BEFORE THE STATE OF SOUTH DAKOTA
PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE PETITION OF	)	
MIDCONTINENT COMMUNICATIONS FOR	)	**Docket No. TC07-117**
APPROVAL OF ITS INTRASTATE SWITCHED	)	
ACCESS TARIFF AND FOR AN EXEMPTION	)	
FROM DEVELOPING COMPANY-SPECIFIC	)	
COST-BASED SWITCHED ACCESS RATES	)	

DIRECT TESTIMONY OF

AUGUST H. ANKUM, PH.D.

On Behalf Of

MIDCONTINENT COMMUNICATIONS

July 29, 2008

EXHIBIT
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I. INTRODUCTION

A. QUALIFICATIONS OF WITNESS

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

A. My name is Dr. August H. Ankum. I am a Senior Vice President at QSI Consulting, Inc., ("QSI"), a consulting firm specializing in economics, econometric analysis, and telecommunications cost modeling. My business address is 1027 Arch, Suite 304, Philadelphia, PA 19107.

Q. WHAT IS QSI CONSULTING, INC.?

A. QSI Consulting, Inc. ("QSI") is a consulting firm specializing in traditional and non-traditional utility industries, econometric analysis and computer aided modeling. QSI provides consulting services for regulated utilities, competitive providers, government agencies (including public utility commissions) and industry organizations.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.

A. I received a Ph.D. in Economics from the University of Texas at Austin in 1992, an M.A. in Economics from the University of Texas at Austin in 1987, and a B.A. in Economics from Quincy College, Illinois, in 1982.

My professional background covers work experiences in private industry and at state regulatory agencies. As a consultant, I have worked with large companies, such as AT&T, AT&T Wireless, Bell Canada and MCI WorldCom ("MCIW"), as well as with smaller carriers, including a variety of competitive local exchange carriers ("CLECs") and wireless carriers. I have worked on many of the arbitration proceedings between new entrants and incumbent local exchange carriers ("ILECs"). Specifically, I have been involved in arbitrations between new entrants and NYNEX, Bell Atlantic, U S WEST, BellSouth, Ameritech, SBC, GTE and Puerto Rico Telephone. Prior to practicing as a telecommunications consultant, I worked for MCI Telecommunications Corporation ("MCI") as a senior economist. At MCI, I provided expert witness testimony and conducted economic analyses for internal purposes. Before I joined MCI in early 1995, I worked for Teleport Communications Group, Inc. ("TCG"), as a Manager in the Regulatory and External Affairs Division. In this capacity, I testified on behalf of TCG in proceedings concerning local exchange competition issues, such as Ameritech's Customer First proceeding in Illinois. From 1986 until early 1994, I was employed as an economist by the Public Utility Commission of Texas ("PUCT") where I worked on a variety of electric power and telecommunications issues. During my last year at the PUCT, I held the position of chief economist. Prior to joining the PUCT, I taught undergraduate courses in economics as an Assistant Instructor at the University of Texas from 1984 to 1986.

A list of proceedings in which I have filed testimony is attached hereto as Exhibit (AA-1).

Q. ON WHOSE BEHALF IS THIS REBUTTAL TESTIMONY FILED?

A. This testimony was prepared on behalf of Midcontinent Communications ("Midcontinent").

Q. ARE YOU ADOPTING THE DIRECT TESTIMONY OF WARREN R. FISCHER?

A. Yes, I am.

Q. DO YOU HAVE EXPERTISE WITH RESPECT TO THE ISSUES BEFORE THE COMMISSION IN THIS PROCEEDING?

A. As previously discussed, I have worked for approximately two decades in telecommunications. Further, I have participated in a large number of proceedings concerning cost models for a number of telecommunications services, including switched access services. I am also very familiar with FCC orders and policies concerning switched access services and rates as I have recently co-authored a whitepaper on the topic for QSI. I have also assisted numerous carriers in workshops, contested proceedings and rulemakings on switched access related topics before numerous state commissions. For example, earlier this month, I participated on behalf of a coalition of CLECs (i.e., CompSouth) in a rulemaking on switched access related issues before the Florida Public Service Commission.

B. PURPOSE AND RECOMMENDATIONS

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. The purpose of this testimony is to respond to issues raised in the testimony of Staff witness Mr. Keith A. Senger. Specifically, I will respond to Mr. Senger's recommendations that (i) the Commission adopt the FCC's benchmarking policies and impose on Midcontinent switched access rates that are no higher than Qwest's, and (ii) the Commission reject Midcontinent's request to charge the "LECA Plus" rates.[1]

Given the considerable efforts and resources expended by Midcontinent and based on a straightforward reading of Commission rules, I recommend that the Commission approve Midcontinent's switched access rate request.

II. MR. SENGER'S RECOMMENDATION THAT THE COMMISSION ADOPT THE FCC'S BENCHMARKING POLICIES SHOULD BE REJECTED

Q. DOES MR. SENGER RECOMMEND THAT THIS COMMISSION ADOPT THE FCC'S BENCHMARKING POLICIES?

A. Yes. Mr. Senger recommends that the Commission reject Midcontinent's request for the mirroring of the LECA Plus rates. Then, on page 11 of his testimony, Mr. Senger states the following:

> I recommend the Commission continue to follow the FCC lead regarding CLEC access rates, continue to support Commission Staff's approach at attempting to create competitive based switched access rates in a non-noncompetitive arena, and approve an intrastate switched access rate for Midco that mirrors or is lower than the ILEC Qwest rate on the same grounds the Commission has done in the past.

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[1] Rates developed using the statewide average schedule formula prescribed in ARSD 20:10:27:12 are commonly referred to as the "LECA Plus" rate.

Q. DO YOU AGREE WITH MR. SENGER'S POLICY RECOMMENDATION THAT THE COMMISSION ADOPT THE FCC'S BENCHMARKING POLICIES?

A. No. Mr. Senger's recommendation lacks support and leads to bad public policy for a large number of reasons. In what follows I will discuss why Mr. Senger's recommendations, in this regard, should be rejected.

Q. FIRST, HAS THE FCC INDICATED THAT ITS BENCHMARKING POLICIES SHOULD BE ADOPTED BY STATE COMMISSIONS?

A. No, not to my knowledge.

A. <u>MR. SENGER MISREPRESENTS THE FCC'S BENCHMARKING POLICIES</u>

Q. DOES MR. SENGER MISREPRESENT THE FCC'S BENCHMARKING POLICIES?

A. Yes. Mr. Senger misrepresents the FCC's policies in a number of ways. When put in proper context, it is clear that it would be inappropriate for this Commission to mirror the FCC's benchmarking policies as they relate to Midcontinent today, as recommended by Mr. Senger.

Q. DOES MR. SENGER FAIL TO MENTION THAT THE FCC *EXPLICITLY* ADOPTED ITS BENCHMARKING POLICIES AS A *TRANSITIONAL* MEASURE AND NEVER INTENDED IT TO BE PERMANENT?

A. Yes. Mr. Senger fails to mention that the FCC explicitly noted that its benchmarking policies, adopted in 2001, were intended as *transitional*, awaiting the FCC's more permanent resolution of inter-carrier compensation issues. As the FCC noted:

> We stress, however, that the mechanism set out below is a *transitional* one; *it is not designed as a permanent solution* to the issues surrounding CLEC access charges.[2]

As recently indicated by the FCC, the agency may finally turn to a more comprehensive approach to inter-carrier compensation issues.[3] Therefore, irrespective of a host of other problems concerning benchmarking policies, any efforts by this Commission to emulate the FCC's benchmarking policies now would be particularly ill-timed given the FCC's current efforts to resolve inter-carrier compensation policies more comprehensively, perhaps completely abolishing the very transitional and flawed benchmarking policies Mr. Senger recommends.

Q. DOES MR. SENGER FAIL TO MENTION THAT THE FCC ADOPTED ITS BENCHMARKING POLICIES BECAUSE OF RESOURCE CONSTRAINTS?

A. Yes. The FCC never found that the CLECs' switched access rates were unreasonable in general. In fact, the FCC noted: "We decline to conclude, in this order, that CLEC access

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2 *In the Matter of Access Charge Reform. Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, Seventh Report and Order and Further Notice of Proposed Rulemaking, CC Dkt No. 96-262, rel. April 27, 2001, ¶7 (hereafter "*CLEC Access Reform Order*").

3 The U.S. Court of Appeals for the D.C. Circuit gave the Federal Communications Commission until Nov. 5 to explain why it had the legal authority to implement certain rules pertaining to Core Communications Inc. If the FCC does not meet the deadline, the court will vacate the rules. The FCC has indicated that it will tackle the inter-carrier compensation issues within the Courts set deadlines.

rates, across the board, are unreasonable."[4] Instead, the FCC noted that addressing CLEC switched access complaints using its existing complaint process may strain the FCC's resources:

> Several parties have already filed with the Commission informal complaints raising this issue in order to preserve their claims from lapse. We are concerned that a flood of unreasonable-rate complaints could *overtax the Commission's resources* to deal with such proceedings in a manner that is timely and efficient yet gives each complaint the attention it deserves.[5]

While resource constraints may be a valid consideration for the FCC, because the FCC regulates thousands of IXCs and CLECs across all fifty states, state commissions deal with far fewer carriers. This is particularly true for this Commission where it already has a proceeding open to discuss the merits of Midcontinent's rates – i.e., this proceeding. Given that the more meaningful issues of Midcontinent's costs, proper pricing policies and other important factual issues are already squarely addressed in this proceeding, I strongly disagree that using the FCC's more general, transitory approach of benchmarking would lead to an economically rational or reasonable result. This is especially true since we know that the FCC will be addressing these issues in the future and it is likely that the transitory mechanism will change.

Q. DOES MR. SENGER FAIL TO MENTION THAT THE TELECOMMUNICATIONS INDUSTRY HAS CHANGED SINCE THE FCC ADOPTED ITS BENCHMARKING POLICIES IN 2001?

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4 *CLEC Access Reform Order*, ¶ 34

5 *Id.* ¶ 25. (Emphasis added.)

A. Yes. On page 6 of his testimony, Mr. Senger discusses the FCC's concerns about CLEC market power:

> I will not review the entire Order, but in general, the FCC found that the market structure for access services prevented competition from effectively functioning and have failed to drive switched access rates to market level pricing. The FCC found that many CLECs were unjustly wielding their monopoly power over the IXC and charging unjust and unreasonable switched access rates.

However, Mr. Senger fails to mention the radical changes that have transpired in the telecommunications industry since the FCC adopted its benchmarking policies in 2001. Most notably, Mr. Senger fails to discuss the impact of the mega-mergers between AT&T-SBC and Verizon-MCI. These developments and others (such as the scores of bankruptcies that occurred since the order was issued) radically alter the underlying assumptions of the FCC's benchmarking decisions.

Q. HOW DO THE CHANGES IN THE TELECOMMUNICATIONS INDUSTRY SINCE 2001 IMPACT THE FCC'S ANALYSIS.

A. In 2001, the FCC's benchmarking policies were motivated by a concern about CLEC market power. Initially, the FCC had rejected any notions that CLECs had market power. For example, in an earlier decision the FCC noted:

> [A]s CLECs attempted to expand their market presence, the rates of incumbent LECs or other potential competitors *should constrain* the CLECs' terminating access rates. The Commission found that access customers likely would take competitive steps to avoid paying unreasonable terminating access charges. Thus, it explained that a call recipient might switch to another local carrier in response to incentives offered by an IXC.[6] (Emphasis added.)

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6 *CLEC Access Reform Order*, ¶ 14.

However, in its *CLEC Access Reform Order*, the FCC revisited the issue to address what IXCs viewed as "the CLECs' abuse of [the FCC's] tariff rules to impose excessive access charges"[7] and *reversed* its prior decision, based upon a number of key market-specific criteria. The FCC noted:

> [T]here is ample evidence that the combination of the market's failure to constrain CLEC access rates, our geographic rate averaging rules for IXCs, the absence of effective limits on CLEC rates and the tariff system create an arbitrage opportunity for CLECs to charge unreasonable access rates. Thus, we conclude that some action is necessary to prevent CLECs from exploiting the market power in the rates that they tariff for switched access services.[8]

Q. DO THE KEY MARKET CRITERIA THAT THE FCC RELIED UPON IN REVERSING ITSELF AND ULTIMATELY CAPPING CLEC ACCESS RATES STILL DOMINATE THE MARKET TODAY – SEVEN YEARS LATER?

A. No. The FCC's concerns about CLEC market power are no longer relevant in light of the radical changes in telecommunications markets that have transpired in the seven years since the FCC last addressed this issue. Mr. Senger fails to acknowledge these events and their impact on the FCC's analysis.

Q. DID THE FCC IDENTIFY TWO PRECONDITIONS THAT WOULD ELIMINATE CONCERNS ABOUT CLEC MARKET POWER AND THUS OBVIATE THE NEED FOR BENCHMARKING POLICIES?

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7 *Id.*, ¶ 1.

8 *Id.*, ¶ 34.

A. Yes. In its 2001 *CLEC Access Reform Order*, the FCC explicitly identified developments that it believed would render exchange access markets competitive enough to eliminate the need for price-regulation on CLEC rates:

> The Commission previously projected that, at least in the case of originating access service, IXCs would likely enter marketing alliances with LECs offering low-priced access service and would thereby be able to exert downward pressure on CLEC access rates. The Commission even raised the prospect that IXCs would themselves choose to enter the local service market as a means of exerting downward pressure on terminating rates.[9]

That is, competitive market pressures would discipline CLEC switched access rates if the following occurred:

1. Alliances were struck between IXCs and ILECs; and,
2. IXCs entered into local exchange markets.

The FCC lamented, however, that neither of these developments had come to pass at the time of its *CLEC Access Reform Order* (2001) and concluded that CLECs could, as a result, exert market power in the provision of exchange access services:

> *However, neither of these eventualities has come to pass, at least not to an extent that has resulted in effective downward competitive pressure on CLEC access rates.* We now acknowledge that the market for access services does not appear to be *structured* in a manner that allows competition to discipline rates.[10]

Q. HAVE THE FCC'S PRECONDITIONS FOR WELL FUNCTIONING ACCESS MARKETS BEEN MET SINCE 2001?

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9 *CLEC Access Reform Order*, ¶32.

10 *Id*, ¶32. (Emphasis added.)

A. Yes. What the FCC was hoping for in 2001 – alliances between IXCs and ILECs and IXC entry into local markets – now *has* come to pass. There have been a number of mergers between the Nation's largest IXCs and largest ILECs, most notably the *megamergers* between AT&T-SBC and Verizon-MCI. Thus, the FCC's prerequisites for competitive exchange access markets have been met for most if not all local exchange markets. Further, AT&T/SBC, Verizon and Qwest have now received section 271 approvals to provide interLATA long distance services using their own facilities. That is, today all of them are allowed to provide long distance services as IXCs thereby vertically bridging the gap between heretofore segmented IXC and local markets – just as the FCC had hoped.

Q. HOW DO THESE CHANGES IN MARKET STRUCTURE ALTER THE ANALYSIS USED BY THE FCC TO SUPPORT ITS BENCHMARKING POLICIES?

A. The watershed megamergers and section 271 approvals impact and alter any conclusions regarding barriers-to-entry faced by IXCs and the ability of CLECs to exercise market power. Given that AT&T, Verizon and Qwest own and operate most of the country's local exchange facilities (necessary for access services), it must be concluded that their IXC affiliates no longer face any CLEC controlled bottlenecks, i.e., they do not face any barriers-to-entry. This means, in turn, that the FCC's findings of CLEC market power – stemming from control over bottleneck facilities – underlying its benchmarking policies are no longer valid.

Q. PLEASE EXPLAIN WHY THE FCC'S FINDINGS OF CLEC MARKET POWER ARE NO LONGER VALID?

A. Simply put, market power requires the presence of barriers-to-entry. Absent barriers-to-entry, CLECs will simply not be able to exercise market power in any of the markets within which they operate, including switched access. CLECs don't have or control bottleneck facilities that would allow them to erect barriers to entry.

Q. COULD YOU GIVE AN EXAMPLE OF HOW THE ABSENCE OF BARRIERS-TO-ENTRY ELIMINATES A CLECS' ABILITY TO EXERCISE MARKET POWER?

A. Yes. For example, assume that a CLEC, as alleged, raises its exchange access rates to earn supernormal profits. Then, the CLEC customer will have become especially attractive to all would-be competitors. It has to be recognized that companies compete not only for the *retail* revenues and profits associated with an end user but for *all* revenues and profits associated with the end user. These revenues and profits also include revenues and profits generated from inter-carrier services, including exchange access revenues. Absent barriers-to-entry, there is nothing that would permit the CLEC to retain a customer associated with higher revenues and profits – other carriers will, one way or another,[11] compete the customer away. In fact, to assume that other carriers

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[11] I say "one way or another" because markets are creative and I cannot predict beforehand all the many ways in which companies may lure customers away.

would *not* compete for customers associated with higher revenues and profits is simply *irrational.*

In other words, competition in retail markets disciplines market behavior in upstream wholesale markets for exchange access markets as well.

Q. SOME REGULATORS FALLACIOUSLY CONCLUDE THAT CLECS HAVE MARKET POWER; IS THERE AN OVERARCHING PROBLEM WITH THEIR ANALYSIS?

A. Yes. While it is true that some industry observers continue to conclude that CLECs have market power in the provision of exchange access services (even with the dramatic changes that have occurred in the market as discussed above), their analysis is based upon "short-run" criteria instead of the more appropriate "long run" criteria required to justify intrusive regulatory pricing intervention (i.e., benchmarking). The argument goes as follows: when an end-user makes or receives a long distance call, the IXC is obligated to originate or terminate the call at whatever prices CLECs may charge because there are no alternatives or substitutes available to the IXC related to that particular call. Therefore, the argument goes, the CLEC has market power.

While this argument may have superficial appeal, it is incorrect. Using this type of a short run analysis, many companies may appear to have monopoly power when in fact, we know they don't. For example, in the short run, airlines on cross-Atlantic flights have market power in the provision of on-flight food and beverage services for any particular flight, and they could even charge excessive prices for bathroom access and get away with it on a short-term basis (i.e., the length of a single flight). In a slightly longer run analysis, however, it is clear that they have little or no market power and are, in fact, operating in a highly competitive environment. For example, if an airline attempted to charge a regular competitive price for airline tickets and then an exorbitant amount for bathroom access on its flights, you can imagine that customers would be looking for other alternatives next time they were choosing a carrier and other airlines would surely swoop in to attract that airline's customers away.

The truth is that a proper market dominance analysis (i.e., an investigation of market power) must be premised on a time horizon that is sufficiently long to permit for demand and supply responses to discipline market participants. In the current situation, the analysis should consider a longer run analysis in which other providers of exchange access, such as vertically integrated RBOC/IXCs, are able to establish their own "exchange access" connection to the end-user. And given that companies like AT&T, Qwest and Verizon own and operate most local exchange networks, it must be assumed that competitors can enter into CLEC markets on very short notice. The time horizon needs only to be sufficiently long for the competitive process of customer acquisition – or rather, the threat of customer acquisition – to play out. Again, as previously established, CLECs (much like the airlines discussed above) operate in a highly competitive environment in which they compete for all the revenues associated with the end-user, which includes not only the revenues from the local exchange, data/video and long distance services offered to the end-user, but also the revenues of exchange access services offered to IXCs. To the extent they are able to establish prices in any of those markets that generate robust revenues; they in turn attract competitors who will be advantaged by winning those customers away. As such, regulators must only step slightly away from the shortest of short-run analysis to understand that retail competition should serve to discipline the upstream wholesale markets of CLECs.

Q. IN ANY EVENT, DID MR. SENGER PERFORM HIS OWN MARKET DOMINANCE ANALYSIS TO ESTABLISH THAT CLECS HAVE MARKET POWER, AS HE CLAIMS THEY DO?

A. No, he did not. He simply relied on the FCC's *outdated* 2001 *CLEC Access reform Order*, as if the last seven years had not brought watershed changes. As such, his recommendations are outdated and irrelevant to current state of telecommunications.

Q. IF THE MARKET HAS CHANGED TO THE POINT WHEREIN THE FCC'S PRIOR ANALYSIS IS NO LONGER VALID, WHY HASN'T THE FCC RE-VISITED ITS ORIGINAL ORDER AND REMOVED THE BENCHMARK REQUIREMENT FOR CLEC INTERSTATE RATES?

A. It is my understanding that the FCC has established a deadline of November 5, 2008 to issue some type ruling on the larger, more comprehensive debate surrounding unified intercarrier compensation reform.[12] CLEC interstate switched access rates are a large component of that overall debate. The FCC will need to deal with those issues when it addresses comprehensive inter-carrier compensation reform. As I suggest below, that is

[12] The U.S. Court of Appeals for the D.C. Circuit gave the Federal Communications Commission until Nov. 5 to explain why it had the legal authority to implement certain rules pertaining to Core Communications Inc. If the FCC does not meet the deadline, the court will vacate the rules. The FCC has indicated that it will tackle the inter-carrier compensation issues within the Courts set deadlines.

the proper approach, i.e., addressing all related inter-carrier compensation issues on a unified, comprehensive basis. It is also one the reasons I believe Mr. Senger's suggestion that this Commission move toward the FCC's dated CLEC benchmarking policy as particularly troublesome – i.e., it is another inappropriate "piece meal" regulatory approach that will undoubtedly cause distortions in a marketplace that should be governed by competitive forces where possible.

Q. DID MR. SENGER NOTE THAT THE FCC'S BENCHMARKING POLICY WAS NOT UNANIMOUS BUT MET WITH THE STRONG DISSENT OF COMMISSIONER FURCHTGOTT-ROTH, THE ONLY ECONOMIST ON THE COMMISSION AT THE TIME?

A. No. As noted, the FCC's benchmarking policies were adopted as transitional and in the face of resource constraints. Further undermining the merit of the FCC's benchmarking policies is the fact that it met with strong dissent from the only economist on the FCC at the time, Commissioner Harold Furchtgott-Roth:

> The majority finds this course of action necessary, because, as a result of our myriad regulations that limit separable contracts and markets for exchange access services, the parties that consume exchange access services rarely receive accurate price signals. Rather than remove the regulations that limit the clarity of price signals, the majority resorts to the opiate for regulators – price regulation.
>
> Two wrongs do not make a right. We should correct the regulations that interfere with price signals, not enshrine price regulation forever while doing nothing to remove the regulatory barriers to exchange access services. To be sure, the Commission's adoption of price regulation in this context is probably lawful, and I do not ordinarily dissent from items that I believe are merely unwise. However, restraint in the face of unwise decisions has its limits. Here, the Commission's decision to initiate price regulation runs counter to

> basic economic principles as well as the deregulatory mandate of the Telecommunications Act of 1996. Accordingly, I dissent from this order.[13]

Commissioner Furchtgott-Roth's dissent is informative and systematically lays out a number of problems with the FCC's benchmarking policies. His dissent is attached hereto as Exhibit (AA-2). While obviously not all FCC Orders are unanimous and they certainly need not be unanimous to have legal effect, the fact that the benchmarking policies have such feeble theoretical underpinnings and were met with such a strong and reasoned dissent by one of the commissioners further calls into question whether they are an appropriate public policy for the economy and consumers of South Dakota.

B. BENCHMARKING POLICIES FOR INTRASTATE ACCESS RATES LACK MERIT – QWEST'S RATES HAVE NO RELEVANCE TO CLECS

Q. WOULD IT BE GOOD PUBLIC POLICY FOR THIS COMMISSION TO BENCHMARK MIDCONTINENT'S SWITCHED ACCESS RATES AGAINST QWEST'S RATES?

A. No. Mr. Senger's recommendation to benchmark Midcontinent's switched access rates against Qwest's rates would lead to bad public policy and be deeply detrimental to local exchange competition in the State of South Dakota.

Q. IS THERE ANY MERIT TO THE CLAIM THAT QWEST'S RATES SHOULD SERVE AS A PROXY OR SURROGATE FOR MARKET BASED RATES?

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13 *CLEC Access Reform Order*, Dissent of Commissioner Furchtgott-Roth, page 1.

A. No. Neither Qwest's intrastate exchange access rates nor their interstate rates are reasonable proxies for CLEC exchange access rates nor are they likely to represent some "competitive market outcome." As the Commission is aware, and as Qwest has noted, Qwest's intrastate switched access rates do not comport with the Commission's switched access rules.

Access charges have historically been set for ILECs based on overall revenue and cost targets that were determined as part of a jurisdictional cost allocation process specific to the ILEC in question– a relatively arcane methodology that is generally inconsistent with economic cost causation principles and has no bearing on a CLECs' operations. Further, both the ILECs' interstate and intrastate exchange access rates were typically set in the context of *complex negotiated deals* that reconciled a large number of often unrelated issues for ILECs, regulators, and other interested parties and involved various *quid pro quos* for lowering exchange access rates. To lift exchange access rates out of this larger context and apply them to CLECs, such as Midcontinent – without any of the *quid pro quos* extracted by Qwest – is unfair and unreasonable.

Q. COULD YOU PROVIDE AN ANALOGY TO ILLUSTRATE WHY QWEST'S SWITCHED ACCESS RATES SHOULD NOT BE *LIFTED OUT OF CONTEXT* AND BE APPLIED TO MIDCONTINENT?

A. Yes. To see why it is inappropriate to pick Qwest's switched access rates – in isolation from other considerations -- as a benchmark for Midcontinent, Staff should consider the following analogy. When a new-car buyer trades in a used car, the total value of the deal involves the price paid for the new car *and* the price received for the trade-in car. For example, if the dealer accepted a lower price for the new car, it probably means that the buyer received less for a trade-in car. Advocates of benchmarking overlook the fact that requiring CLECs to adopt ILEC rates for exchange access is like demanding from a car dealer a low price for a new car without the *quid pro quo* of offering a trade-in car. Qwest, as other large ILECs, received all sorts of consideration in return for exchange access reductions, such as increased USF subsidies, that do not benefit CLECs.

Q. COULD YOU DISCUSS IN MORE DETAIL WHY THE LARGE ILECS' (SUCH AS AT&T, QWEST AND VERIZON) ACCESS CHARGES ARE SPECIFIC TO THE LARGE ILECS AND SHOULD NOT BE APPLIED TO ANY OTHER COMPANY?

A. Yes. Historically, under rate of return regulation, access charges were set for ILECs based on overall revenue and cost targets that were determined as part of a complicated jurisdictional cost allocation process. More recently, however, ILECs' interstate and intrastate exchange access rates have typically been set, as I just noted, in the context of *negotiated deals* that reconcile a large number of issues for ILECs, legislators, and other interested parties, generally providing some form of "revenue neutrality" to the ILEC – i.e., as access rates go down, other regulated rates are adjusted to make up some part, or all, the difference. To lift ILEC exchange access rates out of this larger context and apply them to CLECs – without any acknowledgement of the historical regulatory context – is without merit and inequitable.

The following statement by the FCC on the complex processes originally used in setting exchange access rates for ILECs underscores the fact that these rates were not set by market forces or economic cost causation that would make them good proxies for the economic costs of other carriers.

> The [FCC] uses a multi-step process to identify the cost of providing access service. First, the rules require an incumbent LEC to record all of its expenses, investments, and revenues in accordance with accounting rules set forth in our regulations. Second, the rules divide these costs between those associated with regulated telecommunications services and those associated with non-regulated activities. Third, the separations rules determine the ***fraction*** of the incumbent LEC's regulated expenses and investment that should be ***allocated*** to the interstate jurisdiction. After the total amount of ***interstate*** cost is identified, the access charge rules translate these interstate costs into charges for the specific interstate access services and rate elements. Part 69 specifies in detail the rate structure for recovering those costs. That is, the rules tell the incumbent LECs the precise manner in which they may assess charges on interexchange carriers and end users.[14]

The above FCC description of how access charges have historically been set for ILECs demonstrates two things:

a) the ILECs costs were determined only in some aggregated, top-down[15] sense and then allocated across various "buckets," such as regulated vs. non-regulated, state vs. interstate, etc., and
b) rates were set to recover some general revenue/cost target but were not based on per unit[16] costs that would result from TSLRIC, or other forms of more economically rational cost analysis.

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[14] *In the Matter of Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982, 15991-92, at ¶ 22 (1997) ("*Access Charge Reform Order (1997)*"), *aff'd Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8th Cir. 1998). (emphasis added).

[15] The term "top down" refers to a costing methodology that starts with costs recorded on the company's books and allocates them – top down – over the company's services. By contrast, a bottom up approach starts with a company's telecommunications technologies and network, identifies which technologies and portions of the network are used for certain services, and then proceeds to calculate – bottom up – what the costs are associated with these technologies and portions of the network to arrive at the cost of providing the services. As is generally recognized, the two methodologies may not result in the same service costs or in the same overall costs.

[16] The term "per unit costs" refers to the costs calculated for one unit of a service, such as a minute of use.

c) The ILEC's allocation of *interstate access costs is inherently tied to state interstate access costs*. The two are like *Ying and Yang* and *cannot* be considered in isolation.

In sum, there is no compelling indication that ILEC rates either at the inter- or intra-state level are "cost based" in relation to the economic costs of the ILECs. Surely, however, there is nothing in this process that makes the resulting access rates relevant to CLECs such as Midcontinent, since none of it applies to Midcontinent.

Q. PLEASE EXPLAIN IN MORE DETAIL WHY THE PROCESSES BY WHICH ILEC ACCESS RATES ARE ESTABLISHED HAVE NO RELEVANCE TO CLECS SUCH AS MIDCONTINENT.

A. CLECs like Midcontinent were never part of this complicated process because it has no relevance to the competitive marketplace in which CLECs operate. CLECs do not separate their costs into *regulated and non-regulated* activities and services; likewise, they do not engage in *jurisdictional separations* and *allocations* of costs between state and interstate jurisdictions. Further, while this top-down cost allocation process and similar state-initiated processes may have resulted in rates that permitted ILECs to achieve an *overall recovery* of revenue/cost targets, there is simply nothing in this process that ensures that the resulting rates for individual services, such as the various individual components of the switched access services, are in any way relevant to how such rates would be set in more competitive markets.

Again, it is important to note that the ILECs' interstate and intrastate access costs and revenues are historically intertwined and cannot be considered in isolation from each other.

Q. COULD YOU DISCUSS IN MORE DETAIL THE NEGOTIATED NATURE OF THE "DEALS" THAT ESTABLISH THE ILECS' SWITCHED ACCESS RATES?

A. Yes. The manner by which the ILECs' interstate access rates were set is a good example. On May 31, 2000 the FCC adopted an "integrated interstate access reform and universal service proposal" put forward by AT&T, Bell Atlantic, GTE, SBC and Sprint (referred to by the FCC as the Coalition for Affordable Local and Long Distance Service – CALLS).[17] The *CALLS Order* substantially altered interstate switched access rates, reducing the rates for SBC and BellSouth (both now AT&T) as well as Bell Atlantic and GTE (both now Verizon) dramatically from previous levels. The primary focus of the order was to reduce interstate access rates paid by CALLS' long distance members AT&T (before its merger with SBC Communications) and Sprint, while at the same time allowing CALLS' local exchange members (AT&T and Verizon) to recover lost monies through the interstate universal service support mechanism (*i.e.*, largely a revenue neutral undertaking for the ILECs).[18] Even a cursory reading of the order indicates that the CALLS proposal adopted by the FCC was a landmark event in the process of interstate access reform, and that the reduction in switched access rates offered by the local exchange carriers in return for numerous and important concessions elsewhere was an integral part of the overall "agreement" that was reached.

It is important to note that the exchange access rates produced by the *CALLS Order* were set primarily through *non-public negotiations* between the ILECs, the IXCs and

[17] *Sixth Report and Order* in CC Docket Nos. 96-262 and 94-1, *Report and Order* in CC Docket No. 99-249, *Eleventh Report and Order* in CC Docket No. 96-45, FCC 00-193, Adopted May 31, 2000 (hereafter "*CALLS Order*").

[18] *CALLS Order*, ¶ 3.

apparently the FCC itself. The behind the scenes negotiations establishing the *CALLS Order* and the resulting rates are revealed in an illuminating dissent by FCC Commissioner Harold Furchtgott-Roth.[19] In his dissent, Commissioner Furchtgott-Roth provides a rare look "behind the curtain" of the process leading up to the *CALLS Order* and offers some enlightening insights. He begins his dissent by agreeing that interstate access charges (at that time) bore *little resemblance to the "costs of access actually incurred.*" Further, he then goes on, in a strong statement, to discredit the process by which the lowered rates were reached as "dismaying." Indeed, he goes so far as to suggest that, in his opinion, "the process by which the original CALLS proposal was modified [and ultimately approved] is fundamentally inconsistent with principles of neutrality and transparency that must govern agency decision making."

Specifically, Commissioner Furchtgott-Roth describes a process whereby the CALLS organization (primarily the remaining AT&T, Verizon and Sprint) negotiated with various consumer groups in an effort to craft a modified proposal regarding reduced switched access rates and increased universal service fund monies that would be adopted by the FCC. Commissioner Furchtgott-Roth is highly critical of this process for three primary reasons:

a) The Commission (acting chiefly through the Common Carrier Bureau) apparently "refereed" the negotiations between the parties, and participated in recommending various outcomes negotiated by the parties (*i.e.*, the Common Carrier Bureau apparently agreed to recommend to the Commission for approval, certain components of the parties agreement(s)). Commissioner Furchtgott-Roth complained that the FCC, in playing the dual role of referee and decision maker, had acted in a highly improper manner.

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[19] *Statement of Commissioner Harold Furchtgott-Roth, Concurring in Part and Dissenting in Part*, appended to the CALLS Order, May 21, 2000 (hereafter "*Furchtgott-Roth Dissent*").

b) Several key participants who were interested in the process were denied access to the negotiations which ultimately resulted in the settlement agreement adopted by the FCC, *i.e.*, the Ad Hoc Telecommunications Users Committee, Time Warner Telecom, and the Association for Local Telecommunications Services (basically competitive local exchange carriers),[20] and

c) Concessions regarding access rate levels were gained from the ILECs by the FCC's agreement to make decisions in the ILECs' favor regarding not only additional universal service funds, but also two other actions completely independent from switched access services (*i.e.*, decisions regarding their obligations to provide Enhanced Extended Links – "EELs" – to competing local service providers and an ongoing audit initiative related to continuing property records). As Commissioner Furchtgott-Roth put it: "[I]t was entirely improper for the Commission to have permitted the unrelated matters of depreciation and special access become part of the negotiations."

Q. DOES MR. SENGER IGNORE THESE SAME TYPES OF CONSIDERATION WHEN HE ADVOCATES QWEST'S RATES AS PROXIES FOR "COMPETITIVE MARKET' RATES?

A. Yes. Mr. Senger completely ignores the genesis of Qwest's access rates and *pretends that Qwest's rates have inherent and universal merit beyond Qwest itself.* Nothing could be further from the truth. Qwest has admitted that if it abided by the Commission's switched access rules, that its switched access rates would be higher. As such, Qwest's rates are not in compliance with the Commission's rule and serve no useful benchmark for any carrier, and certainly not for CLECs such as Midcontinent.

Q. ARE THE INTERSTATE ACCESS RATES SET ON A WELL-DEFINED BASIS?

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[20] In short, the ILECs' primary local exchange competitors were barred from the discussions, even though they would have had a direct interest in the resultant switched access rate levels. This is especially true because approximately 1 year later, the FCC required that these same competitors charge exchange access rates no higher than the incumbent LECs, rates which resulted from the CALLS' discussions.

A. No. As I disused previously, access rates for ILECs were established through regulatory "horse trading" aimed at appeasing the few, but enormous, carriers fortunate enough to have been involved in the negotiations.

In any event, it should be clear that Qwest's access rates have no merit *outside the overall context of Qwest's own specific and individual regulatory regimes*. As such, those rates could not, other than by sheer happenstance, be just and reasonable for CLECs such as Midcontinent.

Q. IF QWEST'S RATES WERE TRULY A "MERITORIOUS" PROXY FOR MARKET BASED RATES – AS SUGGESTED BY MR. SENGER – WOULDN'T ONE EXPECT A CERTAIN DEGREE OF UNIFORMITY?

A. Yes. Mr. Senger holds Qwest's rates out as some proxy for market based rates to which CLECs should conform.[21] Presumably Mr. Senger's recommendation is in search of some level of uniformity of rates across companies.

Q. DO QWEST'S SWITCHED ACCESS RATES IN FACT DISPLAY ANY UNIFORMITY?

A. No. I have already explained the arcane and convoluted process that gives rise to the ILECs' switched access rates. There is nothing in that process that would lead one to expect uniformity of rates and indeed, the available data proves that point.

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[21] Senger Direct at 11.

An examination of Qwest's, AT&T's and Verizon's intrastate exchange access rates when viewed across jurisdictions shows that there is an enormous degree of variation from company-to-company and state-to-state. (See diagrams below.) This degree of variation is at odds with any notion that the ILECs' exchange access rates are reasonable surrogates or proxies for a competitive market rate. There is no uniformity – in fact, there is a hodge-podge, reflecting the previously discussed wheeling and dealing involved in exchange-access-rate setting. The notion that these rates establish some type of "competitive market level" is simply false.

QSI surveyed and pulled together switched access rates of the three RBOCs (AT&T, Verizon and Qwest) and their affiliate CLECs[22] and calculated the composite per minute access rates – the aggregated rates that permit comparisons between carriers.[23]

The charts and tables below summarize the results of the access rate survey. They depict the intrastate and interstate access charges and their variations, underscoring the fact that there is no single "universal" or "uniform" level of access charges.

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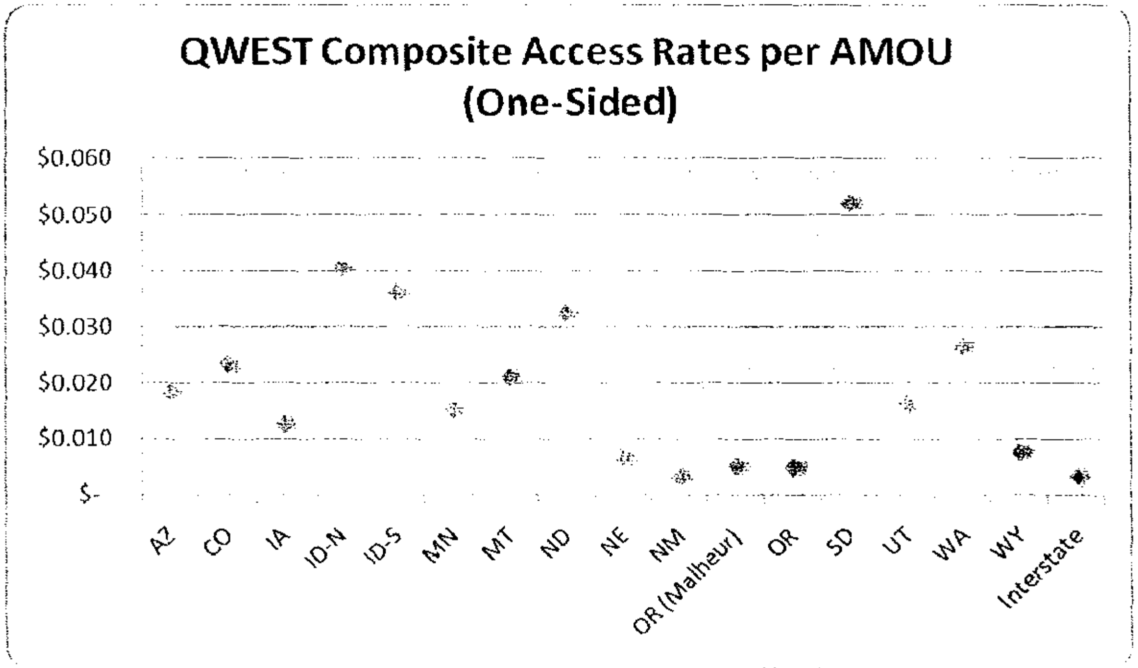
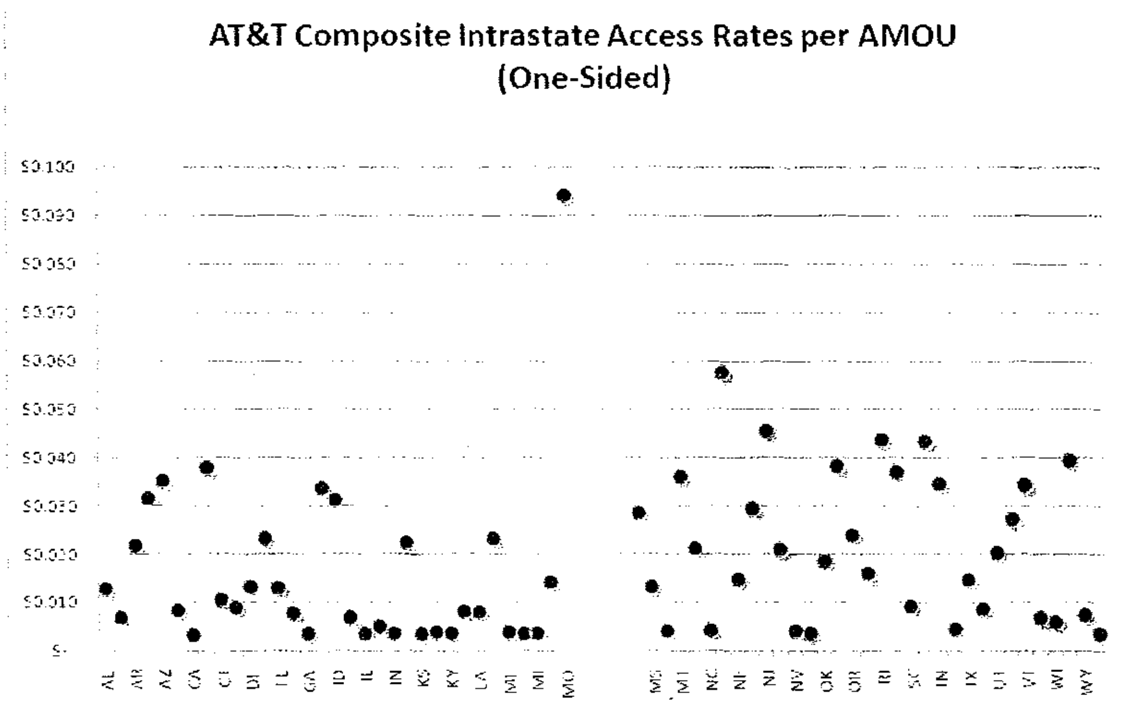
[22] The starting point of QSI's survey was an access rate database obtained from Telview.

[23] The composite rates presented below are rates per access minute of use (one side of a long-distance call). They were calculated based on a scenario that a call is routed via tandem transport with transport mileage of 10 miles. Because this survey was part of the broader study of access rates across company types (RBOCs, mid-sized ILECs, small ILECs and CLECs) and because smaller companies often do not own a tandem, the tandem switching rates are not included in the calculation of the composite rates in order to make an apples-to-apples comparison. In cases where rates were zoned or differentiated according to direction or time of day, a straight average of the differentiated values was used.


QWEST Composite Access Rates per AMOU
(One-Sided)
$0.060
$0.050
$0.040
$0.030
$0.020
$0.010
$-
AZ
CO
IA
ID-N
ID-S
MN
MT
ND
NE
NM
OR (Malheur)
OR
SD
UT
WA
WY
Interstate


AT&T Composite Intrastate Access Rates per AMOU
(One-Sided)
$0.100
$0.090
$0.040
$0.010
$-
AL
AR
AZ
CA
GA
ID
IN
KS
KY
LA
MI
MO
MS
MT
NC
NV
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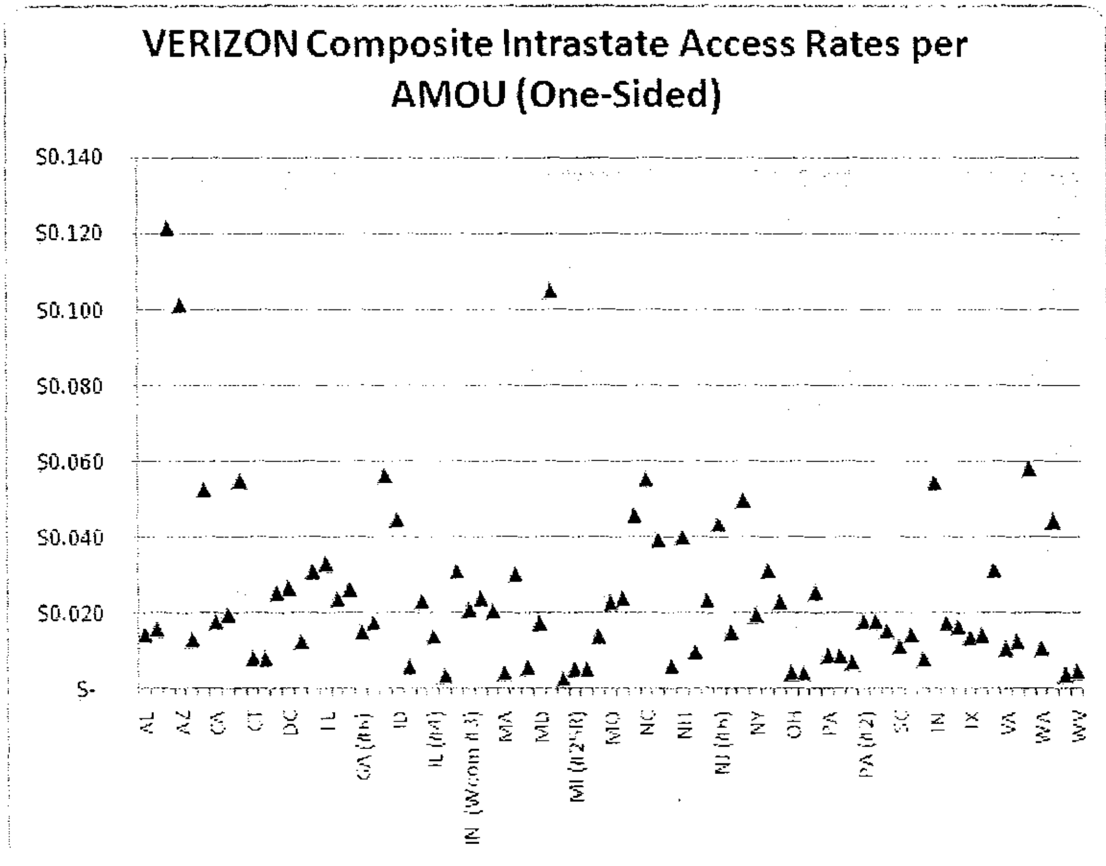

I have included the rates for all three of the largest ILECs (AT&T, Verizon as well as Qwest), just to underscore the fact that there is a total absence of uniformity across the large ILECs switched access rate levels, even where they may serve comparable geographic territories. There is simply no indication that these rates represent any type of competitive result or even a regulatory result based upon common criteria (such as cost causation). It is for this reason that I find it difficult to understand why any state regulator would turn to this hodgepodge of rates and impose it on CLECs, who are demonstrably different and have nothing to do with the process that determine the ILECs' rates.

Q. IF THE COMMISSION ADOPTS MR. SENGER'S RECOMMENDATION, WOULD MIDCONTINENT BE PROHIBITED FROM RECOVERING LEGITIMATED INCURRED COSTS ASSOCIATED WITH SWITCHED ACCESS?

A. Yes. Obviously, a small company such as Midcontinent has generally higher costs than a large company such as Qwest. This can be demonstrated with regard to highly disparate economies of scale enjoyed by the two firms, less buying power on the part of Midcontinent and numerous other factors. In any event, Qwest's switched access rates are lower than the costs incurred by Midcontinent in the provision of switched access services. This means that Mr. Senger's recommendation would prohibit Midcontinent from recovering legitimately incurred costs. Mr. Senger has provided no compelling public policy benefit that would result from such dramatic pricing restraint placed on Midcontinent whereby it must charge rates that fail to cover its costs of production – i.e., Mr. Senger has failed to provide any evidence that there is some public benefit that would result from Midcontinent subsidizing customers of long distance carriers against which it competes.

Q. WOULD MR. SENGER'S RECOMMENDATIONS LEAD TO UNDESIRABLE CROSS-SUBSIDIES?

A. Yes. Mr. Senger's recommendation would force Midcontinent to recoup costs associated with switched access services from customers other than the IXCs. This causes a type of cross-subsidization that is highly inappropriate, particularly in a competitive market.

Q. WHY IS THIS TYPE OF CROSS-SUBSIDIZATION INAPPROPRIATE?

A. Midcontinent's other customers, such as its end-users, *are not the cost causers for costs incurred in the provision of exchange access calls; IXCs and their customers are.*[24] Therefore, the Midcontinent's other customers should not be burdened with the cost recovery responsibility for switched access costs.

To be sure, the cost causers are the IXC customers placing toll calls; as such, it is the IXCs' customers that should shoulder the cost recovery responsibilities of using the network to make the toll call. An arbitrary mixing and matching of cost causation and cost recovery would only lead to inappropriate cross-subsidization schemes that regulators across the country and at the FCC have been attempting to ferret out of telecommunications rates for years.

Q. COULD YOU GIVE AN EXAMPLE OF A PARTICULARLY DISTURBING CROSS-SUBSIDIZATION FLOW THAT WILL EMERGE FROM MR. SENGER'S RECOMMENDATIONS?

A. Yes. Consider a situation wherein the IXC's customer is a telemarketer (a common occurrence) which generates literally millions of calls every day, some of which terminate to Midcontinent's local customers. Under Mr. Senger's recommendations, telemarketers would be able to call Midcontinent's customers at reduced rates and

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[24] This argument is certainly true for terminating exchange access traffic. Where it concerns *originating* access traffic, however, there is a complicating factor in that the IXC's end user and the CLEC's end user is likely the same person. Thus, while the cross-subsidization may not be between different people, it is cross-subsidization between the IXC's services and the CLEC's services which is equally disruptive to critical economic decision-making on the part of the caller.

without facing the full costs of the switched access services they consume. The potentially lower calling rates for telemarketers may in fact stimulate this type of calling. Further, because the telemarketers' IXCs will not pay Midcontinent the full cost of providing switched access (to terminate the telemarketers' calls), Midcontinent's end users will have to pick up the tab for the under recovered costs. Thus, not only will Midcontinent's end users have to endure telemarketing calls, under Mr. Senger's recommendations, *they also have to subsidize them*! I doubt anyone outside of the IXC and its telemarketer client would see the benefit in such a result.

C. MIDCONTINENT SHOULD BE ALLOWED TO RECOVER LEGITIMATELY INCURRED COSTS IN THE PROVISION OF ACCESS SERVICES

Q. IS IT IMPORTANT THAT THE COMMISSION PERMIT MIDCONTINENT TO RECOVER ITS LEGITIMATELY INCURRED COSTS ASSOCIATED WITH SWITCHED ACCESS SERVICES.

A. Yes. As a matter of good public policy, commission's should only prevent companies from recouping costs if there are serious reasons to believe that costs are artificially inflated or incurred due to gross mismanagement. Otherwise, good public policy requires that investors should have a reasonable opportunity to recoup legitimately incurred costs. This is, of course, not just a matter of good public policy but also a matter of ordinary fairness. Mr. Senger's recommendation to deny Midcontinent recovery of legitimately incurred costs is bad public policy, harmful to properly functioning markets and unfair.

Q. IS COST TRADITIONALLY THE TOUCHSTONE FOR WHETHER RATES ARE JUST AND REASONABLE?

A. Yes. Rates should be evaluated based on whether they are *reasonably compensatory for the costs incurred in the provision of services*. That is, the ultimate touchtone for just and reasonable rates is costs.

The Commission should recognize that for the better part of the twentieth century, much of public utility regulation, and certainly the regulation of telecommunications utilities, involved traditional rate-base/cost-of-service regulation. While allocations of costs across various customer classes and jurisdictions, such as intrastate and interstate, might have been impacted by universal service policies, the ultimate basis for rates and revenues was costs. As the United Supreme Court noted:

> The enduring feature of ratesetting from *Smyth v. Ames* to the institution of price caps was the idea that calculating a rate base and then allowing a fair rate of return on it was a sensible way to identify a range of rates that would be just and reasonable to investors and ratepayers.[25]

Thus, even as telecommunications regulation moved away from traditional rate-base regulation in the latter part of the twentieth century, the FCC and state commissions continued to emphasize costs as the relevant benchmark for just and reasonable rates. The notion that costs have been and remain the ultimate benchmark for just and reasonable rates is generally recognized and is evinced by such FCC statements as:

> The Communications Act requires that rates be just and reasonable and not create unreasonable discrimination or undue preference. Section 201(b) and

[25] *See Verizon v. FCC*, 535 U.S. at 487-88.

> 202(a), 47 U.S.C. §§ 201(b), 202(a). [...] ***Costs are traditionally and naturally a benchmark for evaluating the reasonableness of rates.*** [26] (Emphasis added.)

The FCC has repeatedly referenced standard economic theory concerning the benefits of cost-based pricing policies. Going back almost two decades, a good example of how the FCC explained its cost-based pricing policies is the following:[27]

> *Costs* are traditionally and naturally a benchmark for evaluating the *reasonableness of rates*, because cost based rates both deliver price signals which contribute to efficient use of networks and generally distribute network costs to the customer who causes those costs. (Emphasis added.)

In its *Local Competition Order*, the FCC cited the signaling function of cost-based prices as the predominant reason for mandating the use of forward-looking incremental costs as the cost study method to be used in setting cost-based rates as required by section 252(d)(1) of the Act for unbundled network elements:[28]

> We observed in the NPRM that ***economists generally agree*** that prices based on forward-looking long-run incremental costs (LRIC) give ***appropriate signals*** to producers and consumers and ensure ***efficient entry and utilization*** of the telecommunications infrastructure. (Emphasis added.)

These regulatory practices are fully supported by economic theory. Economic texts on public utility regulation either explicitly or implicitly examine rate-setting practices against the backdrop of the *regulated firm's costs*. This is true whether the discussion

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[26] *Investigation of Special Access Tariffs of Local Exchange Carriers*, Memorandum Opinion and Order, 4 FCC Rcd 4797, 4799, at ¶ 32 (1988) ("*Special Access Tariff Order*").

[27] *Special Access Tariff Order*, 4 FCC Rcd at 4799, ¶ 32.

[28] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996) at ¶ 360 ("*Local Competition Order*"), aff'd in part and vacated in part sub nom. *Comp. Tel. Assoc. v. FCC*, 117 F.3d 1068 (8th Cir. 1997) and *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), aff'd in part and remanded, *AT&T v. Iowa Utils. Bd.*, 525 U.S. 366 (1999); on remand *Iowa Utils. Bd. v. FCC*, 219 F.3d 744 (8th Cir. 2000) , reversed in part sub nom. *Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002).

concerns traditional rate of return regulation or other forms of regulation. When rates are set below costs, it may lead to under-recovery and cross-subsidies or constitute such anti-competitive practices as predation; when rates are set too high, it may lead to over-recovery of costs and represent an exercise of market power. Generally, economists advocate that rates be set at costs to provide the appropriate price signals and to prevent all sorts of other distortions. The rare exception to this rule concerns recognition that regulators have other legitimate public policy concerns, such as the pursuit of universal service.[29]

Q. WHEN YOU NOTE THAT RATES SHOULD BE BASED ON COSTS, DO YOU MEAN *COMPANY SPECIFIC* COSTS?

A. Yes. It is important to note that for regulated companies, price regulation invariably focuses on *company-specific costs*. This is particularly true for exchange access rates, which are almost always established on the basis of company-specific considerations, as evinced not only by the history of exchange access rate making but also by the variations in exchange access rates. That is, consistent with standing rate making practices, just and reasonable exchange access for CLECs, such as Midcontinent, should consider company-specific costs.

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[29] Prior to the Act, state commissions deliberately set some rates above cost in order to keep rates for basic local telephone service low, particularly in areas such as rural areas where costs are high. The Act eliminated such implicit subsidies and required that the FCC establish an explicit funding mechanism. Some states, such as Texas, have established an explicit funding mechanism to support universal service.

III. MR. SENGER'S OTHER REASONS FOR RECOMMENDING THAT MIDCONTINENT NOT BE ALLOWED TO TARIFF THE REQUESTED RATES ARE NOT VALID

Q. DOES MR. SENGER RECOMMEND THAT THE COMMISSION REJECT MIDCONTINENT'S REQUEST?

A. Yes. Page 4 of Mr. Senger's testimony states the following:

> Q. **Do you believe Midco should get the 11.5 cent settlement rate?**
> A. Absolutely not.

Q. WHAT ARE MR. SENGER'S STATED REASONS FOR RECOMMENDING THAT THE COMMISSION REJECT MIDCONTINENT'S REQUEST?

A. On pages 4 and 5 of his testimony, Mr. Senger provides five reasons for recommending that the Commission reject Midcontinent's request. Those reasons may be fairly summarized as follows:

- Midcontinent is not similar to, or competing against, SSTelecom, Inc., Midstate Telecom, Inc., and RC Communications, Inc. d/b/a RC Services.
- Staff does not believe that Midcontinent's costs are similar to NVC's or Sancom's costs.
- Allowing Midco to charge 11.5 cents per minute ignores the fact that it would put them at a competitive advantage over the other CLEC, not to mention the ILEC Owest, Midco's biggest competitor.
- Allowing Midcontinent to charge 11.5 cents would violate ARSD 20:10:27:06. That rule prohibits a LEC from charging rates above its costs.
- Allowing Midcontinent to charge 11.5 cents would contradict everything that Commission Staff has been pushing for the past 5 plus years as well as contradict what the FCC has done with CLEC access rates.

In what follows, I will address Mr. Senger's five reasons.

Q. IS THE FACT THAT MIDCONTINENT IS DISSIMILAR FROM CLECS THAT ARE ALLOWED TO CHARGE THE SETTLEMENT OR LECA PLUS RATES RELEVANT?

A. No. Further, I find this particular complaint of Mr. Senger's troubling given that his ultimate recommendation is that Midcontinent's rates be capped at Qwest's rates. Surely Midcontinent is more comparable to the CLEC's Mr. Senger references than it is with Qwest, one of the largest communications companies in the world. Nonetheless, that aside, there is nothing in the rule ARSD 20:10:27:12 that requires that Midcontinent be similar to other companies that are afforded rights to tariff the LECA Plus rates. In fact, the CLECs that are allowed to charge LECA Plus rates would almost by definition be different from the ILECs that charge the LECA Plus rates indicating to me that uniformity amongst the carriers is likely not an implied requirement.

While I am not familiar with the genesis of ARSD 20:10:27:12, I believe that the rule and the settlement rates are motivated by concerns about limiting regulatory burdens on smaller carriers. There is no doubt that Midcontinent qualifies as a smaller carrier with limited resources. As such, the rationale of ARSD 20:10:27:12 and the settlement rates fully applies to Midcontinent.

Q. IS THE FACT THAT MIDCONTINENT'S COSTS MAY BE DIFFERENT FROM NVC OR SANCOM RELEVANT?

A. No. ARSD 20:10:27:12 does not specify that Midcontinent needs to have the same costs as NVC or Sancom. Further, it is my understanding that Mr. Senger has not examined the costs of any of the carriers he is comparing: NVC, Sancom and Midcontinent.[30] As such, it is difficult to examine Mr. Senger's testimony on this point without concluding it is little more than conjecture.

Q. WOULD THE REQUESTED RATES PLACE MIDCONTINENT AT AN ADVANTAGE OVER ITS COMPETITORS?

A. No. Midcontinent has filed a cost study that indicates that the requested rates would allow it to recover its legitimately incurred costs. When a company is allowed to recover its costs, it does not gain an unfair advantage over other companies.

Likewise, as I described above, Midcontinent serves customers who have other communications options. The market can effectively discipline Midcontinent's switched access rates along with the switched access rates of other competitors because they have no ability to erect barriers to entry. The notion that Midcontinent would gain an advantage over Qwest is preposterous. Qwest is one of the largest telecommunications companies in the nation and enjoys tremendous *economies of scale and scope* that translate into very low costs. To compare a small company like Midcontinent to Qwest is like comparing a small neighborhood grocery store to Wal-Mart.

The relationship between *scale economies and costs* is well-recognized by the FCC:

> Fixed costs are the largest portion of the cost of a switch. The average cost of providing service to customers decreases as the number of customers served

[30] See Senger at pages 9 and 10. Also, I presume that the other companies did not file cost support.

> increases. As a general rule, we find that scale economies are more pronounced when switches operate at full utilization. Because incumbent LEC switches serve the majority of customers for local exchange service, they are likely to be able to take advantage of substantially greater economies of scale than the competitor would using its own switches.[31]

Another instance in which the FCC recognized the relationship between size and costs is the following:

> The Commission has recognized that smaller telephone companies have higher local switching costs than larger incumbent local exchange carriers (ILECs) because the smaller companies cannot take advantage of certain *economies of scale*.[32] (Emphasis added.)

Elsewhere, the FCC makes similar observations:

> We find that incumbent LECs retain material scale advantages with regard to provisioning and operating local circuit switches. Requesting carriers therefore will encounter generally greater direct costs per subscriber when provisioning their own switches, particularly in the early stages of entry when requesting carriers may not have the large number of customers that is necessary to increase their switch utilization rates significantly. *When we examine the market as a whole, we find that requesting carriers incur higher costs due to their inability to realize economies of scale using circuit switching equipment.*[33]

The higher switching costs incurred by CLECs have also been recognized in the universal service support context by the USAC; on its website, specifying conditions for high cost support for competitive companies, the USAC notes:[34]

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[31] *In the Matter of Implementation of the Local Competition Provisions of the Telecommunications Act of 1996,* CC Docket No. 96-98, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, FCC 99-238, Rel. November 5, 1999, ¶ 258 ("UNE Remand Order").

[32] *National Exchange Carrier Assn., Inc. proposed Modifications to the 1998-99 Interstate Average Schedule Formulas*, Order, 13 FCC Rcd 24225, at n. 6.

[33] FCC *UNE Remand Order*, ¶ 260. (emphasis added)

[34] See, USAC website for competitive carriers: http://www.usac.org/hc/competitive-carriers/step01/local-switching-support.aspx

> Local Switching Support (LSS) is available to ***competitive carriers*** providing service in the areas of ***rural incumbent carriers*** serving 50,000 lines or fewer (mostly rate-of-return and some price-cap carriers) and designated as eligible telecommunications carriers (ETCs) by their state commissions or the Federal Communications Commission (FCC).
>
> [...]
>
> Local Switching Support is designed to help carriers recoup some of the high fixed switching costs of providing service to fewer customers. LSS helps keep customer rates comparable to more densely populated urban areas.

I have examined cost studies for the RBOCs in many states and have prepared cost studies for a number of CLECs. While I am generally unable to publicly divulge details of those studies due to confidentially agreements and concerns, I can unequivocally say, consistent with the FCC's findings, that the large ILECs have considerably lower costs than small companies such as Midcontinent. In sum, Mr. Senger's concerns that Midcontinent would gain an unfair advantage over Qwest are misplaced.

Q. IS MR. SENGER'S CLAIM THAT MIDCONTINENT WOULD BE CHARGING RATES ABOVE ITS COSTS VALID?

A. No. First, Mr. Senger suggests that he has not examined Midcontinent's costs. As such, his testimony is baseless.[35] Further, as stated in Mr. Fischer's Direct Testimony (which I adopt), "were Midcontinent to spend the time and resources necessary to replicate not only the method, but the data development processes of LECA-members, I am convinced the results of the model would be notably higher than the results represented by the version included with this testimony." In other words, all indications are that the

[35] See Senger at pages 9 and 10: "Essentially Staff has no information to base its case and positions on."

requested rate would serve only to compensate Midcontinent for costs it incurs in providing switched access services.

Q. MR. SENGER ALSO NOTES THAT ALLOWING MIDCONTINENT TO CHARGE THE REQUESTED RATES IS AGAINST EVERYTHING THAT THE COMMISSION HAS SOUGHT TO ACCOMPLISH WITH RESPECT TO SWITCHED ACCESS RATES. PLEASE COMMENT.

A. Mr. Senger's testimony is undermined by the fact that the Commission – based in part on Mr. Senger's recommendations -- has permitted other CLECs to charge the LECA Plus rates. Further, I have already responded in the previous sections to Mr. Senger's recommendation that the Commission adopts the FCC's benchmarking policies and set Midcontinent's switched access rates at the level of Qwest's.

Q. DO YOU AGREE WITH MR. SENGER'S COMPROMISE RECOMMENDATION THAT THE PUC GRANT MIDCONTINENT THE SAME RATES AS THOSE IN THE SANCOM SETTLEMENT?

A. No. On page 11, Mr. Senger makes the following alternative recommendation:

> However, if the Commission is unable to impose the Qwest rate, I suggest the Commission strongly encourage Midco to adopt the Sancom Settlement rates as currently agreed to between Staff and Sancom in TC07-128 for the Mitchell and Aberdeen exchanges while continuing to use the Qwest rate in all other Qwest exchanges.

This is a bad idea and should be rejected by the Commission.

First, this proposal would leave Midcontinent with unrecovered switched access related costs. I have already discussed why this is bad public policy.

Next, Midcontinent's costs of providing switched access services are unlikely to vary from exchange to exchange; thus, Midcontinent should be allowed to charge the same rates in all of the exchanges its serves. Further, ILECs and other CLECs are allowed to charge the same intrastate switched access rates in all of their serving areas; it would be discriminatory to prevent Midcontinent from doing the same.

Last, it appears that the Sancom settlement was reached as a result of the same type of "horse-trading" and "deal" making that I discussed earlier with respect to the large ILECs switched access rates. Sancom filed for an extension from developing cost support for its intrastate switched access rates. Both AT&T and Qwest intervened in Sancom's filing, each with specific concerns. AT&T's intervention specifically states their concern about the lack of cost support and the establishment of unsubstantiated rates. Given that Qwest and AT&T have considerable leverage over smaller carriers (e.g., they often simply withhold payments as a means of "self help" when they do not like CLEC rates), Qwest's and AT&T's interventions and the settlement indicate that there must have been some degree of deal making going on. Given that Midcontinent was not party to the Sancom negotiations, it makes no sense to tie Midcontinent to whatever "works" for Qwest, AT&T and Sancom. It is just common sense that ***only*** parties who together worked out a settlement should be held to the terms and conditions of a settlement; unrelated parties should not be. Mr. Senger's alternative recommendation is unreasonable and unfair and should be rejected.

Q. IF MIDCONTINENT IS NOT ALLOWED TO CHARGE THE REQUESTED RATES WOULD IT BE DISADVANTAGED RELATIVE TO OTHER CARRIERS?

A. Yes. First, Midcontinent has been disadvantaged for years with rates that were lower than those charged by other carriers. While other carriers have either raised their switched access rates or continued to charge higher rates, Midcontinent has essentially maintained lower switched access rates since 2001. *To perpetuate this situation is discriminatory.* Mr. Senger provides no objective reasons for prohibiting Midcontinent from charging the requested rates when at the same time the Commission is permitting other carriers to charge the settlement/LECA Plus rates. While I have provided a detailed discussion of the flaws in Mr. Senger's arguments , I believe that ultimately Mr. Senger's recommendations boil down to personal and subjective judgments: I don't think those are appropriate bases for good public policy.

Q. HAS MIDCONTINENT EXPENDED CONSIDERABLE RESOURCES IN ITS EFFORT TO ESTABLISH APPROPRIATE SWITCHED ACCESS RATES?

A. Yes. As detailed in the Direct Testimony of Warren R. Fischer (whose testimony I adopt), Midcontinent has gone through great lengths to develop cost study support for its requested switched access rates. All the while other companies have been permitted to charge higher rates or have been allowed to charge the LECA Plus rates. Midcontinent is not a large company and the Commission should recognize Midcontinent's considerable efforts and resources expended on support for its rate request. As the Commission rules appear to recognize, public utility regulation should strike a fair balance between promoting the public interest while not being unduly burdensome to smaller companies. I believe that Midcontinent has adequately demonstrated that it is deserving of the switched access rates it is requesting. To instead impose on Midcontinent some arbitrary rates – as recommended by Mr. Senger – is unjust and at odds with the spirit if not a black-letter reading of Commission rules.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.