BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements Transport and Termination, and Resale	**)**	**DOCKET NO. UT-960369**
In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements Transport and Termination, and Resale for US WEST Communications, Inc.	**)**	**DOCKET NO. UT-960370**
In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements Transport and Termination, and Resale for GTE Northwest Incorporated	**)**	**DOCKET NO. UT-960371**

PHASE III

Reply Testimony
of
William Page Montgomery

for

Advanced TelCom Group, Inc.
Electric Lightwave, Inc.
GST Telecom Washington, Inc.
NewEdge Networks, Inc.
Nextlink Washington, Inc.

January 18, 2000

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Table of Contents

1. Introduction and Summary

Q. What is your name and business affiliation?

A. My name is William Page Montgomery. I am the principal of Montgomery Consulting in Laguna Beach, California. I have previously submitted testimony in Phases I and II of this proceeding, on seven separate occasions. I have been involved in telecommunications public policy and regulatory matters since 1974. I have participated in several hundred state-level telecommunications proceedings, and have submitted expert testimony in such matters many times. My consulting assignments have involved analyzing the organization of and the development of competition in telecommunications, as well as numerous policy and economic issues involving rate structures, pricing, cost and cost allocation methods, and tariffs. I have been actively involved in many local exchange competition proceedings and arbitrations in Arizona, California, Connecticut, Florida, Idaho, Illinois, Indiana, Iowa, Kentucky, Maryland, Massachusetts, Michigan, Missouri, Nebraska, New Mexico, Ohio, Oregon, Pennsylvania, Texas, Utah, Washington and Wisconsin. I have degrees in law and economics from Duke University and Butler University, respectively.

Q. What is the purpose of your testimony?

A. A number of competitive local exchange carriers operating in Washington state asked me to analyze the issues raised by the December 15, 1999 testimony on deaveraging of the loop UNE prices previously established by the Commission. Four parties filed direct testimony proposing deaveraged rates: The Commission Staff, General Telephone Company of the Northwest (GT-NW), US West Communications (US West) and AT&T. I will briefly address the strengths and weaknesses of each of the proposals. I will also discuss other issues relative to deaveraging unbundled network elements (UNEs), including the effects, if any, of loop cost deaveraging on universal service.

Q. Can you summarize your testimony?

A. Yes. The Staff's loop deaveraging proposal, presented by Tom Spinks, proves to be the strongest. It is the most empirically-based proposal and recognizes that loop costs vary as much * or more * by distance as by the density of access lines. The Staff's approach also produces a set of data that can be used for different deaveraging configurations. Based on this data set I have developed a deaveraging proposal that will be simpler to implement and administer than the Staff's initial formulation. Whereas the Staff proposal would produce nearly 150 separate rate elements (for US West and GT-NW combined) for the loop UNE, my alternative involves just 28 separate prices. My proposal involves less deaveraging than the Staff's initial proposal but still gives the telephone companies better, more cost-based price signals than the current statewide average loop prices. I will also discuss how distance-deaveraged loop prices should be implemented.

Q. What other issues do you discuss in this testimony?

A. I address two other issues, including the impact of loop UNE deaveraging when the incumbent's retail local exchange service prices are not similarly deaveraged and/or rebalanced. Both US West and GT-NW devote considerable attention to this subject. I will show that the ILECs' complaints in this regard are vastly overstated. The so-called "arbitrage" effects that US West and GT-NW purport to identify are overstated because the ILECs do not acknowledge (a) the extremely limited market penetration of their loop UNEs at this time, or (b) the rapid demand growth and improved financial performance that characterizes both the Washington incumbents and the U.S. telephone industry generally.

"Universal service" is a policy concern only if and to the extent that ILECs might have to raise prices for customers who have no competitive alternatives, in order to prevent the incumbents' financial performance from being significantly harmed. That condition is hardly imminent, however. Moreover, "arbitrage" effects may be a policy concern only if the incumbents do not have mechanisms to move towards more efficient prices for services subject to emerging competition. With the deaveraging of the loop UNEs, the incumbents will also have the ability to adjust prices for any truly competitive markets by utilizing the deaveraged component costs as part of the price floor for their retail offerings.

Q. What is the third issue that you address?

A. The third issue is whether UNEs other than the loop should be deaveraged. The Staff has proposed a three-part unbundling of local switching rates for US West and GT-NW based upon density zones. The other three parties I mentioned believe that unbundled switching rates are not needed. I agree with the latter view. A factor to be considered in any disaggregation of prices is the amount of "noise" in any given cost estimate. To the extent the estimates are imprecise ÿ as they necessarily must be to some degree ÿ the more the cost estimate is carved up or deaveraged the more likely it is that variations in the deaveraged costs are impacted by the noise in the data. This is an important consideration with respect to loop deaveraging and applies to any deaveraged switch costs as well. Because switching is a smaller component of carriers' local service cost structures than loops and may be more readily replicated by competitors of incumbents, switch cost deaveraging does not carry the same benefits as loop deaveraging.

2. <u>Loop Deaveraging Issues</u>

Q. Can you discuss the principal factors affecting the geographic deaveraging of loop costs?

A. Yes. The main factors are the same ones that applied to rate making in a monopoly utility environment or, for that matter, any marketing/pricing decision in a competitive industry. The rate deaveraging should track a provider's costs as closely as possible while not making the overall rate structure unduly complex. In this instance, another consideration is that the deaveraged loop prices must reconcile to US West's and GT-NW's loop costs and prices adopted by the Commission in the earlier phases of this proceeding.

Each of the four deaveraging proposals in the direct testimony achieves reconciliation to the ILECs' Commission-adopted statewide loop costs by applying a mechanical "closure" or scaling factor to the deaveraged cost results. Each party's deaveraging proposals are based upon different cost data sets specific to each proposal. Any of these methods should be generally acceptable, because the different methods are used only to develop relative cost results that are then scaled to the statewide average ILEC costs. None of the cost models or cost data sets is being used to re-estimate the absolute value of the statewide average loop cost.[1]

Q. Can you summarize the loop deaveraging proposals offered by other parties?

A. Yes. US West used its RLCAP cost model, GT-NW used its COSTMOD tool and the Staff and AT&T relied upon versions of the HAI model in order to develop deaveraged loop cost estimates. US West defined density zones based upon the placement of wire centers in Metropolitan Statistical Areas (MSAs) in Washington. [US West witness Thompson, Phase II Direct Testimony, pp. 8-9]. GT-NW defined density zones based upon the national parameters of the COSTMOD tool. AT&T arrayed all of US West's and GT-NW's individual wire center loop costs, based on version 3.1 of the HAI model, in the order of access line density. AT&T then selected density zones based upon natural breakpoints in the data. [AT&T witness Denney, Phase II Direct Testimony and Attachment A].

Staff witness Spinks estimated wire center specific loop costs using some of the data files in version 5 of the HAI model. These data were tested statistically in order to determine the significance of the correlation between costs and density in different density zones. The Staff also used statistical techniques to develop distance-based cost deaveraging as a function of the density cost differences. An algorithm based on the natural log of the loop distance times the regression-derived density cost variable of each zone, produces the distance disaggregation for US West. The cost relationships relative to distance and density for US West are applied to GT-NW data, based on the unique regression-derived density zone cost data specific to GT-NW.

Q. Which of these deaveraging methods is preferable?

A. The Staff's. The ILECs' proposed deaveraged loop costs suffer from two significant flaws. First, their respective density zone definitions are not alike. US West proposes to use MSAs, as I said. US West witness Thompson notes examples of MSAs being used as zones or market areas for some purposes. However, none of his examples use MSAs for cost deaveraging purposes, and the market area definitions cited by Mr. Thompson don't involve cost differences. If the objective is to define disaggregated costs then some artificial

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[1]. US West's data requests to the Staff, numbers 7 through 11, suggest that US West might try to indict the Staff's proposal for being based on the HAI model and the alleged infirmities thereof. US West's approach is incorrect because the HAI data set (not necessarily the entire model) is used by the Staff only for the relative deaveraging purpose. Moreover, US West relied exclusively on its own cost model as did GT-NW. If using any one model to estimate relative deaveraged loop costs were problematic, then the ILECs' methods would be equally infirm – because the Commission did not adopt any single loop cost model in this proceeding.

geographic definition like the MSAs should not be used to the exclusion of the cost information. Costs are the best data to use. GTE's COSTMOD density zones are likewise unique to its proposal and to GTE cost models first developed at least three years ago.

Second, partly because of how their proposed density zones were selected, neither US West's nor GT-NW's proposals achieve significant, truly cost-based deaveraging of loop costs. US West's proposal reduces its statewide average cost by only 8% in the highest density, lowest-cost zone and 3% in the company's middle zone. GT-NW's medium density deaveraged cost is actually lower than the cost of loop in the most dense (and supposedly lowest cost) serving area. US West's and GT-NW's results may demonstrate that density is not the best single variable to use for loop cost deaveraging. On the other hand, it may be that the ILECs selected their deaveraging proposals mainly to minimize the movement towards more cost based rates. As I discuss in Section 4, below, US West and GT-NW are both basically opposed to any loop cost deaveraging.

AT&T's deaveraging proposal has the virtue of being developed using disaggregated wire center-based cost data, but AT&T averages costs for US West and GT-NW. To my knowledge, the Commission has not previously addressed whether different ILECs cost can or should be averaged. AT&T, like the ILECs does not account for loop distances in addition to the density of loops in a wire center area, unlike the Staff's proposal.

Q. It important to account for distance-based cost differences in addition to density differences?

A. Yes. In 1996 when the FCC first determined that deaveraged loop costs would improve the efficiency of prices, there may have been an assumption that density was the most important cost-related variable. The FCC had deaveraged special access line prices based on density, but did not require states to follow the same methods.[2] Since 1996 the learning created by more advanced development of loop cost models has shown that loop distance is a more important driver of loop costs than density. In this docket and in other states, the discussions concerning loop feeder and distribution placement assumptions in different cost models, how the effects of digital carrier systems are modeled and how customer locations are tracked in different models, has served to highlight the importance of distance-related costs. Indeed, most of the disputes that arose regarding different loop cost models implicated distance factors more than loop density.

Q. Does the evidence so far in this Phase III confirm the effects of loop distance on loop costs?

A. Yes. The Staff's analysis presented in Mr. Spinks' Exhibit and workpapers demonstrates that

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[2]. The FCC rule states that "[s]tate commissions shall establish different rates for elements in at least three defined geographic areas within the state to reflect geographic cost differences... [States] may use existing density-related zone pricing plans... , or other such cost-related zone plans established pursuant to state law. In states not using such existing plans, state commissions must create a minimum of three cost-related rate zones." 47 CFR §51.507.

the distance component derived by the Staff's statistical procedure is more significant than density costs. In the three largest US West density zones, the more expensive areas are less than 65% higher than the lowest cost zone. Within any of those zones, however, the longest loops are between 480% and 620% more expensive than the shortest loops. Similarly, in the three largest GT-NW density zones, the more expensive areas are less than 70% higher than the lowest cost zone. Within the GT-NW zones, however, the longest loops are between 560% and 630% more expensive than the shortest loops.

Moreover, even if data did not show that distance is an important driver of loop costs overall, the Commission could still determine that distance-deaveraging had important public interest benefits. Data services are the fastest growing local service at the present time and distance generally has an effect on the throughput achieved by different data services, including some forms of DSL service. DSL has numerous benefits for both CLECs and ILECs, such as faster data connections and more efficient use of existing public switched networks. Thus, loop pricing that reflects distance is efficient with respect to the deployment and use of data services.

Q. Are there any other public interest benefits of loop deaveraging by distance as well as density?

A. Yes. Its no secret that in most states, including Washington, CLECs have been able to utilize the unbundled loop UNE only to a limited extent. Moreover, the ILECs' addition of new retail service access lines (net of their customer churn) continues to vastly outpace the growth rate of competitive services using unbundled loops. The latest data reported by ILECs to the FCC, for June 30, 1999 and December 31, 1998,[3] demonstrate similar conditions for US West and GT-NW. In mid-year 1999, unbundled loops in use constituted less than one-tenth of one percent of US West's retail switched lines in Washington; and barely one-hundredth of one percent of GT-NW's retail lines. Between 12/98 and 6/99 US West installed 18 net new retail lines for every net new loop UNE used by competitors. GT-NW installed almost 400 net new retail lines for every loop UNE installed. Based on data such as these the Commission should find that failure to deaverage loop UNE rates so as to reflect significant and real cost differences is an impediment to the development of local competition in Washington, and therefore contrary to the public interest.

Q. Are there any drawbacks to the Staff's deaveraging proposal?

A. Yes, I think so. The Staff's approach results in an excessive number of discrete rate elements. The resulting rate structure is complex, having 64 rate elements for US West and 80 for GT-NW. The Staff's rate structure is a product of its emphasis on the statistical properties of the loop cost data. If loop costs in two different wire centers appeared to be statistically different based on density, Staff more or less automatically placed them in different density zones. Similarly, the Staff's distance bands were derived from the density zone analysis. The Staff's approach is unbiased and relatively easy to analyze, but there are

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other considerations that should also be reflected in a final rate structure for deaveraged loops.

As I will discuss below, any deaveraging of the existing statewide average loop costs will involve increased operational complexity for ILECs and CLECs alike. However, a rate structure with far fewer rate elements than the Staff's initial proposal can reduce administrative complexity of loop cost deaveraging.

Q. Would a rate structure with fewer discrete element seriously reduce the precision of Staff's underlying economic cost estimates?

A. No. Staff's proposal, like those of the other three parties, requires a mechanical reconciliation factor in order to match the deaveraged relative loop costs to the statewide average costs previously determined by the Commission. As I said above, this step is not in itself a serious deficiency. The relative adjustment arises from (a) the necessity of matching deaveraged numbers to US West's and GT-NW's statewide values and (b) each party's freedom to use different models or cost data to derive relative costs by zone or distance band. In the case of the Staff's proposal, however, the size of the "closure" or reconciliation factor is significantly larger than the difference between the indicated costs for, say, two adjacent density zones or for two or more adjacent distance bands. In other words, the Staff's proposed rate structure can be subject to some additional rate averaging without really affecting the precision of the economic cost estimates themselves. Additional averaging, in effect, mainly affects the impact of closure factor that the Staff used on the deaveraged loop prices.

Thus, it is quite feasible to re-average some of the rates, as I have done. The exhibit attached to my reply testimony shows the effects of re-averaging. Page 1 of the exhibit shows the distance banded rates for US West and GT-NW; page 2 shows the regrouping of the ILECs' exchanges into two density zones (labeled "A" and "B").

Q. Can you describe how you developed the alternative loop deaveraging proposal?

A. Yes. Although it is certainly correct that there could be as many as four density zones for US West, and five for GT-NW, there are exchanges in the Staff's proposed third density zone, such as Spokane and Olympia, in which CLEC activity already has begun. This suggests that some of those third-zone exchanges can already support CLECS' competitive entry (which may be facilities-based, given the less than one percent penetration of loop UNEs experienced by US West to date). Likewise, a number of the GT-NW exchanges in Staff 's second and third density zones are near other exchanges (often US West's) that could be potentially competitive ÿ such as the GT-NW exchanges in or clustered northwest of the Seattle metro area. It is reasonable to group these exchanges into the same density zone, even though their respective densities may be statistically different from each other.

On the other side of the ledger, both US West and particularly GT-NW have a large number of exchanges with substantially higher deaveraged loop costs but with very small numbers of

access lines. Complete deaveraging of loop costs and prices in exchanges with line densities less than 100 may not be needed to stimulate efficient competition. Competitive entry in these latter exchanges is less likely to be based on any kind of terrestrial subscriber plant, whether facilities based or using unbundled loop UNEs. Wireless technologies are likely to play a larger role.

Q. What were the results of your analysis?

A. Based upon this analysis, I decided to group US West and GT-NW's exchanges into two density zones each using the 100 access line density breakpoint identified by Mr. Spinks' analysis. Then I regrouped the first twelve distance bands in the Staff's proposed rate structure into three kilofoot increments. I maintained the next distance band that the staff identified, i.e., twelve to eighteen kilofeet, and re-averaged the costs of all loops over eighteen kilofeet. The results are shown on my exhibit.

Q. How would you characterize the rate structure shown in your Exhibit?

A. I would characterize it as being more "conservative" that the Staff's initial rate structure proposal and more cost based than either of the ILECs' proposed deaveraging. As a "conservative" effort at deaveraging, this type of rate structure is likely to have fewer unforeseen effects. For example, none of the four proposals submitted with the direct testimony discusses whether or how the cost deaveraging would affect residential, as opposed to business subscribers. It may be that some of the proposals would especially benefit businesses. On the other hand, I estimate that roughly 90% and 75% of all their residential subscribers would be located in US West's and GT-NW's respective zones "A" in my proposal. Thus, this loop cost deaveraging does not particularly favor only one class of ILEC customer.

Q. Does this type of loop deaveraging involve any operational issues?

A. Yes. Every significant change in the rate structure for any UNE could affect the carriers' (both ILECs and CLECs) ordering, provisioning and billing processes. The ILECs may argue that loop cost deaveraging should be delayed until they complete "necessary" and possibly quite expensive systems modifications to account for the new rate structure ÿ and they would seek to collect those costs directly from CLECs. In this instance, however, the Commission can adopt a few relatively simple operational guidelines so that deaveraged loop rates can be put in place without major modifications to the ILECs' systems and with the minimal added costs to the industry. In addition, the Commission should encourage or even require the ILECs and CLECs to work cooperatively to agree on and implement these guidelines.

Q. What are these guidelines?

A. First, there should be an "all or nothing" rule. The rates shown on page 1 of my exhibit contain zone average rates as well as loop rates deaveraged by distance. Every CLEC would have to elect to use one or the other format. Because some or many CLECs could elect (permanently) the zone average rates, the deaveraging process would be simplified. (This

approach is also necessary to prevent adverse selection, of course). GT-NW and US West would only have to bill CLECs who elected the zone average rates for one additional rate element compared to their existing statewide loop prices.

Second, CLECs who did elect to utilize the distance based rates should have to assume some of the administration costs of the rate structure. For example, the ordering process and first month's ILEC bill for a loop UNE would reflect only the "A" or "B" zone rate elements. Thereafter, the CLEC could claim an offset against the average amount billed by the ILEC at the zone average rates by calculating the effective distances of the loop UNEs the CLEC was using.

Q. Can the calculations of the deaveraged loop cost distances be made without major modifications to CLEC and ILEC systems and processes?

A. Yes. Modifications to ILEC systems and software should not be required in order to perform the distance calculations within those systems. It some instances the ILECs' loop data bases may not even be accurate or reliable enough to justify modifying the systems for distance calculations. Instead, the industry should use one of the many off-the-shelf software products that measure distances based upon latitudes and longitudes, or street addresses. Hopefully, the industry in Washington can agree on a standardized, available product. Using this method a CLEC would calculate the dollar effects of its distance priced loop UNEs and apply an offset to its bill based upon the average priced UNE. Each ILEC would, of course, have the right to fully review the CLEC's calculations against the ILEC's own data (including the industry agreed-upon distance measuring tool).

The CLECs and ILECs have account teams working with each other (often on a less adversarial basis than their regulatory representatives) and I see no reason why this existing system could not be efficiently extended to the billing adjustments required by distance-based loop UNEs. The other ILEC ordering and provisioning processes associated with loop UNEs today would be entirely unaffected by this overlaid ILEC-CLEC billing adjustment process. Thus, a cooperative approach among US West, GT-NW and interested CLECs in Washington should enable immediate implementation of deaveraged loop costs.

Q. Do you have any other observations about how LECs in Washington should cooperate?

A. Yes. Clearly, the Commission or the Staff should be involved in the cooperative effort, at least on an informal basis. Decisions should be reached within a relatively brief time period. Perhaps most important, every LEC in the process should have but one vote. This approach would stifle any ILEC incentives to delay the process. One might infer that ILECs do have incentives to delay loop deaveraging both from the limited amount of disaggregation they supported in direct testimony, and from the ILECs largely unfounded arguments about harm to universal service.

3. Universal Service "Impacts" of Loop Deaveraging

Q. Can you summarize the issue about how loop deaveraging might affect universal service in Washington?

A. Yes. Both GT-NW and US West argue that the Commission should forego (or at least minimize) loop deaveraging at this time until it has completed two complicated tasks: (1) Developed a comprehensive universal service mechanism for Washington under whatever new grant of statutory authority may be needed for that purpose, and (2) allowed the ILECs to deaverage (or, in effect, re-balance) their existing retail rates for local exchange service. The ILECs' arguments are not persuasive and should be rejected by the Commission.

Q. Should continuation of universal service, or the effects of loop UNE deaveraging on universal service, be a concern to the Commission?

A. The answer is "yes" from a continuing, public policy perspective, but "no" from any sort of practical perspective in the foreseeable future. Universal service is of course a permanent part of the United States' (or, indeed, the world's) telecommunications policy. But in this country, or Washington state, the universal service issue cannot be viewed in terms of one or two variables ÿ such as the large differences between an ILEC's cheapest and most costly loops, or the effects of arbitrage on an ILEC's current inefficient rate structure. Other variables that must be taken into account include:

- the ILECs' very robust financial condition ÿ which would require large general rate decreases under any previous form of rate regulation of telephone utilities;
- the growing demand for both traditional ILEC services and new offerings, and
- the apparently large economic efficiencies associated with the wave of consolidation now underway in the industry.

Indeed, the values placed traditional LECs by these very consolidations show that these large suppliers are not at significant risks from increased competition.

Q. Based on your 25 years of work in this field, do you have an opinion concerning whether US West or GT-NW would ask the Washington Commission to conduct a comprehensive review of all cost and financial variables that impact universal service and loop cost deaveraging?

A. In my opinion, it would be highly imprudent for either ILEC to do anything that might result in any comprehensive Commission review of either's financial or operational performance. It won't happen in the foreseeable future. Although there may be hypothetical concerns that loop deaveraging will increase CLEC arbitrage opportunities, the actual data suggest these opportunities are quite constrained by market conditions. Given the current, extremely limited scope of UNE-based competition, loop cost deaveraging can occur without so-called comprehensive universal service reform. What the ILECs will experience – at worst – is what firms subject to competition confront all the time, i.e., a gradual erosion of some of their relatively more profitable services.

The relationship between competition and universal service is a canard that ILECs have been

using for many purposes: They used it first to try to limit the scope of unbundling, then to resist reciprocal compensation, to seek recovery of special costs only from CLECs, and so on. This latest manifestation of the ILEC argument is no worthier of consideration than the others, particularly since the ILECs are (understandably) very reluctant to have the Commission examine all aspects of their rates and financial condition in a way that would put the universal service argument in the proper light.

Q. Should the Commission seek to prevent CLECs from gaining new arbitrage opportunities?.

A. Not at all. ILECs view arbitrage quite pejoratively, but they are incorrect. Arbitrage is a normal, market clearing mechanism typical of many transactions everyday in most goods and services. And arbitrage is or should be transitory by definition. (The arbitrage opportunity exists until the market is cleared.) ILECs could complain only about arbitrage possibilities that were semi-permanent in nature. But the ILECs can clear any unusual CLEC arbitrage opportunity simply by adjusting their own retail prices – adjustments that do not have to be "revenue neutral" given the ILECs' favorable operational and financial factors that I discussed above. With the deaveraging of the loop UNEs, the incumbents have the ability to adjust prices for services that are truly competitive by utilizing the deaveraged component costs as part of the price floor for their retail offerings. In this way, arbitrage stimulates, as it should, movement towards more efficient prices for services subject to emerging competition. The Commission role, then, is only to see that arbitrage fulfills its appropriate role in the market.

Q. Is there anything particularly notable about the ILECs' arguments against loop UNE deaveraging?

A. Yes. GT-NW's testimony is particularly notable. GT-NW witness Terry Dye tries to make the argument deaveraging loop costs at this time would create opportunities for CLECs to engage in "price arbitrage." Besides this argument, Mr. Dye also suggests that the Commission could adopt a variation on the "efficient component pricing rule" (ECPR) developed by Professor William Baumol as an antidote to the allegedly distorted economic effects on any cost based UNE deaveraging. Mr. Dye's testimony has several glaring errors, however. GT-NW presented the same arguments in Phase II of this proceeding through the testimony of its witness Kirk Lee. Mr. Dye offers the identical rate example sponsored by Mr. Lee in order to support GT-NW's argument against "price arbitrage." [Dye, Phase III Direct Testimony, pp. 11-12]. In Phase II GT-NW argued that the Commission should adopt price markups not based on economic costs, in order to prevent the alleged CLEC "price arbitrage." I demonstrated in my Phase II reply testimony that witness Lee's rate example was incorrect both conceptually and quantitatively. [Montgomery Reply Testimony, Phase II, August 20, 1998, pages 9-14; specifically, p. 12]. I won't reiterate that analysis. In Phase III Mr. Dye now uses the identical, deeply flawed analysis to argue that the Commission should reject rate deaveraging based upon economic cost estimates in order to prevent the alleged CLEC "price arbitrage." Its *deja vu* all over again.

Q. Is GT-NW's testimony notable in any other way?

A. Yes. Mr. Dye's testimony also contains another serious error. Dye's Exhibit TRD-1 contains Professor William Baumol's latest rendition of his ECPR theory.[4] I and several other analysts in this proceeding have explained repeatedly why the ECPR is bad public policy and, in fact, has never been adopted by any U.S. telecommunications regulator. [Montgomery Phase II Reply Testimony, *ibid.*]. Mr. Dye discusses a submission by economists Baumol, Janus Ordover and Robert Willig that the FCC cited with approval in its first Local Competition Implementation Order in FCC Docket 96-98. [Dye Phase II Direct Testimony, p.14]. One might infer from Dye's testimony that the Baumol / Ordover / Willig submission concerned the same subject matter as Mr. Dye's Exhibit TRD-1. It did not. The submission dealt with the economic benefits of unbundling network elements to a much greater extent than ILECs were then advocating. It did not discuss the ECPR. It was sponsored by AT&T. A different submission in FCC Docket 96-98 by Professor Baumol in support of the ECPR was rejected by the FCC – in accord with the findings of most regulatory agencies around the world. Mr. Dye's testimony on this and other points doesn't deserve to be given any significant weight by the Commission.

Q. Can you summarize why the Washington Commission should not delay or otherwise minimize cost-based deaveraging of loop costs based on the ILECs ' misplaced "universal service" arguments?

A. Yes. Comprehensive universal service protection is needed when competitive pressures on an incumbent LEC threaten to harm its financial performance or to require significant price increases for non-competitive services. This is true whether the provider's "financial performance" were measured by traditional earnings tests or defined more broadly as a significant change in the *status quo ante* (in other words, a decline in the ILEC's financial performance might not have to reach truly "confiscatory" dimensions). The smaller the ILEC, the more likely it is that competition may require explicit universal service protection. But US West and GT-NW are not in this position today and its hard to see if or when they will ever need protection from market forces. There is no universal service-related reason to delay loop deaveraging for GT-NW and US West. Likewise, any "arbitrage effects" that arise because of loop deaveraging are a normal, healthy market mechanism and are best addressed through the ILECs' own pricing responses, rather than by delaying implementation of more cost based UNE rates.

4. <u>Deaveraging Other UNEs</u>

Q. You noted that deaveraging of switching UNEs was not necessary. Can you explain why?

A. Yes. AT&T, US West and GT-NW all state that unbundled switching rates are not needed.

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[4]. "Having Your Cake: How to Preserve Universal-Service Cross Subsidies While Facilitating Competitive Entry, Yale Journal of Regulation , 1999.

The data seem to support this view in two respects. As I noted above, the Staff data indicates that density has less impact on switch costs than the impact of either density or distance on relative loop costs. Thus, while the cost data suggest that both density and distance deaveraging of unbundled loop costs is needed in order to make prices for that UNE more cost-based, the same thing may not be said about switching costs.

In addition, it is not clear from a theoretical standpoint that the density of the area served by a wire center should have a significant effect on traffic sensitive switching costs. Thus, even the relatively modest differences between the highest-cost and lowest-cost switching identified in the Staff's data may be somewhat suspect. If the estimates derived from such models are imprecise – as they necessarily must be to some degree – any given cost estimate based on forward-looking economic and engineering models must have some amount of "noise." The cost of tolerating this "noise" in estimates of the economic costs of switching probably exceeds the benefit of deaveraging rates, because switching is a smaller component of carriers' local service cost structure than loops, and switching may be more readily replicated by competitors of incumbents.

5. Conclusion

Q. Can you summarize your recommendations to the Commission?

A. Yes. The loop unbundled network element should be deaveraged both by line density and by distance. In this testimony I have presented one variation on the Staff's initial loop deaveraging proposal. My proposal is simpler but still cost-based. Other variations are possible too. Loop deaveraging should not be delayed, or limited to the ILECs' inadequate deaveraging plans, because of concerns about universal service or the existence of arbitrage opportunities. The local switching UNE does not need to be deaveraged.

Q. Does this complete your testimony?

A. Yes.