COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

Review of the Federal Communications	**)**	
Commission's Triennial Review Order	**)**	**Case No. 2003-00379**
Regarding Unbundling Requirements	**)**	
for individual Network Elements	**)**	

SURREBUTTAL TESTIMONY OF DON J. WOOD

ON BEHALF OF

AT&T COMMUNICATIONS OF THE SOUTH CENTRAL STATES, LLC

APRIL 13, 2004

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Don J. Wood. My business address is 30000 Mill Creek Avenue, Suite 395, Alpharetta, Georgia, 30022.

Q. ARE YOU THE SAME DON J. WOOD WHO PREFILED DIRECT AND REBUTTAL TESTIMONY ON BEHALF OF AT&T IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of BellSouth witness Debra Aron.

In her rebuttal testimony, Dr. Aron engages primarily in a strategy of mischaracterizing my testimony and that of Dr. Bryant, Mr. Turner, and Mr. Gillan, grossly oversimplifying the issues before the Commission, and responding with "facts" that are based on flawed research and that are simply incorrect.[1]

Q. AT PAGE 36 OF HER REBUTTAL TESTIMONY, DR. ARON STATES THAT HER "INTERPRETATION" OF YOUR TESTIMONY IS THAT YOU ARE URGING THE COMMISSION TO DISREGARD PORTIONS OF THE TRO. IS HER "INTERPRETATION" ACCURATE?

A. Not at all. Specifically, Dr. Aron asserts that "Mr. Wood urges the Commission to simply disregard the potential deployment component of the FCC's impairment methodology as part of its determination [of impairment] ... on the grounds that he already knows what the answer should be." Even a cursory examination of my direct testimony will reveal that I am in no way suggesting that the Commission ignore any part of the TRO. To the contrary, I am suggesting a more comprehensive consideration than proposed by Dr. Aron. While she urges the Commission to

[1] As I will explain in more detail below, a demonstration of the significance of these assumptions can be made using BellSouth-provided information and the BACE model.

consider a "potential deployment" analysis in a vacuum, I am recommending that the Commission consider such an analysis as one of an interrelated series of tests. For example, in my direct testimony I asked the Commission to consider the following:

> 1. Based on an extensive record, the FCC found "on a national level that requesting carriers are impaired without access to unbundled local circuit switching when serving mass market customers." (¶419) Impairment is assumed to exist unless and until specific, concrete evidence to the contrary is presented.
>
> 2. Any analysis of *potential* entry via self-provisioned local switching is considered only after the Commission has concluded, pursuant to a sufficiently granular analysis, that *actual* entry has not occurred to any significant degree in the identified markets. This absence of *actual* deployment reveals, at a level of significance that could never be attained by any attempted "potential entry" analysis, the market realities that exist today. Experience indicates that CLECs have either been unable to economically justify the deployment of the own local circuit switching equipment to serve mass market customers, confirming the observed absence of actual entry in this manner.
>
> 3. Any potential entry analysis must consider both operational and economic factors in concert. The existence of operational impairment cannot be overcome by the absence of economic impairment, or *vice versa*.

Dr. Aron argues (p. 36) that I am urging the Commission to disregard any "potential entry" demonstration because I already know what the answer should be. To the contrary, I am urging the Commission – based on its knowledge of Kentucky markets for mass market services and experience with competitive entry into those markets – to consider any "potential entry" claims within the context of what *it* knows the answer will likely be.

Q. DR. ARON (PP. 36-37) STATES THAT THE FCC'S TRIGGER TESTS ARE ASYMMENTRIC. IS SHE RIGHT?

A. No. Dr. Aron argues that "the FCC's trigger's tests are asymmetric tests of impairment: satisfying the triggers demonstrates lack of impairment, but failing them does not demonstrate impairment." Her conclusion appears to be based at least in part on her flawed conclusion that "passing a triggers test clearly indicates that there is no impairment." This, of course, is not what the FCC concluded.

In reality, the FCC explicitly recognized the possibility for exceptions to the results of a triggers analysis, and did so symmetrically. First, as Dr. Aron explains, if the results of a triggers analysis indicate a finding of impairment, the Commission will then proceed to a "potential deployment" analysis in order to determine if some set of factors exists for that market that – in spite of the lack of *actual* deployment – nevertheless indicate that the potential exists for such deployment. Second, as Dr. Aron fails to mention, if the results of a triggers analysis indicate a finding of non-impairment, the Commission may then proceed to an "exceptional barrier" analysis in order to determine if some set of factors exists for that market that would prevent further deployment: "we recognize that there may be some markets where three or more carriers are serving mass market customers with self-provisioned switches, but where some significant barrier to entry exists such that additional carriers with self-provisioned switches are foreclosed from serving mass market customers ... Where the self-provisioning trigger has been satisfied and the state commission identifies an exceptional barrier to entry that prevents further entry, the state commission may petition the [FCC] for a waiver of the application of the trigger, to last until the impairment to deployment identified by the state no longer exists." (¶462).

Q. DR. ARON ALSO REFERS TO AN "ASYMMETRY" IN THE "OBSERVABILITY OF OUTCOMES." DO YOU AGREE WITH HER CONCLUSIONS?

A. Specifically, Dr. Aron argues (p. 3) that "if the Kentucky Public Service Commission ("KYPSC" or "Commission") errs in finding impairment where none exists, the social costs are extremely difficult to measure," but such difficulty does not make these costs "any less real nor less significant." In other words, reaching an erroneous conclusion of impairment will, according to Dr. Aron, result in social costs that are significant though not readily apparent.

In contrast, she argues, "if the Commission errs in finding no impairment where impairment exists," the social cost is low ("merely" the forgone entry of carriers who would rely on the network of the incumbent) but visible. In other words, reaching an erroneous conclusion of non-impairment will, according to Dr. Aron, result in social costs that are apparent but not significant.

Based on her conclusions about social costs, Dr. Aron argues that the Commission should err on the side of a finding of non-impairment (colloquially, she recommends a rule of "when in doubt, throw them out"). Her conclusions, however, rely on the accuracy of her fundamental assumption that if local circuit switching is not available as a UNE,[2] CLECs will invest in their own local circuit switching equipment to serve mass market customers. As I explain below, this assumption has no empirical foundation and is based on confusion regarding cause and effect. The point here is that Dr. Aron goes on to reach some dangerous conclusions based on this very shaky foundation.

At p. 4 she suggests that with "*true* competition" (i.e. competitive entry only in the form of self-deployed equipment and facilities, including local circuit switches), the need for administrative oversight and regulation of BellSouth are reduced. Her flawed logical sequence can be summarized as follows: (1) Elimination

[2] And, by extension, if UNE-P is not available.

of UNE local switching and UNE-P provides missing “incentives” for CLECs to invest in their own equipment, (2) in response to these incentives, CLECs make these investments and are able to compete with BellSouth on this basis, (3) the resulting competitive market forces can act as a substitute for regulation in order to protect consumers. If Dr. Aron’s fundamental premise – that it is economically rational for CLECs to invest in their own local circuit switching equipment to serve mass market customers - is wrong, a more logical sequence is the following: (1) Elimination of UNE local switching and UNE-P eliminates the ability of CLECs to economically serve mass market customers, (2) in response, CLECs must discontinue their offerings to mass market customers in most or all geographic markets, and (3) with no regulation and no competitive market forces to act as a constraint, BellSouth operates as an unregulated monopoly. Dr. Aron completely ignores the social costs of an unregulated monopoly in her analysis, though such an outcome is clearly not good for consumers.

Q. YOU STATED THAT DR. ARON’S FUNDAMENTAL PREMISE THAT IT IS ECONOMICALLY RATIONAL FOR CLECS TO INVEST IN THEIR OWN LOCAL CIRCUIT SWITCHING EQUIPMENT TO SERVE MASS MARKET CUSTOMERS IS WRONG. PLEASE EXPLAIN.

A. Dr. Aron refers (p. 7) to a situation in which “a CLEC would rather exit the market than pursue the UNE-L strategy,” suggesting that whenever a CLEC does not use its own local circuit switching equipment to serve mass market customers, it has simply chosen not to do so. Such as statement is not only flawed and unsupported, it is naive.

Dr. Aron's reasoning is flawed in several areas. Any meaningful analysis of why CLECs in most instances rely upon ILEC-provided local circuit switching to serve the mass market must consider the following three points:

1. CLECs have a number of incentives to pursue a UNE-L strategy, and these incentives have been present since 1996. As Chairman Powell observed in language cited by Dr. Aron (p. 5), CLECs have an incentive to invest in their own facilities in order to offer differentiated services, control their costs, become less dependent on the incumbent (a competitor), and offer redundancy of networks. These incentives exist today; they are not simply created if UNE local switching is unavailable. The relevant question, ignored by Dr. Aron, is "In response to these incentives, what have CLECs done in order to offer services to mass market customers, particularly when UNE local switching or UNE-P has not been available?"

2. In the absence of access to UNE-P, CLECs have not deployed their own local circuit switching equipment to serve mass market customers. Dr. Aron takes issue (p. 39) with my recommendation that the Commission consider important historic evidence regarding impairment, or what she refers to as "a retrospective review of CLEC successes and failures *in a world of ubiquitous UNE-P availability*" (emphasis added). I don't know where Dr. Aron has been for the past eight years, but her fantasy "world of ubiquitous UNE-P availability" certainly didn't exist in the BellSouth region. In reality, BellSouth refused to make UNE-P operationally available until at least the conclusion of AT&T's arbitration with BellSouth in 2000.

As a result, there are two factually distinct time periods that can be examined. The first, from1996 until 2000, consists of a period of time in which CLECs had the *incentive* to invest in their own facilities in order to offer differentiated services, control their costs, become less dependent on the incumbent, and offer redundancy of networks; and did not have access to UNE-P. The second, from 2000 until the present, consists of a period of time in which CLECs had the same incentives, but during which UNE-P was available. Comparing the actions of CLECs during these two time periods can in fact represent a meaningful indicator of impairment.

In reality, during a time in which CLECs had incentives to deploy their own switching facilities – but during which the "corrupting influence" of UNE-P did not exist – CLECs did not invest in local circuit switching equipment in order to offer mass market services. The presence of these two distinct time periods allows us to control for the key variable identified by Dr. Aron (UNE-P availability) and determine if the observable results change in the two scenarios. They don't. Whatever factor is preventing CLECs from making this investment, it isn't the availability of UNE-P: something else (the absence of an economically rational basis for doing so, perhaps) must have prevented CLEC investments in local circuit switching to serve mass market customers during the time in which UNE-P was not available.

3. CLECs have the necessary expertise to deploy the necessary network facilities. Dr. Aron speculates (p. 7) that perhaps the reason that CLECs are not (and have not) deployed local circuit switching facilities to serve mass market customers is because these carriers lack the necessary "expertise with the deployment of actual telephone network facilities." Not only is Dr. Aron's statement completely unfounded, it ignores a wealth of available evidence to the contrary. Dr. Aron cannot seriously be arguing that AT&T has no experience or expertise with the deployment of actual network facilities. Other CLECs attempting to provide services to mass market customers in Kentucky have similar experience and expertise. Dr. Aron also ignores the fact that in many cases CLECs are now relying on the expertise of individuals who were previously employed – and whose expertise was relied upon – by BellSouth. There is absolutely no factual foundation for a conclusion that CLECs have not self-deployed these facilities because they lack the necessary expertise.

Q. AFTER A CONSIDERATION OF ALL OF THESE FACTORS, WHAT IS THE MOST LIKELY REASON THAT CLECS HAVE NOT SELF-DEPLOYED LOCAL CIRCUIT SWITCHING TO SERVE MASS MARKET CUSTOMERS?

A. A review of the factors described by Dr. Aron suggests that CLECs have not made these investments because it is not economically rational for them to do so. Results obtained from BellSouth's BACE model, described in detail later in my testimony, also support such a conclusion.

Q. DR. ARON ARGUES THAT THE EXISTENCE OF UNE-P IMPACTS THE VIABILITY OF UNE-L. DO YOU AGREE?

A. Not at all. Dr. Aron states (p. 36) that there is "no doubt" that the existence of UNE-P affects the "*viability* of pursuing a UNE-L strategy." This is a frankly bizarre notion for which Dr. Aron offers no support. The *viability* of UNE-L depends on the characteristics of the market in question, the revenue opportunities that can reasonably be expected to exist in that market, and the cost (including investment in local circuit switching) required to provide the necessary services. As I describe in my rebuttal testimony, a meaningful business case analysis can be performed if (but only if) all variables are properly established and considered, but "availability of UNE-P" is not one of those variables. It is perhaps telling that the "availability of

UNE-P" is not a variable considered by the BACE, which Dr. Aron endorses as an appropriate analysis.

In reality, CLECs have considered the viability of UNE-L as a means of serving mass market customers, and will probably continue to do so. While the availability of UNE-P may make it possible to serve mass market customers in geographic markets where UNE-L is not viable, UNE-P availability has no impact whatsoever on whether a business case can be made for UNE-L.

Q. DR. ARON ARGUES THAT CLECS GAIN FROM THEIR RELIANCE ON THE INCUMBENT. DO YOU AGREE?

A. No. Such a conclusion is nonsensical for two reasons. First, it is directly at odds with the language attributed by Dr. Aron to Chairman Powell, in which he explains that CLECs have a number of incentives to invest in their own facilities in order to minimize reliance on the ILEC, including "to offer differentiated services, control their costs, become less dependent on the incumbent [a competitor], and offer redundancy of networks."

Second, Dr. Aron (pp. 6-7) explains that a CLEC can utilize UNE-P in order to avoid making the investment necessary for self-deployment. While she makes every effort to tread carefully, she gets dangerously close to the right answer: CLECs rely on UNE-P because a business case that considers all relevant variables cannot be made for the higher risk entry strategy of self-deployment of local circuit switching and UNE-L to serve the mass market. As I explained in my rebuttal testimony, much of the financial risk in self-deployment is created by the fact that the CLEC begins with higher unit costs than BellSouth due to both a lower market share and backhaul requirements. In this respect, BellSouth's "first in" advantage in significant and potentially insurmountable. The FCC's TELRIC methodology puts ILECs and CLECs on a more equal footing by neutralizing – to some degree – this "first in" advantage in the pricing of UNEs by equalizing the component of each carrier's cost associated with this investment risk.

As I described in my rebuttal testimony, a fundamental problem with BellSouth's "potential deployment" analysis is that while Dr. Aron is arguing that CLEC's utilize UNE-P in order to reduce their risk to serve mass market customers, Dr. Billingsley is simultaneously arguing that CLECs investing in their own local circuit switches will experience significantly *less* risk than these same carriers have experienced when using UNE-P.[3] This inconsistency must be resolved in favor of Dr. Aron. Dr. Billingsley's assumption that CLECs will incur less risk and a lower cost of capital when making the substantial investments necessary to self-deploy local circuit switching (and his assumption that the necessary capital will be available at any price) is absurd on its face. While she subsequently reaches the wrong conclusions, Dr. Aron gets closer to the truth: because of the inherently higher risk, a business case analysis cannot support self-deployment of local circuit switching by CLECs to serve mass market customers. A business case can be made, for some geographic markets, to provide such services by utilizing UNE-P.

Q. DR. ARON CITES TO A CORRELATION BETWEEN THE AVAILABILITY OF UNE-P AND THE FAILURE OF CLECS TO SELF-DEPLOY LOCAL CIRCUIT SWITCHING TO SERVE MASS MARKET CUSTOMERS AS A RATIONALE FOR ELIMINATING UNE-P. DO YOU AGREE?

[3] This assumption causes Dr. Billingsley to significantly understate the relevant cost of capital for CLECs, and subsequently causes BellSouth to utilize a discount rate in the BACE that is much too low to reflect the risks associated with the investments that it analyzes.

A. Not at all. Dr. Aron (p. 38) falls victim to a basic logical fallacy. Dr. Aron may be correct that when she notes that there is a correlation between the availability of UNE-P and the failure of competitors to utilize their own switching capacity. But as Dr. Aron certainly ought to be aware,[4] the existence of even a high degree of correlation does not imply causation (and certainly does not suggest that causation applies equally in both directions). It is equally correct to note that there is a correlation between people who fall down a lot and people who don't tie their shoes. The existence of this correlation in no way demonstrates that people *decide* not to tie their shoes *because* they fall down a lot. In the same way, a correlation between UNE-P and CLECs that do not self-deploy local circuit switching in no way demonstrates – or even suggests – that CLECs decide not to self-deploy *because* UNE-P is available. To the contrary, such a correlation could – and almost certainly does – underscore the importance of UNE-P by noting that CLECs use UNE-P where self-deployment of local circuit switching to serve mass market customers is not economically rational.

Q. DR. ARON SUGGESTS (P. 6) THAT THE ELIMINATION OF UNE-P IS OF LITTLE CONSEQUENCE, BECAUSE LOCAL CIRCUIT SWITCHING MAY CONTINUE TO BE AVAILABLE AT "MARKET" PRICES. DO YOU AGREE?

A. No. As an initial matter, "may be available" is not the same as "will be available." The Commission should consider this key distinction before eliminating the mechanism that makes competitive alternatives available to many mass market customers in Kentucky. It is equally important to consider the characteristics of the "market" for local circuit switching and UNE-P. If the triggers analysis indicates that

[4] Anyone who can use phrases like "accommodate heterogeneity in costs" – even if they are wrong when they use it – can be expected to have a rudimentary understanding of statistics.

wholesale alternatives are not available (a neither BellSouth nor Verizon make a claim that such wholesale alternatives exist), BellSouth represents the sole provider of this functionality. Competitive market forces cannot constrain prices if only one provider exists. Finally, Dr. Aron does not suggest that local circuit switching, combined with access to voice grade local loops as a UNE-P offering, "may" be made available (if history is any guide, it won't be).

Q. YOU STATED THAT IT IS IMPORTANT FOR THE COMMISSION TO CONSIDER THE FACT THAT BELLSOUTH WOULD BE THE SOLE PROVIDER OF THIS FUNCTIONALITY IN DR. ARON'S "MARKET." DO YOU HAVE ANY EXPERIENCE THAT SUGGESTS A LIKELY PRICE LEVEL?

A. Yes. In a recent arbitration with ITC^DeltaCom, BellSouth proposed rates for local switching elements that would apply if the Commission reaches a finding of non-impairment. These rates were similar to the "market" rates identified by FCCA witness Gillan in his surrebuttal testimony. As Mr. Gillan explains, BellSouth's idea of a "market rate" is several hundred percent above the existing UNE rate. BellSouth also publishes its idea of "market based rates" on its interconnection website. The section of the *BellSouth/CLEC Agreement* containing *Market Based Rates* current posted shows a proposed rate for a switch line port of $14 per month. The current UNE rate is $1.40, one-tenth of the proposed "market" level.

Q. DR. ARON ALSO PRESENTS REBUTTAL TESTIMONY IN SUPPORT OF THE INPUTS TO BELLSOUTH'S BACE MODEL. DO YOU AGREE WITH HER REASONING?

A. No. I disagree with Dr. Aron's assumptions that existing retail prices will remain unchanged for ten years, that BellSouth has considered revenues at a sufficient level of granularity, and that it is reasonable to expect that all CLECs offering mass market services will capture 15% of the relevant geographic market (particularly if BellSouth's win-back efforts are considered).

Q. PLEASE EXPLAIN WHY YOU DISGREE WITH DR. ARON'S ASSUMPTION THAT EXISTING RETAIL PRICES WILL REMAIN UNCHANGED FOR TEN YEARS.

A. At pp. 14-15, Dr. Aron argues that "the main deficiency (of an assumption of future price reductions) is that it violates the requirements of the FCC's potential deployment analysis. The FCC requires that states evaluate potential deployment business cases *using the existing level of prices and revenues*." As she is wont to do, Dr. Aron is taking one sentence from the TRO and failing to consider its interrelationship with other FCC requirements.

When conducting a business case analysis, it is important to consider the likely level of revenues and costs over the time horizon of the analysis. In a short run analysis, it may be appropriate to consider the current level of prices to be fixed. If the analysis encompasses a longer period of time (such as the BACE's immutable ten year assumption), it is necessary to consider the potential for changes in the level of revenues and costs over time. This uncertainty increases as more distant time periods are considered, thereby increasing the risk associated with these more distant expected cash flows. The consideration of projected revenues and costs – and the uncertainty associated with those expectations – is fully consistent with the FCC's conclusion (¶517) that when "judging whether entry is economic," states must consider how "competitive risks affect the likelihood of entry."

BellSouth has juxtaposed assumptions of fixed price levels, a ten year time horizon, and a discount rate based on a *lower* level of risk than CLEC's currently face. If Dr. Aron were correct that it is reasonable to consider fixed prices (and therefore to assume no uncertainty and no risk associated with that uncertainty), it would not be necessary to conduct an NPV analysis at all; the expected value would simply be the sum of future net cash flows (with no discount rate applied).

Q. DR. ARON HAS ARGUED IN FAVOR OF GRANULAR ASSUMPTIONS REGARDING COSTS AND REVENUES. DOES THE BACE OPERATE IN THIS MANNER?

A. No. In other states Dr. Aron has referred to "the requirement that the (potential deployment) analysis be sufficiently granular to take into account the state of impairment in a particular market," and specifically cites to the FCC's conclusion (¶ 485) that an appropriate analysis must consider "the significant variation in the costs and revenues an efficient entrant is likely to face."[5] Oddly enough, after acknowledging the FCC's requirement in the TRO for such granularity, Dr. Aron has removed this statement from her testimony. While this revision makes her testimony consistent with the BACE – neither considers revenues and costs at the necessary level of granularity - both the BACE and now Dr. Aron's testimony are *inconsistent* with the clear requirements of the TRO that an analysis consider "significant variation in the costs and revenue" of an entrant.

As I described in detail in my rebuttal testimony, the BACE does not (and based on its construction, cannot) do this. BellSouth's existing retail prices for mass market customers are characterized by areas of high rates and low costs, exactly the kind of relationship that the FCC found to be unsustainable. BellSouth's prices and reported costs vary at the wire center level. The price assumptions in the BACE,

[5] See "Rebuttal Testimony of Debra Aron before the Florida Public Service Commission" (p. 14). Docket No. 030851-TP. January 7, 2004.

however, cannot be changed at this level of granularity. Dr. Aron's previous assertion has been that it is necessary to reflect the unique characteristics of a state's customer base. While this is an accurate description of what a business case model *should* do, it is inaccurate with regards to what the BACE *can* do.

Q. DR. ARON MAKES SEVERAL CLAIMS ABOUT HOW THE BACE MODEL TREATS CLEC MARKET SHARE OVER TIME. DO YOU AGREE WITH HER TESTIMONY?

A. No. I disagree with Dr. Aron's market share assumptions in three areas. First, her claims regarding how the BACE treats CLEC market shares is simply factually incorrect. Second, the assumptions and model inputs that she supports fail to reflect important information.

In both her direct and rebuttal testimony, Dr. Aron states that an ultimate market share of 15% is assumed for each CLEC. A review of BellSouth's base run assumptions, however, indicates that the actual assumptions range from 7.53% to 20.12% for residence customers and 3.6% to 32.85% for 1-3 line business customers. If 15% is Dr. Aron's magic number, it is unclear why BellSouth has not actually used it in the BACE.

Second, Dr. Aron's testimony, particularly when compared to Ms. Tipton's,[6] suggests that her assumptions are unlikely to prove true. At p. 29, Dr. Aron argues that "while a penetration rate of 5 percent may be reasonable for a growing CLEC early in its life, it is not appropriate as an ultimate penetration rate." BellSouth's

[6] Ms. Tipton shows five CLECs in each market using self-provisioned local switching (assuming that some carriers are utilizing UNE-P instead , the actual number of CLECs in therefore likely to be higher). In ten years, Dr. Aron's assumptions yield a total CLEC share of the market of between 75% of the total market.

BACE assumptions (sponsored by Dr. Aron) are inconsistent with this statement: based on her "p value" of .5 and an ultimate CLEC market share of 15%, the BACE assumes that every CLEC will have a Year One market share of 7.5% - a market share that is 50% higher than the 5% Dr. Aron refers to as "reasonable" for "a growing CLEC."

Third, Dr. Aron fails to incorporate additional relevant information. She does not discuss (and makes no indication that she has considered) that the customers willing to leave BellSouth are likely to be enticed back to BellSouth's due to "win-back" offerings. In its Fourth Quarter 2003 *Investor Relations Competitor Earnings Update*, BellSouth CFO Ron Dykes is quoted as saying that "BellSouth is on the 'bleeding edge' in terms of aggressiveness in win-backs for UNE-P competitors," and that BellSouth has "won back "40% of its consumer losses, and more than 60% of its business losses." If BellSouth is "on the bleeding edge of aggressiveness" in its efforts to win back customers from UNE-P providers (customers for whom it receives wholesale revenue to recover network costs), it is reasonable to expect that BellSouth would be somewhere beyond the "bleeding edge of aggressiveness" in its attempts to win back customers from a CLEC utilizing self-deployed local circuit switching (customers for whom it receives no revenue). BellSouth's window of opportunity to "win back" a customer before it is actually lost is also greater in a UNE-L scenario. With UNE-P, BellSouth has approximately twenty-four hours before the cutover of the customer is completed. With UNE-L, BellSouth's "win-back before actually lost" window expands to five days.

Based on BellSouth's existing on-but-not-yet-beyond the bleeding edge of aggressiveness win-back offerings, it has been able to entice about half of the customers won by CLECs to return. In other words, a CLEC must win two customers from BellSouth in order to keep one. Assuming that Dr. Aron's assumptions about a CLEC's ability to attract customers are accurate (as described above, a generous assumption), the BACE has overstated both the rate of customer acquisition and ultimate CLEC market share by failing to consider the impact of BellSouth's bleeding edge aggressiveness.[7]

Q. YOU STATED THAT THE BACE CAN BE USED TO DEMONSTRATE THE IMPORTANCE OF USING REASONABLE ASSUMPTIONS. PLEASE EXPLAIN HOW YOU HAVE REACHED THIS CONCLUSION.

A. While the structure of the BACE makes it impossible to reflect all relevant revenue and cost information with sufficient granularity to perform a meaningful business case analysis, it is possible to consider the impact that certain BellSouth assumptions (sponsored by Dr. Aron) have on the results. A table containing these results is attached as Exhibit DJW-SR5.

These results can be summarized as follows:

> If prices are assumed to decrease by 5.1% per year, and no other changes are made to BellSouth's assumptions, the reported NPV declines to negative $50 million.

> If Dr. Billingsley's CLEC-specific cost of capital is used, and no other changes are made to BellSouth's assumptions, the reported NPV declines to $39 million.

[7] A win-back offering effectively reduces that rates against which a CLEC must compete. The ability of BellSouth to make win-back offers underscores the fallacy of Dr. Aron's assumption of constant prices.

> If the CLEC market penetration assumptions are adjusted to reflect the impact of BellSouth's win-back pricing, and no other changes are made to BellSouth's assumptions, the reported NPV declines to negative $21 million.

Q. DR. ARON ARGUES THAT A COST DISADVANTAGE IS INSUFFICIENT TO DEMONSTRATE IMPAIRMENT. DO YOU AGREE?

A. No. She argues (p. 32) that whether "Cost disparities [between ILECs and CLECs], however, are not determinative of whether entry in "economic," but instead that "costs are relevant only within the context of a well-defined business case analysis that evaluates whether entry by an efficient CLEC is economic." As a practical matter in this case, the questions (and the answers) are the same.

Dr. Aron argues (pp. 39-40) that "the claim that a cost disadvantage renders a firm incapable of competing effectively and viably in a market is simply inconsistent with much of modern economic theory, which provides a number of models in which firms with different cost structures providing identical products viably coexist." Dr. Aron goes on to explain that CLECs can "compete by differentiating their products from their rivals and earn a premium" from certain customers. Dr. Aron does not explain why if it is necessary to differentiate a product in order to command a higher price from some customers, firms with higher unit costs but *providing identical products* could successfully compete.

Dr. Aron goes on to describe "the richness of economic models of competition." While the 'richness" of these models may provide for interesting academic debate at a 30,000 foot level, this case is about what is actually happening at ground level. Dr. Aron offers no examples, theoretical or otherwise, of how telecommunications services to mass market customers could be differentiated in a way that would support any significant difference in price, nor does she explain how – even in the absence of BellSouth's ability to effectively reduce the rate against which the CLEC must compete through a win-back offering – a CLEC with a higher per-unit cost can compete on price *for mass market customers within the identified geographic markets in Kentucky*. A description of the "richness" of economic theory cannot serve as a substitute for the granular analysis of actual market conditions required by the TRO.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

AFFIDAVIT

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 Don J. Wood, who, being by me first duly sworn deposed and said that:

He/She is appearing as a witness before the Kentucky Public Service Commission in Case No. 2003-00379, Review of Federal Communications Commission's Triennial Review Order Regarding Unbundling Requirements for Individual Network Elements, and if present before the Commission and duly sworn, his/her testimony would be set forth in his/her Surrebuttal Testimony consisting of______ pages and _________exhibit(s).

[Witness Name]

SWORN TO AND SUBSCRIBED BEFORE ME
THIS 12th DAY OF April, 2004

Deborah L Wood Notary Public

AFFIDAVIT

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 Don J. Wood, who, being by me first duly sworn deposed and said that:

He/She is appearing as a witness before the Kentucky Public Service Commission in Case No. 2003-00379, Review of Federal Communications Commission's Triennial Review Order Regarding Unbundling Requirements for Individual Network Elements, and if present before the Commission and duly sworn, his/her testimony would be set forth in his/her Surrebuttal Testimony consisting of 20 pages and 1 exhibit(s).

[Witness Name]

SWORN TO AND SUBSCRIBED BEFORE ME
THIS 12th DAY OF April, 2004

Deborah L Wood Notary Public