

Ex. \_\_ (MAW-T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Pricing Proceeding ) DOCKET NO. UT-960369  
for Interconnection, Unbundled )  
Elements, Transport and Termination, )  
and Resale )  
\_\_\_\_\_ )

In the Matter of the Pricing Proceeding ) DOCKET NO. UT-960370  
for Interconnection, Unbundled )  
Elements, Transport and Termination, )  
and Resale for U S WEST )  
COMMUNICATIONS, INC. )  
\_\_\_\_\_ )

In the Matter of the Pricing Proceeding ) DOCKET NO. UT-960371  
for Interconnection, Unbundled )  
Elemetns, Transport and Termination, )  
and Resale for GTE NORTHWEST )  
INCORPORATED )  
\_\_\_\_\_ )

DIRECT TESTIMONY

OF

MICHAEL A. WILLIAMS

March 27, 1997

WUTC DOCKET NO. UT-960369  
EXHIBIT NO. (T) 77  
ADMIT  W/D  REJECT

**GTE NORTHWEST INCORPORATED**

**DIRECT TESTIMONY OF**

**MICHAEL A. WILLIAMS**

**WUTC UT-960369, 960370, 960371**

1       **Q.   PLEASE STATE YOUR FULL NAME AND BUSINESS ADDRESS.**

2       A.   My name is Michael A. Williams. My business address is Two Embarcadero  
3       Center, Suite 1160, San Francisco, CA 94111.

4       **Q.   BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

5       A.   I am employed by Analysis Group Economics as a Vice President.

6       **Q.   PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND BUSINESS  
7       EXPERIENCE.**

8       A.   I received a B.A. in Economics from the University of California, Santa Barbara,  
9       and a M.A. and a Ph.D. in Economics from the University of Chicago. Prior to  
10      joining Analysis Group Economics, I was an economist in the Antitrust Division  
11      of the U.S. Department of Justice. While at the U.S. Department of Justice, I co-  
12      authored comments filed with the Federal Communications Commission, the  
13      Securities and Exchange Commission, the Federal Energy Regulatory  
14      Commission, and the United States Postal Service. I have published articles in  
15      a number of academic journals, including the *Journal of Economics and*  
16      *Management Strategy, Journal of Industrial Economics, Behavioral Science,*

1           *Economics Letters, Antitrust Bulletin, Quarterly Journal of Economics and*  
2           *Business, and the Hume Papers on Public Policy.* While at Analysis Group  
3           Economics, I have co-authored comments filed with the Federal  
4           Communications Commission; testified in arbitration proceedings involving  
5           implementation of the *Telecommunications Act of 1996*; and have consulted in  
6           matters involving competition in markets for long-distance telecommunications  
7           services, spectrum auctions, MFJ waiver requests, and competition in wireless  
8           communications.

9           **Q.   HAVE YOU TESTIFIED BEFORE THIS OR ANY OTHER REGULATORY**  
10           **COMMISSION?**

11          A.   I have testified as an expert witness before state public utility commissions and  
12           arbitration panels in Arkansas, Hawaii, Michigan, Minnesota, Missouri,  
13           Nebraska, Texas, and Washington.

14          **Q.   PLEASE SUMMARIZE YOUR TESTIMONY.**

15          A.   My testimony provides the Commission with: (1) a discussion of general types  
16           of costs that GTE should be allowed to recover; and (2) a brief discussion of  
17           how these costs could be recovered.

18          **Q.   WHAT ARE THE COSTS DEFINITIONS AND ECONOMIC CONCEPTS THAT**  
19           **WILL BE DISCUSSED IN YOUR TESTIMONY?**

20          A.   I will discuss the following:  
21

- 1           1.    *Embedded or Historical:* A regulated firm's embedded costs equal its net  
2           investment, i.e., its original investment costs net of accumulated  
3           depreciation.
- 4           2.    *Stranded:* Stranded costs are defined as the current dollar value of  
5           prudent investments (i.e., the rate base) no longer recoverable because  
6           of competitive entry induced by a policy change.
- 7           3.    *Stand Alone:* The stand-alone cost of a service is the cost of producing  
8           that service by a single-product firm.
- 9           4.    *Cross Subsidy:* A rate structure contains cross subsidies if the revenues  
10          collected from any service or any group of services exceeds the stand-  
11          alone cost of that service or group of services. Equivalently, a rate  
12          structure contains cross subsidies if the revenues collected from any  
13          service or any group of services falls below the incremental cost of that  
14          service or group of services.
- 15          5.    *Total Long-Run, Forward-Looking Costs:* These are the firm's total costs  
16          of operations on a forward-looking basis.

17          **Q.    WILL GTE INCUR STRANDED COSTS AS A RESULT OF THE**  
18          **INTRODUCTION OF LOCAL EXCHANGE COMPETITION?**

19          A.    Yes. Regulated firms and their regulatory agencies operate under a "regulatory  
20          contract" that specifies the terms of a bargain in which (1) the firm accepts an  
21          obligation to serve customers at regulated, "just and reasonable" prices on a  
22          nondiscriminatory basis; and (2) the agency grants a franchise to the firm and

1 ensures that it will have an opportunity to recover its capital investments and  
2 earn a competitive, "fair" return on those investments. The regulatory contract  
3 benefits consumers by ensuring that the regulated firm has an incentive to  
4 undertake costly, irreversible, transaction-specific investments to serve  
5 customers. Regulated firms make investments in assets specifically designed  
6 to serve their customers; these assets would have reduced values in other  
7 uses.<sup>1</sup> In order to induce a firm to invest in such specific assets, regulators must  
8 credibly commit not to act opportunistically by capturing the benefits of the firm's  
9 investments through policy changes. The solution to this problem is the  
10 regulatory contract; it provides the necessary assurance to the regulated firm  
11 to induce it to make investments that will provide services to consumers whom  
12 regulators intend to benefit.

13 The introduction of competition into a previously regulated market can be  
14 problematic. Regulated firms operate subject to obligations not placed on new  
15 entrants. These "incumbent burdens" include:

- 16 • Serving as the supplier of last resort;
- 17 • Charging administratively set rates that contain cross subsidies  
18 among both customer classes and geographic areas; and
- 19 • Operating under regulations that make rate changes costly and  
20 time consuming to implement.

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<sup>1</sup> The degree of an asset's specificity equals "the fraction of [its] value that would be lost if it were excluded from its major use." P. Milgrom and J. Roberts, *ECONOMICS, ORGANIZATION, AND MANAGEMENT* (New York: Prentice Hall, 1992).

1           Given these incumbent burdens, new entrants can selectively target high-  
2 margin customers, thereby undermining the ability of the incumbent firm to meet  
3 its regulatory obligations and denying it the opportunity to earn a fair return on  
4 its invested capital, thus creating stranded costs. Stranded costs are measured  
5 as the difference between (1) the book value of the incumbent local exchange  
6 carrier's rate base and (2) the market value of those investments in the  
7 presence of competitive entry. These stranded costs could be caused by (1)  
8 system-wide rate reductions necessary to meet the new competition and (2)  
9 reduced patronage as subscribers switch from the incumbent to the entrant.

10           If upon the introduction of competition, regulators do not take steps to  
11 prevent incumbent suppliers from being denied the opportunity to recover their  
12 investment costs and earn fair returns on those investments, the regulatory  
13 contract will have been breached. I understand that GTE has articulated a claim  
14 that it has a constitutional right for the recovery of its stranded costs.

15       **Q.    COULD REGULATION CAUSE GTE TO BE UNABLE TO RECOVER ITS**  
16       **TOTAL LONG-RUN, FORWARD-LOOKING COSTS?**

17       **A.**    Yes. In contrast to stranded costs, which by definition represent historical costs,  
18 an incumbent carrier (like GTE) may on a long-run, forward-looking basis also  
19 be unable to recover its total long-run, forward-looking costs. If regulation  
20 mandates that the incumbent local exchange carrier must make investments that  
21 it would not make in a competitive market (e.g., investments with negative net  
22 present values), the carrier may be unable to cover its total long-run, forward-

1 looking costs. This could be caused by, for example, below-cost prices set by  
2 regulatory authorities for unbundled network elements and resale services, as  
3 well as by the entry of alternative local exchange carriers targeting high-margin  
4 customers at a time when the incumbent carrier continues to have the obligation  
5 to serve as carrier of last resort. Thus, even if the firm were allowed to recover  
6 its historical capital costs and earn a fair return on those investments, it may be  
7 unable to cover its total long-run, forward-looking costs if regulation mandates  
8 uneconomic investments that subsidize end-users or alternative local exchange  
9 carriers.

10 **Q. IF THE INCUMBENT LOCAL EXCHANGE CARRIER INCURS STRANDED**  
11 **COSTS OR IF IT CANNOT COVER ITS TOTAL LONG-RUN, FORWARD-**  
12 **LOOKING COSTS, HOW SHOULD THESE COSTS BE RECOVERED?**

13 **A.** These costs should be recovered with a competitively neutral charge, which  
14 could be implemented in a variety of ways. For example, a charge could be  
15 placed on end users, alternative local exchange carriers, or both. The important  
16 point is that the effect of the charge would be pro-competitive in that it would  
17 allow the incumbent local exchange carrier to offer the services demanded by  
18 end users and alternative local exchange carriers. Conversely, the failure to  
19 impose such a charge necessarily would have the anticompetitive result of  
20 preventing the incumbent carrier from offering the services demanded by end  
21 users and alternative local exchange carriers.

1 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

2 A. Yes it does.