

Exhibit F

STATE OF ALASKA

REGULATORY COMMISSION OF ALASKA

Before Commissioners:

Mark K. Johnson, Chair
Kate Giard
Dave Harbour
James S. Strandberg
G. Nanette Thompson

In the Matter of the Petition of)
GCI COMMUNICATIONS CORP. for)
Arbitration Under Section 252 of the)
Communications Act of 1996 with the) U-96-89
MUNICIPALITY OF ANCHORAGE a/k/a ATU)
TELECOMMUNICATIONS for the Purpose of)
Instituting Local Exchange Competition)

REGULATORY COMMISSION OF ALASKA
Anchorage, Alaska

VOLUME XII
PUBLIC HEARING

November 10th, 2003
8:50 o'clock a.m.

BEFORE: GLENN CRAVEZ, HEARING EXAMINER

AND KATE GIARD, COMMISSIONER, RCA
JAMES S. STRANDBERG, COMMISSIONER, RCA
G. NANETTE THOMPSON, COMMISSIONER, RCA

APPEARANCES:

FOR GCI: MR. MARK MODEROW
MR. MARTIN M. WEINSTEIN
General Communication, Inc.
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Anchorage, Alaska 99503

FOR ACS: MR. DAVID H. SHOUP
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MARKED/ADMITTED

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1 A Well, once -- once you have a TELRIC proceeding the
2 results of that goes into revenues. And the depreciation
3 component of that sort of disappears. It doesn't matter
4 how you built up that price. You still keep depreciating
5 on the books based upon the lives prescribed in the rate
6 case and the methods prescribed in the rate case. I guess
7 what I'm trying to say is -- I'm trying to understand your
8 questions. I think if we're -- what we're trying to do in
9 the TELRIC model is establish a price that reflects the
10 recovery of the plant built into the model. Sort of no
11 more, no less.

12 Q Now just one other question. ATM/IP, isn't that a packet
13 switch, isn't that the vernacular for that type of switch?

14 A Yes.

15 MR. MODEROW: I have no further questions.

16 HEARING EXAMINER CRAVEZ: Quick follow up.

17 MR. SHOUP: I have just a couple of follow ups.

18 MICHAEL J. MAJOROS

19 testified as follows on:

20 RE-CROSS EXAMINATION

21 BY MR. SHOUP:

22 Q Mr. Majoros, you said ratepayers are not protected if
23 depreciation was too high. But would you agree that in a
24 normal very competitive market where the two principal
25 utilities each have half the market, that would have a

1 tendency to keep retail rates down?

2 A It might.

3 Q Would you have any doubt about that?

4 A Well, I think that you were referring to Commissioner
5 Thompson's question to me, that is a logical conclusion.

6 Q All right. Do you agree regarding accelerated
7 depreciation and I didn't write down what you said about
8 that exactly, but let me just ask you this, the Triennial
9 Review order in paragraph 690 talks about accelerated
10 depreciation. Have you reviewed that paragraph?

11 A Yes.

12 Q Would you agree that in that paragraph the FCC is saying
13 at the bottom of the paragraph recovering more of the
14 initial capital outlay for the asset in the early years
15 would enable a carrier to recover less in later years,
16 thereby allowing it to compete with carriers that have
17 purchased new lower priced equipment in those later years?

18 A Yeah, I think -- and I think it's talking about a
19 situation where prices are declining.

20 Q Where they're declining because people are buying new
21 equipment and fighting with each other over the retail
22 market?

23 A Yes, that's what it says.

24 Q Right. Then why did you say this discussion was about
25 wholesale not retail in these paragraphs of this order?

1 A I don't know.

2 Q You don't know why you said that?

3 A (Indiscernible - laughing.

4 Q Okay. One last thing, Mr. Majoros. We agree, I assume,
5 that you don't have any objection to the proposition --
6 you don't disagree with the proposition that the FCC
7 specifically has authorized accelerated depreciation in
8 the face of competition, right, in the Triennial Review
9 order?

10 A I don't think it's -- you know, subsequent to that the
11 notice of propose rule making came out and all of these
12 issues are going to be addressed and studied in that. I'm
13 not sure they've specifically authorized accelerated
14 depreciation.

15 Q All right. Well you said you'd looked at the paragraph.
16 Let me just read the first part of it to you. This is 690
17 Triennial Review order page 418. This is the first
18 sentence, we clarify that under our economic depreciation
19 requirement a carrier may accelerate recovery of the
20 initial capital outlay for an asset over its life to
21 reflect any anticipated decline in value. And then
22 further down in the paragraph they talk about competition.
23 You don't disagree that they're talking about accelerated
24 and authorizing accelerated depreciation.....

25 A They're talking.....

1 Qdo you?

2 Aabout accelerated, but also as I stated in my -- my
3 t- -- my surrebuttal testimony here that their prop- --
4 they're saying that in anticipation of decline --
5 equipment -- declining equipment prices.

6 Q Due to competition?

7 A And there also we have some evidence that -- and in fact,
8 the FCC recognizes this, that there's a flip side of that
9 coin which is decelerated depreciation which would in the
10 circumstances of this case if you were to adopt
11 accelerated depreciation for switching then you must
12 seriously consider adopting decelerated for outside plant
13 because we have some evidence that those price -- those
14 equipment prices are increasing.

15 MR. SHOUP: Those are my questions. Thank you, Mr.

16 Majoros.

17 A Yes.

18 HEARING EXAMINER CRAVEZ: Okay. As to Exhibits T-64, T-65
19 and T-66?

20 MR. MODEROW: I would move for their admission.

21 MR. SHOUP: No objection.

22 HEARING EXAMINER CRAVEZ: All right. They're admitted.

23 (Exhibits T-64, T-65 and T-66 admitted)

24 HEARING EXAMINER CRAVEZ: Thank you, Mr. Majoros.

25 A Thank you.

1 HEARING EXAMINER CRAVEZ: You may step down.

2 MR. SHOUP: Mr. Hearing Officer, perhaps in the last
3 couple of minutes here, I wonder if we could just get a witness
4 order for tomorrow so we'll all be prepared.

5 HEARING EXAMINER CRAVEZ: That was my next.....

6 MR. SHOUP: Okay. Thank you. Sorry to jump the gun on
7 you.

8 HEARING EXAMINER CRAVEZ:thing. So why don't we
9 identify who those people are going to be.

10 MR. MODEROW: Our first witness will be Cathy Pitts. Our
11 next witnesses will be Tom Brand and Art Menko, then Tom Weiss,
12 then Richard Cabe. And then the contract witnesses I haven't
13 established an order. They're local so it would be depending
14 on who's here. I don't think we'll get to all those tomorrow,
15 but we may.

16 HEARING EXAMINER CRAVEZ: All right. And we're scheduled
17 to resume at 8:30 tomorrow morning.

18 (Off record comments

19 HEARING EXAMINER CRAVEZ: All right. If there's nothing
20 further I think we will hold off on our next witness until
21 tomorrow morning at 8:3. So let's go off record.

22 (Recessed - 4:25 p.m.)

23 2055

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25

Exhibit G

STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

1
2 Before Commissioners: Mark K. Johnson, Chair
3 Kate Giard
4 Dave Harbour
5 James S. Strandberg
6 G. Nanette Thompson

6 In the Matter of the Petition by GCI)
7 COMMUNICATIONS CORP. d/b/a GENERAL)
8 COMMUNICATION, INC., and d/b/a GCI for)
9 Arbitration under Section 252 of the)
10 Telecommunications Act of 1996 with the) U-96-89
11 MUNICIPALITY OF ANCHORAGE d/b/a)
12 ANCHORAGE TELEPHONE UTILITY a/k/a ATU)
13 TELECOMMUNICATIONS for the Purpose of)
14 Instituting Local Exchange Competition)

14 PREFILED DIRECT TESTIMONY OF THOMAS R. MEADE
15 ON BEHALF OF ACS OF ANCHORAGE

16 Qualifications and Experience

- 17 1. Q. Please state your name and business address for the record.
18 A. My name is Thomas R. Meade. My business address is 600 Telephone
19 Avenue, Anchorage, Alaska 99503.
20
21
22 2. Q. Are you presently employed, and if so, by whom and in what capacity?
23 A. I am the Vice President, Revenue Requirements for Alaska
24 Communications Systems (ACS).
25
26

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3. Q. Please summarize your qualifications and experience, including your qualifications in public utility rate and regulatory matters.

A. See my resume attached as Exhibit TRM-1, which details my qualifications and experience.

Purpose of Testimony

4. Q. What is the purpose of your testimony?

A. The purpose of my testimony is to show:

Barriers to entry in Anchorage have been minimal. The depth and speed of competitive market penetration show the absurdity of any claim that ACS's rates or processes have impeded competition.

GCI has far less capital per line at risk than ACS has because of its access to UNE loops.

GCI's planned deployment of cable telephony will create a near-term impact that must be addressed in this docket. Cable telephony will remove a significant number of ACS loops from service and dictate shorter service lives than traditional monopoly depreciation calculations. This forces an

1 allocation of common costs to a lower number of loops, thereby increasing
2 the cost per loop.

3
4 ACS should be granted a higher cost of capital in its UNE rate computation
5 than in traditional rate-making proceedings.
6

7
8 Organization of Testimony

9 5. Q. How is your testimony organized?

10 A. The testimony first quantifies market penetration and discusses "barriers to
11 entry." It then quantifies the capital each company must put at risk in order
12 to serve its customers. This is followed by testimony concerning the
13 heightened level of risk in the current environment and the resulting need
14 to accelerate service lives for depreciation.
15
16

17
18 Barriers to Entry

19 6. Q. How much CLEC market penetration has occurred in Anchorage?

20 A. CLECs in Anchorage now have approximately 50% competitive market
21 penetration. GCI's market penetration alone is now about 44%. (Exhibits
22 TRM-2 through Exhibit TRM-4.)
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7. Q. How does this compare to CLEC market penetration nationally?

A. According to the FCC's local competition web page, market penetration nationally was 13.2% at year-end 2002. (Exhibit TRM-5). Assuming the national rate of penetration grew to 15% by mid-year 2003, GCI's market penetration in Anchorage is nearly three times as high as CLEC market penetration nationally.

8. Q. Are there any other states with market penetration comparable to GCI's market penetration in Anchorage?

A. No. The highest market penetration reported in any other state was New York at 25%. Only three states reported CLEC market penetration above 20%: New York, Rhode Island, and Michigan. (Exhibit TRM-6.)

9. Q. Why is GCI's market penetration relevant to this filing?

A. GCI's high market penetration shows that neither current UNE rates nor ACS practices have created barriers to entry. If barriers exist, they would be evident in suppressed market penetration.

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10. Q. Isn't it appropriate to remove all impediments to market entry in order to promote competition?

A. No. New entrants in any industry face challenges, such as obtaining financing and constructing facilities, developing back-office systems, winning customers, and developing a profitable organization. I believe the South Carolina Commission reached the correct conclusion regarding barriers to entry when it said:

...AT&T and MCI, through the sponsoring of their Nonrecurring Cost Model, attempt to eliminate virtually all nonrecurring charges. Their justification for so doing is a repeated characterization of such charges as 'barriers to entry.' All business ventures carry with them the necessity for assuming some degree of risk and investment. Nothing in the Act requires BellSouth to subsidize its competitors' entry into the market. It is a well-recognized principle that the cause of cost should bear the cost. Costs of ordering and installing lines are caused directly by the party that orders those lines, whether that party is an end user or a CLEC. Thus, such costs are appropriately recovered through nonrecurring charges.

(Exhibit TRM-7.) TELRIC provides the appropriate "build-vs.-buy" signals in pricing and provides for immediate market entry, but it is not intended to make an ILEC "subsidize its competitors' entry into the market." Unbundling at TELRIC prices was intended to accelerate *economic* market entry, not to provide new entrants a subsidy or a permanent competitive advantage.

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11. Q. Do the current competitive rules require GCI, or any CLEC, to risk as much of its capital per line as an ILEC is required to risk?

A. No. The ILEC is still required to invest in loop facilities, which account for 54% of ACS's network facilities in Anchorage. CLECs don't have to invest in loop facilities. They can enter the market by renting ILEC loops, and they can exit the market or lose customers to competitors with no risk of stranding investment in loops. The ILEC bears all the risk of stranded investment if loops become idle, and ACS's risk of stranded investment is high because of the impending deployment of cable telephony.

Relative Capital Deployed

12. Q. Is it possible to compare the relative investment required by the two types of telephone companies?

A. Yes. While creating an "apples-to-apples" comparison creates some problems with the limited data GCI publicly reports, GCI publishes local exchange line-of-business financial statements within its Securities and Exchange Commission 10-K annual report. The "reportable segments" in these line of business financial statements include "Local Access Services." While the information provided is limited, it includes an item titled "Total Assets" assigned to each business segment in the 10-K. GCI also reports

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the total number of access lines it serves. This makes it possible to calculate the assets per line required to serve GCI's customers.

13. **Q. Did you perform a comparable calculation for ACS?**

A. Yes. I computed the comparable ACS assets per line, using ACS's SEC 10-K segment reports. I also performed a similar computation for Anchorage and for all ACS LECs to draw a comparison.

14. **Q. What did the comparison show?**

A. It showed that GCI's investment per line to serve local telephone customers is far less than ACS's for comparable service areas. GCI's reported assets per line at year-end 2002 were \$367. ACS of Anchorage had assets per line of \$929. The ACS LECs as a whole had \$1,107. (Exhibit TRM-8.)

15. **Q. Why is GCI's investment per line so low?**

A. Because GCI uses ACS's facilities to reach its customers. GCI doesn't have to invest in loops to provide services; it rents UNE loops owned by ACS.

16. **Q. Does this have anything to do with efficiency?**

A. No, it is a direct result of the regulatory regime. Because of the legal obligation placed on the ILEC, CLECs can enter a local exchange telephone

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1 market without having to risk the capital that the incumbent must risk, and
2 they can abandon facilities with no concern about money that was spent
3 building those facilities. While GCI has less risk, and many natural
4 economic barriers to entry have been artificially removed, GCI has roughly
5 the same revenue opportunity that ACS has.
6

7
8 Where GCI has chosen to build its own loop facilities, as it did in the
9 Aurora Subdivision, its costs were comparable or higher than the costs that
10 ACS would have incurred to construct similar facilities. (See Prefiled Direct
11 Testimony of William J. Wilks.)
12

13
14 17. Q. Does ACS face greater risk than GCI because ACS owns the loop
15 facilities?
16

17 A. Yes. Unlike GCI, ACS has had to put investors' capital at risk to build loop
18 facilities, and ACS may be facing serious problems recovering the cost of
19 these facilities. If GCI loses a local customer, it simply quits paying \$14.92
20 to rent the loop to that location. If ACS loses a customer to cable telephony,
21 the loop sits idle, even if it cost ACS \$2,000 to construct it. If the loss is
22 permanent, ACS loses the unrecovered cost. GCI can abandon facilities,
23 deploy alternative technology, or even exit the market without worrying
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26

about capital recovery for loops.

Risk

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4 18. Q. You refer to ACS having investment at risk. Is this investment at risk
5 in the current environment?

6 A. Yes. ACS faces the issue of whether it can recover its actual costs. The
7 computation of assets per line is based upon audited financial statements
8 that track the actual deployment of investor dollars. The very fact that this
9 Commission is required to set a price that is not tied to audited numbers
10 creates a risk that investors will be unable to recover their investment.
11

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14 19. Q. If this Commission properly addresses UNE pricing, won't ACS be
15 assured that it will recover its investment?

16 A. No.

17
18
19
20 20. Q. Why not?

21 A. GCI has announced its intent to deploy cable telephony to replace the use
22 of UNE loops. In GCI's 2nd quarter 2003 conference call on Thursday July
23 31, 2003, GCI President Ronald Duncan announced a cable telephony
24 deployment target of "10,000 next year, 20 new ones the following year, 30
25
26

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1 new ones the year after that." (Exhibit TRM-9.) In other words, 60,000, or
2 nearly one-third of ACS's Anchorage loops that are currently in service,
3 will become vacant within three years if GCI's plans are carried out.

4
5 21. Q Is cable telephony really a mature enough technology that it could
6 render much of ACS's investment unrecoverable?

7
8 A. Yes. Nationwide, CLECs serve nearly 3,000,000 lines on coaxial cable
9 rather than copper pairs. (Exhibit TRM-10.) It is also probable that GCI
10 will face an easier transition to cable telephony than many lower-48 CLECs.
11 GCI is not a start-up CLEC, it already has switches and back-office systems
12 in place, and has access to most of the homes in Anchorage through its
13 cable TV monopoly.
14

15
16
17 22. Q. If ACS faces a risk that its loop facilities will become underutilized,
18 should this risk be reflected in a higher cost of capital than is allowed
19 in traditional telephone rate-making?
20

21 A. Yes. As the FCC stated in its recent Triennial Review Order, released on
22 August 21, 2003, "A TELRIC-based cost of capital should reflect the risks
23 of a competitive market." The order further explained:
24
25
26

1 States should establish a cost of capital that reflects
2 competitive risks associated with participating in the type of
3 market that TELRIC assumes. The Commission specifically
4 recognized [in the Local Competition Order] that increased
5 competition would lead to increased risk, which would
6 warrant an increased cost of capital.

7 (Exhibit TRM-11.) In a monopoly environment, the risk that a significant
8 percent of loop facilities would become idle was relatively minor. In the
9 current competitive market, that risk is significant and immediate, and a
10 higher return will be required before investors will risk their money on
11 telephone loops.

12 Service Lives

13
14 23. Q. Can any of the risk associated with loop investment be addressed
15 through depreciation?

16 A. Yes. Shorter service lives can help mitigate the risk. While the pre-
17 competition service lives approved for ACS of Anchorage in Docket U-96-
18 78 are 23 years for underground cable and 19.7 years for buried cable, it
19 would be more appropriate to use much shorter service lives in this
20 environment.
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24. Q. Could GCI's depreciation service lives serve as a benchmark for the reasonableness of ACS's proposed lives?

A. Yes. While the means of setting prices is different for the two types of carriers, the underlying economic principles are not. In both cases, investors voluntarily risk their capital with the expectation that they will eventually get their original investment back plus a profit. Generally Accepted Accounting Principles require the proper matching of revenue and expense. GCI's use of 12-year service lives reflects its accountants' best estimate of the useful, revenue-producing life of its telephone facilities. GCI's Chief Financial Officer and President are both required to certify the accuracy of the SEC 10-K reports that reflect the use of their 12-year lives. In other words, 12 years is GCI's best estimate of the useful life of local exchange telephone facilities in Alaska and can serve as a reasonable composite life for comparative purposes.

25. Q. What is the basis for your statement that GCI uses a 12-year service life for local exchange telephone facilities?

A. First, GCI's SEC 10-K reports indicate that lives for telephone system assets are 10 to 20 years. (Exhibit TRM-12.) ACS's William Wilks attempted to get clarification as to the application of these lives from GCI's Alan Mitchell. Mr. Mitchell eventually clarified that all telephone network assets

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were depreciated over 12 years with the sole exception of GCI's long-distance sub-marine cable. (Exhibit TRM-13.) There is no such submarine cable at issue in this docket, leaving only assets with 12-year lives.

26. Q. Do you believe it is valid to compare GCI's service lives to ACS's?

A. Yes. As I mentioned previously, this is GCI's best estimate of the useful, revenue-producing life of its telephone facilities as certified by GCI's Chief Financial Officer and President. The LEC facilities that GCI currently deploys are similar to those deployed by ACS. There are even parts of town, such as the Aurora Subdivision, where GCI has become the de facto ILEC, with monopoly ownership of traditional circuit-switched copper telephone plant.

27. Q. Has the FCC addressed asset service lives for pricing UNE loops?

A. Yes. The FCC discussed depreciation for UNE pricing in the Triennial Review Order, declaring, "We clarify that under our 'economic depreciation' requirement, a carrier may accelerate recovery of the initial capital outlay for an asset over its life to reflect any anticipated decline in its value." (Exhibit TRM-11.) It is clear that the FCC expects states to approve more rapid depreciation in UNE pricing than has traditionally been used.

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28. Q. Does this conclude your testimony.

A. Yes, it does.

Exhibit H

RECEIVED

AUG 27 2003

STATE OF ALASKA State of Alaska Regulatory Commission of Alaska

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners:

Mark K. Johnson, Chair
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TELECOMMUNICATIONS for the Purpose of)
Instituting Local Exchange Competition)

PREFILED DIRECT TESTIMONY OF DR. HOWARD SHELANSKI
ON BEHALF OF ACS OF ANCHORAGE

Qualifications

1. Q. Please state your name for the record.

A. My name is Dr. Howard Shelanski.

2. Q. Are you presently employed, and if so, by whom and in what capacity?

A. I am Professor of Law and Co-Director of the Berkeley Center for Law and Technology at the University of California at Berkeley. I received

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1 my B.A. from Haverford College in 1986, my J.D. from the University
2 of California at Berkeley in 1992, and my Ph.D. in economics from the
3 University of California at Berkeley in 1993. I have been a member of
4 the Berkeley faculty since 1997. In 1998-2000 I was on leave from my
5 faculty position to serve as a Senior Economist to the President's
6 Council of Economic Advisers (1998-99) and then as Chief Economist
7 of the Federal Communications Commission (1999-2000). I rejoined the
8 Berkeley faculty on a full time basis in July 2000. I formerly practiced
9 law in Washington, D.C. and served as a law clerk to Justice Antonin
10 Scalia of the U.S. Supreme Court.
11
12
13
14

15 I teach and conduct research in the areas of telecommunications
16 regulation, antitrust, and applied microeconomics. My recent
17 publications include articles in the *Yale Journal on Regulation*, the
18 *University of Chicago Law Review*, the *University of Chicago Legal*
19 *Forum*, and *Telecommunications Policy*. I am co-author of the legal
20 textbook *Telecommunications Law and Policy* (Carolina Academic
21 Press, 2001). My C.V. is provided as Attachment A.
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Purpose of Testimony

3. Q. What is the purpose of your testimony?

A. The purpose of my testimony is to discuss what I believe to be the correct principles for determining the forward-looking costs of providing unbundled network elements (UNEs) in keeping with the FCC's TELRIC framework.¹ I will explain why under the FCC's rules the RCA has discretion to implement TELRIC in a manner that provides rational economic incentives for ILECs and CLECs, that is pro-competitive and fair, and that complies with the FCC's policy objectives. I will discuss in particular why neither the FCC's rules nor economic principles require, or make it sensible, for the RCA to adhere to a completely hypothetical network model completely divorced from the realities of ACS's network or the economic environment of the State of Alaska. Such a completely hypothetical model will do more harm than good, is contrary to the FCC's stated policy objectives, and can be improved upon while remaining forward-looking and without relying on any of ACS' embedded costs whatsoever.

¹ My testimony here takes as a given the Commission's conclusion that prices for unbundled network elements should be set based on forward-looking costs. Consequently, I do not address whether or how unrecovered historical costs should be recovered.

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The purposes of the FCC's TELRIC method for pricing unbundled
network elements

4. Q. What is TELRIC pricing and why did the FCC implement it?

A. The local competition provisions of the Telecommunications Act of 1996 have the overarching goal of promoting entry of new firms into local telephone exchanges and of eliminating the long-standing dominance of incumbent local exchange carriers (ILECs). Recognizing that entry into local markets could be difficult because of the up-front capital investment required, Congress provided for competitors to have access to parts of incumbent networks at prices based on the incumbent's "cost." An open question under the Act is what "cost" should mean and how unbundled network elements (UNEs) should be priced. The FCC's TELRIC framework is designed to answer that question by allowing an ILEC to recover the efficient, forward-looking costs of operating its network as if the ILEC were subject to competitive pressure.

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1 5. Q. What is the policy rationale behind the FCC's TELRIC pricing
2 method?

3
4 A. The FCC chose TELRIC to balance two principal concerns. On one
5 hand, the Commission did not want to allow ILECs to charge UNE
6 prices that would reflect network inefficiencies and that would require
7 competitive local exchange carriers (CLECs) to pay more for a network
8 element than the element would cost in an efficient, competitive market.
9 For that reason the Commission rejected a definition of "cost" based on
10 the book costs of the ILEC's existing network (First Report and Order
11 ¶684) and expressly barred the ILECs from recovering "embedded
12 costs", which the FCC defined as "the costs that the incumbent LEC
13 incurred in the past that are recorded in the incumbent LEC's books of
14 accounts." (47. C.F.R. § 51.505(d)(1)). On the other hand, however, the
15 Commission did not want to base UNE prices on "the cost of a
16 hypothetical least-cost, most efficient network" because to do so would
17 "may discourage facilities-based competition by new entrants" by
18 allowing them to use an ILEC's existing network at prices below the
19 costs of that network. (First Report and Order ¶ 683).
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1 The Commission adopted TELRIC as a means of ensuring that
2 CLECs do not pay for embedded inefficiencies of ILEC networks while
3 at the same time ensuring that ILECs are compensated for the total costs
4 of operating their networks efficiently going forward. The critical
5 passage of the Commission's 1996 First Report and Order on local
6 competition that relates to TELRIC is paragraph 685. Several important
7 principles emerge in that paragraph. First, the costs on which TELRIC
8 prices are based should not be unrelated to the efficient costs of the
9 particular network for which UNE prices are being set. The Commission
10 states that costs should be based on "the most efficient technology in *the*
11 incumbent LEC's current wire center locations." (§ 685, emphasis
12 added). The FCC carefully does not set the benchmark at the most
13 efficient technology "available to the industry" (the standard it rejects in
14 § 683) or "available to *an* ILEC." Rather, the Commission determined
15 that however costs are measured, they must reflect the efficient, forward-
16 looking cost of the network actually being priced.

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22 The Commission also recognized that networks evolve over time
23 and that decisions about technology – even decisions efficient when
24 made – will constrain the path of future development of any particular
25 network. As such, the Commission says that TELRIC has the virtue of
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1 basing prices on efficient technology "that is compatible with the
2 existing infrastructure." (§ 685). The Commission made unambiguously
3 clear that the overall purpose of TELRIC is to compensate efficient
4 ILECs, not to subsidize CLECs. In the FCC's own words: "This
5 benchmark of forward-looking cost and existing network design most
6 closely represents the incremental costs that incumbents *actually expect*
7 *to incur* in making network elements available to new entrants." (§ 685,
8 emphasis added). Thus, while forward-looking costs are always to some
9 extent predictive, the FCC's intent was that those predictions be made in
10 a way that is more rather than less likely to correspond to the costs an
11 ILEC will, acting efficiently, in fact incur. As the Commission put it
12 before the U.S. Supreme Court, despite the forward-looking nature of
13 TELRIC, "the costs measured by TELRIC are nonetheless those of the
14 incumbent itself."²
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25 ² Reply Brief for Petitioners United States and the Federal Communications Commission, p.
26 6, *Verizon Communications Inc. v. FCC*, U.S. Supreme Court, filed July 2001. ("FCC Reply
Brief").

1
2 State Regulatory Authorities Have Broad Discretion In Determining TELRIC

3 Rates For Network Elements.

4 6. Q. Did the Commission prescribe specific TELRIC prices that States
5 must adopt or mandate that States use any particular cost model?

6
7 A. No. The Commission's mandate to the States was that they deny
8 compensation for ILECs' embedded costs and that they base UNE prices
9 on efficient, forward-looking costs. Within that mandate, the FCC gave
10 State regulators broad discretion in how they approach TELRIC pricing.
11 The FCC neither said what any particular UNE prices must be nor did
12 they prescribe a particular way for states to model or estimate forward-
13 looking costs. Indeed, strong evidence that the FCC did not establish any
14 particular model or approach lies in the fact that as of the date of this
15 testimony the FCC itself has, after nearly two years, not yet decided the
16 one state TELRIC case (Virginia) over which it has had to take
17 jurisdiction. But there is much more direct evidence of the
18 Commission's intent to grant discretion to the States in the
19 implementation of TELRIC. The Commission itself stated in its briefs
20 defending TELRIC before the U.S. Supreme Court that "[t]he FCC has
21 delegated many of the essential details of implementing TELRIC to the
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1 state public utility commissions.”³ The Commission offered as examples
2 of such discretion the setting of depreciation schedules and costs of
3 capital, but did not limit the states’ discretion to those variables.⁴
4 Incidentally, the Commission has recently reaffirmed that States have
5 broad discretion to set depreciation schedules and costs of capital in
6 UNE proceedings, although it has directed states to employ the higher
7 costs of capital of a competitive firm in setting TELRIC rates and has
8 expressly approved the use of accelerated depreciation in setting UNE
9 prices. (Triennial Review Order at ¶¶ 675-91).
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14 7. Q. Do the Commission’s TELRIC Rules Prohibit States from Looking
15 at an ILEC’s Actual Costs as a Way of Estimating an ILEC’s
16 Forward-Looking Costs?
17

18 A. No. This is a very important point. There is a tendency in debates over
19 TELRIC for the alarm of “embedded costs” to be sounded any time
20 actual ILEC costs are mentioned. But not all “actual” costs are
21 “embedded costs.” Embedded costs are the historical book costs of
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24 ³ Brief for Petitioners Federal Communications Commission and the United States, pp.7-8,
25 *Verizon Communications Inc. v. FCC*, U.S. Supreme Court, filed April 2001.

26 ⁴ Id.

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1 ILEC plant. And the Commission has ruled (as discussed above) that
2 such historical book costs may not form the basis of UNE prices and
3 may not be separately recovered by the ILECs. Forward-looking actual
4 costs are another matter, however. The costs an ILEC will in fact
5 efficiently incur tomorrow are precisely what the FCC has stated
6 TELRIC-based prices should compensate the ILEC for. The fact that the
7 cost is "actual" does not mean that it reflects "embedded" costs in any
8 way.
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13 In addition, even the actual costs of previously installed network
14 facilities may play an evidentiary role in state TELRIC proceedings.
15 Such costs cannot, of course, be considered in and of themselves for
16 compensation through UNE prices. But they can be considered as
17 evidence of what the forward-looking costs of an efficient incumbent
18 will be. If a state regulatory authority is trying to estimate, for example,
19 the forward-looking costs of switching, it will need to estimate the
20 purchase prices for switches going forward. The state agency has
21 several possible ways to do this. For example, it could look at
22 announced list prices of switches, or at what the lowest price is that any
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ILEC in the U.S. is paying for switches, or at what the particular ILEC at issue has recently paid for switches.

The first option above might be inappropriate because list prices might sometimes be much higher than the prices ILECs actually pay. The second option could be inaccurate because a large ILEC may get volume discounts far greater than those that a smaller ILEC receives and, if the proceeding involves a small ILEC, such a measure would unfairly and inefficiently understate that ILEC's forward-looking costs even if that ILEC is operating with optimal efficiency. A state authority might therefore choose the third option and look at recent switch purchases by the ILEC at issue *not* for the purpose of compensating those historical costs, but for the purpose of estimating the forward-looking costs the ILEC can expect to incur. The FCC has in fact expressed its approval of precisely such a use of actual ILEC costs in TELRIC proceedings. In explaining to the Supreme Court how TELRIC works, the Commission cited with approval *AT&T v. FCC*, 220 F.3d 607, 617 (D.C. Cir 2000) which the FCC described in a parenthetical as a case in which a "state commission, in setting TERLIC price for switching element, looked to

1 prices of switches recently purchased by incumbent."⁵ The FCC thus
2 clearly permits state authorities to estimate an ILEC's efficient, forward-
3 looking costs in a number of ways and neither constrains states to use
4 purely hypothetical models nor prohibits them from looking at a
5 particular ILECs actual costs as a basis for determining its forward-
6 looking costs.
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8

9
10 Correct Economic Principles In Applying TELRIC

11 8. Q. Shifting now to economic principles, how should state
12 authorities estimate an ILEC's forward-looking costs of providing
13 network elements?
14

15 A. Forward-looking cost estimates should lead to UNE prices that create
16 efficient incentives for both new entrants and incumbents. Network
17 element prices will be economically efficient if they encourage
18 competitors to make correct decisions about when to use incumbent
19 networks versus when to look elsewhere for inputs or to build their own
20 facilities. If prices for UNEs are too low, they will deter efficient
21 construction of new facilities and induce inefficiently high usage of
22 incumbent networks. Prices that are too low will also negatively distort
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26 ⁵ FCC Reply Brief at 6.

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1 the network investment decisions of the incumbent firms constrained to
2 charge such prices. If, on the other hand, UNE prices are too high, they
3 may deter market entry and encourage wasteful investment in new plant
4 by sending incorrect cost signals to new entrant. The FCC has described
5 such economic signaling as one of "the central purposes of the 1996 Act:
6 to bring meaningful competition to local telecommunications markets: to
7 ensure the efficient use of existing network facilities . . . and to
8 encourage new entrants to make economically rational decisions about
9 whether, or how, to enter a given local market."⁶
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13 Properly determined forward-looking costs for UNEs should thus,
14 in principle, reflect the costs that ACS, acting efficiently over time as a
15 competitive firm, expects to incur going forward. In that way, if a
16 competitor can provide the same function more efficiently using its own
17 facilities, then it will have the appropriate incentives to do so. This is
18 not to say that a forward-looking model should base its estimates on the
19 total costs of currently installed network facilities. Instead, it should try
20 to measure the incremental costs that an efficient, cost-minimizing firm
21 expects to incur as it replaces and expands network facilities over time.
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26 ⁶ Id. at p.22.

1 The model must look forward to choosing the least-cost options from
2 today onward and not look backward to the book costs of embedded
3 plant.
4

5
6 9. Q. Should a forward-looking cost study ignore a carrier's existing
7 facilities and rely on hypothetical models?
8

9 A. No. An economically correct cost study should not discard the entire
10 existing network and proceed based on the assumption that the firm has
11 built a hypothetical, new network from scratch. Indeed, the FCC itself
12 has plainly stated in briefs before the U.S. Supreme Court that "TELRIC
13 assumes no such thing. TELRIC instead rests on the rational economic
14 assumption that, as new, more efficient equipment becomes available,
15 the value of older, less efficient equipment will be affected."⁷ Indeed,
16 the FCC expressly recognizes that "a prudent firm would not replace a
17 facility the moment a more efficient substitute appears on the market."⁸
18
19 The Commission's statements make clear that a cost model *can* contain
20 existing network equipment and is *not* an "embedded" cost model just
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24 ⁷ Reply Brief for Petitioners United States and the Federal Communications Commission, pp.
25 7-8, in *Verizon Communications, Inc. v. FCC*, U.S. Supreme Court, filed July 2001.

26 ⁸ *Id.* at 10.

1 because it does so. The important thing is that such existing equipment
2 not be valued in the model at anything higher than its forward-looking
3 "fair market value."⁹
4

5
6 10. Q. How can a firm be efficient and competitive yet at the same time not
7 immediately deploy new technology as it becomes available?
8

9 A. Three factors give rise to costs that might offset the efficiency of new
10 technology and constrain the speed of network replacement: (1) current
11 network facilities that can still be efficiently used and whose remaining
12 economic value would be lost through premature replacement; (2)
13 anticipated, future technological changes that make it more efficient to
14 wait to replace some network facilities rather than to replace them with
15 technology that is the best available today, but will be obsolete
16 tomorrow; and (3) risk and uncertainty regarding unanticipated changes
17 in technology and market demand. An economically correct cost study
18 should recognize any current economic value – not embedded book
19 value but, as the FCC says, fair market value – of existing network
20 facilities and manage uncertainty about future technological changes and
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26 ⁹ Id. at 9.

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1 future demand for existing network functions, as well as for new kinds
2 of network capabilities that might develop.
3

4 A rational carrier thus will usually invest incrementally in new
5 facilities throughout the life of the network instead of immediately
6 replacing the network with each discrete jump in network technology.
7 The firm's analysis begins with the existing state of the network and
8 moves forward. The efficient mix of technology will likely include
9 some amount of existing plant and will evolve over time. Indeed, an
10 efficient firm should replace and expand network facilities so that it
11 moves towards what at any point in time is the optimal, lowest-cost
12 network, but not so quickly that it incurs costs that offset the efficiencies
13 of new technology.
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18 Put differently, it is important to recognize that, when the starting
19 point of the investment analysis is an existing network rather than a
20 blank piece of paper, the efficient mix of technology for *that* network
21 going forward may differ from the most advanced technology available
22 to the industry in general. Consider, for example, a network that
23 contains mostly copper cable. A new network built today would likely
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1 minimize costs by deploying significantly more fiber-optic cable and
2 much less copper than is currently installed. If we assume that to be the
3 case, then the firm starting from scratch might build a network whose
4 proportions of fiber and copper look like the inverse of what we actually
5 see in place today. But that does not mean that the firm owning the
6 existing, mostly copper, network should tear out copper cable and
7 replace it with glass. It is likely to be more efficient for the operator to
8 move forward *incrementally* with some mix of copper and fiber – a mix
9 that takes into account the existing network as a whole with all its
10 complementary and inter-operating parts, as well as risk factors for
11 changing technology and demand – as it expands and replaces its
12 network.
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18 11. Q. Does your analysis, by allowing for a cost model to reflect continued
19 use of existing plant, support recovery of the embedded costs of an
20 incumbent's network?
21

22 A. No. It is important to distinguish embedded costs of the existing
23 network from the costs of using existing network facilities on a forward-
24 looking basis. My analysis supports using installed plant where doing so
25 is more efficient than replacing that plant, but it recognizes that not all
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past and present costs of existing plant that remains in use will necessarily be recovered. It might be that new technology has come along that causes the *economic* value of an existing network element to decline as discussed above, even though a large amount of the original fixed costs of that element have yet to be recovered. An efficient forward-looking cost model should adjust for the risk that costs might get stranded in the future and become unrecoverable, but that is distinct from recovery of embedded costs that have actually accrued. The unrecovered fixed costs stranded by unanticipated changes in demand or technology are "embedded" and, in my analysis above, are not recovered. Neither an efficient investment decision nor a forward-looking cost study should look at the sunk costs of installed plant. But to recognize that installed plant may have *forward-looking economic* value that should be recovered (e.g., in the form of depreciation and cost of capital) is entirely different from saying that the same plant has historical costs that should be recovered.

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1 Problems With Using Purely Hypothetical Network Models

2 12. Q. How does use of a hypothetical "efficient carrier" cost model fit with
3 *the economic principles you discuss above and with the FCC's policy*
4 *principles and objectives discussed earlier in your testimony?*

5
6 A. There are several potential problems with using a hypothetical, efficient
7 carrier as the model for an ILEC's forward-looking incremental costs.
8 If, for example, the cost inputs for the model do not reflect the costs an
9 efficient ILEC will incur in its actual network and in its home market,
10 the model will fail to achieve the FCC's goal of compensating ILECs for
11 the efficient forward-looking costs they actually occur. It will,
12 moreover, thwart the economic signaling effect of TELRIC and create
13 the very disincentives for facilities-based competition that so concerned
14 the Commission in paragraph 683 of the First Report and Order in 1996.
15 Such would be the case, for example, with any model that modeled an
16 "efficient carrier" as some amalgam of the lowest-cost inputs from
17 ILECs around the country or as a carrier whose scale, scope, territory
18 characteristics, or input prices (*i.e.* labor, equipment costs, costs of
19 capital, etc.) differ from those necessarily faced by the particular carrier
20 at issue. For instance, just because a carrier in one part of the country
21 can trench cable at a low cost because of low labor rates does not mean
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1 that its cable-trenching cost should become the "efficient" level that is
2 assumed in cost models for carriers elsewhere in the country. The labor
3 rates may be higher elsewhere and trenching costs will therefore be
4 higher elsewhere regardless of how efficient a carrier is or of how much
5 competition it faces. It would make no sense to use the lower labor costs
6 when modeling the costs of a carrier that, for reasons outside its control
7 and unrelated to the efficiency of its operations, must pay its workers
8 more. Similarly, it would make no sense to model switch prices for a
9 small ILEC on the prices paid by a large ILEC that buys many switches
10 and may thus get deep quantity discounts that are simply unavailable to
11 other carriers.
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17 13. Q: Would use of the "Modified Synthesis Model" (MSM) comport with
18 the purposes of TELRIC and with the economic principles discussed
19 above?

20 A. No, the MSM most likely would fail to serve the goals of efficient UNE
21 pricing and of fostering beneficial competition. The MSM runs a
22 substantial risk of generating UNE prices completely divorced from a
23 carrier's actual, efficient forward-looking costs. The MSM is precisely
24 the kind of hypothetical, efficient carrier model that is neither required
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1 by TELRIC nor likely to achieve the Commission policies discussed
2 above. As I will explain below, such a model is particularly
3 inappropriate for ACS' costs given the extent and nature of local
4 competition in Alaska.
5

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8 As a threshold matter, it bears repeating that for the reasons
9 discussed at length earlier in this testimony, the RCA has no obligation
10 to use the MSM model and has broad discretion to use a much more
11 realistic and ACS-specific model of forward-looking costs. In fact, the
12 FCC has if anything cast substantial doubt on use of the MSM in UNE
13 cases. The Commission and its staff have repeatedly stated that the
14 Synthesis Model was created to determine the relative cost differences
15 among states for the sole purpose of distributing *national* high-cost
16 support. The Model was not designed to estimate state or company-
17 specific forward-looking costs of providing UNEs.¹⁰ Moreover, the
18 conceptual underpinnings of the Synthesis Model render it an
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23 ¹⁰ In the Matter of Federal-State Joint Board on Universal Service; In the Matter of Forward-
24 Looking Mechanism for High Cost Support for Non-Rural LECs, CC Docket Nos. 96-45 and
25 97-160, *Fifth Report and Order*, FCC 98-279 (rel. Oct. 28, 1998) ("Fifth Report and Order")
26 at ¶ 12; In the Matter of Federal-State Joint Board on Universal Service; In the Matter of
Forward-Looking Mechanism for High Cost Support for Non-Rural LECs, CC Docket Nos.
96-45 and 97-160, *Tenth Report and Order*, FCC 99-304 (rel. Nov. 2, 1999) at ¶ 41 ("Tenth
Report and Order").

1 inappropriate starting point for the development of an accurate state- and
2 company-specific UNE model. Specifically, because the Synthesis
3 Model attempts to size and configure an *unchanging, hypothetical*
4 network to satisfy a *known and fixed* level of demand, it cannot
5 acknowledge the dynamic process by which telecommunications
6 companies actually deploy network resources to provide
7 telecommunications services to meet constantly-changing demand.
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11 The MSM model is, moreover, not even compliant with basic
12 TELRIC principles. The TELRIC methodology is intended to identify
13 an incumbent carrier's forward-looking costs.¹¹ In doing so, it attempts
14 to replicate, "to the extent possible, the conditions of a competitive
15 market."¹² The MSM does not estimate TELRIC costs because it is
16 incapable of estimating the total costs that ACS, or any efficient carrier,
17 can expect to incur, even under forward-looking conditions.¹³ The MSM
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22 ¹¹ TELRIC methodology is intended to produce "costs that incumbents actually expect to
23 incur in making elements available to new entrants." In the Matter of Implementation of the
24 Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98,
First Report and Order, FCC 96-325 (rel. Aug. 8, 1996) ("First Report and Order") at ¶ 685.

25 ¹² First Report and Order at ¶ 679.

26 ¹³ Robert Atkinson, Executive Director of Columbia University's Institute for Tele-
Information and formerly Deputy Chief of the Commission's Common Carrier Bureau,

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specifically and deliberately excludes many of the costs of a dynamic network. One of the primary reasons the MSM produces unattainably low cost estimates is its purely hypothetical assumption that a brand new, "fully functioning" network is built instantaneously and dropped into place at a single point in time – a network that will never experience any growth, churn, or fluctuations in demand. This "instant network in a box" is not how a real network is constructed, nor is it how a network *should* be constructed, as discussed earlier in this testimony.

In fact, witnesses for CLECs have themselves acknowledged the shortcomings of the MSM, if not in this proceeding then certainly in others. AT&T witnesses familiar with proxy models and how networks are actually engineered have admitted that the MSM's fundamental assumptions do *not* reflect reality. For example, AT&T/WorldCom witness Mr. Joseph Riolo, testified that "[i]t would be highly unusual that in a real world situation that you would construct a total network on

described the harm wreaked by uneconomically low UNE prices: "Putting too low a price on unbundled network elements saps the value of companies that have spent money to install their own lines." Act Said to Slow Competition, *Telco Business Report*, July 16, 2001.

1 day one."¹⁴ He acknowledged the MSMI's shortcomings when stating
2 that the Model "is not modeling a network as I would traditionally build
3 it as an ILEC."¹⁵ Similarly, AT&T witness Dr. Mercer – a lead architect
4 of the switching and interoffice facilities components of the MSM –
5 agreed that, in the real world, switching capacity is added over time to
6 accommodate growing demand.¹⁶ The MSM simply does not estimate
7 the forward-looking costs of a functioning, evolving network.
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11 **14. Q. Has the MSM ever been validated with comparisons to real-world**
12 **costs?**
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14 A. No, the rates generated by the MSM have never to my knowledge been
15 validated through rigorous comparison between the costs generated by
16 the model and costs as they in fact turned out to be over any forecast
17 period. One cannot glibly dismiss the obligation of proponents of the
18 MSM or any other hypothetical model to provide such evidence on
19 grounds that the burden of proof lies with ILECs. It is always the case
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22 ¹⁴ Before the California Public Utilities Commission, Docket Nos. I. 93-04-002, R.93-04-003,
23 *Deposition Testimony of Mr. Joseph Riolo* (Mar. 7, 1997) at p. 12 ("California Deposition").

24 ¹⁵ Before the Maryland Public Service Commission, Case No. 8745, *Hearing Testimony of*
25 *Mr. Joseph Riolo* (June 28, 2001) at p. 1003.

26 ¹⁶ Before the California Public Utilities Commission, Docket Nos. I. 93-04-002, R.93-04-003,
Deposition Testimony of Dr. Mercer (Mar. 7, 1997) at p. 442.

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1 that forward-looking costs are predictive and cannot be known with
2 certainty. It makes no sense to ask ILECs to do the impossible and
3 "prove" their forward-looking costs while saying that their opponents in
4 proceeding can enter models that win by default where the ILEC's
5 evidence of its forward looking costs falls short (as it always by
6 necessity will) of absolute proof. State regulators should require that all
7 possible efforts be made to assess and validate the comparative accuracy
8 of competing approaches, regardless of who advocates them. As the
9 FCC has stated, "[o]ne of TELRIC's principal objectives is to *ensure* an
10 incumbent's opportunity, when leasing network elements to others, to
11 recover the full forward-looking cost of those elements (including the
12 cost of capital) over their useful lives."¹⁷ Excusing advocates of
13 hypothetical cost models from showing the economic validity of their
14 models while imposing on ILECs a high burden of proof and constraints
15 on permissible kinds of cost evidence is clearly at odds with this stated
16 objective of TELRIC.
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25 ¹⁷ Brief for Petitioners Federal Communications Commission and the United States, p.7,
26 *Verizon Communications Inc. v. FCC*, U.S. Supreme Court, filed April 2001 (emphasis added).

The Significance of Competition in Alaska

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15. Q. How does the particular competitive situation in Alaska relate to the use of the MSM or any other hypothetical network model of UNE costs?

A. The FCC has consistently stated that a key purpose of TELRIC is to send appropriate signals; appropriate signals to CLECs about when to use their own facilities and when to resort to UNEs, and appropriate signals to ILECs about how efficiently to invest going forward in their networks. As competition develops, it is particularly important to get those price signals right. UNE prices that are too high may deter entry, while UNE prices that are too low will deter facilities-based competition and harm investment in the ILEC's network. The issue of achieving fair, efficient, and realistic UNE prices is particularly pressing in Alaska where local exchange competition is unusually advanced in the State's principal markets. At present, ACS faces very substantial competition from GCI, with market share loss ranging from 20 to 40 percent in ACS' major markets of Juneau, Fairbanks, and Anchorage. But other providers, notably AT&T, have also begun to make inroads. AT&T's market share currently hovers around 6 percent in Anchorage – small by comparison to GCI but non-trivial.

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Of equal importance is the unusually strong potential for local exchange competition to be fully facilities-based in major Alaska markets. For example, GCI recently told financial analysts that it intends to roll out telephone service on its monopoly cable network to as many as 60,000 customers over the next three years.¹⁸ Given the competitive results GCI has already achieved against ACS and given its ability to enter at an even greater rate over its proprietary cable networks, there is no question that GCI has rendered ACS' markets fully contestable. While this raises a question of whether GCI is in any way competitively "impaired" such that it should have access to UNEs at all under the 1996 Act, it certainly makes clear that it would be particularly bad policy for GCI to be able to obtain UNEs at prices that do not accurately reflect ACS' efficient, forward-looking costs. Because hypothetical cost models in general, and the MSM in particular, do not accurately model the actual costs that ACS, acting efficiently into the future, can expect to incur, the RCA should use its permitted discretion under the TELRIC

¹⁸ General Communications (GNCMA) -Q2 2003 Financial Release Conference Call, Thursday, July 31, 2003 2 PM, Transcript Produced by Fair Disclosure Financial Network Inc, at p.12.

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framework to reject such models and to base UNE prices on a more
ACS-specific, realistically grounded, approach to forward-looking cost.

16. Q. Does this conclude your testimony?

A. Yes.