

## **Exhibit I**

Oct. 13, 2003

STATE OF ALASKA

THE 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 by GCI )  
COMMUNICATIONS CORP. d/b/a GENERAL )  
COMMUNICATION, INC., and d/b/a GCI for )  
Arbitration under Section 252 of the )  
Telecommunications Act of 1996 with the )  
MUNICIPALITY OF ANCHORAGE d/b/a ) U-96-89  
ANCHORAGE TELEPHONE UTILITY a/k/a ATU )  
TELECOMMUNICATIONS for the Purpose of )  
Instituting Local Exchange Competition )  
)

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

1. Q. Did you submit direct and opposition testimony in this Docket?

A. I submitted prefiled direct testimony on August 29, 2003.

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

A. The purpose of my testimony is to respond to several arguments that GCI witnesses Terry L. Murray, Robert A. Mercer, and Dana Tindall make in

their pre-filed rebuttal testimony. I will first explain why GCI's witnesses are incorrect when they state that the FCC's TELRIC rules require use of a model that assumes instantaneous and ubiquitous replacement of existing network facilities with new technology. I will next explain why, as an economic matter, such a "blank slate" replacement model neither mirrors how competition actually works nor would be an efficient way to model network costs on a forward-looking basis. Finally, I will discuss why I disagree with Ms. Tindall's testimony regarding the proper test for TELRIC pricing and for ACS' market "dominance."

**I. The FCC's TELRIC Rules Do Not Require That Costs Be Based On An Instantaneous, Full-Replacement Model Of Network Technology**

3. Q. Does TELRIC either specify any particular modeling approach or require use of a hypothetical most-efficient carrier model?
- A. No. The FCC's TELRIC rules do not mandate that regulators use any particular approach to modeling TELRIC. So long as the model is forward-looking, cost-minimizing, and is not based on embedded costs, state agencies have substantial discretion as to how they model TELRIC

costs. It is for this reason that I state in my direct testimony that states have discretion to choose between, for example, the MSM model of TELRIC and a model more grounded in the real-world attributes of a network providing local services in particular markets. While I believe for reasons I will discuss below that the MSM model or other instantaneous replacement models should be avoided for reasons of TELRIC's underlying policy goals, there is little question that state regulators have the legal discretion to adopt a range of models, including those that more realistically model the efficient, forward-looking costs that a given carrier could actually achieve.

Ms. Murray in her rebuttal testimony argues that the RCA in fact has no discretion and must, to comply with the FCC's TELRIC rules, base UNE prices on a hypothetical model that assumes complete and instantaneous replacement of existing networks with new technology. (Murray Rebuttal, p.5) Yet Ms. Murray does not explain how her claim that regulators must assume instantaneous replacement of the network can be squared with the FCC's emphatic statements in sworn briefs before the U.S. Supreme Court that "TRIC assumes no such thing. TRIC instead rests on the rational economic assumption that, as new, more

efficient equipment becomes available, the value of older, less efficient equipment will be affected.”<sup>1</sup> Similarly, Ms. Murray omits the fact that in the FCC’s recent Virginia arbitration case the Commission rejected the MSM in favor of Verizon’s models for switching and transport and expressly stated that it did not find any of the models before it in the proceeding to be fundamentally inconsistent with forward-looking pricing principles (§ 49).

Nor does Ms. Murray successfully base her case on paragraph 685 of the First Report and Order. (Murray Rebuttal p.6). The Commission states that TELRIC means to base prices on efficient technology “that is compatible with the existing infrastructure.” (§ 685). It went on to say that “[the] benchmark of forward-looking cost and existing network design most closely represents the incremental costs that incumbents *actually expect to incur* in making network elements available to new entrants.” (§ 685, *emphasis added*).

In sum, the clear mandate that Ms. Murray claims from the FCC for models like the MSM model is simply nowhere to be found. To be sure, there are Commission orders and statements that favor the

<sup>1</sup> Reply Brief for Petitioners United States and the Federal Communications Commission, pp. 7-8, in *Verizon Communications, Inc. v. FCC*, U.S. Supreme Court, filed July 2001.

instantaneous replacement approach, just as there is a long line of strong statements to the contrary, as cited above and in my direct testimony. The ambiguity in the FCC's precedent, however, undermines GCI's and Ms. Murray's claims that *only* a purely hypothetical, instantaneous replacement model of a network can be used for TELRIC. The FCC's statements to the contrary, its express finding that other kinds of models as consistent with TELRIC, and the lack of any express mandate from the Commission for purely hypothetical models, demonstrates that the RCA has discretion to depart from the MSM and its inputs. This is not at all surprising given the FCC's statement to the Supreme Court that it had "delegated many of the essential details of implementing TELRIC to the state public utility commissions."<sup>2</sup>

4. Q. To the extent this case is not about technology, but about the costs assigned to those technologies in the cost model, should the RCA use only hypothetical numbers derived from a most-efficient carrier model?
- A. Again, the answer is no. There are certain things everyone seems to agree

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<sup>2</sup> Brief for Petitioners Federal Communications Commission and the United States, pp.7-8, *Verizon Communications Inc. v. FCC*, U.S. Supreme Court, filed April 2001.

on when it comes to disputes over TELRIC cost models. One is that the model should strive to be "efficient"—by which I mean it should reflect the lowest-costs that a carrier could realistically incur given available technology to provide the relevant services to the relevant customers in the relevant geographical area. I have argued consistently for these fundamentals, with which Ms. Murray appears to agree. Dispute arises, however, over both the technology that should be assumed in a model and, once that issue is resolved, how the particular dollar values for technology should be determined. The challenge for regulators is that these cost values are to a large extent predictive and will in fact only be incurred, if at all, in the future. My position is that these costs should be as realistic as possible given the characteristics of the particular market or markets at issue in a proceeding. In other words, they should be costs that a competitive, cost-minimizing carrier could actually achieve in providing relevant services to the market at issue. Thus, as I stated in my direct testimony, it makes no sense to borrow input values from carriers or markets that bear no relationship to those for which UNE prices are actually being set. For example, to use costs achieved by a carrier that has superior economies of scale and that serves completely different

geographical markets risks putting costs in the model that could not be achieved by carriers serving the market at issue no matter how efficient they are. Using labor costs from other jurisdictions would raise similar problems.

I agree with Ms. Murray that scale economies and other such differences are irrelevant if the carrier whose low costs are being imported into the model is actually a competitor of the ILEC's, for then the ILEC has no choice but to match the competitor's prices. (I would note, however, that were there a more efficient carrier in the same market, there should not be a UNE proceeding at all because the 1996 Act's "impairment" test for unbundling would not be met.) But borrowing costs from lower cost carriers that are *not* competitors to the ILEC whose network is being priced is a different matter altogether and risks imputing "efficiencies" that could not in fact be achieved in the market at issue.

5. Q. What alternatives do regulators have for determining the costs of the various technological inputs to a model?

A. One approach is to develop entirely hypothetical costs based on

engineering data. Such purely hypothetical costs, however, may have nothing to do with the costs achievable by any real-world carrier no matter how competitive or efficient. Unless such model-derived costs can in some way be validated against data from the real world, there is simply no way to know whether they are at all meaningful for calculating UNE prices. The need for such validation cannot be brushed off. The FCC has consistently stated its view that no matter what cost model is used, it cannot generate results divorced from reality because "the costs measured by TELRIC are nonetheless those of the incumbent itself,"<sup>3</sup> and should be the costs the incumbent "actually expects to incur."<sup>4</sup>

Another approach is to look at what the incumbent is actually paying for technology assumed in the model of forward looking costs. How much does the incumbent actually pay for the latest switches, for transport, or for distribution plant? What are the lowest bids the incumbent has received for labor to trench new outside plant? What contracts has it actually been able to negotiate with its unions going forward? Especially where the incumbent faces competition in its local market, as ACS does, there is sound basis for presuming that the carrier's

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<sup>3</sup> Reply Brief for Petitioners United States and the Federal Communications Commission, p. 6, *Verizon Communications Inc. v. FCC*, U.S. Supreme Court, filed July 2001. ("FCC Reply Brief").

<sup>4</sup> First Report and Order Paragraph 685.

costs are efficient. In this circumstance, be wary of cost models that generate lower costs.

Another additional alternative regulators should look at is the costs incurred by competitors to the ILEC. In that regard, the costs that GCI has incurred to build out its competing telephone services in the markets that ACS serves are significant and should receive substantial weight in this proceeding. Ms. Murray emphatically argues that in a competitive market, a firm "would have to match the prices of new entrants that deployed the most efficient technology currently available." (Murray Rebuttal p. 10). She thus clearly believes that the way a rational CLEC competes is by being efficient—*i.e.* by minimizing its costs to the extent possible so as to under-cut the ILEC. If that is so, then one should presume that, because GCI is a competitive entrant, its costs of building out its rival network are the lowest achievable in the market and should constitute the proper inputs into a forward-looking model of ACS' costs. Yet remarkably, when it comes to actually using GCI's costs, both Ms. Murray and GCI suddenly back off from the notion that competition forces firms to efficient cost levels and simply assert that GCI's costs reflect "anomalous conditions." (Murray Rebuttal p. 18).

Ms. Murray, for example, tries to brush off the relevance of GCI's Aurora project on grounds that it represents "a small increment of demand" rather than the "forward looking costs of a carrier serving the total increment of demand." (Murray at 18). This argument fails for a number of reasons. First, it goes without saying that no wire-line telephone network has ever been constructed in one giant step to serve all demand. Telephone networks are built and upgraded incrementally, so the costs of building or replacing "small increments" of facilities are precisely the costs that are relevant in the real world and are the basis on which firms make decisions in competitive markets. Second, even if it were true that regulators should look to the optimal costs of serving the "total increment of demand" in a market, Ms. Murray presents no evidence that there is a difference in per-unit costs of facilities moving from a small increment of demand to the total market demand. Third, Ms. Murray does not explain how ACS could incur its forward-looking costs in a manner different from the way GCI incurs its costs. ACS is not building an entirely new network in one sweep, but is, like GCI, building out and/or upgrading in increments. The competitive pressure ACS faces from GCI forces it not only to keep the costs of those increments down

but also to keep costs down to the level of GCI's incremental costs network-wide so as to remain competitive in the face of GCI's expansion in the retail market. GCI is, moreover, an extremely experienced builder of telecommunications networks that has a ubiquitous cable (and cable telephony) network in the relevant market. It has succeeded in taking substantial market share from ACS by cutting retail prices. GCI witness Dana Tindall states that GCI's cable telephony network will pass 98% of homes in Anchorage, for example. There are thus good reasons to take GCI's costs as strong evidence of the costs of an efficient, competitive carrier. It is inconsistent for Ms. Murray and GCI to claim, on one hand, that ACS is not acting competitively if it does not match the costs of an instantaneously built, state-of-the-art network but to claim, on the other hand, that a real competitor's costs cannot be benchmarks of efficiency because competitors build networks in increments rather than in one state-of-the-art step.

II. NOT ONLY DOES THE LAW NOT REQUIRE TELRIC TO BE BASED ON A HYPOTHETICAL, INSTANTANEOUSLY REPLACED NETWORK MODEL, BUT ECONOMIC PRINCIPLES COUNSEL AGAINST SUCH A MODEL.

6. Q. Does the hypothetical network model GCI and its witnesses advocate reflect what an incumbent carrier would have to do in response to competition from a new, optimally constructed network?

A. No. The fact that new technology constrains the value of installed facilities does not mean that new technology eliminates the economic value of existing facilities. If it is more efficient for the incumbent to replace its network incrementally, making use of existing facilities that retain economic value even after the new technology becomes available, then it makes no sense to force the incumbent to model its costs based on the full replacement assumption.

7. Q. But wouldn't the hypothetical competitor, having the optimal network with the best available technology, then have lower forward-looking, long-run costs and prevent the incumbent from recovering the costs of its existing network?

A. No. A firm would not keep existing technology if it were cheaper to replace that technology than to continue using it on a forward-looking basis. But it does not follow that new technology always makes all existing assets comparatively inefficient to operate. If the incumbent has

decided not to replace a network element because keeping rather than replacing the existing element makes long-run costs lower on a forward-looking basis, then competition from a new network would not drive the incumbent to replace its existing, efficient facilities to reflect the short-run efficiencies of the new technology. In other words, the new technology may have lower *short-run operating* costs, but once the up-front costs of purchasing that technology are taken into account, it might not have lower *long-run total* costs. The cost structure of the hypothetical, newly built network thus sets an upper bound on the prices the ILEC can charge, but does not necessarily lower them. This is why, as both Ms. Murray and Mr. Mercer acknowledge (Murray Rebuttal p.17; Mercer Rebuttal p.34), real world firms typically have varying vintages of technology that they replace incrementally. Indeed, even vigorously competitive firms do not usually have to drop their retail prices to reflect the operating efficiencies of every technological advance that is adopted.

Even if one assumes that the total forward-looking costs of a new, optimal network would in fact be lower than the ILEC's costs, it is necessary to recognize the risk-adjusted capital and depreciation costs of constructing such a network under the assumptions that Ms. Murray and

GCI make. For if the incumbent is assumed to be subject to entry at any time by an optimal, lower-cost, "best-available" network, then any new entrant will similarly have to assume that it, too, could be subject to such competition in the future. If, as Ms. Murray argues, such entry requires incumbent firms to model costs as if they had reconfigured their networks to match the technology of the new entrant, then the entrant will anticipate that it, too, will have to treat its network as instantaneously replaced and lower its prices when the next newly constructed entrant appears. The entrant's forward-looking depreciation and capital costs will therefore anticipate the required future adjustment and rise accordingly. In particular, the new entrant will have very high depreciation allowances so as to cover the up-front costs it incurred to build its network before the next price-reducing round of entry occurs. Any model of an instantaneous, hypothetically efficient network that does not factor in the high capital and depreciation costs implicit in the model's assumptions is internally inconsistent; it combines the lower depreciation and capital costs of a network that efficiently retains existing technology with the lower short-run costs of a network deploying all new technology. Not only does such a model fail to

measure the TELRIC of any real-world efficient network, but it also fails to capture the full long-run costs of having to reset prices under the instantaneous replacement assumption whenever more advanced technology comes along.

In fact, as the FCC has recognized, firms in the real world do not instantaneously replace their networks with more efficient technology (or set prices as if they had done so), even when facing competition and making efficient, long-run decisions about network technology. One reason that they do not act according to the instantaneous replacement model is that such a model is not necessarily cost-minimizing over time and in fact likely will entail very high capital and depreciation costs. Firms instead replace and upgrade incrementally as it becomes efficient to do so. And competition similarly tends to occur in an incremental manner so that even new entrants, by time they are competing for the "total increment of demand" similarly have mixed vintages of technology that they replace in an evolving, efficient manner. Ms. Murray's depiction of competition as a process in which firms with optimal technology enter markets and immediately challenge incumbents for all customers in the market is belied by GCI itself, which has managed by its

own admission to eliminate ACS' retail dominance and force down retail rates (Tindall Rebuttal pp.6,9) through incremental entry into Alaska's local exchange markets.

**8. Q. Is Ms. Murray correct that the economic definition of the "long-run" compels an instantaneous replacement model for TELRIC purposes?**

**A.** No. This is an extremely important point. Ms. Murray (Murray Rebuttal p. 8-9) begins her argument by citing a definition of the long run that is universally accepted by economists. The general idea is that in the long run, all of a firm's inputs, from its buildings to its personnel to its equipment, are variable. The period must be long enough that, over its duration, everything must be free to vary as more efficient alternatives become available. A firm could, of course, decide to change all of its inputs at any time. Yet it would often be very costly and wasteful to do so. What is important about the economic definition of the long run is that it refers to the period over which a firm has found it efficient—cost reducing—to change every aspect of its production. The economic definition of long run thus involves a continuum by the end of which a firm will have been able to vary all of its current productive inputs. It

does not refer to a particular point in time at which a firm suddenly varies everything, nor does it prescribe the particular changes that a firm should make.

Ms. Murray, in advocating the instantaneous replacement model, is articulating something quite different from the economic definition of the long run she cites, and is in fact advocating a model that contradicts proper long-run economic analysis in a fundamental way. What Ms. Murray urges the RCA to adopt is not a model in which all of ACS' network inputs become efficiently variable (*i.e.* a true long run model), but instead a model in which all of ACS' inputs are treated as changing instantaneously. And it is a model under which, as soon as technology changes and costs are revisited, ACS will be treated as instantaneously replacing its network at that next point in time. Far from being a long run model, the instantaneous replacement approach is instead a sequence of sudden, short-run optimizations. Such instantaneous replacements, if actually executed, would be enormously inefficient over time and would be directly contrary to how efficient firms in fact vary inputs over the long run. For this reason the instantaneous replacement model is quite different from long run economic efficiency and is not, as Ms. Murray

claims, "well grounded in mainstream economic theory" (Murray Rebuttal p.8). Indeed, as one of the world's most influential "mainstream" economists has written: "In a world of continuous technological progress, it would be irrational for firms constantly to update their facilities in order *completely* to incorporate today's lowest cost technology."<sup>5</sup> Instantaneous replacement models do not reflect mainstream economic thinking about what constitutes long-run efficiency.

There are good reasons why firms in the real world, even in fully competitive markets, do not behave the way Ms. Murray claims they should be modeled as behaving. A long-run model should encompass a period that allows for the *possibility* that all inputs are variable. But it need not, and in the real world in most cases will not, assume that all inputs are in fact varied at any particular point of time or over any limited interval of time. Before an existing input is in fact varied, the firm must be able reasonably to predict *how* that input should be assumed to change in the model; *i.e.*, rationally to calculate what an input should vary *to*. Because technology in the telecommunications industry and demand

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<sup>5</sup> Alfred E. Kahn, "Letting Go: Deregulating the Process of Deregulation," MSU Public Utilities Papers (1998) at 91.

conditions are changing over time, a carrier often will be able to make reasoned predictions about what the replacement technology and its associated costs will be only for a limited time into the future. At some point, the cost model becomes too speculative to serve the purpose of guiding efficient investment and pricing decisions. Indeed, permitting an analyst to look beyond the time in which reasoned predictions are possible adds nothing to the value or reliability of the cost study. Such limitations on what can be foreseen are practical limitations on how long run a cost model can be. But they are certainly not a reason to forsake the long run and engage in short-run instantaneous replacement. Such an approach certainly achieves full variability of all inputs, but in an artificial way that forgets about the rational economic efficiency at the core of the accepted economic definition of the long run.

**III. GCI WITNESS DANA TINDALL ARTICULATES INCORRECT TESTS FOR WHETHER TELRIC PRICES ARE CORRECT AND FOR WHETHER ACS IS A DOMINANT CARRIER FOR PURPOSES OF THE 1996 ACT**

9. Q. Do you agree with Ms. Tindall that a correct UNE price “makes a carrier indifferent between leasing facilities from the incumbent or putting customers on its own facilities” (Tindall Rebuttal p. 5)?

A. No. The FCC has made clear that one of the central purpose of TELRIC is to send efficient economic signals; in the Commission's own words, "to bring meaningful competition to local telecommunications markets; to ensure the efficient use of existing network facilities . . . and to encourage new entrants to make economically rational decisions about whether, or how, to enter a given local market."<sup>6</sup> If TELRIC prices were always adjusted to make CLECs indifferent between leasing and building, they would not be able to perform this essential signaling function. Logically, Ms. Tindall's standard would mean that the more efficient a CLEC could become over its own network, the lower the ILEC's UNE prices would have to be. Instead of having incentive to build its own, more efficient network, the CLEC would have equal incentive to continue to use the ILEC's network because of the artificial reduction of UNE prices. The CLEC's decisions would thus be unrelated to relative efficiencies and UNE prices would fail to convey useful signals about entry. If GCI is a more efficient carrier, UNE prices should not make it indifferent between leasing UNEs and building its own facilities, but should push it to build.

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<sup>6</sup> Brief for Petitioners United States and FCC, p. 22, in *Verizon Communications, Inc. v. FCC*, U.S. Supreme Court, filed April, 2001.

10. Q. Do you agree with Ms. Tindall that, despite GCI's success as a competitor, the RCA should treat ACS as "dominant" because there are not competing providers of UNEs? (Tindall Rebuttal p. 9)

A. No. Ms. Tindall's analysis turns the Telecommunications Act of 1996 upside down. Ms. Tindall asserts throughout her rebuttal testimony that GCI has been a remarkably effective competitor. Indeed, she concludes that in the retail market ACS has lost half of its market share and "is arguably no longer dominant." (Tindall Rebuttal p. 9). She nonetheless argues for classifying ACS as dominant for unbundling purposes because there are no competing providers of UNEs.

As an initial matter, the 1996 Act only imposes UNE obligations on ILECs. More fundamentally, however, under the 1996 Act there should be no unbundling in the first place if retail competition in the local exchange market is not "impaired." The evidence Ms. Tindall cites of GCI's competitive success, of its transition to facilities-based service, and of ACS' loss of market share weigh heavily against a finding of competitive impairment in the local exchange market. In the absence of competitive impairment in the local exchange market, the question of competitive impairment in the retail services market, the question of

competing UNE providers is irrelevant because the ILEC should have no unbundling obligations to begin with. Put another way, the 1996 Act conditions an ILEC's obligation to provide UNEs on retail competition, not on UNE competition. GCI seems to want to have things both ways: they have become a full-fledged competing local carrier that is moving increasingly to its own facilities, but wants to preserve the option of using UNEs where it thinks it advantageous to do so. The 1996 Act's impairment standard does not grant such discretionary access to UNEs for CLECs that can otherwise successfully compete. Ms. Tindall's testimony in the end therefore raises not so much the question of what UNE prices should be, but the much more fundamental question of whether ACS should be required to unbundle at all in key markets.

11. Q. Does this conclude your testimony?  
A. Yes.

## **Exhibit J**

STATE OF ALASKA

REGULATORY COMMISSION OF ALASKA

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Mark K. Johnson, Chair  
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\_\_\_\_\_ )

REGULATORY COMMISSION OF ALASKA  
Anchorage, Alaska

VOLUME VII  
PUBLIC HEARING

November 3rd, 2003  
8:30 o'clock a.m.

BEFORE: GLENN CRAVEZ, HEARING EXAMINER

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

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1 A Yes, I did.

2 Q We've marked that prefiled testimony as T-1 and T-2. Are  
3 there any changes you'd like to make in your testimony?

4 A No, sir.

5 Q Okay.

6 MR. SHOUP: I yield the witness to cross examination.

7 HOWARD A SHELANSKI

8 testified as follows on:

9 CROSS EXAMINATION

10 BY MR. MODEROW:

11 Q Dr. Shelanski, you offered testimony in your reply where  
12 you feel that the Dallas and Aurora Subdivisions are  
13 illustrative of the appropriate level of efficiency for  
14 construction of facilities in Anchorage, Alaska, is that  
15 correct?

16 A Could you refer me, please, to the page of my testimony  
17 and the specific lines that you're referring to?

18 Q In your prefiled rebuttal testimony, the question -- wait.  
19 The question would start back on page seven, question  
20 five, but the actual discussion is starting on page nine  
21 of the Aurora and Dallas Subdivisions.

22 A Yes.

23 HEARING EXAMINER CRAVEZ: Mr Moderow, are you in T-2 right  
24 now? Or T-1?

25 MR. MODEROW: I'm in T-2.

1 HEARING EXAMINER CRAVEZ: Thanks.

2 MR. MODEROW: Mr. Hearing Officer, would you want me to  
3 wait or.....

4 HEARING EXAMINER CRAVEZ: No, please go.

5 Q Back to the question, is that a fair statement, that you  
6 feel that the costs incurred by GCI in constructing these  
7 subdivisions are significant and should substantial  
8 weight?

9 A What I explained was that I did not accept that they could  
10 be presumptively brushed aside, and that they are a very  
11 important piece of evidence that should be carefully  
12 considered.

13 Q Now, are you aware of whether or not GCI has ever  
14 constructed any copper distribution plant other than these  
15 two subdivisions?

16 A No, sir, I am not.

17 Q Are you aware of the amount of copper distribution plant  
18 within these subdivisions?

19 A No, I am not.

20 Q Are you aware of where GCI purchased its materials for  
21 these subdivisions?

22 A No, I am not.

23 Q Would it surprise you that these are the only two  
24 construction projects involving copper plant that GCI has  
25 ever undertaken?

1 A No, in fact it would not surprise me at all, nor would I  
2 find it terribly relevant.

3 Q Do you have any idea how many miles of copper wire GCI's  
4 ever engineered and placed?

5 A No, I do not.

6 Q Do you have any idea of the number of miles of copper  
7 distribution cable and drops that ACS has placed?

8 A I would have to see that subject to check. I have seen  
9 those figures. I don't recall them off the top of my  
10 head.

11 Q And would you have any idea of the amount of copper  
12 distribution cable and drop cable that ACS purchases in a  
13 year?

14 A No, I would not.

15 Q Would you have any idea about the contracts that ACS has  
16 entered into for bulk purchases of this type of thing?

17 A No. And maybe to clarify, my testimony was designed to  
18 rebut Ms. Murray's explanations for why the subdivision  
19 builds were not relevant. The only explanation she gave  
20 had nothing to do with prices of copper, levels of  
21 procurement. It was a naked statement that incremental  
22 builds should categorically be irrelevant for benchmarking  
23 costs, and that you had to look to a build with the total  
24 increment of demand. And there's nothing in any TELRIC  
25 proceeding that says that. And as an economic matter,

1 that would (a) be an extremely strange way to model costs,  
2 and (b) it's not at all clear that building the total  
3 increment of demand rather than Dallas Subdivision size  
4 increments of demand would lead you to lower costs.

5 So my testimony was designed, not to talk specifically  
6 about those cases, but to talk about the reasons Ms.  
7 Murray gave for rejecting them, and why I believe they're  
8 economically incorrect.

9 Q And it's your testimony now that the applicable FCC  
10 standard doesn't require considering the total increment  
11 of demand as being the entire market as opposed to an  
12 incremental build?

13 A There is nothing in any FCC order that I have found that  
14 says that. In fact, quite the opposite, that incremental  
15 builds cannot be relevant cost evidence, and that the only  
16 relevant cost evidence is building a complete network to  
17 the full increment of market demand.

18 Q Would it be necessary to correct those costs to the total  
19 increment?

20 A If you knew how to scale them, that would be important,  
21 but I would also suggest that given that ACS is not fully  
22 replacing its network, and indeed it's I think universally  
23 accepted amongst economists that it doesn't make any sense  
24 to model a competitive firm as completely erasing and  
25 rebuilding its network to the full increment of demand. I

1 think that looking at how ACS is actually upgrading and  
2 rebuilding its network in increments can be a cost  
3 benchmark that then when translated through the network is  
4 relevant for modeling costs networkwide. For the same  
5 reason, I think that the increments in which GCI builds,  
6 absent really compelling evidence that there is an economy  
7 of scale in buying copper in a larger bulk, that I've  
8 never heard of an economy of scale in labor.

9 In fact, quite the opposite. But, you know, if there is  
10 an economy of scale in labor, without compelling evidence  
11 of that to categorically say that, oh, this is an  
12 incremental build. It's not representative, strikes me as  
13 incorrect, and that was the point of my testimony on this  
14 point.

15 Q Are you aware of any negotiations between the subdivision  
16 owner and the complex owner and ACS relative to these  
17 subdivisions?

18 A No, sir, I have no specific knowledge about any details  
19 whatsoever to do with these subdivisions.

20 Q Now, you state in your reply testimony, this would be T-2,  
21 that GCI witnesses are incorrect when they state that the  
22 FCC's TELRIC model requires instantaneous -- or assumes  
23 instantaneous and ubiquitous replacement of existing  
24 network facilities with new technology. Is that in your  
25 testimony?

1 A Again, I would like to -- you know, I prefer to, rather  
2 than have my testimony paraphrased, see specifically what  
3 you're referring to?

4 Q That's on page 2, I'm sorry.

5 A Okay. But it is my view that it is incorrect to say that  
6 the FCC's TELRIC require a ubiquitous over placement  
7 model. And I have outlined at great length in both my  
8 direct and my reply testimonies specific statements by the  
9 Commission right up to very recent rulings, Virginia  
10 Arbitration, for example, that make clear that other  
11 models, models other than full ubiquitous replacement  
12 models are okay.

13 Q Now, is it your understanding that they have requested  
14 comment on this assumption in the TELRIC NPRM?

15 A Yes, the NPRM, which is a notice, a request for comment,  
16 not an order, a rule line, or anything with binding force  
17 of law, has requested those -- has requested comments, and  
18 as you correctly said in your opening, characterizes at  
19 least the way TELRIC has been interpreted in the past as  
20 sometimes involving full replacement. On the other hand,  
21 in orders -- in orders that do have binding force of law  
22 in sworn test -- in sworn briefs before the Supreme Court,  
23 the FCC has characterized that a full replacement model is  
24 not mandated by TELRIC.

25 Q But the -- you would concede that the NPRM in that either

1 tentative findings or any issues upon which they've  
2 requested comment are things that may happen in the  
3 future? They are not the current law now?

4 A It's not the current law. The FCC has not requested  
5 comment -- or, I mean, has not drawn a tentative  
6 conclusion regarding forward placement networks to my  
7 recollection in the NPRM. They have requested comment on  
8 one of the ways that state commissions have interpreted  
9 the TELRIC rules. That's my recollection. I do not have  
10 that NPRM before me.

11 MR. MODEROW: I have no further questions.

12 HEARING EXAMINER CRAVEZ: Redirect?

13 MR. SHOUP: Let me clarify something. My understanding  
14 was we would go.....

15 COURT REPORTER: We can't hear you.

16 MR. SHOUP: I'm sorry. My understanding was we were going  
17 to go cross examination, Commission questions and then  
18 redirect, but I'm happy to do it the other way if that's.....

19 HEARING EXAMINER CRAVEZ: No that's fine. Thank you.

20 MR. SHOUP: Is it? All right.

21 HEARING EXAMINER CRAVEZ: Are there any questions from  
22 Commissioners?

23 COMMISSIONER THOMPSON: Just a few.

24 INQUIRY

25 BY COMMISSIONER THOMPSON:

1 Q In your prefiled direct testimony on page 22, in the  
2 middle.

3 COURT REPORTER: I can't hear you.

4 Q Dr. Shelanski, I would like to refer you to prefiled  
5 direct testimony at page 22 -- or page 18, I'm sorry. No,  
6 I slipped myself. I really did mean page 22. You talked  
7 to the -- you talk about the MSF model, and I understand  
8 this testimony may have been written before some of the  
9 FCC's more recent rulings. Do you still believe the  
10 statement made there is correct, that the MSF model was  
11 not compliant with TELRIC principles?

12 A It was written in advance of some of the recent rulings.  
13 I certainly didn't mean to -- I used the work principles,  
14 Commissioner, very carefully there. I don't believe the  
15 MSM is out of compliance with the TELRIC regulations. I  
16 do believe it's in compliance with the TELRIC regulations.  
17 The Commission has said so. But I have not changed my  
18 view that as a policy matter, in terms of what would  
19 happen with respect to economic signalling under the MSM  
20 model, providing correct price signals for both ACS and  
21 GCI. ACS in terms of investing in its network. GCI in  
22 determining what its correct strategy should be. And what  
23 the best strategy for Alaska consumers is.  
24 I have not changed my view that the MSM has serious  
25 disadvantages in terms of accomplishing those policy

1 objectives. So it is my view that an artificial forward  
2 placement model that uses inputs that are not tied to the  
3 particular market at issue would contradict the policy  
4 objectives of TELRIC. It would not well serve them. So  
5 to the extent I believe that the MSM model -- I don't  
6 believe it's illegal. I do believe that it does not well  
7 serve the principles and objectives of TELRIC.

8 Q Now I'd like to refer you back to page 18 where there's a  
9 discussion about the economic value of an existing  
10 network.

11 A Yes.

12 Q You're suggesting that, or seem to be suggesting in the  
13 first part of the page, that we should make some sort of  
14 adjustment based upon risks that the investment might be  
15 stranded in the future, but you also suggest that we  
16 should consider -- when we're setting the economic value  
17 of an existing network, we should consider that it might  
18 be replaced by a superior technology, more cost-efficient  
19 technology. I'm confused about how that statement fits  
20 with ACS's argument in this case about what type of  
21 adjustments, how we should account for GCI's plans to  
22 build cable telephony network in our unique prices. What  
23 are you really trying to tell me about what we should do?

24 A Okay. Well, the point about the economic value goes --  
25 puts it specifically to depreciation. The point about

1 GCI's migrating customers to its cable plant goes not only  
2 to depreciation, but actually also to cost of capital.  
3 And the kinds of risk factors that come in when a carrier  
4 must provide facilities to a competitor, but a competitor  
5 who has no obligation to use those facilities over their  
6 useful life, and moreover may move demand off of the  
7 network such that there will be no use of those facilities  
8 over their useful life.  
9 That leads to two kinds of adjustments that are fairly  
10 unique in the context of the Alaska market with its  
11 combination of extremely high levels of competition and  
12 the reality of the major competitor being in a meaningful  
13 way facilities based, and potentially increasingly  
14 facilities based. Both of those risk factors are ones  
15 that are unusual, and that I have not seen in the context  
16 of any other UNE proceeding.  
17 So the way that the possible migration of customers would  
18 effect both depreciation and cost of capital is (a) to  
19 shorten depreciation lives on some percentage of capital,  
20 to lead to an acceleration at least in recovery, because  
21 of the possibility that in the out years after migration  
22 to the cable plant, there will not be an economic way to  
23 recover the cost of those facilities which ACS must now by  
24 law provide. The other -- so that's on the depreciation  
25 side.

1 On the cost of capital side, one of the risks that goes  
2 into cost of capital are fluctuations of demand. And to  
3 the extent that you can more reasonably expect a  
4 substantial fluctuation of demand, this is a risk premium  
5 that can be anticipated and that can be built into the  
6 cost of capital up front. I would defer to Mr. Blessing  
7 on more detail on the depreciation cost of capital points,  
8 but as an economic matter, that's how I look at that  
9 migration affecting those financial cost elements.

10 Q The FCC's told us that the actual prices, existing prices  
11 are the starting point, and we're supposed to make  
12 adjustments based on what we think forward-looking  
13 technology would be. Your analysis just now doesn't --  
14 you know, if we assume, and I don't believe we have a  
15 record to know that that's true or not, that this cable  
16 telephony network is more cost efficient, wouldn't that  
17 also suggest that somehow we consider the prices of that  
18 more efficient network, and make a downward adjustment in  
19 the value of the existing network?

20 A Well, two points on that. There's no question that if  
21 somebody were to -- if there were suddenly to be a much  
22 more efficient network, and efficient on a forward-looking  
23 basis, meaning not just operation and maintenance costs,  
24 but the full cost, taking into account the construction,  
25 deployment, depreciation and capital costs moving forward

1 of that network, that if ACS put its entire network up for  
2 sale, the price of that network would be lower after this  
3 new, more efficient network had been put in place, and  
4 lower cost network, than it would have been prior to the  
5 development of that network.

6 So the arrival of the more efficient technology, and the  
7 more efficient network, reduces the market value if you  
8 will, of ACS's network, and that is something that would  
9 have to be taken into account in terms of setting the  
10 levels off which -- you know, that are to be depreciated.  
11 Suddenly the network is less valuable, you are  
12 depreciating a lower quantity going forward. So there's  
13 no question that new technology or the existence of a much  
14 more efficient network will effect the market value of  
15 ACS's network. But were that to come to pass, we wouldn't  
16 have to have the proceeding at all, or make any adjustment  
17 whatsoever in the ACS network, because at that point there  
18 would under Federal law cease to be a case, and the  
19 ability to order unbundling at all.

20 COMMISSIONER THOMPSON: Thank you. I have no further  
21 questions.

22 HEARING EXAMINER CRAVEZ: Any other questions from.....

23 COMMISSIONER STRANDBERG: I have one.

24 HEARING EXAMINER CRAVEZ: I'm sorry. Go ahead.

25 INQUIRY

1 BY COMMISSIONER STRANDBERG:

2 Q This is a huge record, and -- but I will ask this  
3 question. As an economist, if ACS loses a customer, do  
4 you feel that loop is truly stranded in an economic sense?

5 A That's a good question. If ACS loses a customer and the  
6 customer is being served over the UNE loop, of course, ACS  
7 is recovering, and, you know, in theory should be  
8 recovering it's full forward looking costs of that loop.  
9 So since that forward looking cost includes the  
10 depreciation and capital costs, it's not -- the investment  
11 is not stranded.

12 If they lose the customer and the customer is migrated to  
13 another network, then the investment is -- there is the  
14 possibility, of course, of winning a customer back, but  
15 during such periods as the customer is not being served  
16 and is being served over the competing facility, it is my  
17 opinion that the invest is at that point stranded.

18 Q In your travels, has it been your experience that  
19 commissions have considered costs on the basis of an  
20 instantaneous ubiquitous replacement of the network, or on  
21 an incremental replacement?

22 A The TELRIC proceeding in which I've -- the only full  
23 TELRIC proceeding that I have -- that I've participated in  
24 in terms of setting UNE prices was the Virginia  
25 arbitration that the FCC decided. And in that case, it's

1 very interesting, the FCC did not require -- did not say  
2 that they were requiring a full replacement model.  
3 Now, as it happened, both of the -- both of the models  
4 that were before the FCC in that case were in some respect  
5 full replacement models, just as the models that are  
6 before you today are in some sense full replacement models  
7 with the debate being over the inputs. But it was not --  
8 but full replacement, and instantaneous replacement, the  
9 strong version of that means using none of the technology  
10 that you have, none of that can be what's efficient  
11 forward looking technology, and all of the inputs must be  
12 what is ideal around the country, not what is feasible  
13 within a particular market place.  
14 And in the Virginia arbitration, the FCC not only did not  
15 require that kind of strong full replacement with  
16 completely hypothetical inputs, they in fact rejected it  
17 in two of the three elements they decided, the switching  
18 and the transport. And, very importantly, the FCC stated  
19 in paragraph 49 of that order that neither of the models  
20 before them, the Verizon model that relied to a greater  
21 extent than the MSM model on actual inputs and on what the  
22 actual technological change would be in the network versus  
23 the MSM, which was really the strong version of full  
24 replacement, full deployment of the best available  
25 everywhere.

1 The FCC said both of them were consistent, neither was  
2 inconsistent was the way they phrased it, with their  
3 forward looking costing principles. And then in fact they  
4 put their money where their mouth was and adopted  
5 Verizon's model on two of the three elements.  
6 So it is not my -- it has not been my experience that  
7 commissions have adopted the radical full replacement  
8 model that is being asked for here. I know that Illinois  
9 actually did not in an important proceeding, and I know  
10 that the FCC has repeatedly said you don't have to assume  
11 that the slate is wiped blank and it is completely  
12 rebuilt.

13 Q Thank you.

14 A Thank you, Commissioner.

15 HEARING EXAMINER CRAVEZ: Any other questions from the  
16 Commission?

17 COMMISSIONER GIARD: I'm going to have a few questions if  
18 I may.

19 INQUIRY

20 BY COMMISSIONER GIARD:

21 Q Dr. Shelanski, in the Verizon order, the Commission spoke  
22 in paragraph 113 that the assets lives that were proposed  
23 by AT&T Worldcom are too long to be consistent with the  
24 forward looking principles upon which TELRIC is based.  
25 And as I was reading through the Verizon, I was wondering,

1        what is the actual competition in that area that the.....

2 A        In Virginia?

3 Q        Um-hum. Virginia.

4 A        Virginia, if you look at the market statewide, I don't

5        know what the figures are today. But roughly speaking,

6        combined business and residential for -- I think 10

7        percent would be a very safe and generous number to put on

8        the level of competition in Virginia. It's somewhat lower

9        than that for residential, it's somewhat higher than that

10       for business.

11       Again, I must be clear, this is subject to check. I don't

12       have the current figures before me.

13 Q       I understand.

14 A       But we were looking at that kind of number. The other

15       thing about Virginia was that there were certain areas,

16       even fairly dense areas of Virginia where there was

17       virtually no competition, so -- and even in Arlington and

18       Alexandria and the northern Virginia D.C. suburb area,

19       which is extremely dense, population densities between

20       three and 4,000 of people per square mile, the amount of

21       competition was, as I say, and today likely still is,

22       somewhere in this 10 percent neighborhood.

23 Q       So then I went on and I went on and I read that the FCC

24       selected the low end of the Safe Harbor, and I wondered if

25       you could tell me why you thought they selected the low

1 end of the Safe Harbor when they set their depreciation  
2 rates?

3 A I don't have an opinion on that, Commissioner. I was not  
4 the cost of capital or depreciation witness. But more to  
5 the point, I read the order about, you know, six or seven  
6 weeks ago when it came out, and I did read that section.  
7 I don't recall what their reasoning was.....

8 Q Okay.

9 A .....on the low end.

10 Q I was also wondering if you had -- in your testimony you  
11 state, and I'm looking at T-2, page 8, lines 18, when you  
12 talk about especially where the incumbent faces  
13 competition in the local market as ACS does, there's a  
14 sound basis for presuming that the carrier's costs are  
15 efficient.

16 A Yes. I think that this is the logical flip side of a lot  
17 of the things that GCI's witnesses are arguing. That  
18 competitors -- that the whole presumption of TELRIC is  
19 that competitors are forced to act efficiently. They  
20 cannot sustain higher costs in an environment where  
21 there's somebody present to take the customer away. And  
22 in a market like Anchorage, Juneau or Fairbanks where the  
23 levels of competition are such that virtually every  
24 customer is up for grabs, and market share has been lost  
25 at a dramatic rate as Mr. Shoup explained in his opening,

1 there's simply no way that inefficient costs can be  
2 sustained in that environment, and every incentive,  
3 especially in this case where there's no chance the  
4 competitor is going away, to make all of the investments  
5 and make the engineering decisions that are on the forward  
6 looking basis efficient.

7 So when I hear that a firm is facing competition and that  
8 the cost it is incurring from that point forward are  
9 inefficient, I get very suspicious. The presumption in my  
10 view should be quite the opposite. Every basic economic  
11 model, every basic eco -- the whole premise of TELRIC is  
12 that from that point forward that you do actually have  
13 competition, you act efficiently.

14 And so I would be very surprised to see a model that  
15 generated substantially lower costs than the costs that  
16 ACS is in fact incurring and expects to incur going  
17 forward.

18 And the Commission is very clear in numerous points, the  
19 costs that TELRIC are supposed to compensate are the ones  
20 that the ILEC, quote, actually expects to incur. They say  
21 that in several points in their -- in paragraph 685 of the  
22 First Report and Order, which is not at all an outdated  
23 order. It's been reiterated and reaffirmed in many of its  
24 specifics and particulars by the Commission. And they say  
25 it again before the Supreme Court and in other places.

1 Because they actually expect to be going forward, to incur  
2 going forward.

3 If I saw a model that generated costs lower than what ACS  
4 actually expected to incur going forward based on its  
5 competitive environment, I would be very, very careful and  
6 require a lot of validation and explanation for how it is  
7 that ACS is passing up these savings that are supposedly  
8 available to them in the competitive environment. And I  
9 guess I would be particularly suspicious when those are  
10 costs that the competitor itself can't achieve.

11 It would suggest that you have two firms with every -- or  
12 claims that they can't achieve. You have two firms  
13 competing, each of which has the incentive to undercut the  
14 other to provide better service and to take customers. If  
15 neither of them is getting costs that come close to the  
16 hypothetical model, that to me would be extremely strong  
17 evidence that, and I would need a very detailed and  
18 specific explanation, to justify the lower costs from that  
19 model. And that's really what I mean from my testimony on  
20 page 8.

21 Q I'm wondering when efficiency is actually achieved?

22 A Well, that -- you know, efficiency -- I guess there are a  
23 number of ways to measure efficiency. And to me you can  
24 measure efficiency at a point in time, ut that does not  
25 mean that you measure efficiency assuming the world ends

1 at this point of time, and there's not further  
2 technological development, no further investment.  
3 Efficiency -- and indeed TELRIC is a forward looking  
4 method, so such an idea wouldn't make any sense at all, of  
5 just freezing and looking at this point in time.  
6 You must take into account what is -- you must measure  
7 efficiency today, taking into account, what are the costs  
8 that will be incurred in the future, and what are the  
9 technology changes that will be incurred in the future?  
10 In answer to when you hit the idealized efficient network,  
11 the answer is never because -- unless you can posit a  
12 world in which technology will stop changing, because 10  
13 years from now I will have what today looks like the best  
14 I could build today, but by then there will be something  
15 new that I'm evolving for -- towards. And that's why the  
16 economic definition of the long run is actually a process.  
17 It's not a point.  
18 It's a process of always varying those inputs to what is  
19 more efficient, taking into account the idea that  
20 something better might come along next week. I am not  
21 going to put a new switch in today and insure the up front  
22 costs, even though it is the best available today, if I  
23 know that next year there's a packet switch technology  
24 going into the network that's going to drop my costs.  
25 Yes, that -- there may be a switch that's more efficient

1       than what I have in the ground, but to buy it would be  
2       much more costly than to wait a year for the better  
3       technology.

4       So you never -- and industry after industry shows this.  
5       Even if a firm, for example, an airline buys a whole new  
6       fleet, so the day they open for business, like Jet Blue,  
7       they've got all brand new planes, and that day they've got  
8       the best available. By the next quarter they don't. And  
9       they don't immediately throw out what they had and buy new  
10      planes. They wait until they need to replace one. They  
11      do the calculation of the -- you know, what is the  
12      operating and maintenance costs of what I have today  
13      versus the purchase price plus operation and maintenance  
14      costs tomorrow of the new plane, and most often you don't  
15      replace. You have multiple vintages of technology in your  
16      network, and you are always evolving as things lose their  
17      economic value to what is better.

18      So you never get to a network where you can go like that  
19      and say, we're done, there's nothing more to do, we've hit  
20      the magic point, because new technologies come along and  
21      the magic point is now advanced forward in time.

22      Nonetheless, because we can make calculations about what  
23      is an intelligent investment strategy going forward, when  
24      it makes sense to replace versus not, and because and  
25      because we replace incrementally, you can say looking

1 ahead, taking into account all of those possible  
2 technology and demand changes, are you operating  
3 efficiently today?

4 Is there some change you could make today that would  
5 reduce your costs going forward up to the next point that  
6 you need to look and see what the new technology is. And  
7 that's a question you can ask.

8 Q I guess what's troubling to me about the -- your  
9 definition of efficiency is not the magic point of when  
10 you achieve it, but the fact that you make an assumption  
11 that efficiency occurs at the beginning of competition.

12 A Yeah. Well, that's the assumption of the hypothetical  
13 model, and that's what I find to be a bit troubling. Oh,  
14 that incentives to be efficient start at the -- I'm sorry.

15 Q No, I think you said that you start functioning  
16 efficiently upon competition.

17 A Yes. I mean, I do believe that when you face competition,  
18 at that point all of your forward looking decisions must  
19 be.....

20 Q Okay.

21 A .....must be efficient.

22 Q Okay.

23 A Yes.

24 COMMISSIONER GIARD: I have no more questions for this

25 witness.

1 HEARING EXAMINER CRAVEZ: Any other questions?

2 COMMISSIONER THOMPSON: Unh-unh. (Negative)

3 HEARING EXAMINER CRAVEZ: Redirect?

4 MR. SHOUP: I just have two.

5 HOWARD A. SHELANSKI

6 testified as follows on:

7 REDIRECT EXAMINATION

8 BY MR. SHOUP:

9 Q Dr. Shelanski, you mentioned in response to a question on  
10 cross examination something about economies of scale,  
11 labor, and you seemed to be tying that to the idea of  
12 ubiquitous replacement. Could you explain what you meant  
13 by that?

14 A Yes. Well, I -- that was in response to Mr. Moderow's  
15 question about why I thought we could not casually dismiss  
16 the Aurora and Dallas Subdivisions. My point was that the  
17 only explanation in Dr. Murray's testimony about why those  
18 weren't -- or the primary explanation was that those were  
19 incremental builds, that they were not builds to the full  
20 increment of demand in the market place. And she assumed  
21 that there would be large economies of scale to building  
22 towards an incremental demand. And my response was first  
23 even if there are economies of scale, the fact that  
24 networks do build incrementally and make that the relevant  
25 point of comparison. But even if one wants to say that

1 you should measure building to the full increment of  
2 demand, it is not clear from Dr. Murray's -- or Ms.  
3 Murray's testimony what the economies of scale would be,  
4 and in particular, given the crucial importance of labor  
5 as a cost driver.

6 I myself have never seen in a construction context an  
7 economy of scale for labor. In fact, quite the opposite.

8 If you were to pull up the entire telephone network in  
9 Alaska, and then try to hire the labor to rebuild it, you  
10 would likely drain the labor market and drive wages up.

11 To the extent that you don't drain the labor market and  
12 drive wages up, you're going to have people working  
13 overtime, more hours of work. I've never heard of an  
14 overtime discount on labor.

15 So if this is a crucial cost driver, you can't just simply  
16 waive your hand and say economies of scale. In fact,  
17 there may be, and I believe there's a strong case to be  
18 made for substantial diseconomies of scale in going to a  
19 full replacement and building the full network. I believe  
20 the case for that is prima facie at least as plausible as  
21 the case for economies of scale.

22 Q One last thing. You've been the senior economist on the  
23 Council -- the President's Council of Economic Advisers,  
24 and the chief economist at the FCC. Where do you draw the  
25 line between -- within the TELRIC structure, where do you

1 draw the line between forward looking costs and subsidy of  
2 a CLEC?

3 A Well, I mean, I think in some senses TELRIC, if you ask  
4 anybody at the FCC, and nobody would say the point of  
5 TELRIC is to subsidize a CLEC, and so at any point where  
6 you're subsidizing a CLEC, you are contradicting what the  
7 Commission itself has indicated to be one of the  
8 absolutely crucial points of TELRIC, which is to send  
9 correct economic signals. So my view is you should never  
10 be subsidizing a CLEC.

11 That said, the question of what is a subsidy is a  
12 difficult one. And if the Commission has found impairment  
13 in a market, and deems unbundling -- that unbundling is  
14 proper, unbundling should take place at TELRIC. Now, it  
15 is very possible that the TELRIC price will be, in fact,  
16 it should be such at that point that the TELRIC price is  
17 lower than what that Commission -- that competitor can  
18 build the network on its own for. That's the point of  
19 TELRIC, to provide that transition and to bring the  
20 efficient economies of the ILEC to the CLEC. If that's  
21 what one wants to call a subsidy, that in the TELRIC is  
22 not a subsidy.

23 What is a subsidy is -- what is a subsidy is when the CLEC  
24 either has an option, an alternative to provide service,  
25 and is using the ILEC's network as an option. We might

1       feel like using theirs instead of building our own, and in  
2       fact it can build at the same cost. That is a subsidy  
3       even by merely provid -- even if it's the same cost that  
4       the CLEC can build at. Even if they're paying the cost,  
5       it's providing a free option value. That's a subsidy. And  
6       in some FCC proceedings, that option value has been  
7       calculated to be enormous.

8       But what is a pure subsidy, and what a number of documents  
9       and studies have found is that the ILECs are not even  
10      recovering their costs. And in any definition that I have  
11      ever heard of, a price that says you may use somebody's  
12      facility at less than it costs them to provide the  
13      facility, provides a subsidy. It is saying to the ILEC  
14      recover, you know, \$10 when your costs are 12. That is a  
15      \$2 subsidy to the competitor no matter how you cut it.  
16      So when -- now, if the ILEC -- if all of the subsidy is  
17      driven by past inefficiency, TELRIC, and this gets to your  
18      question of where the line is, TELRIC has told us that  
19      costs -- to the degree that costs are higher than what  
20      they would be in a real world competitive environment,  
21      that is an amount that you cannot recover, and we're not  
22      counting that as a subsidy. But when you're looking at a  
23      forward looking model for a company that is under  
24      competition that really does have its costs pared down to  
25      an efficient level, and you are giving them less than

1 those costs, that is by any definition a subsidy.

2 MR. SHOUP: Those are my questions. Thank you.

3 HEARING EXAMINER CRAVEZ: Under the rules established by  
4 the Commission, is there any recross?

5 COMMISSIONER THOMPSON: We didn't talk about -- do we need  
6 it?

7 HEARING EXAMINER CRAVEZ: Are you asking for any recross,  
8 Mr. Moderow?

9 MR. MODEROW: I heard a whole bunch of new testimony. I  
10 certainly would keep it brief.

11 HEARING EXAMINER CRAVEZ: Okay. Let's do that. As I  
12 understand, we have quite a few witnesses to get through in two  
13 weeks, so I'll give you recross, but keep it brief.

14 MR. MODEROW: If I can just have a second here to.....

15 HEARING EXAMINER CRAVEZ: While you're conferring, I need  
16 to remind the attorneys that the testimony was marked on  
17 Friday, but exhibits have not been admitted, so as we go  
18 through witnesses, you can move for the admission of any  
19 exhibits, please.

20 (Whispered conversation)

21 HEARING EXAMINER CRAVEZ: I'm sorry? And their prefiled  
22 testimony.

23 MR. SHOUP: And the prefiled as well?

24 HEARING EXAMINER CRAVEZ: Nothing's been admitted at this  
25 time so.....

1 MR. SHOUP: All right.

2 (Whispered conversation)

3 HOWARD A. SHELANSKI

4 testified as follows on:

5 RE CROSS EXAMINATION

6 BY MR. MODEROW:

7 Q Dr. Shelanski, you stated you participated in the Virginia  
8 proceedings, is that.....

9 A Yes, I did.

10 Q And is it fair to say that that was conducted under the  
11 FCC's former baseball arbitration rules?

12 A Yes, it was.

13 Q So if a position was not espoused by a party in that  
14 position, it wasn't available to be adopted, is that  
15 correct?

16 A Well, it depends on what you mean by a position. I mean,  
17 there were opinions that were -- that went way beyond the  
18 specific numbers or part of either parties' baseball  
19 proposal that were part of the record, so I don't know  
20 what you mean by a position.

21 Q But, for instance, if an approach to calculating an  
22 expense wasn't presented by one of the parties, it wasn't  
23 considered.

24 A That is correct, although certainly the full replacement  
25 and instantaneous network proposal was espoused actively

1 by AT&T's witnesses in that proceeding, and they're all  
2 over the record.

3 Q Now you mentioned that switching was one of those where  
4 the FCC allowed some of the costs to be based on an  
5 incremental add-on, is that a fair statement?

6 A I said that the switching was based on Verizon's model.

7 Q And Verizon's model had a start-up cost and then added  
8 capacity later, and that was accounted for, is that  
9 correct?

10 A Subject to check. That proceeding was well over two years  
11 ago, and.....

12 Q Are you aware of GCI's switching proposal in this case?

13 A I'm not prepared to testify about GCI's switching  
14 proposal. I have read testimony on GCI's switching  
15 proposal. I'd leave that to the relevant witnesses.

16 Q Now, are you aware of whether or not ACS intends to try to  
17 win back customers it's lost?

18 A I certainly would -- first of all, I'm not aware of any  
19 specific win back plans from ACS. That's well beyond the  
20 testimony. I would be shocked if ACS did not make efforts  
21 to retain and win back customers going forward.

22 Q Are you aware of any statistics regarding the turnover  
23 rate of local customers in Anchorage, Alaska?

24 A No, sir, I'm not, nor have I been asked to testify on any  
25 such matters in this proceeding.

1 Q Now, you stated that expenses were trended.

2 A I don't know what you're referring to. I don't recall  
3 making that statement. Maybe you can point to where I've  
4 made.....

5 Q Well, I guess.....

6 A .....that statement.

7 Q .....you testified that ACS has become efficient because  
8 of the competition, is that a fair statement?

9 A My argument is that the presumption should be that ACS's  
10 forward looking costs, now that it faces such competition,  
11 are the efficient forward looking incremental costs in  
12 this market.

13 Q Now if you trend their costs in any category from the time  
14 that competition started through the present time, would  
15 that trend be indicative of a move towards efficiencies?

16 A If you properly calculate all of the reasons that firms  
17 need to take into account, expenses, my view would be that  
18 the expenses incurred during a period of competition are  
19 presumptively efficient.

20 Q So we're going to a moment in time then. In other words,  
21 the moment in time we pick, is -- that's efficient,  
22 and.....

23 A I don't know what you mean.

24 Q Well, if you would -- you're saying that when competition  
25 comes, you become efficient, you become ubiquitously

1 efficient overnight or you become more efficient as you  
2 experience competition?

3 A You have the incentive as quickly as is economically  
4 rational to reduce your costs, and to make your network  
5 efficient, because you can no longer charge prices that  
6 cover structural costs, what you might call cost overruns  
7 or cost inefficiencies. So you I would venture to say  
8 overnight have the incentive to begin the process of  
9 reducing your costs as much as is economically rational  
10 and as possible.

11 Q And as time passes then, you achieve and act on that  
12 incentive, and you achieve greater efficiency?

13 A Yes.

14 Q So if -- it would be a relevant factor to look at your  
15 precompetition costs and then your costs during  
16 competition to see how fast you can move to that most  
17 efficient spot, right?

18 A Right, but I want to be very clear, I don't know what you  
19 mean by how fast. If what you're driving at is the idea  
20 that you should see a downward trend in costs, that is  
21 wrong. New technology can be very expensive, and over any  
22 period of time, especially looking back over that trend,  
23 you may see costs trend upwards with the new purchases of  
24 technology indeed as this Commission said in a very recent  
25 electronic order. TELRIC costs can be higher or lower

1 than embedded costs in recognition that you can't look at  
2 the trend and see the direction of the trend and say, ah-  
3 ha, it's more or less efficient. So if that's what you're  
4 driving at, I would have to disagree with the point.

5 Q So you're saying that it's not really a relevant exercise  
6 to look at the way costs are going for either expenses of  
7 operation or purchase and installation of equipment?

8 A No, that's not what I've said at all. It is very relevant  
9 to look at those costs. You just can't simply point to  
10 directions of trend and make that the only inquiry you  
11 have. You need to look at those costs very carefully.

12 It's one of the -- it's one of the reasons that the costs  
13 that the competitor is actually incurring are so  
14 incredibly important and significant, because they tell a  
15 lot about what a firm that has every incentive, in fact,  
16 all of Ms. Murray's testimony is about competitors coming  
17 in and being efficient and driving down the cost of the  
18 ILEC.

19 And Ms. Tindall's testimony is in large extent about how  
20 GCI has been so effective in coming in and taking  
21 competition away by being an efficient superior provider.  
22 That is why when you're looking at efficiency you can't  
23 simply construct something completely hypothetical and  
24 claim, ah-ha, this is efficient. Efficiency has to be  
25 tied in some sense to what a firm really has to accomplish

1 going forward, and what is actually feasible to any  
2 provider, no matter who they are in a particular market.  
3 If labor rates are high in a market, don't bring me labor  
4 rates from Iowa, because no carrier, no matter how  
5 efficient, could achieve them. It makes no sense.  
6 So what you need to do is have a rich and careful  
7 investigation of the costs like the one that is going on  
8 here, focusing on the particular categories that are at  
9 issue, and ask in the context of this market and given  
10 what is feasible in ACS's markets, are these reasonable  
11 and efficient? Efficient, i.e., are these reasonable low  
12 costs kinds of exercises that have occurred and that are  
13 occurring going forward. And as I say, in some sense, the  
14 best presumptive estimate of that would be the cost of the  
15 competitor with all of the incentives to drive costs down  
16 and take business away is incurring.

17 Q Now, turning to the cost of the competitor, are you aware  
18 of any reasons why GCI, which has declared its future  
19 reliance on cable telephony, would actually build copper  
20 plant into subdivisions?

21 A Well, I don't know what the state of GCI's cable network  
22 is in those subdivisions, and it may have made the  
23 decision that it was economically efficient for it to  
24 either not build cable to those subdivisions, or to build  
25 both networks to those subdivisions. Once you've got the

1 ducks and right-of-way, maybe you could get joint use out  
2 of them. I'm not familiar with GCI's strategies and  
3 plans.

4 What I do find interesting is that GCI has been able to  
5 build this plant to these subdivisions and to provide  
6 service to these subdivisions, showing that as a  
7 facilities based carrier, whether on its own plant or  
8 building copper plant, for whatever reasons it has chosen,  
9 it's <sup>\*\*</sup>certainly not facing any impairment in doing so.

10 Q Now, is it your contention, going back to your discussion  
11 of subsidy, is it your contention that all TELRIC costs  
12 above embedded costs are a subsidy to the CLECs?

13 A I don't understand the question. I mean, I certainly  
14 didn't say that. What I meant to say was that all TELRIC  
15 costs, all real tower costs, total element long-run  
16 increment costs need to be recovered through the rate.  
17 Anything that is not recovered is a subsidy. It is a  
18 direct subsidy to the CLEC, yes.

19 (Whispered conversation)

20 MR. MODEROW: I have no further questions.

21 HEARING EXAMINER CRAVEZ: Any follow-up questions from the  
22 Commission?

23 (Whispered conversation)

24 HEARING EXAMINER CRAVEZ: Okay. Any very brief redirect?

25 MR. SHOUP: No redirect.