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OFFICE OF THE EXECUTIVE SECRETARY

April 9, 1998

VIA HAND DELIVERY

Mr. David Waddell
Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37201

Re: BellSouth Telecommunications, Inc.'s Entry into Long Distance (InterLATA) Service in Tennessee Pursuant to Section 271 of the Telecommunications Act of 1996

Docket No. 97-00309

Dear Mr. Waddell:

I am enclosing with this letter an original and thirteen copies of rebuttal testimony prepared by James G. Harralson, William E. Taylor and Michael Raimondi on behalf of BellSouth Long Distance, Inc. in the above referenced matter. Copies are being served on counsel for all parties of record.

Should you have any questions or require anything further at this time, please do not hesitate to contact me.

Sincerely,

Guilford F. Thornton, Jr.

GFT/lb

Enclosures

cc: James G. Harralson
David Richards

CERTIFICATE OF SERVICE

I, Guilford F. Thornton, Jr., hereby certify that I have served a copy of the foregoing on the individuals listed below on this the 9th day of April, 1998.

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Tennessee Regulatory Authority
Docket No. 97-00309

Rebuttal Testimony of

James G. Harralson

on Behalf of

BellSouth Long Distance, Inc.

April 9, 1998

Q. WHAT IS YOUR NAME AND BUSINESS ADDRESS?

A. My name is James G. Harralson. My business address is 32 Perimeter Center East, Atlanta, Georgia 30346.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS DOCKET?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to respond to certain arguments made by David E. Stahly, testifying on behalf of Sprint Communications Company, L.P. In particular, I respond to his testimony's contentions that a "developed competition" test is a prerequisite to BellSouth entry into the interLATA market in Tennessee, that BellSouth has or will engage in an improper price squeeze, and that BellSouth cellular long distance rates are non-competitive. In so doing, I explain how Sprint's business actions contradict Mr. Stahly's testimony, and that the Authority should be persuaded by the testimony of Sprint actions rather than the testimony of Mr. Stahly.

I. THERE IS NO "DEVELOPED COMPETITION" STANDARD

Q. WHAT DOES MR. STAHLY'S TESTIMONY SAY ABOUT A "DEVELOPED COMPETITION" TEST?

A. "I am concerned from a public interest perspective that if BellSouth is permitted to enter the long distance market prior to the development of effective local exchange competition..." (p. 2)

> "If local competition fails to develop, BellSouth will maintain its monopoly position in switched access and be able to leverage that advantage in its in-region long distance market. Conversely, if Section 271 approval is deferred until local competition develops and we are certain BellSouth can not engage in a price squeeze based on its monopoly position in the provisioning of switched access, such approval can then be granted quickly. Thus, uncertainty favors erring on the side of caution and withholding Section 271 approval until local market (and access) competition on a commercial scale has been clearly demonstrated." (p. 4)

Q. IS THIS ASSERTION VALID?

A. No. The Telecommunications Act of 1996 (the "Act") contains no "developed" competition or "commercial scale competition" standard or other competition threshold requirement for a BOC's (Bell Operating Company's) entry into the in-region interLATA market. Congress considered but rejected arguments that some market share loss or "effective" or "substantial" competition standard should be a condition of BOC entry. One will search the interLATA entry provisions of the Act in vain for words and standards such as those used in Mr. Stahly's testimony.

Congress took a different approach. It refused to condition BOC entry on an ambiguous, controversial, and largely unmeasurable standard. Rather, it chose to rely on the competitive checklist that opens BOC networks to local competition and the special set of safeguards that apply uniquely to BOC entry. Compliance with that checklist and the safeguards contained in Section 272 (the separate subsidiary, accounting, audit and nondiscrimination requirements detailed in my previous testimony) are the protections Congress designed to prevent anticompetitive actions. These special provisions would be unnecessary if the Act's requirements were to prohibit entry until there is "developed " competition - when there is effective competition, there will be no need for regulation, much less the special regulation imposed on BOCs by the Act.

Q. DOES THIS ASSERTION CONFLICT WITH THE TELECOMMUNICATIONS ACT OF 1996?

A. Yes. Such an assertion clearly conflicts with the requirements and design of the Act, and if followed, would frustrate the Act's objective to "accelerate rapidly" the opening of telecommunications markets.

The Act provides two methods for BOCs to be relieved of the limitation that prevents their providing in-region interLATA traffic. One method (contained in Section 10 of the Act, 47 U.S.C. §160) has subsumed in it the functional equivalent of a "developed competition" test. Section 10 permits the FCC to forbear from applying <u>any</u> regulation where it determines that (1) enforcement of the regulation is unnecessary to ensure reasonable charges, practices, classifications, and nondiscriminatory treatment; (2) enforcement is not necessary to protect consumers; and (3) forbearance is in the public interest. The Comm...ion is required to consider the competiti... effect of its decision, and a determination that forbearance will promote competition can be the basis for forbearance. If the FCC were to forbear from regulation, BellSouth would not be required to comply with the requirements of Section 27[1], which includes the competitive checklist.[1]

The other section that provides "relief" from Section 271's in-region interLATA limitation is Section 272, which contains the separate affiliate requirement and safeguards described in my direct testimony. Compliance with the separate affiliate and safeguard provisions of Section 272 does not relieve BellSouth of the obligation to comply with the requirements of Section 271 (including the competitive checklist), but compliance does allow BellSouth to participate in the interLATA market, albeit with considerably more burdens than its competitors.

As detailed in my direct testimony, the separate affiliate is subject to many regulatory requirements, including the obligation to "operate independently", undergo a special biennial audit the results of which are made available for public comment, keep separate books and maintain separate credit, and follow special affiliate transaction rules. In addition, Section 272 imposes several non-discrimination requirements on BST. In short, the "relief" from the limitations of Section 271 comes with a significant regulatory penalty.

Imposing a "developed" standard on BellSouth's interLATA entry would effectively erase Section 272 from the Act, and would improperly require BellSouth to satisfy a high forbearance standard before providing interLATA service. Reading Section 272 out of the Act not only would be improper legally, but would frustrate the considered (and correct) judgment of Congress that BOCs could provide competitive benefits to the interLATA market while complying with the competitive checklist that ensures open local competition.

1 Forbearance from enforcement of Section 271 can occur only after its requirements have been fully implemented. 47 U.S.C. §160(d) (1996).

Q. IS MR. STAHLY'S TESTIMONY CONSISTENT WITH SPRINT'S BUSINESS PRACTICE IN TENNESSEE?

A. No. Sprint supplies interLATA service to the local service customers it has in the Johnson City LATA despite the fact that it has no "developed competition" or "commercial scale competition" in its local or access markets. Sprint's decision to serve both the local and interLATA needs of its customers indicates that it does not believe that interLATA service by an incumbent local exchange company is a bar to the development of local competition.

II. ALLEGED PRICE SQUEEZES

Q. WHAT IS YOUR RESPONSE TO THE ALLEGED PRICE SQUEEZES DESCRIBED IN MR. STAHLY'S TESTIMONY?

A. The testimony describes two alleged price squeezes.

In the first instance, the testimony (PP. 21-23) picks off-peak (9 p.m.-9 a.m.) rate elements from a service option offered by SNET in Connecticut, finds that those elements appear to be below an imputed cost of service, and concludes that a price squeeze may have occurred. As his analysis concedes, this conclusion is uncertain at a minimum. If the service option on the whole recovers the incremental cost (including the contribution of the underlying access), the pricing of some rate elements below cost could be consistent with actions in a competitive market. For example, Sprint offers a Fridays Free plan to qualifying customers through which customers pay no charges for calls made on Friday. While the free Friday calls are surely priced below cost, Sprint has presumably designed the service option to produce revenues in excess of its costs.

In the second instance, the testimony describes a hypothetical price squeeze by BellSouth that can be cured only by dramatic reductions in access charges. In order to concoct the price squeeze, however, the hypothesis assumes that BellSouth will enter the long distance market expecting to earn a 0% return on its equity investment in that market, and that BellSouth will be the only provider of access. Neither assumption is correct. BellSouth would not devote resources to activities expected to earn a 0% return over a relevant timeframe, and the access market is open to competition. In fact, Sprint and other competitors can become access providers and, accepting the opposing testimony's assumption that they are as efficient as BST, reap the profit they claim in current access prices. Their claims of a price squeeze, however, are unfounded where long distance service prices recover the non-access incremental costs of the service and imputed access charges.

Q. ARE SPRINT'S PRICING ACTIONS IN TENNESSEE CONSISTENT WITH MR. STAHLY'S TESTIMONY?

A. No. Sprint's (through its affiliate, United Telephone-Southeast, Inc.) retail intraLATA toll rate for the Johnson City LATA is 3¢ per minute, while its access rate to potential competitors for that service is just over 5¢ per minute. Using the definition of a price squeeze contained in Mr. Stahly's testimony would surely lead one to the conclusion that Sprint is engaged in a price squeeze. Further, using Mr. Stahly's analysis, one would have to conclude that Sprint, by accepting 3¢ from retail customers when it could have 5¢ from wholesale customers, is seeking to restrain competition at the expense of current profits.

III. CELLULAR LONG DISTANCE RATES

Q. WHAT DOES MR. STAHLY'S TESTIMONY SAY ABOUT CELLULAR LONG DISTANCE RATES?

A. At page 14 of his testimony, Mr. Stahly states:

> "The likelihood of BellSouth being the low priced provider is further contradicted by BellSouth's pricing behavior in the interLATA toll calling it provides to its cellular customers. Cellular customers pay long distance charges in addition to usage and roaming charges and can choose to use BellSouth's long distance service or any other interexchange carrier's service. BellSouth charges 26¢ per minute for its long distance calling plan, which is significantly higher than AT&T's 15¢ per minute One-Rate, MCI's 12¢ per minute plan, and Sprint's 10¢ per minute SprintSense product. BellSouth's claim that its entry into the interLATA market will increase competition appears to be without merit."

Q. ARE THE TESTIMONY STATEMENTS CORRECT?

A. No. The rate comparisons made are at least misleading because none of the referenced carriers offer the referenced plans to cellular customers unless they also presubscribe their interLATA wireline service, and it is unclear if AT&T's One Rate[SM] is available to cellular customers at all. Because BellSouth cannot offer wireline interLATA service in Tennessee, the only fair comparison is of basic rates. BellSouth's basic interstate cellular rates are in every instance below AT&T's basic interstate rates. BellSouth's intrastate cellular long distance rate in Tennessee is zero, a rate well below all AT&T, MCI, and Sprint rates. Thus, on the whole, BellSouth cellular long distance rates in Tennessee are extremely competitive, a fact that supports BellSouth entry into wireline interLATA long distance.

IV. CONCLUSION

Q. IS SPRINT'S POSITION IN THIS DOCKET CONSISTENT WITH ITS ACTIONS AS A BUSINESS?

A. No. As I mentioned in my direct testimony, Sprint, on July 17, 1997, announced the reorganization of its Local Telecommunications Division (LTD). The resulting organization is intended to permit Sprint's six million local customers (who use seven million lines in nineteen states) to make one call to fulfill their local, long distance, Internet and wireless needs. In short, Sprint intends to offer its customers the simple, convenient one stop shopping that BellSouth wants to offer its customers.

Nowhere does Sprint prove that its incumbent local company has: (1) reduced its carrier access rates to cost (Stahly, pp. 2, 3, 26); (2) interconnection agreements with CLECs that are fully operable (id. p. 27); or (3) local exchange markets that are demonstrably open and subject to "developed competition" (id. p. 4). Sprint has even asked the FCC for permission to delay its implementation of intraLATA dialing parity, something BellSouth will provide coincident with its entry into the interLATA market. Yet, Sprint would impose all of these conditions on BellSouth as a prerequisite to BellSouth interLATA entry. This self-impeachment should not go unnoticed.

Q. ARE SPRINT'S BUSINESS DECISIONS BAD FOR TENNESSEE CUSTOMERS?

A. No. To the contrary, Sprint's business decisions probably will provide options that their incumbent local exchange company customers find attractive, and the public interest will be served by allowing customers to have those choices. That same public interest will be served if customers can choose BellSouth service options as well. But because the position of Sprint in its local markets (in Tennessee and 18 other states) is substantially the same as the position BST occupies in its local markets, Sprint's business decisions should drown the words of its testimony here. Customers and the public interest will be served if BellSouth can act as Sprint has.

Q. WHAT RECOMMENDATION DO YOU HAVE FOR THE AUTHORITY?

A. I recommend the Authority find that BellSouth's entry into the Tennessee interLATA wireline long distance market is in the public interest, thus providing BellSouth customers in Tennessee with at least the same array of choices that Sprint customers in Tennessee enjoy today. The increased competition will benefit Tennessee consumers.

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

<u>AFFIDAVIT</u>

STATE OF GEORGIA

COUNTY OF FULTON

BEFORE ME, the undersigned authority, duly commissioned and qualified in and for the State and County aforesaid, personally came and appeared James G. Harralson, Vice President, Secretary and General Counsel, BellSouth Long Distance, Inc., who being by me first duly sworn deposed and said that:

He is appearing as a witness before the Tennessee Regulatory Authority in Docket No. 97-00309 on behalf of BellSouth Telecommunications, Inc., and if present before the Authority and duly sworn, his testimony would be set forth in the annexed testimony consisting of 8 pages and 0 exhibit(s).

James G. Harralson

SWORN TO AND SUBSCRIBED BEFORE ME THIS THE 7th DAY OF April, 1998.

NOTARY PUBLIC

LISA A. GRAFFAGNINO - NOTARY PUBLIC
County of Dekalb
State of Georgia
My Commission Expires Nov. 6, 2001

BEFORE THE TENNESSEE REGULATORY AUTHORITY

IN RE: BELLSOUTH TELECOMMUNICATIONS, INC.'S ENTRY INTO LONG DISTANCE (INTERLATA) SERVICE IN TENNESSEE PURSUANT TO SECTION 271 OF THE TELECOMMUNICATIONS ACT OF 1996	)))))	DOCKET NO. 97-00309

BELLSOUTH LONG DISTANCE, INC.

REBUTTAL TESTIMONY OF DR. WILLIAM E. TAYLOR

APRIL 9, 1998

n/e/r/a

Consulting Economists

TABLE OF CONTENTS

EXHIBITS

BEFORE THE TENNESSEE REGULATORY AUTHORITY
DOCKET NO. 97-00309
REBUTTAL TESTIMONY OF DR. WILLIAM E. TAYLOR
ON BEHALF OF BELLSOUTH LONG DISTANCE, INC.

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND CURRENT POSITION.

A. My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc. ("NERA"), head of its Communications Practice, and head of its Cambridge office located at One Main Street, Cambridge, Massachusetts 02142.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN THIS PROCEEDING?

A. Yes, I submitted direct testimony in this proceeding on December 12, 1997, on behalf of BellSouth Long Distance, Inc. ("BSLD"). I concluded in my direct testimony that it is in the public interest for BSLD to be authorized to provide in-region interLATA services, as specified in Section 271 of the Telecommunications Act of 1996 ("Act").

II. PURPOSE AND SUMMARY

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. A number of interexchange carriers ("IXCs"), namely, AT&T, Sprint, and WorldCom, have sponsored economic testimony in this proceeding regarding the desirability—from a public interest standpoint—of granting in-region interLATA authority to BellSouth.[1] Without exception, these parties contend that it is not in the public interest to grant that authority at this time. My testimony rebuts that contention, responding primarily to witnesses David Stahly (for Sprint), and Joseph Gillan (for AT&T and WorldCom).

Q. WHAT IS YOUR PRINCIPAL CONCLUSION IN THIS TESTIMONY?

[1] In this testimony, "BellSouth" refers to either the parent corporation or its affiliates, depending on the context.

A. Generally, those parties assert that BellSouth's entry into the supply of in-region interLATA services would harm competition at the present time. Some also assert that its entry should be postponed until there is a measurable or substantial amount of competition in the local exchange market. In my opinion, those positions and the arguments and evidence used to support them are incorrect. The positions of these competitors are blatant, self-serving attempts to postpone the intensification of interexchange competition which would reduce their profit margins. My rebuttal testimony explains the economic errors in those comments.

III. THE PUBLIC INTEREST ISSUE: RESPONSE TO THE IXC POSITION

Q. PLEASE SUMMARIZE THE PUBLIC INTEREST POSITION OF THE IXCS IN THIS PROCEEDING.

A. The IXCs each describe their public interest position in slightly different terms, but the substance of their positions is the same. Their position is that it would be premature for BellSouth to be allowed to supply in-region interLATA services at this time, and that such entry now would be contrary to the public interest.

Three basic premises are offered for that position:

1. The proper focus of the public interest analysis is *not* the benefit to Tennessee consumers that BellSouth's entry into the supply of in-region long distance services could produce, but rather the net effect that such entry would have on the supply of *both* long distance and local exchange services in Tennessee.

2. BellSouth's entry into the provision of in-region interLATA services should be considered premature until actual facilities-based local exchange competition for both business and residential customers is firmly established and proven to be sustainable, as measured by some market share criterion.

3. The net impact of BellSouth's entry, measured across both long distance and local exchange services, would be negative or, if positive, *de minimis*, for two reasons.

    - BellSouth's supply of in-region interLATA services could offer no meaningful additional benefits to consumers or Tennessee's economy because the long distance market is already fully competitive.

    - BellSouth's entry would actually impede competition for both long distance and local exchange services in Tennessee.

Q. WHAT IS YOUR RESPONSE TO THE PUBLIC INTEREST POSITION OF THE IXCS?

A. My response to each of these premises is as follows:

1. Contrary to the IXC perspective, an appropriate analysis should determine the likely benefits to consumers in Tennessee from BellSouth's supply of in-region interLATA services. Significant economic benefits will accrue to Tennessee consumers if, but only if, interLATA prices are brought down significantly and permanently. I believe that BellSouth's entry will create those price reductions. The public interest analysis must, therefore, stay rooted in the supply of in-region interLATA services. Even if it were appropriate to examine the local exchange market, the effects there of BellSouth's entry will not be negative.

2. Contrary to the IXC perspective, Section 271 of the Act allows BellSouth and separate affiliates of Regional Bell Operating Companies ("RBOCs") to supply in-region interLATA services once they have complied with the competitive checklist. As I understand it, there is no requirement that any degree of facilities-based competition be present before entry is permitted. Instead, the checklist standards can be met by, among others, arrangements for incumbent local exchange carriers ("ILECs") to provide interconnection, unbundled network elements, and service resale. The real purpose behind the IXC's call for actual facilities-based competition is to institute a market share test as a precondition for BellSouth's entry and, therefore, to unduly delay such entry. Section 271 of the Act requires no such test.

3. Contrary to the IXC perspective, BellSouth's entry will deliver significant benefits to customers of long distance service in Tennessee for the following two reasons.

   - The long distance (interLATA) market has previously been regulated, is still highly concentrated, has a history of a dominant firm, exhibits parallel pricing, and maintains prices far in excess of marginal cost for some large segments of the market despite the presence of excess capacity in the market. For all these reasons, it is likely that BellSouth's entry will reduce long distance prices in Tennessee. In fact, real world experience has shown that long distance prices are reduced in places where incumbent IXCs are forced to compete with local exchange carriers.

   - The Act contains several, *ongoing* requirements with which BellSouth must comply in order to retain its authorization to provide in-region interLATA services. These requirements—and the prospect of being able to package local and long distance services— will not only facilitate entry by the IXCs into local markets in Tennessee, they will also safeguard against any attempt by BellSouth to behave anti-competitively. Far from impeding competition for local services, BellSouth's compliance with the competitive checklist will ensure and enhance competition.

Q. HOW DO ECONOMISTS APPRAISE THE PUBLIC INTEREST ISSUES REGARDING ONE FIRM'S ENTRY INTO ANOTHER FIRM'S MARKET?

A. In general, actual economic experience and mainstream economic theory both show that the public will generally benefit from additional competition in any market, especially that for in-region interLATA services. There can be no doubt that BellSouth's entry will cause long distance prices to decline. In contrast, witnesses for the IXCs have adopted a scattershot approach by raising hypothetical examples and concocting "what if" ways that BellSouth could create problems for those IXCs. They have *not*, however, raised *real* problems or demonstrated that any of those hypothetical problems will actually have adverse effects on their ability to compete, let alone that the competitive process would be harmed. The Authority, therefore, should focus on the real economic evidence, not hypothetical concerns.

Q. HOW IS YOUR REBUTTAL TESTIMONY ORGANIZED?

A. My testimony addresses the public benefits to the citizens of Tennessee from allowing BellSouth to enter into the supply of in-region interLATA services. I begin by showing that the present state of interLATA competition can be significantly improved by BellSouth's entry into the supply of in-region interLATA services. I point out that claims by the IXC witnesses notwithstanding, the interLATA market remains quite concentrated *despite* the presence in that market of hundreds of small resellers, and that the recent history of prices in that market reflects some form of tacit price coordination. Also, I demonstrate why it is utterly misleading to use changes in "average revenue per minute" (an index advanced by an IXC witness) to judge the state of competition in the long distance market. In addition, I rebut several claims purporting to demonstrate intense competition in that market.

My testimony also rebuts the IXC position that allowing BellSouth to supply in-region interLATA services at the present time will (i) impede effective competition in Tennessee's local exchange markets and (ii) permit BellSouth to employ monopoly leveraging techniques to gradually stifle competition in the interLATA market as well.

IV. BELLSOUTH'S ENTRY WILL PROMOTE MORE EFFECTIVE COMPETITION FOR INTERLATA SERVICES AND BENEFIT CONSUMERS

A. Price Competition for InterLATA Services is *Not* Vigorous

Q. WHAT DO THE IXC WITNESSES CLAIM ABOUT THE PRESENT STATE OF COMPETITION FOR INTERLATA SERVICES?

A. These witnesses claim that the interLATA services are currently provided under conditions of vigorous competition. For example, Mr. Stahly [at 12] declares that

> ... the long-distance market in the Tennessee is currently far more competitive than are the local exchange markets served by BellSouth. ... customers in BellSouth's territory have the option of selecting long distance service from several different IXCs and resellers with hundreds of different calling plans ...

Q. IS IT YOUR POSITION THAT THE INTERLATA MARKET IN THE U.S. IS NOT VIGOROUSLY COMPETITIVE?

A. Yes. I recognize, of course, that subsequent to the AT&T divestiture in 1984, the long distance market has seen several developments that have rendered the market more competitive than before divestiture. However, I do *not* share the view of some of these witnesses that competition in that market, even today, is vigorous. The number of long distance firms is *not* evidence *per se* of vigorous competition, particularly when all but four of those firms exist only as resellers of the long distance services produced by the four facilities-based providers. Moreover, when by the Federal Communications Commission's ("FCC's") own reckoning, those four facilities-based providers account for nearly 88 percent of presubscribed lines (December 1997) and nearly 82 percent of toll revenues (4th Quarter, 1997),[2] no picture of vigorous competition emerges.

The state of interLATA competition may also be viewed from another angle. The Federal Trade Commission and the U.S. Department of Justice employ the Herfindahl-Hirschman index ("HHI"), a measure based on the market share of firms, to assess and classify markets according to how concentrated they are. For example, these agencies use an HHI above 1800

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[2] FCC, *Long Distance Market Shares: Fourth Quarter, 1997*, Tables 2.2 and 3.4.

to classify a market as "highly concentrated." Even with well over a decade of long distance competition, the HHI of the interstate long distance market today exceeds 2800.[3] While a market share-based measure is only one, and often not the best, indicator of competition,[4] there is no denying the fact that the presence alone of large numbers of resellers is not sufficient to make the long distance market truly competitive.

Most troubling of all are indications of tacit price coordination among the major IXCs and a trend of increasing basic rates for long distance service in recent years. There is a legitimate basis for concern that long distance prices remain well above competitive levels.

B. Market Shares are an Ambiguous Measure of Competition

Q. MR. STAHLY [AT 7] ASSERTS THAT AT&T HAS LOST 45% OF ITS MARKET SHARE. ISN'T THIS EVIDENCE OF SIGNIFICANTLY INCREASED COMPETITION IN THE SUPPLY OF INTERLATA SERVICES?

A. No. The FCC has released data[5] that document how AT&T's market share in terms of minutes, revenues, and presubscribed lines have all trended downward since divestiture almost in parallel. But, as other FCC data show, most of the share lost by AT&T over this period has been gained by MCI and Sprint (and, since 1989, WorldCom), leaving little share growth for the hundreds of resellers in the industry. Thus, while three facilities-based providers (AT&T, MCI, and Sprint) accounted for 93.5 percent of toll revenues in 4th Quarter, 1987, their share plus that of the fourth facilities-based provider, WorldCom, had shrunk only to 81.6 percent in 4th Quarter, 1997.[6] This relatively insignificant transfer of revenue market share is hardly evidence of intense competition from the hundreds of firms referred to by the IXC witnesses. More precisely, it is further indication that competition—such as there is of it for interstate

[3] *Ibid.*, Table 3.2.

[4] It appears that the IXC witnesses accept market share measures as being indicative of the state of competition; see, e.g., Stahly [at 28].

[5] Available from the FCC's web site as a downloadable file containing market share and minutes-of-use related data and charts.

[6] *Ibid.*, Table 3.4, fn 2 *supra*.

interLATA services—is essentially managed, if not controlled, by the four facilities-based providers.

Even more significant is the fact that the revenue shares of MCI and Sprint have been virtually stagnant between the 4th Quarter, 1992, and the 4th Quarter, 1997 (17.2 and 18.7 percent respectively for MCI, and 9.3 and 9.5 percent respectively for Sprint).[7] Also, AT&T lost only 13.6 percentage points of its share over that period (from 60.6 to 47 percent), despite the "vigorous competition" that supposedly occurred during that time. Exhibits WET-1 and WET-2 are charts that help to illustrate these trends. In my opinion, any assessment of the state of competition in the entire *market* formed on the basis of movements in the market share of a single, albeit the largest, *firm* is, at best, misleading.

Q. CAN MARKET SHARES TRULY REVEAL THE STATE OF COMPETITION?

A. Not always. In fact, market share is only one indicator, and an imperfect one at that, of the state of market dynamics because it cannot always convey what happens to prices over the period that the shares are observed. The real test of competition—one that measures consumer benefits directly—is whether market prices move in the direction of their corresponding costs. The trend observed in recent years of rising basic long distance rates (demonstrated in my direct testimony), when viewed in the context of relatively stagnant market shares, can only suggest that some form of tacit price coordination has been occurring in the interLATA market.

C. Price Trends are a Better Indicator of the State of Competition

Q. MR. STAHLY [AT 9, EXHIBIT DES-2] CLAIMS, USING AVERAGE REVENUE PER MINUTE DATA, THAT "BETWEEN 1995 AND 1997, SPRINT'S DOMESTIC LONG DISTANCE PRICES DECLINED BY MORE THAN TWICE AS MUCH AS ACCESS COSTS DECLINED." ISN'T THIS EVIDENCE OF STRONG INTERLATA COMPETITION BECAUSE PRICES HAVE DECLINED MORE THAN COSTS?

A. No. This statement is misleading because ARPM is an utterly misleading index of price movements.

[7] *Ibid.*

Q. PLEASE EXPLAIN WHY ARPM IS A MISLEADING INDEX OF PRICE MOVEMENTS.

A. Changes in ARPM do not measure changes in prices for a variety of reasons:

1. ARPM mixes apples and oranges. A high-volume customer who moves from basic long distance to a minimum-volume and minimum-term contract has purchased a different service. While no service prices have changed, ARPM treats the move as if the IXC has reduced prices.

2. ARPM confuses price changes with the impact of volume discount plans. If prices remain fixed but customer demand increases (e.g., due to the increasing use of fax machines), the customer receives a lower marginal price from the IXC's declining-block contract or tariff. The IXC's ARPM will fall because demand has increased, not because the IXC has reduced prices.

3. ARPM can decrease while the prices of all services increase, e.g., if all prices rise and customers shift from high-priced services to low-priced services. No reasonable price index can have this property.

4. ARPM can also decrease even if the price of a different service were to increase. For example, suppose that the IXC were to increase its private line rates while leaving switched services rates unchanged. The private line rate increase would drive large business customers away from private line services to bulk-priced switched services. This change would lower the IXC's ARPM for switched services. Thus, the ARPM measure would make a rate increase (in private line services) look like a rate decrease (in switched services).

5. ARPM will also overstate the effect of a price change if the own-price elasticities for different services are different, even when the percentage price change for each is identical. For example, suppose service *A* has a price of one dollar per minute, a demand of ten minutes, and an own-price elasticity of -0.2, and service *B* has a price of fifty cents per minute, a demand of ten minutes, and an own-price elasticity of -5.0. If the price of each of the services decreases by 10 percent, then the ARPM will decrease by 17 percent. Observe that the anomalous result is not caused by substitution in favor of the lower-priced service—their demands are assumed to be independent in this example—but rather reflects the inadequacies of the index itself.

6. ARPM has decreased historically partly because long distance holding times have increased. Because the first minute is frequently priced higher than subsequent minutes, longer holding times result in lower average revenue per minute with no change in prices.

ARPM, used by Sprint, is not an acceptable index of the change in long distance prices. Therefore, indices of actual prices that control for the services being provided should always be used in place of the aggregate ARPM to indicate price trends.

Q. CAN ARPM ADEQUATELY MEASURE OR REPRESENT THE PRICE/COST DISPARITY FOR EACH CUSTOMER SEGMENT IN THE INTERLATA MARKET?

A. No. Even if the aggregate ARPM were an adequate measure of price movements—which it is not—the IXCs have not demonstrated how the ability to charge different prices to different customer segments has shaped the price/cost disparity (i.e., the degree to which price exceeds cost) by customer segment. Reference to ARPM disguises the actual degree to which that disparity occurs among different customer segments. Indeed, that approach amounts to treating the entire long distance market as being made up of homogeneous customers. That is simply not true. Because ARPM cannot, by construction, accurately reflect the prices that the large segment of non-discount eligible customers pay, it also cannot possibly reveal the price/cost disparity for a substantial group of customers. In fact, the IXCs do little to focus on price-cost relationships across *all* customer groups and, therefore, prove nothing about whether or not there is room for BellSouth to compete against them.

Q. DOES THAT MEAN THAT BELLSOUTH WILL ONLY COMPETE FOR THE SMALLEST VOLUME CUSTOMER SEGMENT?

A. No. Entry into *any* segment for in-region interLATA services will be worthwhile to BellSouth if it is able to charge a lower price than the IXCs and still cover its cost. That is the essence of true competition—a tendency for entry to occur as long as the entrant is relatively at least as efficient as the incumbent (here, the IXCs) and the incumbent is currently enjoying a margin above cost for which the entrant can compete.

Q. PLEASE SUMMARIZE YOUR DISCUSSION OF ARPM AS AN ALLEGED INDICATOR OF COMPETITION FOR LONG DISTANCE SERVICES.

A. First, ARPM has serious conceptual flaws which cause it to give misleading information about how the IXCs have changed prices, even accepting that the introduction of a discount calling plan, for some customers, offers a price reduction. Second, a failure to divulge for what group of services and customers the ARPM is calculated can mislead the reader about what the implications are. All this evidence cannot possibly support the IXCs' position that, based on ARPM, the residential sector of the interLATA long distance market is competitive—whether in the interstate or the intrastate jurisdiction.

Q. MR. STAHLY STATES [AT 9-10] THAT LOW VOLUME USERS HAVE BENEFITED FROM ACCESS REDUCTIONS BECAUSE THE SUBSCRIPTION PRICE FOR TOLL FREE CALLING HAS FALLEN AND, THEREFORE, MORE FIRMS USE THE SERVICE TO THE BENEFIT OF CONSUMERS. DO YOU AGREE?

A. The growth of 800/888 "toll free" service is completely irrelevant to the access charge reductions that the IXCs have failed to pass through to low volume users. The decision of a firm to offer toll free service is a business decision that benefits that firm's customers, none of whom may even be low volume users. Indeed, Mr. Stahly offers no indication, let alone data, that 800/888 toll free service has benefited low volume users, if at all, any more than it has benefited high volume users. Furthermore, while Mr. Stahly claims that individual consumers can afford 800/888 service, it is scarcely credible that toll free service is used for anything other than business purposes except in unique circumstances. It is not low volume residential consumers who have "benefited tremendously from this phenomenon;" rather, that benefit has accrued mostly to high volume business users.

Q. MR. STAHLY CLAIMS [AT 9] THAT LOW VOLUME USERS HAVE BENEFITED FROM ACCESS CHARGE REDUCTIONS BECAUSE THE RESULTING REDUCTION IN LONG-DISTANCE PRICES REDUCES THE PRODUCTION COSTS OF GOODS. DO YOU AGREE?

A. Again, the comparison is completely irrelevant and is an indication that the IXCs are simply grasping at straws. Nobody disagrees that lower long-distance prices result in lower production costs which, if passed through by firms, benefit consumers. The issue is that *low volume long distance users*—those users paying basic rates—have not experienced tangible reductions in their rates as a result of access charge reductions. Arguments like the ones Mr. Stahly makes only serve to divert attention away from the IXCs' obvious aversion to passing through access charge reductions to *all* consumers.

Q. PLEASE SUMMARIZE YOUR ASSESSMENT OF THE STATE OF LONG DISTANCE COMPETITION, PARTICULARLY IN THE CONTEXT OF TESTIMONY SUBMITTED BY THE IXC WITNESSES.

A. My assessment is that while competitive developments have occurred in the long distance market since divestiture, competition in that market is far from reaching its full potential. Despite hundreds of firms (albeit all but four being resellers), equal access, unlimited advertising, and little or no regulation, this market remains trapped in a setting which can be best described as an oligopoly (comprising three or four facilities-based IXCs) with a competitive fringe (comprising hundreds of small resellers dependent on the facilities-based IXCs for capacity). This market has witnessed progressively more stable market shares (particularly between the facilities-based firms and the resellers), a buildup of substantial excess capacity, a reluctance to reduce retail rates any more than access rate reductions and, in fact, a systematic trend toward higher basic retail rates in recent years. These features plus the distinct pattern of lockstep pricing (particularly, price increases) among the major IXCs in recent years all point in the direction of the form of price behavior called tacit price coordination. In this situation, customers would benefit by entry of a major impact player that could stoke the fires of true competition. I believe that entry by BellSouth with the prospect of market price reductions in the neighborhood of an average of 25 percent over the next five years will bring far greater benefits to long distance customers in Tennessee than are presently possible.

D. BellSouth's Entry Will Cause Long Distance Market Prices to Fall

Q. MR. STAHLY [AT 12] ASSERTS THAT "THE INCREMENTAL BENEFITS OF BELLSOUTH'S ENTRY ... WILL LIKELY BE MUCH SMALLER THAN THE CORRESPONDING BENEFITS FROM CLEC ENTRY INTO THE LOCAL EXCHANGE MARKET." DO YOU ACCEPT HIS ASSERTION?

A. No. Mr. Stahly's unsupported and unsubstantiated assertion is a breathtaking example of casual prognostication on a very complicated matter. No IXC witness—certainly not Mr. Stahly himself—has provided hard quantitative evidence that BellSouth's entry into the long distance market will have imperceptible effects on the citizens of Tennessee. Such a claim defies both the reality and common sense.

First, there is growing evidence that competition from ILECs entering the long distance market has forced significant price reductions in that market. For example, facing market share losses from Southern New England Telephone's ("SNET's") entry into the long distance market in Connecticut, effective May 21, 1996, AT&T began offering all direct intrastate calls for only 5 cents per minute (guaranteed for a full year regardless of the time of day), but only to customers subscribing to its interstate long distance services.[8] Rate averaging rules prevent AT&T from lowering its interstate rates in Connecticut without also lowering rates elsewhere. Thus, this competitive response enabled AT&T to respond to SNET's lower rates without lowering interstate prices elsewhere. SNET responded to the AT&T initiative by offering a new plan that bills in-state calls in one-second increments rather than round up to the next minute as AT&T does.[9] From this real world example, it can hardly be argued that SNET's entry into the long distance market has not lowered market prices to Connecticut customers.

Second, BellSouth and other RBOCs or ILECs like it, can hardly be compared to the hundreds of small resellers that populate the so-called "competitive fringe" of the long distance market. Even though BellSouth will enter into the supply of in-region interLATA services as a switchless reseller initially,[10] there is no doubt in my mind that it has the resources to make the transition to a facilities-based provider of both local and long distance services. As I point out on page 19 of my direct testimony, BellSouth can reasonably be expected to have far greater qualitative and quantitative impacts on the long distance market than hundreds of small, limited-operation resellers. Contrary to Mr. Stahly's expectation [at 12], the marketing impact of BellSouth's entry into long distance will likely be similar to that of a major IXC's entry into the local exchange market. That is because the level of customer contact, marketing resources, name recognition, and service quality of BellSouth and of the major IXCs are likely to be roughly comparable.

[8] "AT&T Offers 5 Cent Rate in Connecticut," *Business Wire*, May, 1996.

[9] Susan Jackson, "A Telecom Yankee Defends Its Turf," *Business Week*, October 28, 1996.

[10] Direct testimony of James G. Harralson in this proceeding.

Q. MR. GILLAN [AT 6], REFERRING TO YOUR CROSS-EXAMINATION IN A LOUISIANA DOCKET, STATES THAT YOUR TESTIMONY PROVES THAT IF BELLSOUTH IS GRANTED INTERLATA ENTRY PREMATURELY, PRICES WILL NOT FALL AND CONSUMERS WILL NOT BENEFIT BECAUSE BELLSOUTH WILL BE ABLE TO ATTRACT CUSTOMERS AS A ONE-STOP PROVIDER WITHOUT OFFERING LOWER PRICES. DO YOU AGREE?

A. No. Mr. Gillan cites my testimony correctly but not completely by not accounting for the last sentence of my cited statement. It reads: "[when BellSouth comes in] they will, in my view, take away enough customers from MCI and from AT&T that AT&T and MCI will respond." BellSouth intends to enter the interLATA market with basic rates 5 percent or more below AT&T's basic rates. From an economic perspective, BellSouth will enter the interLATA market at whatever price they think the most profitable and, by taking away enough customers from MCI and AT&T to prompt a competitive response, BellSouth's entry into the interLATA will indeed lower market prices beyond their initial reduction and benefit consumers.

V. BELLSOUTH'S ENTRY WILL *NOT* INHIBIT COMPETITION IN THE INTERLATA OR LOCAL MARKETS

A. BellSouth Will Have Neither the Incentive Nor the Ability to Impede Competition in the Local Exchange Market

Q. THE IXCS UNIFORMLY CONTEND THAT BELLSOUTH'S ENTRY INTO THE IN-REGION INTERLATA MARKET IS PRESENTLY NOT IN THE PUBLIC INTEREST. IS THERE ANY MERIT TO THIS CONTENTION?

A. No. The IXCs wrongly conclude that the net impact of such entry at this time would not be beneficial to the citizens of Tennessee. Contrary to this view, in my opinion, there would be substantial benefits from such entry and few, if any, detriments to either the long distance or the local exchange market as a consequence.

Q. MR. STAHLY [AT 3-4] SUGGESTS THAT BELLSOUTH WILL HAVE LITTLE, OR SUBSTANTIALLY REDUCED, INCENTIVES TO COMPLY WITH THE ACT ONCE INTERLATA ENTRY IS GRANTED AND, THUS, COMPETITION IN THE LOCAL MARKET WILL SUFFER. DO YOU AGREE?

A. No. The opportunity to compete for long distance business undoubtedly provides an incentive for BellSouth to meet the competitive checklist. However, as I read the Act, the competitive checklist requirements do not go away. Therefore, whatever incentive the Act provides to live up to the checklist, it provides an equal—perhaps, even greater—incentive to *maintain* compliance with the checklist. That incentive will likely become even greater as the opportunity cost of not staying in compliance (thus, suffering a revocation of interLATA authority) increases, such as when BellSouth would be in a position to offer local and long distance services on a packaged basis. It is, therefore, inconceivable that BellSouth's incentive to comply with the Act's requirements and to cooperate in making the local market more competitive would diminish once it has been permitted entry into the interLATA market. The loss of the hard-earned opportunity to provide long distance services would be too costly a sacrifice were BellSouth to run afoul of its obligations under the Act. Besides, I do not believe that BellSouth would have the *ability* to impede local competition.

Q. PLEASE EXPLAIN WHY BELLSOUTH WOULD NOT HAVE THAT ABILITY ONCE IT HAS BEEN ALLOWED TO SUPPLY IN-REGION INTERLATA SERVICES?

A. The introduction of competition in the local exchange market and BellSouth's entry into long distance would not mean the immediate end of regulatory oversight of BellSouth by either federal or state authorities. Potential entrants—particularly financially strong and resourceful firms like AT&T, MCI, and Sprint—could exact a heavy price from BellSouth in terms of litigation costs if it were to behave anti-competitively. Structural separation between BSLD and BST, as required by the Act, will curb the opportunity or ability to cross-subsidize one set of services by another. Requiring that prices of services provided by both entities equal or exceed their respective incremental cost floors will also prevent cross-subsidy.[11] Non-

[11] Of course, where pricing below cost is mandated for public policy reasons, an explicit subsidy would need to be created to support such pricing.

discrimination rules for the supply and pricing of essential facilities will apply. Finally, continuing price regulation of BellSouth will further check the ability to cross-subsidize. In short, there are adequate safeguards to protect against any anti-competitive conduct by BellSouth in the local exchange market.

As actual competition in the local market increases, of course, the regulatory oversight and safeguards will become increasingly unnecessary. As that happens, it would be economically efficient to allow free market forces to take over the task of "regulator."

Q. ARE THERE OTHER REASONS WHY YOU BELIEVE THAT BELLSOUTH WOULD NOT BE ABLE TO USE ITS ENTRY INTO THE SUPPLY OF IN-REGION INTERLATA SERVICES TO SUBVERT COMPETITION IN THE LOCAL EXCHANGE MARKET?

A. Yes. In order to subvert competition in the local exchange markets, BellSouth must possess a special cost or marketing advantage over its rivals in the local exchange market itself or derive one from being able to enter the interLATA market. Any special advantage from the former source will be impossible (given the Act's competitive checklist requirements) and any from the latter source would be unlikely (given that its rivals in the long distance market will be large, experienced, and resourceful IXCs).

B. BellSouth's InterLATA Entry Will Increase Competition Regardless of Whether the Local Exchange Market is Competitive

Q. SHOULD COMPETITION IN LOCAL AND LONG DISTANCE MARKETS BE EQUALIZED BEFORE BELLSOUTH IS PERMITTED INTERLATA ENTRY, AS SOME OF THE IXC WITNESSES SEEM TO SUGGEST?

A. No. Even though the Act does not *require* that "full competition" (however defined) take hold in the local market before interLATA entry is permitted, there is a strong suggestion by some witnesses (e.g., Stahly at 27-28, Gillan at 7) that permission for such entry *should* be withheld until *effective* local competition is demonstrated. This is a complete misreading of the Act and greatly exceeds the appropriate economic test envisioned by the Act for permitting interLATA entry.

Equalization of the levels of competition is the *outcome* of establishing competitive parity, not its *prerequisite*. Competitive parity is achieved by providing reciprocal *access* to local and long distance markets; that is the underlying public policy framework of the Act. Long distance providers already have access to local and intrastate toll markets through interconnection, unbundled elements, resale services and local number portability. The RBOCs, by contrast, are still excluded from long distance markets which the Big Three IXCs dominate.

Q. SOME IXC WITNESSES EVEN CONTEND THAT SOME DEGREE OF FACILITIES-BASED COMPETITION IN THE LOCAL MARKET MUST PRECEDE THE GRANTING OF INTERLATA ENTRY TO BELLSOUTH. DO YOU AGREE?

A. Absolutely not. The IXCs' advocacy of some degree of actual facilities-based competition prior to granting BellSouth interLATA entry can logically only mean that nothing short of a market share test in the local exchange market will satisfy them. Historically, resale-based competition alone has never successfully made significant inroads into the market share of the incumbent firm. Only after developing their own networks were MCI and Sprint able to erode a considerable fraction of AT&T's market share. Yet, at the same time, a large number of resellers have collectively not had the same impact that MCI and Sprint have had. Knowledge of this historical reality would explain the IXC's interest in attaching a market share test to the conditions for BellSouth's entry. As I explain later in my testimony, a market share test would enable the IXCs to pursue some strategic posturing that delays BellSouth's entry into the supply of in-region interLATA services considerably.

While the Act is clear about granting an RBOC entry into the in-region interLATA market following compliance with the competitive checklist, my understanding is that there is *no* specific or implied requirement that any degree of actual facilities-based competition occur before such entry is permitted. The checklist standards can be met by, among others, arrangements for RBOCs (or, ILECs in general) to offer interconnection, unbundled network elements, and service resale. These standards will effectively satisfy the need to check the market power, if any, of ILECs that are "large" (in terms of market share) relative to their competitors in the early stages of competition. Adherence to the "some degree of facilities-based competition" standard would be misguided for another important reason: every day that interLATA entry by BellSouth is delayed, consumers in Tennessee are denied the enormous benefits (enumerated in my direct testimony) that such entry can bring.

C. IXC Advocacy of Market Share in Local Market is Irrelevant and Diversionary

Q. IS THE POSITION OF THE IXCS REGARDING A MARKET SHARE TEST NECESSARILY A REQUEST TO PROTECT COMPETITION IN THE LOCAL EXCHANGE MARKET?

A. No. The IXCs' advocacy of a market share test (e.g., Stahly at 28) is also consistent with an effort by them to protect their less than fully competitive market from entry by a robust competitor. The real concern of this Authority ought to be whether the large and financially well-endowed IXCs can—and will—game the advent of local competition in order to frustrate long distance entry by BellSouth because such entry could well produce significant average long distance price reductions. To the extent that the IXCs are reluctant to enter local markets in Tennessee, under the theory that they wish to delay BellSouth's entry into the long distance market, allowing interLATA entry upon compliance with the competitive checklist would actually increase the IXCs' incentive to seriously pursue competitive ventures in both local and long distance markets.

Q. SHOULD BELLSOUTH'S ENTRY INTO THE IN-REGION INTERLATA MARKET AWAIT A MARKET SHARE TEST IN THE LOCAL EXCHANGE MARKET?

A. No. Waiting for a certain level of erosion of BellSouth's local exchange market share prior to authorizing such entry would

1. postpone and deny the benefits to Tennessee consumers of lower interLATA prices, and
2. create the conditions for inappropriate strategic posturing by local exchange competitors.

Also, the market share test is ill-suited to making forward-looking assessments of market power, and can be abused.

Q. PLEASE EXPLAIN HOW THE MARKET SHARE TEST COULD LEAD TO INAPPROPRIATE STRATEGIC POSTURING ON THE PART OF LOCAL EXCHANGE COMPETITORS.

A. If a market share erosion target (say, 30 percent) were announced in advance, and entry into the in-region interLATA market made conditional on it, other local exchange competitors would have little incentive to compete aggressively in the local exchange market. These competitors, particularly the IXCs, would eschew developing their own local exchange facilities and expanding their customer base for local service to meet the target if, as a consequence of doing so, they would have to face the prospect of entry into their core interLATA market by BellSouth.

Q. PLEASE EXPLAIN WHY MARKET SHARE IS AN INAPPROPRIATE TEST OF MARKET POWER.

A. Market power implies the ability by a firm to exercise control over or leadership of the market price. "High" market share is neither necessary nor sufficient for a firm to exercise such power, particularly in regulated markets such as local exchange services. A firm need not have virtually 100 percent market share to be able to effectively exercise price leadership (today's AT&T is a case in point). On the other hand, certain market conditions (such as regulation by this Authority) could impair substantially, or eliminate entirely, the ability of a firm with high market share to control the market price. The Act's competitive checklist requirements with respect to interconnection, unbundled network elements, and service resale would create those conditions. Moreover, a market share is really a "backward-looking" indicator of how the market *was*, not of how it *would be* in the future. If the state of local exchange competition is at all germane to this proceeding, conditions that would establish meaningful and workable competition in the local exchange of the future, not past conditions, should be used to assess whether BellSouth would retain market power.

Q. EVEN ASSUMING THAT BELLSOUTH STARTS OUT WITH NEARLY ALL OF THE LOCAL EXCHANGE MARKET, HOW WOULD FUTURE MARKET CONDITIONS DETERMINE WHETHER BELLSOUTH WOULD RETAIN MARKET POWER OVER PRICES FOR LOCAL SERVICES?

A. The most important component of the local exchange market, namely, basic residential exchange service, is usually priced on the basis of extra-economic considerations. Continuation of this practice, and its close monitoring by regulatory authorities, can hardly safeguard against the vertical price squeeze and, in fact, the Act requires an ILEC to sell carrier access to its long distance affiliate at the same price that it charges IXCs for the same service.[12]

Q. DO YOU AGREE WITH THE EXAMPLE PROVIDED BY MR. STAHLY [AT 18-21] WHICH SUPPOSEDLY SHOWS THAT BECAUSE CARRIER SWITCHED ACCESS IS TYPICALLY PRICED SEVERAL TIMES HIGHER THAN INCREMENTAL COST, BELLSOUTH WILL "HAVE A SIGNIFICANT ARTIFICIAL COST ADVANTAGE OVER OTHER IXCS THAT THEY CAN USE TO DRIVE THE IXCS OUT OF THE INTERLATA MARKET."

A. Absolutely not. Basic economic analysis shows that the vertically integrated firm derives no advantage *in the long distance market* from the (assumed) fact that it is the sole supplier of carrier access service at a regulated price that exceeds incremental cost. Consider Mr. Stahly's example [at 20] in which a 7¢ per minute of access charge imposed by BellSouth on the IXCs is compared with a cost of only 0.5¢ to provide itself access. The difference between cost and access charges is then translated into a 6.5¢ cost advantage in providing long distance services.

The first flaw in Mr. Stahly's example is that under the law BellSouth must charge its long distance affiliate BSLD precisely the same 7¢ per minute. This was Congress' answer to any anti-competitive concern arising from the *level* of the access rate. The second flaw in Mr. Stahly's reasoning is that BellSouth will receive the same 7¢ in access charges, *irrespective* of which long distance provider actually carries the call. However, if its affiliate BSLD were to carry the call, BellSouth would not receive 7¢ per minute in access charges from any unaffiliated long distance carrier. Thus, a BellSouth manager attempting to optimize corporate profits would have to recognize the 7¢ in access *cost* to BellSouth whenever BSLD carried the long distance call—not because of imputation rules or separate affiliate accounting formulas, but because the 7¢ per minute that used to go into its corporate pocket would no longer do so when its own affiliate carried the long distance call. What Mr. Stahly characterizes as a 6.5¢ "profit" to BellSouth even under imputation turns out, under closer scrutiny, to really be a cost. Furthermore, his conclusion [at 21] that an IXC "receiving zero profit will soon be driven out of the market" makes no sense. As long as the IXC is earning its "normal profit," i.e., covering

[12] The Act, ¶272(e)(3).

its cost of capital, there can be no reason for the IXC to exit the market even with zero *accounting* profit.

Q. MR. STAHLY [AT 25] ALSO CLAIMS THAT BECAUSE ALL OF THE PROFITS AND LOSSES OF BELLSOUTH'S LONG DISTANCE AND LOCAL BUSINESSES FLOW TO THEIR CORPORATE PARENT, "BELLSOUTH MAY CHOOSE TO OPERATE ITS LONG DISTANCE OPERATIONS AT A LOSS (PROVIDED IT STILL CAN PASS IMPUTATION TESTS) AND KEEP THE PRICES FOR ALL LOCAL SERVICES AS HIGH AS IT CAN." WOULD THIS BE POSSIBLE?

A. No. There is no way around the simple economics of imputation, and that is why the Act requires BellSouth to charge its long distance affiliate "an amount for access . . . that is no less than the amount charged to any unaffiliated interexchange carrier."[13] Mr. Stahly betrays a fundamental misunderstanding of the mechanics of imputation. Properly implemented, imputation should ensure that the price of the retail service (here, long distance service) is *no less* than the price paid for the wholesale service (here, the essential input carrier access). In other words, long distance service *cannot* be "operated at a loss," i.e., below cost, and still pass the imputation test.

Mr. Stahly is also mistaken in asserting [at 26] that "imputation won't stop BellSouth from exercising a price squeeze," though he concedes it is an important and necessary safeguard. If it is indeed such a safeguard, then what does it guard against if not a price squeeze or "extreme predatory pricing"[14]?

Q. MR. STAHLY ALLEGES IN HIS TESTIMONY [AT 21-22] THAT SNET'S ACTIONS IN CONNECTICUT APPEAR TO BE PARTIALLY LEVERAGING A SWITCHED ACCESS ADVANTAGE. IS THERE ANY MERIT TO THIS ALLEGATION OF A PRICE SQUEEZE?

A. No. As Mr. Stahly himself indicates, the information he presents is hypothetical and inconclusive. What is conclusive, however, is that following SNET'S bundling of residential

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[13] *Ibid.*

[14] It is unclear to me what economic meaning Mr. Stahly attaches to that term.

service in Connecticut: (1) AT&T began offering residential local service in Connecticut only a few months after it entered California, and (2) MCI decided to include Hartford on its short list of initial targets for local entry.[15] Both of these actions were taken despite the fact that Connecticut's largest city is only 137th in the population ranking for U.S. cities.[16]

Q. WHAT APPEARS TO BE THE "BOTTOM LINE" IN THESE CHARGES ABOUT A VERTICAL PRICE SQUEEZE?

A. The real agenda of the IXC witnesses who dispute the usefulness of imputation as a competitive safeguard is to get regulatory action to lower BellSouth's carrier access rates to their incremental costs. This has been a goal of the IXCs for a long time and they have sought every possible avenue to press their claim. There are very good economic reasons why access rates are presently set above cost (e.g., to provide part of the support needed for below-cost pricing of local residential exchange service for public policy reasons). Nothing in the Act requires that access rates be reduced to cost before BellSouth can enter the long distance market, and the Authority should reject the IXC's efforts to secure such reductions. Mr. Stahly's call [at 27] for withholding authority for interLATA entry until switched access is priced at TELRIC is entirely without merit.

Q. CAN MONOPOLY LEVERAGING THROUGH PRICE DISCRIMINATION OCCUR IF BELLSOUTH WERE PERMITTED INTERLATA ENTRY?

A. No. As I have pointed out, Section 272(e)(3) of the Act prevents an ILEC such as BellSouth from selling essential inputs to its affiliate BSLD and other competing unaffiliated carriers at different rates. In addition, the *levels* of those rates cannot by themselves act as entry barriers. What matters for comparative parity is that BellSouth's retail price/cost margin be no less than the price it charges its competitors for the essential input.

[15] "Huber Sees Bell Service Bundling As Residential Competition Key," *Telecommunications Reports*, November 10, 1997.

[16] *Ibid.*

VI. THE PUBLIC INTEREST REQUIRES THAT BELLSOUTH'S INTERLATA ENTRY BE AUTHORIZED

Q. HOW SHOULD THE AUTHORITY DETERMINE WHETHER IT IS IN THE PUBLIC INTEREST TO AUTHORIZE INTERLATA ENTRY BY BELLSOUTH?

A. This Authority should find that the economic benefits to the citizens of Tennessee exceed any economic cost from allowing such entry, and recommend that the FCC grant BellSouth authority to provide in-region interLATA services.

Q. WHAT HAVE THE IXCS URGED THE TENNESSEE AUTHORITY TO FIND IN THIS PROCEEDING, AND HOW DO YOU RESPOND TO THE IXCS' POSITION?

A. The IXCs intervening in this proceeding have uniformly urged the Authority to find that some measure of competition in Tennessee's local exchange markets is necessary before the public interest would be served by permitting BellSouth to offer interLATA services in Tennessee. Whatever the merits of the legal analysis, the *economic* argument for this proposition is grounded in a confusion of the relevant markets.

The Authority is not being asked to deregulate local exchange service or exchange access service, which would be the appropriate regulatory response to a finding of effective competition in local exchange markets. Rather, the Authority is being asked to find that BellSouth's entry *into the long distance market* serves the public interest. Under the Act—as well as in economic theory—when competing long distance providers have alternatives to BellSouth's carrier access service for originating and terminating traffic to BellSouth's local customers, entry by BellSouth into the long distance market can have no significant anti-competitive effects. Inasmuch as BellSouth has satisfied the competitive checklist, long distance competitors can use any combination of their own facilities and parts of BellSouth's facilities and services to originate and terminate traffic at regulated cost-based prices under regulated terms and conditions.

Q. WHAT IS YOUR CONCLUSION ON THE PUBLIC INTEREST ISSUE IN THIS PROCEEDING?

A. As I have explained in this testimony, the arguments and evidence I have reviewed are either unpersuasive or erroneous. The evidence I presented in my direct testimony leaves me more convinced than ever that BellSouth's entry into the in-region interLATA market will make that market more competitive, will reduce prices paid by consumers in Tennessee, will not harm local exchange competition, and, therefore, will be in the public interest.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

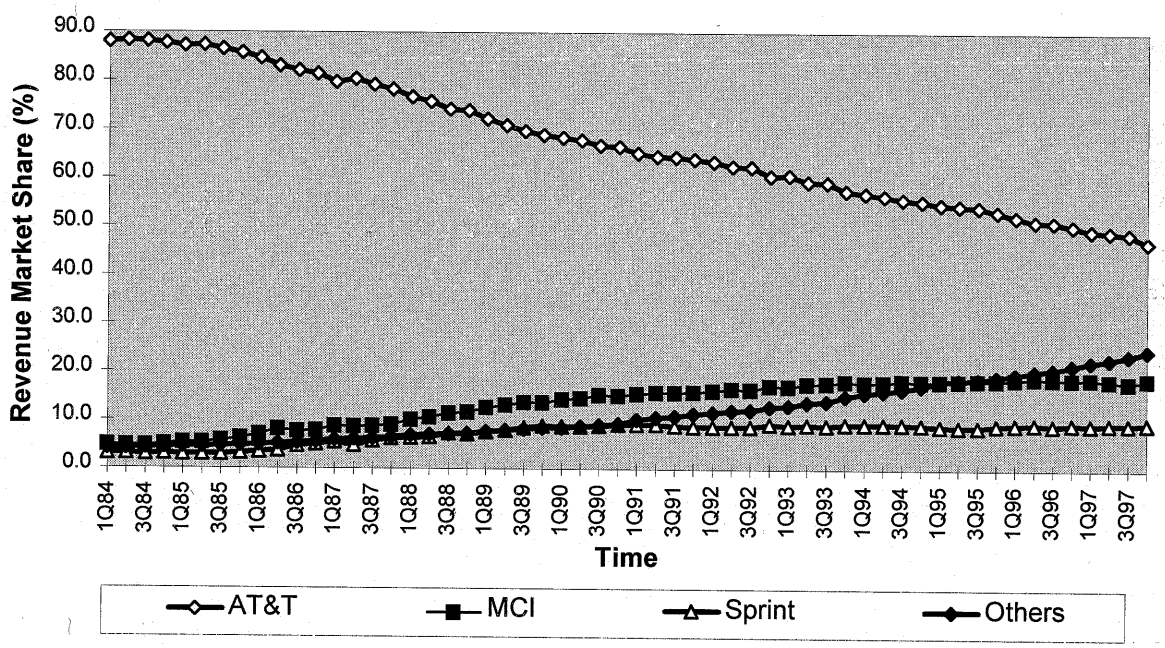
REBUTTAL TESTIMONY OF DR. WILLIAM E. TAYLOR

EXHIBIT WET-1

REVENUE MARKET SHARES OF INTEREXCHANGE CARRIERS, 1984-97

n/e/r/a
Consulting Economists

Figure 1
Revenue Market Shares of Interexchange Carriers, 1984-97



Source: FCC Report , "Long Distance Market Shares—Fourth Quarter 1997," March 1998, Table 3.2.

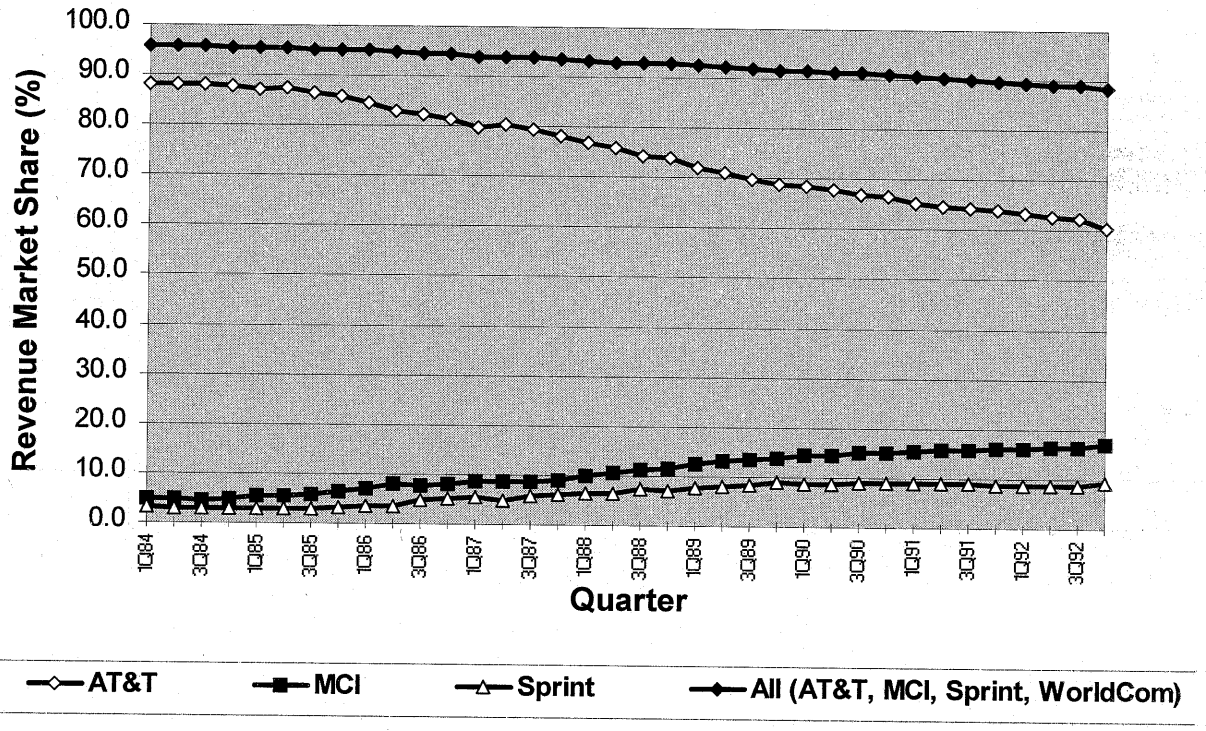
REBUTTAL TESTIMONY OF DR. WILLIAM E. TAYLOR

EXHIBIT WET-2

REVENUE MARKET SHARES OF FACILITIES-BASED CARRIERS, 1984-97

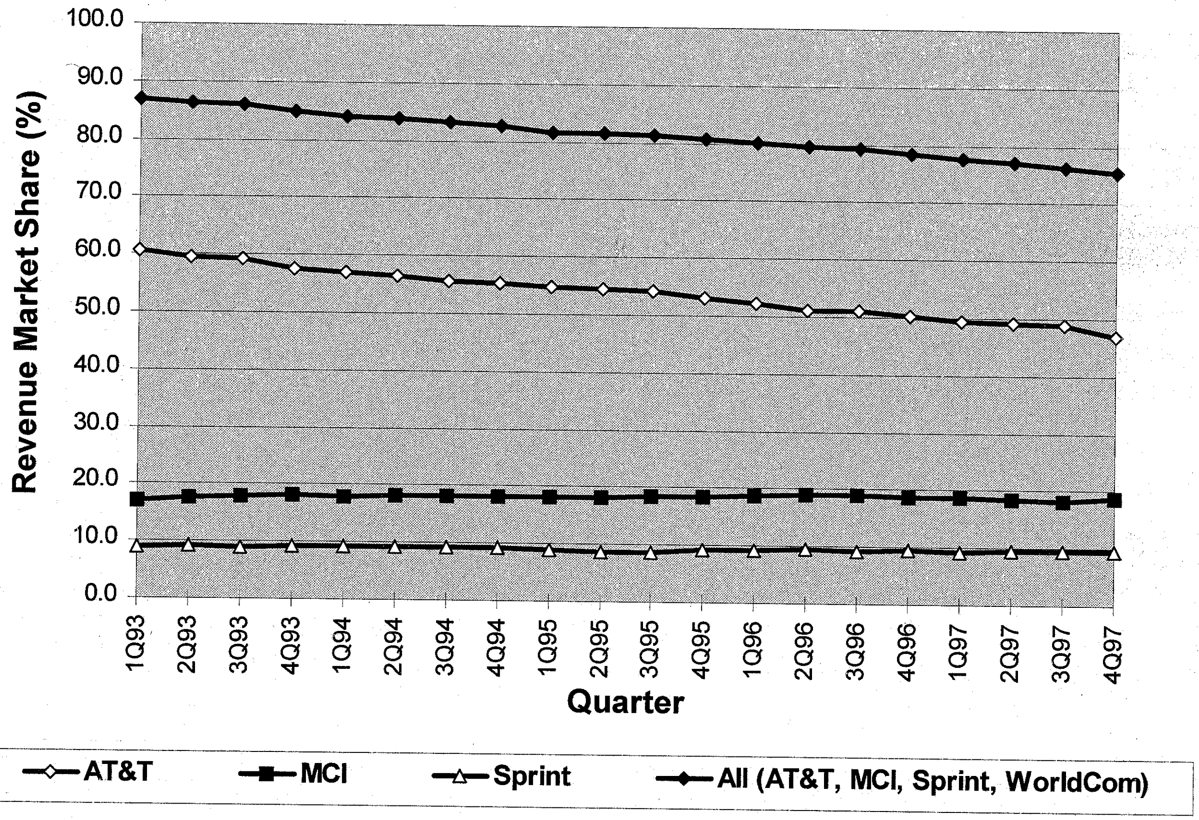
n/e/r/a
Consulting Economists

Figure 2
Revenue Market Shares of Facilities-Based IXCs, 1984-92
(Period of Changing Shares)



Source: FCC Report , "Long Distance Market Shares—Fourth Quarter 1997," March 1998, Table 3.2.

Figure 3
Revenue Market Shares of Facilities-Based IXCs, 1993-97
(Period of Flat Shares)



Source: FCC Report , "Long Distance Market Shares—Fourth Quarter 1997," March 1998, Table 3.2.

AFFIDAVIT

STATE OF MASSACHUSETTS

COUNTY OF MIDDLESEX

BEFORE ME, the undersigned authority, duly commissioned and qualified in and for the State and County aforesaid, personally came and appeared William E. Taylor, who being by me first duly sworn deposed and said that:

He is appearing as a witness before the Tennessee Regulatory Authority in Docket No. 97-00309 on behalf of BellSouth Long Distance, Inc., and if present before the Commission and duly sworn, his testimony would be set forth in the annexed testimony consisting of 23 pages and 2 exhibits.

William E. Taylor
Dr. William E. Taylor

SWORN TO AND SUBSCRIBED BEFORE ME THIS THE 6th DAY OF APRIL, 1998

Christiana Olsen
NOTARY PUBLIC

My Commission Expires:
September 18, 2003

BELLSOUTH LONG DISTANCE, INC.

REBUTTAL TESTIMONY OF MICHAEL RAIMONDI

BEFORE THE TENNESSEE REGULATORY AUTHORITY

DOCKET NO. 97-00309

APRIL 9, 1998

Q. What is your name and position?

A. My name is Michael Raimondi. I am Executive Vice President of WEFA, Inc. (WEFA), an economic consulting and forecasting organization that was formed in 1987 through the merger of Wharton Econometrics Forecasting Associates and Chase Econometrics. WEFA is headquartered at 800 Baldwin Tower in Eddystone, Pennsylvania. My office is located at 25 Burlington Mall Road, Burlington, Massachusetts 01803.

Q. Have you submitted prefiled direct testimony in this proceeding?

A. Yes. My prefiled direct testimony consists of 6 pages plus a 22 page exhibit.

Q. What is the purpose of this rebuttal testimony?

A. This rebuttal addresses specific comments made by David Stahly on behalf of Sprint Communications Company L.P. Mr. Stahly suggests that the "economic benefit proposed by the WEFA study and the price decrease assumptions in the study border on the absurd." Nothing could be further from the truth. The price, information services productivity, and labor force participation assumptions are not only reasonable but conservative. In fact, it is most likely that the estimated $2.2 billion increase in real Gross State Product and 23,729 additional jobs generated by BellSouth's entry into the long distance markets in Tennessee understate the true benefit to the State over the next ten years.

Q. Is a 25% price reduction in interLATA long distance prices over 5 years realistic?

A. Yes. In his testimony, Mr. Stahly states that "WEFA assumes BellSouth entry will automatically lead to a large 25% reduction in long distance prices." However, there is nothing "automatic" about the reduction. This reduction will take place over five years as market forces lead competitors -- in this case joined by BellSouth after they are authorized to enter the long distance markets in Tennessee -- to vie for market share. In this situation, with an additional major competitor in the market, the competitive process will work more effectively than it has in the past, and prices will decline. This has happened on a limited scale in several markets around the country already. BellSouth may or may not lead this price reduction. But companies, competing in a market, that are concerned with gaining or preserving market share and revenue will lower prices, increase quality, and/or repackage services to address market requirements.

In Figure 1, note the continued upward progression of interstate toll prices as represented by the Consumer Price Index for Interstate Toll Services shown. In the middle of 1997, there was a sharp decline in prices as the long distance companies announced the pass-through of the access fee reductions mandated by the Federal Communications Commission (FCC). But immediately thereafter the Consumer Price Index began drifting upward again at the end of 1997 and early in 1998. Access fees -- which comprise the single largest cost component of interLATA long distance service -- did not go up again, but the interstate prices did. This coincides with the "simplified" basic long distance rate structure announced late in 1997. In a competitive industry, cost decreases would lead to price decreases as well. Long distance service is a declining cost industry, but prices tend not to follow costs. BellSouth's entry into the interLATA long distance markets in Tennessee will help reverse this trend.

Figure 1
Consumer Price Index for Interstate Toll Services
(January 1991 = 1.000)

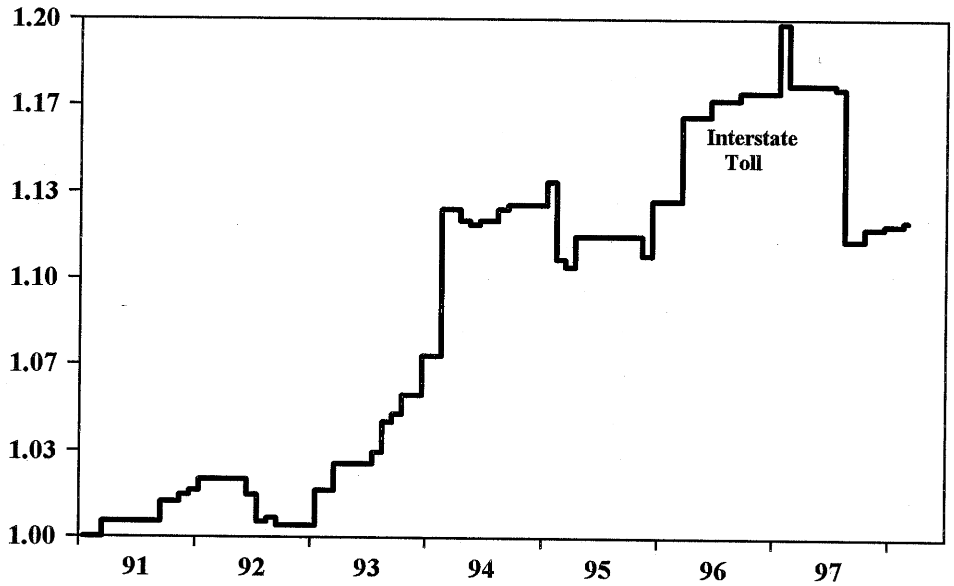


Figure 2, which is replicated from Exhibit 1 of my direct testimony, does indeed show the relationship between basic rates and access fees. Note that access fees are approximately 75% lower than basic rates on a per minute basis. Even after adding one or two cents for additional incremental production costs, the combined incremental production cost is still at least 65% below the basic rates. Figure 3 presents FCC data on average revenue per minute received by the long distance carriers and the average access fees per minute for interLATA minutes of use. In this case, the combined incremental production costs are approximately 45% lower than the average revenue per minute. Finally, if you consider the flat rates referred to by Mr. Stahly (that is, 15¢, 12¢, and 10¢ for AT&T, MCI, and Sprint, respectively) incremental costs are still at least 50%, 40%, and 30% below these prices. Thus, in all cases, prices currently exceed incremental production costs by more than enough to yield a 25% price reduction over the next five years as competition intensifies with BellSouth's entry and market forces push prices closer to the incremental cost of providing service.

Figure 2
Recent Trends in Long Distance Rates
and Exchange Access Charges

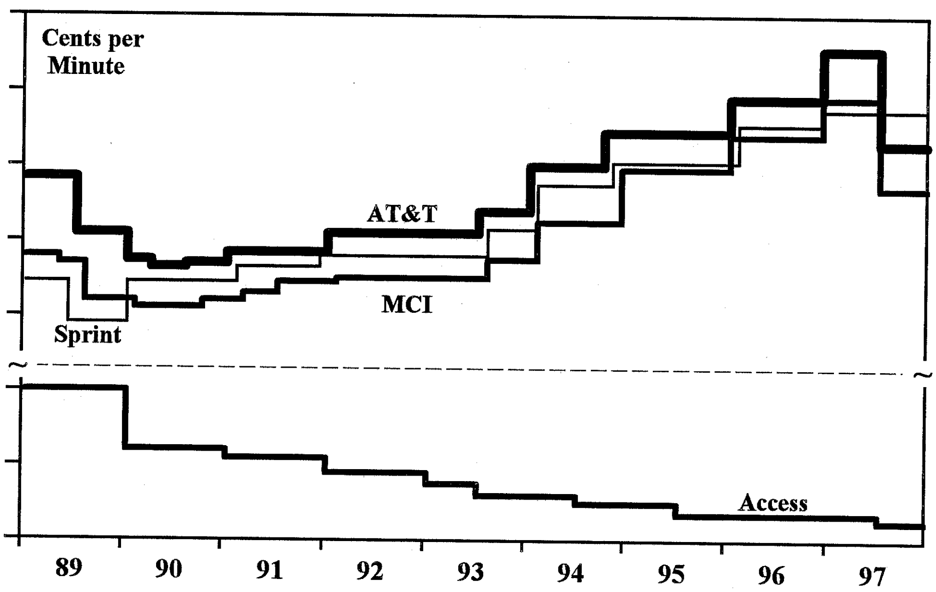
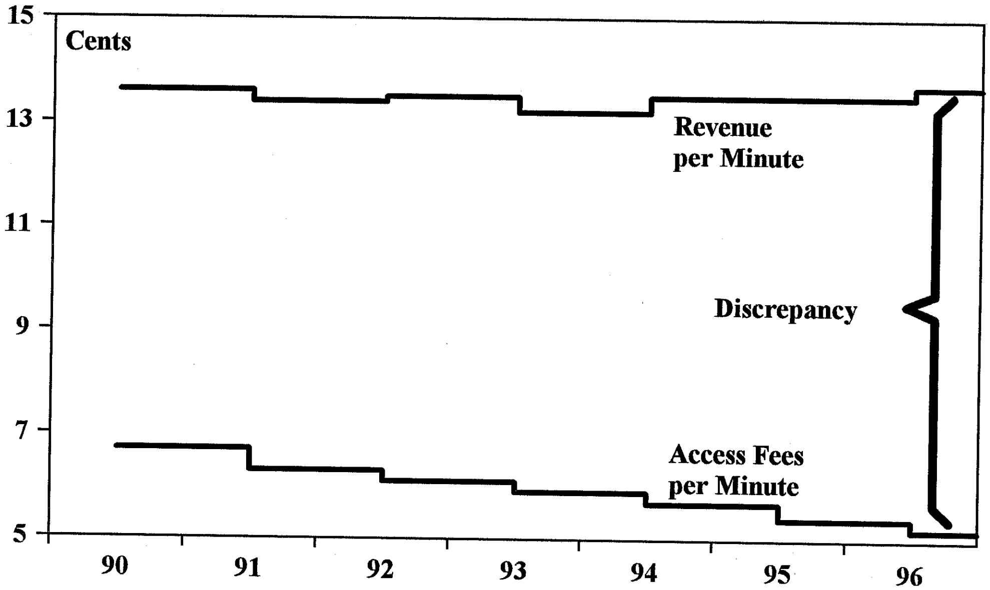


Figure 3
Average Access Fees and Revenue
per Minute



Q. Is the productivity assumption realistic?

A. Yes. In his testimony, Mr. Stahly mistakenly attributes the productivity change used in the analysis to the telecommunications industry. However, in the Long Distance simulation described in my direct testimony, the productivity change is applied to the use of information services. In the study, productivity in the use of information services is increased 2% per year in the first five years of the forecast interval relative to the Baseline forecast. This is due to the entry of BellSouth into the interLATA long distance markets in Tennessee and the dynamic market forces that are set into motion as a result of the entry of a large, new competitor. This adjustment represents the favorable impacts that lower long distance prices and improved technologies will bring to their usage throughout the business community and in households. In the context of increased competition in interLATA long distance, the 2% increase is a conservative adjustment given the much larger productivity advances that have taken place in the past and will continue in the future.

Throughout the economy, the number of white collar workers has grown to be a significant majority of total employment. "Knowledge workers" currently comprise about two-thirds of the white collar group. This portion of the work force has increased its use of information technology and broadly-defined information services at a very rapid rate. These technologies and services facilitate information retrieval and processing, information and data transfers, computer-assisted cooperative work, teleconferencing, video conferencing, and facsimile transmissions. This has occurred even as organizations have become more decentralized and workers more dispersed.

Improvements and cost reductions in information technology have altered the structure and operation of firms and entire industries. This has occurred and will continue to occur as each improvement and/or cost reduction lowers the transaction cost throughout the business and consumer communities. The transaction costs fall not only as prices for key inputs fall but also as the quality of key inputs rises. Thus, faster computers with more memory and more storage, more functional software with easier to use interfaces, faster telecommunications speeds, and better trained workers all combine to lower the cost and improve the quality/productivity of broadly defined information services. Computers and software in use today enable an individual to leverage one's own knowledge, but telecommunications enables a group to integrate and leverage the knowledge of many individuals locally, nationally, and globally.

In the Long Distance simulation, the assumed long distance services price reduction by itself lowers the transaction costs for many information applications and immediately increases the quality and the usage of those information applications. But in addition to the lower prices, competition will lead to additional enhancements in the services that are provided to the users. The change in the industry structure due to the addition of another major competitor will lead to service improvements. And the service improvements will effectively lower the transaction costs for many applications as well. The combination of lower long distance prices and higher quality leads to an increase in the quality or productivity in the use of information services.

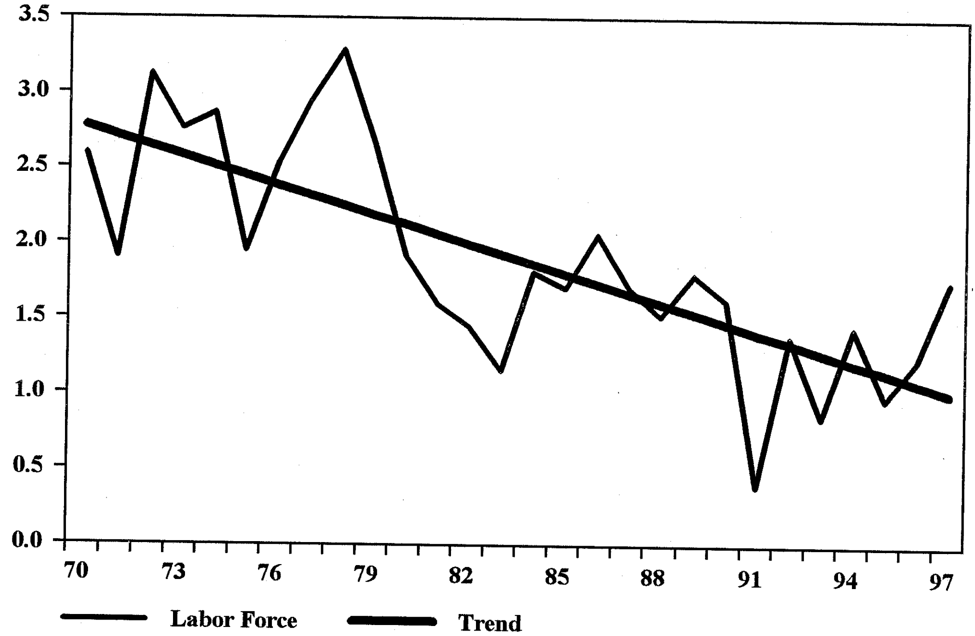
Consider the tremendous improvements that have occurred in telecommunications over the last 20 years -- digital switching, fiber optic technology, and ever-faster modems. Quality in terms of the speed for local and long distance data transmissions alone has improved 25% to 30% per year over the last two decades -- and that is just using standard modem technology for the measurement. The decline in transaction costs from the increase in transmission speed has led to many new local and long distance applications. This will continue, and the increase in competition in the interLATA market will lead to some improvement in the way businesses and households use and exchange information.

A good example of the benefits of lower telecommunications, data, and facsimile transmission costs is the large increase in telecommuting and telework in the United States. From 1986 to 1996, the number of telecommuters increased from 400,000 to 13 million -- that is, from less than 1% of the total work force to 10% of the total work force. Over the next five years, that number will increase to 27 million or 20% of the total work force. Also, from 1986 to 1996, the number of teleworkers increased from 22 million to 47 million -- that is, from about 21% of the total work force to 37% of the total work force. Over the next five years, that number will increase to 60 million or 43% of the total work force. There is a very close relationship between the number of telecommuters and teleworkers and the cost of data and facsimile transmissions and the value of installed information technology. Thus, as costs decline and quality increases, more employers and workers take advantage of productivity improvements in telecommuting and teleworking relationships with coworkers in other parts of the country.

Q. Is the labor force participation assumption realistic?

A. Yes. In the Long Distance simulation, the labor force participation rate is assumed to increase 0.5% in total over the ten year simulation interval relative to the Baseline forecast. This assumption recognizes several facts. First, there has been a significant deceleration in the growth in the labor force due to demographic realities. Second, there has been an increase in the demand for and a corresponding shortage of many types of knowledge/information workers. And third, there has been a slowdown in real income in the economy. As a result, business managers and workers have become increasingly creative in their use of information technology to find workers, locate skills, and generate additional income. In the Long Distance simulation, lower long distance prices and higher information service quality yield lower costs of implementing long distance information processing using workers around the state and the nation. These workers augment the work force, transmit their skills electronically to the locations in which they are needed, and in the process earn income that they need or want.

Figure 4
Growth in the Labor Force
(Annual Percent Change)



Due to demographic factors -- that is, the baby boom generation has given way to the baby bust generation -- growth in the labor force has slowed dramatically during the last 20 years. (See Figure 4.) And the growth in the labor force participation rate has slowed from about 0.5% annually during the 1970s and 1980s to less than 0.2% annually during the first half of the 1990s. Fortunately, the length of the economic expansion since the 1990-91 recession has lured more people back into the labor force resulting in a projected increase in labor force participation growth to almost 0.4% annually from 1996 through 2001. However, after 2001, demographic realities set in, and growth in the labor force participation rate drops to less than 0.1% annually for the rest of the forecast interval.

Businesses need more new recruits even though heavy investment in capital equipment has increased the capital-labor ratio.

One of the constraints imposed by slow labor force growth is a shortage of certain types of workers throughout much of the economy. Computer programmers, systems analysts, network administrators, document processors, desk top publishers, data entry clerks, data analysts, and other computer-related occupations are in short supply. One current example of this is a critical need for Fortran, Cobol, and Basic programmers to help rework the software code for hundreds of thousands of applications to prepare for the inclusion of the year "2000" and higher. The army of programmers who can work in these programming languages is scattered around the country (and around the world). Long distance telecommuting and telework makes it possible for teams to be assembled no matter where the workers are located. The same can be said of other types of workers such as telemarketing sales and service representatives, experienced financial analysts, newsletter publishers, and many others. Some of these workers are or can be employees of business enterprises. Others may be self-employed. But more of these workers can be economically employed as the cost of long distance service falls.

Income constrained households may find it possible to have a non-working spouse enter the labor force by working remotely to earn additional income. While many telecommuting jobs are within a local or intraLATA calling area, more and more possibilities open up as interLATA long distance prices fall. Virtual corporations find it feasible and economically reasonable to utilize the talents and/or support of a computer-assisted graphic artists, computer programmers, data entry clerks, data analysts, or other knowledge-based workers in remote parts of the state, across the nation, or around the world. Lower priced long distance services make this feasible for more businesses and individuals.

Thus, in an environment such as this, labor force participation will grow slightly faster than in the Baseline forecast. In the Long Distance simulation, the assumed value is 0.05% per year for the forecast interval.

Q. Is the analysis provided in your testimony and its exhibit a "net benefits" test?

A. Yes. By law, BellSouth will not be authorized to enter the interLATA long distance markets until it has complied with the 14 point check list. At that point, having complied with the legal requirements, BellSouth's entry will not be "premature" and there will be no "potential losses in local-bundled markets" as Mr. Stahly suggests.

Q. Does WEFA's regional forecasting system distinguish between and among states?

A. Yes. The individual state models incorporate the unique industry distributions and population distributions that lead to relative economic gains or losses in each state compared to other states in its region and the rest of the country. This includes the concentrations of businesses that are intensive users of telecommunications services in general and long distance services in particular. In WEFA's analysis of increased competition in interLATA long distance markets in all states, the unique characteristics of each state do indeed lead to a range of benefits across states. In percentage terms relative to the size of each industry in each state economy, some states gain more while others gain less than Tennessee. For example, California gains more, and Pennsylvania gains less.

The intense competition in the interLATA markets during the 1980s led to lower prices, better services, higher quality, and lower costs for businesses and households. Under the terms of the Telecommunications Act of 1996, competition could be intensified again. While quantifying exactly what will happen is an impossible task, I believe the benefits of increased competition are positive, significant, and important to continued strong growth.

In Tennessee, the result of BellSouth's entry into the interLATA markets in the state will lead to at least $2.2 billion more in real Gross State Product and 23,729 additional jobs over the next ten years.

Q. Does this conclude your rebuttal testimony?

A. Yes.

AFFIDAVIT

STATE OF MASSACHUSETTS

COUNTY OF MIDDLESEX

BEFORE ME, the undersigned authority, duly commissioned and qualified in and for the State and County aforesaid, personally came and appeared Michael Raimondi, Executive Vice President of WEFA, Inc., who being by me first duly sworn deposed and said that:

He is appearing as a witness before the Tennessee Regulatory Authority in Docket No. 97-00309 on behalf of BellSouth Long Distance, Inc., and if present before the Authority and duly sworn, his testimony would be set forth in the annexed testimony consisting of 11 pages.

Michael Raimondi

SWORN TO AND SUBSCRIBED BEFORE ME THIS THE 8th DAY OF APRIL 1998.

NOTARY PUBLIC

My Commission Expires:

RONALD P. MARCHAND
Notary Public, Massachusetts
My Commission Expires June 21, 2002