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March 10, 2010

VIA FEDERAL EXPRESS
Kandace F. Melillo
Administrative Law Judge
Pennsylvania Public Utility Commission
400 North Street
Keystone Building, 2nd Floor
Harrisburg, PA 17120

Re: Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and The Pennsylvania Universal Service Fund, Docket No. I-00040105

AT&T Communications of Pennsylvania, LLC, *et al* v. Armstrong TelephoneCompany - Pennsylvania, *et al*, Docket No. C-2009-2098380

Dear Honorable Melillo:

Enclosed for filing in the above-captioned consolidated matters please find the original and two copies of Statement No. 1.0R, Rebuttal Testimony of Michael D. Pelcovitz On Behalf of Comcast Phone of Pennsylvania LLC and Comcast Business Communications, LLC. All parties to these matters have been served with this filing.

Kindly direct any questions regarding this filing to the undersigned.

Sincerely,

John C. Dodge

Enclosure
cc: James J. McNulty, Secretary
(Please return a Stamp/Return copy of this filing in the envelope provided)
Service List

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PA PUBLIC UTILITY COMMISSION
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund	: : : :	**Docket No. I-00040105**
AT&T Communications of Pennsylvania, LLC ***Complainant***	: : :	
v.	:	**Docket No. C-2009-2098380,**
et al.		
Armstrong Telephone Company - Pennsylvania, et al. **Respondents**	: : :	

PUBLIC

STATEMENT NO. 1.0R

REBUTTAL TESTIMONY

OF

MICHAEL D. PELCOVITS

ON BEHALF OF

COMCAST PHONE OF PENNSYLVANIA, LLC and *COMCAST BUSINESS*

COMMUNICATIONS, LLC

DATED: March 10, 2010

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, TITLE AND BUSINESS ADDRESS.

A. My name is Michael D. Pelcovits. I am a principal with the economic consulting firm of Microeconomic Consulting and Research Associates (MiCRA). My business address is 1155 Connecticut Avenue, N.W., Washington, D.C. 20036.

Q. DID YOU FILE DIRECT TESIMONY IN THIS PROCEEDING?

A. Yes. I filed direct testimony on behalf of on behalf of Comcast Phone of Pennsylvania, LLC and Comcast Business Communications, LLC, (hereafter "Comcast") on November 30, 2009.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my testimony is to respond to several assertions and arguments made by witnesses testifying on behalf of the Pennsylvania Telephone Association ("PTA") and CenturyLink. I will refer to these parties collectively as the RLECs. I will also respond to the mischaracterization and misinterpretation of my testimony by Dr. Wilson (on behalf of the Office of Small Business Advocate ("OSBA")) and Dr. Loube (on behalf of the Office of Consumer Advocate ("OCA")). My testimony is organized according to the subject matter raised by these witnesses:

1. The RLECs' claim that high access charges must be maintained to enable the RLECs to maintain affordable local rates in the high-cost rural areas that they serve.
2. The RLECs' claim that this case is principally about transferring money from the RLECs (and their customers) to the largest long distance and wireless companies.
3. The RLECs' (and OSBA's) claim that the carriers receiving a reduction in access charges will not pass through their lower costs to their customers.
4. Dr. Wilson's and Dr. Loube's claims that long run incremental cost should not be the basis for setting switched access charges.

II. USE OF EXCESSIVE ACCESS CHARGES TO SUBSIDIZE LOCAL EXCHANGE SERVICE IN RURAL AREAS

Q. WHAT REASON DO THE RLEC WITNESSES GIVE FOR MAINTAINING SUCH HIGH INTRASTATE SWITCHED ACCESS CHARGES?

A. The RLEC witnesses argue that high access charges provide implicit subsidies to help cover the high cost of serving rural areas. Absent a replacement of lost access revenues with an increase in explicit subsidies, they say that their local rates would have to increase to unacceptable and unsustainable levels. Mr. Zingaretti, testifying for PTA, further elaborates that the cost incurred by the PTA companies of providing universal service is driven primarily by the very rural nature of the areas they serve.[1] He states that "the major driver of cost is the overall rural nature of the area served by a local exchange carrier," as measured by population density.[2] He then compares the average density of the areas served by the small companies (30.5 lines/square mile), the larger RLECs (49.4 lines/square mile), and Verizon (193.2 customers/square mile), and concludes that "this reliable indicator of higher cost of service is not influenced by the overall size of the company or its corporate affiliations."[3] This justifies, according to PTA and CenturyLink, a continuation of subsidies flowing from the large carriers, serving mostly dense areas, to the smaller companies serving the less dense areas.

Q. DO YOU AGREE THAT THE COST OF SERVING A GEOGRAPHIC AREA IS DRIVEN BY DENSITY?

A. Yes. I agree that line density or customer density is a very important cost driver. I disagree, however, with the RLECs' claim that above-cost access charges can be explained or justified by cross-subsidization of local rates in the highest-cost rural

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[1] PTA Statement No. 1.0, Docket C-2009-2098386, *et al*, Prepared Direct Testimony of Gary M. Zingaretti on behalf of the Pennsylvania Telephone Association Companies (filed Jan. 20, 2010) (hereinafter "Zingaretti Direct") at 26, *et seq*.

[2] *Id.* at 28.

[3] *Id.* at 28-9.

areas. Indeed, while a properly-designed USF subsidy mechanism would likely be targeted at customers in the lowest density areas of the State, the actual cross-subsidy built into existing intrastate switched access charges does not appear to be targeted in this manner. As I will demonstrate below, there is little correlation between the density of the area served by an RLEC and its dependence on above-cost switched access rates to "support" reasonable local exchange rates. My analysis of the data provided by the RLECs on density and access cross subsidies demonstrates that the entire logic of the RLECs' position does not hold together. The RLECs' paradigm cannot be sustained, and their protestations about the dangers of bringing intrastate access rates into parity with interstate rates should be rejected by the Commission.

Q. WHAT ANALYSIS DID YOU PERFORM OF THE RELATIONSHIP BETWEEN ACCESS CROSS SUBSIDIES AND THE DENSITY OF AN RLEC'S SERVING AREA?

A. I analyzed and combined two data sets provided by Mr. Zingaretti. The first data set provides the impact on local rates for each of the PTA companies from a "flash cut" to parity with interstate rates.[4] This data set provides the rate increase per line needed to fully offset the loss in access revenue caused by bringing

[4] Zingaretti Direct at PTA Exhibit GMZ-13.

intrastate rates into parity with interstate rates. It also provides the level of 1-R rates that would be necessary following the flash-cut to parity. The second data set provides the line density of each of the PTA companies, measured as the number of lines per square mile.[5] Mr. Zingaretti used this information to calculate and compare the line density of the PTA companies to Verizon.

I analyzed these data to explore the relationship between the density of an RLEC and the impact of a flash cut to parity on local rates. I conducted regression analyses using a variety of specifications, all of which failed to turn up any systematic relationship between these two variables.[6]

Q. PLEASE EXPLAIN THE STATISTICAL ANALYSIS THAT YOU PERFORMED.

A. I considered two different measures of the impact on local rates of a reduction in access charges to parity. The first measure is the rate increase per line; the second measure is the actual level of the "flash cut" 1-R rates. One or both of these measures should pick up the effect of a reduction in the access "cross subsidy" on

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[5] Zingaretti Direct at PTA Exhibit GMZ-14.

[6] I also performed the same analysis using the flash cut 1-R rates that would result from setting the RLECs' rates equal to Verizon's intrastate rate, *i.e.*, the Verizon proposal in this case. The results of the analysis were similar to those from the proposal to require parity between each RLEC's interstate and intrastate switched access charges.

an RLEC's customers. The first measure, the rate increase per line, should capture the size of the existing cross-subsidy from access charges relative to the petitioner's proposal of a flash cut to interstate parity. The second measure, the level of 1-R rates following a flash cut to parity, should reflect the relative importance of the existing access cross-subsidy in maintaining local rates at the current benchmark, $18/month, across all of the PTA companies. The advantage of this second measure is that will adjust for differences in local rates among the RLECs, which are now being cross-subsidized by access charges.

Q. WHAT ARE RESULTS OF YOUR STATISTICAL ANALYSIS?

A. The first result I will present is a simple correlation coefficient between either measure of the cross-subsidy and line density. A correlation coefficient measures whether two variables tend to move together (either in the same direction or in the opposite direction). The correlation coefficient ranges from minus one to plus one, and the closer the coefficient lies to either 1.0 or to -1.0, the more the two variables are said to be correlated – i.e. when one varies the other will too. A correlation coefficient of zero means that the two variables move independently.

As shown in the table below, the correlation coefficient between density (or in the alternative, the log of density) and either measure of cross-subsidy is nearly zero.[7] One would expect that the correlation coefficient would be highly negative (much closer to negative 1.0), reflecting the supposed relationship between low density and the need for a larger subsidy. The results of this simple statistical test imply that the cross-subsidy provided by access charges is not related to the density (and cost) of the serving area of the RLEC.

[BEGIN CONFIDENTIAL]

[7] Throughout this analysis, I considered whether using the logarithm of density would have any significant effect on the results. (This could be true if the relationship between density and the access cross-subsidy was non-linear.) There was no significant difference between results using levels versus logarithms of density.

[END CONFIDENTIAL]

I also conducted a number of other regression analyses to test the hypothesis that low density would be responsible for a larger historic subsidy. I included other variables, such as the number of lines served by the RLEC, and also removed some of the outlying observations. (I include several of these regression results in Appendix I.) None of these changes to the specification of the regression altered the results in any meaningful way.

Q. WHAT DO YOU CONCLUDE FROM THIS ANALYSIS OF THE DATA PROVIDED BY MR. ZINGARETTI?

A. The data show unequivocally that the excessive intrastate switched access charges are not being used to provide a targeted cross-subsidy to the RLECs serving the highest cost areas of Pennsylvania. Rather, the amount of the cross-subsidy going to each RLEC (on a per-line basis) is quite random in relationship to density, which according to PTA is the key cost driver for its member companies. Other factors must be responsible for the size of the access charge subsidy, yet the RLECs do not appear to feature these factors in their testimonies. The conclusion

I draw is that these other unexplained factors do not provide a good policy justification for maintaining high access charges.

III. PUBLIC POLICY RATIONALE FOR LOWERING ACCESS CHARGES

Q. WHAT CLAIM HAVE THE RLECS MADE ABOUT THE MOTIVATION OF THE OTHER CARRIERS FOR SEEKING ACCESS CHARGE REDUCTIONS?

A. Mr. Zingaretti (on behalf of PTA) claims that the strategy and goal of the carriers seeking access reductions is to increase their profits at the expense of rural customers and carriers. Specifically, he states that the proponents of access reductions have "offered no support that reductions to their expenses are in the public interest" or would benefit Pennsylvania consumers.[8] He also states that that "this entire proceeding is a calculated event, which if successful, would transfer tens of millions of dollars from local service providers and their customers to the largest long distance and wireless carriers in the country."[9]

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[8] Zingaretti Direct at 4.

[9] *Id.* at 5.

Q. DO YOU AGEE WITH THE RLECS' CHARACTERIZATION OF THE PRIVATE AND PUBLIC GAINS FROM ACCESS REDUCTIONS?

A. No. I believe that Mr. Zingaretti is posing a false dichotomy between the interests of the proponents of access reductions and the public interest. This case concerns RLEC access charges that are substantially greater than these same companies' charges for identical call functionality (*i.e.*, local and interstate call termination), and even more out of line with the rates charged by other companies. It is imperative from a public policy standpoint that these rates be reduced to align more closely with cost and the rates for other types of call termination. (As I stated in my direct testimony, the key policy issue is the rates for terminating traffic, which have a much greater impact on the market than originating access charges.) Failure to set the rates for the terminating access bottleneck service at (or close to) cost harms consumers and distorts market behavior and the development of competition in rural areas.

The proponents of access charge reform have every reason to seek reductions in the call termination fees, which are totally beyond their control (due to the terminating access bottleneck). This will benefit the originating carriers, as it will increase their ability to control costs, and reduce arbitrary and artificial distinctions in the cost of call termination. This does not mean, however, that access charge rate-setting is a zero-sum game, whereby any gain from access reductions will have an equal and offsetting loss to the public from some other rate increases. Consumers benefit when prices are aligned with cost, rather than being set by a carrier with substantial market power.

Q. HOW ARE CONSUMERS AFFECTED BY EXCESSIVE ACCESS CHARGES?

A. Terminating access charges are a cost of doing business of the calling party's voice service provider. Excessive access charges, therefore, translate into an increased cost of doing business for the calling party's service provider. In a competitive market, these costs will be passed through to consumers in higher prices for calls – either in per minute rates or in higher monthly flat charges.

Contrary to the RLEC witnesses' assertions, however, this is not a zero sum game. When prices are not aligned with cost, consumers will make decisions based on false information, and either use too little or too much of a service, relative to the economically-efficient level of output. This is true for the RLECs' customers, as well as companies such as Verizon, AT&T, Sprint, and Comcast. For example, a rural customer may choose landline over wireless service, because of false price signals, even though he or she would prefer wireless service if prices were set at cost. Finally, if broader public policy goals are at jeopardy when prices are set at cost, it is far more effective to address these problems with an explicit subsidy program, which would provide targeted funds to achieve well-defined social objectives and not become a "make whole" mechanism to replace lost access revenues.

Q. HOW IS COMPETITION AFFECTED BY EXCESSIVE ACCESS CHARGES?

A. Competition will be affected most directly when direct competitors to the RLECs are unable to recover equivalent terminating access revenues from serving the same type of customer, either because of legal restrictions or internal business practices that would be costly to alter in order to copy the RLECs' distorted pricing practices. The wireless carriers fall under the category of potential direct competitors to the RLECs that are barred legally from charging terminating access charges. Other facilities-based voice service providers, such as Comcast, may not face a legal barrier to matching the RLECs' access charges, and may even do so when using an RLEC tandem. When Comcast uses only its own facilities to terminate traffic, however, it has chosen to avoid the billing disputes and the arbitrage activities that these excessive terminating rates engender. Finally, it is important to note that even if a RLECs' competitor charges identical per minute terminating access rates, competition could still be distorted by factors such as the relative amounts of inbound to outbound calling of each carrier's customers. Markets will perform much more efficiently and consumers will benefit more if these idiosyncratic and artificial incentives are eliminated by bringing access charges and other intercarrier compensation rates to cost-based levels or by adopting a bill and keep regime.

IV. PASS-THROUGH OF ACCESS CHARGE REDUCTIONS

Q. WHAT POSITIONS HAVE THE RLEC AND OSBA WITNESSES TAKEN ON WHETHER THE ACCESS REDUCTIONS WILL BE PASSED THROUGH TO CONSUMERS?

A. Several witnesses claim that the interexchange carriers will not flow through some or all of reduced access charges. Mr. Zingaretti claims that historically the interexchange carriers ("IXCs") have actually increased long distance rates when access rates were declining or stable.[10] Mr. Bosnick says that IXCs have not demonstrated that prior access reductions were passed through.[11] Mr. Lindsey and Mr. Harper claim that since long distance is part of a bundle, no decline is possible in the implicit "free" price of toll within the bundle.[12] Dr. Wilson also

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[10] Zingaretti Direct at 5.

[11] CenturyLink Statement No. 3.0, Docket C-2009-2098386, *et al*, Direct Testimony of David F. Bosnick on behalf of The United Telephone Company of Pennsylvania LLC d/b/a CenturyLink (filed Jan. 20, 2010) at 16.

[12] CenturyLink Statement No. 1.0, Docket C-2009-2098386, *et al*, Panel Direct Testimony of Jeffrey L. Lindsey and Mark D. Harper on behalf of The United Telephone Company of Pennsylvania LLC d/b/a CenturyLink (filed Jan. 20, 2010) at 27.

states that toll carriers would likely profit by passing through less than the full amount of access charges to their toll customers.[13]

Q. WHAT IS YOUR OPINION OF THE CLAIMS MADE BY THESE OTHER WITNESSES ABOUT THE PASS-THROUGH OF ACCESS CHARGE REDUCTIONS?

A. The pass-through issue is a red herring, *i.e.*, an effort intended to divert attention from the real problem at hand. Pass-through is an irrelevant issue and should not be factored into this proceeding, because the toll market and the market for bundles are workably competitive and the toll carriers' rates are constrained to cost-based levels. Hence, if the cost of providing toll service falls due to a decrease in access charges, then the toll rates will flow through the benefits of the access charge reduction to consumers.

The only logical alternative to this proposition is that the toll market is not competitive, such that toll carriers can retain a substantial portion of cost reductions. In other words, if the toll carriers have significant market power then consumers are being overcharged now and will be overcharged even more after access rates are reduced. But if the Commission were to adhere to such a view, it

[13] OSBA Statement No. 1, Docket C-2009-2098386, *et al*, Direct Testimony of John W. Wilson on behalf of the Pennsylvania Office of Small Business Advocate, (filed Jan. 20, 2010) (hereinafter "Wilson Direct") at 14.

would be logical to attack the problem directly by regulating the rates charged by these companies.

The simple truth of the matter is that the toll carriers[14] face competition, which, although not perfect textbook competition, is sufficient to insure that consumers benefit from cost reductions and that regulation of the toll carriers' retail rates would be wasteful and costly.

I also dispute the RLECs' claim that the toll carriers have not passed through access reductions in the past. I have not analyzed the issue in Pennsylvania, but base my opinion on my expertise in analyzing the pass-through issue raised at the Federal Communications Commission ("FCC"). The simple truth is that pass-through cannot be measured without extensive empirical work, in order to adjust for factors such as, changes in rate structure or creation of new rate plans and changes in other costs.[15] Also, pass-through cannot be analyzed without data on revenues and quantities of each toll carrier over a sufficient period of time. Simply put, a serious pass-through analysis cannot be done

[14] I use the term toll carriers in response to the way the RLECs present the issue. In reality the carriers that pay terminating access charges to the RLECs will be wireless and wireline carriers serving customers throughout the State.

[15] For a discussion on pass-through in telecommunications *see* T. Randolph Beard, et al, *The flow through of cost changes in competitive telecommunications: Theory and evidence, in* EMPIRICAL ECONOMICS 30:1-19 (2005).

without abundant data and sophisticated economic tools. Otherwise, the results are likely to be misleading.

Finally, there is another "wrinkle" that makes a pass-through analysis even harder to undertake. If the purpose of the analysis is to test whether the toll carriers are acting competitively, then it is not sufficient to test whether access charge reductions are passed-though on a dollar-for-dollar basis. Rather, it is necessary to analyze the shape of the demand curve and the supply elasticity, because in a competitive market pass-through can be greater or less than 100% depending on these factors. Indeed, there is a large and sophisticated body of literature on the pass-through issue (much of it related to tax incidence), which bears on the matter.[16]

For these reasons, I recommend that the Commission adhere to its current policy to treat the toll market (and the bundled service market) as competitive, and accept the logical policy judgment that access cost reductions will be passed through to consumers and provide significant benefits to consumers.

[16] For a recent survey of the literature on tax incidence theory *see* Don Fullerton and Gilbert E. Metcalf, *Tax Incidence*, *in* HANDBOOK OF PUBLIC ECONOMICS, VOLUME IV (Alan J. Auerbach and Martin Feldstein eds., 2002).

V. APPRORIATE COST STANDARDS FOR ACCESS CHARGES

Q. IN YOUR DIRECT TESTIMONY IN THIS CASE, WHAT COST STANDARD DID YOU PROPOSE FOR SETTING ACCESS CHARGES?

A. I proposed that the reasonableness of access charges should be judged relative to the long run incremental cost ("LRIC") of providing the service. LRIC is the standard measure used to assess the impact of rates on efficiency and consumer welfare. Since the evidence is quite clear that the LRIC of switched access is very close to, if not equal to, zero, there can be no cost justification for current levels of the RLECs' intrastate switched access charges.

Q. WHAT CRITICISMS HAVE DR. WILSON AND DR. LOUBE LEVELED AGAINST YOUR POSITION ON USING LONG RUN INCREMENTAL COST AS THE BASIS FOR SETTING SWITCHED ACCESS CHARGES?

A. Dr. Wilson states that my "assertions … are entirely unencumbered by fact. The undeniable facts in this case are that local access exchange facilities are, as described above, very costly and that they are required and designed for toll service as well as for local service."[17] He goes on to say that where related uses share facilities, "it is a sham to single out one of those uses as the cost-causer or

[17] Wilson Direct at 9.

as the zero cost incremental user. That is simply a self-serving contrivance in the pursuit of a free ride."[18]

Dr. Loube presents a much more reasoned argument, stating that if the prices for all services are set at long run incremental cost, the carrier will be unable to recover its total cost.[19] Dr. Loube is correct, and at no point did I state or mean to imply that all prices of the ILECs can be set at LRIC. My answers below will attempt to clarify the policy rationale for setting access charges (and all intercarrier compensation rates) no higher than LRIC.

Q. HOW DO YOU RESPOND TO DR. WILSON'S CRITICISM OF YOUR POSITION?

A. Dr. Wilson mischaracterizes my testimony and then presents an illogical and anachronistic position on intercarrier compensation. To begin with, it is interesting to note, in response to his unrestrained accusation that my position "is unencumbered by fact" and that it is a "sham" and "self-serving contrivance" to exclude toll carriers from responsibility for recovering a portion of the joint and

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[18] *Id.*

[19] OCA Statement No. 1, Docket C-2009-2098386, *et al*, Direct Testimony of Dr. Robert Loube on behalf of the Pennsylvania Office of Consumer Advocate, (filed Jan. 20, 2010) at 42.

common cost, that the FCC has recently made nearly identical points as I have about the pricing of intercarrier charges in relationship to cost.[20]

The FCC proposed in 2008 to change the cost standard for intercarrier compensation to "the traditional economic definition of incremental cost," which would exclude any portion of common cost,[21] including the cost of the loop. Elaborating on this point, the FCC stated that:

> under the traditional economic definition, the incremental cost of call termination would be determined by estimating the stand alone cost of a network, which incorporates all existing services except call termination … and then subtracting this amount from a comparable estimate of the total cost of providing all the same existing services, including call termination. As should be obvious, the incremental cost of call termination under the traditional economic definition should be significantly lower than that calculated under a TELRIC [Total Element Long Run Incremental Cost] methodology.[22]

The FCC then reviewed evidence on the long run incremental cost of call termination, which suggests that $0.00058 as a very generous upper bound for the LRIC of switching.

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[20] *High-Cost Universal Service Support,* WC Dockets No. 05-337 & CC Dockets No. 96-98, *et al.*, Order on Remand and Report and Order and Further Notice of Proposed Rulemaking (rel. Nov. 5, 2008) (FCC 08-262), at Appendix C, ¶¶ 231-263.

[21] *Id.*, ¶246.

[22] *Id.*, ¶246

I am not presenting this FCC document, however, to propose a specific estimate of LRIC. Rather, I wish to clarify that the LRIC standard for judging call termination rates is not an extreme or outlandish methodology, but rather the conventional wisdom, from which Dr. Wilson deviates without considering the implications for the marketplace. Dr. Wilson's proposal to allocate joint and common cost across different services is not supported by economic theory and would be harmful to the development of competition.

Q. WHAT ARE DR. WILSON'S MAIN ARGUMENTS FOR INCLUDING JOINT AND COMMON COST WITHIN THE COST OF TOLL OR ACCESS SERVICE?

A. Dr. Wilson argues that since toll carriers need and use local access facilities, they should be required to "support" the costs of these facilities.[23] He states that it would be "unfair" to not require toll carriers to recover their "fair share" of these joint and common costs.[24] He elaborates further by claiming that since the market for toll has become competitive and has "sorted itself out" as the major toll

[23] Wilson Direct at 12.

[24] *Id.* at 7 ("Any additional reduction in ILEC access charges would essentially push all, or virtually all, of the cost of these facilities onto local exchange ratepayers. This would be unfair to residential local exchange ratepayers . . . .").

carriers have been merged into ILECs, there is even more reason to shift costs onto the toll carriers.[25]

Q. WHAT IS YOUR OPINION OF DR. WILSON POSITION ABOUT THE "FAIRNESS" OF ALLOCATING JOINT AND COMMON COSTS TO TOLL CARRIERS?

A. A criterion of "fairness" for rate setting does not provide much policy guidance to the Commission. This is especially true now that markets are open to competition, since a conflict between a particular definition of fairness and marketplace forces is likely to be won by the market. If toll service were to be allocated a portion of the loop cost, which is not incremental to usage, competition will undermine this arbitrary cost allocation. This is what led the FCC to shift recovery of loop cost (and other joint and common cost) to the end user. While it may have been "unfair" to burden low volume end users with a larger share of the cost of the network, it was not possible to continue to recover large shares of these costs from larger volume customers.

Dr. Wilson's pursuit of some Platonic ideal of fairness is even more futile in today's world of bundled service offerings. As he has admitted, the large

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[25] *Id.* at 10.

stand-alone long distance companies have vanished, due to mergers with the local companies and the entry of the former Regional Bell Operating Companies into long distance markets. This means that allocation of costs between originating local and long distance usage (or between fixed and per-minute charges) is meaningless. Most originating access is provided by the local carrier to itself, which means that the formal structure and level of access charges will be irrelevant to the pricing decision. Hence, the "fairness" of the rate structure faced by most telephone subscribers will be driven almost entirely by the individual bundled service providers, subject to marketplace discipline. Dr. Wilson may not like the outcome of this competitive interaction, but it is powerful enough to crush his concept of a fair cost allocation.

Q. SHOULD TERMINATING ACCESS CHARGES BE ALLOCATED A PORTION OF JOINT AND COMMON COST?

A. Absolutely not. The attempt to "tax" terminating traffic to subsidize some local carriers is contrary to good policy and to well-established Federal law and policy. To explain this point, I will distinguish between two different issues. The first is whether different types of terminating traffic should be taxed at different rates. The second is whether terminating traffic should be taxed at all to provide a profit stream to the terminating carrier.

Discrimination in the price of terminating traffic is a bad idea. It is inefficient and encourages "arbitrage" to evade the non-cost-based rate discrimination. This policy has been explained in great depth by the FCC in its various intercarrier compensation proceedings, and has been accepted by the vast majority of commenting parties. If this principle is adopted, it should solve Dr. Wilson's concern about "fairness," because there will be no explicit allocation of common cost among "local" and "toll" traffic. All terminating traffic will pay the same rate. A separate question remains, however, as to whether one carrier should help pay another carrier's common costs. This is the second issue that I defined above, namely whether there should be tax on terminating traffic.

Q. SHOULD ONE CARRIER CONTRIBUTE TO ANOTHER CARRIER'S JOINT AND COMMON COSTS?

A. No. From a policy standpoint this can lead to inefficient behavior and distort competition. Some CLECs, for example, have argued that they should be able to charge higher call termination rates than a competing ILEC serving the same geographic area, in order to offset their higher costs of doing business. I see no reason, however, why a carrier should be able to impose the costs of its own inefficiency on other carriers. Similarly, there is no reason for an RLEC to tax other carriers' customers to offset its purported higher costs of doing business. If it is not acceptable, from a policy standpoint, to recover this RLEC's costs from its own customers, then a broadly-based universal service fund should come to the rescue. This would enable greater regulatory control of the size of the subsidy, and also if the subsidy were portable, it would facilitate competition in this rural area. It would be counterproductive, however, to offset reductions in access revenue with a dollar-for-dollar increase in the Pennsylvania USF. This would constitute corporate welfare and would obviate the public policy benefit from targeting subsidies to the highest cost geographic areas and limiting the size of the subsidy to the minimum necessary to achieve social objectives.

From a practical standpoint, Congress and the FCC have answered this question by setting local transport and termination rates (i.e. reciprocal compensation rates) at TELRIC, which exclude almost all joint and common costs. And if the FCC forces these rates to LRIC, it will remove additional fixed costs from terminating rates. This means that so long as this Commission adheres to a policy of setting non-discriminatory termination rates, it will have to squeeze out any amounts above LRIC (or TELRIC) from intrastate access rates. The only pertinent question is when this will happen, not if it will happen.

Q. WHAT ABOUT DR. LOUBE'S POINT?

A. I agree with Dr. Loube that it may not feasible for an ILEC to set all prices at LRIC. Some prices will have to be set above LRIC to enable the carrier to recover all of its costs. The question of whether terminating traffic should pay more than LRIC is a legitimate and crucial question, which I have answered in the negative above.

VI. SUMMARY AND CONCLUSION

Q. PLEASE BRIEFLY SUMMARIZE YOUR REBUTTAL TESTIMONY.

A. The RLECs' excessive access charges cannot be justified by the supposed need to cross subsidize local rates in high cost areas. The subsidies implicit in access charges are not correlated to line density, which is the RLECs' own proxy for cost. Excessive access charges also cannot be justified as an efficient or "fair" mechanism to recover the common costs of the telephone network. It is neither efficient nor sustainable to recover an ILEC's costs from levies on terminating carriers, especially when the "tax" on termination falls disproportionately on only one type of usage – intrastate toll.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY AT THIS TIME?

A. Yes, it does.

CONFIDENTIAL

CERTIFICATE OF SERVICE

I, John C. Dodge, hereby certify that I have this day caused to be served a copy of the foregoing document upon the persons listed below by the means indicated in accordance with the requirements of 52 Pa. Code § 1.54:

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