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December 12, 1995

ORIGINAL FILE COPY

BY HAND DELIVERY

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

Re: Docket No. 950985-TP

Dear Ms. Bayó:

Enclosed for filing on behalf of MCI Metro Access Transmission Services, Inc. (MCImetro) in the above referenced docket are the original and 15 copies of the rebuttal testimony of Mr. Don Price and Dr. Nina Cornell.

By copy of this letter this document has been provided to the parties on the attached service list.

Very truly yours,

RDM

Richard D. Melson

RDM/cc
Enclosures
cc: Parties of Record

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

REBUTTAL TESTIMONY OF

DR. NINA W. CORNELL

ON BEHALF OF

MCI METRO ACCESS TRANSMISSION SERVICES, INC.

DOCKET NO. 950985-TP

(MCIMETRO SUBDOCKET)

DECEMBER 12, 1995

Q. WHAT IS YOUR NAME AND ADDRESS?

A. My name is Nina W. Cornell. My address is 1290 Wood River Road, Meeteetse, Wyoming, 82433.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony responds to the direct testimonies filed by Dr. Banerjee and Mr. Scheye. Because Dr. Banerjee's testimony is both rebuttal in the complaint case brought by Continental Cablevision and direct testimony in the complaint cases brought by MFS and MCImetro, I will refer to it as Banerjee Testimony.

Q. DR. BANERJEE CLAIMS THAT YOU ARE OVERLY PESSIMISTIC IN YOUR EVALUATION OF THE EFFECTS OF BARRIERS TO ENTRY IN FLORIDA LOCAL EXCHANGE MARKETS BECAUSE YOU IGNORE THE NAME RECOGNITION AND MARKETING SKILLS OF FIRMS LIKE AT&T AND THE CURRENT PENETRATION OF FIRMS LIKE MFS. (BANERJEE TESTIMONY, PAGE 7-8) DO YOU AGREE WITH HIS ANALYSIS?

A. No. Dr. Banerjee notes that I and other witnesses raised four specific claims with regard to barriers to entry: (1) large sunk costs; (2) the time it takes for entrants to grow; (3) the need for sunk marketing expenditures; and (4) the need for cooperation from other carriers. Dr. Banerjee addresses only the third of these points. The problem with his reply is that, even if accurate when applied to the local exchange market, it fails to address or overcome the barriers to entry posed by the other three points.

Q. CAN NAME RECOGNITION PREVENT AN ENTRANT INTO LOCAL EXCHANGE MARKETS IN FLORIDA FROM HAVING TO INVEST LARGE SUMS OF MONEY TO INSTALL LOCAL NETWORKS THAT WOULD BE SUNK SHOULD THE FIRM FAIL?

A. No. No matter how great the marketing skills of a firm, they do not reduce the high sunk costs inherent in building local exchange networks. Name recognition, for those firms that do have it, may make initial marketing efforts easier or more successful, but even that is not certain. The very same name recognition that Dr. Banerjee cites for AT&T has not made it easy for AT&T to conquer the computer market.

Q. CAN A FIRM WITH NAME RECOGNITION BUILD A NEW NETWORK ANY FASTER THAN A FIRM WITHOUT?

A. No. Name recognition may make it easier for one firm to gain financing to build a network, but the actual time that it takes to acquire rights of way and to lay plant and equipment does not change because a firm has name recognition. Building networks that duplicate the geographic reach of the networks the incumbent local exchange carriers already have in place will take a very long time, no matter whether the firm that starts to do so has name recognition or not. Moreover, having world-wide interexchange networks will not shorten this time either. Local networks require the placing of plant in places where the interexchange networks do not now reach. There will be no shortcuts possible just because the firm has an interexchange network.

Q. WILL NAME RECOGNITION CHANGE THE NEED FOR ENTRANTS TO HAVE COOPERATION FROM OTHER ENTRANTS AND PARTICULARLY FROM THE INCUMBENT FOR THE ENTRY TO HAVE ANY CHANCE OF BEING SUCCESSFUL?

A. No. Marketing skills cannot overcome obstacles -- in the form of higher costs than those borne by the incumbent -- posed by the refusal of the incumbent to cooperate to the degree necessary for true competition to be possible in these markets. For entrants to be able to offer ubiquitous reach to those customers that might want to use the services of the entrant, cooperation from all other providers is essential.

Q. DR. BANERJEE CLAIMS THAT THERE IS NO BARRIER TO ENTRY CREATED IF INTERCONNECTION CHARGES ARE NOT EQUAL, CONTRARY TO YOUR CLAIM IN YOUR DIRECT TESTIMONY. (BANERJEE TESTIMONY, PAGES 9-10) DO YOU AGREE?

A. No. In a remarkable sleight of hand, Dr. Banerjee announces that there is no entry deterrence due to asymmetric interconnection charges so long as there is what he calls proper imputation, then fails to prove at any place that even his imputation test, which is the wrong imputation test, is met. Indeed, in his discussion on page 49, lines 23-25, he actually proves that even his imputation test cannot be met by the proposed use of switched access charges for interconnection charges.

Q. WHY DOES DR. BANERJEE SAY THERE SHOULD BE ASYMMETRIC

INTERCONNECTION CHARGES?

A. Dr. Banerjee discusses two different reasons for asymmetric interconnection charges in two different places in his testimony. In the section discussing barriers to entry, Dr. Banerjee asserts that BellSouth's interconnection charges levied on entrants should be higher than the charges paid by BellSouth to entrants because of a need by BellSouth to collect "contribution" towards its "special obligations." (Banerjee Testimony, page 9, lines 5-9) Later in his testimony, Dr. Banerjee also discusses higher costs for BellSouth to terminate traffic than the costs incurred by entrants. I discuss this argument below in my rebuttal to Dr. Banerjee's opposition to the use of mutual traffic exchange for interconnection.

Nowhere in his testimony does Dr. Banerjee offer any evidence of the total cost of the "special obligations" he claims BellSouth faces. He also fails to demonstrate that the "contribution" that would be collected would in fact go to pay for those obligations. If there is such a cost, it should be quantified, and any amount needed to recover it should be collected in a manner that ensures that only that amount is collected and that the proceeds are used in the manner intended. This is not the case with the proposed "contribution" in the charges for interconnection. There is no limit on the amount that might be collected, and no demonstration that the funds would be used solely for meeting "special obligations."

Dr. Banerjee does not claim that the discussion in my direct testimony of how unequal interconnection charges would disadvantage an equally efficient entrant is wrong in the absence of "special obligations" on the part of BellSouth. In the absence of any evidence whatsoever of the cost of the alleged "special obligations," the Commission should not allow asymmetric interconnection charges for the reasons given in my direct testimony (pages 9-10).

Q. WHAT IS DR. BANERJEE'S VERSION OF IMPUTATION?

A. Dr. Banerjee claims that the proper version of imputation is to require the retail service of the incumbent to recover its costs plus the same contribution that is included in the price of essential inputs used by entrants. (Banerjee Testimony, page 42, lines 4-14)

Q. WHY IS THIS NOT THE CORRECT IMPUTATION STANDARD?

A. Dr. Banerjee's approach to imputation would allow the incumbent to raise the costs imposed on entrants in order to engage in anticompetitive behavior. The proper imputation standard is to require the incumbent local exchange carrier to recover from its retail service the price it charges for bottleneck monopoly inputs plus all of the remaining costs of providing the retail service. In this way, if the incumbent local exchange carrier provides bottleneck monopoly inputs in less than the most efficient manner, the entrants are not put under a price squeeze caused by the forced inefficiency.

Dr. Banerjee's approach, which would look only at the "contribution" contained in the rate for the bottleneck monopoly inputs, would allow the incumbent to provide the bottleneck monopoly input inefficiently to the entrant, calculate the "contribution," and then provide the bottleneck monopoly inputs to itself in a more efficient manner. The result would be that the incumbent could charge a lower price than the entrant not due to greater efficiency in the provision of the retail service, but due to the ability of the incumbent to force inefficiency on the entrant. This would force equally efficient firms from the market caused by the inefficient provision of the bottleneck monopoly inputs by the incumbent, not the inefficiencies of the entrant.

Q. DOES DR. BANERJEE OFFER ANY EVIDENCE THAT BELLSOUTH'S LOCAL EXCHANGE SERVICES COULD PASS AN IMPUTATION TEST GIVEN THE RATES PROPOSED FOR LOCAL INTERCONNECTION?

A. No. Dr. Banerjee provides no imputation analysis of the proposed rates whatsoever.

Q. YOU SAID HE ESSENTIALLY ADMITS THAT BELLSOUTH'S RETAIL RATES COULD NOT PASS AN IMPUTATION TEST GIVEN THE PROPOSED RATES FOR LOCAL INTERCONNECTION. WHY?

A. Dr. Banerjee claims that local exchange services are provided below cost, yet BellSouth proposes to charge switched access charges for local interconnection. Switched access charges are both above cost and contain a "contribution." Although Dr. Banerjee offers absolutely no support for his claim that local exchange services are provided below cost, if they were, there is no possibility that they would pass an imputation test -- his or the proper one.

Q. GIVEN DR. BANERJEE'S REBUTTAL, HAVE YOU CHANGED YOUR OPINION THAT ASYMMETRIC INTERCONNECTION CHARGES WOULD POSE A SIGNIFICANT BARRIER TO ENTRY?

A. No.

Q. DR. BANERJEE SAID HE FOUND YOUR CONCERN "HIGHLY CONTRIVED" THAT THE USE OF SWITCHED ACCESS CHARGES FOR INTERCONNECTION MIGHT FORCE THE ENTRANT TO MIRROR THE ARCHITECTURE OF THE INCUMBENT. DO YOU AGREE?

A. No. Apparently Dr. Banerjee does not understand switched access charges. Switched access charges have a set number of rate elements: local switching, local transport, and the charges that are established to collect "contribution." One of these is a charge for the use of the customer's local loop, the Carrier Common Line charge.

Dr. Banerjee claims that if an entrant's architecture is different, the entrant could have a different set of rate elements. He specifically claims that the entrant could have a fixed charge to recover "fixed plant (e.g., loops) . . . . " (Banerjee Testimony, page 12, line 23) The problem is that this would violate his earlier claim that only the incumbent or entering firms that have "special obligations" can recover "contribution" in their interconnection rates. Charges intended to recover fixed costs not caused by interconnection by definition collect "contribution."

Q. DO YOU STILL BELIEVE THAT THE USE OF SWITCHED ACCESS CHARGES AS THE MODEL FOR INTERCONNECTION COULD FORCE THE ENTRANT TO MIRROR THE ARCHITECTURE OF THE INCUMBENT?

A. Yes. If the entrant can only charge for interconnection on the switched access charge structure, the entrant would be forced to recover less towards its total costs if it uses an architecture that does not include all of the cost components that are included in switched access charges than it could recover if it mirrored the architecture of the incumbent local exchange carrier. If the Commission does not order the use of Mutual Traffic Exchange, the entrant is likely to have to pay for interconnection on almost all of the local exchange service calls its customers make, particularly at the beginning. The incumbent, on the other hand, will pay for interconnection on only a very small percentage of the local exchange calls made by its customers. The very high proportion of calls that will require the entrant to pay for interconnection means that the interconnection price structure will be a very important consideration for the entrant in determining how it will build its network. The citizens of Florida will lose some of the most important benefits from entry if entrants are deterred from trying new and better architectures for providing services.

Q. DR. BANERJEE CLAIMS THAT YOU ADVOCATE BILL AND KEEP, WHICH IS TERMINATING LOCAL CALLS "FOR FREE." DO YOU AGREE?

A. No. Dr. Banerjee erroneously claims that I propose that local calls be terminated for free. I advocate Mutual Traffic Exchange, which looks much like bill and keep. Mutual Traffic Exchange is not terminating calls "for free." It is instead payment in kind rather than in cash for the service. The requirement that one carrier terminate calls for a second carrier in exchange for the second carrier terminating calls for the first carrier is not terminating "for free."

Q. DR. BANERJEE CLAIMS THAT YOU HAVE OVERLOOKED A NUMBER OF

"CRITICAL REAL-WORLD ECONOMIC FACTORS" WHEN YOU CLAIM THAT MUTUAL TRAFFIC EXCHANGE IS THE MOST EFFICIENT FORM OF INTERCONNECTION ARRANGEMENT. (BANERJEE TESTIMONY, PAGE 14, LINE 20) DO YOU AGREE?

A. No. Dr. Banerjee lists four "factors" that he claims I overlooked when I discussed the efficiency benefits from Mutual Traffic Exchange. These four factors are "(1) customer characteristics; (2) incentives of carriers to minimize costs; (3) carriers' cost characteristics; and (4) carrier requirements for recovering contribution toward the cost of special obligations." (Banerjee Testimony, pages 14-15) I disagree with his analysis of each of these "factors."

Q. WHAT DOES DR. BANERJEE CLAIM IS THE RELEVANCE OF CUSTOMER CHARACTERISTICS TO THE QUESTION OF HOW TO PAY FOR INTERCONNECTION?

A. Dr. Banerjee claims that entrants will seek out customers in a manner that is not independent of the interconnection rate. According to Dr. Banerjee:

> If the terminating switched access charge is outrageously high, the entrant would seek customers with high origination-termination ratios. Conversely, if terminating switched access is free (or priced below the <u>entrant's</u> incremental cost of originating traffic), the entrant would seek customers with low origination-termination ratios. (Banerjee Testimony, page 17, line 24, to page 18, line 6, emphasis in the original)

As a result, he claims that my claim that traffic will tend to be in balance over time is not necessarily true.

Q. DO YOU AGREE WITH HIS ANALYSIS?

A. No. First of all, Dr. Banerjee apparently does not understand when interconnection charges would be paid. Second, he does not understand the incentives facing network operators to gain customers.

A carrier would have to pay an interconnection charge whenever a call originated by a customer of its network terminates to a customer of the other carrier's network. Thus, high origination to termination ratios mean that the carrier with customers of that kind would pay interconnection charges much more often than would the other carrier. If the other carrier had high interconnection charges, the entrant would not want customers with high origination to termination ratios, contrary to Dr. Banerjee's claim.

Dr. Banerjee's alternative example involved the preferences of entrants if interconnection charges were based on Mutual Traffic Exchange. If a customer has a low origination to termination ratio, that means that the carrier to which the customer subscribes would pay for fewer call terminations than would the other carrier. In this setting, however, if the interconnection payment was in the form of Mutual Traffic Exchange, that would mean that the carrier serving the customer would bear the costs for more terminations than would the other carrier. Thus, Dr. Banerjee is wrong that the use of Mutual Traffic Exchange would make the entrant prefer to have customers with a low origination to termination ratio.

The problem with all of this analysis, however, is that entrants are not likely to select customers on the basis of origination to termination ratios. Once a carrier has decided to put facilities in a given geographic area -- namely down some particular street -- that carrier will want to serve every customer that it can profitably serve along that route. Moreover, for a carrier to be able to profitably serve a customer means simply that the additional costs of serving that customer be less than the revenues it could get from the customer. So long as the cost of (1) the rights of way and the facilities in them to go from the street to the customer and (2) the costs of providing switching are less than the revenues to be received, the carrier will happily serve the customer. Even if the facilities go down that particular street because an initial customer had a particularly favorable service profile, it does not mean that the rest of the customers along the route share that profile. Only if the costs of terminating calls on another carrier's network are outrageous, will the question of originating and terminating call ratios become relevant to the customers the entrant would be willing to serve.

Q. DR. BANERJEE CLAIMS THAT HE GIVES ENTRANTS MORE CREDIT FOR "MARKETING SAVVY" THAN YOU IN THAT HE BELIEVES ENTRANTS WILL BE ABLE TO MAKE A DISTINCTION AMONG CUSTOMERS BASED ON ORIGINATION TO TERMINATION RATIOS. (BANERJEE TESTIMONY, PAGE 29, LINES 11-18) IS THIS INFORMATION A MATTER OF "MARKETING SAVVY?"

A. No. Except for 800-type calls, the vast majority of customers do not have any form of records to show how many incoming calls they receive. Moreover, in a flat-rate local exchange environment, most customers also do not have direct information on how many outgoing calls they make, unless they have customer premises equipment that records that data. Short of wire-tapping, entrants cannot know the traffic patterns of most customers. Obviously there are exceptions: airline reservation offices, and phone ordering operations clearly receive many more calls than they make.

These exceptions, however, pose a different challenge for marketing, at least for an interim period. Customers that depend upon a large number of incoming calls for their businesses are the kinds of firms most likely to want true number portability. For at least some time to come, this will not be available. Therefore, unless one of this kind of customer is moving sufficient distances to require a telephone number change in any event, entrants will have little success attracting these customers.

Q. DR. BANERJEE CLAIMS THAT MUTUAL TRAFFIC EXCHANGE WOULD RESULT IN CARRIERS FOCUSING ONLY ON MINIMIZING ITS OWN COST OF DELIVERING TRAFFIC TO THE OTHER CARRIER, AND THAT NO CARRIER WOULD HAVE THE INCENTIVE TO MINIMIZE THE COSTS OF TERMINATING TRAFFIC. (BANERJEE TESTIMONY, PAGE 18-20) DO YOU AGREE?

A. No. Dr. Banerjee completely ignores the incentives of those same carriers to minimize the costs of the terminations that it is performing in exchange for the terminations that the other carrier performs for it. In kind payments are real costs to the companies that perform them, and those companies have real incentives to minimize those costs.

Q. DR. BANERJEE USES THE EXAMPLE OF THE USE OF THE TANDEM, CLAIMING THAT UNDER MUTUAL TRAFFIC EXCHANGE, ENTRANTS

WOULD PREFER TO TERMINATE LOCAL CALLS AT THE TANDEM, RATHER THAN DELIVERING THEM TO EACH OF THE END OFFICES. IS HIS EXAMPLE A GOOD EXAMPLE OF WHAT HE IS CLAIMING?

A. No. He seems to believe that end office terminations would be the most efficient way to terminate traffic. According to Dr. Banerjee:

> As the example of terminating traffic at tandems rather than at central offices shows, incentives to produce the socially most efficient outcome are diminished under bill and keep. (Banerjee Testimony, page 20, lines 14-18)

In fact, however, until the total volumes of traffic reach a certain level, it is more efficient for termination to go through BellSouth's tandems than to have every entrant connected directly to every BellSouth end office. Indeed, based on discussions around the country, incumbent local exchange providers themselves intend to use their own tandem switches to aggregate the traffic intended for the networks of entrants. Dr. Banerjee notes that all carriers have an incentive to <u>deliver</u> traffic at least cost. If it were more efficient for traffic to be delivered by the incumbent to the entrant without use of the tandem, the incumbent would not use the tandem as part of its method of delivering traffic to the entrant.

Q. DOES DR. BANERJEE'S TANDEM SWITCH EXAMPLE RAISE ANY OTHER CONCERNS?

A. Yes. Dr. Banerjee claims that under Mutual Traffic Exchange entrants will not face the costs of using BellSouth's network to terminate calls. What he does not address is that his proposal for charging for interconnection creates incentives for the incumbent to inefficiently impose costs upon the entrants in order to try to block or impede entry. If the incumbent can set how it terminates calls and impose a charge for each element of the routing, it can use how it chooses to route traffic to impose additional costs upon the entrant even if the routing chosen was not the most efficient. Dr. Banerjee's discussion of use of the tandem by entrants raises one possibility. If there are in fact more end offices in the BellSouth network than is efficient, Dr. Banerjee's implicit desire that entrants be forced to connect directly to each end office is just an attempt to raise the cost of entry inefficiently.

Q. DR. BANERJEE ALSO CLAIMS THAT YOUR RECOMMENDATION FAILS TO TAKE INTO ACCOUNT DIFFERENCES IN CARRIERS' COSTS. DO YOU AGREE?

A. No. Dr. Banerjee notes that all carriers may not have the same costs, but then fails to show why this is of any relevance. If interconnection were truly an independent service and if it were possible to have an effectively competitive market for interconnection, there would be a single price for that service, the price set by that market. If different firms had different costs, either the more efficient firms would make higher profits, or those firms with higher costs would be forced out of the market by the firms with lower costs. Which of these outcomes would occur would depend upon whether the lower cost firms could supply the entire market for interconnection or not.

Interconnection is not an independent service, and it is not possible to have an effectively competitive market for interconnection services. It is possible, however, for the Commission to set the terms and conditions for interconnection that would prevail if the incumbent local exchange carriers did not have such overwhelming incentives to try to use interconnection to prevent or deter entry. The best approach is to require the use of Mutual Traffic Exchange, at least for the interim period prior to the full deployment of true number portability. If the Commission chooses any other approach, competition will not bring as many benefits to consumers in Florida, but the Commission can lessen the problems created only if it sets a single rate to be charged by all for interconnection. If it allows asymmetry in the rate, it will prevent equally efficient carriers from entering.

Q. DR. BANERJEE ALSO CLAIMS THAT MUTUAL TRAFFIC EXCHANGE DOES NOT ACCOUNT FOR "BELLSOUTH'S NEED TO RECOVER ITS LOST CONTRIBUTION." (BANERJEE TESTIMONY, PAGE 22, LINES 10-11) DO YOU AGREE THAT BELLSOUTH HAS A "NEED" TO RECOVER LOST CONTRIBUTION?

A. No. Dr. Banerjee claims that:

> Some of BellSouth's retail local exchange services have always been priced above the relevant incremental costs to contribute towards recovery of:
> (1) the fixed common costs of the ubiquitous network,
> (2) subsidies to services priced inefficiently (e.g. basic local services and service to rural customers) to achieve certain regulatory objectives, and
> (3) historical costs not yet accounted for because of uneconomic regulatory depreciation rates. (Banerjee Testimony, page 22, line 17, to page 23, line 3)

He then goes on to argue that customers of entrants should not be able to "avoid" paying this contribution. (Banerjee Testimony, page 23, lines 5-17) What Dr. Banerjee is really arguing is that BellSouth should be made whole in a revenue requirement sense no matter how well or badly it fares in the competitive battle. This would be very bad public policy.

The only possible legitimate concern raised by Dr. Banerjee would be any need to pay for subsidies for universal service. For this to be legitimate, however, he or some other witness for BellSouth would have to prove that such subsidies exist and would have to demonstrate the precise cost imposed by them. Then some mechanism should be devised to ensure that those costs were paid, but it should not be through the price for interconnection. The rest of the "needs" cited by Dr. Banerjee are not appropriately charged to the customers of the entrants. Competition works to force firms to become more efficient, whether the efficiencies show up as lower fixed and common costs, or lower incremental costs of particular services. If the customers of entrants are forced to "contribute" to those costs of BellSouth, one of the two major benefits of competition -- lower costs and lower prices -- will be lost to consumers in Florida.

Q. DR. BANERJEE CLAIMS THAT THE AGREEMENT BETWEEN TCG AND BELLSOUTH ALLOWS FOR MUTUAL TRAFFIC EXCHANGE ONLY IF TRAFFIC IS IN BALANCE, BUT THAT OTHERWISE THERE IS A CASH PAYMENT. DO YOU AGREE?

A. No. The terms of the agreement allow for Mutual Traffic Exchange if the administrative costs of payment for interconnection are greater than the amount of monies to be exchanged. Dr. Banerjee apparently believes this will only occur if traffic is in balance. The agreement, however, caps the amount a carrier might have to pay if traffic is out of balance, by limiting the amount a carrier would have to pay to no more than 110% of the other carrier's traffic. It is entirely possible that the administrative costs of cash payments could exceed the amount of interconnection charges due within the variance permitted under the agreement. Indeed, given BellSouth's desire to limit the amount by which interconnection payments could vary despite traffic imbalances, Mutual Traffic Exchange is clearly the preferable approach to interconnection.

Q. DR. BANERJEE CLAIMS THAT THERE IS NO REASON TO BELIEVE TRAFFIC WILL BE IN BALANCE, AND THAT NICHE MARKETING COULD ENSURE THAT TRAFFIC IS OUT OF BALANCE. DO YOU AGREE?

A. No. I have already discussed why the kind of "niche marketing" Dr. Banerjee expects to occur is in fact unlikely. As entrants acquire customers, they are likely to acquire a number of customers with a wide range of traffic patterns. The merging of these different traffic patterns means that the total traffic is likely to be in balance even if the traffic of some customers is not.

Q. DR. BANERJEE CLAIMS THAT THE FACT THAT ENTRANTS COMPETE FOR CUSTOMERS MAKES THE FACT THAT BILL AND KEEP IS OFTEN USED BETWEEN ADJACENT INCUMBENT LOCAL EXCHANGE CARRIERS MEANINGLESS. DO YOU AGREE?

A. No. Dr. Banerjee correctly notes that "[c]ompetition for customers introduces a strategic variable into the interconnection decisions of carriers." (Banerjee Testimony, page 31, lines 22-24) The overwhelming strategic variable is the ability of the incumbent to use interconnection as an anticompetitive tool. There is no such ability in the case of non-competing adjacent local exchange carriers. That is precisely why the Commission should take very seriously the appropriateness of using exactly the same form of interconnection with entrants. Where the incumbents cannot engage in anticompetitive use of interconnection, they very often choose to use bill and keep. That demonstrates how efficient they themselves view this approach to interconnection. The Commission should order the use of Mutual Traffic Exchange between competing carriers in recognition of the fact that the only difference between the two cases that has any relevance to the issue is the ability of the incumbent to engage in anticompetitive strategic use of interconnection pricing.

Q. DR. BANERJEE CLAIMS THAT YOUR RECOMMENDATION THAT ANY CASH PRICE FOR INTERCONNECTION NOT BE SET ABOVE TOTAL SERVICE LONG RUN INCREMENTAL COST IN ORDER TO ALLOW THE LOWEST POSSIBLE LOCAL EXCHANGE SERVICE RATES IGNORES THE NEED TO SET PRICES BASED ON "SECOND-BEST" PRINCIPLES. (BANERJEE TESTIMONY, PAGES 40-41, 43-45) DO YOU AGREE?

A. No. Dr. Banerjee claims that because of the need to price some services above total service long run incremental cost in order to recover the shared and common costs of the firm, the proper approach to pricing is to set all prices above incremental cost in inverse proportion to the elasticity of demand (the inverse elasticity rule). According to Dr. Banerjee:

> Wholesale services like interconnection are, in general, far less price-elastic than retail services. Efficiency losses from contributions (analogous to per-unit taxes) are minimized

> when the greatest (least) amount of contributions are assessed to the least (most) price-elastic services. Recovering contribution from interconnection can lead to inefficient behavior only to the extent that firms can actually avoid interconnection. As long as contribution is confined mainly to unavoidable services (like interconnection or essential network facilities), the distortions imposed on carriers would be minimal, and the associated welfare losses from recovering contribution from these services should be small. In contrast, recovering contribution only, or mainly, from more price-elastic retail services (which, in many cases, are already priced well above costs) will be correspondingly inefficient and welfare-reducing. (Banerjee Testimony, page 52, line 13, to page 53, line 7)

Dr. Banerjee claims that this is the most efficient form of pricing when prices cannot be set equal to marginal or incremental cost. He also claims that my concern about setting interconnection prices so that local exchange prices can fall as far as possible is nothing more than a lament that prices in telecommunications cannot be set using first-best principles, namely at marginal cost. (Banerjee Testimony, page 45, lines 2-5)

There are several problems with Dr. Banerjee's claims. First of all, use of the inverse elasticity rule can only promote static economic efficiency, but not dynamic economic efficiency. If there is any sector of the economy that is dynamic, it is telecommunications. Thus, pricing rules adopted for telecommunications should work to promote dynamic, not static efficiency.

Second, the rule only has static efficiency effects when the elasticities used are market elasticities, not firm elasticities. The elasticities that would be available to BellSouth to follow this rule are firm elasticities, not market elasticities. Indeed, Dr. Banerjee implicitly endorses the use of firm elasticities when he claims that retail services are more elastic in demand than wholesale services. To the extent that this is the case, it is only because retail customers have some alternative suppliers in some instances. Otherwise, the demand for the input is derived from the demand for the retail service, and the elasticities should not differ.

Third, Dr. Banerjee is wrong when he says that even static efficiency is enhanced using the inverse elasticity rule on prices for intermediate goods and services. Intermediate goods and services are goods and services that themselves are inputs into other goods and services. The static efficiency that can be gained from the use of the inverse elasticity rule only occurs when the services to which this rule applies are final services. Interconnection is an intermediate service, and so should not be subject to the inverse elasticity rule.

Fourth, Dr. Banerjee apparently wants to violate his own proposed imputation requirement. If more "contribution" is to be recovered from wholesale services than from retail services, it cannot be the case that the retail services would pass even his wrong version of imputation.

Q. WERE YOU "LAMENTING" THE NEED TO USE SECOND-BEST PRICES IN TELECOMMUNICATIONS WHEN YOU SAID THAT ANY PRICE FOR INTERCONNECTION HIGHER THAN ITS DIRECT ECONOMIC COST (WHICH IS THE TOTAL SERVICE LONG RUN INCREMENTAL COST) WOULD RESULT IN PRICES HIGHER THAN THEY OTHERWISE COULD BE?

A. No. My concern is simple: any markup over the direct economic cost that is contained in interconnection charges raises the floor price that is possible no matter how robust competition becomes. This is the case because the price for interconnection cannot be competed down. Therefore, any recovery above cost in that rate is shielded from market pressure, even if the amounts recovered go to pay for inefficiencies of the incumbent local exchange carrier rather than efficient costs. If, on the other hand, the rate for interconnection is set just at cost, and no higher, all of the costs of the incumbent firm are ultimately able to be subjected to a market test for efficiency. This is much better for consumers in Florida than the approach advocated by Dr. Banerjee, which is aimed at ensuring that BellSouth recovers the same amount of net revenue whether or not it is the most efficient firm.

Q. DR. BANERJEE CLAIMS THAT INTERCONNECTION PRICING IS SUBJECT TO DISCIPLINE BECAUSE OTHERWISE CARRIERS WILL BYPASS INTERCONNECTION SERVICES. DO YOU AGREE?

A. No. Dr. Banerjee apparently does not understand how switched services work when he says this. No switched local exchange carrier can bypass interconnecting to all other switched local exchange carriers serving customers in the same geographic market because to do so is to cease to provide ubiquitous reach to its customers. Customers demand ubiquitous reach, and will change carriers if the original carrier cannot supply ubiquitous reach. Neither the carrier on whose network a call originates nor the calling customer determines which carrier must terminate the call. That determination is made by the choice of local exchange carrier made by the called party. Thus, the originating carrier cannot bypass the interconnection service of that second carrier. In the passage from his testimony cited above from pages 52-53, Dr. Banerjee appears to contradict this claim of his when he talks about how interconnection is an unavoidable service.

Q. DR. BANERJEE CLAIMS THAT YOUR CONCERN THAT INTERCONNECTION

PRICES SET ABOVE DIRECT ECONOMIC COST WOULD PREVENT LOCAL EXCHANGE RATES FROM FALLING AS FAR AS THEY OTHERWISE MIGHT IS INVALID BECAUSE BELLSOUTH'S LOCAL EXCHANGE RATES ARE CAPPED AT RATES THAT ARE BELOW COST AND AT RATES THAT ARE BELOW WHAT WOULD BE "FIRST-BEST" PRICES. (BANERJEE TESTIMONY, PAGES 49-50) DO YOU AGREE?

A. No. Dr. Banerjee simply asserts that all local exchange rates are below cost. He offers no evidence for that claim. Moreover, he offers no evidence whatsoever that BellSouth is the most efficient carrier, such that even if its rates are below its costs, those are the most efficient costs that could exist in this market. Until there is a fair market test of what are the efficient costs to provide local exchange service, Dr. Banerjee's claims cannot be supported. The only way to have that fair test is to set interconnection prices no higher than their direct economic cost. The most efficient way to set interconnection rates at direct economic cost and no higher is to require carriers to interconnect using Mutual Traffic Exchange. That approach saves the carriers and society the costs of constructing and using measurement and billing systems that do not now exist.

Q. DR. BANERJEE ALSO CLAIMS THAT THE "CONTRIBUTION" INCLUDED IN BELLSOUTH'S SWITCHED ACCESS CHARGES "IS EQUAL TO THE <u>AVERAGE</u> RETAIL CONTRIBUTION FROM ALL OF BELLSOUTH'S CUSTOMERS." (BANERJEE TESTIMONY, PAGE 50, LINES 10-13, EMPHASIS IN THE ORIGINAL) HE CLAIMS THAT THIS MEANS THERE IS NO CONCERN BECAUSE NEW ENTRANTS WILL CONCENTRATE ON ONLY

THE HIGHER "CONTRIBUTION" CUSTOMERS. DO YOU AGREE?

A. No. Once again, Dr. Banerjee has made a claim with absolutely no empirical support. Nowhere does he show that the "contribution" in switched access charges is equal to the average retail "contribution." Indeed, if BellSouth has been imputing switched access charges into its intraLATA toll rates, as it should to conform even to Dr. Banerjee's principle of competitive parity, this claim is almost certainly false.

Even were his claim accurate, his policy conclusion would be flawed. Including a markup over cost in interconnection rates may force entrants to become niche marketers, but this would not be a good public policy approach. The largest gains for consumers in Florida from entry into local exchange markets will come if the interconnection prices are set in such a way that entrants are free to try to market to all consumers, rather than being forced to compete only for the customers who provide the highest net revenue.

Q. DO YOU ALSO HAVE REBUTTAL TO MR. SCHEYE'S DIRECT TESTIMONY FILED IN THIS PORTION OF THE DOCKET?

A. Yes. Most of my rebuttal to Mr. Scheye is the same as the rebuttal I filed in Docket No. 950985-TP (Local Interconnection) (Continental Subdocket). Accordingly I would like to adopt my rebuttal testimony, dated November 27, 1995, as part of my rebuttal testimony in this portion of the docket.

Q. MR. SCHEYE ARGUES THAT BELLSOUTH SHOULD NOT BE FORCED TO ALLOW TWO ENTRANTS TO INTERCONNECT WITH EACH OTHER

THROUGH THE USE OF COLLOCATION BY ONE OF THE ENTRANTS. (SCHEYE TESTIMONY, PAGES 28-29) DO YOU AGREE?

A. No. Mr. Scheye claims that BellSouth should not have to allow such interconnection because that was not what collocation was meant for and because it would violate BellSouth's tariff. Neither of these is a good reason for denying a collocator the ability to interconnect with another entrant in this manner. When collocation was first introduced, there was no local exchange switched services entry. It is not surprising that this was not the initial purpose of collocation. That is not a good reason, however, to allow BellSouth to impose unnecessary costs on entrants.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY IN THIS PORTION OF THE DOCKET?

A. Yes.