BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale	)	**DOCKET NO. UT-960369**
In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale for U S WEST COMMUNICATIONS, INC.	)	**DOCKET NO. UT-960370**
In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale for GTE NORTHWEST INCORPORATED	)	**DOCKET NO. UT-960371**

DIRECT TESTIMONY OF

TERRY R. DYE

ON BEHALF OF

GTE NORTHWEST INCORPORATED

SUBJECT: PRICING POLICY

DECEMBER 15, 1999

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND TITLE.

A. My name is Terry R. Dye. My business address is 600 Hidden Ridge Drive, Irving, Texas, 75015. I am employed by GTE Service Corporation as Manager - Pricing Policy and am representing GTE Northwest Incorporated ("GTE") in this proceeding.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.

A. I received a Bachelor of Science in Economics in 1977 and a Master of Arts in Economics in 1979, both from the University of Missouri. After graduation I worked for the Missouri Department of Natural Resources, as a Planner, until accepting employment as an Economist with the Missouri Public Service Commission in 1981. Thereupon, I was assigned to the Rates and Tariffs Section of the Communications Department. I was responsible for the review and preparation of testimony, exhibits and cost support data submitted in support of tariff filings and making recommendations based upon that review.

In January 1984, I accepted a position as a Rate Manager in the Economics and Rates Department of the Illinois Commerce Commission. In that capacity, I had general rate design responsibility over telephone utility matters in the Rate Design Section.

I joined Contel Telephone Operations in January 1985 as a Senior Financial Analyst in the Pricing Group of the Revenue Department. I was promoted to Pricing Manager in December 1987.

With the merger of Contel and GTE in 1991, I accepted the position of Rate Design Manager with GTE. From January 1993 to January 1994 I held the position of New Services Manager in the Pricing Department, and then I was assigned to my current position.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE ANY REGULATORY COMMISSIONS?

A. Yes. I have testified on numerous occasions in the area of telecommunications ratemaking and cost methodologies in both Missouri and Illinois. While with Contel, I testified in the states of South Carolina, West Virginia, and New York. Since joining GTE I have testified for GTE Hawaiian Telephone Company and GTE Northwest Incorporated. In addition, I have presented testimony in proceedings related to the Telecommunications Act of 1996 in the states of Pennsylvania, Ohio, Illinois, Indiana, Wisconsin, Michigan, Kentucky, Arkansas, New Mexico and Alabama.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony addresses and presents GTE's deaveraging proposal for unbundled network element (UNE) rates and interconnection rates as requested by the Commission. I also address the public policy implications of deaveraging UNE prices. My testimony explains that UNE prices should not be deaveraged in a vacuum, because they are inextricably linked to retail prices and Universal Service support. Specifically, my testimony illustrates the problems created when wholesale rates are implemented inconsistently with retail rates.

I will also specifically address: (1) the general guidelines that should be adopted for use in future proceedings to appropriately develop deaveraged UNE prices, and (2) the appropriate basis for deaveraging UNE prices.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. My testimony is summarized as follows:

- Based on the record in this case, and the Commission's prior orders, the Commission should only require UNE loop rates to be deaveraged.
- Only three density zones are appropriate based on the current record.
- GTE's deaveraged UNE rates are as follows:

	High Density	Medium Density	Low Density
2-Wire Unbundled Loop	$22.92	$22.49	$30.51
4-wire Unbundled Loop	$34.38	$33.74	$45.77

- However, UNE rates should not be deaveraged until ILECs' retail and access service rates are deaveraged and rebalanced based on the replacement of existing implicit Universal Service support with sufficient explicit support from a competitively neutral Universal Service Fund.
- In the presence of a retail rate structure that contains implicit support for Universal Service, uniform "cost-based" wholesale (i.e. UNE) prices encourage inefficient entry in some markets, while preventing entry

altogether in other markets. Such an environment threatens the viability of Universal Service.

- Competitively neutral UNE prices are required for the Commission to meet the twin goals of (1) maintaining Universal Service and (2) increasing competition in local service markets throughout Washington. Competitive neutrality is best achieved by rebalancing retail rates toward cost, establishing an explicit Universal Service fund to maintain "affordable" rates, and aligning the ILEC's retail and wholesale rate structures.
- Absent retail rate rebalancing and the establishment of an explicit Universal Service fund, competitive neutrality can not be achieved simply by deaveraging current UNE prices. Such an approach is a move in precisely the wrong direction as it serves only to amplify the problems of arbitrage.

Q. DO YOU BELIEVE IT IS POSSIBLE FOR THE COMMISSION TO MAKE *FINAL* DECISIONS ABOUT THE DEGREE AND LEVEL OF UNE DEAVERAGING IN THE ABSENCE OF MORE COMPREHENSIVE AND UP TO DATE COST INFORMATION?

A. No. It is unlikely that the rates established in this phase of the docket will be final since the rates are based on cost studies over three years old. The Commission, however, has clearly indicated its intention to proceed with deaveraging based upon the cost models and the evidence already of record.[1] A further decision will likely

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[1] See, NINETEENTH SUPPLEMENTAL ORDER, in this Docket, page 5. "[T]he Commission clearly contemplates in its 18th ORDER that Phase III will proceed upon the cost models and the evidence

need to be made based on more comprehensive and up-to-date information. Nevertheless, the Commission can establish a set of rates to meet the FCC's requirement (contained in Rule 51.507(f)) to establish different rates in at least three geographic areas. The Commission can also establish the fundamental criteria to be used for deaveraging rates in further proceedings.

Q. AT THIS TIME, PRIOR TO MORE UP-TO-DATE AND COMPREHENSIVE INFORMATION, WHAT DEGREE OF DEAVERAGING DOES GTE PROPOSE?

A. As a starting point, given the constraint to use cost evidence already of record and the fact that the Commission may not have time to simultaneously deaverage retail and wholesale rates, only UNE loops exhibit the cost characterists sufficient for determining deaveraged rates. Therefore, GTE proposes to deaverage UNE loops into the minimum of three separate groups as discussed in the testimony of GTE witness David Tucek. This initial deaveraging proposal is being made, in part, due to the requirement to rely on the cost models and evidence already on record and the limited scope of this current phase of the proceeding.

Q. WHAT SPECIFIC RATES ARE YOU PROPOSING FOR THESE THREE ZONES?

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already of record. Doing so permits an accelerated schedule to implement deaveraged prices in a more timely manner, allows the Commission to come to closure of this proceeding, and does not foreclose the development of new prices in a future proceeding."

A. Based on the ratio of the statewide average costs, noted in the testimony of GTE witness David Tucek, to the unbundled loop rate of $23.94 authorized by this Commission, I calculated an average mark-up for the recovery of common and overhead costs. In addition, I applied a ratio of 1.5 to the deaveraged 2-wire prices to arrive at the deaveraged 4-wire prices, consistent with the Commission's previous decision. Applying these factors to the deaveraged loop costs identified in the testimony Mr. Tucek yields the following proposed unbundled loop rates:

	High Density	Medium Density	Low Density
2-Wire Unbundled Loop	$22.92	$22.49	$30.51
4-wire Unbundled Loop	$34.38	$33.74	$45.77

Q. WHAT GENERAL GUIDELINES SHOULD THE COMMISSION ADOPT FOR USE IN FUTURE PROCEEDINGS TO DEVELOP DEAVERAGED RATE STRUCTURES FOR UNES?

A. The Commission should rely on guidelines that promote deaveraged UNE rates reflecting the following characteristics:

(1) they should be based on variations in the underlying costs to provide the specific UNE.

(2) they should include a reasonable allocation of common cost recovery;

(3) they should be consistent with retail rate structures and levels (*i.e.*, eliminate the uneconomic arbitrage of the ILECs' rate structures);

(4) they should provide the incentive for efficient competitive entry into all geographic markets for all customer sets; and,

(5) they should allow the ILEC an opportunity to recover its actual costs.

Finally, any decision regarding rate deaveraging must weigh the operational costs of deaveraging against the potential consumer gains. GTE proposes that future proposals for deaveraging be reflective of the above guidelines.

Q. WHY ARE ACTUAL COSTS SIGNIFICANT IN DEVELOPING DEAVERAGED PRICES FOR UNES?

A. Section 252(d)(1) of the Act prescribes that the just and reasonable rate of a network element "shall be based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the . . . network element [and] may include a reasonable profit." Obviously, a firm does not have the possibility to make a profit unless it can first recover all of its actual costs. The FCC recognized this fact in paragraph 699 of its *First Report and Order*, where it stated that there can be no profit unless a firm earns at least "the total revenue required to cover all the costs of [the] firm." Therefore, the identification of GTE's actual costs is essential in developing UNE prices under section 252(d)(1) of the Act.

Q. HAS THE WASHINGTON COMMISSION ALREADY ADDRESSED GTE'S ACTUAL COST ARGUMENT?

A. Yes. In its Seventeenth Supplemental Order, the Commission stated its belief that under the FCC's TELRIC pricing rules, it was prohibited from considering an ILEC's actual costs when pricing UNEs. However, as explained in Phase II by GTE witness Kirk Lee, GTE believes that prices based solely on TELRIC pricing violate the Act and the Constitution precisely because they do not allow an ILEC to recover its actual costs. Therefore, GTE continues to believe that in establishing deaveraged UNE prices, the Commission must provide ILECs an opportunity to recover their actual costs.

Q. WHAT OTHER FACTORS SHOULD BE CONSIDERED IN DETERMINING DEAVERAGED UNE RATES?

A. UNE rates should not be deaveraged in a vacuum. The deaveraging guidelines set forth in this testimony depend on the removal of implicit supports from retail rates. Efficient, deaveraged UNE rates must be established at the same time, and to the same extent, that retail rates and Universal Service supports are deaveraged. In order for consumers to benefit from the provision of UNEs to an ILEC's competitor, the Commission's deaveraged UNE prices must also ensure "*competitive neutrality*". When establishing UNE prices, the Commission's deaveraging decisions should not be based solely on estimates of the forward-looking incremental costs.

The FCC recognized this principle when it voluntarily stayed its UNE deaveraging rule until six months after the FCC issues a final order in its Universal

Service Docket, CC Docket No. 96-45, the purpose of which was to implement high-cost Universal Service support for non-rural LECs under section 254 of the Act:

> By linking the duration of the stay to the universal service proceeding, we afford the states and ourselves the opportunity to consider in a coordinated manner the deaveraging issues that are arising in a variety of contexts affecting local competition. We are considering in the universal service proceeding what level of geographic deaveraging to use in determining the universal service support available to non-rural LECs serving high-cost areas. States are confronting similar issues. In addition, in the access charge reform proceeding, we are continuing to assess the application of deaveraging policies to the interstate access rates of incumbent LECs. ***Applying different standards for, or degrees of, geographic deaveraging in different contexts might create arbitrage opportunities or distort entry incentives for new competitors.*** Temporarily staying the effectiveness of section 51.507(f) will afford regulators the opportunity to consider the ramifications of deaveraging for the pricing of unbundled network elements, for universal service support in high-cost areas, and for interstate access services.

(*Stay Order*, CC Docket No. 96-98 (May 7, 1999) (emphasis added)).

GTE agrees that the deaveraging of UNEs is necessarily linked to Universal Service and the promotion of efficient competition. In fact, deaveraging UNEs without removing implicit support from retail rates is the worst possible approach the Commission could pursue in this docket, because it exacerbates the cream-skimming or arbitrage problem that exists today.

Q. CAN YOU EXPLAIN IN MORE DETAIL THE IMPORTANCE OF "*COMPETITIVE NEUTRALITY*"?

A. The challenge before the Commission is to create UNE prices that promote efficient competition while preserving Universal Service. These two goals are inextricably linked. Efficient competition takes place in an environment that is competitively neutral. As discussed in an article by William Baumol [2], a competitively neutral environment "does not favor incumbents in the final-product market over entrants or the reverse."

As the Baumol Article emphasizes, the advantages of competitive neutrality are several:

- Competitively neutral prices ensure that neither the ILEC nor potential competitors are artificially excluded from any retail market. That is, the ILEC and any new competitors are allowed to serve each and every market, to the extent that it is efficient for each firm to do so.

- Competitively neutral prices eliminate the incentives for "cream-skimming" by competitors. That is, a competitor will have no incentive to favor the provision of high-margin (business) services over low-margin (residential) services.

- Competitively neutral prices promote competitive entry while preserving "affordable" rates to preferred customer classes.

In sum, only by establishing competitively neutral UNE prices can the Commission meet the twin goals of (1) maintaining Universal Service and (2) increasing competition in local service markets throughout Washington.

Q. HAS THE CONCERN OVER COMPETITIVE NEUTRALITY BEEN PREVIOUSLY RECOGNIZED IN WASHINGTON?

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[2]See William J. Baumol, *Having Your Cake: How to Preserve Universal-Service Cross Subsidies While Facilitating Competitive Entry*, YALE JOURNAL ON REGULATION, VOLUME 16, 1999, at p. 3. ("Baumol Article"). (Attached as Exhibit TRD-1)

A. Yes. During Phase II of this proceeding, Commissioner Hemstad recognized a potential "market misallocation" if UNEs were deaveraged but retail rates remained averaged: "[I]f the loop cost is deaveraged, but the ILEC must price retail services at an average, the CLEC will have a substantial opportunity for easy entry under the higher-priced umbrella for the retail price of the loop in urban areas." Tr. 2007-2008 (Statement of Commissioner Hemstad).

Q. WHAT ARE SOME OF THE PROBLEMS THAT ARISE WHEN DEAVERAGING OF WHOLESALE SERVICES OCCURS WITHOUT COMPETITIVE NEUTRALITY?

A. The particular failings of this approach are (1) it induces entrants to “cream-skim” profitable customers from the ILEC while simultaneously preventing them from offering service to subsidized customers, and (2) it does not permit an ILEC to recover its total *forward-looking incremental costs* upon which the Commission relied to develop UNE rates, much less its actual costs. To see why this is so, consider the following Table:

TABLE ONE
CLECS ARBITRAGE OPPORTUNITY
UNDER EXISTING AVERAGE UNE PRICES

	Residence			Business		
Service	UNE Price	Resale	Retail	UNE Price	Resale	Retail
Loop	$23.94	$12.10	$13.46	$23.94	$36.06	$40.11
Port	$1.29			$1.29		
Local Usage	$1.26	$0.22	$0.24	$1.26	$0.44	$0.49
SLC		$3.43	$3.43		$5.62	$5.62
Vertical		$2.67	$2.97		$0.97	$1.08
Toll	$0.27	$5.58	$6.21	$0.25	$5.44	$6.05
Intrastate Access	$0.56	$6.73	$6.73	$0.93	$11.29	$11.29
Interstate Access	$0.96	$8.10	$8.10	$1.60	$13.59	$13.59
Total Per Line	$28.28	$38.83	$41.14	$29.27	$73.41	$78.23
Arbitrage/Line/Month	$10.55			$44.14		
Lines	583,686			193,615		
Total Monthly Arbitrage	$6,157,887			$8,548,387		

This Table presents the various alternative prices for virtually the same services supplied to the average residential and business customers. As is the case in most states, and Washington is no exception, the retail rates for these services contain implicit Universal Service support, and are thus not based solely on forward-looking incremental costs. Consequently, the resale rate, which is defined as the retail rate minus the avoided cost of retailing, also includes the underlying implicit support. When UNE prices are set so that competitive local exchange carriers ("CLECs") seeking to provide these services can lease the UNEs of the ILEC at prices allegedly equal to their "cost-based" rates, it is plain to see that market entry via the use of UNEs is biased in favor of the business customers.

"Cost-based" UNE prices, in combination with resale prices that are not based on cost, create an arbitrage opportunity that prevents the ILEC from recovering even its alleged total forward-looking incremental costs. (Of course, the more relevant concern is whether the ILEC can recover its total actual costs, because in the absence of meeting this objective, telecommunication services could not be provided.) Because the Table provides a view of the average customers, and since the provision of service through UNEs theoretically just recovers forward-looking incremental costs and the provision of services through resale will fail to cover forward-looking incremental costs for some customers, the ILEC cannot recover its total forward-looking incremental costs. Thus, if the Commission's goal is to establish UNE prices which permit recovery of forward-looking costs, cost-based UNE prices in combination with resale prices that are not cost-based will fail to meet this objective.

Q. SOME CLECS HAVE ARGUED THAT UNE PRICES SHOULD BE "DEAVERAGED" BEFORE THE ILEC IS PERMITTED TO REBALANCE RATES. DO YOU AGREE?

A. No. Such a proposal would be detrimental to competition and the goal of providing Universal Service because it would fail to satisfy the principle of competitive neutrality. In fact, deaveraging wholesale rates, without simultaneously deaveraging retail rates, would be a move in *precisely the wrong direction* because it would simply amplify the problems created by uniform UNE prices. That is, it would allow entrants an even *greater* opportunity to cream-skim those customers currently providing Universal Service support, while ensuring the ILEC would remain the single source of supply to customers located in high-cost areas who currently receive implicit support.

Q. HAVE PREVIOUS ADVOCATES OF UNIFORM TELRIC PRICING RECOGNIZED THE NEED TO CONSIDER THE ILEC'S RETAIL RATE STRUCTURE WHEN ESTABLISHING UNE RATES?

A. Yes. The Baumol Article presents a methodology for establishing competitively neutral prices for accessing those network elements considered to be bottleneck facilities. The system of non-uniform or differential access prices he recommends takes into account the incumbent provider's retail rate structure.

This is an important observation because the FCC and others have relied on an earlier affidavit co-authored by Professor Baumol in which he stated that "the appropriate forward-looking benchmark for pricing [UNEs] is total service long run incremental cost, or TSLRIC." (See Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig ¶ 3, at 2, Implementation of the Local Competition Provisions in the Telecomms. Act of 1996, 11 F.C.C.R. 15,499 (1996) (No. 96-98).) Following both the filing of this affidavit and the release of the FCC's First Report and Order, it became industry practice to use the term "TSLRIC" to refer to the long-run incremental cost of a service and "TELRIC" to refer to the long-run incremental cost of a particular network element. In his recent article, Professor Baumol demonstrates, using what he refers to as "The Level Playing Field Theorem," that uniform TELRIC UNE prices are not competitively neutral and, if adopted, will undermine productivity and efficiency by enabling less efficient firms to undercut suppliers that are more efficient in their use of resources. When retail rate structures contain support for Universal Service, Professor Baumol states "to calculate the efficient price of a bottleneck service one need merely observe the final-product price currently charged by the owner of the bottleneck facility, and subtract from it the pertinent incremental cost." (Baumol Article, p. 7).

Q. YOU STATED THAT DEAVERAGING UNE RATES, WITHOUT SIMULTANEOUSLY DEAVERAGING RETAIL RATES, WOULD IMPEDE ENTRY INTO SERVICES NOW RECEIVING UNIVERSAL SERVICE SUPPORT. DO CLECS HAVE THE OPPORTUNITY TO SERVE THOSE CUSTOMERS IF THEY ARE ALLOWED TO DRAW SUPPORT FROM THE UNIVERSAL SERVICE FUND?

A. Yes, but this adjustment alone does not solve the problem. It is not surprising that those CLECs that advocate the deaveraging of UNE rates also advocate the need to draw from the Universal Service fund in order to serve those customers receiving implicit support (e.g., residential customers with little or no usage, see Table One above). However, they fail to mention the effect their proposal would have on the *sources* of Universal Service funding. Like a coin, the provision of Universal Service has two sides: there are *providers* of support and there are *recipients* of support. For CLECS, the deaveraging of UNE rates, before rate rebalancing occurs, combined with the opportunity to draw from the USF, is a "heads I win" and "tails you lose" proposal. Unfortunately, the "you" in this proposal is the consumer who is denied the true benefits of competition and, ultimately, the preservation of Universal Service.

Q. WHAT APPROACH ARE YOU RECOMMENDING TO MITIGATE THE PROBLEMS DISCUSSED ABOVE?

A. The preferred solution would involve the simultaneous deaveraging of both retail and wholesale rates. The deaveraging of retail rates would take into account both cost and demand characteristics. The benefits of this approach are threefold: (1) enhance allocative efficiency in the pricing of retail services; (2) ensure competitive neutrality; and (3) promote competitive entry in all service markets to the benefit of Washington consumers. If the resulting retail prices for services that fall within the definition of Universal Service are deemed to be "unaffordable" or unacceptable, then the Commission should advocate the establishment of a fully sufficient, explicit, and *portable* Universal Service support mechanism.

As a second-best approach, if the Commission believes it does not have the time or the statutory authority to take the steps outlined above, then GTE proposes that the Commission seek a waiver from the FCC's deaveraging rule until the Commission can address all relevant issues simultaneously. This proposal does nothing, however, to eliminate the problem of the facilities-based redlining discussed above or to correct market price signals for competition in the interim.

If however, the Commission decides it must deaverage UNEs now, without correspondingly deaveraging and rebalancing retail rates to remove the implicit

Universal Service support, then GTE proposes a minimal level of deaveraged wholesale rates to avoid further distortions in the market.

Q. PLEASE CONCLUDE AND SUMMARIZE YOUR TESTIMONY.

A. The issues being investigated in this docket are vitally important, as they affect the nature and scope of all future competition for local telecommunications services throughout the state of Washington. Done correctly, the establishment of appropriate prices for UNEs will satisfy the requirements of the Telecommunications Act of 1996 and will promote full and effective competition to the benefit of all consumers. Done incorrectly, however, UNE pricing will create an environment in which certain markets for local services would be characterized by arbitrage and inefficient entry, while other markets would see competitive entry prevented altogether.

In order to avoid this undesirable latter outcome, the Commission should keep paramount in its considerations the policy goal of establishing and preserving "competitive neutrality." Competitive neutrality is achieved when UNE prices provide entrants and incumbents an equal opportunity to compete. This environment offers full access to all efficient suppliers in each and every market, and allows pervasive competition to coexist with the provision of Universal Service at rates deemed to be in the social interest.

Competitive neutrality is best achieved by a regulatory environment in which all prices (retail and wholesale) are in line with costs after taking into account demand conditions. This solution, of course, requires the rebalancing of retail rates to eliminate the implicit support for Universal Service that currently pervades these rate structures.

If the Commission believes it does not have the authority to implement a comprehensive deaveraging strategy at this point, it should seek a waiver of the FCC's deaveraging rule until it can address all relevant issues simultaneously. If the Commission instead wishes to proceed with UNE deaveraging now, the Commission should adopt the rate levels I have proposed in my testimony.

When the Commission does a more comprehensive deaveraging of UNE prices, it should do so only where the geographic variation in the cost of providing a particular UNE is great enough to warrant a deaveraged price. That is, the consumer benefits generated by deaveraging should outweigh the costs of maintaining the deaveraged pricing. Under this criterion, I believe that in Washington only loops exhibit the cost and market characteristics that would make deaveraging appropriate. A more definite answer to the unbundling question will be possible only after review of more comprehensive and updated information.

Q. DOES THIS COMPLETE YOUR DIRECT TESTIMONY?

A. Yes.