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Federal Communications Commission
Office of Secretary **April 2, 1997**

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, D. C. 20554

Re: Ex Parte Meeting -- CC Docket 96-98
Implementation of the Local Competition Provisions
of the Telecommunications Act of 1996 Reconsideration

Dear Mr. Caton:

For inclusion in the above referenced proceeding, attached are copies of the Rebuttal Testimony of Janusz A. Ordover and the Rebuttal Testimony of Kevin Curran, filed on March 19, 1997, on behalf of AT&T with the State of New York Public Service Commission. Both submissions address non-recurring charges and how they can affect the development of local services competition.

Two (2) copies of this Notice are being filed with the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

A handwritten signature in cursive script that reads "Bruce K. Cox".

Attachments (2)

cc: Ms. K. Franco
Mr. T. Power
Ms. A. Seam

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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Joint Complaint of AT&T Communications)
of New York, Inc., MCI Telecommunica-)
tions Corporation, WorldCom, Inc.)
d/b/a/ LDDS WorldCom and the Empire)
Association of Long Distance Telephone)
Companies, Inc. Against New York Tele-) CASE 95-C-0657
phone Company Concerning Wholesale)
Provisioning of Local Exchange Service)
by New York Telephone Company and)
Sections of the New York Telephone's)
Tariff No. 900)

Proceeding on Motion of the Commission)
to Examine Issues Related to the Con-)
tinuing Provision of Universal Service) CASE 94-C-0095
and to Develop a Regulatory Framework)
for the Transition to Competition in)
the Local Exchange Market--Resale Phase)

Proceeding on Motion of the Commission)
Regarding Comparably Efficient Inter-) CASE 91-C-1174
connection Arrangements for Residence)
and Business Links)
)

REBUTTAL TESTIMONY

OF

JANUSZ A. ORDOVER

ON BEHALF OF

AT&T COMMUNICATIONS OF NEW YORK, INC.

DATED: March 19, 1997

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 **I. QUALIFICATIONS AND SUMMARY OF TESTIMONY.**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Janusz A. Ordover. My business address is
4 Economics Department, New York University, 269 Mercer
5 Street, New York, New York 10003.

6 **Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EMPLOYMENT
7 HISTORY.**

8 A. I received my Ph.D. in Economics with the Highest
9 Distinction from Columbia University in 1973. Upon
10 graduation, I joined New York University (NYU) with the rank
11 of Assistant Professor. I am now a Full Professor of
12 Economics at NYU. I also have taught as a Visiting
13 Professor at Columbia University, Yale University, and
14 Bocconi University in Milan, Italy. I took leaves of
15 absence to join the Technical Staff at Bell Laboratories
16 and, from 1991 to 1992, to serve as Deputy Assistant
17 Attorney General for Economics in the Antitrust Division of
18 the U.S. Department of Justice. My curriculum vitae is
19 attached as Exhibit JAO-1.

20 **Q. PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.**

21 A. I have authored almost one hundred articles on various
22 topics in economics, including industrial organization and

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 regulatory economics. I have served as an expert witness
2 before Congress, federal and state administrative agencies,
3 and federal and state courts on competition matters
4 involving the telecommunications, cable television,
5 railroad, airline, postal service, and many other
6 industries. I have served as a consultant to the Federal
7 Trade Commission and to the Department of Justice on
8 antitrust policy; for the Organization for Economic
9 Cooperation and Development ("OECD") on issues of
10 competition, deregulation, and international trade; for the
11 World Bank on telecommunications policy; and for the post-
12 communist governments of Poland, Russia, and Hungary on the
13 proper structure and enforcement of competition policy and
14 regulation of infrastructure industries. I have conducted
15 research studies, written, and consulted on the pricing of
16 network access and international settlement rates,
17 competition in the provision of international
18 telecommunications services, service and access pricing,
19 yellow page directory services, the economics of the
20 information superhighway, radio spectrum allocation for
21 advanced specialized mobile radio services, and the
22 prospects for liberalization of telecommunications markets
23 in Latin America and the post-communist countries of Eastern

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 Europe. Recently, I participated in a mission sponsored by
2 the World Bank to review telecommunications regulations in
3 Argentina. Also under the auspices of the World Bank, I
4 have provided public policy counsel to the government of El
5 Salvador in connection with the impending privatization and
6 liberalization of telecommunications in that country.
7 Finally, I have been engaged by Telstra, a
8 telecommunications provider in Australia, to analyze the
9 extent of market competition in the provision of
10 international telecommunications in that country. I have
11 filed testimony on behalf of AT&T Communications of New
12 England, Inc., with the State of Connecticut, Department of
13 Public Utility Control, on the subject of public benefits
14 from open and undistorted competition in the provision of
15 local exchange services. I also have filed testimony on
16 behalf of AT&T Communications of Wisconsin and AT&T
17 Communications of Indiana on the timing of intraLATA
18 presubscription, and on behalf of AT&T Communications of
19 Illinois, Inc., on the classification of business Bands B
20 and C usage services. Recently, I have provided direct
21 testimony on behalf of AT&T Communications of Illinois
22 before the Illinois Commerce Commission in connection with
23 its investigation into forward-looking cost studies (ICC

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 Docket 96-0486), and on behalf of AT&T Communications of
2 Wisconsin in connection with arbitration proceedings to
3 establish an interconnection agreement with GTE North, Inc.
4 (Public Service Commission of Wisconsin Docket 265-MA-102,
5 2180-MA-100). I have filed affidavits on behalf of AT&T
6 with the Federal Communications Commission in response to
7 the FCC's August 19, 1996, Notice of Proposed Rulemaking in
8 CC Docket No. 96-98, *Implementation of the Local Competition*
9 *Provisions in the Telecommunications Act of 1996*, and in
10 response to the Notice of Proposed Rulemaking in CC Docket
11 No. 96-262, *Access Charge Reform* (December 24, 1996). I
12 also participated in the FCC's economists' open forum on the
13 economics of interconnection.

14 **Q. PLEASE STATE THE PURPOSE OF YOUR TESTIMONY IN THIS**
15 **PROCEEDING.**

16 A. The purpose of my testimony is five-fold: (1) to summarize
17 briefly the benefits of opening New York local telephone
18 markets to full and effective competition and the means
19 Congress established in the Telecommunications Act of 1996
20 to foster such local competition; (2) to explain why New
21 York consumers are likely to be denied the full benefits of
22 local competition, even if legal entry barriers fall and

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 even if the retail services and unbundled network elements
2 that NYT is obligated to provide to new entrants were
3 efficiently priced, unless the New York State Public Service
4 Commission ("Commission") also prevents NYT from acting on
5 its incentives to erect other economic barriers to entry;
6 (3) to demonstrate that improper "non-recurring" charges
7 paid only by potential new entrants are among the most
8 potent -- and thus most harmful - entry barriers; (4) to
9 propose a pro-competitive, competitively neutral methodology
10 for classifying and quantifying claimed "non-recurring" and
11 related costs that promotes the public policy goals of the
12 Telecommunications Act ("1996 Act"); and (5) to propose
13 appropriate recovery mechanisms for these costs that do not
14 competitively disadvantage or advantage incumbents like NYT
15 or potential new entrants like AT&T in their ability to gain
16 or retain telecommunications customers.

17 **Q. PLEASE SUMMARIZE THE KEY CONCLUSIONS OF YOUR TESTIMONY.**

18 A. First, the benefits of competition are well-documented and
19 undeniable. Effective and undistorted local competition
20 will ensure that New York consumers receive the best and
21 most innovative services at the lowest cost that today's -
22 and tomorrow's - technologies can provide.

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 Second, potential new entrants' entry, exit, expansion and
2 contraction decisions reflect all forward-looking costs of
3 doing business in New York markets. Those costs include not
4 only costs of NYT's bottleneck services and facilities, but
5 also the hidden costs of discrimination and foot-dragging
6 and the costs associated with one-time or transactional
7 "non-recurring" charges that potential new entrants may be
8 required to pay.

9
10 Third, the sheer magnitude of NYT's proposed non-recurring
11 charges creates a real danger to emerging competition.
12 Unless properly limited, designed and recouped, non-
13 recurring charges could become a potentially insurmountable
14 barrier to entry. The Commission must, therefore, carefully
15 scrutinize these changes, limit their magnitude and adopt a
16 competitively neutral recoupment mechanism. Otherwise,
17 because, under NYT's proposal, only new entrants would bear
18 these costs, that proposal would create a significant
19 artificial and unwarranted cost disadvantages facing these
20 entrants and would exacerbate the existing entry barriers.

21
22 Fourth, economic analysis and public policy considerations
23 provide an alternative to NYT's proposal. This alternative

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 assures NYT a reasonable opportunity to recover all of its
2 efficient, forward-looking costs of providing carrier-to-
3 carrier services in the new multiple-carrier environment
4 mandated by the 1996 Act, including one-time competition
5 onset costs, and does not advantage or disadvantage carriers
6 in their ability to obtain and retain telecommunications
7 customers. This approach involves three steps: (1)
8 separating NYT's well in excess of \$100M in purported "one
9 time development expense" between one-time costs caused
10 generally by the onset of the new competitive regime
11 mandated by the Act and "transactional" costs directly
12 linked to the filling of specific orders placed by
13 individual new entrants; (2) subjecting the costs assigned
14 to each category to rigorous scrutiny, placing the burden on
15 NYT to justify its costs as efficient and forward-looking
16 and excluding any costs that fail to meet that standard or
17 that reflect "upgrades" or activities required only because
18 of NYT's past (or present) inefficiencies; and (3) requiring
19 competitively neutral recovery to the extent any recovery by
20 NYT from its potential competitors of NYT's competition
21 onset costs is warranted.

22 Fifth, at a minimum, competitive neutrality requires that
23 NYT amortize any of its competition onset costs,

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 attributable to the passage of the 1996 Act for the benefit
2 of all end users, over the effective life of the
3 competition-enhancing investments and to spread those costs
4 across all carriers that use the local network to provide
5 end user services -- including NYT -- so that no carrier
6 bears more than its proportionate share of those costs and
7 each, including NYT, has an equal opportunity to recover
8 them from the end users that will directly benefit from
9 those competition onset expenditures.

10 Sixth, there are public policy reasons, consistent with the
11 Act, indicating that some of the non-recurring costs that
12 will be incurred by AT&T, and other potential entrants,
13 should also be recovered in a competitively neutral manner.

14 **Q. WHAT IS NYT'S PROPOSAL REGARDING NON-RECURRING COSTS?**

15 A. As noted in Judge Linsider's March 7, 1997 correspondence to
16 Counsel for NYT, the January 31, 1997 filing is complex and
17 NYT's proposal is not easy to understand. As I understand
18 it, NYT seeks recovery for 1996 "actual" and forthcoming
19 1997 costs -- well in excess of \$100M -- that it claims are
20 necessary to transition to a multi-carrier environment. NYT
21 seeks to recover these costs solely from new entrants

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 through: (1) monthly recurring charges for resellers and UNE
2 purchasers; and (2) uniform "per transaction" charges.

3 **Q. IS NYT'S PROPOSAL CONSISTENT WITH THE PRO-COMPETITIVE GOALS**
4 **OF THE 1996 ACT?**

5 A. No. NYT's proposal, if adopted, would constitute a barrier
6 to entry into New York's local exchange market.

7 **II. THE SOCIAL BENEFITS OF PROMOTING ENTRY INTO LOCAL EXCHANGE**
8 **MARKETS.**

9 **Q. WHY SHOULD NEW YORK STATE PROMOTE ENTRY INTO LOCAL EXCHANGE**
10 **MARKETS?**

11 A. Local exchange markets are the last vestige of monopoly in
12 the provision of telecommunications services. The
13 Commission has recognized in its most recent decisions that
14 the consumer benefits from regulatory policies that promote
15 and facilitate competition in local exchange markets are
16 likely to be substantial. This pro-competitive deregulatory
17 stance is consistent with the broad public policy principles
18 underlying the 1996 Act. Indeed, the passage of the 1996
19 Act offers a unique opportunity to extend the benefits of
20 competition to users of every product and segment of the
21 telecommunications industry, especially local exchanges, in
22 which competition has been the least extensive and

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 effective. However, in New York, these pro-competitive
2 benefits will not be realized unless potential entrants into
3 local exchange markets can obtain the necessary inputs from
4 NYT on economically efficient and nondiscriminatory terms
5 and do not pay a discriminatory share of non-recurring
6 costs.

7 **Q. WHAT ARE THE BENEFITS TO THE END-USERS OF TELECOMMUNICATIONS**
8 **SERVICES THAT ARE LIKELY TO FLOW FROM PRO-COMPETITIVE**
9 **POLICIES TOWARDS LOCAL EXCHANGE SERVICES?**

10 A. It is a fundamental tenet of economics that undistorted and
11 effective competition is the most powerful force in
12 promulgating economic efficiency and in guiding
13 technological change to serve the public interest. Indeed,
14 when undistorted competition reigns, market outcomes further
15 many of the most important goals of the public interest.
16 For example, undistorted and effective competition assures
17 that prices are no higher than necessary to cover the costs
18 of providing the particular service. In contrast, prices in
19 a monopoly environment may not only cover costs but also
20 generate excessive profits, and service providers may lack
21 adequate incentives to keep their costs as low as possible,
22 thereby wasting economic resources. By offering to

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 successful suppliers the full rewards for their investment
2 and marketing initiatives, and with relative efficiency,
3 competitive markets provide full incentives for these
4 elements of desirable dynamic behavior. By eliminating
5 impediments for firms to vie with each other best to meet
6 customers' needs and to devise and implement new methods of
7 serving customers, thereby gaining business and earning
8 profits, undistorted competitive markets assure that
9 customers will be served by the suppliers best able to shape
10 and harness technology and to satisfy demands at the lowest
11 cost.

12 **Q. WHAT FORMS OF LOCAL ENTRY AND COMPETITION DO THE 1996 ACT**
13 **AND THE FEDERAL COMMUNICATION COMMISSION'S ("FCC")**
14 **IMPLEMENTING RULES CONTEMPLATE?**

15 A. The Act and the FCC's implementing rules contemplate three
16 forms of competition in the provision of local exchange
17 services. The first, "facilities-based" entry, will be
18 provided by those new entrants that construct their own
19 networks. The second is "resale" entry, a form of retail
20 competition in which the new entrant purchases end-user
21 telecommunications services from the incumbent at wholesale
22 rates for resale to end users. The third form of entry is

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 "unbundled network element" or "UNE-based" entry, whereby an
2 entrant purchases the use of some or all of individual
3 components, or elements, of the incumbent' network and
4 builds its own end user services from the use of those (and,
5 possibly, some of its own) facilities. Resale and UNE-based
6 entry significantly reduce barriers to subsequent
7 facilities-based entry along the critical interactive
8 dimensions of sunk costs, scale economies, and significant
9 entry risks by allowing the entrant to build a customer base
10 before it sinks costs in replicating the incumbent's
11 facilities. As a result, resale and UNE-based entry are
12 likely to occur more quickly and widely than full-fledged
13 facilities-based entry. Moreover, these two new entry paths
14 obviate the need to build new and duplicative facilities
15 when doing so would be socially inefficient. Accordingly,
16 resale and UNE-based entry -- if not foreclosed by
17 artificial and arbitrary entry barriers -- present the best
18 prospects for bringing the benefits of competition to New
19 York consumers rapidly.

20 **Q. DOES THE TELECOMMUNICATIONS ACT FAVOR ANY PARTICULAR FORM OF**
21 **ENTRY?**

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 A. No. The public policy expressed in the Act is that all
2 forms of efficient entry into presently monopolized local
3 exchange markets are desirable. Consistent with this policy
4 view, the provisions of the Act do not favor any particular
5 form of entry. To the contrary, the Act's objective is to
6 promote competition in all its forms. At the same time, the
7 Act offers no guarantees of success to prospective entrants.

8 **III. THE SOCIAL COSTS OF ECONOMIC ENTRY BARRIERS THAT DISCOURAGE**
9 **OR FORECLOSE EFFICIENT ENTRY.**

10 **Q. CAN THE 1996 ACT AND THE FEDERAL COMMUNICATIONS COMMISSION'S**
11 **("FCC") IMPLEMENTING RULES FOSTER THE EMERGENCE OF**
12 **UNDISTORTED AND EFFECTIVE COMPETITION IN THE PROVISION OF**
13 **LOCAL EXCHANGE SERVICES?**

14 A. Yes, but not standing alone. The Act and the FCC's rules
15 establish a sound framework for the emergence of local
16 competition. If properly and efficiently implemented - with
17 careful attention to all potential entry barriers -- that
18 framework should ultimately foster effective competition.
19 However, the Act and the FCC rules alone are not sufficient
20 to assure that competition will materialize. NYT currently
21 exercises bottleneck monopoly control over most of the local
22 network in New York and accordingly has strong incentives to

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 discourage and foreclose competitive entry. Thus, if
2 competition is to emerge, the Commission must implement the
3 Act and the rules in a manner that ensures that all existing
4 artificial impediments to effective competition are removed
5 and that NYT cannot erect new barriers to competition.

6 **Q. WHAT PRECISELY IS A "BARRIER TO ENTRY?"**

7 A. Economists define a barrier to entry as a cost that must be
8 incurred by a new entrant that incumbents do not (or have
9 not had to) bear.¹

10 **Q. CAN UNDISTORTED AND EFFECTIVE COMPETITION BE GUARANTEED**
11 **SIMPLY BY REQUIRING INCUMBENTS LIKE NYT TO BASE PRICES FOR**
12 **UNBUNDLED NETWORK ELEMENTS ON EFFICIENT TOTAL ELEMENT LONG**
13 **RUN INCREMENTAL COST ("TELRIC")?**

14 A. No. Efficient, TELRIC-based pricing for UNEs, which
15 replicates competitive market pricing outcomes, is a
16 necessary, but not sufficient, condition to effective and
17 undistorted competition. In making entry (and exit)
18 decisions, potential new entrants must consider all forward-
19 looking costs of doing business in New York local telephone
20 markets. Plainly prices that AT&T and others will pay for

¹ See Dennis Carlton and Jeffrey Perloff, Modern Industrial Organization, Harper Collins Publishers (1994), chap. 4, for a full discussion of the concept.

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 wholesale services and network elements are not the only
2 costs they will incur. A new entrant must also consider the
3 unstated, but no less real, costs of doing business with an
4 incumbent local exchange monopolist, which has the
5 incentives to raise its rivals' costs and impede their entry
6 and expansion. Unless effectively constrained by regulatory
7 oversight, such anticompetitive activities can greatly
8 increase a potential new entrant's costs and thereby harm
9 competition and consumers.

10 **Q. ARE THERE OTHER FORMS OF POTENTIAL ECONOMIC ENTRY BARRIERS**
11 **THAT THE COMMISSION SHOULD CONSIDER?**

12 A. Yes. NYT's submission reaffirms that a bottleneck
13 monopolist constrained by regulation from overcharging
14 competitors directly for essential inputs can try to
15 accomplish the same anticompetitive result indirectly by
16 artificially increasing "non-recurring" charges levied on
17 the rivals thereby giving itself a significant competitive
18 advantage and causing contrived entry barriers.

19 **Q: WHY SHOULD THE COMMISSION BE CONCERNED ABOUT THESE CONTRIVED**
20 **ENTRY BARRIERS?**

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 A: Artificial entry barriers represent a very real and serious
2 threat to the goals of fostering local competition and
3 customer choice as embodied in the 1996 Act. Real
4 competition that leads to the most efficient provider
5 winning and serving customers will not occur if new entrants
6 bear a competition onset levy (whether in the form of an
7 explicit charge or the implicit cost of discriminatory
8 treatment) from which the incumbent is exempt. In those
9 circumstances, efficient competition will, at a minimum, be
10 discouraged and may be foreclosed altogether.

11 **IV. THE THREAT THAT IMPROPER "NON-RECURRING" CHARGES POSE TO**
12 **EFFECTIVE AND UNDISTORTED LOCAL COMPETITION IN NEW YORK.**

13 **Q. SHOULD THE COMMISSION BE PARTICULARLY CONCERNED ABOUT ENTRY**
14 **BARRIERS FROM IMPROPER "NON-RECURRING" CHARGES?**

15 A. Yes. Although all artificial entry barriers impose social
16 costs and should be minimized as far as possible, there is
17 one aspect of improper "non-recurring" charges that is
18 particularly important here. "Non-recurring" charges
19 constitute an especially potent entry barrier when, like the
20 charges for competition onset costs proposed by NYT, they
21 are sunk, meaning that they cannot be recovered by the

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 entrant if it fails and decides to exit the market.²
2 Imposing such costs solely on entrants would create a
3 significant cost disadvantage for these entrants vis-a-vis
4 NYT and could seriously distort entry and expansion
5 decisions. Such a cost disadvantage is precisely the
6 disadvantage caused by entry barriers.

7 **Q: COULD YOU PROVIDE AN EXAMPLE OF THE POTENTIAL**
8 **ANTICOMPETITIVE IMPACT OF IMPROPER "NON-RECURRING" CHARGES?**

9 A: Yes. Consider a market consisting of 10 customers all
10 served by Incumbent LEC. There is a single potential
11 entrant, New Entrant, that would like to compete for those
12 customers. Assume also that the recurring charges that
13 Incumbent LEC charges New Entrant for all elements required
14 to produce local services are properly based on pertinent
15 TELRICS. Assume that these recurring charges total
16 \$10/month for the network element "platform." On a going
17 forward basis then, Incumbent LEC and New Entrant face the
18 same cost structure for essential inputs, and we would
19 expect the competitor who, using these and other inputs, can
20 best satisfy an end user's needs at least cost to win that

² See William J. Baumol, John Panzar, and Robert D. Willig, Contestable Markets and The Theory of Industry Structure,

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 customer. There is one hitch. Incumbent LEC claims that it
2 has to incur \$1000 to modify its network to accommodate New
3 Entrant (and any subsequent entrants). Incumbent seeks to
4 recover those competition onset costs from New Entrant,
5 whose prospective entry is the alleged "cause" of those
6 costs. In this situation, New Entrant and Incumbent LEC
7 have very different cost structures. Incumbent LEC can
8 profitably serve any customer willing to pay \$10 plus
9 Incumbent LEC's forward-looking retailing and other costs.
10 But if an equally efficient New Entrant enters and matches
11 that price it will incur a \$1,000 loss, equal to the charges
12 for the Incumbent LEC's competition onset costs. Knowing
13 that it will have to bear Incumbent LEC's "non-recurring"
14 charges, which will be sunk once paid, and that Incumbent
15 LEC can profitably price its services low enough to prevent
16 New Entrant from recovering all of that cost, New Entrant
17 may choose not to enter. The entry problem is further
18 exacerbated because New Entrant has its own competition
19 onset costs (for example, costs of modifying its own
20 computer and billing systems to interface with Incumbent
21 LEC), which it must recover from its customers. Although

Harcourt Brace Jovanovich (1982), for a development of the
concept of sunk costs.

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 this example obviously oversimplifies the issues, it
2 illustrates the effects and potential competitive harms that
3 will result if entrants alone bear all competition onset
4 costs.

5 **V. A COMPETITIVELY NEUTRAL MECHANISM FOR RECOUPMENT OF "NON-**
6 **RECURRING" COSTS.**

7 **Q. GIVEN THAT NON-RECURRING COSTS SHOULD NOT BE RECOVERED ONLY**
8 **FROM ENTRANTS, WHAT IS THE PROPER RECOVERY MECHANISM?**

9 A. Before I can answer this question, I must first discuss
10 various categories of non-recurring costs.

11 **Q. WHAT ARE "NON-RECURRING" COSTS?**

12 A. By definition a "non-recurring" cost is a cost incurred only
13 once, and a "non-recurring" charge is a charge assessed only
14 once. Unfortunately, in practice, "non-recurring" is a
15 rather broad term used to describe a variety of cost
16 categories for which different recoupment mechanisms are
17 appropriate. It is therefore critical that the parties to
18 this proceeding describe and categorize the costs at issue
19 with utmost precision.

20 **Q. ARE THERE ANY GENERAL CATEGORIES INTO WHICH "NON-RECURRING"**
21 **COSTS CAN BE PLACED?**

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 A. Yes. There are two broad categories into which such costs
2 should initially be assigned. First, there are those costs
3 that an ILEC must incur in order to comply with the most
4 general pro-competitive provisions of the Act - that is, the
5 costs an efficient monopoly provider must incur to enable
6 its network to be used efficiently by multiple carriers.
7 These costs are not caused by competing carriers' actual
8 entry but must be incurred to facilitate entry generally -
9 to make entry possible. I refer to these costs as
10 "competition onset" costs. For example, the costs of
11 designing electronic "gateways", the downstream operations
12 support system, and process modifications that will allow
13 competing carriers to have real-time electronic access to
14 the incumbent's operations support systems (and which are
15 discussed in more detail in the testimony of John Lynott),
16 fall into this category. The existence and magnitude of
17 these costs is not attributable to a particular competing
18 carrier's request for services or facilities. These costs
19 stem, instead, from the Act's mandate that local exchange
20 markets should be open to competition and that new entrants
21 should have nondiscriminatory access to the incumbent's
22 network. Competition onset costs likely do not depend on

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 the mix of new entrants, as between resellers and UNE-based
2 providers.

3 **Q. WHAT IS THE SECOND CATEGORY OF NON-RECURRING COSTS?**

4 A. The second general category of "non-recurring" costs are
5 "transaction costs" (sometimes characterized as "ancillary"
6 costs). These are the costs that an efficient incumbent
7 with an efficient multiple-carrier capable network incurs in
8 response to individual requests for services or facilities
9 by a competing carrier (or changes in service). These costs
10 are incurred following entry and thus need not be expended
11 in anticipation of entry.

12 **Q. ARE THESE TRANSACTION COSTS LIKELY TO BE SIGNIFICANT?**

13 A. It is my understanding, although I am no expert, that given
14 the electronic interface and OSS requirements of the Act and
15 the FCC's rules, these transaction costs are not likely to
16 be significant because most of the work of "filling" a
17 request for services or network elements can be accomplished
18 electronically by the requesting carrier's own personnel.
19 There may be exceptions, of course - the construction of a
20 physical collocation cage to meet the requesting carrier's
21 specific needs is one oft-cited example. Whatever the
22 magnitude of these costs, however, it is critical that this

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 category include only the specific costs directly
2 attributable to individual carrier's actual requests. And
3 ensuring that is true will require constant vigilance by the
4 Commission, because, as NYT's proposal demonstrates, NYT has
5 powerful incentives to overstate costs in the transaction
6 cost category.

7 **Q. WHY IS IT SO IMPORTANT FOR THE COMMISSION TO ASSURE THAT**
8 **TRANSACTION COSTS AND COMPETITION ONSET COSTS ARE SEPARATELY**
9 **IDENTIFIED?**

10 A. Briefly, there are two reasons. First, these categories of
11 costs should be recovered differently. Second, even if
12 proper recovery mechanisms are designed and implemented,
13 misallocation of competition onset costs to the transaction
14 cost category would create an artificial entry barrier and
15 harm nascent competition. It is obvious that the higher the
16 transaction costs are the more costly it will be for a new
17 carrier to enter and to switch a customer from the
18 incumbent.

19 **Q. ONCE COMPETITION ONSET AND TRANSACTION COSTS ARE PROPERLY**
20 **SEPARATED, HOW SHOULD THE COMMISSION DETERMINE WHICH**
21 **COMPETITION ONSET AND TRANSACTION COSTS SHOULD BE ELIGIBLE**
22 **FOR RECOVERY?**

95-C-0657
94-C-0095
91-C-1174

JANUSZ A. ORDOVER

1 A. Putting aside the issues of from whom recovery is
2 appropriate and what recovery mechanism should be used -
3 and, as explained below, the answers to those questions are
4 very different for transaction costs and competition onset
5 costs - a single familiar principle should guide the
6 Commission in determining amounts eligible for recovery.
7 That principle is that only efficient, forward-looking
8 incremental costs should be eligible for recovery. In this
9 context, application of that principle has at least two
10 important implications. First, the appropriate baseline for
11 determining the relevant incremental costs (whether
12 competition onset costs or transaction costs) is not the
13 incumbent's existing network or practices, but an efficient
14 network and efficient practices. Thus, with respect to each
15 cost item for which the incumbent seeks recovery
16 eligibility, the Commission should ask whether the activity
17 or investment that generates that cost would be incurred by
18 an efficient monopoly provider. If the answer is no, the
19 cost should be ineligible for recovery. Second, even if the
20 cost is one that an efficient monopoly provider would incur
21 to make its network multiple-carrier capable, only the
22 amounts an efficient provider would spend for that activity
23 or investment should be eligible for recovery. Thus, any