

Before the  
**WASHINGTON UTILITIES  
AND TRANSPORTATION COMMISSION**

AT&T Communications of the Pacific  
Northwest v. Verizon Northwest, Inc.

**Docket No. UT-020406**

Direct Testimony

of

**LEE L. SELWYN**

on behalf of

AT&T Communications of the  
Pacific Northwest, Inc.

September 30, 2002

ALLEGEDLY PROPRIETARY DATA  
HAS BEEN DELETED

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INTRODUCTION

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**Qualifications**

Q. Please state your name, position and business address.

A. My name is Lee L. Selwyn. I am President of Economics and Technology, Inc. (“ETI”), Two Center Plaza, Boston, Massachusetts 02108. Economics and Technology, Inc. is a research and consulting firm specializing in telecommunications economics, regulation, management and public policy.

Q. Please summarize your educational background and previous experience in the field of telecommunications regulation and policy.

A. I have prepared a Statement of Qualifications, which is attached hereto as Attachment 1.

Q. Dr. Selwyn, have you previously testified before the Washington Utilities and Transportation Commission (“WUTC” or “Commission”)?

A. Yes. I have testified before the WUTC on a number of occasions dating back to the late 1970s. In April, 1978, I submitted testimony on behalf of the Boeing Company and Sears, Roebuck and Company in Dockets U-77-50, U-77-51, and U-77-52. In November 1982, I submitted testimony before the Commission on behalf of the Tele-Communications Association (TCA) in Docket U-82-19 concerning the transfer of Pacific Northwest Bell

1 assets and personnel to AT&T as part of the Plan of Reorganization arising out of the break-  
2 up of the former Bell System, and appropriate pricing of terminal equipment. In September,  
3 1988, I submitted two pieces of written testimony to the Commission in Docket U-88-2052-  
4 P regarding the competitive classification of certain of Pacific Northwest Bell's services.  
5 My testimony on behalf of Public Counsel in that case addressed competitive classification  
6 of Pacific Northwest Bell's intraLATA toll services, while my testimony on behalf of  
7 Telecommunications Ratepayers Association for Cost-based and Equitable Rates  
8 (TRACER) and the State of Washington Department of Information Services addressed  
9 competitive classification of Pacific Northwest Bell's private line services. In January 1990,  
10 I submitted testimony on behalf of TRACER, Public Counsel, and the State of Washington  
11 Department of Information Services in Docket U-89-3031-P regarding GTE-Northwest's  
12 proposal for alternative regulation. I also submitted testimony on behalf of TRACER in  
13 June 1993, Dockets U-89-2698-F and U-89-3245-P proposing a "Modified Incentive  
14 Regulation Plan" for US West Communications (USWC). On April 17, 1995, I submitted  
15 direct and supplemental testimony on behalf of the Staff of the Washington Utilities and  
16 Transportation Commission in Dockets UT-941464, UT-941465, UT-950-0146 and UT  
17 950265, regarding the cost studies filed by US West in support of its proposed local trans-  
18 port restructure and expanded interconnection tariffs. On August 11, 1995, I submitted  
19 testimony in Docket UT-950200 on behalf of the Staff of the Washington Utilities and  
20 Transportation Commission concerning US West's request for an increase in its rates and  
21 charges. On October 31, 1997, I offered testimony in Docket UT-961638 on behalf of  
22 Public Counsel and TRACER in response to US West's request to be relieved of its obliga-  
23 tion to serve. On March 4 and June 28, 1999 I sponsored responsive and surrebuttal  
24 testimony, respectively, in Docket UT-980948 on behalf of WUTC Staff regarding US

1 West's petition and accompanying testimony seeking to end the imputation of "yellow  
2 pages" directory advertising revenues to its Washington regulated telephone operations. An  
3 affidavit that I prepared, dated March 28, 2002, was submitted by AT&T in support of its  
4 petition in the current proceeding.

5

6 In addition to the aforementioned appearances, ETI has served as a consultant to the  
7 Commission and has submitted other filings and reports to the Commission. In October,  
8 1984, ETI prepared a comprehensive evaluation of Local Measured Service (LMS), *A Multi-  
9 Part Study of Local Measured Service*, for the WUTC. In 1985, I was co-author, along with  
10 Patricia D. Kravtin and Nancy J. Wheatley of ETI, of Reply Comments of the U.S. Depart-  
11 ment of Energy, Richland Operations Office, regarding cost of service issues bearing on the  
12 regulation of telecommunications companies. These Reply Comments were submitted to  
13 the Commission in November of that year. In 1987, ETI was engaged by the Commission to  
14 undertake an examination of the outside plant construction and utilization practices of US  
15 West Communications and to present recommendations based on that investigation. The  
16 final report arising from that assignment, *An Analysis of the Outside Plant Provisioning and  
17 Utilization Practices of US West Communications in the State of Washington*, was submitted  
18 to the Commission in March 1990. I was co-author of that report, along with Patricia D.  
19 Kravtin and Paul S. Keller of ETI.

20

1 **Assignment**

2

3 Q. What is the purpose of your testimony?

4

5 A. I have been asked by AT&T Communications of the Pacific Northwest, Inc. (“AT&T”) to  
6 analyze and provide an opinion as to the reasonableness of Verizon Northwest’s (“Verizon”  
7 or “the Company”) intrastate access charges, and to examine those access charges along  
8 with Verizon’s existing retail toll rates for the purpose of determining whether Verizon  
9 Northwest’s current rate structure satisfies the Commission’s access charge imputation  
10 requirements.

11

12 **Summary of Testimony**

13

14 Q. Dr. Selwyn, please summarize your testimony.

15

16 A. My testimony addresses three fundamental concerns with respect to Verizon Northwest’s  
17 intrastate switched access rates:

18

19 • First, Verizon Northwest’s intrastate switched access rates are set far above cost — in  
20 fact, at many times their actual costs.

21

22 • Second, Verizon’s excessively priced switched access rates diminish competition for  
23 toll services by creating a price squeeze on other toll carriers who are required to

1 purchase the overpriced bottleneck switched access services from Verizon in order to  
2 provide toll service to end users.

- 3
- 4 • Finally, as if oblivious to the excessive intrastate switched access prices that the  
5 Company imposes upon its competitors, in setting its own retail rates Verizon  
6 Northwest and Verizon Long Distance (its Section 272 long distance affiliate) ignore  
7 this Commission's imputation standards by offering retail intrastate toll rates at levels  
8 that are well below the imputed price floor for such service.

9

10 This testimony provides an update to the imputation calculation presented in my March 28,  
11 2002 affidavit, based upon additional information provided through discovery that was not  
12 available to me at the time that my earlier affidavit was being prepared. My revised calcu-  
13 lations continue to support my original conclusion that several Verizon retail toll pricing  
14 plans fail imputation, thereby placing IXCs at a serious competitive disadvantage vis-a-vis  
15 Verizon Northwest in the intrastate toll services market.

16

17 In order to ensure the continued development of competition in the Washington intrastate  
18 toll market and prevent competitive toll carriers from being squeezed out of that market, the  
19 Commission should require Verizon to lower intrastate switched access prices to levels that  
20 will ensure that Verizon's existing retail toll rates satisfy the access charge imputation  
21 requirement. Although the Commission could eliminate the price squeeze by requiring  
22 Verizon to raise retail toll rates to a level at or above the imputation floor, reducing switched  
23 access charges to cost is clearly the preferable approach, since it will result in more compe-



1           tition, lower intrastate toll rates overall, minimize the potential for anticompetitive cross-  
2           subsidization of other services, and will bring retail end user prices much closer to cost.

## 1 VERIZON NORTHWEST'S INTRASTATE ACCESS CHARGES

2

3 **Verizon Northwest's intrastate switched access rates are set at extraordinary multiples of**  
4 **cost, the continuation of which provides a competitive advantage for Verizon to the**  
5 **detriment of its toll service competitors.**  
6

7 Q. What are Verizon Northwest's current intrastate switched access rates?

8

9 A. I have calculated Verizon Northwest's tariffed intrastate switched access rates to be \$0.0614  
10 per originating minute and \$0.0375 per terminating minute.<sup>1</sup> These prices include all  
11 common line, local switching, tandem switched transport, information surcharge, USF and  
12 residual charges as they apply to interexchange carriers ("IXCs") seeking to provide intra-  
13 state toll service in Washington for calls originating and/or terminating in Verizon  
14 Northwest's service territory. Thus, for an intrastate toll call that both originates from and  
15 terminates to Verizon Northwest local exchange service subscribers, the total switched  
16 access charge would be \$0.0989.

17

18 Q. Do these rates differ from the rates you provided in your March 28, 2002 affidavit that  
19 accompanied the AT&T Complaint?

20

21 A. Yes. In response to Staff Data Request No. 7, Verizon provided confidential copies of  
22 recent toll rate imputation studies filed with the Commission for a variety of currently-

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1. WN U-16, Verizon Northwest Inc., Facilities for Intrastate Access, Section 4, 4<sup>th</sup> revised sheet 343, 1<sup>st</sup> revised sheet 343.A, 3<sup>rd</sup> revised sheet 344, 10<sup>th</sup> revised sheet 346, and Section 12.5, 6<sup>th</sup> revised sheet 560 and 1<sup>st</sup> revised sheet 561, all of which are effective December 13, 2001; Verizon Northwest Response to Staff Data Request No. 7, Attachment D.

1 offered Verizon Northwest intrastate toll service offerings.<sup>2</sup> I have made slight modifica-  
2 tions to my calculation of Verizon's intrastate switched access rates to reflect information  
3 contained within these studies that was not available to me at the time my March 28, 2002  
4 affidavit was being prepared. I have made the following adjustments, each of which is  
5 consistent with Verizon's analysis:

- 6
- 7 • In lieu of my conservative use of the Zone 1 originating CCL rate, I have adopted  
8 the use of the Verizon-calculated weighted average originating Carrier Common  
9 Line (CCL) charge.
  - 10
  - 11 • I applied Verizon's "universal service recovery charge" of \$0.00152 per minute to  
12 both originating and terminating minutes.
  - 13
  - 14 • I increased the length of the Tandem Switching Facility from 8 miles to 10 miles.
  - 15
  - 16 • I employed an "Access to Toll Conversion Factor" to the originating minute of use  
17 calculation.

18

19 As a result of these modification, my calculation of the originating and terminating Verizon  
20 intrastate access rates more closely matches the average rates paid by IXCs.

21

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2. Verizon's most recent imputation analysis filed with the Commission was conducted in March, 2000. *See*, Verizon response to Staff Data Request No. 7, Confidential Attachment D, page 2 ("the *Verizon Imputation Study*").

1 Q. Are Verizon Northwest's switched access charges set at levels that will permit other inter-  
2 exchange carriers to compete with Verizon Northwest for the provision of toll services in  
3 Washington?

4

5 A. No, they are not. As a wholesale service, switched access should be priced at forward-  
6 looking economic cost, including a reasonable allocation of forward-looking joint and  
7 common costs and a "competitive return" on investment. Setting switched access prices in  
8 excess of cost forces retail long distance prices to be set at above-cost levels, which has the  
9 effect of suppressing consumer demand for the service and diminishing competition overall.  
10 In addition, to the extent that the provider of switched access service — Verizon Northwest  
11 and its affiliate Verizon Long Distance — is itself also a provider of retail toll services *in*  
12 *competition with the purchasers of its switched access services*, setting those access charges  
13 in excess of actual cost provides Verizon with a formidable competitive advantage, in that it  
14 *has the ability* to set its retail price at a level that is profitable to Verizon but unprofitable to  
15 its competitors, because when the overpriced access services are included in competitors'  
16 costs — which they must be — the competing providers would be forced to set their own  
17 retail price *below their cost* in order to attract retail customers to their services.

18

19 Q. What has been the effect of the 1996 federal *Telecommunications Act* upon the pricing of  
20 switched access services?

21

22 A. Historically, above-cost pricing of switched access was a device that had been used by  
23 ILECs and sanctioned by regulators as a means for providing an *implicit subsidy* to basic  
24 local exchange service. However, the 1996 federal *Telecommunications Act* prohibits

1 implicit subsidies,<sup>3</sup> a prohibition that has recently been upheld with respect to access charges  
2 by the Fifth Circuit Court of Appeals.<sup>4</sup> Maintaining switched access charges above cost-  
3 based levels means that some subsidy still remains.<sup>5</sup> Although the Commission has pursued  
4 access charge rate restructuring for ILECs operating in Washington,<sup>6</sup> the rate restructuring  
5 has not yet accomplished a rate reduction to cost-based levels.

6  
7 Q. Is there any context in which the Commission has set cost-based rates for services that  
8 closely resemble the functions provided by switched access services?

9  
10 A. Yes. In Docket No. UT-960369,<sup>7</sup> a case involving rates for *local* interconnection,  
11 unbundled network elements, local transport and termination, and local service resale, the  
12 Commission set rates for Verizon's local switching and transport functions that it

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3. Section 254(e) of the Telecommunications Act of 1996 (47 U.S.C. § 254(e)) *requires* that all subsidies be made explicit, and that prices for telecommunications services be just, reasonable and cost-based.

4. *COMSAT Corp. v. FCC*, 250 F.3d 931 (5<sup>th</sup> Cir. 2001).

5. If earnings without inclusion of the access charge markup exceed the Company's authorized rate of return, then even the myth that access charges are used to subsidize basic service would need to be replaced by the reality that access charges are used solely to increase ILEC profits. *See, e.g., Petition for Investigation into the Cost of Universal Service and to Reform Intrastate Carrier Access Charges*, WUTC Docket No. UT-970325, Comments of AT&T Communications of the Pacific Northwest, Inc., April 8, 1998.

6. *Washington Utilities and Transportation Commission, Complainant, v. U S West Communications, Inc., Respondent*, WUTC Docket No. UT-941464, October 31, 1995, at 82.

7. *See generally, Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale*, WUTC Docket No. UT-960369.

1 determined to be cost-based.<sup>8</sup> Local switching , tandem and transport functions furnished to  
2 CLECs for transport and termination of CLEC-originated traffic involve *exactly the same*  
3 *functionality as the switched access services that Verizon provides to IXCs*. In fact, in its  
4 *First Interconnection Order*, the FCC expressly recognized “that transport and termination  
5 of traffic, whether it originates locally or from a distant exchange, *involves the same*  
6 *network functions*.”<sup>9</sup>

7  
8 Q. If the transport and termination of traffic for local and long distance calls involves the same  
9 network functions, is there any economic basis for pricing them very differently?

10  
11 A. No. Where costs are the same, the rates for providing these identical services should also be  
12 the same. The Commission’s cost-based UNE rates for Verizon’s local switching and  
13 common transport are \$0.0014151 per minute and \$0.0002012 per minute, respectively;<sup>10</sup>  
14 thus, on the basis of those cost-based UNE rates as determined by the Commission,  
15 Verizon’s cost to provide switched access service is also \$0.0016163 per minute at each end  
16 of the call, or \$0.0032326 per minute<sup>11</sup> if the call originates from and terminates to a

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8. Cost-based rates include an allocation of joint and common costs, and permit a fair return on the carrier’s investment.

9. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, released August 8, 1996, 11 FCC Rcd 15499 (“*First Interconnection Order*”), at para. 1033, emphasis supplied.

10. WN U-21, GTE Northwest Incorporated, Unbundled Network Elements, Section 4, original sheet 6, effective December 15, 2000.

11. In providing switched access, Verizon might also incur a cost for tandem switching. However, no such rate has been adopted by Verizon in its UNE tariffs. *See Id.* If one were to  
(continued...)

- 1 Verizon local exchange service customer.<sup>12</sup> On that basis, Verizon's \$0.0989 intrastate  
2 switched access rate is set at a multiple of more than 30 times the cost of this service.<sup>13</sup>  
3
- 4 Q. Is there any other service that provides functionality similar to switched access for which  
5 Verizon's prices are set based upon costs?  
6
- 7 A. Yes. Verizon also exchanges traffic with Commercial Mobile Radio Service ("CMRS")  
8 carriers including its own affiliate, Verizon Wireless, under a reciprocal compensation  
9 arrangement that is similar, but not identical, to that applicable to ILEC/CLEC traffic.<sup>14</sup> In  
10 the FCC's *First Interconnection Order*, CMRS providers were designated as "telecom-

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11. (...continued)

assume that the Commission had found Verizon's cost-based rate for tandem switching to be identical to Qwest's, then Verizon would incur an additional \$0.00141 per minute per end for tandem switching. *See* WN U-42, Qwest Corporation, Interconnection Services, section 3, original sheet 3, effective December 2, 2000. A two-ended call originating and terminating to a Verizon local exchange service customer would thus increase to \$0.0060526.

12. It is my understanding that this Commission has not yet established rates for reciprocal compensation for terminating local exchange traffic, and that such compensation is negotiated between carriers and set forth in their interconnection agreements. However, counsel has advised me that current reciprocal compensation charges between Verizon Northwest and other carriers do not exceed \$0.0053157 per minute, thus making Verizon's switched access charges about 7 times higher than termination charges for local traffic. *See* AT&T Complaint.

13.  $(\$0.0989 \div \$0.0032326) = 30.59$ . If one includes the estimate for tandem switching as described in footnote 11 above, then Verizon's switched access rates are set at more than 16 times the cost for this service.

14. It is my understanding that the Commission has not yet established per-MOU rates for reciprocal compensation for terminating local exchange traffic, and that such compensation is negotiated between carriers and set forth in their interconnection agreements.

1       munications carriers” as that term is defined at 47 U.S.C. § 153(44).<sup>15</sup> As such, the FCC  
2       determined that CMRS providers are eligible to receive reciprocal compensation payments  
3       for the transport and termination of traffic handed off to them by LECs and to compensate  
4       LEC on that same basis for CMRS-originated traffic handed-off to LECs for termination.<sup>16</sup>  
5       However, in designating the *type* of traffic interchanged between a LEC and a CMRS  
6       provider that would be subject to reciprocal compensation, the FCC defined the CMRS  
7       “local calling area” for reciprocal compensation purposes to be the so-called “Major Trading  
8       Area” (“MTA”),<sup>17</sup> the geographic area adopted by the FCC as the territory covered by  
9       individual PCS licenses.<sup>18</sup> Specifically, the FCC concluded that “traffic to or from a CMRS  
10       network that originates and terminates within the same MTA is subject to transport and  
11       termination rates under section 251(b)(5), rather than interstate or intrastate access  
12       charges.”<sup>19</sup> As a general matter, MTAs are substantially larger than a typical ILEC local  
13       calling area. For example, most of Washington State is divided into only two MTAs. The  
14       western Washington MTA covers roughly two-thirds of the state, and is larger than the

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15. *First Interconnection Order*, 11 FCC Rcd 15499, at para. 993.

16. *Id.*, at para. 1008.

17. *Id.*, at para. 1036.

18. *Implementation of Sections 3(n) and 332 of the Communications Act; Regulatory Treatment of Mobile Services Amendment of Part 90 of the Commission's Rules To Facilitate Future Development of SMR Systems in the 800 MHz Frequency Band Amendment of Parts 2 and 90 of the Commission's Rules To Provide for the Use of 200 Channels Outside the Designated Filing Areas in the 896-901 MHz and 935-940 MHz Band Allotted to the Specialized Mobile Radio Pool*, GN Docket No. 93-252; PR Docket No. 93-144; PR Docket No. 89-553, *Third Report and Order*, FCC 94-212, 9 FCC Rcd 7988, Released September 23, 1994; Adopted August 9, 1994.

19. *First Interconnection Order*, at para. 1036.



1 Seattle LATA. The eastern MTA covers the eastern one-third of Washington along with the  
2 Idaho panhandle, portions of Wyoming, and all of Montana. A portion of the Portland,  
3 Oregon MTA spills over into the southwestern corner of the state, covering Vancouver and  
4 Longview and smaller communities on the Washington side of the Columbia River.<sup>20</sup>

5 Washington MTAs cover intrastate distances of up to about 200 miles and, in the case of the  
6 Spokane MTA, interstate distances of as much as 600 miles.

7  
8 In the case of traffic exchanged between ILECs and CLECs, reciprocal compensation  
9 applies for calls that are rated as *local*,<sup>21</sup> calls rated as *toll*, while physically processed by the  
10 ILEC in exactly the same way as local calls, are subject to access charges rather than  
11 reciprocal compensation. Thus, the intraLATA non-local wireline calls that are subject to  
12 access charges would, if carried by a CMRS provider rather than by a CLEC or an IXC, be  
13 *exempt* from access charge treatment, with intercarrier compensation based upon the  
14 applicable reciprocal compensation arrangement. And because wireless carriers have the  
15 ability to exchange traffic without incurring access charges over a wide geographic area,  
16 they typically offer their customers much larger local calling areas than wireline carriers,  
17 affording the wireless carriers (including Verizon's own affiliate, Verizon Wireless) an  
18 enormous competitive advantage vis-a-vis CLECs and IXCs with respect to similar point-to-  
19 point calls precisely because the access charges associated with wireline toll-rated calls are

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20. Rand McNally, Inc., *Commercial Atlas and Marketing Guide*, 1994 edition, at 38-39.

21. The precise terms of reciprocal compensation arrangements and the definitions of what constitutes "local" calls are generally set out in individual interconnection agreements negotiated between the ILEC and the CLEC or determined by the Commission in an arbitration decision made pursuant to 47 U.S.C. § 252.

1 so much higher than those applicable to “local calling area” traffic exchanges between  
2 ILECs and CMRS carriers.

3  
4 For example, a 130-mile wireline call originated by a customer in Blaine to the WUTC’s  
5 offices in Olympia would be rated as an intraLATA toll call and would be subject to access  
6 charges if carried by an IXC. That same call, if originated over a wireless phone in Blaine,  
7 could be handed-off to the ILEC (Qwest in this case) for termination in Olympia under the  
8 terms of the CMRS carrier’s interconnection agreement with the ILEC, *i.e.*, under reciprocal  
9 compensation or bill-and-keep, as applicable. Whereas the wireline caller would be subject  
10 to a toll charge, the same call placed from a wireless phone would be treated as local.<sup>22</sup>

11 Verizon Wireless and other CMRS carriers have in fact been heavily promoting this “no toll  
12 charge” feature of their services. Verizon Wireless, for example, has been advertising its  
13 “America’s Choice” Plan, “Where your home calling area stretches coast to coast.”<sup>23</sup> A  
14 growing number of consumers are using their wireless phone, and not their wireline phone,  
15 to place long distance calls *precisely because the wireless rate plans carry no toll charges.*<sup>24</sup>

16 It is patently unfair for IXCs to be placed at so large a competitive disadvantage vis-a-vis

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22. Verizon Wireless “Local DigitalChoice” service provides a local calling area consisting of the entire states of Washington and Oregon and the northern portion of the Idaho panhandle. <http://www.verizonwireless.com/ics/plsql/customize.intro>. See Attachment 2.

23. See *id.*

24. See, e.g., “Some Telephone Subscribers Drop Land Lines for Cellular Phones,” *The Dallas Morning News*, September 15, 2001; “Many Mobile-phone Users are Deciding that they Don’t Need a Land Line at All,” *Boston Globe*, December 17, 2001.

1 wireless carriers merely because IXCs are forced to pay access charges for many calls for  
2 which CMRS carriers are not.<sup>25</sup>

3  
4 Q. Can you think of any economic justification for permitting switched access prices to remain  
5 above cost, while other similar services are being provided at cost-based rates?

6  
7 A. No. Setting switched access rates at cost is the only way to establish a foundation for  
8 sustainable competition. In fact, the competitive benefits of setting switched access prices at  
9 cost have been explicitly recognized by the FCC in its *CALLS Order*, where it stated:

10  
11 Finally, the reduction in switched access usage charges will promote  
12 competition in the long-distance market between BOC affiliates entering this  
13 market and IXCs. To the extent switched access usage charges paid by IXCs  
14 are significantly above cost, BOC affiliates would have a competitive  
15 advantage because they would obtain switching services from the BOCs at  
16 cost. By driving switched access usage charges closer to their actual costs  
17 more quickly than would occur under the existing price cap regime, the  
18 CALLS Proposal will minimize the competitive advantages BOC affiliates  
19 would have over IXCs in offering long-distance services while switched access  
20 rates were significantly above cost.<sup>[26]</sup>

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25. Even where a CMRS-originated call terminates to a wireline customer outside of the MTA of the calling party, the wireless carrier is subject to ILEC access charges only at the terminating end of the call. Moreover, since CMRS rates are not regulated either by the state commissions or the FCC, CMRS carriers are under no obligation to “impute” any originating access charge into the price they charge for the call. CMRS carriers can thus offer their customers “free” toll calling, whereas IXCs are forced to incur out-of-pocket access charges for the same calls.

26. *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Long Distance Users, Federal-State Joint Board On Universal Service*, CC Docket Nos. 96-262 et al, *Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No.*  
(continued...)

1 Lowering switched access prices to cost-based levels will assure that incumbent LECs and  
2 competitive toll carriers both face identical costs for the underlying wholesale service of  
3 providing the first- and last-mile connection between the calling party and the called party,  
4 and will thus enhance the opportunity for the development of a competitive market for  
5 intraLATA toll services. As discussed in the next section of this affidavit, the existence of  
6 switched access rates at levels substantially above cost has permitted Verizon Northwest to  
7 implement an anticompetitive price squeeze against other toll providers that, if permitted to  
8 continue, will be detrimental to the continued efforts of the Commission to foster compe-  
9 tition for intraLATA toll service and may even cause adverse repercussions in the emerging  
10 competitive local market.

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26. (...continued)  
96-45, FCC 00-193 (rel. May 31, 2000) ("*CALLS Order*"), at para. 158 (footnote omitted).

## 1 THE PRICE SQUEEZE ANALYSIS

2

3 **Verizon Northwest’s above-cost switched access prices result in an anticompetitive price**  
4 **squeeze for competing intrastate toll carriers.**

5

6 Q. How does Verizon Northwest’s ability to charge above-cost switched access prices harm  
7 competition?

8

9 A. When any carrier *other than Verizon Northwest* provides intrastate toll service to a Verizon  
10 Northwest local exchange service subscriber, the interexchange carrier must purchase  
11 switched access *from Verizon Northwest* in order to originate and/or terminate the intrastate  
12 call from/to a Verizon Northwest local service customer. From the perspective of the  
13 competing intrastate toll provider, these access charges are an actual cash out-of-pocket  
14 cost. When Verizon Northwest or an affiliate that is wholly-owned by Verizon provides  
15 retail toll services, Verizon does not utilize its own switched access service *per se*, but does  
16 provide the corresponding functionality *for itself* to originate and terminate such calls at its  
17 local subscribers’ access lines.<sup>27</sup> Unlike Verizon Northwest’s competitors, however,

---

27. Access services are ordinarily provided out of tandem switches known as “Access Tandems.” The routing of an IXC-handled call would thus typically involve local switching and common transport from the originating subscriber’s serving central office to the Verizon access tandem, where it will be switched to a dedicated interoffice trunk to the IXC’s “point of presence.” The reverse will typically take place at the terminating end of the call. Thus, when a call is handled by an IXC, Verizon may provide as many as four switching functions (two end office switching operations and two access tandem switching operations). When Verizon Northwest provides the same call end-to-end, the route may involve no or only one tandem switching operation. Thus, where Verizon Northwest is the retail toll service provider, its costs may actually be less than the costs it incurs in furnishing access services to a competitor. This is why Verizon Northwest is required to impute *the access charge* that its competitors pay rather  
(continued...)

1 Verizon Northwest does not “pay” itself for these pseudo-switched access functions. Hence,  
2 whereas the interexchange carriers’ profit margin is the difference between the retail toll  
3 price and all of its costs, including the out-of-pocket switched access charge, Verizon  
4 Northwest’s profit margin is the difference between the retail toll price and Verizon  
5 Northwest’s *actual cost* of providing the switched access functionality to itself as part of its  
6 retail toll service. Thus, Verizon alone has the ability to reap additional profits equal to the  
7 difference between the cost and retail rate for switched access functionality.

8

9 Q. How is an imputation requirement intended to address this concern?

10

11 A. The purpose of requiring that an ILEC “impute” access charges into the retail prices it sets  
12 for its end-user services is to try to force the ILEC to treat as “costs” to itself the level of  
13 payments that its competitors are required to make to the ILEC for access services.  
14 Unfortunately, however, since ILECs do not actually incur such “costs” in the form of out-  
15 of-pocket cash payments to another entity, the imputation requirement often interferes with  
16 their overall profit incentives, which are to maximize profits relative to actual costs, not  
17 artificially contrived “costs” that do not really exist.

18

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27. (...continued)

than its own costs for the equivalent functionality in determining whether its retail price satisfies the imputation price floor.

1 This point was explored in a paper released earlier this year by Jerry A. Hausman, Gregory  
2 K. Leonard, and J. Gregory Sidak.<sup>28</sup> In that paper, the authors claim that upon their entry  
3 into the New York and Texas long distance markets following their receipt of Section 271  
4 authority, both Verizon and SBC, respectively, have offered lower long distance rates than  
5 had been previously available from IXCs. Notwithstanding the questionable accuracy of the  
6 authors' empirical results, they nonetheless advance a theoretical basis for the BOC conduct  
7 that they claim to have observed, known as "double marginalization." Hausman *et al.*  
8 explain "double marginalization" as follows:

9  
10 Double marginalization occurs when two companies have a vertical supplier-  
11 customer relationship. The upstream company sets its margin to maximize its  
12 profits individually, while the downstream company does the same. If the  
13 upstream company begins to offer the downstream product also, it generally  
14 will set the final price of the downstream product to maximize its profits  
15 jointly. The company offering the combined product will often find that it can  
16 increase its profits by lowering the price of the final product below the  
17 combined price that would obtain in the previous situation.

18  
19 Suppose that a BOC's incremental margin on the provision of network access  
20 is \$0.02 per minute, while the IXC's incremental margin on residential long-  
21 distance service is \$0.04 per minute. The BOC will find it to be profit  
22 maximizing to lower the total margin from \$0.06 per minute because it earns  
23 both margins, rather than only a single margin (\$0.02 for access + \$0.04 for  
24 long-distance = \$0.06 total margin). The BOC would also be using two sets of  
25 facilities, local access and long-distance facilities, to earn this higher margin.  
26 When the BOC decreases the price slightly, it sells more access and more long-  
27 distance services and earns approximately \$0.06 per minute. In contrast, if an  
28 IXC decreases the price, it only receives the additional margin from increased

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28. Jerry A. Hausman, Gregory K. Leonard and J. Gregory Sidak, "The Consumer-Welfare Benefits from Bell Company Entry into Long-Distance Telecommunications: Empirical Evidence from New York and Texas" ("Hausman/Leonard/Sidak" or "HLS"), unpublished study presented at the Department of Justice Telecom Workshop, "*The Drivers and Significance of Competition in Local Telecommunications: Empirical Evidence*," Washington, DC, July 23, 2002.

1 sales of long-distance service of \$0.04 per minute. Thus, the BOC has a  
2 greater incentive to charge lower long-distance prices than does an IXC.  
3 Furthermore, when the BOC lowers the long-distance price, the IXCs will  
4 lower their prices, which will increase the number of long-distance minutes  
5 demanded and consequently the number of access minutes demanded from the  
6 BOCs.  
7

8 The ability of Verizon to adopt a “double marginalization” pricing strategy, as Hausman *et*  
9 *al* believe has occurred in New York, requires that Verizon continues to have market power  
10 in the local exchange and access services markets. The authors observe that:

11 Although the original example of double marginalization was in the case of  
12 monopoly, it is [sic] applies as well to imperfect competition, which  
13 characterizes telecommunications markets because of the large fixed and  
14 common costs. The Areeda-Hovenkamp antitrust treatise, for example,  
15 observes that “[t]he double marginalization model appears to make robust  
16 predictions that vertical integration results in increased output and lower prices  
17 any time the affected markets are something less than perfectly competitive.”  
18 Under current regulatory policies, access and long-distance services are both  
19 sold at prices exceeding marginal (incremental) cost, so as to cover the large  
20 fixed costs of local and long-distance networks. Although access reform since  
21 the Telecommunications Act of 1996 has decreased the BOCs’ access margin,  
22 it has not eliminated the entire margin. Thus, double marginalization still  
23 leads to the prediction that BOC entry into the in-region interLATA market  
24 will lead to lower long-distance prices. Our econometric findings support this  
25 economic analysis, which has not been taken into account by the DOJ and FCC  
26 in their section 271 implementation analyses.<sup>29</sup>  
27  
28

29 If the authors’ empirical findings and claims as to “double marginalization” are accurate,  
30 this condition would indicate that both Verizon in New York and SBC in Texas are in  
31 violation of both the Section 272(e)(3) imputation and the Section 272(a) and (b) separate  
32 affiliate requirements, and is consistent with my own findings in the present matter that

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29. *HLS*, at 18, footnotes omitted.



1 Verizon Northwest has violated the WUTC’s imputation requirements in setting its  
2 intrastate toll prices in Washington State.

3  
4 “Double marginalization” will occur as between the ILEC and its long distance affiliate or  
5 integrated business unit *only when the two entities seek to maximize their joint profit — i.e.,*  
6 *when they explicitly do not deal with each other at arm's length* and instead pursue a  
7 strategy that ignores the tariff rate for switched access and instead focuses solely upon  
8 actual cost. Appendix 1 contains an illustrative example of “double marginalization” and its  
9 application to Verizon Northwest.

10  
11 Q. In Washington State at the present time, Verizon’s interLATA services are being provided  
12 by its long distance affiliate, Verizon Long Distance (“VLD”) rather than on an integrated  
13 basis with local and intraLATA services being offered by Verizon Northwest. Does that  
14 condition obviate the requirement that VLD also satisfy the WUTC’s imputation require-  
15 ments with respect to its retail intrastate long distance rates?

16  
17 A. No, it does not. On May 24, 2002, the FCC issued a *Notice of Proposed Rulemaking*  
18 regarding the sunset of the separate affiliate “transitional” requirements under Section 272  
19 as they apply to Bell Operating Companies.<sup>30</sup> In its comments to the FCC, Verizon has  
20 argued that the sunset provision applies simultaneously in *all* Verizon jurisdictions  
21 commencing three years after Verizon had first obtained Section 271 authority in New York

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30. *In the Matter of Section 271(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, *Notice of Proposed Rulemaking*, 17 FCC Rcd 9916 (2002) (“*Notice*” or “*NPRM*”).

1 (December 1999).<sup>31</sup> If the FCC adopts Verizon’s interpretation of the federal statute (an  
2 interpretation with which I strongly disagree and which is at odds with the tentative conclu-  
3 sions of the NPRM itself), and absent an extension of the current three-year sunset, it is  
4 possible that Verizon Northwest (although not itself a Bell Operating Company covered by  
5 the NPRM) may then seek to provide all of its local and long distance services on a fully  
6 integrated basis. Thus, although Verizon is, for the present, providing interLATA services  
7 to its Washington customers out of a separate affiliate, that condition could change before  
8 the present proceeding is concluded. Confirming Verizon’s intentions with respect to such  
9 integrated operations is a recent *Petition for Forbearance* that Verizon submitted to the FCC  
10 on August 5, 2002.<sup>32</sup> In that *Petition*, Verizon alleged that the requirement that it maintain  
11 separate local and long distance networks was costly and inefficient:

12  
13 The restriction imposes duplicative costs on Verizon’s section 272 affiliates by  
14 requiring them to hire additional personnel to do provisioning and maintenance  
15 work that could be done more efficiently by sharing personnel with the BOC,  
16 which already has employees with the skill sets that are applicable to long  
17 distance services. The restriction also requires the separate affiliate to develop  
18 and operate its own operating support systems when the BOCs’ OSS could  
19 perform the same tasks with little modification, and develop redundant  
20 network operating control systems and back office provisioning functions.<sup>33</sup>  
21

22 It is thus reasonable to assume that, if unencumbered by the “operate independently”  
23 requirement of Section 272(b)(1) and any other applicable legal constraints on integrated

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31. *Id.*, *Comments of Verizon*, August 5, 2002, at 3-6.

32. *Petition of Verizon for Forbearance From the Prohibition of Sharing Operating, Installation, and Maintenance Functions Under Section 53.203(a)(2) of the Commission’s Rules*, CC Docket No. 96-149, *Petition for Forbearance*, August 5, 2002 (“*Verizon OI&M Petition*”).

33. *Id.*, at 3.

1 operations, Verizon Northwest and Verizon Long Distance would in Washington State  
2 pursue integration of their respective networks and services. For all of these reasons, the  
3 WUTC should “pierce the corporate veil” and treat any VLD services and operations within  
4 Washington State as if they were being performed and provided on a fully integrated basis  
5 by Verizon Northwest.<sup>34</sup>

6  
7 Q. Is there any real cost difference between what Verizon provides itself and what it provides  
8 to competitive IXCs?

9  
10 A. There can be, particularly if Verizon has integrated the access and interexchange network  
11 functions. However, Verizon’s pricing of switched access provided to its competitors is in  
12 any event at many multiples of the actual cost of either stand-alone access services or of the  
13 access functions that Verizon provides to itself on an integrated basis. The “cost” of  
14 switched access as seen by competing IXCs consists of the cash payments they make to  
15 Verizon, which are at tariffed rates for switched access services, whereas for Verizon  
16 Northwest the “cost” of the switched access functionality is the actual cost of providing the  
17 switching and transport functions that are bundled into the retail end-to-end toll service.

18  
19 As discussed above, the *functions* that are involved in providing switched access to IXCs are  
20 *identical* in every material respect to the functions associated with *local switching, tandem*  
21 *switching* and *common transport*, which are provided as Unbundled Network Elements

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34. In addition to access services, Verizon Northwest and/or its parent or other affiliate provides various other non-access services to its long distance affiliate, often on terms that would hardly qualify as “arm’s length.” I discuss this in more detail at pages \*\*35-\*\*38 below.

1 (UNEs) by Verizon Northwest at rates that the Commission has determined to be cost-  
2 based,<sup>35</sup> as required by Sections 251 and 252 of the *Telecommunications Act of 1996*. As  
3 referenced above, this Commission has determined the cost of the local switching and trans-  
4 port functions to be only \$0.0032 per minute. If the tariffed rates for switched access  
5 services (as they apply to IXCs) are set at any level *above* the actual cost of providing the  
6 service, and assuming that competitors' retail intrastate toll rates are necessarily set at levels  
7 roughly comparable to those being charged by Verizon (something that would be expected  
8 to occur in a competitive market), competitors will face higher costs than Verizon  
9 Northwest, and will thus be forced to deal with a decidedly lower — or even a *negative*  
10 —profit margin.

11  
12 Q. Can you provide an example to illustrate this point?

13  
14 A. Yes. Consider the following scenario. As discussed above, Verizon Northwest's *cost* of  
15 providing switched access is approximately \$0.0032 per minute (at both ends combined),  
16 while the current average per-minute tariffed rate for switched access is \$0.0989 per minute.  
17 As I will discuss later in this testimony, for imputation purposes, non-access retailing  
18 functions amount to roughly \$0.0457 per minute.<sup>36</sup> Verizon Northwest's cost for its retail

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35. It is my understanding that the Commission has not yet established a tandem switching UNE rate.

36. In this scenario, it is assumed that the retailing and billing and collection costs faced by Verizon Northwest and IXCs are identical. In fact, Verizon's *non-access* costs are likely to be considerably lower than those that would be confronted by an IXC for the same non-access functions. As an ILEC, Verizon can include its customers' intraLATA toll calls on their local service bills at near-zero incremental cost, whereas a nonaffiliated IXC would be forced to either  
(continued...)

1 toll service is then \$0.0489, whereas competing carriers confront total out-of-pocket costs  
2 (for access and non-access items) of \$0.1444, nearly three times Verizon Northwest's cost  
3 *for exactly the same intrastate toll service*. If the prevailing retail rate for intrastate toll  
4 service is, say, \$0.15 per minute, then Verizon Northwest's gross margin (revenue minus  
5 costs) would be \$0.1011 per minute [ $\$0.15 - \$0.0489$ ], while competing carriers would only  
6 realize a margin of about one-half of one cent per minute (assuming that they were able to  
7 charge the same retail price as Verizon Northwest).<sup>37</sup>

8  
9 If, in the above example, Verizon Northwest were to lower retail rates to \$0.13 per minute,  
10 the Company would still have a margin of \$0.0811 per minute, but it would actually *cost*  
11 *competitors more than they receive in revenues* in order to serve customers at this retail  
12 price level. Given the large discrepancy between the cost and price of switched access,  
13 Verizon Northwest has the ability and the incentive to impose a price squeeze on its compe-  
14 titors by reducing retail rates towards *or below* the level of the competitors' out-of-pocket  
15 costs (including access payments to Verizon itself), thereby minimizing or eliminating  
16 altogether the profit margin that would be available to its rivals.

---

36. (...continued)

purchase billing and collection services from Verizon or, alternatively, perform these same functions on a stand-alone basis for itself. In addition, non-ILEC long distance carriers are likely to incur significantly greater marketing costs than would an ILEC, since the latter has the unique opportunity to "sell" its intraLATA long distance service during the same contact *initiated by the customer* for the purpose of ordering *local* telephone service.

37. Non-ILEC competitors frequently find that in order to attract customers away from the incumbent they must offer consumers a *lower* price than that being charged by the incumbent. If, for example, IXCs were forced to set their price at \$0.14 (*i.e.*, one cent lower than Verizon's price), they would then sustain a net *loss* on every minute they sell. It is unreasonable to expect competitors to remain in the market for very long under these conditions.

1 Q. How would lowering switched access rates to cost-based levels redress this competitive  
2 imbalance?

3

4 A. Moving the rates for switched access closer to cost-based levels eliminates Verizon  
5 Northwest's ability to effect a price squeeze on competitive toll carriers. If access charges  
6 are set at cost-based levels, both Verizon Northwest and its rivals will be operating on  
7 roughly similar footing: They will each be confronting roughly the same access costs  
8 (although Verizon's actual costs would still be lower), and will be able to compete with  
9 respect to who can be most efficient in converting the wholesale access services, together  
10 with the various value-added components, into the retail intrastate toll offering. There is  
11 nothing *per se* wrong with the price/cost margin becoming narrower; what is objectionable  
12 is when the effect is disproportionately imposed upon competitors due to above-cost pricing  
13 by Verizon Northwest of the essential switched access service. Only after adopting cost-  
14 based rates for switched access will Verizon Northwest and its competitors face equivalent  
15 costs, revenues and margins in the intrastate toll market, *thus eliminating any kind of*  
16 *monopolistic advantage on the part of Verizon Northwest.*<sup>38</sup> The likely result would be  
17 lower retail rates for consumers from both Verizon and competitive IXCs.

18

19 Q. And what are the consequences of failing to make the appropriate cost-based reductions in  
20 switched access rates?

21

---

38. Even then, Verizon Northwest will still maintain a significant cost advantage vis-a-vis competing IXCs, in that it will still confront near-zero long distance billing costs and near-zero marketing costs for sales made using the "inbound channel."

1 A. So long as Verizon Northwest's actual cost for providing switched access to itself is lower  
2 than the cost for switched access faced by competitors, Verizon Northwest's gross margin  
3 for toll services will *always* be higher than that available to its competitors. Not only does  
4 this situation provide Verizon Northwest with a formidable competitive advantage in the toll  
5 market, it also affords Verizon Northwest an incentive and the market power to implement a  
6 price squeeze. As competition pushes retail toll prices closer and closer to the competing  
7 carriers' price floor, the gross margin available to competing carriers is effectively squeezed  
8 out. Once the margin is eliminated, other carriers will have no economic incentive to  
9 provide toll service, thus permitting Verizon Northwest to remonopolize the adjacent  
10 intraLATA (and ultimately interLATA) toll markets. Verizon Northwest's competitive  
11 advantage and its ability to implement a price squeeze will remain until switched access  
12 rates are reduced to cost-based levels. Only after achieving this important and realistic goal  
13 will the playing field be nearly level as between Verizon Northwest and its competitors with  
14 respect to toll service.

15

16 **Verizon Northwest's retail intraLATA toll rates fail to satisfy the Commission's**  
17 **established imputation standards.**

18

19 Q. What is the purpose of an imputation test, such as the one employed by this Commission,  
20 with respect to an ILEC's retail price for any competitive service?

21

22 A. The purpose of an imputation test is to assure that such price fully covers all charges that the  
23 ILEC would apply to a competitor for any essential services that are required by the  
24 competitor in order to offer a competing retail service. Thus, even though Verizon

1 Northwest does not “pay itself” any access charge, the imputation test is applied to assure  
2 that the price that a competitor would pay *to Verizon* for switched access and other essential  
3 functions, together with any *non-access costs* that Verizon Northwest incurs in providing  
4 retail toll service, is not in excess of the retail price that Verizon Northwest charges its end-  
5 user customers for the retail toll service.

6  
7 Q. Can you describe more specifically how an imputation test should be applied to Verizon  
8 Northwest’s toll services?

9  
10 A. Yes. In performing an imputation test with respect to Verizon Northwest’s toll services, it is  
11 necessary that each *individual toll service rate plan*, rather than some average of all retail  
12 rates or an average revenue per minute, be examined relative to the sum of *imputed access*  
13 and actual non-access costs. Verizon Northwest offers a variety of intrastate toll service  
14 pricing plans. It is not sufficient for an imputation test to be made across all of these various  
15 pricing options; each one must individually and independently satisfy the imputation  
16 requirement. Using an average revenue per minute across all toll calling plans would allow  
17 some services that may be priced well above the price floor to mask (*i.e.*, subsidize) other  
18 services whose retail prices fall below the price floor. Therefore, the imputation test must  
19 be performed separately with respect to the retail rate for each calling plan in order to deter-  
20 mine whether or not the price for that particular service is appropriately set above the price  
21 floor.<sup>39</sup>

---

39. The WUTC reached this conclusion in Docket U-87-1083-T, wherein it rejected Pacific Northwest Bell’s (“PNB’s”) proposal to analyze the average rates of a toll calling plan.

(continued...)



1 Q. How would you recommend that the Commission set the price floor for toll service so as to  
2 ensure that Verizon Northwest does not obtain an anticompetitive advantage for the  
3 provision of toll service vis-a-vis its competitors?  
4

5 A. The price floor for toll service is comprised of the costs incurred by the incumbent carrier  
6 for both access-related and non-access functions. Access-related functions include all  
7 “bottleneck” access elements, both traffic sensitive and non-traffic sensitive.<sup>40</sup> The non-  
8 access functions associated with toll service are the costs associated with actually providing  
9 service to end users using the essential functions (*e.g.*, network switching and interexchange  
10 transport) supplied by the incumbent LEC. Costs associated with non-access network  
11 functions include billing/collection, retailing/marketing, and the use of the Local Number  
12 Portability (“LNP”) database; these types of costs are incurred by both Verizon Northwest  
13 and its competitors when providing toll service, and as such must also be incorporated into

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39. (...continued)

As the Commission stated, “[t]he better approach requires that each individual [] rate be priced no lower than the approved imputation rate.” *See* Washington Utilities and Transportation Commission v. Pacific Northwest Bell Telephone Company, WUTC Docket No. U-87-1083-T, *Fifth Supplemental Order*, 93 P.U.R. 4<sup>th</sup> 430, May 25, 1988 (“Docket No. U-87-1083-T *Fifth Supplemental Order*”), at 442. The Commission also rejected USWC’s proposal to use average toll rates to satisfy imputation in its *Fifteenth Supplemental Order* in Docket UT-950200, citing Staff’s conclusion that “[a]llowing imputation at average rates would stifle competition because the Company could freely devise high-volume plans that others couldn’t match.” *See* Washington Utilities and Transportation Commission v. US West Communications, Inc., WUTC Docket No. UT-950200, *Fifteenth Supplemental Order*, April 11, 1996. Notwithstanding this notion, as I explain later in this affidavit, TNS data on Verizon Northwest’s average revenue per minute across all toll calls fails to satisfy the imputation standard as set forth herein.

40. WUTC Docket No. U-87-1083-T *Fifth Supplemental Order*, Finding of Fact #5.

1 the price floor for toll service.<sup>41</sup> My approach to defining the price floor applicable to  
2 Verizon Northwest's toll service consists of calculating the costs for switched access, as  
3 well as all non-access costs, such as billing and collection, retailing and marketing, and  
4 using the LNP database, that Verizon Northwest would incur if it were just another  
5 interexchange carrier providing toll service.

6  
7 Q. Can you elaborate on how this should be done?

8  
9 A. Yes. To begin, it is necessary to calculate the average switched access price per billed  
10 access minute paid by IXCs, based upon the tariffed switched access rates for Verizon  
11 Northwest and other Washington ILECs as would be applied to telecommunications carriers  
12 seeking to purchase switched access. Tariffed switched access prices are the underlying  
13 network costs faced by IXCs in providing toll service, and therefore it is these prices that are  
14 relevant in a proper imputation calculation. The Commission agrees with this position, as it  
15 stated in its *Fifth Supplemental Order* in Docket No. U-87-1083-T with respect to PNB (but  
16 which would apply to all incumbent LECs):

17  
18 To dispel any lingering doubts, the Commission clarifies that the access  
19 charges to be imputed cover both types of costs, nontraffic sensitive (NTS)  
20 costs and traffic sensitive (TS) costs. [The incumbent] should bill itself for  
21 access in the same manner as it bills interexchange carriers.<sup>42</sup>  
22

---

41. To the extent that the non-access costs may vary from one calling plan to the next, the *plan-specific* non-access costs should be used in determining that the price exceeds the imputed costs. For purposes of this affidavit and because I have no specific information to the contrary, I have assumed that the non-access costs are the same for all calling plans.

42. WUTC Docket No. U-87-1083-T *Fifth Supplemental Order*, at 441.

1 In calculating the TS and NTS access costs for Verizon Northwest, I have modeled the per-  
2 minute of use charges an IXC would pay for a call originating in Verizon Northwest's  
3 service footprint and terminating elsewhere in the LATA, but not necessarily in Verizon  
4 Northwest's footprint. As such, the access charge that would be paid by an IXC for the  
5 originating end of the call would be whatever Verizon Northwest's tariffed rates are (*i.e.*,  
6 \$0.061 per minute, as developed above). As for the terminating end of the call, what the toll  
7 carrier pays depends upon where the call terminates; it is thus necessary to estimate a  
8 weighted average terminating rate.

9  
10 Q. In calculating the weighted average terminating rate, did you rely on the same methodology  
11 you described in your March 28, 2002 affidavit?

12  
13 A. No. Once again, when preparing my affidavit, it was necessary to use the best information  
14 that was available to me at that time. For that reason, I weighted terminating access rates for  
15 Verizon Northwest, Qwest, Sprint and CenturyTel according to the quantity of switched  
16 access lines served by each carrier.

17  
18 I have made two adjustments to my prior methodology, and each is adopted from *Verizon's*  
19 *Imputation Study* as provided in response to Staff Data Request No. 7. First, rather than  
20 weighting terminating access rates by the quantity of switched access lines, Verizon's study  
21 weights terminating access rates by the "percent of traffic" terminating to each carrier.<sup>43</sup> My  
22 use of access line weightings was intended to serve as a surrogate for that data, which I did

---

43. See *Verizon Imputation Study*, at page 2, line 34.

1 not have at that time. I have adopted those same percentages for the calculations that I am  
2 providing here.

3

4 Second, in compiling the weighting for terminating LECs, Verizon only includes a single  
5 entity to represent the independent carriers in Washington. Identified in the *Verizon*  
6 *Imputation Study* as “ILEC Terminating,” these rates are attributed solely to “Telephone  
7 Utilities of Washington.” Verizon acknowledges that “Telephone Utilities of Washington”  
8 do not account for 100% of the access lines in the “ILEC” category,<sup>44</sup> yet it nonetheless  
9 utilizes only this carrier’s rates when calculating the weighted average terminating rate.<sup>45</sup> It  
10 is my understanding that Telephone Utilities of Washington has changed ownership, and  
11 since April 7, 1998 has been operated as CenturyTel.<sup>46</sup> In seeking to maintain consistency  
12 with the *Verizon Imputation Study*, I have therefore continued to use the rates of CenturyTel  
13 exclusively to represent the “ILEC” category when calculating weighted terminating access  
14 rates.<sup>47</sup> With these two adjustments, I have calculated the weighted average terminating rate  
15 to be \$0.0375.

16

---

44. *Id.*, at Note 1.

45. *See* Verizon Northwest response to AT&T Data Request No. 25.

46. *See*, <http://www.wutc.wa.gov/webdocs.nsf/0492664a7ba7ed8b88256406006bf2ca/b2e7e6f33ac6ffa3882565f3005d8be8!OpenDocument>, accessed 9/27/02.

47. My approach appears to be consistent with Verizon Northwest’s “updated” imputation study, provided in response to Staff Data Request No. 26. *See* Verizon response to Staff Data Request No. 26, Attachment 26b, page 2, Note 1.

1 The combined weighted average access charge that a toll carrier would face for a call placed  
2 from a subscriber in Verizon Northwest's service territory to another resident of Washington  
3 is \$0.0989. Attachment 3 to this testimony provides the details of this calculation.<sup>48</sup>  
4

5 Q. How did you incorporate billing and collection into your imputation calculation?  
6

7 A. The Commission has repeatedly stated that since billing and collection are competitive  
8 services, it is appropriate to impute the Long Run Incremental Cost ("LRIC"), rather than  
9 tariffed rates, that an ILEC incurs in performing this function.<sup>49</sup> In my affidavit, I relied  
10 upon the only publicly available per-minute cost for billing and collection for independent  
11 companies that I could find, that being a cost of \$0.0346 per minute adopted by the  
12 Commission in its *Fifth Supplemental Order* in Docket No. U-87-1083-T.<sup>50</sup> However, once  
13 again the *Verizon Imputation Study* provided additional information regarding Verizon's

---

48. In response to Staff Data Request No. 26, Verizon Northwest provided what it has described as an "updated analysis of the imputation price floor." I received this confidential response at the time that my testimony was being finalized; therefore, I have not had the opportunity to thoroughly analyze the substantial "updates" that Verizon has made, except to observe that many of these involve fundamental methodological changes that had not been utilized by the Company in its earlier imputation studies. It is likely that these new methodologies will be addressed in Verizon's responsive testimony, in which event I will consider their appropriateness and accuracy, and respond accordingly in my rebuttal testimony.

49. See WUTC Docket No. U-87-1083-T *Fifth Supplemental Order*, at 433; Washington Utilities and Transportation Commission, Complainant, v. U.S. West Communications, Inc., Respondent, WUTC Docket No. UT-950200, *Fifteenth Supplemental Order: Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling*, 4/11/96, at 97.

50. Even though GTE, an independent carrier, was an intervening party in that proceeding, there is no indication in the Order that GTE objected to the use of \$0.0346 per minute as representative of its LRIC for Billing and Collection.

1 cost for billing and collection, which appears to be roughly BEGIN PROPRIETARY  
2 << [REDACTED] >> END PROPRIETARY per minute.<sup>51</sup> Clearly, this figure is substantially lower  
3 than the \$0.0346 figure that I had relied upon in my affidavit. However, Verizon’s claimed  
4 billing and collection “cost” as used in its 2000 imputation study appears to be substantially  
5 understated.<sup>52</sup>

6

7 Q. Please explain.

8

9 A. Verizon is required, pursuant to Section 272(b)(5) of the federal *Act*, to post and disclose the  
10 details of transactions between its Section 272 long distance affiliate (Verizon Long  
11 Distance) and its Bell Operating Company ILEC entities. According to the Section  
12 272(b)(5) disclosure information provided on Verizon’s website, Verizon New York’s  
13 charge to Verizon Long Distance for billing and collection services is approximately \$1.15

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51. In response to AT&T Data Request No. 8, Verizon Northwest provided a copy of the proprietary cost study in support of its alleged billing and collection cost. As discussed earlier, Verizon Northwest subsequently provided an “updated” imputation study in response to Staff Data Request No. 26, in which its billing and collection cost has been revised. Rather than opine as to which of Verizon Northwest’s costs and cost studies it believes accurately represent its true cost of providing billing and collection to toll service providers, I will again consider the appropriateness and accuracy of the representations made by Verizon Northwest in its responsive testimony, and respond accordingly in my rebuttal testimony. I would note, however, that the adjustment made by Verizon to its billing and collection cost is of a sufficiently small magnitude that my concerns regarding Verizon’s apparent understatement of these costs remain.

52. AT&T Data Request No. 28 requested a historical list of the Billing and Collection costs calculated by Verizon Northwest since 1985, which, in theory, would provide insight into the dramatic cost decrease for Billing and Collection that Verizon Northwest is portraying. Verizon Northwest’s answer to this request is (at best) non-responsive, as it refers only to the Company’s response to AT&T Data Request No. 8, which inquired only as to the *already provided* cost for billing and collection appearing in the *Verizon Imputation Study*.

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1 per account (plus postage, which varies based upon weight).<sup>53</sup> This is precisely the type of  
2 billing and collection cost that a proper imputation analysis should capture; that is, one that  
3 is imposed by Verizon when it provides these services to an IXC (Verizon Long Distance in  
4 this case). If the proprietary figure of BEGIN PROPRIETARY << [REDACTED] >> END  
5 PROPRIETARY per minute were accurate, that would imply that the average number of  
6 minutes per line is approximately BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY  
7 when, according to FCC data, average residential interLATA toll calling amounts to just 74  
8 minutes per month.<sup>54</sup> Ignoring any “additional postage” that Verizon might incur for adding  
9 the long distance billing to Verizon’s local service bill, the actual per-minute cost of  
10 Verizon’s billing and collection function would be closer to \$0.0155.<sup>55</sup> The extremely small  
11 level of toll billing and collection costs that Verizon is now claiming may possibly be  
12 explained if, in making this calculation, Verizon had assigned all *joint* local/toll billing and  
13 collection costs entirely to its monopoly *local* services, in effect attributing to toll only those  
14 *additional* costs that would not exist but for the inclusion of toll call charges on customers’  
15 local service bills. Use of that type of “cost” for purposes of determining a toll price floor is  
16 entirely analogous to the use of TELRIC costs, rather than actual access charges, for impu-  
17 tation purposes, *and is equally invalid*. For this reason, I believe that the \$0.0155 per-  
18 minute billing and collection cost that I derived from posted affiliate transaction data  
19 represents the *minimum* amount that should be included in determining the price floor. In

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53. <http://www.verizonld.com/pdfs/VLDTransactionDetailWebPage1.pdf>, accessed 9/24/2002.

54. FCC, Industry Analysis Division, Common Carrier Bureau, *Trends in Telephone Service*, May 2002, at Table 15.2.

55.  $\$1.15 \div 74$

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1 that regard, I would also observe that the WUTC's prior determination of a \$0.0346 per-  
2 minute billing and collection cost was specifically for *Independent* (i.e., non-BOC) telep-  
3 hone companies, of which Verizon Northwest, formerly GTE-Northwest, is still one.

4 Although I am adjusting my price floor calculation to include the \$0.0155 figure based upon  
5 Verizon New York's Section 272(b)(5) posting and FCC average usage data, it is entirely  
6 possible that the earlier WUTC determination is the more accurate figure.

7  
8 Q. What additional factors are included in the price floor that you have calculated?

9  
10 A. The price floor must also cover all imputed access charges plus all non-access retailing costs  
11 incurred by Verizon Northwest to provide retail toll service to its end user customers.

12 Retailing costs include such items as marketing, advertising, service ordering, and customer  
13 service. Retailing costs are appropriately included in the development of the price floor,  
14 since these represent the costs of functions that must be incurred both by Verizon Northwest  
15 and by competitive carriers in order to provide toll service at retail. In a surrebuttal affidavit  
16 submitted by Dr. William E. Taylor on behalf of Qwest Communications, Inc., in Minnesota  
17 PUC Docket No. P-421/CI-01-1372 (the "Section 272 compliance" proceeding held in  
18 connection with Qwest's Section 271 Application for in-region interLATA authority in  
19 Minnesota), Dr. Taylor provided an estimate of "marketing expenses" incurred by IXCs in  
20 connection with retail long distance services.<sup>56</sup> According to Dr. Taylor, retailing costs for

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56. In the Matter of a Commission Investigation into Qwest's Compliance with Section 272 of the Telecommunications Act of 1996's Separate Affiliate Requirement; PUC Docket No. P-421/CI-01-1372, OAH Docket No. 7-2500-24487-2; Surrebuttal Affidavit of Dr. William E. Taylor on behalf of Qwest Corporation, January 16, 2002, at para. 20.



1 interexchange carriers are roughly \$0.03 per minute, or perhaps even more.<sup>57</sup> For the  
2 purposes of this price floor calculation and consistent with Dr. Taylor’s estimate, I have  
3 employed this \$0.03 per minute figure as an estimate for retailing costs.<sup>58</sup>  
4

5 The final element that should be included in the price floor is an estimate of the charges  
6 incurred by competitive carriers on a per-minute basis for queries to the local number  
7 portability (“LNP”) database.<sup>59</sup> These queries are performed whenever a customer-dialed  
8 NXX code is designated as having a ported number. Once the call is initiated, the query is  
9 performed in order to assess whether that particular number has been ported. The frequency  
10 with which these queries occur is dependent upon the quantity of ported numbers, and the  
11 number of NXX codes containing ported numbers. It is reasonable to assume that queries

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57. *Id.*

58. Verizon’s “updated” imputation analysis provided in response to Staff Data Request No. 26 also included (for what appears to be the very first time) a cost associated with “marketing” that is substantially lower than Dr. Taylor’s estimate and, more importantly, well below what I understand to be general industry experience. Using FCC interLATA calling volumes of 74 minutes per month, Verizon’s newly-produced “marketing costs” of BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY per minute would imply that *total annual marketing costs per account* were only BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY. With Presubscribed Interexchange Carrier (“PIC”) churn rates running in the 25% to 30% range and IXC customer acquisition costs running into the hundreds of dollars per customer, Verizon’s “marketing cost” estimate appears, on its face, not to be credible. In any event, because I have not had the opportunity to thoroughly analyze this new information and, assuming that Verizon undertakes to provide testimonial support for it, I will address these new “marketing cost” claims in my rebuttal testimony.

59. Verizon’s tariff refers to LNP as “Service Provider Number Portability,” or “SPNP.” The Verizon Telephone Companies, Tariff FCC No. 1, Section 13.3.16.

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1 are performed on 67.87% of all originating calls, based on the fact that 67.87% of all NXX  
 2 codes in Washington are LNP-capable.<sup>60</sup>

3  
 4 The tariffed rate for LNP database queries is \$0.0006,<sup>61</sup> and this charge is applied on a per-  
 5 message basis when the call is initiated by the originating caller, irrespective of whether or  
 6 not the call is actually completed. Since this charge is message-based, it is necessary to  
 7 apply factors in order to estimate the cost on a per-minute basis — some of which are  
 8 considered proprietary by Verizon Northwest,<sup>62</sup> which in turn results in a proprietary desig-  
 9 nation for the final number. The final derived per-minute amount for the LNP database  
 10 query is not only quite small,<sup>63</sup> but also proprietary. Use of one proprietary number in my

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60. Telcordia Technologies; Local Exchange Routing Guide, 1/1/02.

61. I have utilized the “SPNP Database Query” rate, which assumes that the toll carrier submits the query to the database over the signaling system, rather than the higher “SPNP Query” rate, which requires Verizon to query the database. *Id.*, at Section 13.3.16.F, original page 13-97, effective April 28, 2001.

62. In Verizon’s confidential response to AT&T Data Request No. 12, Verizon Northwest indicated that the Company’s average completed call is BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY minutes in length. Due to the fact that the LNP database query charge is applied regardless of whether or not the call was completed, it is also necessary to apply an “attempts-to-completion” ratio as well. Verizon failed to provide a “current” attempts to completion ratio in response to discovery. *See* Verizon’s response to AT&T Data Request No. 13. An attempts-to-completion ratio of 1.0 (which we know to be extremely unlikely occurrence) has the effect of applying the LNP database charge only to completed calls. As the ratio of attempts per completion increases, the impact of the LNP database query charge increases. I believe a ratio of 1.40 attempts per completion to be reasonable in spreading these incurred costs over completed calls, and should serve as a “rebuttable presumption,” particularly since Verizon failed to provide their own number when asked.

63. This value is calculated using the following formula: (tariffed rate for the LNP database query \* percent LNP NXX occurrence \* average attempts per completion) ÷ average  
 (continued...)

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1 calculation of the price floor would cause the result of my calculation to be proprietary as  
2 well; therefore, in the interests of maintaining a public record whenever possible, I am  
3 removing the per-minute charge for LNP database queries in my bottom-line price floor  
4 calculation. Due to the small value of the LNP database cost, its removal has no real impact  
5 on my calculation.

6

7 Q. What is the end result of your calculation of the appropriate price floor for Verizon  
8 Northwest's intrastate toll service?

9

10 A. Combining these three items (average switched access price, billing and collection cost, and  
11 retailing costs) establishes the price floor for intrastate toll service that is required in order  
12 for Verizon to satisfy the Commission's imputation requirement. Based upon these calcu-  
13 lations, the price floor for Verizon's intrastate toll services is \$0.1444 per minute.<sup>64</sup>

14

15 Q. How should this price floor be used to determine whether or not Verizon Northwest's retail  
16 toll satisfies the imputation threshold?

17

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63. (...continued)

minutes of use per message. All told, I have estimated the effective per-minute cost for LNP database queries to be BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY.

64. If I were to include the LNP database query, the price floor would be BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY. The slight mathematical discrepancy is due to rounding.

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1 A. To determine whether or not Verizon Northwest's retail toll rates satisfy the \$0.1444  
2 imputation threshold, it is necessary to compare that price floor with the current intrastate  
3 toll rates being offered by Verizon Northwest and by Verizon Long Distance, its long  
4 distance affiliate, adjusted for uncollectible revenue. "Uncollectibles" represent those  
5 revenues billed by a carrier but which are unpaid by consumers. In order to appropriately  
6 represent the actual revenue received by Verizon Northwest (on average) for a particular  
7 service, it is necessary to subtract some amount from the retail rate being billed to the  
8 customer. According to Verizon Northwest's 2001 annual report filed with the  
9 Commission, Washington intrastate uncollectible revenue totaled just under \$8.9-million, or  
10 1.8% of the Company's \$480.3-million in Washington intrastate revenue.<sup>65</sup> Accordingly, I  
11 have subtracted 1.8% from each of the retail toll rates under review in order to account for  
12 uncollectibles. Tables 1 and 2 summarize the intrastate toll rate plans currently being  
13 offered by Verizon Northwest and Verizon Long Distance, respectively, to both residential  
14 and business toll customers in Washington, and the revenue per minute less uncollectibles  
15 for each plan.

16

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65. Verizon Northwest 2001 Annual Report, Schedule I-1, page 2, lines 59 and 60, provided in response to AT&T Data Request No. 3.

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Table 1					
Verizon Northwest Intrastate Toll Calling Plans					
<u>Business</u>			<u>Residential</u>		
Calling Plan	Peak Rate	Less 1.8% Uncollectible	Calling Plan	Peak Rate	Less 1.8% Uncollectible
Business Value Cents	\$0.100	\$0.098	Residential Value Cents	\$0.080	\$0.078
Easy Savings Flat Rate	0.100	0.098	One Easy Price	0.100	0.098
Easy Savings Business	0.136	0.133	Easy Savings Plan	0.128	0.125
<p>Notes:</p> <p>Business and Residential "Value Cents" plans have \$4.95 monthly fee.</p> <p>Easy Savings Business rate shown is for commitment levels that trigger a 20% discount. Customers subscribing to a longer term can obtain discounts of up to 30%.</p> <p>Residential "Easy Savings Plan" rates based upon usage over \$25/month.</p> <p>Residential "One Easy Price" plan has no monthly charge.</p> <p>Off-peak rates are either equivalent to or lower than peak rates.</p>					
<p>Sources:</p> <p>Verizon Northwest Inc. Washington Price List 2, Section 2, First Revised Sheet 1; Section 4 (entire).</p>					

Table 2

Verizon Long Distance Washington Intrastate Toll Calling Plans

<u>Business</u>			<u>Residential</u>		
Calling Plan	Anytime Rate	Less 1.8% Uncollectible	Calling Plan	Peak Rate	Less 1.8% Uncollectible
Simple Options 3-yr term	\$0.085	\$0.083	State Saver	\$0.080	\$0.078
Firm Rate 3-yr term	0.085	0.083	Big Deal	0.083	0.081
Simple Options 1-yr term	0.095	0.093	SmartTouch	0.090	0.088
Firm Rate 1-yr term	0.095	0.093	E-Values	0.10	0.098
Simple Options no term	0.100	0.098	Timeless	0.10	0.098
Firm Rate no term	0.100	0.098	Best Times	0.11	0.108

Notes:  
 "Simple Options" and "Firm Rate" plans specify monthly usage commitments, but the intrastate toll rates do not vary with usage commitments.  
 "State Saver" and "Best Times" have \$4.75 monthly fee.  
 Residential "E-Values" and "Timeless" plans have no monthly fee or minimum charge.  
 "Big Deal" is a prepaid service (\$5.00 for 60 minutes) for customers subscribing to Big Deal local service.  
 Off-peak rates are either equivalent to or lower than peak rates.

Sources:  
 \*\*[http://www22.verizon.com/longdistance/business/plan\\_simpleoptions.jsp](http://www22.verizon.com/longdistance/business/plan_simpleoptions.jsp), accessed 9/27/02.  
[http://www22.verizon.com/longdistance/business/plan\\_firmrate.jsp](http://www22.verizon.com/longdistance/business/plan_firmrate.jsp), accessed 9/27/02.  
[http://www22.verizon.com/longdistance/residential/plan\\_comparison\\_tool.jsp](http://www22.verizon.com/longdistance/residential/plan_comparison_tool.jsp), accessed 9/27/02.  
<http://www22.verizon.com/ForYourHome/SAS/ProdDesc.asp?id=6100&state=WA>, accessed 9/27/02.  
 Conversation with Verizon Long Distance customer service representative, 9/27/02.

Q. Based upon Verizon's intrastate toll pricing, as summarized in these tables, what do you conclude about whether or not Verizon Northwest's intrastate toll pricing plans satisfy the imputation test?

A. Assuming that customers make rational choices in selecting the best pricing plan to meet their usage requirement, each of Verizon's intrastate toll pricing plans appearing in Tables 1

1 and 2 have retail rates that are below the price floor for intrastate toll service<sup>66</sup> — thus, *each*  
2 *of the Verizon Northwest residential and business intrastate toll service plans identified in*  
3 *the Tables above fails the imputation test.*<sup>67</sup> Moreover, for each of the rate plans above, I  
4 have modeled only the “peak” rate and considered that to be the average revenue per minute  
5 received by Verizon. If “off-peak” usage had also been included, Verizon’s true average  
6 revenue per minute within each specific calling plan would undoubtedly be lower, which  
7 would push these services even further below the imputation floor.<sup>68</sup>

8  
9 Q. When the ILEC is permitted to set intrastate toll rates below the price floor, what is the  
10 impact on competitors?

11  
12 A. Verizon’s predatory pricing practice of setting intrastate toll rates below the price floor is  
13 the most extreme example of implementing a price squeeze, because in order to gain market

---

66. For services with a monthly fee, the amount of that fee must be apportioned across all usage and added to the per-minute usage charge. However, since customers have the ability to purchase no fee/no minimum pricing plans at rates of 10 cents per minute or less, it is reasonable to assume that no rational customer would subscribe to a plan in which the combined monthly and per-minute charges would exceed that level.

67. The only intrastate rate plans being offered by Verizon Northwest or Verizon LD that do not fail the imputation test are Verizon Northwest’s Easy Savings Plan for Business (when the customer’s commitment triggers a 10% or 15% discount, which puts per minute rates at \$0.145 to \$0.153 per minute) and the Easy Savings Plan for Residence with usage under \$25 per month (with a per minute rate of \$0.153). *See Verizon Northwest Inc. Washington Price List 2, Section 2, First Revised Sheet 1; Section 4, First Revised Sheets 4-10.*

68. Calculating a true revenue per minute for each calling plan requires detailed time-of-day demand data for Verizon’s actual customers. Verizon Northwest objected to providing this type of data in response to discovery, claiming it was “competitively sensitive information not relevant to the issues in this proceeding.” *See Verizon Northwest response to AT&T Data Request No. 5.*

1 share and compete with Verizon Northwest, competitors must offer intrastate toll service *at*  
2 *or below* the levels offered by Verizon. To do otherwise would provide customers no incen-  
3 tive to purchase the competitor's service. Since most of Verizon Northwest's retail intra-  
4 state toll rates are already set below the price floor for intrastate toll service, *competitors are*  
5 *forced to set toll rates at levels that guarantee a revenue shortfall and a zero or negative*  
6 *profit margin*. To the extent that competing carriers are unable to meet Verizon's price for  
7 *intrastate* services, their ability to compete in the adjacent *interstate* toll market could also  
8 be impaired, thereby enhancing Verizon's ability to force its rivals out of this segment as  
9 well.

10  
11 Q. Why is it important to go through the more rigorous process of setting an appropriate price  
12 floor, rather than simply requiring that the ILEC price its toll services in excess of switched  
13 access rates?

14  
15 A. It is common for incumbent LECs to contend that their own toll rates are appropriate so long  
16 as these rates are set at or above the rates for bottleneck switched access services that are  
17 levied upon competitive toll carriers. Such an approach ignores the *non-access costs* faced  
18 by any toll service provider, *including the ILEC*, for functions such as billing and collection,  
19 retail/marketing costs, uncollectibles, and use of the LNP database, as discussed above. As I  
20 have demonstrated, these non-access costs are real and verifiable, and as such are incurred  
21 by the incumbent carrier. As I have shown, Verizon Northwest's toll rates are not set at  
22 sufficient levels to demonstrate recovery of these non-access costs *as well as* the imputed  
23 cost of switched access.

24



1 Q. What economic conditions permit Verizon Northwest to offer its toll services at rates that do  
2 not, in fact, cover all of its costs?

3

4 A. The most obvious answer is that neither Verizon Northwest nor Verizon Long Distance  
5 actually “pay” itself any of the access charges that are being “imputed” in these cost floor  
6 calculations. We can estimate Verizon’s actual out-of-pocket costs for intrastate toll  
7 services by substituting Verizon’s TELRIC-based UNE rates for call origination and call  
8 termination for the imputed switched access charges that were used in the cost floor calcu-  
9 lation, and its seemingly “additional cost” of toll billing and collection that I believe may  
10 have been calculated by attributing all joint costs of local and toll billing and collection  
11 entirely to local, as I have already discussed. Verizon will, of course, be required to “pay”  
12 terminating access charges to Qwest and other ILECs. On this basis, Verizon’s actual  
13 “cost” per minute of intrastate toll is only BEGIN PROPRIETARY << [REDACTED] >> END  
14 PROPRIETARY, even though its competitors’ costs are much closer to the \$0.1444 price  
15 floor.

16

17 If one accepts the argument that above-cost access charges are needed in order to provide  
18 support for other services, then when Verizon sets its intrastate toll rates below the access  
19 imputation cost floor, then Verizon must be recovering these shortfalls through revenues  
20 from other, noncompetitive services. This practice unambiguously amounts to an anticom-  
21 petitive cross-subsidization of its competitive toll service. Because ILECs such as Verizon  
22 Northwest provide multiple services, they have the ability to effect such cross-subsidies  
23 quite easily.

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1 Consider, once again, the costs associated with billing and collection. Assume that the cost  
2 of providing billing and collection for local exchange service is \$1.50 per customer per  
3 month, and that the cost of billing and collection for toll service, if performed on a stand-  
4 alone basis, is \$1.00 per customer per month. Also assume that if performed at the same  
5 time and compiled on the same bill, the cost of providing billing and collection for local  
6 exchange and toll service combined is \$1.60 per customer per month,<sup>69</sup> implying a joint cost  
7 of \$1.50 for the two functions combined. In setting its retail prices and consistent with the  
8 “double marginalization” concept I have discussed above, an incumbent carrier might then  
9 consider the non-access cost of providing billing and collection for its toll service to be the  
10 differential in cost for toll billing and collection over and above what it would incur for local  
11 exchange billing only, *i.e.*, \$0.10 in this example.<sup>70</sup> However, a stand-alone IXC that does  
12 not provide other services to a captive group of ratepayers would incur the full \$1.00 cost  
13 per customer per month, and would thus be forced to recover those costs through its retail  
14 toll rates.<sup>71</sup>

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69. In the current Sec. 272 compliance proceeding before the Minnesota Public Utilities Commission being held in conjunction with Qwest’s Sec. 271 Application for In-Region InterLATA Authority, the Administrative Law Judge has found that “[t]he actual costs incurred by the Qwest BOC in combining its billing with that of QCC [the Sec. 272 long distance affiliate] may be lower than ten cents per bill page.” State of Minnesota Office of Administrative Hearings for the Minnesota Public Utilities Commission, *In the Matter of a Commission Investigation Into Qwest’s Compliance with the Separate Affiliate Requirements of the Telecommunications Act of 1996 (Section 272)*, OAH Docket No. 7-2500-14487-2, Minn. PUC Docket No. P-421/CI-01-1372, Findings of Fact and Conclusions of Law and Recommendations issued March 14, 2002, at FOF 84.

70. Faced with the same situation, one could also conclude that the full cost for toll billing and collection is \$1.00, and the incremental cost for local exchange service is \$0.10.

71. As the Minnesota ALJ observed in the Qwest Sec. 272 proceeding, footnote 40 *supra*, at FOF 84, “[t]he payment between QCC and the Qwest BOC has no impact whatsoever  
(continued...)

1 In this example, the ILEC in effect “allocates” \$1.50 out of the \$1.60 combined cost of local  
2 and toll billing to *local*, allocating only the additional \$0.10 to toll, allowing the competitive  
3 toll service to escape all responsibility for any share of the joint costs of this shared function.  
4 While some might argue that such an arrangement does not constitute a cross-subsidy in that  
5 the cost of local service is not increased, there can be no question but that the competitive  
6 service is being afforded the entire benefit of the economy of scope: But for the ILEC’s  
7 incumbency in the local exchange market, the billing and collection cost of the toll service  
8 would be a dollar, not a dime. More importantly, by assigning all joint costs to the mono-  
9 poly service, or by ignoring these costs altogether, the ILEC further expands the price  
10 squeeze to which it subjects its rivals. As such, imputing the full value of non-access costs  
11 into Verizon’s toll service rates is necessary to prevent Verizon from squeezing profits away  
12 from the competitors by virtue of its incumbency advantages.

13

14 I would note that this problem is exacerbated when Verizon provides its local and long  
15 distance services on an integrated basis. The differential cost of “piggy-backing” the access  
16 and interexchange transport and switching functions onto the base cost of providing local  
17 network services will be considerably below the stand-alone cost than an IXC will incur for  
18 providing interexchange services alone. If Verizon allocates all of the stand-alone costs of  
19 local services to the local category and assigns only the additional costs of access and  
20 interexchange functions to the “long distance” category, the effect will be to assign and

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71. (...continued)

on the revenues received by QSC (the common parent of QCC and the Qwest BOC) or QCI (the ultimate parent company). But the offering of the “negotiated price” to third parties can make participation in the service too expensive or impair the ability of those third parties to compete in the market.”

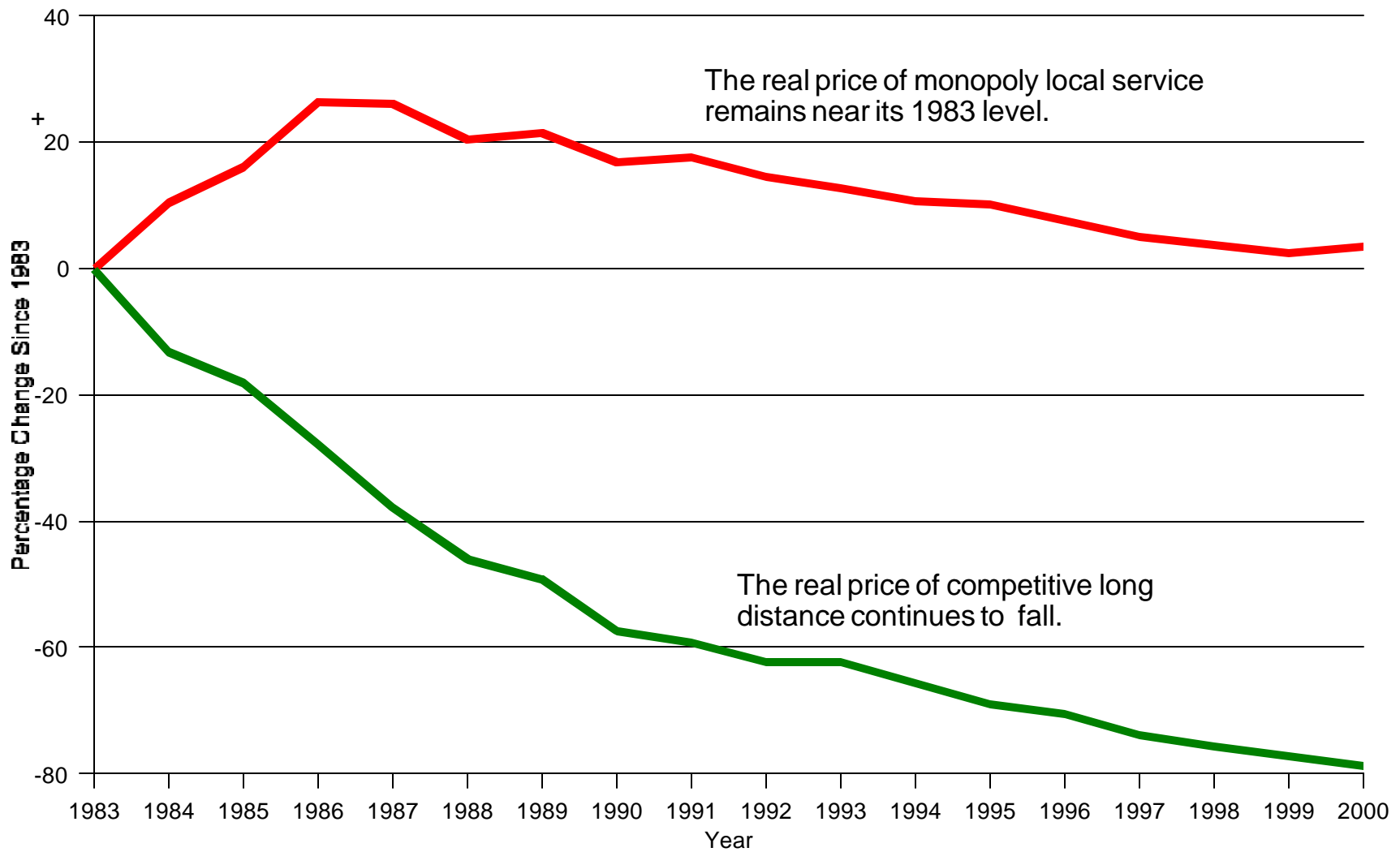
1 recover all *joint costs* exclusively and entirely to the monopoly local category. If Verizon  
2 then seeks to set its retail long distance prices so as to profit-maximize solely with respect to  
3 these differential costs, non-ILEC competitors could be subjected to an even more drastic  
4 price squeeze than they are today.

5  
6 **Lowering switched access prices to cost-based levels is the best mechanism for dismantling**  
7 **Verizon's price squeeze on competitive toll service providers and for encouraging the**  
8 **expansion of intrastate toll competition in Washington state.**  
9

10 Q. Why is it preferable to require Verizon Northwest to lower its switched access rates to  
11 competitors to cost-based levels than to simply require Verizon to raise its retail toll rates  
12 above an appropriate price floor?

13  
14 A. Although the Commission can, in principle, eliminate the price squeeze in the toll service  
15 market by either raising Verizon's retail toll rates or by lowering Verizon's switched access  
16 rates, the latter choice is clearly to be preferred and is consistent with the cost-based pricing  
17 of essential services foundation of the *Telecommunications Act of 1996*. First, reducing  
18 Verizon Northwest's intrastate switched access rates to cost-based levels will mean that  
19 Verizon Northwest and competing IXCs will confront roughly the same *actual out-of-pocket*  
20 *costs* for the essential switched access functions, whether these are acquired implicitly by  
21 Verizon Northwest as part of its bundled end-to-end retail toll service, or explicitly by an  
22 IXC through purchase of switched access services from Verizon Northwest. Indeed, were  
23 Verizon permitted to *increase* its retail toll rates as the means for eliminating the existing  
24 price squeeze, the effect would be to provide Verizon with an even higher margin on its  
25 intrastate toll services, potentially fueling cross-subsidization of other competitive services

1       and in so doing shifting the price squeeze problem from toll to those services. Second, the  
2       competitive nature of the toll market will force carriers to flow through the access cost  
3       reductions in their retail prices — an outcome that has clearly occurred in the case of  
4       *interstate* toll services (see Figure 1).



**Figure 1: Adjusted for inflation, long distance rates have fallen by nearly 80% since 1983, the last year before the Bell System break-up. By contrast, ILEC local rates have remained essentially unchanged over that same period.**

Source: FCC, *Trends in Telephone Service*, Table 14.5; FCC, *Statistics of Communication Common Carriers*, 1995/1996 Edition, Table 8.4 and 2001 Edition, Table 5.6; Bureau of Labor Statistics, Inflation Calculator at: <http://www.bls.gov/cpi/>. Long distance rate for 2000 is an estimate.



1 The result: retail toll rates in Washington State can be expected to decrease by an amount  
2 corresponding to the access charge reduction, thereby stimulating additional use of the public  
3 switched network and resulting in lower prices for all Washington residential and business  
4 consumers. As the Commission has previously noted, “[a] reduction in access rates can be  
5 expected to have substantial economic benefit for residential and business customers of this  
6 state. Toll calls are a substantial portion of the total telephone bill of many customers, and [a]  
7 reduction will make their overall telephone service more affordable.”<sup>72</sup> Finally, reducing  
8 switched access rates to cost-based levels and adhering to the imputation requirements set forth  
9 in this affidavit will provide the best opportunity to hold potential future price squeezes in the  
10 intrastate toll service market in check. Thus, overall, reducing access charges is a far superior  
11 policy than requiring that Verizon Northwest raise its retail toll rates so as to satisfy imputation  
12 and eliminate the prevailing price squeeze, as it will allow Verizon Northwest and its intraLATA  
13 toll competitors to compete on a more equitable and equal basis.

14

15 Q. Does this conclude your direct testimony at this time?

16

17 A. Yes, it does.

---

72. Washington Utilities and Transportation Commission, Complainant, v. U S West Communications, Inc., Respondent, WUTC Docket No. UT-950200, 15<sup>th</sup> Supplemental Order, April 11, 1996, at 112 (footnote omitted).

**Attachment 1**

**Statement of Qualifications  
Lee L. Selwyn**



## **Statement of Qualifications of LEE L. SELWYN**

Dr. Lee L. Selwyn has been actively involved in the telecommunications field for more than twenty-five years, and is an internationally recognized authority on telecommunications regulation, economics and public policy. Dr. Selwyn founded the firm of Economics and Technology, Inc. in 1972, and has served as its President since that date. He received his Ph.D. degree from the Alfred P. Sloan School of Management at the Massachusetts Institute of Technology. He also holds a Master of Science degree in Industrial Management from MIT and a Bachelor of Arts degree with honors in Economics from Queens College of the City University of New York.

Dr. Selwyn has testified as an expert on rate design, service cost analysis, form of regulation, and other telecommunications policy issues in telecommunications regulatory proceedings before some forty state commissions, the Federal Communications Commission and the Canadian Radio-television and Telecommunications Commission, among others. He has appeared as a witness on behalf of commercial organizations, non-profit institutions, as well as local, state and federal government authorities responsible for telecommunications regulation and consumer advocacy.

He has served or is now serving as a consultant to numerous state utilities commissions including those in Arizona, Minnesota, Kansas, Kentucky, the District of Columbia, Connecticut, California, Delaware, Maine, Massachusetts, New Hampshire, Vermont, New Mexico, Wisconsin and Washington State, the Office of Telecommunications Policy (Executive Office of the President), the National Telecommunications and Information Administration, the Federal Communications Commission, the Canadian Radio-television and Telecommunications Commission, the United Kingdom Office of Telecommunications, and the Secretaria de Comunicaciones y Transportes of the Republic of Mexico. He has also served as an advisor on telecommunications regulatory matters to the International Communications Association and the Ad Hoc Telecommunications Users Committee, as well as to a number of major corporate telecommunications users, information services providers, paging and cellular carriers, and specialized access services carriers.

Dr. Selwyn has presented testimony as an invited witness before the U.S. House of Representatives Subcommittee on Telecommunications, Consumer Protection and Finance and before the U.S. Senate Judiciary Committee, on subjects dealing with restructuring and deregulation of portions of the telecommunications industry.

In 1970, he was awarded a Post-Doctoral Research Grant in Public Utility Economics under a program sponsored by the American Telephone and Telegraph Company, to conduct research on the economic effects of telephone rate structures upon the computer time sharing industry. This work was conducted at Harvard University's Program on Technology and Society, where he was appointed as a Research Associate. Dr. Selwyn was also a member of the faculty at the College of Business Administration at Boston University from 1968 until 1973, where he taught courses in economics, finance and management information systems.

Dr. Selwyn has published numerous papers and articles in professional and trade journals on the subject of telecommunications service regulation, cost methodology, rate design and pricing policy. These have included:

“Taxes, Corporate Financial Policy and Return to Investors”  
*National Tax Journal*, Vol. XX, No.4, December 1967.

“Pricing Telephone Terminal Equipment Under Competition”  
*Public Utilities Fortnightly*, December 8, 1977.

“Deregulation, Competition, and Regulatory Responsibility in the Telecommunications Industry”  
*Presented at the 1979 Rate Symposium on Problems of Regulated Industries - Sponsored by: The American University, Foster Associates, Inc., Missouri Public Service Commission, University of Missouri-Columbia, Kansas City, MO, February 11 - 14, 1979.*

“Sifting Out the Economic Costs of Terminal Equipment Services”  
*Telephone Engineer and Management*, October 15, 1979.

“Usage-Sensitive Pricing” (with G. F. Borton)  
(a three part series)  
*Telephony*, January 7, 28, February 11, 1980.

“Perspectives on Usage-Sensitive Pricing”  
*Public Utilities Fortnightly*, May 7, 1981.

“Diversification, Deregulation, and Increased Uncertainty in the Public Utility Industries”  
*Comments Presented at the Thirteenth Annual Conference of the Institute of Public Utilities, Williamsburg, VA - December 14 - 16, 1981.*

“Local Telephone Pricing: Is There a Better Way?; The Costs of LMS Exceed its Benefits: a Report on Recent U.S. Experience.”

*Proceedings of a conference held at Montreal, Quebec - Sponsored by Canadian Radio-Television and Telecommunications Commission and The Centre for the Study of Regulated Industries, McGill University, May 2 - 4, 1984.*

“Long-Run Regulation of AT&T: A Key Element of A Competitive Telecommunications Policy”

*Telematics*, August 1984.

“Is Equal Access an Adequate Justification for Removing Restrictions on BOC Diversification?”

*Presented at the Institute of Public Utilities Eighteenth Annual Conference*, Williamsburg, VA - December 8 - 10, 1986.

“Market Power and Competition Under an Equal Access Environment”

*Presented at the Sixteenth Annual Conference, “Impact of Deregulation and Market Forces on Public Utilities: The Future Role of Regulation”*

*Institute of Public Utilities, Michigan State University*, Williamsburg, VA - December 3 - 5, 1987.

“Contestable Markets: Theory vs. Fact”

*Presented at the Conference on Current Issues in Telephone Regulations: Dominance and Cost Allocation in Interexchange Markets - Center for Legal and Regulatory Studies Department of Management Science and Information Systems - Graduate School of Business, University of Texas at Austin*, October 5, 1987.

“The Sources and Exercise of Market Power in the Market for Interexchange Telecommunications Services”

*Presented at the Nineteenth Annual Conference - “Alternatives to Traditional Regulation: Options for Reform” - Institute of Public Utilities, Michigan State University*, Williamsburg, VA, December, 1987.

“Assessing Market Power and Competition in The Telecommunications Industry: Toward an Empirical Foundation for Regulatory Reform”

*Federal Communications Law Journal*, Vol. 40 Num. 2, April 1988.

“A Perspective on Price Caps as a Substitute for Traditional Revenue Requirements Regulation”

*Presented at the Twentieth Annual Conference - “New Regulatory Concepts, Issues and Controversies” - Institute of Public Utilities, Michigan State University*, Williamsburg, VA, December, 1988.

“The Sustainability of Competition in Light of New Technologies” (with D. N. Townsend and P. D. Kravtin)

*Presented at the Twentieth Annual Conference - Institute of Public Utilities Michigan State University*, Williamsburg, VA, December, 1988.

“Adapting Telecom Regulation to Industry Change: Promoting Development Without Compromising Ratepayer Protection” (with S. C. Lundquist)  
*IEEE Communications Magazine*, January, 1989.

“The Role of Cost Based Pricing of Telecommunications Services in the Age of Technology and Competition”  
*Presented at National Regulatory Research Institute Conference*, Seattle, July 20, 1990.

“A Public Good/Private Good Framework for Identifying POTS Objectives for the Public Switched Network” (with Patricia D. Kravtin and Paul S. Keller)  
Columbus, Ohio: *National Regulatory Research Institute*, September 1991.

“Telecommunications Regulation and Infrastructure Development: Alternative Models for the Public/Private Partnership”  
*Prepared for the Economic Symposium of the International Telecommunications Union Europe Telecom '92 Conference*, Budapest, Hungary, October 15, 1992.

“Efficient Infrastructure Development and the Local Telephone Company's Role in Competitive Industry Environment” *Presented at the Twenty-Fourth Annual Conference, Institute of Public Utilities, Graduate School of Business, Michigan State University*, “Shifting Boundaries between Regulation and Competition in Telecommunications and Energy”, Williamsburg, VA, December 1992.

“Measurement of Telecommunications Productivity: Methods, Applications and Limitations” (with Françoise M. Clottes)  
*Presented at Organisation for Economic Cooperation and Development, Working Party on Telecommunication and Information Services Policies, '93 Conference “Defining Performance Indicators for Competitive Telecommunications Markets”*, Paris, France, February 8-9, 1993.

“Telecommunications Investment and Economic Development: Achieving efficiency and balance among competing public policy and stakeholder interests”  
*Presented at the 105th Annual Convention and Regulatory Symposium, National Association of Regulatory Utility Commissioners*, New York, November 18, 1993.

“The Potential for Competition in the Market for Local Telephone Services” (with David N. Townsend and Paul S. Keller)  
*Presented at the Organization for Economic Cooperation and Development Workshop on Telecommunication Infrastructure Competition*, December 6-7, 1993.

“Market Failure in Open Telecommunications Networks: Defining the new natural monopoly,” *Utilities Policy*, Vol. 4, No. 1, January 1994.

*The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers*, (with Susan M. Gately, et al) a report prepared by ETI and Hatfield Associates, Inc. for AT&T, MCI and CompTel, February 1994.

*Commercially Feasible Resale of Local Telecommunications Services: An Essential Step in the Transition to Effective Local Competition*, (Susan M. Gately, et al) a report prepared by ETI for AT&T, July 1995.

“Efficient Public Investment in Telecommunications Infrastructure”  
*Land Economics*, Vol 71, No.3, August 1995.

*Funding Universal Service: Maximizing Penetration and Efficiency in a Competitive Local Service Environment*, Lee L. Selwyn with Susan M. Baldwin, under the direction of Donald Shephard, A Time Warner Communications Policy White Paper, September 1995.

*Stranded Investment and the New Regulatory Bargain*, Lee L. Selwyn with Susan M. Baldwin, under the direction of Donald Shephard, A Time Warner Communications Policy White Paper, September 1995

“Market Failure in Open Telecommunications Networks: Defining the new natural monopoly,” in *Networks, Infrastructure, and the New Task for Regulation*, by Werner Sichel and Donal L. Alexander, eds., University of Michigan Press, 1996.

*Establishing Effective Local Exchange Competition: A Recommended Approach Based Upon an Analysis of the United States Experience*, Lee L. Selwyn, paper prepared for the Canadian Cable Television Association and filed as evidence in Telecom Public Notice CRTC 95-96, Local Interconnection and Network Component, January 26, 1996.

*The Cost of Universal Service, A Critical Assessment of the Benchmark Cost Model*, Susan M. Baldwin with Lee L. Selwyn, a report prepared by Economics and Technology, Inc. on behalf of the National Cable Television Association and submitted with Comments in FCC Docket No. CC-96-45, April 1996.

*Economic Considerations in the Evaluation of Alternative Digital Television Proposals*, Lee L. Selwyn (as Economic Consultant), paper prepared for the Computer Industry Coalition on Advanced Television Service, filed with comments in FCC MM Docket No. 87-268, In the Matter of Advanced Television Systems and Their Impact Upon the Existing Television Broadcast Service, July 11, 1996.

*Assessing Incumbent LEC Claims to Special Revenue Recovery Mechanisms: Revenue opportunities, market assessments, and further empirical analysis of the "Gap" between embedded and forward-looking costs*, Patricia D. Kravtin and Lee L. Selwyn, In the Matter of Access Charge Reform, in CC Docket No. 96-262, January 29, 1997.

*The Use of Forward-Looking Economic Cost Proxy Models*, Susan M. Baldwin and Lee L. Selwyn, Economics and Technology, Inc., February 1997.

*The Effect of Internet Use On The Nation's Telephone Network*, Lee L. Selwyn and Joseph W. Laszlo, a report prepared for the Internet Access Coalition, July 22, 1997.

*Regulatory Treatment of ILEC Operations Support Systems Costs*, Lee L. Selwyn, Economics and Technology, Inc., September 1997.

*The "Connecticut Experience" with Telecommunications Competition: A Case in Getting it Wrong*, Lee L. Selwyn, Helen E. Golding and Susan M. Gately, Economics and Technology, Inc., February 1998.

*Where Have All The Numbers Gone?: Long-term Area Code Relief Policies and the Need for Short-term Reform*, prepared by Economics and Technology, Inc. for the Ad Hoc Telecommunications Users Committee, International Communications Association, March 1998.

*Broken Promises: A Review of Bell Atlantic-Pennsylvania's Performance Under Chapter 30*, Lee L. Selwyn, Sonia N. Jorge and Patricia D. Kravtin, Economics and Technology, Inc., June 1998.

*Building A Broadband America: The Competitive Keys to the Future of the Internet*, Lee L. Selwyn, Patricia D. Kravtin and Scott A. Coleman, a report prepared for the Competitive Broadband Coalition, May 1999.

*Bringing Broadband to Rural America: Investment and Innovation In the Wake of the Telecom Act*, Lee L. Selwyn, Scott C. Lundquist and Scott A. Coleman, a report prepared for the Competitive Broadband Coalition, September 1999.

Dr. Selwyn has been an invited speaker at numerous seminars and conferences on telecommunications regulation and policy, including meetings and workshops sponsored by the National Telecommunications and Information Administration, the National Association of Regulatory Utility Commissioners, the U.S. General Services Administration, the Institute of Public Utilities at Michigan State University, the National Regulatory Research Institute at Ohio State University, the Harvard University Program on Information Resources Policy, the Columbia University Institute for Tele-Information, the International Communications Association, the Tele-Communications Association, the Western Conference of Public Service Commissioners, at the New England, Mid-America, Southern and Western regional PUC/PSC conferences, as well as at numerous conferences and workshops sponsored by individual regulatory agencies.

**Attachment 2**

**Verizon Wireless**

**Washington Local Calling Area**

**Advertisement for Coast-to-Coast  
Home Calling Area Service**

# Price Plan Maps: Local DigitalChoice<sup>®</sup>

Local Home Airtime Rate Area



### IMPORTANT MAP DISCLAIMER

This rate map approximates where rates apply and is **not** a depiction of actual service or rate availability or wireless coverage. The mapped territory contains areas with no service. Wireless Service is subject to network and transmission limitations, including cellsite unavailability, particularly in remote areas. Alaska has limited service. Customer equipment, weather, topography and other environmental considerations associated with radio technology also affect service.



# Now pack your minutes with every business trip.

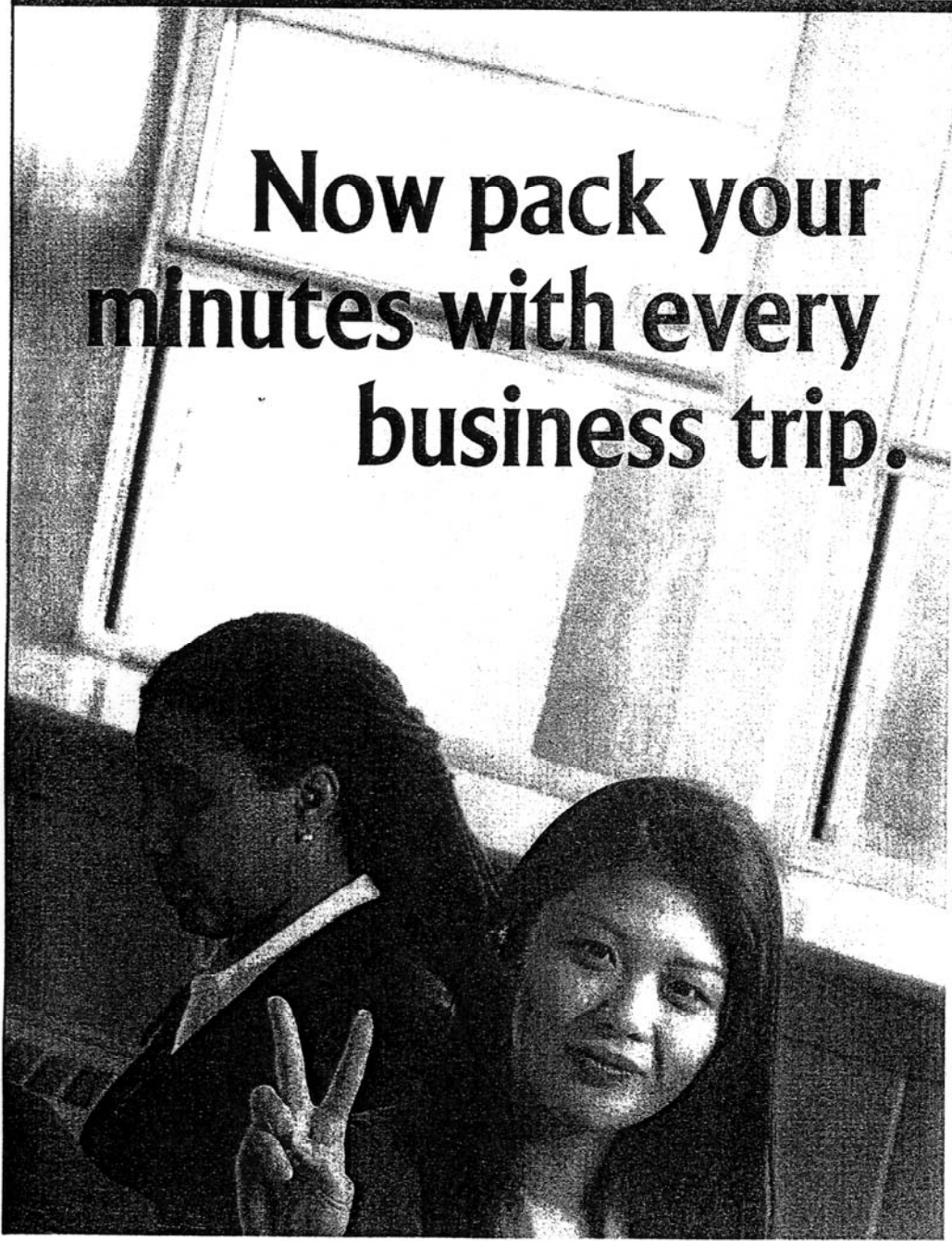


Introducing

**The America's Choice<sup>SM</sup> Plan.**  
Where your home calling area stretches coast to coast.

With the America's Choice calling plan from Verizon Wireless, all your plan minutes are national minutes. You can call from anywhere on the America's Choice network to anywhere coast to coast with no roaming or long distance fees. And when you sign up for America's Choice, the network covering over 248 million people, you'll be a part of the largest wireless network in the nation, connecting more people in more places than any other provider.

Just another way we're working to bring you the best wireless network and the best values. So where will you choose to take your minutes with America's Choice?



## **Attachment 3**

### **Intrastate Toll Price Floor Calculation**

### Attachment 3

#### Intrastate Toll Price Floor Calculation

ALLEGEDLY PROPRIETARY DATA HAS BEEN REMOVED

**Weighted Average\* Intrastate Access Charges:**

1	Verizon-WA Orig. Access	\$0.0614
2	Wt'd Verizon-WA Term. Access	\$0.0151
3	Wt'd QWEST-WA Term. Access	\$0.0113
4	Wt'd Century Tel-WA Term. Access	\$0.0111
5	<b>Total Weighted Average Access</b>	<b>\$0.0989</b>

**Sources:**

Verizon Northwest Inc WN U-16 Facilities for Intrastate Access, Sections 4 and 12.5; Verizon's response to Staff Data Request No. 7, Attachment D.  
 Verizon Northwest Inc WN U-16 Facilities for Intrastate Access, Sections 4 and 12.5.  
 Qwest Corporation, WN U-44 Access Service, Sections 3.8 and 6.8.  
 CenturyTel of WA, WN U-4 Access Services, Section 16; WECA, WN U-1, Schedule 4.  
 Sum (line 1:line 4)

**Billing & Collection**

6	Cost of ICO Billing and Collection	\$0.0155
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Verizon New York cost to Verizon Long Distance for billing and collection services, divided by average residential monthly interLATA toll calling MOU. See <http://www.verizonld.com/pdfs/VLDTransactionDetailWebPage1.pdf>, and FCC, Industry Analysis Division, Common Carrier Bureau, *Trends in Telephone Service*, May 2002, at Table 15.2.

**Retailing/Marketing Functions**

7	Estimate of retailing/marketing functions	\$0.0300
---	---	----------

In the Matter of a Commission Investigation into Qwest's Compliance with section 272 of the Telecommunications Act of 1996's Separate Affiliate Requirement; Minnesota PUC Docket No. P-421/CI-01-1372, OAH Docket No. 7-2500-24487-2; Surrebuttal Affidavit of Dr. William E. Taylor on behalf of Qwest Corporation, January 16, 2002, at para. 20.

**LNP Database Inquiry**

8	LNP Query Service, per query	\$0.0006
9	Percent Occurence	67.87%
10	Attempts per message	1.40
11	Average MOU per message for Verizon	**
12	Cost for LNP database inquiry, per MOU	**

The Verizon Telephone Companies, Tariff FCC No. 1, Section 13.3.16.F, original page 13-97, effective 4/28/2001.  
 Percentage of NXX codes in Washington that are LNP capable. LERG, January 2001.  
 Estimate -- no current number available from Verizon. See Verizon response to AT&T Data Request No. 13.  
 PROPRIETARY: Verizon response to AT&T Data Request No. 12.  
 PROPRIETARY: Verizon response to AT&T Data Request No. 12. (Line 8 x line 9 x line 10) / 11

13	<b>Price Floor (Access, B&amp;C, Retailing, LNP)</b>	<b>**</b>
----	--	-----------

PROPRIETARY: Verizon response to AT&T Data Request No. 12. line 5 + line 6 + line 7 + line 12

14	<b>Price Floor (Without Proprietary LNP database charge)</b>	<b>\$0.1444</b>
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line 5 + line 6 + line 7

\*Access charges weighted according to Verizon Northwest's "percent of traffic." See, Verizon response to Staff Data Request No. 7, Attachment D.

## **Appendix 1**

### **An Illustration of “Double Marginalization”**

## Appendix 1

### An Illustration of “Double Marginalization”

The mechanics of the “double marginalization” process can best be illustrated graphically. Figure 1a below diagrams the demand and cost conditions confronting an IXC that is required to purchase access services at tariff rates from the ILEC and for which the access charges represent true out-of-pocket costs. DD’ is the downward-sloping demand curve that represents consumer demand for long distance service.  $C_{N-IXC}$  represents the *non-access cost* that is confronted by the IXC.  $C_{IXC}$  represents the total cost to the IXC, including both access charge payments to the ILEC ( $P_A$ ) and the non-access costs ( $C_{N-IXC}$ ). Confronted with these demand and cost conditions, the IXC will set its retail price,  $P_{IXC}$ , at the level that maximizes the IXC’s profits, which are identified as the area labelled “IXC Profits” on the diagram. The ILEC’s profits on the access services it sells to the IXC are a function of the ILEC’s access charge ( $P_A$ ) less the ILEC’s actual costs (TELRIC) of those access services ( $C_A$  on Figure 1a) times the quantity of access that the IXC purchases, which is in turn a function of the quantity of retail long distance service that the IXC sells, which is in turn a function of the IXC’s retail long distance price. The ILEC’s access profits are represented by the area market “ILEC Profits” on the diagram.

Figure 1b illustrates the cost and demand conditions being confronted by the ILEC when it provides long distance and access services on an integrated basis. Here, the ILEC’s costs are only the *non-access costs* that the ILEC confronts, as represented by the line marked  $C_{N-ILEC}$  on the graph, and the incremental costs of the network service including the access functions,  $C_{ILEC}$  on the graph. The *cost floor* that would confront the ILEC if it were following the imputation

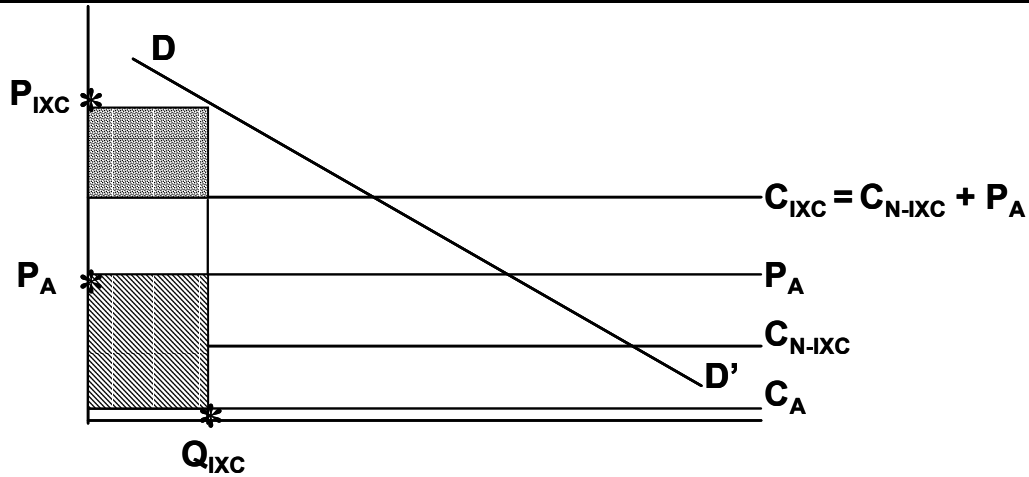


Figure 1a

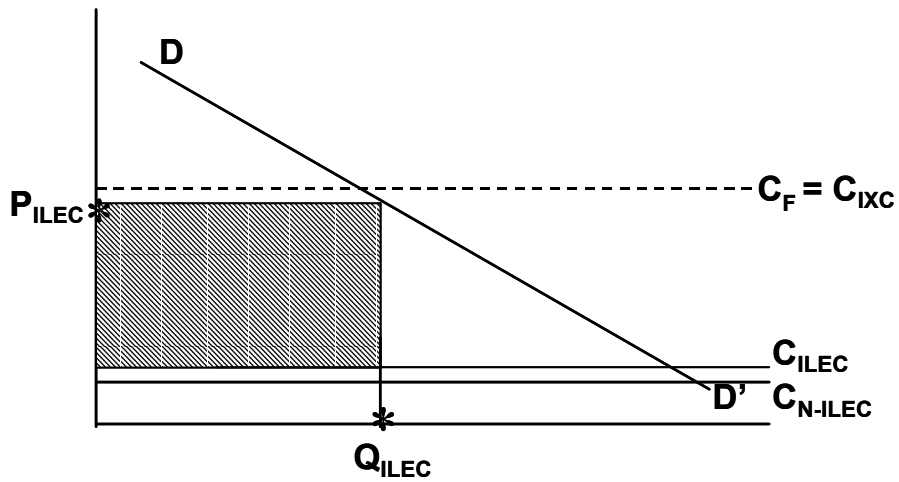




Figure 1b

-  ILEC Profit
-  IXC Profit

**Figure 1.** Double marginalization provides the ILEC with the incentive and ability to impose a price squeeze on the IXC.

rules is represented by the dashed line marked  $C_F$  on the graph, which includes the *imputed* access charges that the IXC confronts and is thus the same as  $C_{IXC}$  on Figure 1a. However, because the ILEC does not actually confront out-of-pocket access costs, its *profit-maximization price level*,  $P_{ILEC}$ , will be based upon only the *non-access costs*, and will result in profits as represented by the area marked “ILEC Profits” on the diagram. By ignoring the price floor that includes a cost element (access) that the ILEC does not actually confront, the ILEC’s incentive is to offer its retail service at a lower price (possibly one that is below the price floor, as shown in the diagram), thereby enabling it to sell more minutes and thus earn greater profits than had been possible when the retail price was being controlled by the IXC. Of course, the IXC will then be unable to maintain its pre-ILEC entry price, and will be subjected to a price squeeze with the (then) prevailing retail price being set below the IXC’s actual out-of-pocket costs.

The results of my calculation of Verizon Northwest’s price floor for toll service are entirely consistent with the “double marginalization” conduct that Hausman *et al.* had attributed to Verizon after its long distance entry in New York and which I have previously discussed. This is demonstrated on Figure 2 below, on which I have reproduced the illustrative diagrams from Figure 1 to reflect the actual price and cost results that I have derived in my testimony.

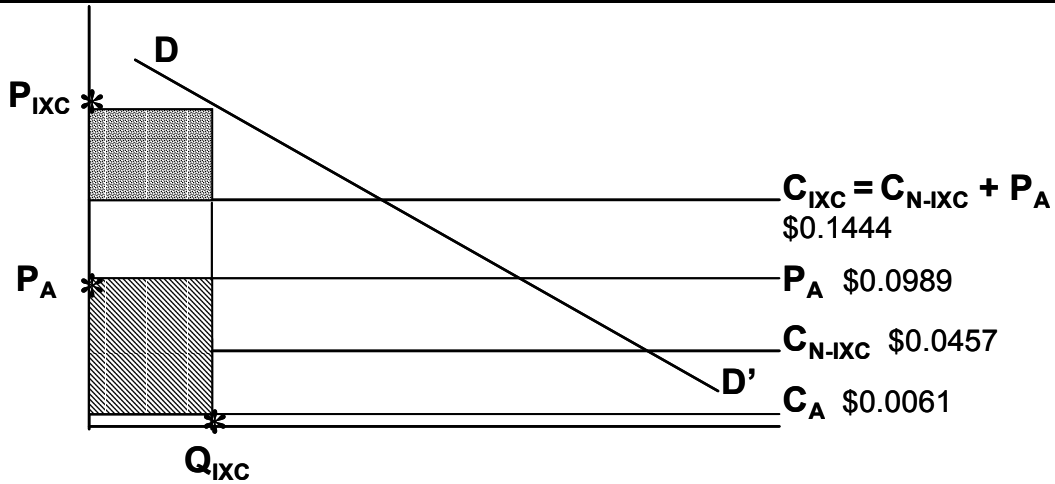


Figure 2a

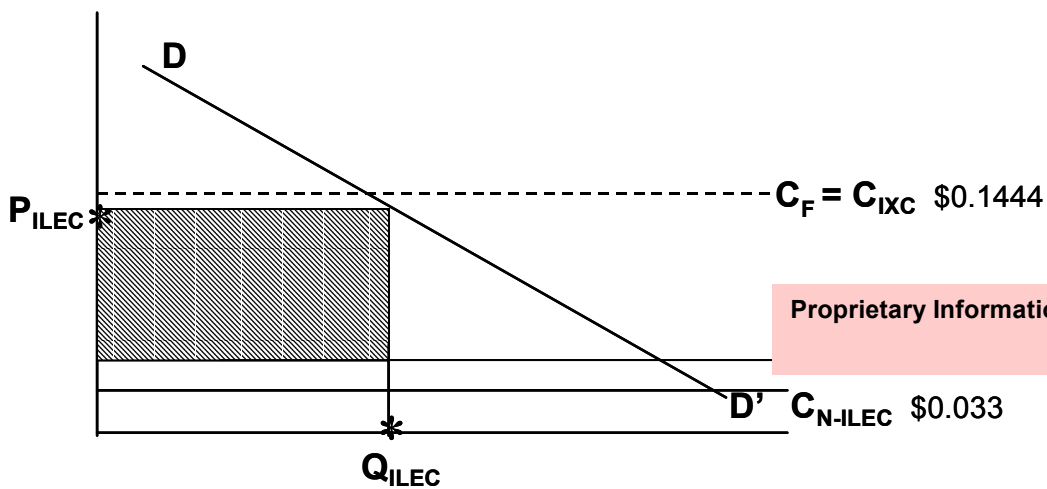


Figure 2b



-  ILEC Profit
-  IXC Profit

Figure 2. Verizon Northwest’s costs and pricing practices in Washington indicate conduct that is consistent with double marginalization.