

ANDERECK, EVANS, MILNE, PEACE & JOHNSON, L.L.C.

ATTORNEYS AT LAW

EUGENE E. ANDERECK
TERRY M. EVANS
ERWIN L. MILNE
JACK PEACE
CRAIG S. JOHNSON
RODRIC A. WIDGER
GEORGE M. JOHNSON
BEVERLY J. FIGG
WILLIAM S. LEWIS
VICTOR S. SCOTT
COREY K. HERRON

700 EAST CAPITOL AVENUE
COL. DARWIN MARMADUKE HOUSE
P.O. BOX 1438
JEFFERSON CITY, MISSOURI 65102-1438
TELEPHONE 573-634-3422
FAX 573-634-7822

MATTHEW M. KROHN
LANETTE R. GOOCH
SHAWN BATTAGLER
ROB TROWBRIDGE
JOSEPH M. PAGE
LISA C. CHASE
DEIDRE D. JEWEL
JUDITH E. KOEHLER
ANDREW J. SPORLEDER
KELLIE R. NILGES
OF COUNSEL:
MARVIN L. SHARP
PATRICK A. BAUMHOER
GREGORY C. STOCKARD (1904-1993)
PHIL HAUCK (1924-1991)

August 28, 2002

Secretary
Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102-0360

FILED³

AUG 28 2002

Re: Case No. TR-2001-65

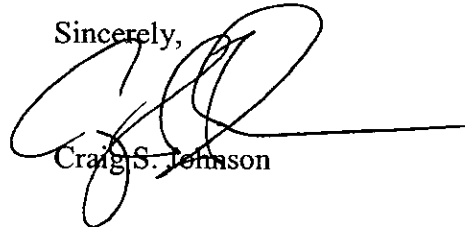
Missouri Public
Service Commission

Dear Sir:

Enclosed please find for filing on behalf of the MITG Companies, an original and eight (8) copies of the Surrebuttal Testimony of Kent Larsen. A copy of this letter and a copy of the enclosed Testimony has been served upon all counsel of record.

Thank you for seeing this filed.

Sincerely,



Craig S. Johnson

CSJ:tr
Enc.

cc: MITG Managers
Kent Larsen
Office of Public Counsel
General Counsel
Thomas R. Parker
James M. Fischer
Mary Ann (Garr) Young
Brian T. McCartney
Carl J. Lumley/Leland B. Curtis

Carol Keith
Paul G. Lane
Sheldon K. Stock
Stephen F. Morris
Paul H. Gardner
Lisa Creighton Hendricks
J. Steve Weber
Rebecca B. DeCook

Trenton Office
9th And Washington
Trenton, Missouri 64683
660-359-2244
Fax 660-359-2116

Springfield Office
1111 S. Glenstone
P.O. Box 4929
Springfield, Missouri 65808
417-864-6401
Fax 417-864-4967

Princeton Office
207 North Washington
Princeton, Missouri 64673
660-748-2244
Fax 660-748-4405

Smithville Office
119 E. Main Street
P.O. Box. 654
Smithville, Missouri 64089
816-532-3895
Fax 816-532-3899

BEFORE THE PUBLIC SERVICE COMMISSION

STATE OF MISSOURI

**In the Matter of an Investigation of the)
Actual Costs Incurred in Providing Exchange)
Access Service and the Access Rates to be)
Charged by Competitive Local Telecommun-)
ications Companies in the State of Missouri.)**

Case No. TR-2001-65

SURREBUTTAL TESTIMONY

of

KENT LARSEN

on behalf of

THE MISSOURI INDEPENDENT TELEPHONE GROUP

August 29, 2002

FILED³

AUG 28 2002

**Missouri Public
Service Commission**

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In the Matter of an Investigation of the)
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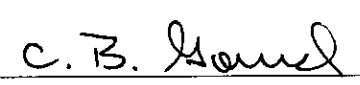
AFFIDAVIT OF KENT LARSEN

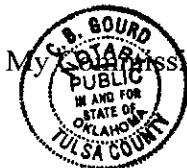
STATE OF OKLAHOMA)
) ss.
COUNTY OF TULSA)

Kent Larsen, of lawful age, on my oath states, that I have participated in the preparation of the foregoing testimony in question and answer form, consisting of _____ pages, to be presented in this case; that the answers in the foregoing testimony were given by me; that I have knowledge of the matters set forth in such answers; and that such matters are true to the best of my knowledge and belief.


Kent Larsen

Subscribed and sworn to before me this 16th day of August, 2002.


Notary Public #02004632



My Commission Expires: 4-23-06

1 **Q. Please state your name and your business address.**

2 A. My name is Kent Larsen and my business address is 1000 Vermont Ave, NW,
3 10th Floor, Washington DC. 20005

4

5 **Q. By whom are you employed and in what capacity?**

6 A. I am a Senior Communications Consultant with Bennet & Bennet, PLLC assisting
7 small and rural LECs in financial and regulatory matters.

8

9 **Q. On whose behalf are you testifying?**

10 A. I am testifying on behalf of the Missouri Independent Telephone Company Group
11 (MITG). The MITG consists of seven rural high cost small Incumbent Local Exchange
12 Carriers (ILECs), being Alma Telephone Company, Chariton Valley Telephone Corp.,
13 Choctaw Telephone Company, Mid-Missouri Telephone Company, MoKan Dial Inc.,
14 Modern Telecommunications Company, and Northeast Missouri Rural Telephone
15 Company.

16

17 **Q. Are you the same Kent Larsen that filed Direct and Rebuttal testimony in**
18 **this docket?**

19 A. Yes

20

21 **Q. What is the purpose of your testimony?**

1 A. The purpose of my testimony is to clarify my position that the Commission must
2 consider “actual” costs, a position addressed by Dr. Johnson in his rebuttal testimony. I
3 will also support portions of the rebuttal testimony of Office of the Public Counsel (OPC)
4 witness Ms. Barbara Meisenheimer, and will challenge portions of the rebuttal testimony
5 of Sprint witness Mr. Brian Staihr. Finally, I will summarize the position of the MITG
6 LECs in this case.

7
8 **Q. In his rebuttal testimony, Staff’s witness Dr. Ben Johnson disagrees with**
9 **your direct testimony that the Commission requires “actual” access costs to be**
10 **evaluated in this case. He apparently believes you mischaracterized his approach**
11 **using Total Service Long Run Incremental Costs (TSLRIC) as non-compliant with**
12 **the Commission’s requirement to evaluate “actual” cost. Did Mr. Johnson correctly**
13 **characterize your concerns with his approach to calculating costs, especially the**
14 **costs of the MITG LECs?**

15 A. No, unfortunately Mr. Johnson misunderstood my concerns. Dr. Johnson
16 questions my concern that “actual” costs are required to be evaluated in this case and that
17 his hypothetical cost analysis is inappropriate. As an initial matter, I agree with his view
18 with respect to hypothetical cost concepts; all of cost accounting is the application of
19 hypothetical concepts attempting to explain a firm’s behavior. I would even agree that the
20 cost standard I prefer, embedded costs allocated by FCC Parts 36 and 69, is also a
21 hypothetical concept of cost. The concept of assigning costs is by nature subjective and

1 the history of cost allocation in the telecommunications industry has always been an effort
2 to support public policy objectives by assigning costs to services.

3 However, as stated in my direct testimony, even assuming the Commission
4 determined that TSLRIC methods constituted the appropriate cost standard for exchange
5 access service in Missouri, Dr. Johnson's calculation of MITG LEC TSLRIC costs does
6 not approach a reasonable standard of "actual" costs. A review of the relevant portion of
7 my direct testimony as cited in part by Dr. Johnson is in order:

8
9 Even if the Commission determined that TSLRIC reflected an appropriate cost
10 standard, TSLRIC costs produced by a model or through any other statistical
11 technique would not qualify as "actual" TSLRIC. Only an examination of an
12 individual carrier's costs can determine what that carrier's actual TSLRIC costs
13 are. A model produces answers that are "merely possible", not actual.
14

15 The point I was making in my direct testimony and the point questioned by Dr. Johnson's
16 rebuttal testimony is this -- if the Commission determined that TSLRIC was the proper
17 cost standard, then a TSLRIC study based upon the actual costs, or at least a reasonable
18 effort at modeling the actual experience of an MITG LEC, is required to meet the "actual"
19 criteria required by the Orders in this case. No matter how Dr. Johnson characterizes his
20 cost calculation, his statistical modeling technique as applied to MITG LECs is
21 inadequate.
22

1 **Q. How are Dr. Johnson's methods inadequate?**

2 A. As I testified in my direct testimony, for each of the types of costs that Dr.
3 Johnson presented; e.g., Stand Alone, TSLRIC, etc., Dr. Johnson started with a statistical
4 technique based upon the costs of Verizon and Sprint to develop MITG, STCG and Alltel
5 ILEC "costs". His statistical approach to identifying each element of an MITG ILEC's
6 cost-- whether used in the Stand Alone or TSLRIC study-- was a hypothetical, simplistic,
7 and unreliable regression technique. I questioned whether his basic statistical approach
8 developing a MITG ILEC's TSLRIC cost produced the MITG ILEC's actual TSLRIC
9 cost. In summary, a calculation of a firm's TSLRIC cost should be grounded in the reality
10 faced by that firm, not an unreliable statistical surrogate calculation based upon another
11 firm's cost or a statistical sample of a group of firm's costs.

12
13 **Q. In your direct testimony and again in your testimony here, you characterized**
14 **Dr. Johnson's use of regression analysis to develop MITG costs as inappropriate**
15 **and unreliable. Has Dr. Johnson presented any additional testimony supporting his**
16 **approach to modeling MITG LEC costs using regression analysis?**

17 A. No. His direct testimony very briefly describes his approach to calculating MITG
18 LEC costs. In his rebuttal testimony, Dr. Johnson does not discuss the statistical
19 reliability of his regression methods at all. No other witness supports Dr. Johnson's
20 statistical approach to calculating MITG costs. Dr. Johnson also ignores his own
21 objectives in this case. On page 25, lines 8 and 9 of his direct testimony, Dr. Johnson

1 states, "In our view, the ability to develop cost estimates on a uniform, consistent basis
2 was imperative in this investigation."

3 I do not believe the methods used to develop the MITG ILECs Stand Alone,
4 TSLRIC, or Average costs were developed consistent with methods used to develop the
5 Stand Alone, TSLRIC and Average costs of Sprint, Verizon or SWBT. In order to
6 develop MITG ILECs Stand Alone, TSLRIC, or Average costs, the actual conditions or
7 actual forward looking costs particular to each carrier should be examined and quantified,
8 not estimated using surrogate costs developed by questionable statistical calculations.
9 Alltel witness Brandon's rebuttal testimony is consistent with this view. Mr. Brandon
10 testifies that Alltel provided costs and data consistent with the data supplied by other
11 larger LECs yet Alltel's cost were developed using the same faulty statistical methods as
12 was used for MITG LECs.

13
14 **Q. In his rebuttal testimony, Dr. Johnson quotes U.S. Court rulings supporting**
15 **his definition of "actual" costs. In what way are these cases relevant to the**
16 **Commission in this case?**

17 A. These quotes are very relevant. Although the context of these cases involved
18 questions concerning the proper calculation of cost for local interconnection¹, the
19 citations Dr. Johnson quotes address whether my "narrow" definition of "actual" costs is

¹ These cases involved local interconnection, not exchange access. The FCC does not use TELRIC or TSLRIC to develop interstate exchange access service costs for MITG LECs.

1 supported by the Courts. Quoting the 8th Circuit Court of Appeals on page 4 of Dr.

2 Johnson's rebuttal testimony:

3 "It is clear from the language of the statute that Congress intended the rates to be
4 "based on the cost...of providing the interconnection or network element, not on
5 the cost some imaginary carrier would incur..." (Citation in original, emphasis
6 added)
7

8 The court said that the FCC may establish TSLRIC or TELRIC as the cost standard for
9 local interconnection instead of embedded or historical cost but the calculation of those
10 TSLRIC or TELRIC costs must be based upon the LECs TSLRIC or TELRIC cost, not an
11 imaginary carrier's cost. My concern is that Dr. Johnson's use of a statistical regression
12 analysis developing the MITG LEC's costs represents the imaginary carrier the 8th Circuit
13 cautioned against. What the Court requires is that a LEC develop *its* unique, actual
14 forward-looking economic cost in support of its TSLRIC pricing. The Court prohibits the
15 imposition of an imaginary carrier's TSLRIC to substitute for the actual TSLRIC of an
16 actual LEC. Finally, and as a point of clarification, Dr. Johnson is correct in stating that
17 concepts like TSLRIC and Stand Alone costs are somewhat hypothetical in nature
18 (Johnson rebuttal, page 2, question at 19-20 and response beginning at 21). However
19 application of a hypothetical concept does not give license to apply that concept to
20 imaginary LEC costs. The Commission is free to apply hypothetical costing concepts to
21 actual LEC costs but must refrain from applying these cost concepts to a hypothetical
22 LEC's cost. Dr. Johnson applied hypothetical concepts to data that does not represent
23 MITG LECs' operations or costs.
24

1 **Q. Dr. Johnson testifies at length supporting the methods he employed to**
2 **calculate the costs of the larger LECs (SWBT, Sprint and Verizon). The larger**
3 **LECs support LRIC as the proper method to allocate exchange access costs yet**
4 **SWBT and Sprint still question Dr. Johnson's methods. Can you comment on the**
5 **differences between the approaches recommended by the larger LECs versus the**
6 **Dr. Johnson's methods?**

7 A. Certainly. Dr. Johnson included elements of the larger LECs' costs *provided by*
8 *the larger LECs* in his allocation methods. While the larger LECs embrace Dr. Johnson's
9 use of LRIC, a careful reading of SWBT and Sprint witnesses' testimony reflects their
10 concern that he did not accurately reflect *their* LRIC costs. I believe the larger LECs
11 concerns are consistent with the 8th Circuit Court's prohibition against the use of
12 imaginary networks Dr. Johnson cited in his rebuttal.

13
14 **Q. Do you share the larger LEC's concerns?**

15 A. Absolutely. While the larger LECs are concerned that Dr. Johnson may have
16 incorrectly stated their costs even after they provided significant input into his processes,
17 I am extremely concerned that Dr. Johnson's use of an unreliable regression technique
18 fails completely to reflect the costs of the MITG LECs. In essence, MITG LEC costs may
19 be "doubly imaginary" in Dr. Johnson's analysis – first in the errors claimed by the larger
20 LECs and then in erroneous reliance on that faulty analysis in the application of
21 regression analysis in the calculation of MITG LEC costs.

1
2 **Q. What would result from the application of LRIC cost concepts to exchange**
3 **access rates?**

4 A. Witnesses for price cap LECs do not believe they would be subject to LRIC-based
5 exchange access rates. Nevertheless, I believe these witnesses support LRIC since they
6 testify that a LRIC-based exchange access service rate would apply to other carriers but
7 not themselves. Rate of return LECs would be faced with significant reductions to their
8 exchange access rates likely requiring increases to local rates. Since rate of return LECs
9 represent a relatively small portion of the Missouri LEC market, even if IXC's were
10 willing or required to pass along such savings, it is unlikely the customers of LECs
11 regulated by rate of return rules would enjoy toll rate reductions sufficient to overcome
12 the local rate increases that may be required to provide the rate of return LECs the
13 opportunity to recover their total costs. A decision to limit CLECs to LRIC-based
14 exchange access rates would likely be appealed as anti-competitive if their primary
15 competition, the price cap LECs, were not regulated under the same scheme.

16
17 **Q. On page 14, lines 17 through 22 of her rebuttal, OPC witness Meisenheimer**
18 **challenges SWBT witness Barch regarding cost causation principles. Do you agree**
19 **with her testimony?**

20 A. Absolutely. Ms. Meisenheimer does a very good job demonstrating the fallacy of
21 the "cost causer" argument. Blanket statements and economic theories that local

1 telecommunications use *alone* causes a loop to be built are not grounded in reality. I agree
2 with Ms. Meisenheimer that many consumers may connect to the PSTN to make only toll
3 calls and make few, if any, local calls. Thus, it is at least arguable that *that* consumer's
4 desire to make toll calls "caused" that consumer's loop to be built.

5
6 Ultimately, determinations of theoretical cost are useful only in support of
7 competing theories of rate design. Since telecommunications is somewhat unique with its
8 high fixed costs, relatively low incremental cost and infinitely small variable cost, carriers
9 are always seeking to assign the fixed cost to other carriers or other carriers' customers by
10 assigning the "blame" of fixed cost causation.

11
12 **Q. Ms. Mesinheimer also describes an IXC's choice to "build or buy" loops. Do**
13 **you agree with this portion (page 13, lines 11 through 21) of her rebuttal testimony?**

14 **A.** Yes. She succinctly identifies the true economics of loop cost in a different and
15 more appropriate light than the "cost causer" theories supplied by various witness in this
16 case. Simply stated, any carrier that believes loops do not have costs can build its own
17 cost-free loops or pay a fair share for their use, regardless of the "cost causer".

18
19 **Q. Sprint witness Staihr discusses a fruit stand pricing scheme, the fallacy of Dr.**
20 **Johnson's "beef and leather" example of joint and common costs, and presents an**
21 **example using television sets, cable service and VCRs in an attempt to dismiss the**

1 **idea that a telecommunications network owner does not incur joint or common cost.**

2 **Can you comment on these illustrations used in his testimony?**

3 A. Yes.

4
5 **THE FRUIT STAND, STAND ALONE VERSUS LRIC COSTS**

6 Mr. Staihr provides a fine analysis of stand-alone and TSLRIC cost analysis and
7 the attendant subsidy issues with his fruit stand analysis. His other examples are a
8 different matter.

9
10 **BEEF AND LEATHER**

11 Mr. Staihr correctly states that it is impossible to separate the production of beef
12 from the production of leather, stating that the input (feed) to one process (beef) is by
13 definition an input into another process (leather). He then states that this is not the case in
14 the production of telecom services. I disagree. It is equally impossible to separate the
15 production of local service (beef) from the production of toll service (leather), both using
16 a loop (feed). The input (loops) to one process (local) is by definition an input into
17 another process (toll).

18
19 **TVs, VCRs AND COMMON COST**

20 Mr. Staihr's analysis using video equipment retail pricing is, at the surface an
21 appealing analogy, but it lacks relevance in this case. Mr. Staihr is mixing retail pricing

1 with production economics. Mr. Staihr' central thesis is that the cost of a cable television
2 service does not carry with it the cost of the television set as a joint cost. That may be true
3 in terms of the retail pricing to consumers but I disagree with his application of the retail
4 pricing of video equipment when the equipment is used as factors in the production of a
5 service. To illustrate my disagreement with his example, I will use the same assets but
6 will demonstrate the economics from a production cost perspective, not a retail pricing
7 perspective.

8 First, one must assume a TV has a limited life and therefore has a "cost" per unit
9 (hour) of viewing time, regardless of the input device (VCR, cable, DVD, etc.) used.
10 Assume a TV owner decides to purchase a pay-per-view (PPV) boxing event then, based
11 upon "demand" from his neighbors, decides to sell seats, or at minimum share the cost, of
12 the event. Now, assuming a *rational* pricing scheme, the TV owner would factor in the
13 number of neighbors that will view the PPV event and his incremental cost (the PPV fee,
14 electricity, the risk of beverage spills resulting in a cleaning bill, etc.) *and* a portion of his
15 fixed or common cost (the TV, the use of his house, normal wear and tear on the sofa)
16 when deciding what to charge each viewer. The neighbors could have watched the PPV
17 on their TVs and would have "used up" some portion of their own TV's lives (and thus
18 incurred their own "stand-alone" cost) but, acting rationally, determine it is cheaper to
19 share the incremental cost of the PPV and share the cost of "using up" their host's TV,
20 sofa, etc. Regardless of the definition of "cost" to the TV owner of either the PPV fee

1 (incremental cost) or the TV (common cost), the total cost to produce the PPV event are
2 quite real to the TV owner. The question is how to equitably distribute all costs.

3 The TV owner could charge slightly more than the pro rata share of the “out of
4 pocket” PPV fee and electricity to cover the total cost of both the PPV fee and the use of
5 the TV, house and sofa. He could also decide to recover only the PPV fee. The latter
6 decision means that, from the TV owner’s perspective, the TV’s cost and the risk of a
7 spilled beverage does not disappear; rather the costs are reallocated as a “hospitality” cost
8 that he internalizes. Regardless of the economic theory of his costs, the cable and power
9 companies demand payment and a portion of the finite life of the TV and sofa are “used
10 up”, thus incurring a real cost to the TV owner.

11 Mr. Staihr, and other advocates of “cost causer” theories, argue that since the TV
12 owner was going to watch the boxing match or even use the TV for other purposes
13 anyway, use of the TV should be free. Others might argue that even the incremental cost
14 of the PPV event becomes a common cost once the TV owner decides to view the PPV
15 event, regardless of his neighbors demand. In other words, he is the cost causer of both
16 the TV and the PPV event and all other viewers get free access to his TV and the boxing
17 match. Both arguments suggest that once a decision to purchase a TV is made for the first
18 use (cause) of the TV, all additional uses are cost-free. They are not.

19 In reality, ignoring copyright law, this is an economically efficient use of the TV
20 and the PPV event. The alternative is for each neighbor to purchase his own subscription
21 to the boxing event, consume some portion of his own TV’s finite life, consume his own

1 electricity and risk spilling his own beverage on his own sofa, in other words each
2 neighbor incurs his own "stand-alone" cost. Whether the TV or PPV fees are costs that
3 are considered fixed, incremental, joint or common, all costs must be recovered. Thus, the
4 TV is in fact a joint or common cost element when used as a factor in the production of a
5 neighborhood PPV event.² Even adopting Mr. Staihr's definitional distinction, at least
6 some portion of the TV's cost is a direct cost in the provision of the PPV event.

7 Mr. Staihr's example of retail pricing applies for video equipment and services
8 but misses the mark when applied to a firm's production decisions. The video equipment
9 he describes is sold at the same price whether for consumption or in the provision of an
10 integrated video viewing service. Notions of joint versus incremental costs are irrelevant

² A decision to internalize common costs, or any costs, may assume a future benefit. The costs do not disappear. The TV owner may determine that a neighbor will host the next PPV event, thus he chooses to internalize some or all of his real costs to insure he is invited to that next event where his neighbor uses up his TV's cost and risks his sofa. On the other hand, if the first TV owner's choice to internalize some or all of his costs results in his neighbors repeatedly taking advantage of his hospitality without reciprocation, the TV owner in this example may determine that his hospitality cost has no future benefit and thus he should either recover his hospitality cost from his neighbors on a per-PPV-event basis or produce less neighborhood PPV events. In either case, his costs are real and must be recovered. If he cannot recover his costs either directly or through some assumed future benefit, he will be less willing to produce the PPV events for the benefit of his neighbors. Assuming both he and his neighbors always want to view PPV events, total neighborhood PPV costs rise as each neighbor provisions and "uses up" his own TV and each neighbor pays for his own individual PPV event. The neighbors cut off from the TV owner's PPV events could then appeal his decision to the neighborhood association, where a ruling could force him to continue to offer PPV events in his home and permit recovery of only the incremental PPV charge, thus prohibiting recovery of his TV and sofa costs. Forced into an irrational cost recovery scheme, the TV owner could decide to use a smaller, black and white TV rather than the big screen he previously provided and offer wooden benches rather than a sofa for seating. The neighborhood is now provided with a less pleasurable viewing experience due to the TV owner's inability to recover his total costs from all users of his investment.

In summary, the neighborhood has three choices – 1) all PPV viewers pay for all costs where a rational allocation of all costs provides maximum pleasure to the most possible neighbors at minimal cost to each viewer, and where all costs are recovered; 2) PPV viewers refuse to share costs, each neighbor pays the "stand-alone" costs for the PPV event and total neighborhood PPV costs are highest; or 3) force the TV-owning neighbor to absorb some of his real costs albeit providing the lowest possible PPV price for his neighbors but discouraging the TV owner's willingness and ultimately ability to provide an optimal viewing

1 when analyzing consumption by end users – these principles only apply when analyzing
2 production decisions.

3
4 LOOPS AS DIRECT, NOT COMMON COSTS

5 Mr. Staihr refutes the contention of many that loop costs are common costs,
6 asserting instead that loops are a “direct cost of connecting to the public switched
7 network”. (Staihr rebuttal, page 16, lines 17-18).³ Regardless of how Mr. Staihr classifies
8 loop costs, it does not appear that Mr. Staihr is advocating that the direct cost of a loop
9 should be recovered from a single class of customer, e.g., local use only. Assuming then
10 that loops are a direct cost to connect to the public network, then loops are a direct cost
11 for local connectivity *and* for connectivity to a toll provider, thus a direct cost of
12 exchange access service.

13 Perhaps this is simply a semantics issue since another Sprint witness, Randy
14 Farrar, asserts in his rebuttal (page 6, lines 18-20) that the FCC’s forward looking cost
15 standard, which he claims is superior⁴, “includes an assignment of directly attributable
16 shared costs and includes a reasonable allocation of common costs.” I can only assume
17 that Sprint’s position is ultimately one that supports its right to recover all of its costs,

experience.

³ I interpret the term “public switched network” to be a description of the interconnected network that is privately owned by carriers, and devoted to public use by customers. Local loops are a portion of this privately owned carrier network. I have some difficulty with his assumption that you can disassociate the network from a portion of its components.

⁴ In my rebuttal testimony and again here, I challenge Sprint witness Farrar’s reliance upon FCC rules that apply to local interconnection, not exchange access. Nevertheless, I cite Mr. Farrar’s testimony here in an attempt to clarify what may be a conflict or perhaps confusing terminology in Sprint’s position in this case.

1 including loop costs, from some mix of rate design applied to all of its customers that use
2 some or all of its network assets, regardless of whether the costs are direct or common,
3 incremental or fixed.

4
5 **Q. Mr. Larsen, please summarize your testimony in this case.**

6 **A.** In response to the concerns expressed by Staff witness Johnson my testimony
7 clarifies that it is inappropriate to use imaginary costs in lieu of actual costs, even if the
8 cost allocation concept is hypothetical, which in fact all cost allocation mechanisms are.
9 Although my testimony, Dr. Johnson's testimony and the testimony of several other
10 witnesses do not support LRIC cost allocation concepts in the development of exchange
11 access service costs, if the Commission decides to apply LRIC-based concepts to such
12 costs, each LEC should develop its LRIC costs based upon its network and circumstance.
13 Use of a statistical surrogate method as used by Dr. Johnson does not meet the standard of
14 the Commission. The Commission should reject any economic theory that assumes the
15 first user of a loop caused the loop to be built and should therefore pay the full cost of the
16 loop. Telecommunications companies and their customers that use a loop for its second
17 or third purpose should pay a proportionate share of its cost. Finally, the Commission
18 should be skeptical of parties that support LRIC as the basis for developing exchange
19 access service costs but would not themselves be subject to LRIC-based exchange access
20 service pricing.