

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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CHAIRMAN  
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COMMISSIONER  
4 SANDRA D. KENNEDY  
COMMISSIONER  
5 PAUL NEWMAN  
COMMISSIONER  
6 BOB STUMP  
COMMISSIONER

7  
8 IN THE MATTER OF THE REVIEW AND  
9 POSSIBLE REVISION OF ARIZONA  
10 UNIVERSAL SERVICE FUND RULES,  
11 ARTICLE 12 OF THE ARIZONA  
12 ADMINISTRATIVE CODE.

Docket No. RT-00000H-97-0137

11 IN THE MATTER OF THE  
12 INVESTIGATION OF THE COST OF  
TELECOMMUNICATIONS ACCESS.

Docket No. T-00000D-00-0672

13  
14 **NOTICE OF FILING**

15  
16 The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the  
17 Rejoinder Testimony of Dr. Ben Johnson in the above-referenced matter.

18  
19 RESPECTFULLY SUBMITTED this 5th day of March, 2010.

20  
21  
22 \_\_\_\_\_  
Michelle Wood  
Counsel

1 AN ORIGINAL AND THIRTEEN COPIES  
of the foregoing filed this 5th day of  
2 March, 2010 with:

3 Docket Control  
Arizona Corporation Commission  
4 1200 West Washington  
Phoenix, Arizona 85007

5 COPIES of the foregoing hand delivered/  
6 mailed this 5th day of March, 2010 to:

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1 By \_\_\_\_\_  
Ernestine Gamble

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REJOINDER TESTIMONY  
OF BEN JOHNSON, PH.D.  
On Behalf of  
THE STATE OF ARIZONA  
RESIDENTIAL UTILITY CONSUMER OFFICE  
Before the  
ARIZONA CORPORATION COMMISSION

Docket Nos. T-00000D-00-0672 and RT-00000H-97-0137

**Introduction**

**Q. Would you please state your name and address?**

A. Ben Johnson, 3854-2 Killlearn Court, Tallahassee, Florida 32309.

**Q. What is your present occupation?**

A. I am a consulting economist and president of Ben Johnson Associates, Inc., an economic research firm specializing in public utility regulation.

**Q. Are you the same Ben Johnson that filed direct testimony in this proceeding on January 6, 2010?**

A. Yes, I am.

1     **Q. Did you file reply testimony on February 5, 2010 in this docket?**

2     A. No, I did not. The filing date for Staff and RUCO's first round of testimony was on January 6,  
3     2010, more than a month after all other parties filed their direct testimony. Between January 6  
4     and February 5, no additional testimony was filed which could serve as the basis for my reply  
5     testimony. In the interest of conserving resources, I decided to wait until this filing date to file  
6     additional testimony, which gave me the opportunity to respond to the testimony filed on  
7     February 5.

8  
9     **Q. What is your purpose in making your appearance at this hearing?**

10    A. Our firm has been retained by the Residential Utility Consumer Office ("RUCO") to assist with  
11    RUCO's participation in this generic proceeding to investigate the pricing of intrastate switched  
12    access service, including proposals to reduce access rates by increasing local rates, and/or  
13    expanding the Arizona Universal Service Fund ("AUSF"). In this testimony I respond to some  
14    of the points raised in the reply testimony of Staff witness Wilifred Strand, Verizon witness Don  
15    Price, AT&T witness Debra Aron, and ALECA witness Douglas Meredith. The fact that I do  
16    not respond to certain issues raised by the other witnesses in this proceeding should not be  
17    construed as my acceptance of their positions on those issues.

18  
19    **Q. Let's start with Staff witness Wilifred Strand. What portion of his reply testimony do you  
20    wish to address?**

21    A. I would like to briefly comment on his concerns regarding my proposal to make AUSF support  
22    portable between carriers. As I explained in my direct testimony, AUSF support should not  
23    necessarily be limited to the incumbent carrier. Rather, support should be readily transferable  
24    from one carrier to the next, if a customer in a high cost area changes carriers. Mr. Strand noted  
25    such an approach would be "theoretically attractive". However, he is concerned that it would

1 "suffer from some practical shortcomings". [Strand Reply, p. 4]

2 ETC support for each state was capped [by the FCC] at the level of  
3 support that competitive ETCs in that state were eligible to receive  
4 during March 2008 on an annualized basis. Further, portability from  
5 Staffs perspective means that as a customer changes carriers, the support  
6 that follows the customer to the new carrier would be offset by an  
7 equivalent reduction in the support provided to the carrier that loses the  
8 customer. Staff does not believe that such a provision can be  
9 implemented absent the processing of an R14-2-103 filing by a company.  
10 [Id.]  
11

12 I agree that there are practical, logistical and legal issues that would need to be resolved before  
13 implementing any changes to the AUSF. However, such issues need to be resolved in any  
14 event, and they do not arise simply due to my recommendation that support be portable.  
15 Admittedly, these issues might be more complex if the Commission allows other carriers to  
16 participate in the AUSF. Making the AUSF competitively neutral is a fairer, more theoretically  
17 sound approach, which offers significant public policy benefits which justify the additional  
18 effort involved in resolving the associated implementation issues.

19 I would also note that the cap referenced by the Staff witness is a constraint on CLEC  
20 federal support. The cap on federal support should not preclude adopting a policy of  
21 transferability for state universal service support. In any event, there is no need to decide at this  
22 juncture exactly what approach should be used – if the Commission concludes that changes are  
23 warranted to the current arrangements, it should probe into the issues further, and evaluate the  
24 pros and cons of various approaches, before moving forward with implementing any changes.

25 Finally, I would note that, in principle, AUSF support that follows the customer to a new  
26 carrier should be offset by a reduction in the support received by the carrier that loses the  
27 customer. This is what happens in a normal competitive marketplace, where a firm that loses  
28 market share experiences a reduction in its revenues, forcing it to cut costs and increase  
29 efficiency. Unless a similar mechanism is adopted by the Commission, AUSF support will be

1 viewed as an "entitlement" by the incumbent carriers, reducing their incentives to operate  
2 efficiently, and increasing the danger of the fund growing to the point where it imposes an  
3 unreasonable burden on customers located in the urban parts of the state.

4 As I explained in my direct testimony, the potential burden will be particularly severe if  
5 payments from the fund are based upon the incumbent's embedded costs. If the AUSF is tied to  
6 embedded costs, as the incumbent LEC's market share declines, its embedded investment and  
7 other fixed costs will be spread over fewer lines. This would increase its embedded cost per-  
8 line, potentially increasing its per-line draw from the AUSF. If other carriers also draw from the  
9 AUSF based upon the embedded cost per-line of the incumbent, their funding amount will  
10 increase even more rapidly (as they receive an increasing amount per line multiplied times an  
11 increasing number of lines), and the total size of the fund will escalate.

12 The potential for the AUSF to impose an unreasonable burden on urban customers will  
13 vary depending on various aspects of the support mechanism. For instance, if an economic cost  
14 modeling approach is used, rather than an embedded cost-based methodology, the risks are  
15 reduced, since the Commission can readily determine the extent to which economies of scale  
16 should be reflected in the AUSF calculations. Initially, economic costs could be developed  
17 based upon the assumption of a single hypothetical network serving 100% of the customers. If  
18 competition develops in rural areas and market shares decline, the Commission can determine  
19 whether it should continue to use this hypothetical 100% market share assumption, ("as if" the  
20 modeled carrier serves the entire market), or whether it should modify the cost analysis to  
21 reflect a lower assumed market share which reflects less extensive economies of scale (e.g. "as  
22 if" the modeled carrier serves 80% of the market). This flexibility in varying "what if"  
23 assumptions is one of the inherent advantages of an economic cost model. Another key aspect is  
24 the benchmark mechanism which is used, and in particular, the extent to which carriers will be  
25 required to recover some of the high costs of serving rural areas from sources other than the

1 AUSF – for instance, from the rates they charge their retail customers, from the federal high  
2 cost support mechanism, and from rates charged for internet access and other unregulated  
3 ancillary services which are provided by using many of the same network facilities used in  
4 providing basic local service.

5  
6 **Q. Let's turn to the reply testimony of Verizon witness Don Price. What issue raised in his**  
7 **testimony would you like to address?**

8 A. I would like to briefly respond to his comments about recovery of loop costs. In my direct  
9 testimony, I stated that the entire cost of the access line should not be recovered from the  
10 particular end user who requests installation of the line. In response, Mr. Price notes that  
11 Verizon "has proposed that the Commission utilize Qwest's current intrastate access rates as the  
12 benchmark for the ALECA members". [Price Reply, p. 49] Mr. Price further explains:

13 The Qwest intrastate access rates are set well above economic cost,  
14 meaning that those rates contain a contribution toward joint and common  
15 costs, including the cost of the local loop. So leaving aside any  
16 disagreement I might have with Mr. Johnson's cost allocation theories,  
17 the Commission need not be concerned with the scenario Dr. Johnson  
18 portrays. [Id.]  
19

20 I would note that this proceeding doesn't include any cost studies or detailed information  
21 concerning the allocation methodologies supporting Qwest's intrastate access rates, and thus it  
22 isn't feasible to determine what share of Qwest's joint and common costs are being recovered in  
23 its current switched access rates. But, one thing is clear – Qwest's costs are primarily incurred  
24 within the state's urban areas, whereas the focus of this proceeding is on the State's rural areas.  
25 Since per-line costs are higher in rural areas than in urban areas, it is clear that whatever percent  
26 share of joint and common costs is being borne by Qwest's intrastate access rates, a much  
27 smaller share of the analogous costs of rural carriers would be borne by those same rates if they  
28 were applied to smaller carriers operating exclusively within the rural parts of the State. Stated

1 another way, by applying Qwest's access rates to rural carriers, the share of their loop costs  
2 which will be recovered will be substantially less than the share of loop costs which is  
3 recovered by Qwest when charging those same per-minute rates in Phoenix and Tucson.

4  
5 **Q. Let's now discuss the reply testimony of AT&T. What issues would like to address?**

6 A. I would like to respond to several comments made by AT&T witness Debra Aron. Specifically, I  
7 would like to address Dr. Aron's comments regarding the possible effects of rate increases on  
8 universal service; her comments regarding the proper recovery of joint and common costs; her  
9 contention that access charges have not been an effective tool for recovering a portion of  
10 network costs, including joint and common costs; and, the impression she seems to have that I  
11 am recommending a regulatory system which favors new entrants at the expense of established  
12 carriers.

13  
14 **Q. What does Dr. Aron have to say about universal service and subscriber penetration rates?**

15 A. In response to my concerns about the possible negative impact of increased local exchange rates  
16 on universal service, Dr. Aron states:

17 [W]hile the potential effects of retail price increases on overall telephone  
18 penetration is certainly an issue that regulators must attend to, the  
19 evidence suggests that at least some increase in retail rates is tolerable.  
20 Dr. Johnson's testimony fails entirely to recognize that 97 percent of the  
21 population in Arizona over the age of 15 has a wireless phone, and that  
22 the wireless, wireline, and VoiP networks are interconnected; and fails to  
23 appreciate the implications of these 21st century realities for universal  
24 service. As I discussed in my Direct Testimony, even if increasing retail  
25 wireline prices caused some customers to drop their wireline telephone  
26 service, this would not necessarily have any effect at all on universal  
27 service or telephone penetration if those customers choose to rely on  
28 other technologies to meet their communications needs. Only to the  
29 extent that price increases cause customers to drop their wireline phone  
30 and to not subscribe instead to cable telephony, wireless, or some other  
31 form of telephony, would retail rate increases possibly impact goals of  
32 universal service.

1  
2           Nevertheless, it is certainly reasonable to advise the Commission to  
3           “think through the consequences” of reducing access rates and develop a  
4           plan to minimize any potential adverse consequences. [Aron Reply, p.  
5           78]  
6

7           Dr. Aron seems to be suggesting that decreased landline subscribership doesn't matter, since  
8           alternative means of communication exist. However, Dr. Aron has glossed over the inherent  
9           differences between wireline service and "alternatives" such as wireless and VOiP service. For  
10          most customers, wireless (and VOiP) services primarily function as complements to wireline  
11          service, rather than direct substitutes. For instance, some customers may purchase wireless  
12          service for use while driving around the state, or when visiting the nearby towns and cities, even  
13          if they live in a remote area where the wireless carrier's call quality is grossly inferior to that  
14          provided by the regular phone line. There is no evidence in this proceeding concerning call  
15          quality in specific locations within the state, or the extent to which wireless and broadband  
16          alternatives are available in various parts of the state, or the prices that are charged for these  
17          other services. Absent more evidence concerning these issues, the Commission should not  
18          assume that the universal service goal could be maintained even without the state's rural  
19          wireline carriers.

20  
21          **Q. What are some of the important differences between wireline service and alternatives like**  
22          **wireless and VOiP?**

23          A. First, there are significant differences in the way these services are priced. Wireless and VoiP  
24          services typically are provided as a package offering which includes various enhanced services  
25          and long distance services. As a result, they are generally priced far higher than incumbent's  
26          stand alone basic exchange service. Further, wireline services are typically priced on a flat fee  
27          (unlimited local usage) basis. Wireless services, on the other hand, are typically priced on a

1 monthly volume of calling basis. The more you expect to use the phone, the more you can  
2 expect to pay for wireless service – either because of per-minute charges or because of the need  
3 to purchase a pricing plan with a large bundle of minutes. The pricing structure of wireline  
4 services typically allows users to pick up the phone as often as they want, and allows them to  
5 talk to others in their local calling area as much as they want, without having to be concerned  
6 they might receive a large bill at the end of the month. In contrast, the wireless industry  
7 continues to price its services with respect to anticipated usage levels. Because of consumer  
8 preferences, there has been a strong trend away from pure per-minute pricing of wireless  
9 services, toward “bundled” pricing. Yet, even with the decline in per-minute costs resulting  
10 from increased economies of scale and favorable trends in technology, the wireless industry  
11 continues to price most of its offerings on the basis of different levels of anticipated usage.

12 Another important consideration when comparing wireless service to wireline and VoIP  
13 service is the quality of the calls that can be placed on each. Wireline services typically provide  
14 higher quality, more reliable communication than these alternatives. Calls placed over land lines  
15 are typically dropped less often than calls placed over wireless facilities. Further, land line calls  
16 are less subject to weather interference; they are not subject to structural interference; they are  
17 less subject to congestion problems; they are less frequently subject to cross talk; and, they are  
18 less frequently subject to static, noise, fading, and other aspects of poor sound reproduction.  
19 Although wireless service offers the advantage of greater mobility, it does not serve a close  
20 substitute for wireline consumers who care about having consistently accurate, noise-free sound  
21 reproduction. Given a choice between pulling a cell phone out of their pocket or walking across  
22 the room to use a conventional phone, consumers will often choose the latter option because of  
23 these differences in sound quality and reliability.

24 Just as postal service, overnight delivery services, and email service all serve as  
25 occasional alternatives to wireline phone service, a limited degree of substitution between

1 wireless and wireline services have always occurred in practice, at least at the edges of the  
2 market (for certain customers and certain situations). Although the minority of people who  
3 have abandoned wireline service in favor of wireless or VOIP services is increasing, wireless  
4 and wireline services have always been, and to a great extent continue to be, complementary  
5 services, rather than close substitutes. While exact comparisons are difficult to make, because  
6 of the many differences between wireless and wireline services, it was (and is) obvious that the  
7 Commission cannot simply ignore the public policy benefits of offering universally available,  
8 reasonably priced wireline local service throughout the state – nor can the Commission assume  
9 that wireless or broadband cable service will provide an adequate, cost-effective alternative to  
10 traditional basic local exchange service in rural areas. Thus, it is reasonable to continue to  
11 provide support for the high cost of providing that service – through intrastate access charges,  
12 the AUSF, or (preferably) a combination of the two.

13  
14 **Q. Hasn't AT&T proposed a graduated implementation of local exchange rate increases?**

15 A. To a certain extent. As explained by Dr. Aron:

16 AT&T proposed to reduce intrastate access rates to interstate rates  
17 immediately, but phase in price increases over time to replace that  
18 revenue by setting a maximum annual price increase. The forgone  
19 revenue that is not recovered through the annual increase would be  
20 replaced with AUSF funds in the short run, but the AUSF support would  
21 be decreased and the retail price would be increased until it reaches an  
22 established benchmark over a measured period of time (for example, two  
23 years) to minimize rate shock. Such a plan would provide Arizona long  
24 distance customers with the benefits from reduced access rates  
25 immediately, would reduce incentives for arbitrage, and would decrease  
26 the distortions to intermodal long distance competition, while phasing in  
27 the necessary retail rate increases over time and to a level that the  
28 Commission considers acceptable and consistent with universal service  
29 goals. This plan meets Dr. Johnson's objectives of increasing efficiency  
30 (by decreasing access rates right away) while moving slowly and  
31 deliberately on retail price increases that he believes could reduce  
32 telephone penetration. [Id., p. 79]

1 I agree that phasing in any allowed price increases would help avoid the risk of rate shock and  
2 ameliorate the potential for price changes leading to reduced subscriber penetration. As well, to  
3 the extent access charge reductions are passed through to customers in the form of dollar-for-  
4 dollar reductions in retail intrastate long distance rates in the state, the resulting reduction in  
5 phone bills will also serve to ameliorate the impact of higher local rates to some extent.

6 However, AT&T hasn't provided sufficient assurance that if it obtains the access charge  
7 reductions it is requesting, those reductions will, in practice, be fully passed-through to retail  
8 long distance customers in the state. Nor is there any reason to assume that the long distance  
9 market is sufficiently competitive to ensure an immediate, dollar-for-dollar reduction in retail  
10 long distance rates. Absent a specific, enforceable promise to pass through any rate reductions,  
11 a decision to reduce access rates and increase local rates will not necessarily leave retail  
12 customers whole – the overall net impact may be to shift money from the bank accounts of the  
13 state's retail customers, to the accounts of its telecommunications carriers.

14  
15 **Q. What does Dr. Aron have to say about the proper recovery of joint and common costs in**  
16 **the context of access charge reform?**

17 A. In my direct testimony, I explained that for more than 30 years, AT&T and other long distance  
18 carriers have been arguing, in various ways and various forums, that they should be allowed to  
19 use the local networks without paying anything for this privilege. In response, Dr. Aron states:

20 AT&T is proposing to pay rates that by all evidence exceed the ILECs'  
21 costs of providing switched access service to AT&T. ... The cost  
22 associated with switched access is the cost of switching and associated  
23 transport, not the cost of the loop. [Id., p. 80]

24  
25 Dr. Aron has conveniently ignored my discussion of more than 90 years of court decisions and  
26 regulatory practice regarding the appropriate recovery of loop costs, and other joint and  
27 common costs. As I pointed out in my direct testimony, in 1923 the U.S. Supreme Court, in

1            Smith vs. Illinois Bell Telephone Company rejected the costing approach preferred by Dr. Aron,  
2            in which long distance services are assumed to only be responsible for their direct costs. The  
3            Supreme Court concluded that allocating the entirety of loop costs onto intrastate service would  
4            result in an "undue burden" on that category of service. The same principle applies within the  
5            intrastate jurisdiction, with respect to unduly burdening local exchange service. This principle  
6            of fairly distributing the joint or fixed costs of the network to all of the users of the network has  
7            been repeatedly applied and upheld since then. Despite continued arguments like the one  
8            advanced by Dr. Aron, the policy of spreading these costs across multiple services has been  
9            affirmed in numerous proceedings throughout the country. [See, e.g., Johnson Direct, p. 7 et.  
10           seq.]

11  
12    **Q. Haven't the interexchange carriers recently had some success with their argument?**

13    A. Yes. The wireless carriers have been successful in persuading the FCC to allow them to access  
14    the local networks without paying much, if any, of the joint and common costs of the network,  
15    and the interexchange carriers have persuaded the FCC to greatly reduce per-minute interstate  
16    access charges, and to adopt various other policies that have the effect of shifting costs onto  
17    local customers. While some aspects of those policies may be considered successful at least in  
18    some respects, there are other aspects that are problematic. For example, the FCC has been  
19    relying on a federal USF mechanism to ameliorate the potential impact on rural carriers and  
20    rural customers -- but the federal USF has grown rapidly in size, and the FCC hasn't figured out  
21    how to completely solve that problem. It is currently investigating the issue, and is relying on a  
22    freeze to constrain the size of the fund.

24    **Q. Can you now discuss Dr. Aron's contention that access charges have not been an effective**  
25    **tool for recovering a portion of network costs, including joint and common costs?**

1 A. In my direct testimony I stated that although the Commission could consider the possibility of  
2 deviating somewhat from the status quo, including the level of access charges, I recommend the  
3 Commission adhere to traditional cost recovery patterns absent extraordinary circumstances.

4 In reply, Dr. Aron referred to these cost recovery patterns as a "crumbling and antiquated  
5 system of excessive access rates". [Id., pp. 80-81]

6 [Access revenues] create a self-reinforcing downward spiral of support  
7 for LECs because high access rates force wireline long distance rates up,  
8 which makes wireline long distance service less competitive relative to  
9 wireless and other technologies that do not pay access rates to the same  
10 extent as do wireline IXCs, or do not pay them at all; customers migrate  
11 from wireline to other forms of long distance communication; and access  
12 revenues dry up for the LECs that they historically supported. [Id., p. 81]  
13

14 I will acknowledge the the FCC has been expanding the discrepancy between federal and state  
15 interconnection compensation policies, which is putting downward pressure on the support local  
16 exchange carriers receive from intrastate switched access charges. The FCC has preempted  
17 state regulation of wireless and broadband internet access services, and it is allowing wireless  
18 carriers to originate and terminate in-state long distance calls on the wireline local exchange  
19 networks without requiring these carriers to pay intrastate switched access charges. This has led  
20 to pricing practices in the wireless industry which blur the distinction between local and long  
21 distance calls. All of these federal regulatory policies are placing downward pressure on  
22 intrastate long distance prices and calling volumes.

23 Due to the pressures exerted by these federal policies, it may be helpful to reduce  
24 reliance on switched access rates and to concurrently expand reliance on the AUSF as the  
25 primary mechanisms used to support the high cost of phone service in rural Arizona. A shift  
26 toward the AUSF would be particularly logical if it is feasible to broaden the scope of the AUSF  
27 to include participation from wireless and broadband carriers. If the revenue base of the AUSF  
28 were substantially broadened, to include additional carriers and additional services – including

1 both wireless services and internet access services – it would be easier to protect customers  
2 from unreasonable increases in basic local exchange rates.

3 However, I would point out that, in my direct testimony I was not arguing against any  
4 changes whatsoever, nor was I opposed to a well-thought-through shift toward greater reliance  
5 on the AUSF. Rather, I was arguing that any changes to these support mechanisms need to be  
6 carefully planned and researched, and that the burden of proof should lie with the parties  
7 advocating the proposed changes.

8

9 **Q. Can you now discuss Dr. Aron's implication that you are recommending a regulatory**  
10 **scheme that favors new entrants at the expense of established carriers?**

11 A. In my direct testimony I pointed out that the Commission should carefully evaluate the potential  
12 consequences of proposed realignments of telecommunications prices at this stage in the effort  
13 to transition toward a more competitive market. I also noted that the policy changes being  
14 advocated in this case won't necessarily help new entrants gain a foothold in the market, and  
15 may hinder further progress towards effective competition. Dr. Aron apparently misunderstood  
16 these comments to mean I favored somehow subsidizing new entrants:

17 Helping new entrants gain a foothold in the market, is not a valid or  
18 responsible public policy goal. Helping new entrants gain a foothold in  
19 the market means subsidizing them, protecting them from competition,  
20 applying rules unequally to them, or otherwise enhancing their ability to  
21 succeed beyond what the quality and costs of their own business can  
22 accomplish. Such market intervention is harmful to competition and  
23 harmful to consumers. This is a classic flaw associated with what is  
24 known as the “infant industry” Often implemented in the form of tariffs  
25 to protect a fledgling domestic industry from foreign competition, the  
26 “infant industry” rationale encourages policy makers temporarily to  
27 handicap incumbents or offer preferences to their less-experienced rivals  
28 in order to boost the latter’s ability to compete and overcome the alleged  
29 advantages of incumbency. There are many pitfalls associated with infant  
30 industry regulations, which cause economists, as a whole, to question  
31 their wisdom in most circumstances. [Id., p. 82]

1  
2 Effective competition is a valid public policy goal, and need not be inconsistent with the goal of  
3 universal service. Nothing in my testimony suggests that I am in favor of subsidizing new  
4 entrants, or "protecting them from competition, applying rules unequally to them, or otherwise  
5 enhancing their ability to succeed beyond what the quality and costs of their own business can  
6 accomplish."

7           However, in this industry barriers to entry tend to be very significant -- including  
8 barriers that have been created by, or are perpetuated by, various government policies. Thus, it  
9 is reasonable and appropriate for the Commission to consider whether various policy options  
10 have the effect of either increasing or lowering those barriers. Changes in the structure of the  
11 AUSF or other policy options being considered in this proceeding can and should be evaluated  
12 with respect to whether those changes will encourage or discourage entry into the industry. For  
13 instance, policy changes which reduce the availability of revenues from access charges may  
14 have the effect of reducing the profitability and viability of competitive local exchange carriers  
15 (CLECs). Similarly, policy changes which have the effect of increasing the size of the AUSF  
16 may have the effect of increasing barriers to entry into rural markets – particularly if the AUSF  
17 continues to be effectively available only to the incumbent local exchange carriers. In  
18 recommending that AUSF funding be treated as “portable” support which follows customers,  
19 rather than carriers, so that if a customer “votes with their feet” by changing carriers, AUSF  
20 funding support would shift to the new carrier, I am recommending that the Commission should  
21 try to avoid policies which make it more difficult for new entrants to gain a foothold in the  
22 industry.

23  
24 **Q. Can you briefly discuss recent competitive trends in the telecommunications industry?**

25 **A.** The largest single step to opening up the entire industry in general, and the local exchange

1 market in particular, was adoption of the 1996 Telecom Act, in which Congress mandated the  
2 removal of many barriers to competitive entry. This triggered an enormous shift in the  
3 structure, and regulation, of the local exchange market. The 1996 Act established a national  
4 policy in favor of local competition, and it declares invalid all state rules that restrict entry or  
5 otherwise limit competition in telephone service. While the 1996 Act reduced legal barriers to  
6 entry, it was not as effective in removing economic barriers to entry. None of the firms with the  
7 greatest expertise in local telephony ever made any substantial effort to enter any of the local  
8 exchange markets dominated by other incumbent carriers. Like “the hound that didn’t bark,”  
9 this absence of significant market penetration is extremely significant, and it strongly suggests  
10 the continued presence of very substantial (albeit not highly visible) barriers to entry. If  
11 competitive entry were as easy as the large incumbent carriers often claimed, (or barriers to  
12 entry were as insubstantial as they claimed), then at least one or two of these carriers would  
13 have started to vigorously compete with each other.

14 Rather than realizing the vision of numerous small carriers vigorously competing with  
15 each other in each local market, we have instead seen massive industry concentration similar to  
16 that which characterized this industry from the early 1900's until the old Bell System was  
17 broken up by the AT&T divestiture. Wave after wave of mergers have been approved by  
18 regulators, consolidating many of the Regional Bell Operating Companies, numerous  
19 independent (non-Bell) local exchange carriers, once-independent long distance carriers, and  
20 many of the largest, most innovative competitive carriers. Still other small players were  
21 eliminated from the industry through various bankruptcy filings. This crescendo of mergers  
22 reached its climax when Verizon was allowed to acquire MCI and SBC was allowed to acquire  
23 AT&T. The Verizon acquisition of MCI was particularly noteworthy since MCI had previously  
24 completed a long series of mergers and acquisitions, in which it gobbled up dozens of  
25 competing long distance carriers, internet backbone carriers, and competitive local exchange

1 carriers. As a result of these mergers, AT&T and Verizon control huge portions of the internet  
2 backbone and long distance markets, in addition to large shares of numerous wireline and  
3 wireless markets throughout the country. Yet, neither of these firms has shown much interest in  
4 competing with each other in the traditional basic local exchange market, or in the broadband  
5 internet market. The lone exception is wireless, where they do compete aggressively.

6  
7 **Q. What are the consequences of this industry consolidation?**

8 A. First, this consolidation has directly and indirectly reduced competition in various markets  
9 throughout the country. Second, consolidation allowed some of the largest, most highly  
10 advantaged firms to expand and strengthen their already-dominant position within the industry,  
11 making it even harder, or impossible, for smaller firms in the industry, or new entrants, to  
12 compete with these “mega-carriers”. Arguably, this long series of mergers has undone much of  
13 the benefits wrought by the 1996 Telecom Act, facilitating a trend toward a more co-operative  
14 or shared oligopoly market structure, in which a relatively small number of firms, led by  
15 Verizon and SBC, dominate specific geographic regions and market segments, while avoiding  
16 to various degrees direct, head-to-head competition in many segments. Third, many of the  
17 firms that had been aggressive, independent participants in the regulatory, legislative and  
18 judicial processes (E.g., AT&T, MCI, WorldCom, Metropolitan Fiber and other firms that were  
19 acquired by MCI) are no longer providing an effective counterbalance to the advocacy efforts of  
20 Verizon and AT&T before the FCC, state legislatures, and state regulatory bodies.

21 Although the consolidation hasn't been as extreme in the wireless industry, the FCC and  
22 other policy makers have also authorized a massive consolidation of that part of the industry.  
23 Federal officials initiated a policy of widely disbursed spectrum licenses, which initially  
24 encouraged dozens of new entrants into the industry, and ensured that that nearly every major  
25 metropolitan market had half a dozen competing carriers – including some smaller local and

1 regional carriers. Policy makers subsequently approved a series of mergers and acquisitions  
2 which allowed large amounts of spectrum to be concentrated into the hands of a small number  
3 of firms that face each other in numerous markets throughout the nation – AT&T, Verizon, T-  
4 Mobile, and Sprint-Nextel.

5  
6 **Q. What about the cable companies? Doesn't their entry into the telecommunications**  
7 **markets indicate some level of competition?**

8 A. Yes. Cable companies, with their vast networks, are uniquely situated and are an important part  
9 of the overall competitive picture. However, their success is based upon some unique  
10 circumstances, and not simply the result of reduced barriers to entry. In fact, during the  
11 Triennial Review proceedings earlier this decade, the FCC placed little weight on evidence  
12 concerning telephony services provided over cable television facilities when analyzing barriers  
13 to entry. For example, the FCC stated that a cable company providing local phone service  
14 “provides no evidence that competitors have successfully self-deployed switches as a means to  
15 access the incumbents’ local loops, and have overcome the difficulties inherent in the hot cut  
16 process”. [FCC Triennial Review Order, ¶440]

17 While government policy has often been designed to encourage entry and effective  
18 competition, not all policy decisions have worked out as intended or expected. As this brief  
19 historical review makes clear, there is good reason to be concerned about the “unintended  
20 consequences” of policy changes. I want to be clear that I am not proposing an "infant  
21 industry" approach, which would subsidize inefficient firms, or skew things in favor of smaller  
22 carriers and against the largest firms. Rather, I am simply suggesting that the Commission  
23 ought to think carefully about the potential impact of alternative policy options that are before  
24 it. In evaluating the pros and cons of various policy alternatives, the Commission should be  
25 cognizant of the potential impact of those alternatives on the policy goal of encouraging

1 effective competition, and it needs to think carefully about the potential effects of its actions –  
2 before implementing drastic changes to existing industry arrangements. Otherwise, changes  
3 that are intended to solve problems in one area may result in worse problems in another area.  
4 The Commission should try to avoid increasing barriers to entry, and it should try to take  
5 proactive steps to design policies which do not favor larger firms over smaller ones, or favor  
6 incumbent firms over new entrants – thereby advancing effective competition as one aspect of  
7 its public policy decisions.

8  
9 **Q. Can you now turn to the reply testimony of ALECA? What issues do you intend to**  
10 **address?**

11 A. I would like to briefly respond to ALECA witness Douglas Meredith's comments regarding cost  
12 trends in the telecommunications industry, and his comments regarding unregulated activities  
13 and revenues. With regard to the first issue, Mr. Meredith states:

14 Although switching costs have fallen with technological advances, the  
15 costs of placing aerial and buried cable and constructing outside plant  
16 structures have increased. Because of lower population densities, cable  
17 and plant costs are also proportionately higher for ALECA's members.  
18 One mile of cable could serve hundreds if not thousands of customer  
19 [Sic.] in Qwest's urban areas. By contrast, one mile of cable may well  
20 serve far fewer than a hundred customers, even as few as one customer  
21 per mile. Dr. Johnson also ignores how competition is eroding revenues.  
22 Like similar incumbent LECs all across the country, ALECA member  
23 companies have lost access lines to competitors (e.g., wireless carriers  
24 and VoIP service providers). At the same time, the high fixed costs of  
25 local telephone service in a specific geography have not fallen as quickly  
26 (if at all) as line losses, thereby tending to raise the cost of access per  
27 line. [Meredith Reply, p. 10]

28  
29 I do not dispute the fact that costs are higher than average in rural areas where there are  
30 relatively few customers per mile of cable. However, this testimony doesn't really address the  
31 point I was making, which is that there have been favorable downward cost trends in the

1 industry which should not be ignored. Unlike many sectors of the economy, in the  
2 telecommunication industry the cost of many services has declined over time. In more recent  
3 years, one of the most important ways this phenomena has been seen is in the ability to spread  
4 the cost of utility poles and other fixed plant investment across both voice and data traffic. As  
5 internet traffic has grown, the effective cost per unit of information communicated has  
6 continued to decline sharply over time. These cost trends should facilitate a downward trend in  
7 costs for the ALECA members.

8 The ability to use local network facilities for both voice and data purposes has greatly  
9 reduced the “real” cost of voice traffic – although the impact of this favorable trend isn't  
10 necessarily fully reflected in the cost data reported for intrastate regulatory purposes, which  
11 doesn't necessarily reflect the full impact of increasing volumes of data traffic. Whether an  
12 incumbent LEC’s “actual” costs of voice traffic have been increasing or decreasing over time  
13 will depend in part upon how successfully it has responded to changing technological and  
14 economic conditions. In this regard, it is important to realize that outcome of these trends in the  
15 future may depend, in part, on the regulatory policies and incentives adopted by this  
16 Commission. For instance, if the AUSF were to be greatly expanded, structured in a manner  
17 which makes it exclusively available to the incumbent LECs, this may largely insulate them  
18 from pressures to operate as efficiently as possible, to adopt cost-effective new technologies,  
19 and to improve their work processes. An expanded AUSF, which is not competitively neutral  
20 would make life easier for the owners and managers of the ALECA member firms, but it would  
21 not advance the public interest. A sound approach to the AUSF will provide encouragement and  
22 incentives for the incumbent LECs to cut their costs as much as possible, and to continually  
23 increase their efficiency. Even if there is little actual competitive entry into rural markets, the  
24 threat of potential entry may be an important force pressuring these firms to control their costs,  
25 and take full advantage of favorable technological trends, thereby ensuring that the AUSF does

1 not place an undue burden on urban customers.

2 Taken to the extreme, a poorly designed high cost support system, would provide the  
3 incumbent LECs with guaranteed 100% recovery of their “actual” costs, no matter how high,  
4 and allow them to indefinitely preserve any excess profits they may currently be generating,  
5 while protecting them from competition, by ensuring that no other firms are allowed to draw  
6 from the AUSF. Even worse, such a poorly designed policy would require retail customers in  
7 urban areas to provide these carriers with full compensation for any lost revenue or margin  
8 which these firms experience when customers reduce their reliance on traditional wireline  
9 service or increase their use of wireless and broadband communications. Clearly, a properly  
10 designed AUSF should not insulate these firms from the pressures that encourage a typical  
11 competitive firm to operate as efficiently as possible, nor should it guarantee these firms will  
12 continue to receive their existing level of revenues and profits, regardless of how high their  
13 current profits, or how little effort they make to control their costs.

14

15 **Q. Finally, can you respond to Mr. Meredith's comments regarding unregulated activities?**

16 A. In my direct testimony, I recommended the Commission look closely at how the unregulated  
17 services affected the share of network cost borne by regulated intrastate services. Mr. Meredith  
18 replied:

19 [T]he FCC has prescribed elaborate rules for allocating incumbent LEC’s  
20 accounting costs between regulated and unregulated activities. 20 CFR  
21 64. ALECA’s member companies participating in these proceedings, all  
22 comply with FCC rules. Therefore all nonregulated activities of the  
23 ALECA members have already been removed and should not be a factor  
24 in this proceeding. [Id., p. 11]

25

26 I don't find this argument persuasive in the least. The Commission should look into this issue  
27 closely. It should not ignore this issue, or assume the FCC's rules are adequate to deal with the  
28 issues that are relevant to this proceeding, or to assume that this Commission has no say in

1 determining the appropriate allocation of costs for intrastate jurisdictional purposes –  
2 particularly in the context of a fair value rate base analysis, or to assume that there are no  
3 ambiguities, or room for interpretation of those rules. A cavalier dismissal of this important  
4 issue is particularly inappropriate when coupled with the ALECA members' opposition to any  
5 form of rate case or regulatory review of their existing earnings.

6 Some parties are arguing that AUSF increases can appropriately be authorized without  
7 looking closely at the earnings of carriers or the impact of growth in internet access and other  
8 non-jurisdictional services. AUSF (or local rate) increases should not be approved merely  
9 because the rate changes would be "revenue neutral." A policy of "revenue neutrality" is  
10 appealing to carriers, since it protects them from adverse changes in their revenues, but it is not  
11 fair to customers. Revenue neutrality fails to protect customers from bill increases, it fails to  
12 ensure that the public interest is protected, and it is not a sufficient basis for waiving the  
13 requirement that rate changes be accomplished in the context of appropriate findings concerning  
14 fair return on fair value.

15 Preferably, the Commission would consider reductions in access charges in conjunction  
16 with individual rate case proceedings, which would allow the Commission to closely examine  
17 all of these issues, including the appropriate allocation of shared network costs to internet  
18 access and other non-regulated services. However, if the Commission were to conclude that  
19 individual rate proceedings would impose too large an administrative burden, and are not  
20 legally required, then it should at least probe into these issues in the context of a future phase of  
21 this proceeding, after collected detailed accounting information from the carriers and providing  
22 an ample opportunity for the parties to conduct detailed discovery concerning that information.  
23 Detailed, carrier-specific fact finding investigation is needed, to ensure that urban customers are  
24 not required to make higher than necessary payments into the AUSF. As part of this on going  
25 investigation, the Commission should look closely at the appropriate allocation of loop costs

1           and other shared network costs to internet access and other unregulated services.

2

3   **Q.   Does this complete your rejoinder testimony, which was prefiled on March 5, 2010?**

4   A.   Yes, it does.