

**STATE OF NEW HAMPSHIRE
BEFORE THE
PUBLIC UTILITIES COMMISSION**

Petition by Certain Rural Telephone Companies)
Regarding CLEC Registrations)
within Their Exchanges) Docket No. DT 10-183

**DIRECT TESTIMONY OF
MICHAEL D. PELCOVITS**

ON BEHALF OF

**NEW ENGLAND CABLE AND TELECOMMUNICATIONS ASSOCIATION,
INC.**

October 22, 2010

1 **I. INTRODUCTION AND SUMMARY**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Michael D. Pelcovits. I am a principal with the economic consulting
4 firm of Microeconomic Consulting and Research Associates (“MiCRA”). My
5 business address is 1155 Connecticut Avenue, N.W. Suite 900, Washington, D.C.
6 20036.

7 **Q. Would you please summarize your experience and educational**
8 **qualifications?**

9 A. I received my Ph.D. in Economics from the Massachusetts Institute of
10 Technology in 1976. Since serving on the economics faculty of the University of
11 Maryland and as a Senior Economist at the Civil Aeronautics Board, I have spent
12 my entire career specializing in the economics of regulation and competition in
13 the telecommunications industry.

14 From 1979 to 1981, I was a Senior Economist at the Federal
15 Communications Commission (“FCC”), Office of Plans and Policy. From 1981 to
16 1988, I was a founding member and principal of the consulting firm Cornell,
17 Pelcovits and Brenner. In 1988 I joined MCI Communications Corporation and
18 remained with the Company following its merger with WorldCom until 2002. I
19 held positions of increased responsibility at MCI, and was appointed Vice
20 President and Chief Economist of the corporation. In this position I was

1 responsible for the economic analyses of policy and regulatory matters provided
2 and presented by the Corporation before Federal, state, foreign, and international
3 government agencies, legislative bodies and courts.

4 **Q. What are your professional responsibilities at MiCRA?**

5 A. I joined MiCRA in October 2002, immediately after leaving MCI, and am one of
6 six principals of the firm. MiCRA is an economic consulting firm based in
7 Washington, DC. The firm was founded in 1991 by a group of economists who
8 served in senior positions at the Antitrust Division of the U.S. Department of
9 Justice. MiCRA provides economic analysis, expert testimony, and economic
10 research to clients in a wide range of antitrust, regulatory, and other legal and
11 public policy settings. Since joining MiCRA, I have testified before several state
12 regulatory commissions on telecommunications policy and ratemaking issues.
13 These testimonies have focused on the importance of establishing the proper
14 foundation to facilitate competition in telecommunications markets. I have also
15 filed several declarations before the FCC on a wide range of common carrier,
16 wireless, and international telecommunications policy issues. I have also
17 consulted and provided testimony on telecommunications, intellectual property
18 and competition matters before several other administrating bodies and courts,
19 including U.S. Copyright Royalty Judges; London Court of International
20 Arbitration; and Federal District Courts.

1 **Q. Have you testified before the New Hampshire Public Utilities Commission**
2 **(“PUC” or “Commission”) previously?**

3 A. Yes. I testified in Docket No. DT 07-011, concerning the transfer of assets from
4 Verizon New England to FairPoint Communications, and in Docket No. DT 08-
5 013, Comcast Phone’s application to serve customers in certain TDS service
6 territories.

7 **Q. What is the purpose of your testimony in this case?**

8 A. The purpose of my testimony is to provide my expert opinion on whether the
9 required adjudicative hearing process, under RSA 374:22-g and other state laws
10 applicable to requests to enter service territories of rural incumbent local
11 exchange carriers (“rural ILECs” or “RLECs”), constitutes an entry barrier that is
12 preempted under 47 U.S.C. § 253. I am not an attorney and do not offer a legal
13 opinion. Rather, based on my expert knowledge as an economist with over thirty
14 years’ experience in telecommunications regulation, I will propose an economic
15 framework for analyzing whether entry barriers are likely to constrain the
16 effectiveness of competition in rural local exchange markets in New Hampshire.
17 The analysis of entry barriers is an important and well-researched concept in the
18 economics literature, and I believe that the proper application of this literature to
19 the relevant markets will be beneficial to the Commission in making a
20 determination of the legality of certain procedures.

1 **Q. Would you please summarize your testimony?**

2 A. Yes. Entry barriers are a key determinant of the level of competition in a market.
3 A business (hereinafter “firm”) will not enter a new market unless it can
4 overcome barriers to entry and offset the costs of entry with profits earned in the
5 new market. Entry barriers are high in local exchange markets, and a major
6 purpose of the Telecommunications Act of 1996 (hereafter “TA96”) was to
7 reduce entry barriers as much as possible to foster competition in these markets.

8 New Hampshire laws, RSA 374:26 and 374:22-g, which when read
9 together require that the Commission allow rural ILECs to obtain an adjudicative
10 evidentiary hearing related to the “public good,” are significant barriers to entry.
11 This is especially so, since apparently an adjudicative hearing would be required
12 for each and every request by a competitive local exchange carrier (“CLEC”) to
13 enter a rural ILEC’s service territory and would need to consider the effect on the
14 rural ILEC’s opportunity to realize a reasonable return on investment. If the
15 requirements of 374:22-g remain in place, then the adjudicative hearing
16 requirement likely would lead to no or diminished competition in certain rural
17 local exchange markets and thereby deny consumers in these exchanges the
18 freedom to choose among alternative suppliers of telephone service. The reason
19 for this is that the cost of adjudicating these issues, and the risks of failure to
20 obtain a certificate, will be high relative to the potential benefits from entering the
21 market. Moreover, even if some firms overcome the adjudicative hearing entry

1 barrier and initiate service in a given rural market, other firms will not be willing
2 to bear the costs of entry. Overall, choices will be limited, and competition will
3 be less vigorous than in the absence of this entry barrier.

4 **Q. Please describe the topics that you will cover in your testimony.**

5 A. In the next section, I present my understanding of the legal and policy framework
6 that underlies Federal preemption of entry barriers, such as the RSA 374:22-g and
7 the attendant RSA 374:26 adjudicative hearing requirement. In the subsequent
8 section, I explain the importance attached to entry barriers as discussed in the
9 economics literature. Next, I explain how the conceptual economic framework
10 should be applied to rural local exchange markets in New Hampshire. Finally, I
11 discuss how the rural ILECs' ability to obtain a statutory adjudicative hearing and
12 full panoply of associated processes (procedural conferences, discovery,
13 testimony, briefs, factual and legal findings) on issues relating to their business
14 prospects would constitute a significant barrier to entry.

15 **II. LEGAL AND POLICY FRAMEWORK OF THE CASE**

16 **Q. What is your understanding of the issues that the Commission must decide in**
17 **this case?**

18 A. A rural ILEC, with amicus support of the association of rural ILECs, filed an
19 appeal with the New Hampshire Supreme Court to revoke authorizations granted
20 by the Commission without an adjudicative hearing to two CLECs (MetroCast

1 and IDT) to compete in the rural ILEC's service territory. The key issue was
2 whether the CLEC authorizations, granted without affording the rural ILEC a
3 right to adjudicative hearings, complied with state statutory requirements. The
4 New Hampshire Supreme Court in *Appeal of Union Telephone Company d/b/a*
5 *Union Communications*, 161 N.H. __ (decided May 20, 2010) determined that
6 RSA 374:22-g must be construed together with RSA 374:26 to require the PUC to
7 hold an adjudicative hearing on the "public good" before deciding whether to
8 allow a telephone utility to compete in the service area of another telephone
9 utility, unless all parties waived such hearing.¹ However, the Court recognized
10 the possibility that Federal law preempts the New Hampshire statute and
11 remanded this issue to the Commission for additional fact finding and resolution.

12 **Q. What is the adjudicative process that the RLECs may obtain on request**
13 **under RSA 374:22-g and other state statutes if it is not preempted by Federal**
14 **law?**

15 A. The RLECs seek an opportunity to have an adjudicative hearing and for the
16 Commission to make the required findings as to whether a CLEC application
17 would be in the public good pursuant to RSA 374:22-g and RSA 374:26.
18 According to RSA:22-g, the Commission's determination of the public good must
19 consider interests of competition with other factors including, but not limited to,
20 fairness; economic efficiency; universal service; carrier of last resort obligations;

¹ Hereafter to be cited as "*Appeal of Union Telephone Company*."

1 the incumbent utility's opportunity to realize a reasonable return on its
2 investment; and the recovery from competitive providers of expenses incurred by
3 the incumbent utility to benefit competitive providers.

4 Parties to a Stipulation in this case agree that if the statutory requirements
5 of 374:22-g, and 374:26, which provides for a public hearing when determining
6 whether a franchise is for the "public good",² are not preempted by Federal law,
7 the adjudicative hearing procedure would include issuance of public notice; an
8 opportunity for parties to file testimony; an opportunity to propound discovery;
9 the right to obtain a public evidentiary adjudicative hearing to review and address
10 the evidence; the ability to submit briefs; and issuance of a Commission decision
11 that rendered factual and legal conclusions. It is my understanding that this
12 adjudicative procedure could be invoked each time a CLEC files an application
13 for entry into a rural ILEC service territory.

14 I should note that my testimony assumes a CLEC entry request that does
15 not require unbundling by the rural ILEC of its network facilities under 47 U.S.C.
16 § 251(c). A Section 251(c) unbundling request to a rural carrier could require an
17 additional set of Commission procedures under 47 U.S.C. § 251(f) that is not
18 addressed by my testimony in this proceeding.

² *Appeal of Union Telephone Company*, at 7

1 **Q. What is the legal basis cited by the New Hampshire Supreme Court that**
2 **governs whether the application process required by New Hampshire law**
3 **would be preempted?**

4 A. TA96 included provisions that mandate preemption of State or local government
5 statutes or regulation that “may prohibit or have the effect of prohibiting the
6 ability of any entity to provide any interstate or intrastate telecommunications
7 service.”³ According to the case law cited by the New Hampshire Supreme Court,
8 a determination of preemption should consider whether the law “materially
9 inhibits or limits the ability of any competitor or potential competitor to compete
10 in a fair and balanced legal and regulatory environment.”⁴ In addition, “federal
11 law preempts certain provisions of [state] law that make it more difficult for
12 another carrier to compete in [an] area served by [a] rural telephone company;”
13 and “federal law preempts state statute requiring prior hearing because it creates
14 substantive and procedural constraint upon [the] ability of [a] potential competitor
15 to provide local exchange services.”⁵ As the New Hampshire Supreme Court
16 indicated, “[a] prohibition does not need to be complete or insurmountable to run
17 afoul of §253(a).”⁶ In one of these cases, a state Commission (Wisconsin)

³ 47 U.S.C. §253(a).

⁴ *Appeal of Union Telephone Company*, at 10, citing to Puerto Rico v. Municipality of Guayanilla, 450 F. 3d 9, 18 (1st Cir. 2006).

⁵ *Appeal of Union Telephone Company*, at 10, citing to In the Matter of American Communications Services, Inc., 14 F.C.C.R. 21,579, 21,616-21 (1999); and Re: Sprint Communications Company L.P., No. 6055-NC-103, 2008 WL 2787762, at *8 (Wisconsin Public Service Commission May 9, 2008).

⁶ *Appeal of Union Telephone Company* at 10, citing Puerto Rico v. Municipality of Guayanilla.

1 preempted a state adjudicative hearing requirement as being violative of the
2 TA96.⁷

3 **Q. How do you approach the question of what factors should affect the**
4 **Commission's determination about Federal preemption?**

5 My understanding of Federal law is that entry barriers are determined based on
6 the effect of a state statute or regulation on the prospects for competitive entry in
7 that state's telecommunications market. I do not seek to render a legal opinion on
8 the meaning of the law, but rather will provide an economic framework that I
9 believe will be helpful to the Commission in its decision making process. The
10 framework I will employ is the analysis of entry barriers to competition in a
11 concentrated or monopolized market. There is no question in my mind that the
12 provisions of the New Hampshire statute described above constitute an entry
13 barrier. The critical question from an economic standpoint is whether the entry
14 barriers created by the New Hampshire statute would have a significant effect on
15 the ability of firms to enter and compete against the rural ILEC.

16

⁷ See Sprint Communications, *supra*.

1 **III. THE ECONOMICS OF ENTRY BARRIERS**

2 **Q. What is an entry barrier?**

3 A. There are numerous definitions of entry barriers provided in the economics
4 literature. Carlton and Perloff, the authors of a widely-used textbook of Industrial
5 Organization, state that an entry barrier is anything that prevents an entrepreneur
6 from instantaneously creating a new firm in a market. Elaborating on this
7 definition, they say that long-run barriers to entry are significant, and constitute
8 “a cost that must be incurred by a new entrant that incumbents do not (or have not
9 had to) bear.”⁸

10 One key factor that will affect the importance of entry barriers is the level
11 of sunk costs that need to be expended to enter a market. Sunk costs are exactly
12 what they sound like, i.e., costs that the firm cannot recover if it exits the market
13 after incurring these costs. Sunk costs determine to a large extent the “riskiness”
14 of entering the market, and thereby the significance of the entry barrier. As
15 explained by Carlton and Perloff:

16 “If large sunk costs are associated with entry and if entry is unsuccessful,
17 the entrant’s losses are large. In such a setting, threats of strategic
18 behavior (for example, vigorous price cutting) may prevent new entry... In
19 such a case, the need for large-scale investment that involves large sunk

⁸ Dennis Carlton and Jeffrey Perloff, *Modern Industrial Organization*, 4th edition, 2005, at 77 (“Carlton and Perloff”); this definition is adapted from a definition first proposed by George Stigler. See George Stigler, *The Organization of Industry*, Chicago, IL: University of Chicago Press, 1968.

1 costs could well provide a disincentive for a potential entrant because it
2 would have so much to lose.”⁹

3 The key point to keep in mind is that the significance of entry barriers
4 should be assessed in terms of their impact on the profit calculation that a
5 potential entrant must make prior to committing to enter a market. Entry barriers
6 will be very significant if the sunk costs of entry are high relative to the level of
7 profits that the firm expects to earn after it successfully enters the market.

8 **Q. How will entry barriers affect consumers?**

9 A. The significance of entry barriers is that they can protect the incumbent firm from
10 entry that, although harmful to itself, would be beneficial to the public. Professor
11 Fisher has adopted a definition of entry barriers that highlights the divergence of
12 private interest from the public interest. He defines entry barriers as anything that
13 prevents entry when entry is socially beneficial.¹⁰ As explained in a recent
14 scholarly article on the definition of entry barriers, “For Fisher, an entry barrier is
15 socially harmful only if potential entrants make a calculation that is different from
16 the one that society would want them to make in deciding whether to enter an
17 industry that possesses the barrier in question.”¹¹

18 The focus of this part of the economics literature is the divergence of the
19 private and public interest. Since entry usually makes incumbent firms worse off,

⁹ Carlton and Perloff, at 80.

¹⁰ See Franklin M. Fisher, “Diagnosing Monopoly,” *Quarterly Review of Economics and Business*, 1979, 19, 7-33.

¹¹ See R. Preston McAfee, Hugo M. Mialon, and Michael A. Williams, “What is a Barrier to Entry?” *American Economics Review* 94(2), May 2004, 462.

1 or at least requires them to become more efficient, the incumbents will have an
2 incentive to engage in entry deterring behavior.

3 On the other hand, consumers will benefit from entry so long as the
4 entrant is risking its own capital. The simple reason is that additional entry will
5 typically drive down prices and also may increase product variety and quality.
6 Therefore, the interests of consumers and the incumbents are not aligned when it
7 comes to an assessment of the effects of newly-created entry barriers on a market.

8 **Q. How significant are the potential benefits to consumers from competitive**
9 **entry into previously monopolized voice markets?**

10 A. Competition provides significant benefits to consumers of voice services. In
11 2007, I analyzed the potential nationwide benefits from competition in voice
12 markets by cable providers.¹² This study showed that over a five-year period,
13 between 2008 and 2012, expected benefits totaled over \$100 billion. These
14 benefits are being realized throughout the country, wherever competitors have
15 entered the market successfully. Unfortunately, these benefits will not be
16 forthcoming in rural areas if barriers to entry are too high.

17 **Q. What has been the policy of New Hampshire towards competition?**

¹² Michael D. Pelcovits and Daniel E. Haar, "Consumer Benefits from Cable-Telco Competition,"
MiCRA, November 2007. Available at:
http://www.micradc.com/news/publications/pdfs/Updated_MiCRA_Report_FINAL.pdf

1 A. My understanding is that the State Constitution and Legislature have stated a
2 strong preference for competition over monopoly. The New Hampshire
3 Constitution at part II, article 83, expressly provides: "Free and fair competition in
4 the trades and industries is an inherent and essential right of the people and should
5 be protected against all monopolies and conspiracies which tend to hinder or
6 destroy it." A 1995 statute (1995 N.H. Ch. 147) that created the original version
7 of RSA 374:22-g applicable to Verizon/FairPoint areas and the original version of
8 RSA 374:22-f governing entry into rural areas (later repealed) made clear that the
9 State's policy is "to encourage competition for all telecommunications services,
10 including local exchange services, which will promote lower prices, better
11 service, and broader consumer choice for the residents of New Hampshire." RSA
12 374:22-g, as amended, itself provides that "all telephone service territories will be
13 nonexclusive" and that the Commission may "authorize multiple
14 telecommunications carriers in any telephone service territory" to the extent
15 consistent with Federal and state law. (RSA 374:22-g, I) Finally, a desire to
16 facilitate competition in rural areas can be inferred from the 2008 legislative
17 decision in N.H. Ch. 350 to eliminate the former RSA 374-22-f that established
18 special procedures for telecommunications entry requests into rural territories and
19 treats all entry requests under the general entry statute in RSA 374:22-g.

1 **IV. RURAL LOCAL EXCHANGE MARKET IN NEW HAMPSHIRE**

2 **Q. What is the nature of the markets where CLEC entry would potentially be**
3 **disrupted by the proposed adjudicative process for entering rural ILEC**
4 **service areas?**

5 A. At issue in this proceeding are territories served by ILECs with less than 25,000
6 access lines. This Commission's website lists eleven ILECs with tariffs available
7 on-line. One of these companies is FairPoint, which has more than 25,000 access
8 lines and is not covered by these provisions.¹³ I have obtained publicly available
9 information concerning nine of the other ten companies from the Universal
10 Service Monitoring Report ("Monitoring Report").¹⁴ The only company listed on
11 the Commission's website but not in the Monitoring Report is Northland
12 Telephone Company. I will focus my analysis on each of these nine companies.

13 **Q. As a general matter, what investments have to be made to enter the territory**
14 **of one of these rural ILECs to provide voice service?**

15 A. There could be a wide range of investment costs, which will depend on the extent
16 the potential entrant has facilities in place that provide other services (e.g., high
17 speed data or video); population density; topographical conditions; and spectrum

¹³ My understanding is that CLEC requests to serve FairPoint's service territory are subject to a nonadjudicative application process under the Commission's rules, specifically, PUC 431.01.

¹⁴ Federal-State Joint Board on Universal Service, *Universal Service Monitoring Report, CC Docket No. 98-202, 2009*.

1 costs for wireless service. The FCC's Broadband Model estimates investment
2 costs for broadband facilities in the range of several thousand dollars.

3 **Q. Will entry barriers deter a CLEC from entering the market if it already**
4 **owns or has an affiliation with a firm that owns wireline facilities in the**
5 **ILEC's footprint?**

6 A. Yes. Cable companies cannot provide voice service without adding equipment
7 and incurring other sunk costs associated with the provision voice service. In
8 order to provide voice service, a cable company must deploy facilities to connect
9 to the public switched telephone network, and to add voice capability to its
10 network. Furthermore, if a cable company does not cover the entire footprint of
11 an ILEC, then it would have to expend greater resources on a per subscriber basis
12 to provide service to only a subset of customers served by the ILEC. Adding
13 significant additional costs of entry, including certification and/or interconnection
14 as discussed below, would discourage a new entrant from providing competitive
15 services in these ILEC areas.

16 **Q. What other factors will affect a firm's decision whether to enter a rural**
17 **ILEC market?**

18 A. Most important, the presence (or expectation) of other competitors in the market
19 will affect an entrant's expectation of market share, and therefore the potential for
20 a stream of profits in the future. Also, competition may drive down prices (and

1 margin) from these services. On the other side of the equation is the potential
2 benefit to an entrant that will offer other services, e.g., data and video, and may
3 benefit from the bundling of these services together with voice service. These are
4 all important factors that may affect whether entry occurs.

5 **Q. What have you learned about the markets served by the nine rural ILECs in**
6 **New Hampshire that are addressed in the data that you received?**

7 A. According to the Monitoring Report, these companies each served between 470
8 and 11,500 lines in 2007. The Report also provides information on the High-
9 Cost loop support payments these companies receive from the Federal Universal
10 Service Fund (“USF”), along with data on their unseparated non-traffic sensitive
11 (“NTS”) revenue requirements and interstate access minutes. I summarize this
12 information in the table below.

<u>Study Area Name</u>	<u>Number of ILEC Loops</u>	<u>Unseparated NTS Revenue Requirement</u>	<u>Total High-Cost Support Payments</u>	<u>High-Cost Support per Line</u>	<u>Total ILEC Interstate Access Minutes</u>
Bretton Woods Tel. Co.	965	\$311,110	\$396,558	\$411	1,340,819
Granite State Tel.	9,704	\$4,552,486	\$2,151,753	\$222	25,486,325
Dixville Tel. Co.	470	\$255,892	\$107,745	\$229	510,617
Dunbarton Tel. Co.	1,724	\$794,523	\$305,274	\$177	4,153,524
Union Tel Co.	7,263	\$1,806,797	\$1,246,824	\$172	18,612,909
Kearsarge Tel. Co.	9,176	\$3,047,272	\$919,740	\$100	29,661,608
Merrimack County Tel.	7,545	\$2,186,344	\$1,206,180	\$160	24,225,540
Wilton Tel Co.	3,185	\$1,066,077	\$463,980	\$146	10,523,696
MCTA	11,500	\$3,513,457	\$1,128,258	\$98	38,563,972

1

2 **Q. What conclusions can you draw from this data?**

3 A. These companies are serving small exchanges that are likely to have limited profit
 4 potential for new entrants. A new entrant would be competing for a small pool of
 5 revenue and could expect to grow market share relatively slowly, eventually
 6 reaching perhaps 20% to 30% of the market after several years.¹⁵ The entrant
 7 would be competing against incumbents that receive substantial subsidies from
 8 the Federal USF and in some cases substantial funding from Federal stimulus
 9 funds (i.e., American Reinvestment and Recovery Act) to construct broadband

¹⁵ Cable is the most successful entrant in most telephone markets, so its success in other markets should be indicative of the best case scenario for the first new entrant into rural exchanges. Nationwide, cable served 22.2 million basic phone customers, out of a market of 118 million switched access lines. (See *Trends in Telephone Service*, FCC, September 2010, Table 8.4; Available at: <http://www.ncta.com/Stats/CablePhoneSubscribers.aspx> (last visited October 15, 2010)).

1 facilities.¹⁶ Moreover, the entrant would face economic barriers to entry in
2 addition to the barriers discussed above created by the application process. The
3 entrant would have to invest in any service-related facilities or equipment, obtain
4 interconnection or traffic exchange rights from the RLEC or other carriers, and
5 undertake marketing to publicize its new services, among other costs in addition
6 to the cost of complying the actual Commission entry process. Hence, given the
7 combination of the potentially burdensome adjudicative hearing requirement on
8 each entry application and other service-related investment costs, the potential for
9 successful profitable entry is far from assured in these markets.

10 **Q. Can you provide some estimate of the profit potential for a firm entering one**
11 **of these rural markets?**

12 A. Yes. I will do so subject to a significant caveat that this is a stylized model that
13 provides a “back-of-the-envelope” calculation, and is only useful to give a sense
14 of the entry proposition in these markets. It provides a framework or context for
15 understanding the impact of entry barriers of a certain size.

16 I approach this exercise by estimating the net revenue (or profit margin)
17 that an entrant can expect to earn from entering a new rural ILEC service
18 territory. Net revenue is equal to revenues minus the ongoing operating expenses
19 as defined by factors discussed below. After deriving an estimate for net revenue,

¹⁶ Bretton Woods Telephone (\$985,000), Kearsarge Telephone (\$372,532), and Merrimack Telephone (\$2,2021,197) have received grant awards under the Broadband Initiatives Program (“BIP”). See <http://www.broadbandusa.gov/files/BIP%20Round%201%20and%20Round%202%20Awardees.pdf> (last visited on October 22, 2010).

1 I compare it to the investment cost that would need to be incurred to enter the
2 market. Note that the net revenue potential used in this exercise is a function of
3 three key factors. First is the size of the rural ILEC's customer base. Second is
4 the share of the market that the entrant expects to achieve. Third is the operating
5 expense of serving these customers, which is typically expressed as a percentage
6 of revenue.

7 **Q. What is the net revenue potential from offering voice service in competition**
8 **with a rural ILEC?**

9 A. In the table below I present a baseline estimate of net revenue for an ILEC
10 territory with 1,000 lines. Net revenue is shown for a ten year period, and is
11 based on an S-curve of market penetration that I have used in other work.¹⁷ The
12 other three inputs are based on the inputs used by the FCC in its Broadband
13 Availability Gap Model.¹⁸ These are: revenue per customer equal to \$33.46 per
14 month; operating margin (revenue minus operating expenses) equal to 40%; and
15 the discount rate equal to 11.25%.

¹⁷ Michael D. Pelcovits and Daniel E. Haar, "Consumer Benefits from Cable-Telco Competition,"
MiCRA, November 2007. Available at:
http://www.micradc.com/news/publications/pdfs/Updated_MiCRA_Report_FINAL.pdf

¹⁸ FCC, "The Broadband Availability Gap," OBI Technical Paper No. 1, April 2010. Available at:
<http://www.broadband.gov/plan/> (last visited October 21, 2010).

<u>Year</u>	<u>ILEC Customers</u>	<u>Market Share</u>	<u>Monthly Revenue per Customer</u>	<u>Operating Margin</u>	<u>Margin per Customer</u>	<u>Net Revenue</u>	<u>Discounted Net Revenue</u>
1	1000	1%	\$33.46	40%	\$13.38	\$2,101	\$1,889
2	1000	2%	\$33.46	40%	\$13.38	\$3,369	\$2,722
3	1000	3%	\$33.46	40%	\$13.38	\$5,299	\$3,848
4	1000	5%	\$33.46	40%	\$13.38	\$8,140	\$5,314
5	1000	8%	\$33.46	40%	\$13.38	\$12,118	\$7,111
6	1000	11%	\$33.46	40%	\$13.38	\$17,317	\$9,134
7	1000	15%	\$33.46	40%	\$13.38	\$23,529	\$11,156
8	1000	19%	\$33.46	40%	\$13.38	\$30,205	\$12,873
9	1000	23%	\$33.46	40%	\$13.38	\$36,609	\$14,025
10	1000	26%	\$33.46	40%	\$13.38	\$42,117	\$14,503
<u>Present Discounted Value</u>							<u>\$82,575</u>

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2

3

The model yields an estimate of \$82,575 as the present discounted value of the stream of operating profits from entry into a 1,000 line market.

4

Q. What is the meaning of this estimate of the stream of operating profits?

5

A. In a traditional business analysis, the net present value of an investment must be

6

positive in order to even consider making the investment.¹⁹ Otherwise the firm

7

will be better off using its capital resources for some other project. In this stylized

8

model, the decision whether to enter this local exchange market will depend on

9

whether the initial investment required to enter the market is less than or equal to

10

the net present value of the stream of operating profits.

¹⁹ James C. Van Horne, *Financial Management and Policy*, Sixth Edition, Prentice-Hall Inc. 1983, Chapter 5.

1 **V. SUNK COSTS ASSOCIATED WITH THE ADJUDICATIVE PROCESS REQUIRED FOR**
2 **ENTRY INTO NEW HAMPSHIRE RURAL TERRITORIES**

3 **Q. What costs will the entrant have to bear if it must follow the requirements of**
4 **the adjudicative hearing process envisioned under RSA 374:22-g and other**
5 **statutes?**

6 A. I would expect the costs to be substantial relative to the size of these markets and
7 the concomitant profit potential. Legal costs for the certification process, as well
8 as for the potential interconnection negotiation and/or arbitration, are quite likely
9 to be significant. This is certainly the experience of the CLECs in many
10 jurisdictions and also demonstrated in the IDT interconnection arbitration case
11 with Union Telephone in Docket 09-048. This latter arbitration case required
12 substantial regulatory proceedings over nearly a year's time, including an early
13 2009 filing of an arbitration petition, briefing of two motions to dismiss brought
14 by the rural ILEC on various legal grounds, and multiple sessions involving the
15 parties with the Commission-appointed Arbitrator. The factors of RSA 374:22-g
16 are expansive, and could require significant costs in assembling and litigating as
17 an adversarial evidentiary proceeding as envisioned by the ILECs and set forth in
18 the stipulation. The time to market would also be significantly impacted by these
19 proceedings. In particular, one of the public good elements of RSA 374:22-g,
20 “the incumbent utility’s opportunity to realize a reasonable return on investment,”
21 could turn the entry process into a potential rate case for the incumbents.

1 **Q. What do you mean by a rate case for the rural ILECs?**

2 A. If the rural ILECs claim that competitive entry will affect their opportunity to
3 realize a reasonable return under RSA 374:22-g, then the only way to rebut this
4 claim effectively is to conduct an analysis of the incumbent's financial condition.
5 For example, suppose that the rural ILEC claims that a competitor will divert 20%
6 of its revenue, but it will not be able to reduce its costs by any appreciable
7 amount. Hence, the rural ILEC would claim that its expected rate of return would
8 fall precipitously. Depending on which party has the burden of proof, the
9 applicant may need to conduct a thorough analysis of the incumbent's rate base,
10 operating expenses, and projected revenue from current and new sources (e.g.,
11 data and video). The investigation also would need to include a fact-specific
12 analysis of whether the incumbent could compensate for lost revenue through its
13 new, unregulated revenue streams, such as wireless, video, or high speed data
14 services, which are becoming an increasingly important part of the ILECs'
15 business plans, especially as they deploy new broadband facilities. This is likely
16 to be a very time-consuming and costly undertaking.

17 Indeed, the substitution of price cap regulation for rate of return regulation
18 was driven in part by the interest among all parties, regulators, regulated firms,
19 and interveners, to obviate the need for rate cases. As explained in a history of
20 telecommunications policy by Gerald Brock (former Chief of the Common
21 Carrier Bureau at the FCC):

1 “Although simple in concept, the rate base rate of return method requires
2 extensive controls over a company. The accounting system must be
3 specified and the depreciation rates prescribed in order to make the profit
4 figures reasonable. Otherwise, the monopolist can escape the control of
5 regulation by accounting changes that hide the true profits. The entire
6 process occurs in a formal way through public rulemaking and
7 administrative determinations...The complexities and importance of the
8 particular procedures used for regulation are a function of the uncertainty
9 in the industry and the need for formal procedures to guard against
10 arbitrary action. There are no generally known correct prices in an
11 industry in the abstract. Thus there must be specified standards in order to
12 check whether prices are reasonable and to evaluate changes in prices.”²⁰

13 **Q. Why is it necessary to undertake such a thorough financial review to analyze**
14 **these issues?**

15 A. This is the reality of regulation. The only way to sort out competing claims about
16 the reasonableness of a rate of return is to conduct a thorough analysis.

17 There may be a mistaken impression that it is possible to find a shortcut
18 and limit the analysis of the reasonableness of the rate of return. The experience
19 of the Massachusetts Commission during its transition to price cap regulation is
20 instructive. As explained by the then-Chairman, Paul Vasington, the
21 Massachusetts Commission’s intention to limit the scope of its earnings review
22 failed miserably:

23 “The Commission’s intent in setting out this scope of earnings review was
24 to conduct a limited review of earnings for the purpose of generally
25 assessing the reasonableness of then-current rates. In practice, however,
26 the review ended up being tantamount to a rate case, with a full
27 investigation of the prudence of expenses and investments, establishment
28 of a reasonable return on equity and capital structure, and investigation of

²⁰ Gerald W. Brock, *Telecommunications Policy for the Information Age*, Harvard University Press, 1998, at 257.

1 affiliate transactions. This part of the investigation of Verizon's proposal
2 ended up being so demanding that the commission was forced to bring its
3 rate case team from another staff division...to conduct the review."²¹

4 **Q. In your prior testimony before this Commission, you stated that the**
5 **incumbent should be able to respond to competitors and still recover a**
6 **reasonable return. How does comport with your statements in this testimony**
7 **that a proceeding akin to a full rate case may be required to determine the**
8 **effect of competition on the RLEC?**

9 A. In my prior testimony in Docket No. DT 08-013, I stated that "competition
10 presents a challenge to the firm or firms already in a market."²² I also stated that
11 it was my expectation that an efficient, well-managed market incumbent should
12 be able to respond to competitors and still recover a reasonable return on past and
13 future investment. I still believe this to be true, based on my experience and
14 research on the local exchange industry. Here, a different situation exists where
15 the governing entry statute requires an adjudicative hearing process that, at
16 minimum, mandates consideration of the impact of entry on the rural ILEC's rate
17 of return. My testimony above indicates that a rate case-like proceeding may well
18 be required to meet this statutory requirement, depending on the nature of the
19 arguments raised by the rural ILEC. I view this as a central element in my
20 recommendation that a statutory adjudicative hearing requirement containing this
21 factor raises serious entry barrier concerns. Absent this statutory requirement, my

²¹ Paul B. Vasington, "Incentive Regulation in Practice: A Massachusetts Case Study," *Review of Network Economics*, Vol. 2, Issue 4, December 2003, at 455.

²² Direct Testimony of Michael D. Pelcovits, Docket No. DT-013, September 9, 2008, at 11.

1 policy recommendation to the Commission would be to relegate the issue of the
2 impact on competition on the incumbent to playing no role or, at most, a very
3 minor role in the decision as to whether entry is in the public interest.

4 **Q. Are there other issues that could also become costly to litigate before the**
5 **Commission under the provisions of RSA 374:22-g?**

6 A. Yes. There are several other issues that could be subjected to a very fact-intensive
7 investigation, if the Commission were to use the procedures envisioned by the
8 ILECs. Specifically, the ILECs may claim that entry will have adverse effects on
9 the twin issues of universal service and the carrier of last resort obligations. If
10 these are treated as empirical issues, then the fact-gathering and analytical
11 exercises would consume significant resources of all parties involved in the case.
12 The logical alternative to conditioning CLEC entry on resolution of universal
13 service issues would be to allow entry, and then stand ready to provide
14 competitively-neutral subsidies to consumers that are no longer able to obtain
15 service at reasonable prices as a result of the effects of competition on existing
16 subsidy flows. If this method of proceeding is not possible, then the potential
17 entrants may face an insuperable obstacle to entry. In turn, rural consumers will
18 not benefit from the competitive choice and innovative services enjoyed by their
19 urban counterparts.

1 **Q. You have opined that burdens imposed on applicants to enter rural markets**
 2 **could serve as a significant barrier to entry. What is the basis for this**
 3 **opinion?**

4 A. The potential reward from entering a new local market is the stream of profits
 5 that could be earned. Above, I estimated the net present value of this profit
 6 stream to be \$82,575 for a 1,000 customer market. In the table below, I show the
 7 profit potential for each of the nine rural ILEC territories in New Hampshire for
 8 which I have a loop count.

<u>Study Area Name</u>	<u>Number of ILEC Loops</u>	<u>Net Present Value of Profit</u>	<u>Net Present Value Remaining after \$100,000 Application Costs</u>
Bretton Woods Tel. Co.	965	\$79,685	-\$20,315
Granite State Tel.	9,704	\$801,308	\$701,308
Dixville Tel. Co.	470	\$38,810	-\$61,190
Dunbarton Tel. Co.	1,724	\$142,359	\$42,359
Union Tel Co.	7,263	\$599,742	\$499,742
Kearsarge Tel. Co.	9,176	\$757,708	\$657,708
Merrimack County Tel.	7,545	\$623,028	\$523,028
Wilton Tel Co.	3,185	\$263,001	\$163,001
MCTA	11,500	\$949,613	\$849,613

9

10 In order to earn this profit stream, the applicant would need to expend
 11 considerable capital resources – especially relative to the prospective level of

1 profits. If the cost of litigating the application process alone were to be in the
2 range of \$100,000, then the profit potential left over to cover all other investment
3 costs would range from a negative \$61,190 for the Dixville Telephone Company
4 territory to \$849,613 for MCTA territory. Furthermore, the longer the application
5 process drags out, then the lower the net present value of the future stream of
6 profits.

7 **Q. What is your basis for using \$100,000 as an estimate of the cost of a contested**
8 **adjudicative hearing request?**

9 A. This estimate is consistent with the costs of public interveners in non-telephone
10 rate cases in a number of states.²³ I am not aware of any recent telephone rate
11 cases; although my experience from interventions from other rate-setting
12 proceedings is that the cost and complexity of a telephone rate case could require
13 an intervener to spend far in excess of \$100,000.

14 **Q. Does recent history of regulatory proceedings involving rural ILECs at the**
15 **Commission give you any obvious reasons to question your estimate above?**

16 A. No. To the contrary, the proceedings of which I am aware show that New
17 Hampshire RLECs, either individually, through the New Hampshire Telephone

²³ Beth Givens, *Citizen's Utility Boards: Because Utilities Bear Watching*, Center for Public Interest Law, University of San Diego School of Law, 1991, at 17. The statement made is that a "typical regulatory proceeding requiring as much as \$100,000 in legal and expert witness fees." This figure is provided in 1991 dollars, which would be worth \$160,000 today, based on the change in the Consumer Price Index.

1 Association (“NHTA”), or both, are willing to devote litigation resources that, in
2 turn, force entrants to devote significant resources to achieve favorable litigation
3 results from the Commission. As noted above in the Introduction, I was
4 personally involved in the Comcast Phone entry case, Docket 08-013, which was
5 heavily litigated and took more than a year to complete. The MetroCast and IDT
6 entry requests that were approved by the Commission following a nonadjudicative
7 process and later appealed to the New Hampshire Supreme Court in the *Appeal of*
8 *Union Telephone Company* also appear to have been very substantial litigations,
9 with the active involvement of the RLEC at issue and the NHTA at both the
10 Commission and appellate levels.

11 Q. **Does this level of resource commitment by rural ILECs to regulatory**
12 **proceedings at the Commission and the courts surprise you?**

13 A. No. New Hampshire RLECs have a significant and understandable interest in
14 seeking to influence the terms and conditions under which CLECs will be allowed
15 to enter their territories, a process that appears to have begun in earnest with the
16 Docket 08-013 Comcast Phone entry request in late 2007 and early 2008 and
17 gained potential momentum with the repeal of the RLEC-specific entry statute,
18 former RSA 374:22-f, in mid-2008. I would expect, moreover, that the rural
19 ILECs will continue to have a compelling incentive to devote regulatory resources
20 to seek to prevent or limit the entry of competitors able to take away market share,
21 force market-related service pricing reductions, or both. The combination of the

1 RSA 374:22-g adjudicative hearing requirement for entry requests as construed by
2 the appellate court in the *Appeal of Union Telephone Company* case and rural
3 ILEC incentives to devote litigation resources poses a significant risk to the
4 development of customer-beneficial competition in New Hampshire's rural areas,
5 absent Commission action in this proceeding.

6 **Q. What is the likely consequence to consumers from the erection of regulatory**
7 **barriers to entry into rural areas of New Hampshire served by the RLECs?**

8 A. If entry does not take place or is delayed, consumers will lose on several accounts.
9 First, consumers will not receive the same choice among voice service providers
10 that are now available in most of the rest of the State and across the country.
11 Second, consumers will lose the benefit of lower prices, whether they obtain
12 service from a new entrant, or whether they remain with the incumbent, which
13 must lower prices to respond to the entrant(s). Third, consumers will continue to
14 be confused about the options available in the marketplace. The confusion stems
15 from situations where a rural consumer is served by a cable company that is not
16 authorized to offer voice service in an RLEC's footprint, but does offer voice
17 service in neighboring areas that are part of another ILEC's (e.g., FairPoint)
18 service territory. Consumers are typically not aware of their rate center
19 boundaries and will have a difficult time understanding why the cable company
20 does not offer them a widely-available service. This confusion could be

1 eliminated, if entry barriers were reduced, and potential entrants could pursue
2 their plans to enter new rural market.

3 **VI. CONCLUSION**

4 **Q. What is your conclusion on whether the adjudicative hearing processes that**
5 **can be invoked by the rural ILECs under RSA 374:22-g and other statutes**
6 **would constitute a significant barrier to entry in the rural exchanges in New**
7 **Hampshire?**

8 A. I conclude that there is a very high likelihood that the envisioned adjudicative
9 process could become a significant barrier to entry into the rural exchanges of
10 New Hampshire. The time and delay associated with adjudicating a case that
11 must consider the impact of entry on the incumbent and universal service issues
12 would be very high relative to prospective gains from entering the market,
13 especially when considered in conjunction with other entry-related sunk costs.
14 Moreover, rural ILECs would have an incentive to use the process as an entry
15 barrier because of the potential adverse effects of entry on their profits. This
16 highlights a likely divergence between the private interest of the ILEC and public
17 interest of the rural customers of New Hampshire.

18 **Q. Does this conclude your testimony?**

19 A. Yes.