ATTACHMENT 3

PUBLIC

OFFICE OF CONSUMER ADVOCATE

PREPARED DIRECT TESTIMONY

OF

DR. DAVID S. HABR

Office of Consumer Advocate
Iowa Department of Justice
310 Maple Street
Des Moines IA 50319-0063

IN RE: Qwest Corporation
Docket No. INU-00-2

May 4, 2001

Q: Please state your name and address.

A: David S. Habr, 310 Maple Street, Des Moines, Iowa.

Q: By whom are you employed?

A: I am employed by the Consumer Advocate Division of the Iowa Department of Justice as the Chief of the Technical Bureau.

Q: When did you join the staff of the Consumer Advocate Division?

A: In November of 1987. For the previous six years I had been employed by the Utilities Division of the Iowa Department of Commerce.

Q: Would you describe your education and experience?

A: I received a Bachelor of Arts (1968) and a Master of Arts (1969) degree from the University of Nebraska-Lincoln. In both cases my major field of study was Economics. I received a Ph.D. in Economics from Washington State University in 1976. My dissertation is entitled "The Relationship Between Advertising and Liquor Sales in the State of Washington." Within economics, I have specialized in the following fields: industrial organization and government regulation, public utility economics, and transportation economics.

Prior to joining the Utilities Division staff in 1981, I was employed as an economist by the University of Nebraska-Lincoln (1968-69), Washington State University (1969-73), Drake University (1973-79), and Mitchell and Mitchell Economists, Ltd. (1979-80).

At Drake University I taught several different areas within economics including "Public Utilities and Transportation," "Government Regulation of Business," and "Managerial Economics." While at Mitchell and Mitchell, I developed and directed a feasibility study for the City of Des Moines and developed and estimated a revenue forecasting model for Northwestern Bell.

For the year prior to joining the staff of the Utilities Division, I was engaged in a private consulting practice. In the course of this practice, I was called upon to determine damages in antitrust cases and I testified on behalf of Midwestern Telephone Company, Inc. in Docket No. RPU-80-40. I have also testified in court proceedings and before the Iowa Industrial Commission.

As a member of the Utilities Division or Office of Consumer Advocate staff, I have testified in the proceedings shown on Appendix A of my testimony. I also provided staff review in a number of utility cases that were not litigated.

I served as a member of the NARUC Ad Hoc Committee on Diversification during 1986-87 and I presented a paper on double leverage at the committee's 1987 winter meeting. Since 1990 I have been an active member of the NASUCA Economics and Finance Committee. My paper entitled "A Note on Transaction Costs and the Cost of Common Equity for a Public Utility" appeared in the January 1988 issue of the *NRRI Quarterly Bulletin*.

In addition to my regular duties, I taught a seminar on antitrust economics at the Drake Law School in the fall of 1981. During the spring and fall of 1987 I taught the macroeconomics class in the Drake M.B.A. program.

Q: What is the purpose of your testimony in this case?

A: My testimony goes to the issue of whether or not it is in the public interest to allow Qwest to enter the interLATA long distance market in Iowa.

Q: Is it in the public interest to allow Qwest to enter the Iowa interLATA long

distance market at this time?

A: No. Qwest's entry into the interLATA long distance market can reasonably be expected to have a stifling, if not fatal, impact on local exchange competition. This serious expected adverse impact in the local markets will greatly outweigh any expected incremental beneficial impact in the interLATA long distance market.

Q: How did you arrive at this conclusion?

A: My conclusion is based on two factors. First, relying on check list compliance to assure that entry in the local exchange market will occur is in effect relying on the contestable market hypothesis to assure just and reasonable prices for consumers. For those of us who live in Iowa, the contestable market hypothesis is the economic equivalent of saying "if you open it, they will come."

Even if the check list is met, incumbency still constitutes a major barrier to sustainable entry that must be overcome by competitive local exchange carriers (CLECs) if they are to successfully enter the market. Qwest, by virtue of its ownership of the Bell operating company serving Iowa, has been the dominant incumbent local exchange carrier in Iowa for decades. This long period of incumbency during which the only choice for local exchange service was "the phone company" results in a great deal of customer inertia which means that newly formed competitive local exchange carriers have to pry customers away from "the phone company."

Second, allowing Qwest, the incumbent local exchange carrier (ILEC), to enter the interLATA long distance market before sustainable entry has occurred in the local exchange market has the impact of raising entry barriers rather than lowering them. Thus, rather than "leveling" the playing field for Qwest, allowing Qwest to enter the interLATA long distance market at this time actually tilts the playing field more in Qwest's favor.

Q: **What gives rise to customer inertia?**

A: Qwest has had a long term relationship with its customers that covers decades which gives it a well established market presence along with a known brand and reputation. Add to this customer incurred transaction costs associated with switching local service providers and one gets a significant impediment or entry barrier that CLECs must overcome.

Q: **How could a CLEC overcome this type of entry barrier?**

A: In order to overcome this type of entry barrier, it is very helpful for the CLEC to be able to offer something the ILEC cannot. Up to this point, that "something" has been the ability to offer bundled local and long distance service and even with this advantage, their success has been limited. Obviously, allowing Qwest to offer bundled local and long distance eliminates this CLEC advantage and helps Qwest maintain its incumbency entry barrier.

Q: **What do you mean when you refer to "sustainable entry?"**

A: By sustainable entry I mean entry where the entrants achieve a profit level that allows them to survive as viable, *independent* market participants who are able to challenge ILECs on multiple fronts.

Q: **Has significant sustainable entry been achieved in Iowa?**

A: Significant sustainable entry has not been achieved in Iowa. McLeodUSA is the largest CLEC in Iowa and it has not achieved sustainable entry. Its losses have increased from $11 million in 1995 to over $500 million in 2000 for a grand total of more than $1 billion during this six year period. McLeodUSA acknowledges at page 27 of its 2000 SEC Form 10k that it expects ". . . to incur significant operating losses during the next several years . . .." Without profits, entry cannot be sustained.

Q: What does McLeodUSA's experience tell you about the entry barriers it faces?

A: It tells me the barriers are substantial. Based on the above statement in their 2000 10k, McLeodUSA will have to be in business for at least nine or ten years before it *may* achieve profitability. That is a significant hurdle to overcome.

Q: Do you have any other evidence that Qwest has market power in the areas it serves?

A: Yes. FCC Form 477 provides information that can be used to calculated a Herfindahl-Hirschman Index (HHI) for Qwest's service territory.[1] Assuming that all of the Iowa reporting CLEC's only operate in Qwest's service territory, based on December 31, 2000 information, the HHI for Qwest's service territory is 7,546. This index value lies in between the HHI of a pure monopolist (HHI = 10,000) and a market served by two firms of equal size (HHI = 5,000). An HHI of this magnitude certainly suggests that Qwest has significant market power in its

1. The HHI is calculated by summing the squared market share of each participant. Thus a monopolist with 100 percent of market yields an HHI of 10,000 ($=100^2$) while two firms each having 50 percent of the market yields an HHI or 5,000 ($= 50^2 + 50^2$).

service territory.

Additional evidence of Qwest's market power in the local exchange market is found in the fact that there are no reporting competitive local telephone companies in 80% of the postal zip code zones in Iowa. (See Table 11 of the FCC report entitled "Local Telephone Competition: Status as of June 30, 2000" issued in December of 2000. The report can be found at: http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcom1200.pdf.)

Finally, there may be a number of CLECs operating in Iowa but they are small. Companies are required to file FCC Form 477 for each state in which they have 10,000 or more access lines. Table 5 of the FCC report noted above shows four reporting CLECs for Iowa. In fact, [redacted].

Obviously, the vast majority of CLECs in Iowa have less than 10,000 access lines. Given their small size, they cannot be expected to provide meaningful competition in the sense that they can limit Qwest's ability to extract monopoly profits. In fact, the current collection of CLECs more closely resembles legalized poachers making forays on the manor. They make an occasional capture but they are not significant threats to the power or existence of the manor.

Q: **Are these findings consistent with the Iowa market share information presented in Mr. Teitzel's testimony at page 37?**

A: Yes. Based on Qwest's service area, Mr. Teitzel shows Qwest with 86.3% of the market and the CLECs with the remaining 13.7% of the market. If there was only one CLEC, these market shares yield an HHI of 7,635. On the other hand, if there were as many CLECs as Mr. Teitzel asserts in his confidential exhibit DTL-1 and they all had equal portions of the CLEC "share," the HHI would be 7,452.[2]

Q: Do you agree with David Teitzel's testimony at page 15 that Confidential Exhibit DTL-1 lists CLECs that are actively providing local telephone exchange service somewhere in Iowa?

A: No. A review of the [redacted] companies listed on the Iowa pages of Exhibit DLT-1 shows that [redacted] do not have tariffs on file with the Iowa Utilities Board. Without such tariffs on file, these companies cannot provide local telephone service in Iowa. Of the remaining 20 companies listed on the Iowa pages of Confidential Exhibit DTL-1, 11 only provide services in isolated areas, in some cases as small as a single exchange, three provide services to business customers only, and three provide services to credit risk customers at prices ranging from roughly $40 to $50 per month. (See Confidential Exhibit DSH-1.)

Q: Has Qwest become unprofitable in Iowa as a result of CLEC activities?

A: No, based on their data which they have supplied the OCA, Qwest earned at least [redacted]% on its regulated Iowa operations in 2000.

Q: You mentioned earlier that allowing Qwest to enter the interLATA long distance market would raise entry barriers. Is this a barrier in addition to

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2. On examining the companies in Mr. Teitzel's list, it was found that a significant number did not actually have tariffs on file with the Iowa Utilities Board. See Confidential Exhibit DSH-1. Because the assumed shares of these companies are so small, the impact on the HHI is negligible. The HHI with these companies removed is 7,457 versus 7,452 when they are included.

the local exchange incumbency barriers?

A: Yes. By bundling its products, a firm with market power can make it harder for rival firms to compete with it. Professor Barry Nalebuff of Yale's School of Management has two recent companion papers on this topic, "Bundling as an Entry Barrier" and "Competing Against Bundles." These papers can be found on the Internet at http://www.haas.berkeley.edu/~imio/Bundling.pdf and http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID239684_code000831530.pdf?cfid=529663&cftoken=90398399&abstractid=239684 respectively.

What Professor Nalebuff finds and his conclusions are very important for this proceeding. In the first paper Professor Nalebuff shows

> ". . . that bundling is a particularly effective entry-deterrent strategy. A company that has market power in two goods . . . can, by bundling them together, make it harder for a rival with only one good to enter the market. ("Bundling as an Entry Barrier," abstract.)

And, he concludes, in part, as follows:

> Although creating a bundle doesn't stop competition, it forces competitors to play the game bundle against bundle. A firm that has only some components of a bundle will find it hard to enter against an incumbent who sells a package solution at a discount. ("Bundling as an Entry Barrier," p. 20.)

In his second, and broader paper, Professor Nalebuff concludes, in part, the following:

> Putting all of these results together leads to a fuller picture of bundling. As powerful as bundling is to a monopolist, the advantages are even larger in the face of actual competition or potential competition. Selling products as a bundle can raise profits absent entry, raise profits even against established but uncoordinated firms, all the while lower profits of existing or potential entrants and putting these rivals in the no-win position of not wanting to form a competing bundle. ("Competing Against Bundles," p. 12.)

Q: How is Professor Nalebuff's analysis relevant if CLECs, by including

interLATA long distance, are able to provide a bundle possibly superior to that offered by Qwest?

A: It is very relevant because it shows why Qwest wants to be able to bundle interLATA long distance. Under the status quo, it is the firms that make up the competitive fringe that have the power of the bundle that includes interLATA long distance. The power of this bundle gives them a means needed to establish a sustainable foothold in the local exchange market. Allowing Qwest to offer the same bundle not only eliminates this advantage for CLECs, it gives Qwest, the firm that already has market power, all the power of a bundle that includes interLATA long distance.

Q: Does this conclude your direct testimony?

A: Yes.

Appendix A

Regulatory Proceedings in Which Dr. Habr Has Testified While
A Member of the Utilities Division or Consumer Advocate Staff

COMPANY	DOCKET NUMBER
Northwestern Bell	RPU-81-40
Northwestern Bell	RPU-82-49
MCI	RPU-84-2
Northwestern Bell	RPU-84-7
Peoples	RPU-84-42
Union Electric	RPU-85-9
Iowa Public Service	RPU-85-14
Iowa Electric	RPU-85-31
Iowa Electric	RPU-86-7
Peoples	RPU-86-11
Great River	RPU-86-12
Iowa Power	RPU-87-2
Iowa Public Service	RPU-87-3
Iowa Public Service	RPU-87-6
Deregulation of Interlata, etc.	INU-88-2
Ottumwa Water Works	AEP-88-1
Iowa Southern	RPU-89-7
Iowa Electric	RPU-89-9
Iowa Resources and Midwest Energy	SPU-90-5
Rochester Telephone Co. et al	SPU-91-3
Midwest Gas, a Division of Iowa Public Service	RPU-91-5
Iowa Public Service	RPU-91-6
Iowa Southern	RPU-91-8
Iowa Electric	RPU-91-9
Iowa Electric and Union Electric	SPU-92-7
Energy Policy Act of 1992	INU-93-1
Interstate Power Company	ECR-93-1
Midwest Power Systems	ECR-93-2
Interstate Power Company	RPU-93-6
U S West Communications, Inc.	RPU-93-9
IES Utilities, Inc.	ECR-94-2
IES Utilities, Inc.	RPU-94-2
Iowa-Illinois Gas & Electric	TF-94-640
MidAmerican Energy Company	P-831

Appendix A

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COMPANY	DOCKET NUMBER
Midwest Wind Developers v. Iowa Electric Light and Power Company et al; and Windustries, Inc. v. Iowa Electric Light and Power Company et al	AEP-95-1 et al
McLeod Telemanagement v. U S WEST Communications, Inc.	FCU-96-1/FCU-96-3
Lost Nation-Elwood Telephone Company	TCU-96-9
GTE Midwest Incorporated	RPU-96-6
South Slope Cooperative Telephone Company	TCU-96-12
U S WEST Communications, Inc.	RPU-96-9
MidAmerican Energy Company	TF-97-229
CalEnergy Company and MidAmerican Energy Holdings Company	SPU-98-8
MidAmerican Energy Holdings Company, MidAmerican Energy Company, Teton Formation L.L.C., and Teton Acquisition Corporation	SPU-99-32
Qwest Corporation	TF-00-250