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September 29, 1995

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 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

SEPTEMBER 29, 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. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS DOCKET?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony responds to the testimony filed on behalf of BellSouth (Southern Bell). In particular, my testimony addresses the issue of the proper terms and conditions of interconnection and the issues surrounding unbundling and resale.

I. Interconnection for Terminating Local Calls

Q. WHAT ARE THE PROBLEMS WITH THE PROPOSALS OF BELLSOUTH REGARDING COMPENSATION FOR TERMINATING LOCAL EXCHANGE CALLS?

A. There are at least four major problems with the proposals of BellSouth for terminating local exchange calls that originate on a different network. First, BellSouth insists on treating terminating calls as though it were a service that entrants could choose not to purchase should they desire not to do so. This is wrong.

Second, BellSouth proposes a rate level for compensation for terminating local calls for entrants that on its face is anticompetitive. It also does not minimize implementation costs, contrary to the claim of Mr. Varner. Third, BellSouth proposes a rate structure that is both inefficient and anticompetitive, in that it attempts to recover twice for the same costs. Fourth, BellSouth refuses to recognize that it should have to pay the same price for having entrants terminate its calls as it charges entrants to terminate theirs.

Q. WHAT IS THE PROBLEM WITH TREATING TERMINATION OF LOCAL CALLS AS THOUGH IT WERE AN OPTIONAL SERVICE FOR ENTRANTS?

A. The major problem with BellSouth's view of termination of local calls is that it wants to use the service as another profit-making service for BellSouth. If this were to be allowed, one of the major benefits from granting entry would have been reduced or eliminated, namely the ability of entry to compete away inefficiencies and other sources of prices above costs.

Entrants do not want a service from BellSouth to terminate local calls because they do not want to provide this service themselves. Instead, they <u>must</u> use this service in order to be able to be in the local exchange business at all. Customers demand ubiquity of reach -- the ability to call all other subscribers in a local exchange area. This does not mean just the subscribers of a single provider, but all of the subscribers of all of the providers. To supply this, entrants must be able to terminate calls to subscribers of BellSouth. Moreover, once an entrant has a single customer, BellSouth has to get that entrant to terminate calls that originate on BellSouth or else BellSouth no longer would be providing a ubiquitous local exchange service. Thus, terminating local exchange calls is not a service like most normal services, where an entrant can decide for itself whether or not it wishes to acquire that service. Instead, entrants will never be able to avoid using BellSouth to terminate some local exchange calls unless BellSouth ceases to provide local exchange service.

Q. WHAT IS THE SIGNIFICANCE OF THE FACT THAT ENTRANTS CAN NEVER AVOID USING BELLSOUTH TO TERMINATE SOME LOCAL EXCHANGE CALLS?

A. The significance of the fact that entrants can never avoid using BellSouth to terminate some local calls is that entrants can never compete down the cost imposed on them by the compensation they are required to pay BellSouth for that termination. If BellSouth is allowed to charge a payment in cash instead of in kind, whatever is the level of that payment is a permanent part of the costs of the entrants. If BellSouth is allowed to set the payment at any level above cost, the amount by which that payment exceeds cost becomes a part of the minimum possible price for local exchange service. That amount, even if inefficient, cannot be eliminated by competitive pressures, and will remain forever in the floor price the market can reach for local exchange service. This is bad for consumers in Florida. The Commission should not adopt any compensation plan for terminating local exchange calls that prevents the market from driving prices as low as possible. BellSouth's plan does not meet this requirement.

Q. WHY WOULD ANY AMOUNT ABOVE COST PREVENT PRICES FROM

REACHING THEIR LOWEST POSSIBLE LEVEL?

A. It is important to understand that whatever prices are set for compensation for terminating local calls become part of the economic costs of the companies that must pay them. Entrants will be denied service if they do not pay the asking price. Thus, these prices are real costs to the entrants and are part of economic costs, even if those prices are above the direct costs to provide terminations for local calls.

If there is to be any competition at all for the end user services that the incumbent local exchange companies provide at the same time they provide these necessary termination services for their rivals, the prices the incumbents charge their rivals must be part of the price floor facing the incumbent carriers as well. Otherwise, the incumbent local exchange carriers can charge their rivals more for terminating local calls than they recover for providing the whole call, which would allow the incumbents to underprice equally efficient rivals. This is anticompetitive and prevents the development of competition for the services affected. Thus, if any competition is to be possible, the incumbent local exchange carriers must recover in their rates to end users at least the same prices for terminating local calls as they charge their rivals. As a result, whatever those prices are become part of the economic costs of the end user services.

Entrants do not only have costs imposed upon them by the incumbents for terminating calls. They also have direct costs for other inputs into their retail services. Further, they also have indirect costs that they must recover through markups over direct cost in their retail service rates. If the rates that entrants must pay for the incumbent to terminate local calls include some of the recovery of the indirect costs or profits of the incumbent local exchange carriers, two bad effects occur. First, the basic level of prices in the market is higher than it would be otherwise, as all firms will have to price to recover their own indirect costs, and to help recover the indirect costs and profits of the incumbent. Second, the amount of recovery of the incumbent's indirect costs will be shielded completely from competitive pressure.

If prices for terminating calls are set at cost, but no higher, all firms will have to look to their retail customers for recovery of all of their indirect costs, as well as for recovery of their direct costs of providing the retail services. A firm that is inefficient at supplying the functions that do not vary with the volume of service will discover that it has to set its retail prices higher than its more efficient competitors. This will cause it to lose market share, and so force it to become more efficient at performing those functions. This is to the benefit of consumers in Florida.

If, however, prices for terminating calls include a markup over cost, this same market pressure cannot develop for the amount of the markup contained in rates. Basically, it is very important to remember that interconnection rates cannot be competed down. Under those circumstances, the costs recovered in those prices cannot face a market test for efficiency.

If the Commission wants competition to bring retail prices down to the lowest possible cost of providing them, it will have to set the prices for terminating local calls to recover just the economic cost of providing this function and no more.

Q. WHY IS IT APPROPRIATE FOR BELLSOUTH TO LOOK ONLY TO ITS RETAIL CUSTOMERS TO RECOVER INDIRECT COSTS AND EARN PROFITS?

A. It is appropriate for BellSouth and entrants both to recover their indirect costs and profits only from retail customers because carriers go into business to supply retail services, not interconnection services. The need to supply and to use interconnection services is a consequence of the need to interconnect networks, and, while necessary, should not be the source of recovery of indirect costs or profits.

Indirect costs consist of overhead costs and shared costs. Overhead costs are costs of the entire firm that are not attributable to any specific function or service. By definition, these overhead costs are not greater because BellSouth provides interconnection services than they would be if BellSouth did not provide interconnection services. Thus, prohibiting BellSouth from recovering its overhead costs from its interconnection services does not place it at a disadvantage. If any costs that are identified as "overhead" would not exist if BellSouth did not provide those interconnection services, they are misidentified as overhead costs and should be attributed to the interconnection services.

Similarly, costs that are shared by BellSouth's interconnection services and some subset of its retail services, by definition, also would be the same whether or not BellSouth provided the interconnection services. Thus, prohibiting BellSouth from recovering its shared costs from its interconnection services does not place it at a disadvantage.

At the same time, as discussed above, allowing BellSouth to recover these indirect costs from its interconnection services (1) eliminates the potential for competitive market forces to erode these costs, (2) creates the opportunity for BellSouth to place new entrants in an anticompetitive price squeeze, and (3) hampers facilities-based competition initially, but in the long term encourages inefficient investment by new entrants that could result in the unnecessary stranding of efficient BellSouth facilities. Moreover, if BellSouth can recover indirect costs from its interconnection services, it will have the incentive to identify all of its costs that are not direct economic costs -- and perhaps even misattribute some direct economic costs -- as overhead or shared costs, even if these costs are costs associated with inefficient investments or operations or with competitive services. The incentive to do this will be reduced if these costs cannot be recovered from interconnection services.

Q. WHY IS THE RATE LEVEL THAT BELLSOUTH PROPOSES TO CHARGE AS COMPENSATION FOR TERMINATING LOCAL CALLS ORIGINATED ON THE NETWORKS OF ENTRANTS ANTICOMPETITIVE ON ITS FACE?

A. The rate that BellSouth proposes to charge is the same as access charges. BellSouth would charge this rate for just the terminating portion of the call. This rate is higher than the rate that BellSouth charges end users to carry the whole call.

One way to see the problem is to compare the measured service rate to the switched access charge. The measured service rate is 12¢ per message for business, after a 75 message allowance. Assuming a three minute call, that is less than the switched access charges the carrier would pay to terminate a call. Moreover, the problem is even worse for residential users. BellSouth charges 10¢ per message after a 30 message allowance. Residential calls tend to be longer than business calls, so the price squeeze is larger for residential calling.

Q. MR. KOUROUPAS DID AN IMPUTATION TEST FOR RESIDENTIAL LOCAL EXCHANGE SERVICE THAT MR. VARNER CRITICIZED IN HIS TESTIMONY. ARE MR. VARNER'S CRITICISMS VALID?

A. No. In fact, Mr. Varner criticizes Mr. Kouroupas for not taking into account revenues that an entrant might receive from other services as part of the analysis. This only demonstrates that Mr. Varner does not understand what imputation is supposed to do and why it is vital to protect the process of competition, or how imputation should be performed.

Q. WHAT IS IMPUTATION SUPPOSED TO DO AND WHY IS IT VITAL TO THE PROCESS OF COMPETITION?

A. Imputation is absolutely necessary to prevent a price squeeze. The Commission should always require imputation of the price the incumbent charges dependent competitors for all bottleneck monopoly elements into the incumbent carrier's end user rates for services that compete with the services provided by dependent competitors. Otherwise, the incumbent can prevent an equally efficient competitor from entering or remaining in the market because the incumbent will have put that competitor under a price squeeze. This distorts or destroys competition. I discussed the need for imputation and the way in which a price squeeze distorts or destroys competition by creating a barrier to entry in my direct testimony, at pages 22-23.

Q. WHAT IS THE PROPER WAY TO PERFORM AN IMPUTATION TEST?

A. An imputation test should be performed whenever the incumbent supplies a bottleneck monopoly input that is needed by a dependent competitor to provide an end user service that competes with an end user service provided by the incumbent. The proper way to perform an imputation test is to take the retail rate the incumbent charges for its version of the end user service and compare it to the sum of 1) the price charged for the essential input used by the competitor to provide a competing end user service, and 2) all of the remaining costs the incumbent incurs to provide its end user service. If the retail rate for the end user service does not equal or exceed the sum of the two components, it indicates a price squeeze, which is anticompetitive. If the retail rate does not equal or exceed this sum, the Commission should either lower the rate charged for the bottleneck monopoly input, or raise require the incumbent to raise its retail end user rate. Note that an imputation test does not include revenues from or the costs of other services.

Q. WHY ARE OTHER REVENUES FROM OTHER SERVICES IRRELEVANT TO THE PROPER IMPUTATION TEST?

A. The question that an imputation test seeks to answer is whether an equally efficient firm could remain with the incumbent in the market for the end user service, given the price the incumbent charges for the bottleneck monopoly input. If the only way that the dependent competitor could do so is to "borrow" revenues from other services, the dependent competitor cannot remain in the market. Firms without captive monopoly ratepayers do not engage in such "borrowing," because to do so only reduces the profits the firm could otherwise earn. Thus, insisting that the imputation test take into account other revenues is an admission that the rate for the bottleneck monopoly input is anticompetitive, and that the end user service rate does not pass an imputation test.

Q. MR. VARNER CLAIMS THAT THE USE OF BELLSOUTH'S EXISTING

SWITCHED ACCESS RATES MINIMIZES IMPLEMENTATION COSTS. (PAGE 14, LINES 20-22.) DO YOU AGREE?

A. No. Based on cost data supplied in other states, the existing billing system for switched access is one of the most costly billing systems used by incumbent local exchange carriers. Moreover, because it is prone to errors, it imposes additional significant costs to audit and verify the bills. There is no social benefit from imposing these costs on local exchange service, costs which would drive up the minimum possible rates for local exchange service.

Q. WHY DO YOU SAY THAT BELLSOUTH IS PROPOSING A RATE STRUCTURE THAT IS INEFFICIENT AND ANTICOMPETITIVE?

A. Dr. Banerjee, on behalf of BellSouth, criticizes the compensation proposal of Mr. Kouroupas because it only contains a flat capacity charge per month, not both a capacity charge and a usage charge. Dr. Banerjee recommends instead that the Commission first adopt the switched access charge proposal of BellSouth, then move to a two-part charge, one a flat charge and a usage charge in addition. Dr. Banerjee's proposals, if adopted, would prevent any entry into local exchange service. This would deny consumers in Florida all of the benefits that entry into the local exchange market is intended to produce.

Q. DR. BANERJEE OPPOSES THE CHARGE PROPOSED BY MR. KOUROUPAS BECAUSE HE SAYS A CAPACITY CHARGE DOES NOT INCLUDE ALL OF THE COSTS THAT WILL BE CAUSED BY TERMINATING LOCAL

EXCHANGE CALLS. IS HE CORRECT?

A. No. Dr. Banerjee apparently fails to understand at all the principle of cost causation. According to Dr. Banerjee, whenever there are facilities that serve more than one service, there are costs caused by usage. That statement is simply not relevant to the proposal of Mr. Kouroupas, and not always correct.

Mr. Kouroupas recommended that the cost of the additional capacity that BellSouth would have to install to serve peak period demand for local call termination be assessed in a per port charge to the entrant. While I do not know whether Mr. Kouroupas covered all of the elements of cost in his proposal, there is nothing inherently wrong in theory with the idea that the costs caused by a service could be recovered through a charge set equal to the cost of the capacity caused at peak by the service being provided. This is one way that compensation charges could be assessed, should the Commission determine that compensation be in cash, rather than adopting the approach of charging for terminating local calls in kind, which I believe to be a much better approach, as I discussed in my direct testimony at pages 10-20.

There is no basis for Dr. Banerjee's claim that if a facility is shared, there are additional usage charges that should be added to the capacity costs discussed above. In fact, the capacity costs discussed above, assuming they include all of the cost elements, recover all of the costs discussed by Dr. Banerjee. His approach would recover those costs twice over.

Q. DOES THE INEFFICIENCY OF DR. BANERJEE'S APPROACH STEM FROM THE FACT THAT IT TRIES TO RECOVER THE SAME COSTS TWICE?

A. That is part of the inefficiency. The remainder of the inefficiency is the use of the switched access charge rate structure and levels for compensation for terminating local exchange calls. As I noted at page 22 of my direct testimony, use of switched access charges either causes an upward spiral in local exchange rates, or prevents entry. Neither is efficient, and if allowed to go into effect would cause consumers in Florida to miss some or all of the benefits of local entry.

Q. DR. BANERJEE ALSO CALLS CAPACITY COSTS FIXED COSTS. IS HE CORRECT?

A. No. Capacity costs can be variable costs if the total amount of capacity can vary with the total level of usage. For example, the cost of adding a port that carries all of the traffic that can be placed on a DS1 is a traffic sensitive cost. The variance is whether one port is added, or more than one port. Proposing to charge both for the capacity and a rate for the usage would be double-counting.

Q. DO YOU BELIEVE THAT THE COMMISSION SHOULD ADOPT THE PROPOSAL PUT FORWARD BY MR. KOUROUPAS?

A. Mr. Kouroupas' proposal would not be the best approach to compensation for termination of local exchange calls. The best approach would be to adopt Mutual Traffic Exchange, particularly for the period prior to full implementation of true number portability, as I discussed at pages 10-20 of my direct testimony.

This approach is the same as the approach used today between BellSouth and independent local exchange providers, as shown on page 2 of 2 of Mr. Scheye's

Exhibit ___ RCS-1. This is not surprising, given the desire to seek efficiency where there are no gains to carriers from anticompetitive or inefficient behavior. The fact that the incumbent local exchange carriers chose Mutual Traffic Exchange when they could not benefit from anticompetitive behavior is strong support for the Commission to order it in order to ensure efficiency when entry has been allowed.

If, after true number portability has been implemented and been in effect there is a problem of persistent and significant imbalance in traffic being exchanged, the Commission could shift to compensation in cash, rather than in kind. At that time, it could determine whether a capacity charge or a per minute charge would be the most efficient approach.

Q. WHEN YOU REFER TO TRUE NUMBER PORTABILITY, ARE YOU REFERRING TO REMOTE CALL FORWARDING OR DIRECT INWARD DIALING ARRANGEMENTS?

A. No. True number portability ends having the customer's former local exchange provider involved in handling all calls that go to the ported number. This requires some form of data base solution to number portability.

Q. DO YOU BELIEVE THAT TRAFFIC WILL TEND TO BE IN BALANCE AFTER THE IMPLEMENTATION OF TRUE NUMBER PORTABILITY?

A. Yes. Even Dr. Banerjee appears to agree, although he expresses some confusion about what traffic balance really means. On page 12, line 22, to page 13, line, 2, he claims that traffic will move to balance in "the long run." He then goes on to define "better quality" customers as those having the highest ratio of terminating to originating traffic. (Banerjee Direct, page 13, lines 13-18) On page 13, line 22, to page 14, line 3, however, he says:

> if and when traffic volume between BellSouth and the ALEC approaches balance, and the ALEC has the better quality customers (as defined above), we could very well expect no offsetting payments (as Dr. Brock implies in GWB-1) but significant net payment flows from BellSouth to the ALEC.

This claim is nonsense. If traffic is or is approaching balance, there should be no "significant net payments" whether from BellSouth to an entrant or from an entrant to BellSouth. The claim is even more nonsensical, moreover, if BellSouth's proposal were to be accepted, given that BellSouth is demanding that the entrants pay more per minute for compensation than BellSouth would pay the entrants.

Q. YOU ALSO SAID THAT BELLSOUTH REFUSES TO RECOGNIZE THAT IT SHOULD HAVE TO PAY THE SAME PRICE THAT IT CHARGES OTHERS TO TERMINATE LOCAL EXCHANGE CALLS. WHY?

A. Mr. Varner does not explain why, but simply claims that reciprocal compensation does not mean equal compensation. If the Commission were to agree, it would be creating a barrier to entry, as I discussed in my direct testimony at pages 9-10.

Q. MR. SCHEYE CLAIMS THAT IF TRAFFIC IS NOT IN BALANCE, THE INCUMBENT LOCAL EXCHANGE CARRIER SHOULD BE ALLOWED TO CHARGE ITS CUSTOMERS FOR CALLING TO "SPECIFIC TYPES OF

NUMBERS" BUT THAT ENTRANTS WILL HAVE NO SUCH NEED. DO YOU AGREE?

A. No. Mr. Scheye is just trying by subterfuge to get a rate increase that he cannot otherwise get given the current regulation of BellSouth. BellSouth is already paid in full for terminating calls by its own customers. The only reason BellSouth would need to receive more from its own customers is if BellSouth insists on, and the Commission agrees to, a compensation system that requires BellSouth to pay cash to terminate calls on the networks of entrants.

When retail customers subscribe to local exchange service, it has always been the case that the rates they have paid have been considered the price to get calls from them to the called party, with the exception of any reverse billing services. This is true for local exchange services as well. A customer subscribing to flat-rated service pays a specific price each month and is able to place an unlimited number of calls to other parties in the same local exchange calling area. The customer expects all of those calls to be terminated at no charge to the called party. Similarly, if a customer subscribes to measured local exchange service, the customer pays on a usage-sensitive basis, but the charge covers both the origination and the termination of the call. Starting now to charge more for calls to "specific types of numbers" is simply an attempt to charge double for the same calls.

Q. MR. SCHEYE ALSO DISCUSSES THE PHYSICAL MEANS OF INTERCONNECTION THAT BELLSOUTH IS PROPOSING TO MAKE AVAILABLE. HAS BELLSOUTH PROPOSED THE MOST EFFICIENT FORM OF PHYSICAL INTERCONNECTION FOR TERMINATING LOCAL CALLS?

A. No. Mr. Scheye says that all interconnection should occur either at a tandem or an end office. Mr. Scheye does not propose to allow entrants to interconnect using a meet point, although this would be the most efficient form of interconnection.

II. Unbundling and Resale

Q. WHY IS THERE A NEED FOR UNBUNDLING AND INCREASED ABILITY TO RESELL LOCAL EXCHANGE SERVICES?

A. There are at least three reasons why unbundling and removal of resale restrictions are necessary in telecommunications, even though they might not be for most other goods and services. First, telecommunications are very different from almost all other goods and services in our economy. Second, the long history of this market as a regulated monopoly requires attention to how the monopoly is ended. Third, nobody can be certain how much of local exchange service can be supplied competitively, but if only some part can, failure to require unbundling and resale could prevent the necessary market test.

Q. HOW IS TELECOMMUNICATIONS DIFFERENT FROM ALMOST ALL OTHER GOODS AND SERVICES IN THE ECONOMY?

A. There are a number of differences between telecommunications and other goods and services in the U.S. economy, but two of the key ones for analyzing how to structure the market are: 1) the fact that telecommunications services require that all providers be able to be interconnected if the services are to function; and 2) the fact that consumers demand nondiscriminatory ubiquity of reach, at least within a given geographic area. Thus, a firm that wants to provide telecommunications services to a group of customers must be able to interconnect in order to terminate calls to all other telecommunications consumers and to receive calls from all other telecommunications consumers. Moreover, it must be able to do so within a given geographic area at no price higher than is charged by the incumbent.

This is not like almost any other product that consumers buy. If I want to buy coffee, I do not care which other consumers buy coffee, or what types of coffee they buy, so long as a store is willing to sell me the kind of coffee I want at a price no higher than my willingness to pay. Moreover, the price I pay does not depend upon which of my neighbors I am going to invite over to drink it with me.

In contrast, I do care who else subscribes to telephone service, and in some cases I care about what services they have chosen. For example, when trying to send data between computers, it is important to know whether one of the parties subscribes to call-waiting, as that can disrupt computer communications. Moreover, I, like most other customers, would object to taking service from a carrier who charged me different rates for local calling depending upon whom I was calling, when those differences were not based on real cost differences.

Q. WHAT IS THE SIGNIFICANCE OF THE FACT THAT TELECOMMUNICATIONS HAS BEEN A REGULATED MONOPOLY FOR A LONG PERIOD OF TIME?

A. The main significance of the history of telecommunications as a regulated monopoly is that this is not a market like others where entry has always been legal and where various firms could have relatively equal chances to serve the market choosing whatever entry strategies they might want. In virtually all other parts of the economy, firms are free to decide what "parts" -- inputs -- they will make and what "parts" they will buy from third party suppliers as they enter new markets. In local exchange services, because of the past monopoly, the only available supplier of most "parts" is the incumbent. These "parts" can only come from unbundling and the removal of restrictions on resale. This requires action by the Commission, because the incumbent does not want to lose its monopoly, and can avoid or delay doing so by refusing to unbundle or to allow resale.

As I noted above, the question that needs a market test is how much of local exchange service, if any, can be supplied under conditions of effective competition. The market may answer this question in a number of ways. Most discussions assume that the answer may involve customer segments, namely that some customer segments will be able to support effective competition but possibly not others. There is a different possible answer, however. It may well be that from the point of view of efficient supply of services, some of the functions now bundled into local exchange service could be competitively supplied for all, or for virtually all, customers. For example, it could turn out that local exchange switching, including the provision of auxiliary services supplied by switches, could be subject to effective competition, but some or all of the functions now provided by the local loop could not. (I am not making any predictions, just posing a hypothetical.) Essentially, permitting the incumbent local exchange carriers to prevent resale or not to unbundle would amount to allowing them to use their past governmentally-granted monopolies to create unnecessary barriers to entry, thereby preventing the market from giving an accurate answer to the question of where effective competition could develop. This is not in the public interest.

Q. WHY ARE UNBUNDLING AND THE REMOVAL OF RESALE RESTRICTIONS NECESSARY TO ELIMINATE UNNECESSARY BARRIERS TO ENTRY?

A. Unbundling and the removal of resale restrictions are necessary to eliminate the barrier to entry created by attempts to force entrants to enter on a larger scale or scope than the entrants would otherwise choose. The more that an entrant must do from the moment of entry, the less likely entry will be and, if entry does occur, the fewer will be the number of entrants. If a new bakery had not only to bake bread but also to establish retail stores before it could sell any bread, it would pose a significant barrier to entry into the production of bread, and there would be many fewer bakeries than there are today. While this bakery example is obvious, as we are all accustomed to being able to buy different brands of bread in a single grocery store, what should be bundled and what should not are not as obvious in local telecommunication services.

The initial experience with entry in the interstate telecommunications market demonstrates the effects of bundling and lack of resale on the ability to enter and the pace of entry. Initially, AT&T refused all interconnections to competing toll carriers, and there was virtually no entry. It took a series of regulatory and court proceedings to ensure that there would be some interconnections -- an unbundling from the previous end-to-end service approach advocated by AT&T. The offering of interconnections enabled some entry. It was not until AT&T was forced to allow entrants to resell its MTS and WATS services, however, that the entrants could reach out and offer service in any meaningful way to residential users. Without the ability to resell the services of AT&T, the entrants would have had to build their own networks to every community in the country before they could offer toll services that terminated calls ubiquitously throughout the United States. Over time, however, the entrants into the interexchange markets have expanded their networks to reach with their own facilities areas they previously could serve only through resold AT&T services. Today, some of the same changes are needed to unbundle functions involved in providing local exchange service and to increase the ability to resell services currently declared off limits to resale by the incumbent local exchange carriers.

For decades, if not a century, we have been accustomed to the idea that all of our basic local telecommunications needs come from a single firm in bundled form. Because most consumers do not perceive that they can or want to buy unbundled service functions, entrants will also have to offer bundled basic service functions to attract any customers. It may well be, however, that not all of these functions can be produced directly for all customers by entrants, whether from the outset or ever. They will need to be able to buy some functions from the incumbent while producing others in order to provide the entire bundle that consumers expect. If the incumbent can refuse to sell the unbundled functions to the entrants at appropriate prices, entrants who may be equally or more efficient at providing the other piece parts of basic local exchange service will be prevented from entering and increasing the efficiency of telecommunications.

The same analysis applies to the need for resale. As I noted above, unbundling and the removal of resale restrictions are both means of allowing entrants to determine which "parts" needed as inputs into a bundled local exchange service sold to end users they want to make themselves and which they want to "buy" from other producers. This is no different from decisions available to entrants and incumbent firms alike in other parts of our economy.

Q. WHAT ELEMENTS HAS BELLSOUTH SAID IT WOULD UNBUNDLE?

A. Mr. Scheye gives a list of unbundled elements that BellSouth says it will make available. (Page 11, line 15, to page 12, line 2.) One of the problems with his list is the insistence that unbundled loops will be provided through the existing private line tariff.

Q. IS PRIVATE LINE SERVICE THE APPROPRIATE WAY TO PROVIDE UNBUNDLED LOOPS?

A. No. Private lines are an end to end service, not unbundled functions. For example, BellSouth performs all of the testing and engineering for private lines, aspects of service that entering local exchange firms would perform for unbundled local loops.

Q. HOW SHOULD PRICES FOR UNBUNDLED ELEMENTS BE SET?

A. Prices for unbundled elements should be set based on costs. Those prices should also pass an imputation test, so that the combination of those prices and the prices BellSouth charges for its bundled services do not create a price squeeze.

Q. WHY MUST THE PRICES FOR UNBUNDLED ELEMENTS BE SET SO AS TO AVOID A PRICE SQUEEZE?

A. If a price squeeze is allowed to exist, then an equally efficient firm will be prevented from entering the market. Whatever is the relationship of the price set for the monopoly inputs by the supplier to that supplier's cost of providing them, the price set by the monopolist is a cost for a purchasing firm. If that purchaser is equally efficient as the monopoly firm in supplying the end user service, that means that the rest of the purchasing firm's costs are equal to the monopolist's costs for everything but the monopoly input. If there is a price squeeze, however, that equally efficient firm cannot cover its costs at the price established by the monopoly firm for the end user service, and so it cannot enter the market.

Q. WHAT IS BELLSOUTH'S PROPOSAL FOR ADDITIONAL UNBUNDLING?

A. Mr. Varner proposes that the Commission subject any further requests for unbundling under the Open Network Architecture (ONA) framework. In addition to the elements already in the ONA framework that require the party requesting unbundled services to show the utility, technical feasibility, cost feasibility, and market demand for the service, Mr. Varner would also have the Commission require the requesting party show how the unbundling would facilitate competition and why the requesting party could not provide the capabilities itself.

Q. DO YOU AGREE WITH MR. VARNER'S PROPOSAL OF WHAT A PARTY WANTING MORE UNBUNDLING SHOULD HAVE TO SHOW?

A. No. Mr. Varner's list is tantamount to requiring the requesting party to share every aspect of its marketing, construction, and business plans with BellSouth as part of an attempt to gain unbundled elements. This creates enormous barriers to use of any request process, as it would allow BellSouth to learn in advance about every aspect of the requesting party's business and respond in the market likely before it even decides whether or not to unbundle. The Commission should not follow the ONA process when determining whether to order further unbundling by BellSouth.

Q. WHAT SERVICES SHOULD THE INCUMBENT LOCAL EXCHANGE CARRIERS MAKE AVAILABLE FOR RESALE?

A. Incumbent local exchange carriers should make available for resale all of their monopoly basic local exchange services, both in their current forms and unbundled from auxiliary services. By that I mean that incumbent local exchange carriers should make basic local exchange service available for resale, but the reseller should be able to supply any of the auxiliary services that it would like to supply, such as operator services and the like.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.