, president and chief executive officer, The Eastern Management Group before the House Judiciary Committee*, May 22, 2001.

92 Hardy, Quentin, *Conqueror In the Carnage*, FORBES MAGAZINE (FORBES.COM), March 5, 2001. Downloaded September 14, 2001 from <www.forbes.com/forbes/2001/0305/073.html;$sessionid$4IMT1AIAADPJ1QFIAGWCFEY?_requestid=145493>.

And finally, I observe that investors are getting a better appreciation for the fact that telecommunications services is a scale business. The marketplace cannot, and efficiency will not, support hundreds of new landline telecommunications carriers. A study by JP Morgan / McKinsey concludes that a few markets can support 4-5 facilities-based entrants, but that "no market will long support the 10 or more entrants seen in recent years."[93]

In sum, while many CLECs (and their investors) have suffered dramatically, and while many companies have gone out of business, several players remain as viable, strong and growing competitors that may survive on their own, or combine with other domestic or foreign carriers to compete against incumbent LECs. As a matter of fact, various CLEC executives have stated that their prospects for the future are optimistic.[94] Moreover, business fundamentals, and the normal economic dynamics of industry "shake-out", not ILEC-CLEC relations, are at the heart of the recent decline in the telecommunications industry.

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93 *Broadband 2001*, p. 111.

94 For example, Noelle Beam, the Vice President of XO Communications has said that "[o]perationally, XO is probably stronger now than it ever has been" (*Debt drowns phone firms*, WASHINGTON POST, July 9, 2001); and Robert Taylor, the CEO of Focal Communications recently declared that "[c]ustomer demand for an alternative is growing, and people who think the competitive carriers are dead have just been reading the wrong tea leaves." (*Focal Secures Cash Infusion*, CHICAGO TRIBUNE, October 8, 2001). Likewise, Allegiance Telecom's chairman and CEO, Royce Holland, has also shown his optimism about the results of TA96: "People say opportunity has waned and the Telecom Act isn't working. I don't think that's the truth." (*CLEC: Tower of Babel*, UPSIDE TODAY, July 31, 2001).

**Q.45 Please comment on Mr. Kohly's statement that the Missouri Commission's recommendation in favor of §271 approval means, at best, that SBC meets the "minimum standards required to open the local market to competition."[95]**

A.45 Mr. Kohly might characterize the market-opening requirements of TA96 as "minimum," but I do not. As I stated in my direct testimony, it is a testament to how anesthetized we have become to the steps that have been taken to provide easy entry into the local telecommunications services marketplace that permits someone to make such a comment.[96] It is worth recognizing that requiring the incumbent to provide an extensive array of unbundled network elements or discounted resale services *at all* is itself an extraordinary obligation. Interconnection, unbundling, and resale at a discount are all substantial obligations, some of which, in my judgment, go well beyond what would be required of ILECs under antitrust law[97] and all of which substantially ease entry for new carriers.

**Q.46 Mr. Kohly says that there are fundamental entry barriers in Missouri that will not permit truly sustainable competition.[98] Please comment.**

A.46 Mr. Kohly's analysis on this point seems to be a response to SBC's §271 application, especially insofar as he bases his conclusions on the DOJ's assessment of SBC's provisioning of UNEs and UNE-platform. My reading of the DOJ's assessment is that the Department expressed concerns with element prices, but these have since been reaffirmed by the Missouri Commission.[99] Thus, at worst, the prices are in a range where

95 *Kohly Rebuttal*, p. 14.

96 *Aron Direct*, p. 24-25.

97 The court's opinion in *Goldwasser, et al., versus Ameritech Corporation*, 222 F.3d, 399-400 (7th Cir. 2000) is consistent with this view.

98 *Kohly Rebuttal*, p. 14.

99 *MPSC Written Consultation*.

parties could respectfully disagree, and it would seem that this would not create a "fundamental" entry barrier that would preclude "truly sustainable" competition.

**Q.47 If the FCC modifies the list of UNEs by, for example, removing High-Capacity Loops, would this necessarily harm CLECs' ability to compete by creating uncertainty in the marketplace, as Mr. Kohly claims?[100]**

A.47 Absolutely not. It is legally required, as well as economically appropriate, to eliminate from the list of UNEs those items that do not meet the "necessary" and "impair" tests expressed in TA96.[101] Provided that the FCC addresses its obligations in a reasoned and sober fashion, there is no reason why removing elements from the list of UNEs would harm competition through the creation of uncertainty. Individual competitors may be negatively affected by the removal of one or another UNE, but other competitors, such as those that self-provide their networks or that sell network capacity or functionality to others in the marketplace in competition with the incumbent, will benefit from the removal of the element from the list. Basically, streamlining regulation by removing items from it that do not require regulation benefits full and fair competition.

**Q.48 Mr. Kohly describes a situation where SWBT engages in predatory pricing after being deregulated.[102] Is his scenario likely?**

A.48 No. It is virtually impossible. Predation requires that the firm be in a position to drive competitors out of the marketplace and then keep them out long enough to increase its prices and recoup the profits, and then some, that the firm gave up during the

100 *Kohly Rebuttal*, pp. 18-19.

101 TA96, §251(d)(2).

102 *Kohly Rebuttal*, p. 19.

exclusionary phase of its plan. I will not go into great detail of a proper predatory pricing analysis, but I will point out that even if firms such as AT&T were to exit the marketplace, which itself is not a credible threat, one would also have to erect substantial entry barriers that would keep AT&T and others from re-entering the marketplace once SWBT increased prices to recoup the forgone profits. There is no credible scenario by which SWBT could recoup its lost profits based on such predatory pricing. Absent such a scenario, rational firms simply will not engage in such a practice.

I should add that my analysis appears to have been accepted by AT&T's own economic witness during SBC's §271 application in Missouri. In a transcript that I reviewed, AT&T economist John W. Mayo says:

> Q. Would you agree with me, Dr. Mayo, that the U.S. Supreme Court has stated that predatory pricing is rarely tried and more rarely successful?
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> A. Yes, I agree. In fact, I've said as much myself in – in material that I've written, that predatory pricing in its rawest form – is – is pretty much a rare bird. And the reason is that – that pure predatory pricing would inflict losses on yourself, hemorrhaging yourself profits in the hope of driving someone out of business. And a variety of strict conditions have to hold for that to be a profitable strategy.[103]

Dr. Mayo says that SBC's incentives to engage in predatory pricing upon integrating local and in-region interLATA long distance service are "highly unlikely."[104] In discussing AT&T's ability to engage in predatory pricing in the interLATA business, Dr. Mayo agreed with the questioner that even if AT&T were to succeed in driving out its competitors, regulators would not permit AT&T to increase its prices above competitive

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[103] *Transcript of Proceedings (John W. Mayo)*, Before the Public Service Commission of Missouri, Hearing, March 3, 1999, Case No. 99-227 ("*Transcript*"), p. 646, lines 17-24.

[104] *Transcript*, p. 657, lines 11-15.

levels.[105] I submit that the same is the case here: regulators would not permit SBC or SWBT to increase its prices above the competitive level in the unlikely (or impossible) event that it successfully drove its competitors out of the marketplace. Dr. Mayo also volunteers that he is speaking about "classic predatory pricing,"[106] of the sort that I just described. He says that the man or woman on the street may be considering a broader menu of anticompetitive actions than those contemplated under "classic predatory pricing" when they use the term "predatory pricing."[107]

I have to say that I personally have never heard a man or woman on the street talk about predatory pricing. However, I have often heard individual firms opine that price reductions made by their rivals might be anti-competitive, and thereby confuse their own fortunes with the public welfare. Truly abusive pricing is, as Dr. Mayo says, a rare bird. But, allegations of such pricing are not. Firms are all to happy to have the ear of a sympathetic policy makers who might force firms to stop reducing their prices or even to insert a profit cushion into the pricing structure for the benefit of the firm's rivals.

I would not characterize Mr. Kohly as simply a man on the street; I can only take Mr. Kohly at his word that he is concerned about "predatory pricing," though he mentions, but does not specify, "anti-competitive behavior." His arguments are seen to be profoundly incorrect, even by the analysis of one of AT&T's own economists.[108]

**Q.49 SWBT witness Hughes argued that the Commission's ability to set UNE rates and resale discounts will help provide retail pricing discipline. Mr. Kohly concludes that**

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105 *Transcript*, p. 651, lines 18-25, p. 652, line 1.

106 *Transcript*, p. 651, lines 5-17.

107 *Transcript*, p. 656, lines 4-10.

108 Mr. Kohly's concerns about predatory pricing directly conflicts with Mr. Voight's specter where deregulation is "little more than a euphemism to raise prices." (*Voight Rebuttal*, p. 9). Taken together, Staff and Intervenor testimony is a prescription for regulatory stasis and rigidity that is a step away from, not toward, full and fair competition.

**this is not true and that such regulation is no substitute for price cap regulation.**[109] **Please comment.**

A.49 It appears that Mr. Kohly may simply misunderstand Mr. Hughes' argument.[110] His response to the issue is far, far off the point. The argument is this. The Commission has the authority to set UNE prices and resale discounts according to the approaches consistent with TA96. In practice, this means that UNE prices have been set according to some forward-looking costing methodology, and resale rates set according to an avoided cost methodology. Any CLEC in Missouri has UNEs and discounted retail services available to it at Commission established rates. In the case of UNEs, this means that if SWBT increases retail prices it opens a wider margin between UNE rates and retail rates, thus enticing competitive entry and increasing opportunities for CLECs profitably to undercut SWBT's prices, because UNE rates are unaffected by the increase in retail prices. As I explained earlier, the same mechanism applies to some extent to resale services as well. *It is in this way that the marketplace itself can supersede the need for retail price regulation.*

**Q.50 Please comment on Mr. Kohly's example that appears to demonstrate an "SBC Access Cost Advantage" in intraLATA toll calling.**[111]

A.50 In Mr. Kohly's example, "SWBT" faces the economic cost of access ($0.010 per minute in the example), while an "IXC" faces an access price above cost ($0.061 per minute in the example). Mr. Kohly concludes that SWBT "would be able to price its toll services at

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109 *Kohly Rebuttal*, pp. 19-20.

110 See, for example, Direct Testimony of Thomas F. Hughes before the Missouri Public Service Commission, Case No. TO-2001-467, p. 31.

111 *Kohly Rebuttal*, pp. 28-29.

or near the IXCs' cost of providing toll services."[112] Mr. Kohly further submits that SWBT could undercut the IXC and drive it from the market, all in an effort to "gain market share."[113]

Mr. Kohly's analysis is incorrect. First, driving prices to cost is not a sign of anticompetitive behavior, but a predictable and beneficial effect of competition. One of the fundamental tenets of basic economics is that competition tends to drive prices towards costs, thereby eroding profits. While AT&T might bemoan the prospect of lost profits in the long distance market, it is not in the public interest for the Commission to protect AT&T's profit stream from competition.

Second, if Mr. Kohly is implying that SWBT would price *below* cost, his analysis is again incorrect, and such an analysis was demonstrated to be incorrect in the *Schmalensee & Brandon* §271 affidavit that Mr. Kohly himself discussed earlier in his testimony.[114] *Schmalensee & Brandon* say, and I concur, that "this naive argument is flat-out wrong."[115] The reason is found in Mr. Kohly's own tabular example. In that example, if the IXC serves the customer, SWBT generates $0.061 in access revenues and incurs $0.010 in access costs, for a net of $0.051. Suppose for illustration that both SWBT and A&T incur $0.03 per minute in other (non-access) costs of providing long distance and that AT&T prices all the way down to its cost, $0.091 per minute. If SWBT serves the long-distance customer, and matches AT&T's price, SWBT generates $0.091 in revenues, and $0.04 in costs (access costs plus other costs) for a net of $0.051, which is precisely the same net to SWBT as when it sold a minute of access to the IXC. SWBT is therefore indifferent at those prices to providing access to the IXC or providing long-

112 *Kohly Rebuttal*, p. 29.

113 *Kohly Rebuttal*, p. 29.

114 See, for example, *Schmalensee & Brandon*, pp. 31-37.

115 *Schmalensee & Brandon*, p. 32.

distance service itself to the customer *unless SWBT is more efficient than the IXC.* In other words, SWBT has no access cost advantage, artificial or otherwise, because in both cases the firm generates $0.051.

Now if SWBT tried to undercut AT&T's price, it could only do worse. At any retail price below $0.091, SWBT would make less net revenue (i.e., less than $0.051) than it would by selling the same minute to AT&T in the form of access.

**Q.51 Are there other flaws with Mr. Kohly's example?**

A.51 Yes. If SWBT reduces its retail price of intraLATA service in order to win more business, that should be considered a good thing. It is pro-consumer, even if it happens to harm AT&T's parochial interests. As a general rule, lower prices offered by an unregulated firm benefit consumers in the short run, and typically benefit consumers in the long run as well. Situations where lower prices benefit consumers in the short run but harm them in the long run are rare. Such a situation requires that the firm price low enough to drive others (such as AT&T) out of the market and then increase prices to monopoly levels to recoup the forgone profits, while continuing to keep AT&T and all others out of the market as well.

**Q.52 Please discuss another flaw in Mr. Kohly's example.**

A.52 Besides being against SWBT's own best interests, the scenario described in Mr. Kohly's example can exist with respect to originating access only if SWBT remains the sole provider of access in the future. However, given the requirements of TA96, that is no longer the case now, let alone in the future. Because SWBT must provide unbundled loops and UNE-platform, AT&T can integrate into the local service market via its own facilities, UNE loops, or UNE-platform and provide a combined local/toll product to its

customers. AT&T would then retain access charges itself and incur only the actual economic cost of access, at least with respect to originating access. Simply put, AT&T can put an end to all of its concerns about being harmed asymmetrically by a price war in the intraLATA toll business, and that is simply by getting into the local business. To the extent that AT&T expands its local service to those customers that use switched access in a serious way, it neutralizes any possible concerns with SWBT's retail intraLATA toll prices vis à vis SWBT's originating access rates.

**Q.53 So, when Mr. Kohly says that "AT&T has two choices; either provide toll service to the customers or choose not to provide toll service,"[116] he is incorrect?**

A.53 Mr. Kohly is incorrect. Mr. Kohly forgets that AT&T is no longer an "IXC" under TA96, but simply a telecommunications carrier and that the divestiture nomenclature that divided the industry fades into history under TA96. AT&T should expand its efforts in the local residential service market to curb its fears about the access prices.

**Q.54 Please discuss Mr. Kohly's proposed remedies to his concerns about anti-social pricing.[117]**

A.54 Mr. Kohly offers two remedies for his concerns, meritless though these concerns may be. The first is for the Commission to reduce access charges to "incremental cost."[118] The second is to require SWBT to impute access charges to its retail rates.[119]

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116 *Kohly Rebuttal*, pp. 23.

117 *Kohly Rebuttal*, pp. 28, 31.

118 *Kohly Rebuttal*, p. 31.

119 *Kohly Rebuttal*, p. 28.

Mr. Kohly's recommendation to decrease intrastate access charges to incremental cost appears to be disingenuous to me. All knowledgeable observers of the telecommunications industry know full well the historical reason that access charges exceed cost, namely, to keep the price of residential local exchange service lower than it otherwise would be. His proposal puts into the Commission's lap the requirement to rebalance rates by increasing the residential line rate while reducing access charges. While such a rebalancing may be needed, and indeed, may increase social welfare, Mr. Kohly should acknowledge the steps required to implement his proposal.

As for Mr. Kohly's second proposed remedy, he seeks to have the Commission build a profit cushion for AT&T by preventing SWBT from reducing rates below the imputation level. This cushion may comfort AT&T, but it harms consumers.

**Q.55 Mr. Kohly says that his concerns about predatory pricing "extend to the local market."[120] Please respond.**

A.55 Not only does Mr. Kohly err in his analysis for the various reasons I described in my response to Mr. Kohly's discussions about intraLATA toll, but he contradicts the very theory that he himself advanced in the previous case. In his discussion of intraLATA toll, Mr. Kohly's general idea was that deregulation would provide SWBT with the opportunity to increase access rates[121] and decrease retail intraLATA prices in a manner that would "drive competitors from the market."[122] Mr. Kohly now uses the same reasoning in the local marketplace,[123] substituting UNEs for access as SWBT's "monopoly" input.

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120 *Kohly Rebuttal*, p. 32

121 *Kohly Rebuttal*, pp. 26, 27.

122 *Kohly Rebuttal*, p. 28.

123 *Kohly Rebuttal*, p. 32.

The logic of this argument is inconsistent with the facts. After all, nothing in this proceeding would deregulate UNE prices or cause them to be based on something other than on cost. Thus, one of the main pillars of Mr. Kohly's access/intraLATA toll arguments is simply untrue in the case of UNE/local service. The analogy does not transfer.

Moreover, Mr. Kohly then takes the next step to contradict one of his own recommended prescriptions. In the case of access/toll, Mr. Kohly says, "AT&T would support classifying SWBT's toll services as competitive if SWBT's access rates were reduced to incremental cost."[124] It is certainly true that UNEs are based on such an incremental cost analysis yet Mr. Kohly *still* says that SWBT could engage in predatory pricing in local service.[125] I conclude that (1) Mr. Kohly's theory of predatory pricing is just as flawed in the local service marketplace as it was in his discussion of intraLATA toll; and that (2) because Mr. Kohly's theories and recommended policies are internally inconsistent and contradictory they provide the Commission with a basis for making decisions that could only be characterized as arbitrary and capricious.

**Q.56 Mr. Kohly says that other states, such as Texas, have "safeguards to prevent predatory pricing for local exchange services."[126] Please discuss.**

A.56 In the specific instance of Texas, where I have participated in a case related to anticompetitive pricing, I submit that the Texas Commission's position on "safeguards" is considerably more nuanced than the characterization provided by Mr. Kohly on the basis of some sections of the Texas Public Utility Regulatory Act.[127] In that case,[128] one

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124 *Kohly Rebuttal*, p. 31.

125 *Kohly Rebuttal*, p. 32.

126 *Kohly Rebuttal*, p. 33.

127 STATE OF TEXAS PUBLIC UTILITY REGULATORY ACT, (As Amended), Effective as of September 1, 1999.

issue open to the Commission's consideration was a rule that would have created a "rebuttable presumption" of anti-competitive behavior if a carrier's price for a service or package was less than the sum of the TELRIC-based wholesale prices of components.[129] AT&T endorsed the standard.[130] According to the Commission, AT&T argued that any price that did not meet the relevant imputation standards was anticompetitive.[131] The Commission rejected AT&T's position and said:

> [A]n anticompetitive standard is more appropriately developed on a case-by-case basis. The commission finds that circumstances surrounding allegations of anticompetitive behavior may vary significantly from case to case, and therefore a single rebuttable presumption may not adequately address the range of anticompetitive behaviors over which the commission has jurisdiction pursuant to PURA §51.004 and other sections of PURA.[132]

I agree with the Texas PUC that anticompetitive standards are more appropriately applied on case-by-case bases than as a one-size-fits-all rule with a presumption of anticompetitive intent. In many instances, prices that are alleged to be anticompetitive and that are of concern to the ILEC's rival also provide benefits to consumers. Hence, aiding the complainant may well harm the consumer. In such cases, a fact-based analysis would seem to be more appropriate than a simple presumptive rule that protected the competitor but potentially harmed the consumer.

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128 *Rulemaking to Implement PURA Chapter 58 Provisions Relating to Customer Specific Contracts, Pricing Flexibility, and Promotional Offerings*, PUBLIC UTILITIES COMMISSION OF TEXAS, Case Number 21155 Order issued September 29, 2000. (*Texas Flexibility Order*).

129 The issue was the possible implementation of rule §26.226(d)(3):

> **§26.226(d)(3).** There is a rebuttable presumption that the price of the service or package is anti-competitive against a competitor if an electing company's retail price for the service or package of services is less than the sum of the total element long run incremental cost (TELRIC)-based wholesale prices of components needed to provide the service or package of services, respectively.

130 *Texas Flexibility Order*, p. 5.

131 *Texas Flexibility Order*, p. 6.

132 *Texas Flexibility Order*, p. 9.

**Q.57 Mr. Kohly says that there must be a price floor to prevent cross-subsidy of more competitive services by less competitive services.[133] Please comment.**

A.57 The incentive to cross-subsidize is borne of rate of return regulation. Under rate of return regulation, a firm may be able to increase its overall profits by shifting costs from a service class that is unregulated to one that is regulated via rate of return. However, a firm that is not subject to regulation (or is subject to price caps) has no incentive to cross subsidize. There is no institutional mechanism to translate cost shifting, were it to occur, into incremental profitability. Thus, Mr. Kohly's concerns about cross-subsidy are misplaced.

## V. RESPONSE TO WORLDCOM WITNESS DONALD PRICE

**Q.58 WorldCom contends that SWBT's UNE rates are "above economic cost" and this is indicative of SWBT's "market power" and ability to limit entry.[134] Furthermore, OPC contends that "PSC approval of UNE pricing above that in Texas also poses a barrier to entry in Missouri."[135] What is your response to these allegations?**

A.58 First, SWBT does not have market power with respect to UNE prices. The Commission, not SWBT, determines justness and reasonableness of UNE prices in Missouri.

Second, whether or not SWBT has market power with respect to UNEs, that does not determine market power at the retail level. UNEs are provided at regulated rates, on regulated terms. The strong growth in UNE-based services identified in Mr. Hughes' testimony demonstrates that UNEs are serving as a viable component of an entry strategy.

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133 *Kohly Rebuttal*, p. 34.

134 *Price Rebuttal*, pp. 11-15.

135 *Meisenheimer Rebuttal*, p. 15.

Third, the Commission in its recent Order supporting SWBT's initial 271 application explicitly addressed these very same issues. The Order is clear in its response and speaks for itself:

> ...the Commission concludes that SWBT provides nondiscriminatory access to UNEs at any technically feasible point under just and reasonable rates, terms, and conditions, and at cost-based rates, as required by the Act.[136]

With regard to UNE prices exceeding those charged by SWBT in Texas, OPC made this very same point in the §271 proceeding, to which the Commission explicitly responded:

> Some participants in this proceeding, requested that the Commission require Texas pricing in every instance in the M2A. See, e.g., OPC's Post Oct. Hearing Comments at 3; Primary Network's Post Oct. Hearing Comments at 11.
>
> The rates for UNEs in Missouri set in Case No. TO-97-40 are appropriately based on Missouri costs, and the Commission finds the proposal to utilize Texas rates in lieu of Commission-approved TELRIC rates in Missouri to be unreasonable. Prices for most of the network elements that are actually used in volumes by CLECs were established by the Commission in the AT&T arbitrations (Case Nos. TO-97-40, et al. and TO-98-115), and in the DSL arbitrations with BroadSpan (Case No. TO-99-370), Sprint (Case No. TO-99-461) and Covad (Case No. TO-2000-322).
>
> Based on the findings of fact set out above, the Commission also concludes that the non-recurring rates in the M2A are consistent with TELRIC.
>
> The Commission further concludes that the interim rates in the M2A based on Texas rates, are also TELRIC-compliant. Furthermore, the Commission has committed to entering orders establishing permanent rates as soon as possible in cases already established.
>
> The Commission concludes that SWBT's proposed pricing in the M2A complies in all respects with section 252(d)(1)(A).[137]

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136 *Missouri § 271 Order*, p. 69.

137 *Missouri § 271 Order*, p. 74.

Furthermore, the Commission concluded:

> The Commission gave each CLEC that chose to participate every opportunity to raise any issue in response to SWBT's request for authority to provide interLATA long-distance services in Missouri.[138]

**Q.59 WorldCom contends that in your direct testimony you argued "that the mere availability of UNE-P eliminates all potential for market power that it may have in the retail markets."[139] Did you make such a claim in your direct testimony?**

A.59 Curiously, Mr. Price fails to provide a citation to where I make this allegation. It could be because I did not make any such statement. What is true, however, is that UNE-P offers another avenue, like resale but at a different price point, by which carriers can enter the local exchange market without making a significant sunk investment.

## VI. RESPONSE TO SPRINT WITNESS DAWN RIPPENTROP

**Q.60 Sprint offers the following construct for evaluating competition: competing services must be (1) "readily available" and (2) "practical" to use.[140] How does Sprint define these terms?**

A.60 Sprint contends that for a service to be readily available and practical to use the provider must have "ubiquitous coverage," installation intervals that "meet or beat the ILEC," and a quality of service that "equals[s] or exceed[s] the ILEC."[141]

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138 *Missouri § 271 Order*, p.7.

139 *Price Rebuttal*, p. 14.

140 Rebuttal Testimony of Dawn Rippentrop before the Missouri Public Service Commission, Case No. TO-2001-467 ("*Rippentrop Rebuttal*"), p. 5.

**Q.61 Are these reasonable parameters for evaluating "effective competition"?**

A.61 No. First, an analysis of competition does not hinge on the "coverage" of any *one* alternative provider's services but the collective availability of *all* alternative providers' services. Moreover, as I have already explained, ubiquity is not necessarily required if there are no barriers to entering the market. Finally, as was explained in detail in my direct testimony, the extent to which an alternative service competes against an existing service depends not on the equality or superiority of the alternative service, but on the "reasonable interchangeability" of the alternative service's attributes in the eyes of consumers. A "meet or beat" quality requirement says little if anything about the alternative service's substitutability. For instance, in evaluating whether an economy vehicle faces effective competition, the ubiquitous availability of luxury vehicles may not necessarily be useful or relevant, even though the luxury vehicle's attributes would, in some sense, "meet or beat" the economy vehicle's. Instead, what is relevant is identifying those vehicles that are reasonably available and that consumers consider reasonably interchangeable with the economy vehicle.

**Q.62 Intervenors and Staff contend that SWBT's switched access services are not effectively competitive. Can you summarize their opposition?**

A.62 Yes. Intervenors argue that switched access is a "locational monopoly."[142] In particular, Intervenors contend that in the local exchange market, CLECs and SWBT largely compete for end-users, but that an IXC has no choice of access provider for any given

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141 *Rippentrop Rebuttal*, p. 5. See, also, *Price Rebuttal*, p. 6, where he contends that a CLEC would have to replicate SWBT's local exchange network in Missouri in order to effectively compete against the incumbent.

142 *Kohly Rebuttal*, p. 23.

long distance customer. Accordingly, "ILECs have no incentive to lower switched access rates in the face of CLEC competition."[143]

**Q.63 Do you agree with this reasoning?**

A.63 No, I do not agree. Local exchange competition is directly relevant to assessing the extent of switched access competition. As I alluded to earlier, I believe that there is a mechanism for alternative carriers, and the end-user customer's IXC in particular, to constrain SWBT's conduct in the switched access market, particularly on the originating end. This mechanism is the powerful arbitrage opportunities afforded IXCs by access to UNE loops if, as I described earlier, the IXC integrates into the provisioning of local exchange service as contemplated by TA96. If an ILEC were to attempt to exploit a "locational monopoly" and increase its originating switched access prices, it would create a profit opportunity for IXCs.

**Q.64 Please explain.**

A.64 If an ILEC were to increase its originating access rates, it would create the opportunity and incentive for the IXC to attract the customer to its own local service. By self-provisioning access (via SWBT's UNE loops at TELRIC-based rates, via UNE-P, or via its own facilities), the IXC could offer a better price deal to its end-user customers than it could offer as the stand-alone IXC that purchases access from the ILEC.

To see how this works, consider an example. Suppose the originating switched access rate were $0.06 per minute, and the true cost of access were $0.01 per minute. Suppose that the IXC charged its retail customers $0.09 per minute, which covers the IXC's other costs of $0.03 per minute, including capital costs. If the ILEC were to

[143] *Rippentrop Rebuttal*, p. 12.

increase the access rates to $0.07 per minute, the IXC could counter by offering the customer a *discount* of up to $0.05 per minute on its long-distance minutes if the customer were to obtain *both* its local and long-distance services from the IXC. If the customer switched, the IXC's access costs would fall by $0.05 per minute, making such an offer profitable for both the customer and the IXC. Of course, the ILEC cannot replicate this offer if it cannot also offer in-region interLATA long-distance service.

In my opinion, market forces, such as those described above, will inevitably act to ultimately erase the distinction between local and long distance service. That distinction is an artificial one from consumers perspective to begin with, being a legacy of regulatory structure. The fact that loosening regulation on originating access might well induce IXCs to compete more aggressively in the local market, and thereby hasten the disappearance of that regulatory distinction, strikes me as a positive side effect of deregulating originating access, not a problem.

**Q.65 Does this conclude your surrebuttal testimony?**

A.65 Yes.