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April 6, 2000

BY HAND DELIVERY

Mr. K. David Waddell
Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

Re: Petition of the Tennessee Small Local Exchange Company Coalition for Temporary Suspension of 47 U.S.C. § 251(b) and § 251(c) Pursuant to 47 U.S.C. § 251(f) and 47 U.S.C. § 253(b).
Docket No. 99-00613

Dear Mr. Waddell:

Enclosed please find the original and thirteen (13) copies of the Rebuttal Testimony of Steven E. Watkins on behalf of Petitioner.

Thank you for your consideration in this matter. If you have any questions, please do not hesitate to call me.

Very truly yours,

R. Dale Grimes

DRG/cp
Enclosures
cc: Richard Collier, Esq. (w/encls.)
Vincent Williams, Esq. (w/encls.)
Henry M. Walker, Esq. (w/encls.)
Val Sanford, Esq. (w/encls.)
Kemal M. Hawa, Esq.(w/encls.)
James P. Lamoureux, Esq. (w/encls.)
Mr. John Feehan (w/encls.)

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:

PETITION OF THE TENNESSEE SMALL LOCAL EXCHANGE COMPANY COALITION FOR TEMPORARY SUSPENSION OF 47 U.S.C. § 251(b) AND 251(c) PURSUANT TO 47 U.S.C. § 251(f) AND 47 U.S.C. § 253(b).	)))))	DOCKET NO. 99-00613

REBUTTAL TESTIMONY

OF

STEVEN E. WATKINS

on behalf of

The Petitioner

Ardmore Telephone Company
CenturyTel of Adamsville, Inc.
CenturyTel of Claiborne, Inc.
CenturyTel of Ooltewah-Collegedale, Inc.
Concord Telephone Exchange, Inc.
Crockett Telephone Company, Inc.
Humphreys County Telephone Company
Loretto Telephone Company, Inc.
Millington Telephone Company, Inc.
Peoples Telephone Company, Inc.
Tellico Telephone Company, Inc.
Tennessee Telephone Company
United Telephone Company
West Tennessee Telephone Company, Inc.

"Tennessee Small Local Exchange Company Coalition"

April 6, 2000

Q: PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A: My name is Steven E. Watkins. My business address is 2120 L Street, N.W., Suite 520, Washington, D.C., 20037.

Q: DID YOU PROVIDE DIRECT TESTIMONY IN THIS PROCEEDING ?

A: Yes. I submitted testimony (to be referred to simply as "Watkins") on behalf of the Tennessee Small Local Exchange Company Coalition (to be referred to as the "Coalition"). The fourteen (14) members of the Coalition provide local exchange and exchange access services predominantly in the more rural and smaller town areas of Tennessee.

Q: WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ?

A: This testimony is presented in rebuttal of the testimony of witness Don J. Wood (to be referred to simply as "Wood") submitted on behalf of intervenor, Southeastern Competitive Carriers Association. I will respond to inaccurate statements that Witness Wood makes in his testimony that, if accepted and relied upon, could lead the Tennessee Regulatory Authority ("TRA") to counterproductive and improper policy conclusions.

Q: DO YOU HAVE ANY INITIAL COMMENTS REGARDING THE NATURE OF THE TESTIMONY SUBMITTED BY WITNESS WOOD ?

A: Yes. I have several observations.

1. His testimony mischaracterizes my testimony by attributing incorrect conclusions and assumptions.

2. His testimony sets forth pro-competitive slogans which may be strategically seductive from the standpoint of his clients and the promotion of selective market entrants but are imbalanced and indifferent with respect to the equally important interests of all rural customers, the public interest, and the preservation of Universal Service objectives.

3. Contrary to Witness Wood's assertions, the testimony provided by the Coalition provided a multitude of current regulatory and industry conditions and inherent outcomes under which likely harm to rural users generally would be apparent and, therefore, contrary to the public interest.

4. Despite his attempts to utilize pro-competitive slogans to counter my testimony, Witness Wood does not invalidate any of the rural customer impacts or conclusions outlined in my testimony. He does not explain how any of the harmful outcomes are not the natural and likely consequence of the circumstances which the suspension request seeks to avoid. Mr. Wood did not and cannot rule out that the imposition of interconnection requirements would exacerbate conditions adverse to the overall interests of rural customers and Universal Service goals and would force burdens on rural

telephone companies and rural users far beyond those which an efficient competitive market would impose.

5. His testimony in several places is premised on a fundamental misunderstanding of the Act with respect to the operations of Section 251(f)(1) and 251(f)(2).

6. Finally, Witness Wood attempts to suggest that the TRA should require some form of showing in this proceeding that would be tantamount to an impossibility. He seems to think that there should be a demonstration of harm to rural users that would occur under events that the request seeks to avoid, or that the parties should speculate quantitatively about outcomes that are qualitatively apparent. However, Congress granted authority to States to take action to avoid harm to rural users. Congress did not intend that actual harm be endured and observed before States can address what would be natural outcomes. Congress gave this authority to State commissions because they are in the best position to decide public interest issues which obviously involve judgement about speculative events.

Q: CAN YOU GIVE AN EXAMPLE OF WITNESS WOOD'S MISSTATEMENTS ?

A: Witness Wood misrepresents my testimony in several instances. He attempts to provide at pp. 22-23 what he calls his understanding of my "major points," Unfortunately, his understanding is not always correct.

For example, without providing a citation, Witness Wood suggests incorrectly that the conclusions in my testimony are based on an assumption that the Coalition members "are ill-prepared to compete . . . ." Wood at p. 23. No such assumption is present nor can it be gleaned from my testimony. To the contrary, I have the utmost of confidence in the telecommunications service excellence and commitment of the Coalition members. I expect that the TRA shares my view that the smaller, rural incumbent LECs provide higher quality, more reliable, and more customer responsive service to rural customers than do the larger LECs in the industry. Subjected to a fair, efficient, and overall beneficial form of competition, under conditions whereby policies have been properly adjusted and reworked to ensure the same successful Universal Service result as today, the Coalition members can be expected to compete in their rural areas quite capably.

Witness Wood misses the real point. It is not the rural LECs themselves that are ill-suited to compete. It is the current state of regulation, with its historical regulatory policies, rate structures, price averaging, and the carrier of last-resort responsibility (all which currently apply to incumbents but not new entrants) that result in conditions that prevent beneficial competition in areas served by rural LECs. The imposition of interconnection requirements on rural LECs would aggravate the adverse effects. Congress recognized this and gave the TRA and other State commissions the tools to avoid these adverse circumstances in rural LEC service areas.

Q: IF WITNESS WOOD MISCHARACTERIZED YOUR MAIN POINTS, THEN WHAT WERE THE CONCLUSIONS OF YOUR TESTIMONY ?

A: In this instance, I would summarize my testimony as three related conclusions.

1. The Coalition members operate under a regulatory approach that has been found by policymakers in the past to be consistent with the public interest and Universal Service goals. Watkins at pp. 7-10. The member LECs have engineered and built networks in relatively higher cost areas to provide service to virtually all customers located in their service territories. The customers served in those areas receive quality telecommunications service at prices reasonably comparable with urban users. In return, the LECs have been provided, by virtue of a set of federal and state cost allocation and recovery policies, a reasonable opportunity to recover the costs of building and operating these ubiquitous networks. The relatively lower customer density and higher per-customer and per-unit costs are not in dispute with respect to the Coalition members. Watkins at pp. 10-11. The current quality of their services and the prices for those services are known. The relatively greater reliance by the Coalition members on the results of the historical cost allocation and recovery plans, including access revenues, rate averaging among different classes of users, and universal service cost recovery is also apparent. Watkins at pp. 11-12.

2. The Coalition members are encumbered with rate structures, pricing constraints, rate averaging, among other regulatory requirements, as well as an apparent obligation to provide last-resort, back-up service for other providers. Watkins at pp. 26-28. This current status is not in dispute. If interconnection requirements were to be applied to the Coalition members while subject to these conditions, the rural companies would be required to endure conditions that would be unduly economically burdensome well beyond those typically associated with efficient competitive entry. Watkins at pp. 13-22. The majority of rural users not targeted by new providers under these disparate conditions would be subjected to adverse economic impact generally.

3. Until all regulatory plans are properly established including sufficient and predictable Universal Service, access, and jurisdictional cost separations plans, and existing rules can be modified in an orderly fashion, the imposition of interconnection requirements will inflict significant adverse economic impact on rural users. Watkins at pp. 22-26. The incomplete status of the policy plans is not in dispute. The current lack of a complete, effective and integrated plan is an inherent condition in favor of granting the suspension.

Q: IS THERE ANY TESTIMONY OF WITNESS WOOD WITH WHICH YOU AGREE ?

A: Yes. As Witness Wood correctly concludes at p. 26, I am "both sincere and passionate" about my observations and conclusions with respect to the state of regulation and the likely outcome of applying interconnection requirements to smaller companies serving rural customers.

He also correctly recognizes that Congress "gave state regulators . . . the ability to limit

or delay implementation of some of the Act's requirements . . . ." Watkins at pp. 13, 16-17, and 18, and Wood at p. 4.

I agree that the TRA should examine the current state of regulation as it applies to the incumbent rural LECs, the status of the effort to restructure and reformat successfully the Universal Service, access, separations and other regulatory rules to address multiple provider competition, and the dynamics of selective market entry to determine "whether the outcomes that represent undue economic harm" or adverse economic impact on rural users of telecommunications services generally "have sufficient likelihood of occurrence." Watkins at pp. 13 and 29, and Wood at p. 22.

Finally, Witness Wood observes at p. 12 that the FCC understands that application of interconnection requirements "might be unfair or inappropriate to apply . . . to smaller or rural telephone companies." He also recognizes at p. 12 that suspension and/or modification of these requirements "for the period of time, that policy considerations justify such . . . suspension or modification" are contemplated by the policies and rules. Some policy considerations lead to the conclusion that some interconnection requirements may never be appropriate or fair for the smallest and more rural LECs. Watkins at pp. 4-6. Other policy considerations demonstrate that suspension of interconnection requirements is appropriate unless and until proper Universal Service, access, separations, and regulatory plans are in place to address the policy concerns.

Q: WITNESS WOOD SUGGESTS AT PAGE 26 OF HIS TESTIMONY THAT YOU BELIEVE THAT A REGULATED MONOPOLY IS PREFERABLE TO A COMPETITIVE MARKETPLACE. DO YOU HAVE ANY RESPONSE ?

A: Yes. I would assume from Witness Wood's statement that it is his counter belief that a competitive marketplace is always preferable to a regulated monopoly. I will emphasize that these are only beliefs. Economics is a science in an infant stage of reliability. No one knows with certainty under what conditions only benefits will arise consistent with society's goals and the codified Universal Service objectives. Congress left the conditions under which competition will emerge open to limitations and modifications. If there were absolute economic laws, society would not need to rely on the democratic process or the judgement of industry policymakers such as the TRA to decide issues and the public interest.

Regardless, competitive markets do not necessarily or always lead to beneficial societal results with respect to the majority of citizens or individual societal considerations. Ubiquitous telecommunications service to all, including those located in higher cost, less dense areas, according to terms (price and quality) that are equivalent to lower cost areas, has been judged by our nation to be a worthwhile societal goal. Competitive markets, by themselves, did not, and will not, achieve this outcome. We have the history of the first half of the twentieth century under which inadequate or no service to rural areas demonstrates that point. Watkins at pp. 7-8 and 15. As was necessary in the past, the Act recognizes that rural market areas may require more regulatory participation to ensure that Universal Service and other societal goals are met.

Arguably, at some point in time when regulations and policies have been altered, the probabilities may change. If incumbent LECs were not strapped with requirements counter-productive and contrary to efficient market entry effects; if specific, predictable and sufficient Universal Service, access, and jurisdictional separations plans were in place and shown to achieve the same success under multiple provider conditions; if these plans can successfully preserve prices that do not reflect the extremes in cost differences, maintain equal quality delivery of service to all, and incentives for network investment in high cost areas, then a properly designed competitive market may be preferable in rural areas.

However, considerable uncertainty exists with respect to whether the policy success of the past can be recreated in a more competitive environment. This uncertainty is highest with respect to rural users and rural areas.

Q: BUT AS WITNESS WOOD SUGGESTS AT PAGES 3 AND 26, DID NOT CONGRESS INTEND FOR COMPETITION TO BE THE COURSE ?

A: Congress adopted a course that balances two interrelated, but potentially conflicting, goals: competition and Universal Service. If Congress had intended an indifferent and oblivious reliance on competition, then Congress would not have (1) adopted the lengthy Section 254 of the Act discussing Universal Service, (2) adopted several specific provisions that explicitly call for extraordinary treatment of rural areas and the smaller telephone companies that serve these areas, and (3) provided States with the authority to apply their judgement with respect to suspensions and modifications of the interconnection requirements for smaller telephone companies and rural users. Witness Wood's testimony suggests incorrectly that Congress did not intend for these provisions to be used separately and in proper balance with the provisions addressing competition.

Q: WITNESS WOOD AT PAGE 25 TAKES ISSUE WITH WHAT HE DESCRIBES AS YOUR ASSUMPTION THAT THE COSTS OF LEC NETWORKS ARE LARGELY FIXED. WITNESS WOOD STATES THAT "SWITCHING, INTEROFFICE TRANSPORT, AND NETWORK OPERATION COSTS ARE VARIABLE RATHER THAN FIXED." IS HE CORRECT ?

A: This is an example where mathematical, theoretical models of the world defy a common sense understanding of reality. I do not know what studies Witness Wood could have reviewed, but the premise of his statements is wrong.

First, Witness Wood omits local distribution plant from his statement. It is a fact of network design that the relative proportion of total company plant devoted to local distribution loop plant will be greater for LECs serving less densely populated areas. This is a fundamental finding in the examination of Universal Service as policymakers have understood for decades. The Coalition members serve less densely populated areas and, therefore, have considerable investment in local distribution plant which is

predominantly "sunk" into the ground for its useful life.

In addition to omitting local distribution plant, his presumptions about switching, interoffice transport and feeder plant costs are, at best, misleading. Perhaps Witness Wood has been misled by the high cost models that the Federal Communications Commission has been studying for Universal Service cost support purposes. As I will explain, the model approach is fundamentally flawed with respect to Universal Service policy.

The Coalition members act as "carriers of last resort" ("COLR") The costs of a COLR's network and the provision of services are related to the costs of building and operating a ubiquitous network. The models often presume incorrectly that network costs vary immediately and directly with the number of customers served. This is a critical flaw in the models.

If a carrier intends to be a COLR, its engineering involves life cycle estimates of plant and population projections to arrive at the network that will be required to serve all. The network costs are therefore based on the cost of a network that may be needed to serve the total number of customers (all customers, served and unserved) that the COLR projects will require service in the next several years. As a result, the COLR's network costs are largely fixed for the life of the plant.

The network costs of a COLR do not change appreciably when the market is divided. If another carrier competes and the service area market is split, the total network cost for the COLR does not significantly change. If the amount of switched minutes of use through a central office decreases, the LEC cannot viably dismantle and sell or reuse part of its switch that is no longer needed. Moreover, Witness Wood has misinterpreted theoretical models to arrive at the illogical conclusion that "the feeder portion of the local loop . . . will not represent stranded investment if a customer receives service from a competitor." Wood at 25. If a LEC loses half of its customers, it cannot go into the field and dig up feeder plant or transport facilities and sell them. It is prohibitively expensive to salvage outside plant, and there is no market for the used plant. The COLR is caught with stranded plant which it may be required to maintain to stand ready, as an unpaid back-up, to continue to serve as COLR. A newer entrant with selective market opportunities can manage its investment and plant exposure to minimize this risk.

If a COLR were to lose some of its customers to a competitor, its per-line network cost would go up because it will have only a small reduction in its network costs since its total investment does not change. Yet under a model that uses lines in service as the input variable, the model predicts decreases in cost that defy reality. And a model that uses minutes of use to predict switching costs will also be wrong. In other words, the loss of 50% of the COLR's customers will not lead to any immediate proportionate decrease in its network costs, particularly if the LEC must continue to stand ready to serve all customers in the area. Yet the models that Witness Wood has reviewed apparently lead him to this illogical conclusion.

The problem here is that a theoretical mathematical model designed for one purpose is being misapplied for an inappropriate purpose. If Carrier A serves 10,000 customers and Carrier B serves 5,000 customers under stable and static conditions, it is reasonable to suggest that the plant investment of Carrier A will be more than Carrier B, presuming all other variables equal. For static comparison purposes, the models may have some limited use. However, it is a fallacy to suggest that the relationship between variables in the mathematical models somehow suggest that if Carrier A loses half of its customers then its plant investment must be the same as Carrier B. This fallacy is the basis of Witness Wood's illogical conclusion.

Q: DOES THE FCC's UNIVERSAL SERVICE MODEL APPROACH TO PREDICTING HIGH COST RECOGNIZE THESE FACTORS ?

A: No. The FCC's *Ninth Report and Order* in CC Docket No. 96-45 perpetuates the flaw. I call this flaw the "zero-sum game" presumption. If the zero-sum game flaw is not properly addressed, the Universal Service plan will not yield sufficient or predictable high cost support.

As service provision is divided in a market, each carrier loses economy of scale because neither can modify their fixed network costs. In an example of two providers splitting the market equally, the number of customers served per square mile for each network provider will be half of what the density was when there was only one provider. The modeling approach appears to totally disregard this obvious dynamic. In sparsely populated areas, the reduction in economy of scale can lead to enormous changes in the per-customer and per-unit cost of networks that must stand ready to provide Universal Service to all. If the flaw is not addressed, the per-customer changes in cost of dividing an already thin market will eventually be reflected in either higher rates, lower quality networks, or both.

Q: WITNESS WOOD STATES AT PAGE 25 THAT YOU IGNORE SITUATIONS WHERE THE COMPETITOR CONTINUES TO USE THE INCUMBENT'S FACILITIES. IS THAT CORRECT ?

A: No. First, if new entrants only intended to provide service by using the incumbent's network, I question the value of what would be a needless "middleman"entity creating greater cost to society. The fact is there would be no real competition under resale and exclusive use of the incumbent's network. A competitor's success would not rely on the creation of value to the public in the form of goods and services -- only in its ability to arbitrage opportunities created by regulatory rules. Similarly, a competitor's "success" should not be premised simply on opportunities to "game" the system as some competitive LECs pursue unwarranted compensation under Section 251(b)(5) reciprocal compensation interconnection requirements (as US LEC apparently has in North Carolina -- See BellSouth Telecommunications, Inc. v. US LEC of North Carolina, Inc., Docket No. P-561 SUB 10, Order Denying Reciprocal Compensation (Mar. 31, 2000 N.C. Util. Comm.)).

Second, contrary to Witness Wood's statement, I did not ignore this issue. In fact, at pp. 19-20 of my testimony, I explained the adverse effects of a new entrant using the network of an incumbent for the purpose of shielding all risk and identifying the "cream" customers to selectively target. As the new entrant prepares its selective market entry strategy, the incumbent is required to meet the commitment to build and operate its ubiquitous COLR network.

Q: AT PAGE 25 WITNESS WOOD DOUBTS YOUR ASSERTION THAT THE SECTION 251(c) INTERCONNECTION REQUIREMENTS, IF APPLIED, WOULD HANDICAP INCUMBENTS. DO YOU HAVE A RESPONSE ?

A: Yes. The Section 251(c) requirements, when applied, impose disparate requirements on incumbents. Witness Wood recognizes this fact. Wood at p. 7 ("ILEC-specific obligations"). I explained at pp. 4-5 of my testimony the onerous nature of the Section 251(c) requirements. The sequence of events in the industry over the last decade (including the anti-trust actions against the Bell system) and the existence of the exemption Congress afforded rural telephone companies from these disparate requirements support my view. The severity of these disparate requirements compared to the typical inter-company requirements that apply to all other competitive industries supports my view.

The FCC has been careful in the manner in which it explains these requirements. After recognizing that the incumbents have economy of scale (of course, Bell companies have much greater scale than do the Coalition members), the FCC observes that the Act requires "that these economies be shared with entrants." "Sharing" of "economies" is a modest choice of words. If the Section 251(c) requirements were to be applied, "sharing" means diverting one competitor's (the incumbent's) network to the exclusive use of another competitor thereby denying use of the facilities by the incumbent. The incumbent has no mutual right to use other carrier's facilities. And recent policies have concluded that incumbents should receive compensation for the use of their plant at prices based on theoretical estimates of incremental cost. Such one-sided transactions would never occur in an efficient competitive entry market because such transactions potentially reward a less efficient provider at the expense of a more efficient provider. Such one-sided transactions at incremental prices would never occur voluntarily or naturally in an efficient competitive market.

If these involuntary requirements apply only to incumbents and if some requirements extract economic value from the incumbent and grant this value to the new entrant, at compensation levels that efficient competitive markets would not voluntarily accept, then the requirements are clearly handicapping measures. Large Bell companies may be able because of their size to endure the handicapping without immediate, calamitous results. And Bell companies may have been willing to accept the handicaps in order to advance other objectives; e.g., interLATA freedom. Smaller LECs and those more vulnerable because of their high cost and reliance on a system of revenues created by regulatory cost

allocation and recovery policies are likely to be affected more immediately and more adversely. Moreover, the Coalition members do not possess the same potential "barrier to entry" market power, name recognition, and large urban service concentrations as Bell companies.

Moreover, it would be most ironic and inconsistent with the Congressional exemption for smaller LECs to be handicapped by the onerous Section 251(c) interconnection requirement to "share" what are already relatively higher-cost, challenged "economy of scale," rural networks.

Q: HOW DO THESE CONDITIONS LEAD TO ADVERSE ECONOMIC EFFECTS FOR RURAL USERS ?

A: The incumbents operate under disparate regulatory requirements compared to new entrants. Watkins at pp. 26-28. Applying interconnection requirements to the small ILEC's under these conditions will not lead to overall beneficial results. Fostering new selective market entrants with interconnection requirements while incumbents remain under asymmetrical requirements leads to the likelihood that the overall effect will be harmful.

For example, under the current system incumbents have averaged rates and cannot change those rates quickly. Because high cost customers are averaged with low cost customers, and because the rates for higher volume users are averaged with those of lower volume users, there are inevitably customers and/or areas for which the average price is well above the true efficient cost of service to that specific customer or area.

This illustrates why the danger is so great. The prices of incumbent LECs depart widely from the underlying true cost of serving some customers so that all customers can be served at reasonable rates. This situation provides an opportunity for inefficient selective market entry into the provision of services that are overpriced. The new selective market entrants will concentrate on the services and users where prices, by virtue of the averaging and value pricing policies of the past, are held above levels associated with truly efficient entry costs.

Inefficient or equally efficient providers need only price below the averaged price. In this way, the new providers are rewarded with unwarranted profits. The incumbent loses the contribution it previously received from the lower than average cost customers to offset the averaged prices with the higher than average customers. The incumbent is eventually forced to raise the average price to support the network for service to a declining number of overall customers with an increasing proportion of higher cost customers. The new entrant exploitation of the selective market entry leads to a greater cost to society for the same telecommunications services. Society as a whole is subjected to a overall detrimental effect.

Witness Wood offers what is a hollow cost recovery suggestion. There is no relief to rural users of the detrimental consequences if incumbent, rural LECs were to be forced as

Witness Wood suggests on p. 10 to recover "those costs that are unique to that ILEC because of the nature of the geographic area that it serves" under current regulatory conditions and the selective market harm discussed above. There is no plan today to recover these costs in a non-detrimental manner. Only if policies and rules were fully in place to establish a successful Universal Service plan, to resolve changes in access and jurisdictional separations, and to remove the disparate regulation applied to the carrier of last-resort incumbent LECs would there be the possibility of non-detrimental consequences.

Q: YOU STATED ABOVE THAT WITNESS WOOD HAS A FUNDAMENTAL MISUNDERSTANDING OF THE OPERATION OF SECTIONS 251(f)(1) AND 251(f)(2) OF THE ACT. CAN YOU EXPLAIN ?

A: Although I specifically explained the separate distinctions of Sections 251(f)(2) and 251(f)(1) at pp. 4-7 of my testimony and attached excerpts from the Act, Witness Wood apparently misunderstands the operation of these separate provisions. Throughout his testimony, he confusedly introduces the word "exemption" with respect to this proceeding. This proceeding is under Section 251(f)(2), and the Coalition members have requested suspension of specific interconnection requirements. For example, Witness Wood is in error when he states at p. 3 "the petition . . . to be exempt from . . . provisions of the Act."

He further apparently believes incorrectly that small telephone companies can request exemptions and that State commissions can grant to telephone companies exemptions from interconnection requirements. First, there is no possibility of exemption for any carrier from the Section 251(a) interconnection requirements; moreover, there is no opportunity for suspension or modification of these requirements. Second, the only exemption that exists is with respect to the imposition of the Section 251(c) requirements to rural telephone companies. Rural telephone companies did not need to request, and have not requested, exemption as Witness Wood's testimony suggests. On p. 11, he incorrectly states that "[a] rural LEC may also petition for an exemption from only the requirements of § 251(c)." Instead, the true characterization is that Congress granted this exemption in the Act subject to an opportunity for other carriers to seek to remove this exemption. Regardless, the proceeding under which a State commission examines whether a carrier's request to remove the exemption will not result in harm to the public interest is under Section 251(f)(1). This proceeding, in contrast, is a request for suspension and is proceeding under Section 251(f)(2).

The conclusions of Witness Wood must be discounted when he repeatedly misconstrues the facts. For example, he makes the incorrect statement on pp.20-21 that he has apparently reviewed "requests for exemptions from § 251(c)" and these have been "withdrawn" or "denied." He cannot possibly be aware of, or have reviewed, requests for exemptions because there are none. Similarly, there cannot be a withdrawal of such request. Instead, a new entrant must submit a bona fide request for interconnection and request that the State commission review whether the exemption that a rural telephone company already has should be maintained. The request comes from the new entrant, not

the incumbent. It is the new entrant that is seeking a change in the requirements. If Witness Wood is actually aware of a withdrawal of an "exemption request," then the withdrawal was by the new entrant that initiated the request. If there was a withdrawal, the exemption that Congress granted is still in place with respect to the targeted rural telephone company.

Witness Wood also references at p. 21 actions by the Iowa Utilities Board ("IUB") in discussing his mistaken views about the process associated with what he continues incorrectly to call exemption requests. There were no "separate petitions of three rural ILECs" as he states on p. 21. There were no requests for exemption, at all. In the case of South Slope Cooperative Telephone Company, U.S. West was the party submitting a request to the IUB. GTE made the request in the case of Winnebago Cooperative Telephone Association. The City of Hawarden filed the request in the case of Heartland Telecommunications Company of Iowa.

In my opinion, the facts in Iowa support the conclusion that the requests of the large LECs -- US West and GTE -- were merely harassment and retribution directed at the smaller companies' activities in competition with US West and GTE in more urban areas. The bona fide nature of the interconnection requests triggering these events in Iowa, in retrospect, is questionable. It appears to me that the only business purpose of US West and GTE may have been to harass and intimidate the smaller carriers.

Q: ARE THERE OTHER ERRORS IN WITNESS WOOD'S TESTIMONY ?

A: Yes. Witness Wood is wrong when he suggests on pp. 20-21 that determinations with respect to interconnection requirements and smaller LECs in other states never involve the Section 251(b) requirements. Besides his incorrect perpetuation of the word "exemption" and the confusion this presents, Witness Wood has also missed the fact that the suspension and modification proceedings in at least four other states have explicitly addressed and granted suspension of the Section 251(b) requirements. I understand that the decisions in these other states (Indiana, Pennsylvania, Mississippi, and Alabama) are already a part of the record in this proceeding before the TRA.

Q: ARE THE PROCEEDINGS CONDUCTED IN IOWA RELEVANT HERE ?

A: No. The proceedings in Iowa were conducted under Section 251(f)(1) while this proceeding is under Section 251(f)(2). The Coalition members were not parties to the proceeding in Iowa and, therefore, did not communicate their public interest concerns to the Iowa Board and had no interest in challenging the conclusions. Moreover, a Section 251(f)(1) proceeding is confined to a specific bona fide request from a specific carrier.

More importantly, the TRA and rural users in Tennessee are fortunately not bound by the actions of the IUB. The actions of the IUB demonstrate either an unwarranted disregard for any consideration of the public interest or the inability of the rural telephone companies to effectively communicate the public interest considerations to the IUB. The

IUB removed the exemption that Congress put in place even though conditions had not changed for rural users in Iowa.

Q: ARE WITNESS WOOD'S OBSERVATIONS ABOUT RETAINED EARNINGS RELEVANT HERE ?

A: I hesitate to suggest that the level of a company's retained earnings has absolutely no relevance. I presume that the TRA is relieved to learn that the carriers that serve the needs of rural users in the State are financially healthy (if that is what the reference to retained earnings is intended to suggest). However, whatever relevance that the IUB attached to the existence of retained earnings with respect to the rural telephone companies in Iowa is not fully explained, and, in any event, the conclusion is irrational.

I should point out that two of the rural telephone companies in Iowa are organized as cooperatives. Cooperatives do not have profits. All of the revenues collected that are greater than the cost of operation are eventually returned to the members of the cooperative. Accordingly, the use of the terms "net income" and "retained earnings" with respect to cooperatives is incorrect. Instead, the end user members of a cooperative contribute capital to the cooperative which the cooperative uses to finance its plant and operations. This capital eventually is returned to the members. The point is that the IUB's discussion about retained earnings of cooperatives is conceptually misplaced in the first place.

In any event, the adverse effects that I have explained in my testimony are the result of the dynamics of costs and cost recovery combined with selective market entry. None of these dynamics are negated by the existence of retained earnings. The retained earnings reference is a red herring. To the extent that a company has retained earnings, the conclusion to be drawn is that it may be able to operate under adverse conditions and endure losses longer than would otherwise be the case.

Congress provided for suspensions or modifications of interconnection requirements to avoid adverse effects on rural users generally and to avoid imposing economic burdens. The effects that I have demonstrated arise regardless of retained earnings levels or the health of the company. Congress did not suggest that there is no need to protect rural users from adverse effects if the subject company happens to be financially healthy. It is adverse to starve a person regardless of whether he or she is healthy or not. Is Witness Wood suggesting that Congress did not intend for the rural safeguards designed to protect the interests of rural customers to apply if the rural telephone company is financially healthy ? Are rural customers to be protected only when a rural telephone company is financially unhealthy ?

Q: YOU STATED ABOVE THAT WITNESS WOOD SUGGESTS A SHOWING THAT AMOUNTS TO AN IMPOSSIBILITY. CAN YOU EXPLAIN ?

A: Yes. His testimony attempts to paint the Coalition members into a corner by suggesting that "proof" should be produced for what is inherently future events about which we all

must speculate. Naturally, the request of the Coalition is with respect to potential requirements that could be applied in the future. The request is to avoid applying requirements that would likely lead to adverse effects on rural users. Obviously, one cannot "prove" possible events in the future that are not present today. The Coalition also sees no productive purpose for its members or the TRA to embark on an effort to speculate quantitatively in a battle over what are possible effects of events in the future. Watkins at pp. 12-13. Such an effort would involve unresolvable debate over assumptions about events with which there is little experience to be observed. Such an exercise would present its own set of economic burdens to the Coalition members and their rural customers.

The Coalition has set forth solid grounds for its request. The conditions under which the Coalition members operate are a matter of fact. Watkins at pp. 7-12. The regulatory rules and policies that apply to the Coalition members are a matter of public record. The conditions under which new entrants operate are also known. The cost characteristics of the Coalition members are known. I have explained at length, in step-by-step rational terms, the dynamics of cost allocation, cost recovery, rate averaging, and selective market entry. To accept these outcomes as likely requires no more than an understanding of the telecommunications industry, the incumbents, the interests of the selective market entrants and the dynamics of the cost and price issues. It is an inherent set of conditions and a straightforward relationship between costs and cost recovery that prove our points.

Witness Wood repeatedly suggests that the TRA's determination should only be guided by, and should be restricted to, the FCC's rules. This suggestion is inconsistent with what the FCC has already acknowledged. First, the FCC has recognized that the Act imposes the duty on State commissions to make determinations under Section 251(f)(2). The FCC has concluded that State commissions have the sole authority to make determinations. Moreover, in enacting its rules, the FCC's stated purpose was to issue guidelines to assist State commissions. Since that time, appeals courts have also held that the States have discretion with respect to the preservation of Universal Service objectives.

Regardless, even if the FCC's rules were the only guidance, the imposition of the interconnection requirements from which the Coalition members seek a suspension would produce adverse economic effects that would be unduly economically burdensome on Coalition members beyond that typical of efficient competitive entry markets.

Finally, in rational terms and at length, I have explained in my testimony the likely outcomes which would result in significant adverse economic impacts on users of telecommunications services in rural areas served by the Coalition members. This testimony explained and drew conclusions about cost characteristics, cost allocation, cost recovery, rate averaging, and the dynamic effects with respect to rural areas under selective market entry and potential interconnection requirements. Other than the arguments that I have rebutted in this testimony, Witness Wood does not dispute any of my observations or conclusions. I cannot find in Witness Wood's testimony where he has explained in rational terms how, if at all, any of my observations are wrong or the events unlikely.

For the reasons presented in my Direct and Rebuttal Testimony, the Tennessee Regulatory Authority should grant the request of the Tennessee Small Local Exchange Company Coalition for suspension of specific interconnection requirements.

Q: DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY ?
A: Yes.

DISTRICT OF COLUMBIA, ss:

BEFORE ME, the undersigned authority, a Notary Public, duly commissioned and qualified in the District of Columbia, personally came and appeared Steven E. Watkins, who, being by me first duly sworn deposed and said that;

He is appearing as a witness on behalf of the Tennessee Small Local Exchange Company Coalition before the Tennessee Regulatory Authority and if present before the Authority and duly sworn, his rebuttal testimony would be as set forth in the pre-filed rebuttal testimony dated April 6, 2000, and filed in Docket No. 99-00613.

This 4th day of April, 2000.

Steven E. Watkins

Sworn to and subscribed before me this 4th day of April, 2000.

Notary Public, D.C.

My Commission Expires:

CHANG HO CHOI, NOTARY PUBLIC
DISTRICT OF COLUMBIA
COMMISSION EXPIRES: 6/14/2004

CERTIFICATE OF SERVICE

I hereby certify that a true and exact copy of the foregoing was served on the following counsel of record, via the method checked, on April 6, 2000:

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