

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

Docket No. DT 10-183

Petition by Certain Rural Telephone
Companies Regarding CLEC
Registrations within Their Exchanges

**REBUTTAL TESTIMONY OF
DOUGLAS MEREDITH
ON BEHALF OF**

**Bretton Woods Telephone Company, Inc.,
Dixville Telephone Company
Dunbarton Telephone Company, Inc., and
Granite State Telephone, Inc.**

December 8, 2010

1 **I. Introduction**

2 **Q: Please state your full name.**

3 A: My full name is Douglas Duncan Meredith.

4 **Q: Are you the same Mr. Meredith that prepared direct testimony in this proceeding**
5 **(filed October 22, 2010)?**

6 A: Yes.

7 **Q: On whose behalf are you testifying?**

8 A: I am testifying on behalf of the Granite State Telephone, Inc., Dunbarton Telephone
9 Company, Inc., Bretton Woods Telephone Company, Inc. and Dixville Telephone
10 Company (collectively referenced as “RLECs”).

11 **Q: What is the purpose of your testimony?**

12 A: My purpose in providing this rebuttal testimony to the New Hampshire Public Utilities
13 Commission (“Commission”) is to respond to the direct testimonies of Michael D.
14 Pelcovits filed on behalf of the New England Cable and Telecommunications
15 Association, Inc. (“Pelcovits Direct”) and Kath Mulholland on behalf of segTEL, Inc.
16 (“Mulholland Direct”).

17 **II. Barriers to Entry**

18 **Q: In his Direct Testimony, Dr. Pelcovits states on page 9 that “[t]he critical question**
19 **from an economic standpoint is whether the entry barriers created by the New**

1 **Hampshire statute would have a significant effect on the ability of firms to enter and**
2 **compete against the rural ILEC.” Do you agree with his framing of this issue?**

3 **A:** No. I disagree with Dr. Pelcovits’ framing of the issue. 47 U.S.C. § 253 is not concerned
4 merely with “significant” effects - it is concerned with prohibitive effects. Section 253(a)
5 states that “[n]o State or local statute or regulation, or other State or local legal
6 requirement, may prohibit or have the effect of prohibiting the ability of any entity to
7 provide any interstate or intrastate telecommunications service.” Even though Section
8 253 is titled “Removal of Barriers to Entry,” one should not read too much into that. My
9 plain English understanding of the statute provides guidance that it does not forbid all
10 barriers, and it clearly does not provide for unconditional entry into an RLEC territory.
11 For example, subpart (b) provides for regulations intended to preserve and advance
12 universal service, protect the public safety and welfare, ensure the continued quality of
13 telecommunications services, and safeguard the rights of consumers. Furthermore,
14 subpart (f) allows the state to impose 214(e)(1) eligible telecommunications carrier
15 (ETC) requirements on a CLEC entering an area served by a rural carrier.

16 **Q: Do all regulatory barriers to entry “prohibit or have the effect of prohibiting the**
17 **ability of any entity to provide any interstate or intrastate telecommunications**
18 **service?”**

19 **A:** No. In his testimony, Dr. Pelcovits’ has provided a wide ranging, if theoretical,
20 discussion of entry barriers from an economic standpoint, but I do not find it particularly
21 relevant. For example, on page 10 of his testimony, Dr. Pelcovits subscribes to the view
22 that any condition that prevents “instantaneous” entry into a market constitutes a barrier
23 to entry, citing Carlton and Perloff. This is hardly pertinent to the issue at hand, however.
24 Technical and financial entry barriers abound in the telecommunications industry, due to

1 the extensive infrastructure investment and long lead times. Furthermore, most state
2 public utility commissions require that the new entrant obtain approval before offering
3 service. Consequently, not all of the classic entry barrier theories are applicable here.

4 Interestingly, even Carlton and Perloff, Dr. Pelcovits' sources for the
5 "instantaneous entry" definition, agree with me on this. In a previous work, they have
6 explained that this definition of entry barrier, which they attribute to Stigler:

7
8 is inadequate; it would mean, for example, that the cost of hiring labor or
9 the cost of building a plant would be considered an entry barrier.

10 Moreover, it would imply *that any industry in which entry takes time*
11 *would be characterized as having a barrier to entry.*¹

12 The central question in this proceeding is not one of whether there are barriers to entry in
13 the telecom industry. The question is whether a hearing to review an application for
14 service constitutes a material barrier to entry that prohibits the ability to provide
15 telecommunications services and that is preempted by the Act.

16 **Q: Does the requirement of a hearing to review evidence from the applicant and the**
17 **RLECs appear to you to be a material barrier to entry that prohibits or has the**
18 **effect of prohibiting an entrant to provide telecommunications services in the RLEC**
19 **territories?**

20 A: No. Section 253 of the Act itself contemplates exceptions to any hard-and-fast
21 elimination of barriers to entry and this Commission is within its duty under federal and
22 state statues to scrutinize any application to offer telecommunications services in RLEC
23 territories to determine what competitively neutral regulations are appropriate for this
24 entry. As I established in my Direct Testimony, adjudicative proceedings for CLEC entry
25 are common to many states. The Commission should adopt sensible regulations that

¹Dennis Carlton and Jeffrey Perloff, *Modern Industrial Organization*, 1st edition, 1990, at 172 (emphasis supplied).

1 allow it to review the application to offer any communications service and what
2 regulations should be imposed on an entrant seeking to offer telecommunications service.
3 An evidentiary hearing is a part of this process.

4 **Q: Do the benefits of competition automatically favor policies encouraging entry into a**
5 **RLEC market?**

6 A: No. The state of competition and its benefits in rural areas is a matter for a fact-based
7 investigation. The Commission should not accept the premise sponsored by Dr. Pelcovits
8 that competition is universally good in rural areas when the Act itself tempers the benefits
9 of competition in rural areas and provides for specific provisions ensuring the public
10 good is preserved with the introduction of competition. Critical in this investigation is
11 where the competition is going to be. If competition exists in the more populated areas of
12 a rural study area, then the less populated areas of the study area may be neglected by the
13 RLEC because scarce resources will need to be directed to the areas of competition.
14 Instead of preserving and advancing universal service throughout the study area in a
15 uniform manner, the RLEC will have to allocate already scarce investment dollars to
16 focus on the areas where there is wireline competition. The benefits of competition and
17 the benefits of universal service in rural areas can be at odds with each other. These
18 issues need to be balanced in order to preserve and advance universal service to all areas
19 within a study area. This balance is seen in subparts (b) and (f) of Section 253 where, for
20 example, a state commission may require an entrant to serve the entire study area of a
21 RLEC in order to enter the market.

22 My view is consistent with that of one commentator that Dr. Pelcovits relies on,
23 Franklin Fisher. On page 11 of his testimony, Dr. Pelcovits cites Dr. Fisher for the
24 statement that an entry barrier is “anything that prevents entry when entry is socially
25 beneficial.” Dr. Pelcovits goes on to equate “social benefit” as cost savings to all

1 customers on a nationwide basis. Dr. Fisher, on the other hand, offers a different
2 perspective. In the same paragraph that Dr. Pelcovits cites, Dr. Fisher explains that the
3 phrase “anything that prevents entry when entry is socially beneficial . . . is a fairly fancy
4 way of describing a situation in which unnecessarily high profits are being earned and
5 society would be better off if they were competed away, but firms cannot enter to do
6 this.”² Referring to the scenario I have described in the previous paragraph, I submit that,
7 first of all, as rate-of-return regulated utilities, the RLECs do not even have excess
8 profits, let alone “unnecessarily high” profits. Second, it is therefore probable new
9 entrants will “compete away” the sustaining return on capital, bleeding away the profits
10 from populated and/or low cost areas that currently support service in less populated
11 and/or high cost areas. It is this very situation that is a major concern of the RSA 374:22-
12 g.

13 Thus, CLEC entry into a RLEC study area should not be assumed to be in the
14 public interest where the “public” is the population of the entire study area. A fact-based
15 hearing to assess this condition is a reasonable public policy regulation that does not
16 appear to be preempted by Section 253(a) of the Act.

17 **Q: Should a fact-based investigation occur for each potential entrant?**

18 A: Yes. The investigation should occur for each entrant because the results of the
19 investigation may be materially different for different potential entrants. For example, on
20 page 2 of her direct testimony, Ms. Mulholland of segTEL described how her company’s
21 mode of entry is significantly different from that of the NECTA companies.

²Franklin M. Fisher, “Diagnosing Monopoly,” Quarterly Review of Economics and Business at 23 (1979).

1 **Q: Dr. Pelcovits suggests that barriers to entry are long-run cost barriers “that must be**
2 **incurred by a new entrant that incumbents do not (or have not had to) bear.” Are**
3 **there long-run costs that incumbents must bear that entrants don’t have to bear?**

4 A: Yes. Today, carrier of last resort obligations are borne by incumbents and not by CLECs
5 not designated as eligible telecommunications carriers. For example, these obligations
6 may require RLECs to provide service to all end-user customers in the study area even
7 when the costs to provide service are greatly in excess of the revenues and supports
8 received for high cost customers. Revenues from lower cost customers in the study area
9 help support the higher cost customers through implicit support derived from study area
10 average pricing. The Commission should investigate this condition prior to imposing
11 regulations on an entrant because there may need to be competitively neutral
12 regulations/policies adopted for this study area as allowed by Section 253(b).

13 **Q: Dr. Pelcovits discusses, on page 15 of his testimony, sunk costs in the deployment of**
14 **voice service. Do you agree that if the cable company does not cover the entire**
15 **footprint of a RLEC area, the per subscriber costs are higher?**

16 A: No. This analysis fails to account for the significant scale economies cable companies
17 have. For example, most cable companies centralize switching at the regional or network
18 level. Thus, there are far less switching costs for the limited footprint customer base in
19 an RLEC area because the cable company is using one switch for a multitude of
20 incumbent footprints. The same experience is realized by cable companies in other
21 operations that have large scale economies such as billing and customer service.
22 Furthermore, a cable company may not serve an entire footprint for the simple reason that
23 it has altogether avoided the expense of building out to remote areas.

1 **Q: On page 20 of his testimony, Dr. Pelcovits presents a table that assumes that it takes**
2 **10 years for a cable operator to reach a market share of in excess of 25 percent. Do**
3 **you agree with this assumption?**

4 A: No. My understanding is that a voice market share of over 35 percent is achieved in far
5 less time than 10 years. For example, Cablevision, starting from a base of 280,000 voice
6 customers in 2004, had in five years grown that number to over 2 million, or 42.5% of the
7 4.8 million homes that its cable passes in its New York area market.³ So the present
8 discounted value presented by Dr. Pelcovits is underestimated in this respect.

9 **Q: Is the assumption of a 40 percent operating margin consistent with cable company**
10 **operations?**

11 A: The 40 percent value used by Dr. Pelcovits is too low for cable operators. This value is
12 from the National Broadband Plan estimate for telephone operations. Dr. Pelcovits
13 should have used a cable company margin based on actual operations. A good example
14 is available in the Form 10-Q filing by Comcast for the period ending June 30, 2010.⁴ On
15 pages 28 and 30 of that filing, Comcast indicated that its phone business revenues for the
16 six month period were \$1.79 billion and phone business expenses were \$286 million,
17 resulting in an expense ratio of 16 percent. Thus, on the margin, for an incremental
18 service such a voice for a cable company, the data clearly indicate that an operating
19 margin of *at least* 80 percent is more realistic from an operating cash viewpoint. Voice
20 service is an incremental service with high margins for cable companies because large
21 portions of the infrastructure are already in place and where customers already have cable

³See Cablevision 2005 Letter to Shareholders at 3, attached hereto as Exhibit DDM-02, and Cablevision 2009 Form 10-K Report at 3, attached hereto as Exhibit DDM-03.

⁴ Attached hereto as Exhibit DDM-04.

1 and data services, adding voice is a low-cost activity. I recommend using an 80 percent
2 margin for this proceeding.

3 **Q: What conclusion do you draw if the market share and operating margin values used**
4 **by Dr. Pelcovits are low?**

5 A: Low values for both variables lead to a low present discounted value stream over his
6 projected ten years. If these values are higher, there is a higher value to market entry.
7 This leads to the conclusion that the cost-benefit proposition proposed by Dr. Pelcovits is
8 too conservative.

9 **Q: Can you quantify the value entry proposition with updated market share and**
10 **operating margin numbers?**

11 A: Yes. Using the same schedule used by Dr. Pelcovits, I show a faster market share (to 35
12 percent) and a higher operating margin (80 percent). I donot have data on cable coverage
13 of the RLEC area. I calculate the discounted net revenue assuming that cable coverage is
14 at 60 percent of the RLEC customer base. The result is that the present discounted value
15 (without changing the discount) is \$279,443.
16

17 Below are the updated Sheets 4 and 2 of the Excel workbook used by Dr. Pelcovits with
18 the adjustments discussed above. (Market share entries reflect 60% area coverage
19 factor).
20

<u>Year</u>	<u>ILEC Customers</u>	<u>Market Share in 60% of Area</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	6%	\$33.46	80%	\$26.77	\$19,273	\$17,324
2	1000	9%	\$33.46	80%	\$26.77	\$28,909	\$23,358
3	1000	12%	\$33.46	80%	\$26.77	\$38,546	\$27,995
4	1000	15%	\$33.46	80%	\$26.77	\$48,182	\$31,455
5	1000	18%	\$33.46	80%	\$26.77	\$57,819	\$33,929
6	1000	21%	\$33.46	80%	\$26.77	\$67,455	\$35,581
7	1000	21%	\$33.46	80%	\$26.77	\$67,455	\$31,983
8	1000	21%	\$33.46	80%	\$26.77	\$67,455	\$28,749
9	1000	21%	\$33.46	80%	\$26.77	\$67,455	\$25,841
10	1000	21%	\$33.46	80%	\$26.77	\$67,455	\$23,228
						Present Value	\$279,443

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2

<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	\$269,662	\$169,662
Granite State Tel.	9,704	\$2,711,712	\$2,611,712
Dixville Tel. Co.	470	\$131,338	\$31,338
Dunbarton Tel. Co.	1,724	\$481,759	\$381,759
Union Tel Co.	7,263	\$2,029,593	\$1,929,593
Kearsarge Tel. Co.	9,176	\$2,564,167	\$2,464,167
Merrimack County Tel.	7,545	\$2,108,395	\$2,008,395
Wilton Tel Co.	3,185	\$890,025	\$790,025
MCTA	11,500	\$3,213,592	\$3,113,592

3

1 **Q: On page 27 of his testimony, Dr. Pelcovits suggests that a proceeding meeting the**
2 **requirements of RSA 374:22-g could result in legal fees of \$100,000. Do you believe**
3 **that this is a reasonable estimate?**

4 A: No. Dr.. Pelcovits' estimate appears to include costs associated with interconnection
5 issues (*See Pelcovits Direct at 21:7-8*). Thus, his estimate should be reduced by the cost
6 of interconnection negotiations. In any event, relative to all other costs involved with a
7 cable operation and adding voice services and the discounted net revenue expected over
8 10 years, the additional cost associated with a hearing (even if it reaches Dr. Pelcovits'
9 presumed amount of \$100,000) does not present a significant barrier in the ability to
10 provide voice service for most rural areas.

11 **Q: Does the application hearing develop into a rate case?**

12 A: Not necessarily. Dr. Pelcovits does not appear to have participated in a small company
13 rate case. A small company rate case is far different than a non-telecom rate case, such
14 as an electric or gas utility case. Furthermore, the inquiry related to the RSA 374:22-g
15 factors does not need to delve deeply into individual service costs. Instead, it involves a
16 higher level analysis of fixed and common costs as they relate to average revenue per
17 user.

18 Based on my experience and observation of small company reviews, the burden
19 of conducting them need not be onerous. For example, earnings reviews used to
20 determine the distribution of state universal service funds in Nebraska and Colorado are
21 not considered burdensome and do not approach the \$100,000 value set by Dr. Pelcovits
22 for the applicant, whereas I have seen large company rate cases involving electric and gas
23 utilities to far exceed the \$100,000 value, and in some instances a small LEC rate case
24 can exceed this level. (These are applicant costs and not intervenor costs that are
25 generally less). I believe a state commission can review the selected matters addressed in

1 the statute for a RLEC for an intervenor's cost that is less than the \$100,000 amount by
2 Dr. Pelcovits' back of the envelope estimate. I also observe that Dr. Pelcovits does not
3 conclude that a rate case will be required—instead he notes that a rate case may well be
4 required depending on the arguments raised by the rural ILEC. This suggests to me that it
5 may be possible that the Commission can craft a procedure to streamline its review and
6 thereby reduce the burden of a hearing to review the issues identified in the statute.

7 **Q: In her testimony, Ms. Mulholland has stated that it can take 12 to 18 months to**
8 **turn-up services in a new market. In your experience, does this seem like a normal**
9 **timeframe?**

10 A. Each CLEC's circumstances are different. As I previously mentioned, the
11 telecommunications business is infrastructure intensive and it is certainly possible that
12 network deployment could take this long, depending on the CLEC's marketing strategy,
13 its staffing, its finances, the technology of its network and its vendor relationships. In
14 any event, network deployment timeframes are independent of the regulatory process,
15 and are factors that all carriers contend with, regardless of the state commission approval
16 process. Furthermore, for purposes of this proceeding, I doubt the relevance of segTEL's
17 experience as Ms. Mulholland has related it. For example, on page 3 of her testimony,
18 she describes a theoretical process that would be typically be associated with entry into a
19 large ILEC territory, involving a request for network unbundling and a corresponding
20 interconnection arbitration. This is an unlikely scenario in this case, given that the
21 RLECs are subject to the rural exemption of Section 251(f) of the Act, which exempts
22 them from much of the interconnection process described by Ms. Mulholland. Even if
23 Ms. Mulholland is signaling that segTEL would seek to lift this exemption, this is an
24 inquiry that is totally separate from the one in this proceeding.

1 **Q: On page 25 of his testimony, Dr. Pelcovits suggests an alternative to a review, which**
2 **is for the Commission to allow CLEC entry and then stand ready to provide support**
3 **if needed. Do you agree with this approach?**

4 A: No. This sounds like a state universal service fund, only implemented after the RLEC is
5 in a weakened condition. To correctly place the right incentives for all providers in a
6 study area, the option of Section 253(b) or (f) regulation is better than the stand-ready
7 approach. The analogy that comes to mind is placing a reinforced railing at the top of a
8 cliff's edge instead of an ambulance at the bottom of the cliff. Placing 253 regulations in
9 advance of entry will produce behavior that benefits the entire public. Cleaning up after a
10 failure of policy isn't likely to benefit the public as a whole.

11 **Q: Does this conclude your pre-filed rebuttal testimony?**

12 A: Yes.