

1 **Q. Assuming PTIC would experience downward pressure on its profit margins due**
2 **to UNE competition, do you agree this would justify maintaining the rural**
3 **exemption?**

4 A. No. As I explained above, if PTIC does experience some reduction in its profits, this
5 won't necessarily translate into a loss of "support" for universal service. PTIC claims
6 that terminating the rural exemption would be economically burdensome on PTIC's
7 customers because it would have to increase rates, and more particularly it will need to
8 increase the rates it charges its highest cost customers (in zone 5). However, there is
9 no basis for assuming the entire amount of lost profits will translate into increased rates,
10 and it certainly isn't reasonable to assume the entire rate increase would land on these
11 particular customers.

12 To the extent PTIC actually does suffer a reduction in profits due to UNE
13 competition, it will have several options for dealing with the situation, just like any other
14 firm facing increased competition. As PTIC noted, it could increase its prices.
15 However, it could also cut its costs, or accept a smaller profit margin.

16 While PTIC only mentions the option of raising prices, this is not a typical
17 response to competitive pressures, nor would it be a very wise move. By raising prices
18 around the time customers are first beginning to think about having the opportunity to
19 choose another local service provider, PTIC may speed up its loss of market share,
20 stimulating some customers to change carriers who otherwise would have stayed with
21 the status quo.

22 Cutting costs, on the other hand, is a typical reaction to increased competitive
23 pressures, and one that wouldn't be self-defeating. A relatively small reduction in costs
24 could be sufficient to offset the reduction in revenues and profits which might otherwise
25 result from UNE competition. Other options would include rolling out new services,

1 intensified marketing efforts, or even selectively cutting some prices, in order to
2 stimulate increased volume and generate higher revenues. If these efforts aren't
3 sufficient, another option would be to live with lower profit margins, which is sometimes
4 one of the results of the competitive process.

5
6 **Q. PTIC claims that terminating the rural exemption would be inconsistent with the**
7 **1996 Act's universal service provisions, because the lost revenue would not be**
8 **available to support high cost areas. Would you please respond to this line of**
9 **reasoning?**

10 A. Yes. PTIC states:

11
12 ...termination of PTICA's rural exemption would cause a reduction in
13 universal service support in the amount of \$802,858 annually, with no
14 offsetting decrease in costs. This support is currently relied upon to
15 offset PTICA's costs of serving its highest cost customers
16 (predominately those in service Zone 5). The \$802,858 amount that
17 would be lost represents a flow of support to customers in service Zone
18 5 in the amount of \$37.57 per line per month. ... This outcome would
19 not be consistent with maintaining universal service and, therefore,
20 would not pass the test required to terminate PTICA's rural exemption.
21 [Smith, p. 4]
22

23 For the reasons just given, there is no basis for assuming the impact would land on
24 customers—cost reductions, volume increases or lower profit margins are all viable
25 alternatives to raising prices as competition intensifies. Moreover, there is absolutely no
26 basis for assuming PTIC would, or should, increase rates for this particular group of
27 customers. PTIC asserts that the burden of its lost profit will be shifted entirely onto
28 customers in high cost areas, but Mr. Smith has failed to provide any evidentiary

1 support for this bald assertion. Thus, he has failed to demonstrate any nexus between
2 its projection of \$802,858 in lost profits and the statutory “test” to which he refers.

3
4 **Q. Could you elaborate upon this statutory test?**

5 A. As I mentioned earlier in my testimony, Section 251 (f)(1)(B) of the 1996 Act provides
6 that “the State commission shall terminate the exemption if the request is not unduly
7 economically burdensome, is technically feasible, and is consistent with section 254”.
8 Section 254(b)(5) provides that “[t]here should be specific, predictable and sufficient
9 Federal and State mechanisms to preserve and advance universal service”.
10 Additionally, the appellate court has held that the Commission must obtain information
11 regarding what universal service support mechanisms are available for utilization and
12 determine what support would be derived from each identified support mechanism.

13
14 **Q. If GCI is allowed to rent loops, will universal service continue to be preserved
15 and advanced through specific, predictable and sufficient mechanisms?**

16 A. Yes. PTIC has identified 5 sources of revenue that it uses to recover its costs; it
17 characterizes these revenues streams, net of certain costs, as “support” for universal
18 service. While I don’t necessarily agree with this characterization, PTIC will continue
19 to benefit from these same revenue sources for every line it continues to provide to
20 retail customers. For each line that is lost to GCI through UNE competition, it will
21 instead receive revenues from the UNE rental rate. In turn, GCI will benefit from the
22 five revenues identified by PTIC, and will be able to use these revenue sources to pay
23 the rental charges imposed by PTIC, as well as the other costs of providing service to
24 these customers.

1 PTIC has correctly pointed out that its loop costs vary depending upon density
2 and distance from the wire center. Since customers tend to pay the same rates,
3 regardless of where they are located, it is fair to say that some of the high costs of
4 serving customers in remote, low density areas are supported by revenues received
5 from customers in lower density, less remote locations. Stated differently, under the
6 existing system of rate averaging, support flows from low cost areas to high cost areas
7 (because similar prices are charged in all areas, despite differences in cost). This flow
8 of support is quite specific, it is clearly predictable, and it is sufficient to ensure that
9 universal service is maintained.

10 A specific, predictable and sufficient flow of support will also be available in the
11 context of UNE rentals: more specifically, cost averaging can be used in setting UNE
12 rates, thereby ensuring that support flows from low cost areas to high cost areas. In
13 other words, the UNE rates for loops located in town can be averaged with the UNE
14 rates for loops located out of town, thereby generating sufficient revenues to cover the
15 cost of serving both areas, while also ensuring that the UNE rates for the areas outside
16 of town aren't unreasonably high.

17 There is nothing inherent in UNE competition which precludes generating
18 support for high cost areas through the mechanism of price averaging. In fact, this type
19 of averaging is fully consistent with the assumptions used by Mr. Smith in his exhibits.
20 As shown on Exhibits RAS-7 through RAS 11, he has assumed that PTIC's loop rental
21 price will exceed its loop costs in low and medium cost areas, while the price will be
22 less than its loop costs in its highest cost areas. This price averaging generates revenue
23 support for the high cost areas. This averaging mechanism is well understood, it is
24 specific and it is predictable. Moreover, there is nothing inherent in the UNE rental
25 process which precludes it from being sufficient. The amount of compensation which

1 PTIC will receive from UNE rentals will be determined during the arbitration process.
2 The primary guideline during the arbitration process is cost recovery, and thus it is
3 reasonable to conclude that sufficient support will be available to protect universal
4 service. While the possibility certainly exists that PTIC will experience some reduction
5 in profits due to UNE competition, there is no basis for concluding that this reduction
6 will be so severe that it would cause the support for universal service to be insufficient.
7

8 **Q. Do you therefore conclude that the Rural Exemption should be terminated?**

9 A. Yes. In my opinion, it would be reasonable to terminate the Rural Exemption. Under
10 the Commission's Order U-97-82(1), termination of the exemptions simply sets in
11 motion the process by which PTIC might eventually be required to meet the conditions
12 of §251(c). Termination of the exemptions creates a path towards competition, but it
13 does not in itself determine the extent to which competition will be allowed, the specific
14 rules under which PTIC and its competitors will operate, or the specific prices which
15 PTIC will charge for rental of its unbundled elements. For all the reasons explained in
16 my testimony, termination of the exemption does not impose an immediate economic
17 burden on PTIC, nor should the Commission assume that competition through
18 unbundled elements will eventually lead to an undue burden on PTIC—much less an
19 undue burden on its customers.

20 Removing the exemption is just an early step, not one of the final steps, in the
21 path towards increased competition in PTIC's service area. The arbitration process
22 will establish UNE rates which will compensate PTIC for the cost of the elements which
23 it rents to GCI, and which will help support universal service. As discussed earlier in
24 my testimony, I will concede the possibility that UNE competition will place some
25 downward pressure on PTIC's profit margins. However, the magnitude of the potential

1 profit loss is not excessive, and PTIC can respond to this potential reduction in profits
2 in many different ways, just as any other firm which faces increased competitive
3 pressures.

4 It should also be noted that the Commission will have additional opportunities
5 to evaluate and mitigate any potential adverse effects of UNE competition. For
6 instance, it could conclude that certain provisions of the Telecom Act should be
7 suspended for some period of time, or that they should not apply to some portions of
8 PTIC's service territory. The Commission can use the suspension and modification
9 process, in conjunction with the arbitration process and its ongoing rule making efforts,
10 to examine the issues in detail, and to carefully consider the potential economic
11 consequences of alternative policies designed to implement the intent of the Telecom
12 Act in the context of the Alaska market.

13 The Commission has the opportunity to use the suspension/modification
14 provisions in order to carefully craft an appropriate set of rules of the Commission's
15 own devising--rules that provide it with the flexibility to deal on a case by case basis
16 with the unique circumstances facing each of Alaska's local exchange carriers. Using
17 this approach, it should be possible to carefully distinguish rules which should apply in
18 one part of a carrier's service territory with those that should apply to another part.
19 The wide range of circumstances applying to PTIC's exchanges provides a perfect
20 example of why it is appropriate to remove the exemption and then use the
21 suspension/modification provisions to tailor a precise policy that fits each situation. In
22 contrast, to maintain an exemption for PTIC's smallest exchanges, the Commission
23 would need to also maintain a blanket exemption for PTIC's largest exchanges as well.

24 Since this Commission is fully aware of the unique circumstances applicable to
25 rural Alaska, there is no reason to assume that it would blindly apply the same rules to

1 remote villages that apply to Denver, Newark or Anchorage. In my opinion, there is no
2 reasonable basis for assuming that the Commission will be unable, or unwilling, to craft
3 rules which appropriately open markets to competition where feasible, while protecting
4 universal service and ensuring that its rules do not impose an undue economic burden
5 on PTIC.

6
7 **Q. Would the requested terminations be consistent with the universal service**
8 **provisions of §254 of the Act?**

9 A. Yes. As an economist, I see no direct economic impact of the terminations on the
10 ability of PTIC to continue providing the services it currently provides in rural and high
11 cost areas, at the same rates it currently charges. Terminating the exemptions will
12 simply start the clock in a countdown toward increased competition. Moreover, the
13 Commission has already taken steps towards eliminating any economic burden and
14 protecting universal service. The Commission opened Dockets R-97-5 and R-97-6 in
15 order to address

16 actions to be taken immediately to ensure that the existing access
17 charge and universal service systems operate fairly and effectively
18 during the transition to full local exchange competition in Alaska. [Order
19 R-97-5(1)/R-97-6(1)].
20

21 As Mr. Smith mentioned, Order R-97-5(7)/R-97-6(7) moved the DEM weighting
22 portion of the intrastate access support from access charges to the state universal
23 service fund. However, that is not all the order did. In addition to making the support
24 provided by DEM weighting explicit, the Commission adopted the CASBB mechanism
25 I discussed earlier, and allowed deaveraging of access charges.

26 Universal service can be protected. PTIC has not presented any evidence that
27 lifting the rural exemption will result in support mechanisms that are unspecific,

1 unpredictable or insufficient. However, to the extent that the Commission feels further
2 regulatory modifications are needed, it can suspend various provisions of the Telecom
3 Act as they apply to PTIC. Furthermore, it may be appropriate to modify certain
4 provisions, in order to further protect universal service while encouraging a movement
5 towards effective competition. In my opinion, the primary thrust of the Commission's
6 efforts should be towards creating an appropriate system for supporting universal
7 service in the context of a competitive market. It should not be concerned with limiting
8 the scope of competition in reaction to speculation about the potential consequences of
9 increased competition in the absence of an appropriate set of regulatory decisions.

10
11 **Q. Should PTIC be apprehensive regarding the portability of universal service**
12 **support?**

13 A. No, it should not. The intent of the 1996 Act is to encourage telecommunications
14 competition-- whenever, however, and wherever it is economically feasible; and the
15 portability of universal service support is a vital element in the promotion of competition
16 in rural and high cost areas. The APUC's primary concern in this area will be to ensure
17 that service in such areas remains reasonably priced, ubiquitous, and of high quality, not
18 to favor one competitor over another. In short, the development of effective
19 competition in PTIC's service territories, when and if it emerges, won't necessarily
20 prove to be a hardship for PTIC. If PTIC maintains or improves its service quality,
21 cuts costs, stimulates traffic and subscribership in response to competitive pressures,
22 the results may turn out to be as beneficial for PTIC as for GCI, other competitors and
23 customers. But if competition is to be encouraged, a reasonable first step is to lift the
24 exemptions.

25

1 **Q. If PTIC is exempted from UNE competition, will this have implications for other**
2 **parts of the state?**

3 A. Yes. If a rural exemption is maintained for PTIC, the prospects for increased
4 competition in Alaska will be significantly reduced. If UNE competition isn't to be
5 mandated in areas like Juneau and Fairbanks, it will set a precedent that does not bode
6 well for increased competition in the smaller, less urbanized parts of the state. While it
7 is important to protect universal service, retaining the rural exemption isn't necessarily
8 the best solution. This tends to reduce the Commission's flexibility, and it tends to
9 delay the emergence of competitive alternatives for Alaskan customers. In some
10 markets, if UNE competition is prohibited, the final result may be to encourage
11 excessive reliance upon facilities-based competition, to the exclusion of resale and
12 renting of unbundled elements. This would be unfortunate, particularly if facilities based
13 competition is unduly encouraged in areas where UNE-based competition would be
14 economically more efficient.

15

16 **Q. Could maintaining the exemptions deprive consumers of lower rates?**

17 A. Yes. Despite the fact that PTI's subsidiary companies are all rural LECs, they are not
18 equally rural, nor are all their exchanges equally high cost. According to the map
19 attached to Mr. Bennett's testimony in the proceeding before remand, all six TUA
20 exchanges are in the vicinity of Fairbanks (2 exchanges) or Juneau (4 exchanges).
21 PTIC's sole exchange is in Fairbanks. The 67 exchanges of TUNI are widely
22 dispersed, and include some areas that are likely to involve very low density and high
23 costs; however, they are not equally rural. TUNI has 17 exchanges in the Juneau-
24 Sitka-Ketchikan area; it has nine exchanges along the Kenai peninsula and eight on
25 Kodiak Island. Some of these serving areas may be fairly compact and may possibly

1 be capable of sustaining some degree of competition. While the potential for workable
2 local competition is obvious in Anchorage, it may also be feasible in Fairbanks, Juneau,
3 and many other parts of the state. If the exemptions are not terminated, it will be much
4 more difficult for a competitor like GCI to install bops to provide ubiquitous service to
5 all segments of the market--particularly residence customers. Thus a pattern of
6 business competition may emerge, with no corresponding competitive pressures in the
7 residence parts of these markets, to the possible detriment of residence customers.
8