**BEFORE THE**
**WASHINGTON STATE UTILITIES AND TRANSPORTATION COMMISSION**

| | |
|---|---|
| **IN THE MATTER OF**<br><br>**QWEST CORPORATION PETITION FOR COMPETITIVE CLASSIFICATION OF BUSINESS SERVICES IN SPECIFIED WIRE CENTERS** | **NO. UT-000883** |

# DIRECT TESTIMONY OF SARAH J. GOODFRIEND, PH.D.
# ON BEHALF OF
# PUBLIC COUNSEL AND TRACER

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## I. INTRODUCTION AND ORGANIZATION OF TESTIMONY

**Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.**

A. My name is Sarah J. Goodfriend. I am an economic consultant in private practice, specializing in antitrust and competitive issues in the U.S. electric power and telecommunications industries. My business address is 701 Brazos, Suite 310 in Austin, Texas, 78701.

**Q. ON WHOSE BEHALF ARE YOU TESTIFYING BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION (WUTC)?**

A. I am testifying on behalf of the Public Counsel and the Telecommunications Ratepayers Association for Cost-based and Equitable Rates (TRACER).

**Q. PLEASE PROVIDE A BRIEF DESCRIPTION OF YOUR EXPERIENCE AS AN ANALYST IN THE ECONOMICS OF REGULATED ELECTRIC AND TELECOMMUNICATIONS UTILITIES AND IN COMPETITION ANALYSIS.**

A. I have roughly twenty years of experience in regulatory reform and competition analysis of electric and telecommunications utilities. Prior to graduate school, in 1978-1979, I was employed as an economist by the Public Utility Commission of Texas (PUCT). Both my undergraduate and graduate studies, including my dissertation, addressed the economics of regulated electric utilities, as did my work experience during this time. I received a Ph.D. in economics from the University of North Carolina at Chapel Hill in 1985. My initial post-graduate employment was with the U. S. Federal Trade Commission (FTC), Bureau of Economics. At the FTC I specialized in regulation and antitrust policy and provided expert testimony on behalf of the FTC before federal agencies. In 1987, I joined the Office of Economic Policy at the Federal Energy Regulatory Commission (FERC-OEP) where I worked as a policy advisor and expert witness focusing on issues of regulatory reform and competition analysis in electric utility networks. I returned to the PUCT in 1992 to create an Office of Economic Policy and was appointed a PUC Commissioner by Governor Ann Richards in 1993. As a member of the PUCT staff and as a Commissioner I participated in NARUC, serving on the Communications Committee, the NRRI Board of Directors and participating in educational conferences and forums.

After leaving the PUCT and prior to starting my own practice, I joined the Washington D.C. office of MCI Telecommunications Corporation (now WorldCom's) regulatory analysis group. For MCI, my primary responsibility was to develop economic and regulatory policies addressing state commission implementation of the Federal Telecommunications Act of 1996. In this capacity, I supervised MCI engineering consultants developing cost and pricing comments and provided expert testimony to state commissions in Section 251 proceedings. In my consulting practice I have continued to specialize in analysis of competition in telecommunications and electricity markets. My resume provided as Exhibit SJG-2 supplies additional details of my educational background and work experience.

**HAVE YOU TESTIFIED PREVIOUSLY BEFORE THE WUTC?**

A. Yes, I provided written testimony on behalf of McLeod USA Telecommunications Services, Inc. in the US WEST – Qwest merger proceeding. My testimony was stipulated into the record in that proceeding.

**Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

**A.** I have been asked by Public Counsel and TRACER to evaluate whether Qwest's Petition, supporting testimonies, and documentation demonstrate that effective competition exists according to the guidelines provided to the Commission in RCW 80.36.330, WAC 480-120-022 and WAC 480-120-023 and thus, whether granting the Petition furthers state legislative policy set forth in RCW 80.36.300. Specifically



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in accordance with WAC 480-120-022(7), I will evaluate whether the services for which Qwest seeks competitive classification are subject to *effective competition*, that is, whether the customers of these services have reasonably available alternatives and that service is not provided to a significant captive customer base.

In addressing the question of whether effective competition exists for the customers at issue, I have analyzed the Petition and its supporting data in light of the factors enumerated in RCW 80.36.330, this Commission=s most recent application of RCW 80.36.330 (Docket No. UT-990022) and the economic frameworks for competitive analysis employed by the FCC, the FERC and antitrust authorities. If applied using an explicit antitrust-oriented approach, the factors enumerated in RCW 80.36.330 produce a consistent, precise and reliable framework for identifying where effective competition is or will soon exist (and, where it does not, how the Commission may foster its development).

**Q. HOW IS YOUR TESTIMONY ORGANIZED?**

A. My testimony has five parts. Following this introductory section, in Part II, I provide findings and summary recommendations. In Part III, I provide a brief overview of diversity among business customers. In Part IV, I use the four factors of RCW 80.36.330 in a competitive analysis with three subsections, (1) “Identification of Relevant Markets”, (2) “Measurement of Market Concentration” and “Market Share” and (3) Conditions of Entry in Relevant Markets. I use the facts of this Petition and those of prior proceedings to illustrate how I apply the factors and develop economic inferences concerning effective competition. I develop a working definition of the statutory requirement of when competition is effective, such that customers of the service have reasonably available alternatives and that the service is not provided to a significant captive customer base.

## II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

**Q. WHAT ARE YOUR FINDINGS WITH RESPECT TO THE EXTENT OF EFFECTIVE COMPETITION?**

There is no basis for the Commission to grant the Petition. Granting the Petition provides Qwest new *upward* pricing flexibility and a new ability to more finely discriminate among its business customers. I will show how Qwest has failed to meet its factual burden because Qwest has failed to properly identify the relevant market when examining *the extent to which services are available from alternative providers in the relevant market* as required by RCW 80.36.330(1)(b).

If the Commission grants the pricing flexibility and ability to discriminate among customers that Qwest seeks,[1] identifiable groups of Qwest business customers would become subject to the exercise of market power. I investigate the state of effective competition for identifiable customer groups -- very large customers, single tenant customers occupying large buildings, and very small business customers. The very large customers I describe are customers with 1000 or more employees. The very small customers I describe are customers with 1 to 4 employees. Upward pricing flexibility, the ability to offer customer-specific contracts without regard to the prohibitions against undue preference or discrimination, and the transfer of services from tariff to price list requirements permits Qwest to exercise market power over these two and other distinct business customer groups. Qwest's ability to raise prices (and absent regulatory oversight, Qwest's ability to fail to reduce prices as costs decline) are a profitable exercise of market power for the customer/service combinations Qwest identifies as lacking reasonably available alternatives for its business services. This Commission has already granted Qwest the ability to lower price to cost.

**PLEASE PROVIDE THE BASIC FACTUAL UNDERPINNINGS FOR YOUR FINDINGS.**

A. Specifically, I find:

In purchasing US WEST, Qwest has acquired an incumbent local exchange (ILEC) network with many existing business customers. As a consequence of US WEST's historical obligation to serve, Qwest controls a ubiquitous telecommunications network of existing facilities capable of providing the services listed in Attachment A to its Petition to all business customers who demand them, regardless of business customer location in its franchise territory.

Qwest ignores limitations on entrants' collective ability to provide effective substitutes for all the customers who demand business services in the areas included in the Petition. At this early stage of entry, CLECs' market entry strategies are *not* to provide reasonably available alternative products to all existing Qwest business customers. Rather, CLECs are focused on providing services to various kinds of high volume, high margin business customers located in close proximity to their existing backbone fiber facilities.

The possibility that CLEC entry will be sufficiently likely, sufficiently rapid and sufficiently large to render Qwest's exercise of market power over business customer segments currently lacking reasonably available alternatives unprofitable is remote. Were CLECs to enter non-priority business segments prematurely, CLECs would face significant costs of entry and exit. Qwest possesses the information and ability to exercise market power over a significant captive base of business customers without attracting entry.



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**Q. WHAT IS YOUR RECOMMENDATION TO THE COMMISSION?**

A. I recommend that the Commission deny the Petition. Qwest has failed to identify relevant markets. Quest has not provided the data and analysis that are necessary to evaluate the state of competition in the products and areas included in its Petition. The data Qwest provides does not reflect forward-looking marketplace conditions because Qwest has failed to address the competitive implications of either (1) its current pricing and contracting flexibilities or (2) the implementation of deaveraged UNE rates for zones included in its Petition.

CLECs' ability to use UNE loops to serve business customers is an important means of entry. Yet, Qwest data shows very little use of unbundled loops for entry by CLECs, suggesting that issues of access, ease of use and price may be discouraging this entry strategy. In addition, the entry data by wire center in Qwest's Petition reflect UNE loop rates which have been superceded. The data reflects existing interim UNE loop rates of $11.33 and $13.37. These costs will be replaced by the zone specific UNE loop rates approved by the Commission. For example, the Commission has approved UNE Loop costs for Zone 5 of $24.18. Seven of the 31 wire centers in the Petition are Zone 5 wire centers.[1] No analysis of these significant changes in marketplace conditions appears in Qwest testimony.

[1] The seven affected wire centers are: Issaquah, Vancouver Orchards, Spokane Chestnut, Spokane Hudson, Spokane Moran, Spokane Walnut and Spokane Whitworth. *See* WUTC, 24th Supplemental Order, Docket No. UT-960369 at 25-26.



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## III. AN OVERVIEW OF BUSINESS CUSTOMER DIVERSITY IN AREAS INCLUDED IN THE PETITION

**Q. WHAT IS THE PURPOSE OF THIS SECTION?**

A. The purpose of this section is to provide some basic descriptive information about the size and distribution of businesses in the wire center areas potentially affected by



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Qwest's Petition. This information is important because my testimony focuses on economically important differences among Qwest business customers, particularly as customers vary by business size and location.

**Q. WHAT INFORMATION WILL YOU PROVIDE HERE?**

A. I will provide business size information from public agencies. The two tables below show the size distribution of business firms in King and Spokane counties.

The table shows the distribution of total employment for King County across firms from 1 to 1000+ employees, broken into nine size categories. Total employment for King County measured as of first quarter 1999 was 1,109,089 employees in 74,652 individual firMs. Two-thirds (66.7%) of the 74, 652 firms have zero to four employees. At the other end of the continuum, the eighty-one largest firms account for 23.3% of business employment.



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## King County

Size of firm distribution for all ownerships,
Including multiple establishments, first quarter 1999.

| *Size Range* | *No. of Firms* | *% of Total* | *Employment* | *% of Total* |
|---|---|---|---|---|
| *Total* | **74,652** | 100.0% | **1,109,089** | 100.0% |
| *0-4* | **49,802** | 66.7% | **64,852** | 5.8% |
| *5-9* | **9,839** | 13.2% | **65,152** | 5.9% |
| *10-19* | **6,568** | 8.8% | **88,931** | 8.0% |
| *20-49* | **4,905** | 6.6% | **149,056** | 13.4% |
| *50-99* | **1,906** | 2.6% | **131,862** | 11.9% |
| *100-249* | **1,145** | 1.5% | **173,789** | 15.7% |
| *500-999* | **114** | 0.2% | **78,118** | 7.0% |
| *1,000+* | **81** | 0.1% | **258,031** | 23.3% |

** = Confidential, - = Zero Units*
Last Update: November 30, 1999.

## Spokane County

Size of firm distribution for all ownerships,
Including multiple establishments, first quarter 1999.

| *Size Range* | *No. of Firms* | *% of Total* | *Employment* | *% of Total* |
|---|---|---|---|---|
| *Total* | **13,700** | 100.0% | **180,882** | 100.0% |
| *0-4* | **8,647** | 63.1% | **11,522** | 6.4% |
| *5-9* | **2,083** | 15.2% | **13,814** | 7.6% |
| *10-19* | **1,361** | 9.9% | **18,375** | 10.2% |
| *20-49* | **996** | 7.3% | **30,358** | 16.8% |
| *50-99* | **333** | 2.4% | **23,100** | 12.8% |
| *100-249* | **207** | 1.5% | **31,505** | 17.4% |
| *250-499* | **34** | 0.2% | **11,758** | 6.5% |
| *500-999* | **30** | 0.2% | **19,918** | 11.0% |
| *1,000+* | **9** | 0.1% | **20,532** | 11.4% |

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**Q. WHAT SIMILARITIES AND DIFFERENCES ARE APPARENT IN LOOKING AT THE TWO COUNTIES?**

A. Although Spokane County total employment is about 16% of King County employment, the distributions are basically similar. Spokane County has 18% of the firms that King County has, making Spokane's mean average firm size measured in this way bit smaller than in King County. Again, the most common firm size is in the 0-4 employee range. In this size range, the average size of the smallest firm in Spokane is 1.33 employees; the average size is 1.3 in King County. The nine largest employers in Spokane County, however, employ 11.4% of the workforce, a significantly smaller portion of the total workforce than large firms account for in King County.

**Q. HOW LARGE ARE THE LARGEST FIRMS?**

A. I have data on the largest firms in the Puget Sound area. The largest of these firms have more than 6000 employees. The table below lists only the largest 10 private employers in the Puget Sound Area and does not include educational institutions and governmental agencies.



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**Puget Sound Employment Statistics**
**Top 10 Private Sector Firms by Employees**

| Firm | Type of Business | Employees in Puget Sound Area |
|---|---|---|
| Boeing | Aerospace manufacturing | 98,440 |
| Microsoft | Software developer | 15,400 |
| Safeway | Grocery stores | 9,851 |
| Sisters of Providence (Health Care) | Hospitals, long-term care, hospice, more | 9,423 |
| Group Health Cooperative | Health care services | 8,800 |
| Fred Meyer, Inc. | Department stores | 8,100 |
| Nordstrom | Fashion specialty retailer | 7,700 |
| Seafirst | Banking and financial services | 6,831 |
| Alaska Air Group | Airline holding company | 6,234 |
| U S West | Telecommunications | 6,106 |

Source: Puget Sound Business Journal

Data as of July 10, 1999

Puget Sound Area includes: Island, King, Kitsap, Pierce, San Juan, Skagit, Snohomish, Thurston, and Whatcom Counties.

**Q. WHAT OTHER INFORMATION ABOUT DIFFERENCES AMONG BUSINESS FIRMS HAVE YOU EVALUATED IN YOUR ANALYSIS?**

A. I have considered where business firms are located in relation to a CLEC backbone fiber network. Where firms are located affects the cost of building facilities to bring these customers onto a network. Thus the location of firms is important information. While I have not performed exhaustive research on this topic, information I have for the City of Seattle confirms my general impression that business firms tend to be distributed throughout a major metropolitan or city area. For the City of Seattle, a list of the distribution of business licenses by zip code appears below. Businesses are generally distributed throughout the city. However, it is not clear from the available information whether zip codes with a small number of licensees are unpopulated by businesses or are the locations of geographically large individual firms.



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## City of Seattle Business Licenses by Zip Code

Licenses Current As of June 21, 2000

(RESPONSE TO PUBLIC DISCLOSURE REQUEST DATED JUNE 19, 2000)

| Item No. | Zip | Active BLs | Remarks | Item No. | Zip | Active BLs | Remarks |
|---|---|---|---|---|---|---|---|
| 1 | 98101 | 3,889 | | 30 | 98138 | 2 | |
| 2 | 98102 | 1,644 | | 31 | 98144 | 1,611 | |
| 3 | 98103 | 2,630 | | 32 | 98145 | 10 | |
| 4 | 98104 | 3,187 | | 33 | 98146 | 351 | |
| 5 | 98105 | 2,312 | | 34 | 98148 | 86 | |
| 6 | 98106 | 795 | | 35 | 98151 | 0 | Invalid Zip |
| 7 | 98107 | 2,116 | | 36 | 98154 | 215 | |
| 8 | 98108 | 1,796 | | 37 | 98155 | 439 | |
| 9 | 98109 | 2,549 | | 38 | 98158 | 4 | |
| 10 | 98110 | 66 | | 39 | 98160 | 0 | |
| 11 | 98111 | 31 | | 40 | 98161 | 45 | |
| 12 | 98112 | 1,728 | | 41 | 98164 | 70 | |
| 13 | 98114 | 14 | | 42 | 98166 | 132 | |
| 14 | 98115 | 2,864 | | 43 | 98168 | 382 | |
| 15 | 98116 | 1,332 | | 44 | 98170 | 0 | |
| 16 | 98117 | 1,898 | | 45 | 98171 | 0 | Invalid Zip |
| 17 | 98118 | 1,867 | | 46 | 98174 | 1 | |
| 18 | 98119 | 1,649 | | 47 | 98177 | 459 | |
| 19 | 98121 | 1,741 | | 48 | 98178 | 388 | |
| 20 | 98122 | 2,331 | | 49 | 98181 | 401 | |
| 21 | 98124 | 87 | | 50 | 98184 | 0 | |
| 22 | 98125 | 2,314 | | 51 | 98185 | 9 | |
| 23 | 98126 | 828 | | 52 | 98188 | 401 | |
| 24 | 98129 | 0 | Invalid Zip | 53 | 98190 | 0 | |
| 25 | 98131 | 0 | Invalid Zip | 54 | 98191 | 2 | |
| 26 | 98132 | 0 | Invalid Zip | 55 | 98195 | 23 | |
| 27 | 98133 | 1,583 | | 56 | 98198 | 117 | |
| 28 | 98134 | 1,155 | | 57 | 98199 | 1,215 | |
| 29 | 98136 | 795 | | | | | |

In the following section I explain why differences in business circumstances are meaningful for competition analysis.

### III. COMPETITIVE ANALYSIS USING FACTORS ENUMERATED IN RCW 80.36.330.



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## A. Introduction

**WHAT IS YOUR PURPOSE IN THIS SECTION?**

A. I use the four factors of RCW 80.36.330 in a comprehensive framework to analyze the Petition. While the Commission is not limited to consideration of these factors, the four factors collectively incorporate the necessary tools of competition and antitrust analyses addressing issues of horizontal market concentration, i.e., analyses which rely on the Department of Justice and Federal Trade Commission Horizontal Merger Guidelines.

**WILL YOU BE EMPHASIZING THE FRAMEWORK OF THE MERGER GUIDELINES?**

A. Yes. This framework is routinely applied in economic analyses of competition in regulated industries by federal and state antitrust agencies, the FERC, the FCC and state regulatory authorities.

**Q. HOW IS THIS SECTION OF YOUR TESTIMONY ORGANIZED?**

A. I follow a four step process. First I discuss some fundamental aspects of market power analysis. Second, I discuss and identify relevant markets in this proceeding. I address RCW 80.36.330(1)(b), *the extent to which services are available from alternative providers in the relevant market,* and RCW 80.36.330.1(c), *the ability of alternative providers to make functionally equivalent or substitute services readily available at competitive rates, terms and conditions,* under the second section, Identification of Relevant Markets.

Third, I discuss measures of market concentration. I address RCW 80.36.330(1)(a), *the number and size of alternative providers of service,* under Measurement of Market Concentration. I also address the portions of RCW 80.36.330(1)(d), which identify *the extent of affiliation, market share and market share growth as other indicators of market power,* in Measurement of Market Concentration.

In the fourth section, I address Conditions of Entry In Relevant Markets. Here I address RCW 80.36.330(1)(d)'s *ease of entry* standard and revisit the RCW 80.36.330(1)(c) term, *readily available,* as it appears in the phrase, *functionally equivalent or substitute services* ***readily available.*** After developing and illustrating these constructs, I develop a working definition of when competition is effective, such that customers of the service have reasonably available alternatives and that the service is not provided to a significant captive customer base.

**Q. PLEASE PROVIDE A DEFINITION OF MARKET POWER.**

A. Seller market power is the ability to profitably maintain prices above competitive levels for a significant period of time.[2]

**Q. WHAT ARE THE FUNDAMENTAL TENETS OF MARKET POWER ANALYSIS?**

A. A fundamental tenet of market power analysis is that for market power to be exercised, the firm (or firms) being investigated must possess both the *ability* and *incentive* to exercise market power. In turn, a firm has the incentive to exercise market power if it is profitable to do so. Conclusions about whether a firm gains either the ability and/or incentive to exercise market power as a consequence of a change in market conditions, e.g., merger, pricing flexibility, etc. rest on a careful examination of the characteristics of the market being investigated.

A second tenet of market power analysis is that it is the perspective of the buyer that is a primary focus, since buyers are the target of seller market power. Evaluations of whether a buyer or buyers perceive certain products to be "good substitutes" and whether, in response to a price increase, buyers can "quickly and easily" substitute among products are key evaluations. Thus, concepts and facts about how quickly and easily buyers can substitute among products and/or among suppliers at different locations are basic questions. How, and the extent to which buyers will respond to a single[3] firm's attempt to increase price of a particular product is a working evaluation *of price elasticity of demand.* Similarly, how and the extent to which alternative sellers will respond to a single firm's attempt to introduce a "small but significant and nontransitory" price increase is the working evaluation of *price elasticity of supply*.

[2] Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, April 2, 1992, Section 0.1 Purpose and Underlying Policy Assumptions

[3] The analysis is also performed for groupings of firms. For ease of exposition, I refer to the behavior of a single firm.



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Said somewhat differently, these elasticities of substitution constitute the true "buyer protection plan" in response to an attempted price increase.

Finally, the available data is usually far from the ideal data that an economist would like to see. Thus, to minimize the judgement calls involved, asking the right questions and gathering the best available data to answer these questions is essential to forming supportable inferences about likely competitive effects. In this proceeding, Qwest has failed to provide the kind of data or analysis needed to evaluate the extent of competition.

**Q. IN THE PARAGRAPH ABOVE YOU USE THE PHRASE "SMALL BUT SIGNIFICANT AND NONTRANSITORY" PRICE INCREASE. WHY?**

A. All market power analysts must choose methodological tools and concrete measures for the economic concepts they employ. The DOJ and FTC have chosen the term "small but significant and nontransitory" price increase as a methodological construct.[4] In most contexts, the antitrust agencies consider a "small but significant" price increase as five percent over the prevailing price.[5] The demand and supply responses being examined will depend upon the time period chosen for adjustment. The time period of adjustment and thus, the working definition of "nontransitory" varies with the purpose of the particular analysis. In product market definition, "nontransitory" is generally operationalized as "lasting for the foreseeable future." In geographic market definition, when the supply response of sellers not currently in the market is being investigated, "nontransitory" is operationalized as a price increase of one year. Operational standards also exist when evaluating ease of entry, and I will discuss these in that section of my

[4] The Merger Guidelines stress that the "small but significant and nontransitory" price increase is a methodological tool, it is not a tolerance level for price increases.

[5] Merger Guidelines, Product Market Definition, Section 1.11 General Standards



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testimony.

### B. Identification of Relevant Markets

**Q. What is the purpose of defining relevant markets?**

A. Relevant market definition is the fundamental building block of competition analysis because it identifies, in the first instance, the products and suppliers that can provide economically meaningful responses to an attempted exercise of market power by, in this case, the incumbent LEC. Virtually all subsequent evaluations, including assessment of entry barriers, depend upon its accuracy.

When relevant product (geographic) markets are defined too narrowly, products (suppliers) which are good substitutes for those deemed "within" the market are erroneously excluded. When relevant product (geographic) markets are defined too broadly, products (suppliers) which are not actually substitute providers for buyers of the relevant product are erroneously included in the market. When relevant markets are defined too broadly, market concentration and dominant firm market share will typically be understated, errors may be introduced in evaluating ease of entry, and the exercise of market power may unwittingly be permitted.

**Q. YOU SPOKE OF A RELEVANT PRODUCT MARKET AND A RELEVANT GEOGRAPHIC MARKET, ISN'T THERE JUST A "RELEVANT MARKET"?**

A. Yes. I discuss these issues separately for convenience. With respect to the very large firms I considered, Qwest has failed to define the relevant product market properly. With respect to the very small firms I considered, Qwest has failed to define the relevant geographic market properly. These failures lead Qwest to improperly aggregate data in both areas, which, in turn, leads to incorrect conclusions about Qwest's ability and incentive to exercise market power profitably if granted pricing flexibility.

### 1. Identification of Relevant Product Markets

**Q. HOW SHOULD PRODUCT MARKET DEFINITION BEGIN?**

A. Each of the products for which Qwest is requesting pricing flexibility should first be considered individually. This is because we do not know how well an existing alternative product will be able to provide a good substitute for buyers (if Qwest were to impose a price increase in the Qwest product). This approach requires that we identify potential alternatives. Methodologically, these products comprise an array from "next-best" to least-best substititutes. These "next-best' substitutes will vary in the degree to which they are truly similar to the Qwest product. At some point, the next-best substitute is such an inferior offering from the buyer's point of view that the firm that controls the series of superior substitutes for the Qwest product does not need to control the remaining alternatives in order to profitably sustain a price increase.

Thus, the first focus question is, for Buyer A, "What are the available alternative products for Qwest product X, such that, should Qwest attempt to raise the price of X, Buyer A will be able to avoid the attempted exercise of market power in Product X by "quickly and easily" substituting (say) Entrant 1's product Z? If product Z proves to be the next-best and a "good substitute" for X, then Product Z is included in the relevant product market for Buyer A.

Thus, antitrust authorities begin analysis by first examining "*each* product (*narrowly defined*) produced or sold by *each* merging firm..." [italics added][6] As potential

[6] For a single seller analysis: "Specifically, the Agency will begin with each product (narrowly defined) produced or sold by each merging firm and ask what would happen if a hypothetical monopolist of that product imposed at least a "small but significant and nontransitory" increase in price, but the terms of sale of all other products remained constant. If, in response to the price increase, the reduction in sales of the product would be large enough that a hypothetical monopolist would not find it profitable to impose such an increase in price, then the Agency will add to the product group the product that is the next-best substitute for each merging firm's] product." [footnote omitted] Merger Guidelines, Product Market Definition at 1.1



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alternative products prove to be such good substitutes that they must be included in the relevant product market (because the attempted exercise of market power over the existing set of relevant products fails unless these products are included), a limit is found to the range of "good substitutes" and a boundary is drawn between products which are "good substitutes" and alternatives which are, in a sense, "too far away" in Buyer A's evaluation. The relevant product market is defined as the smallest group of products for which Buyer A suffers the hypothesized price increase rather than "switch" to an alternative.

**Q. WHAT IF DIFFERENT KINDS OF BUYERS USE DIFFERENT QWEST PRODUCTS?**

A. Buyers must be grouped as "similarly-situated" with respect to the kind of Qwest product (and substitutes) they are interested in.



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**Q. IS IT POSSIBLE THAT THERE ARE NO GOOD SUBSTITUTES FOR SOME QWEST PRODUCTS IN THE PERCEPTION OF A CERTAIN KIND OF BUYER?**

A. Yes. This is why analysis should begin with each Qwest product narrowly defined and examine substitution possibilities.[7] For illustration, suppose there is a Qwest product that is so preferred to the next-best alternative product that it demands a price premium among the buyers that use it. The next-best product alternative sold by the entrant is sold at a discount to the Qwest price. Buyers who don't care about the premium feature of the Qwest product presumably have already switched to the entrant product, because the discount is sufficiently compensatory to induce these buyers to do so. A different set of buyers who highly value the Qwest premium product continue to buy it. Assume further that the premium Qwest may charge to these buyers who value the service highly is constrained by regulation to approximate a competitive price. *The kind of product substitution analysis I describe, which begins with analysis of the Qwest product, would be capable of revealing the conditions under which Qwest could profitably raise price to these buyers because potential alternatives were not "quick and easy" substitutes for the Qwest product.*

**Q. ISN'T THIS PROBLEM YOU DISCUSS JUST THEORETICAL?**

A. No. I will identify several instances where I believe Qwest has a product monopoly. Unfortunately, the stumbling block to analyzing this issue even further is that Qwest fails to provide useful information about differences in the demand for Qwest products among the business customers it serves, which would allow the necessary analysis.

**Q. HOW DOES QWEST ADDRESS THE ISSUE OF PRODUCT SUBSTITUTION AND IDENTIFICATION OF RELEVANT PRODUCT MARKETS?**

[7] Usually, the analysis occurs at prevailing prices. See Merger Guidelines, Section x.

A. Mr. Teitzel provides the following discussion in his Direct Testimony.

**Q. DO COMPETITORS OFFER EVERY BUSINESS SERVICE OFFERED BY QWEST?**

**A.** No. Nor does Qwest offer every service provided by its competitors. However, this does not make the market for basic services any less competitive. Product differentiation is the hallmark of a competitive environment. That each provider offers its services at different prices or in different packages is a part of the choice that a competitive market brings to customers. Without such differentiation, one would have to question whether the market was in fact competitive at all. Attachments B and D leave no doubt that services equivalent to those provided by Qwest have been employed in every competitive area examined.[8]

**Q. PLEASE COMMENT ON MR. TEITZEL'S POSITION.**

A. First, although Mr. Teitzel's proclamation that "product differentiation is the hallmark of a competitive environment" is not always true, it certainly is true that for the telecommunications services listed in Attachment A of the Petition, Qwest and entrants strive to differentiate their products in the eyes of potential business customers.

Second, Mr. Teitzel's enthusiasm for product differentiation as a supplier business strategy indicates why it is important to consider Qwest products *narrowly-defined* in evaluating ease of substitution (in response to a price increase). In fact, where product differentiation is an important competitive strategy, it becomes all the more necessary (for accurate identification of relevant product markets) to segregate customers according to whether, and if so, the extent to which, they perceive close substitutes for the Qwest product currently purchased. The (pro-competitive) purpose of product differentiation by an entrant is to succeed in creating a product that will engender

[8] Teitzel Direct, pages 17-18



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business customer loyalty, i.e., some inelasticity of "cross-product" demand with respect to other product(s) positioned as the customer's "next best substitute." Product differentiation by a dominant firm, achieved through anticompetitive activity. simply entrenches its dominance and prolongs customer captivity.

**Q. MR. TEITZEL RELIES ON ATTACHMENTS B AND D. WHAT INFORMATION IS PROVIDED IN ATTACHMENTS B AND D?**

A. Attachment B shows that the five entrants listed provide, by price list, almost all the features that Qwest provides for Basic Business Service. Attachment D lists six product categories: (1) Basic Business Service, (2) Features, (3) Centrex Network Services, (4) Foreign Exchange Service, (5) Local Trunk Service and (6) DID Trunk Service. The extent to which (in Qwest's view) the nineteen entrants listed offer similar service for each of the six categories is indicated by placing, in the appropriate table cell, a brief description of the service and of the range or ranges of prices charged. For Mr. Teitzel, the information provided by Attachments B and D "leave no doubt that services equivalent to those provided by Qwest have been employed in every competitive area examined."

**Q. DOES QWEST PROVIDE OTHER INFORMATION THAT COULD BEAR ON THE QUESTION OF WHETHER ENTRANTS' PRODUCTS MAY BE CAPABLE OF SUBSTITUTING FOR QWEST PRODUCTS IN RESPONSE TO A PRICE INCREASE?**

A. Yes. Attachment C cross lists features and functionalities available by three different switch types.

**Q. IS THE INFORMATION PROVIDED IN ATTACHMENT B, C, AND D A SUFFICIENT BASIS FOR EVALUATING WHETHER THE STATUTORY STANDARDS OF RCW 80.36.330(1)(B) AND (C) ARE MET, I.E., FOR DETERMINING "THE EXTENT TO WHICH SERVICES ARE AVAILABLE FROM ALTERNATIVE PROVIDERS IN THE RELEVANT MARKET" AND "THE**

**ABILITY OF ALTERNATIVE PROVIDERS TO MAKE FUNCTIONALLY EQUIVALENT OR SUBSTITUTE SERVICES READILY AVAILABLE AT COMPETITIVE RATES, TERMS AND CONDITIONS?"**

A. No, the task of identifying "relevant markets" is ignored. Real world product and customer segmentation is ignored. This has distinct consequences for a competition analysis. By lumping all products together for analysis, Qwest ignores the fact that many products are created for and marketed to distinct customer segments. This in turn implies that, for each distinct customer segment, some of the products currently produced by entrants are not and should not be classified as "reasonably available alternatives" or good substitutes for the product they are buying from Qwest.

**Q. PLEASE EXPLAIN WHAT YOU MEAN BY "DISTINCT CUSTOMER SEGMENT."**

A. Certainly. A business customer currently using a single access line product differs in its product demands from a current Centrex customer, who differs in turn from a PBX customer. Qwest's six product categories implicitly recognize market segmentation, but Qwest ignores the implications. Qwest explicitly segments customers. Qwest tariffs restrict product offerings so that only certain kinds of customers are eligible to buy certain products. For example, the CUSTOMCHOICE package of discretionary services is available only to one, two and three line business customers.[9]

Mr. Teitzel's Attachment DLT-2C reports results separately for large and small business customers. *confidential*

[9] See http://tariffs.uswest.com, Job No. WA2000-060, (effective October 1, 2000)



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Like Qwest, entrants develop products in hopes of attracting and retaining the kind of customer, because of its size and the nature of its telecommunication demands, for whom one or more of its particular product offerings is an excellent "fit." Teligent, Inc.'s product description at Original Page 58 and Original Page 66 of Attachment D to the Petition is one example of product customization and market segmentation.[10] Yet, inexplicably, except for the broad distinction of "large" and "small" customers in Mr. Teitzel's Exhibits, Qwest ignores, for the purpose of analysis, the commercially, and thus economically, significant feature of market segmentation.[11]

**Q. ARE YOU SAYING THAT QWEST MUST DEFINE A PRODUCT MARKET FOR EVERY SINGLE PRODUCT IN ATTACHMENT A?**

A. No. I am saying that Qwest has made no effort, even in the face of its own product differentiation, to identify customer-product "clusters" that function as economically meaningful relevant product markets, i.e., for the set of identified

[10] Bates numbers not intelligible.

[11] CLECs also segment the business market. Joe Basile, CEO of GST Telecommunications, explains: "We [GST Telecommunications] segment the business market, if you would, into three primary areas which we then go after. These areas are the small and medium size business customer. The second is what we call the data centric customer, whether that's a larger corporate customer or customers who are much more saavy with data and internet skills. Then third is our broad band market which carry other carriers that we serve and then very large customers who have broad band needs." Excerpted from Joe Basile, GST Communications, CEO Interview published 02/05/1999 by the Wall Street Transcript. Copyright material used by permission. available(by subscription)at http://www.twst.com/perl/get Article.pl?file=techno/GAC610 page 1 of 10



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customers, the products within the market that are "good substitutes" (in response to a hypothesized price increase). This analytical admission, however, would require Qwest to recognize that distinct buyer segments (and demand curves) exist in this proceeding.

**Q. PLEASE EXPLAIN.**

A. In telecommunications, business buyers' needs are highly dependent on business size. This suggests an easy way to begin to group products is looking at business buyer demands by business size. (For example, a distinction between small and mid-size to large business customers can be drawn according to whether the business has enough volume to justify a PBX.)[12] Cahners In-Stat group, a research and information consulting firm specializing in telecommunications and information analysis develops economic profiles for information services vendors which focuses on four distinct business customer segments, the SOHO (Small Office, Home Office) Business Market, covering firms with less than 5 employees, the Small Business Market, covering firms with 5-99 employees, the Middle Market, covering firms with 100-999 employees and the 1000+ employee Enterprise Market. [13] This is the approach Qwest should have taken. Rather, Qwest has conveniently and improperly side-stepped an examination of business customer heterogeneity. Where customers and customer circumstances differ, the products they buy from Qwest and the potentially good substitutes will differ. This is why antitrust product market definition begins with each product sold by Qwest and examines the response of that product's buyers to possible substitutes.

**Q. WHAT KIND OF ERROR IS INTRODUCED BY A FAILURE TO RECOGNIZE DISTINCT PRODUCT MARKET GROUPS FOR DISTINCT BUSINESS CUSTOMER SEGMENTS?**

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[12] See Alfred E. Kahn and Timothy J. Tardiff, Economic Evaluation of High-Capacity Competition in Seattle, December 22, 1998 footnote 6, page 4.

[13] See http://www.instat.com/cls-seg.htm visited 9/10/2000

A. The basic problem is that, by failing to focus on customer segments and demands, all Qwest products and all entrant products are asserted to be fungible, and the resulting aggregation of data provided as Exhibits to the Qwest's Petition leaves a mistaken impression of the extent of substitutability both in terms of the extent of product substitution and supplier substitution available to buyers. Said differently, Qwest has effectively defined its products in Attachment A as an "average product" and simply asserted that each entrant is capable of providing a good substitute "average product." Recognition of segmentation would begin to identify instances where entrant products are more extensively in competition with Qwest products and for which customers, versus where competition is non-existent or thin because entrants are incapable of, or not interested in, developing and marketing product alternatives. In US WEST's previous competitive classification proceeding, US WEST explicitly identified business users of high capacity services as a distinct product/customer segment.

**Q. EARLIER, YOU SAID YOU HAD EXAMPLES SHOWING WHERE QWEST IS LIKELY TO HAVE A PRODUCT MONOPOLY FOR CERTAIN BUYERS. WHAT ARE THESE SITUATIONS?**

A. The first of these situations is products sold to very large firMs. Products sold to very large firms is a relevant product market. The second situation is the sale of Market Extension line service to businesses interested in expanding beyond an individual wire center, and the third product is the Centrex 21-CustomChoice feature group. All these products have unique geographic reaches and flexibilities that CLECs are unable to duplicate at this stage of market entry.

## A. Product Demands of Very Large Buyers

**Q. PLEASE PROCEED WITH YOUR ANALYSIS OF THE PRODUCTS SOLD TO VERY LARGE**



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**FIRMS.**

A. Very large firms have unique product demands. As the ILEC network evolved, it developed the capability of responding to these needs. CLECs do not yet have the size or network ubiquity to provide good substitute service.

One characteristic of a very large firm is the need to network its many and diverse business locations together and with the PSTN for voice and video and/or data needs. These customers expect high quality, redundant interconnection. Large firms typically have urban, suburban and rural locations that need interconnection. Moreover, large firms know they can economize on procurement costs and management oversight by using a single seller for these needs. They also recognize that use of more than one supplier introduces the possibility of degraded service. Thus, the ILEC is clearly in a better position to serve these very large firms.

In the evolution of the PSTN, the ILEC was able to customize its network architecture for the voice and early bandwith needs of these large customers. Network ubiquity and resulting breadth of the ILEC's product line give the ILEC a unique ability, at the existing level of CLEC market penetration, to address the multiple and sometimes highly customized demands that characterize a very large buyer.

The CLECs, on the other hand, are at a significant disadvantage in any attempt to serve the large and geographically diverse firm. Indeed, the diversity of locations and needs can require a CLEC to serve a very large business through both direct interconnection to its fiber network and using unbundled loops available through collocation. For example, a company with voice and video transport needs may also want to provide its telecommuters the ability to access the company's intranet or computers from their homes. Similarly, a company may rely on the PSTN for its voice needs in locations where it leases rather than owns the buildings it is using. Because of its size, this firm


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accounts for the majority of switched traffic at the wire center.

**Q. CAN CLECS COMPETE WITH QWEST FOR THE BUSINESS OF VERY LARGE FIRMS?**

A. Not yet. The economics of CLEC entry imposes certain imperatives on CLEC business expansion and marketing decisions.

Q. **WHAT ARE SOME OF THE ECONOMIC CONSIDERATIONS CLECS MUST MAKE IN INCREASING THEIR SHARE OF BUSINESS CUSTOMERS?**

A. In this early stage of entry, CLECs are naturally focused on serving the high-volume, high product demand, but low cost to serve, business customer. Very large firms do not fall into this group. The Commission noted in Docket No. UT-990022, "Today, network maps in Seattle and Spokane virtually follow the grid pattern of the streets in the downtown business core, and fiber rings trace major arteries throughout the wire centers in the petition." [14] Finding there to be no significant captive customer base, the Commission noted that "multiple providers operate in these business-oriented, downtown commercial centers using a combination of owned and leased facilities."[15] It is no surprise that CLEC's locate their network facilities to pick the

"lowest of the low-hanging fruit," central business district wholesale and retail customers with high volume demands for service.[16]

[14] Eighth Supplemental Order, III. Commission Discussion and Decision

[15] Ibid.

[16] Using US WEST's geographic database of hi-cap service locations and CAP fiber-optic routes, US WEST's engineering consultants found the customer locations in the US WEST database to be widespread but large concentrations of them are located along major business corridors, with 60% of the US WEST hi-cap customer

(continued...)



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In analyzing the expansion of CAP backbone networks, US WEST engineering consultants identified three basic economic imperatives for CLEC customer acquisition:

A likely CAP build strategy would appear to involve several elements, all aimed at maximizing the number of services provided (revenue) while minimizing the total path distance (cost). Such a strategy could be focused on the following locations:

Locations with high service volumes near the existing CAP routes.

Extend further from existing routes over time, prioritizing targets based on service volumes, distances and adjacent addresses (opportunity to share path costs with more than one location).

Extend long distances only when service volumes are high and path costs are low (aerial paths for fiber cable, or DS1/DS3 service provided via wireless).[17]

(...continued)
locations within 1000 feet of a CAP fiber route. 44% of US WEST hi-cap customer locations were within 500 feet, almost 75% of the locations are covered at 2000 feet and fewer than 13% were beyond 4,000 feet.[16] Thus, necessary entrant facilities were in close proximity to the US WEST hi-cap customers located in the 2,517 buildings with US WEST hi-cap facilities in Seattle. Power Engineers, Inc. Seattle Cost Study and Model, See Attachment 7 to *Additional Comments in Support of US WEST's Petition* in Docket No. UT-990022.

[17] Ibid. Page 16.



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**Q. VERY LARGE CUSTOMERS ARE HIGH VOLUME CUSTOMERS. ARE THESE CUSTOMERS ATTRACTIVE TO CLECS?**

A. Not yet. When very large companies have high volume needs located outside the dense urban core, for example, the CLEC is unlikely to obtain the facilities sharing that it does if it were to provide the same service to an individual buyer located in a more densely concentrated business area. There may be instances where the CLEC has an opportunity to meet the very large company's needs by combining its demands with those of an adjacent firm, but opportunities for facility sharing will be fewer than in more densely populated areas.

**Q. HAVE CLECS APPROACHED VERY LARGE COMPANIES WITH OFFERS TO PLACE LOCATIONS ON-NET?**

A. Yes. However, the CLECs typically require the very large company to pay upfront costs for access; alternatively, CLECs will require a long-term contract. It is rational for the CLEC to require these terms; to serve the very large customer, the CLEC will have to make idiosyncratic capital investments, useful only for service to the very large customer. Thus the CLEC needs some assurances it will not suffer a substantial loss or "cost of exit" should the very large customer choose an alternative supplier. This investment situation contrasts with a CLEC's willingness to make upfront expenditures to build facilities into a high rise building, where the facility can be used by multiple tenants and redeployed among them at relatively low cost.

**Q. DO CONSIDERATIONS OF IDIOSYNCRATIC CAPITAL AND COSTS OF EXIT APPLY TO SERVICE TO VERY LARGE CUSTOMERS USING UNBUNDLED LOOPS?**

A. Yes, particularly at this early stage of CLEC market penetration. As discussed earlier, a very large company is demand may utilize a large portion of the capacity of an individual voice switch. Even if the CLEC used the very large firm as an "anchor tenant" on its switch, it would need to coordinate this service delivery with the collocation and traffic aggregation strategy directed toward its targeted business customers in the area. This situation may require the CLEC to incur the cost of modifying its entry schedule to accommodate the large firm and/or to incur some period of excess capacity in the switch and/or the transport facility it installs to carry traffic from the ILEC wire center to its switch.

**Q. WHAT OTHER CONSIDERATIONS APPLY WHICH DISCOURAGE CLECS FROM ENTERING THE MARKET COMPRISED OF VERY LARGE CUSTOMER DEMANDS?**

A. It has been said that CLEC market share would be larger if CLECs could execute seamless cutovers. Even if a CLEC had grown large enough to offer a comprehensive set of services to a very large customer, such that it could completely displace the ILEC, it would still need to execute the service change without significant disruption of very large customer business. At this stage of CLEC development, in terms of anticipated profit margins and costs, the telecommunications demands of very large customers apparently are still too complex and unique for CLECs to offer good substitutes for ILEC telecommunications services. These same issues are discussed at more length in the Conditions of Entry section.

### B.Product demands for geographic reach and flexibility

**Q. PLEASE PROVIDE YOUR ANALYSIS OF THE MARKET EXTENSION LINE PRODUCT AND CENTREX21-CUSTOMCHOICE.**

A. In Attachment A, (1) Market Extension Line and (2) Centrex 21-CustomChoice feature group (not the underlying Centrex 21 platform) are listed. Qwest advertises both of these products in terms of a unique geographic reach and flexibility.[18] Market Extension

[18] Market Expansion Lines provide a local identity in another area by providing you with a local telephone number and White and Yellow Pages listing in a new area without requiring a physical location there. Calls to

(continued...)



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Line is a "super FX" line product. And it is important to note that in reviewing Attachment D of the Petition, only Winstar offers any type of FX service. For a business in Seattle thinking of expanding to Tacoma, if the CLEC does not own, control or lease the necessary facilities, the CLEC cannot set up a Market Extension Line in Tacoma for the Seattle business customer. The analysis is the same for Centrex21-CustomChoice. In the absence of good substitutes for the application the business customer is interested in, Qwest can sustain a "small but significant and nontransitory" price increase in this product.

**Q. IS THERE EVIDENCE CONSISTENT WITH YOUR EXAMPLE THAT QWEST MAY HAVE CONTROL OVER PRICE FOR CERTAIN OF ITS DIFFERENTIATED PRODUCTS FOR CERTAIN BUSINESS SEGMENTS?**

A. Yes. On September 1, 2000 Qwest introduced a new configuration of CUSTOMCHOICE, available to one, two and three line business customers only. The pending request obsoletes the old configuration of CUSTOMCHOICE. The substantive differences between the old and new configurations are two: The new configuration (1) adds Remote Access Forwarding and Scheduled Forwarding to the set of standard

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(...continued)
your Market Expansion Line number are automatically routed to another location of your choice. Advertised benefits of the line include an ability to reach potential markets anywhere -- without adding an extra phone line. "Whether you are across town or across the country, your customers will be able to reach you toll-free by calling your Market Expansion Line number in their area...Move to a new location with a new phone number and a Market Expansion Line will ensure your customers make the move with you. Even if customers call your old phone number, a Market Expansion Line will deliver their calls to you." http://www.uswest.com/pcat/small_business/product/1,1749, 117_3_1, 00.html visited 9/9/00

The second product is Custom Choice -- Centrex 21, targeted to businesses having 3 to 50 lines. One advertised benefit is that "Its portable--if your business moves anywhere within US West's 14 state region, you can take your CustomChoice Centrex 21 system with you." http://www.uswest.com/pcat/small_business/product/1,1749,402_3_1,00.html

The underlying service Centrex 21 for both analog and ISDN lines is provided under banded rates. This illustrates that the underlying service may have substitutes yet a particular feature package may not. See, US WEST COMMUNICATIONS, INC. WN U-31, 9.1.17 Centrex 21 Service, Section 9, 3rd Revised Sheet 14.17, effective November 1, 1999.

services/features which businesses are entitled to use on an unlimited basis, and (2) the monthly rate is increased by about 22% from $23.06 to $28.06.[19]

**Q. HAS THE COMMISSION CONSIDERED THE ISSUE OF RELEVANT PRODUCT MARKET DEFINITION IN THE CONTEXT OF RCW 80.365.330 BEFORE?**

A. Yes, and the analysis provided there shows why Qwest's analysis in this proceeding is so deficient. In Docket UT-990022, the Commission considered US WEST's request for competitive classification of high capacity services (DS-1 and higher capacity facilities). US WEST consultants identified the relevant market for high capacity services *with respect to the segment of customers having demand for the service.* US WEST's consulting economists explicitly identified buyers in the relevant product market, defining the market as services provided to customers with usage sufficiently great to be economically served with high-capacity facilities.[20] Moreover, US WEST consultants, using economic analysis of substitution possibilities, identified services which were and which were not in the relevant product market:

> …in terms of the familiar standard of the Merger Guidelines, purchasers of these services would not shift their demands to high-capacity facilities in response to a "small but significant" increase in the price of their current services…because...high capacity access to large users and low-capacity access to small users are not substitutable on the demand side, the two are in separate product markets. [citing Horizontal Merger Guidelines, Section 1.11][21]

[19] The Merger Guidelines would measure the price increase in terms of the retail product provided. Thus, a better indicator of the price increase is in terms of the change in the sum of the access line price plus the new feature price.
The pending configuration also contains text, probably intended to clarify existing practice, indicating that normal nonrecurring charges apply where Business CUSTOMCHOICE is provided in association with the installation of new business individual flat rate service or, with the move of business flat rate service from one location to another.
[20] Kahn and Tardiff, Attachment L at 3.
[21] Kahn and Tardiff, Attachment L at 4.


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I am simply holding Qwest to the same product market definition standard, which I believe is required by RCW 80.36.330, that it presented in its previous competitive classification proceeding before this Commission.

### 2. Identification of Relevant Geographic Markets

**Q. HOW HAS QWEST IDENTIFIED GEOGRAPHIC MARKETS IN THIS PROCEEDING?**

A. Qwest has identified 31 areas, defined by the boundaries of 31 Qwest wire centers as the relevant geographic markets in this proceeding based on considerations of "ease of measurement and implementation."[22] Although a wire center is a convenient unit of observation, it fails to capture business customer demands for products that can only be delivered across multiple wire centers, such as the telecommunications demands of very large businesses. Similarly, use of wire centers as geographic markets creates a focus on the extent of CLEC wire center collocation, which, while likely to be a broad indicator of growing competition for all telecommunications services, has no direct relationship with CLECs' ability to supply alternatives for the Qwest products listed in Attachment A.

**Q. PLEASE EXPLAIN WHY THE LEVEL OF COLLOCATION AND PENDING COLLOCATIONS HAVE NO DIRECT RELATIONSHIP WITH CLECS ABILITY TO SUPPLY ALTERNATIVES FOR QWEST PRODUCTS TO DIVERSE CUSTOMERS THROUGHOUT THE WIRE CENTER AREA.**

A. Collocation can serve the purpose of interconnection, or it can provide access to unbundled network elements. As Ms. Jensen discusses, CLECs can access the business customer through the purchase of unbundled loops or through their own or another provider's facilities-based network.

[22] Direct Testimony of David L. Teitzel page 6



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Ms. Jensen observes that for the Bellevue Sherwood wire center, of the ten alternative providers porting telephone numbers, only two utilize Qwest unbundled loops. Six providers subscribe to 808 unbundled loops in this wire center as of June 2000. In the Seattle Elliot wire center, of the twelve alternative providers, only three utilize Qwest unbundled loops. Seven CLECs subscribed to 585 unbundled loops.[23] Of significance for geographic market definition, Ms. Jensen reports that most of the alternative providers purchasing unbundled loops in the thirty-one wire centers are using the loops to sell "DSL type" services.[24]

**Q. PLEASE CONTINUE WITH YOUR DISCUSSION OF INFERENCES AVAILABLE FROM OBSERVED COLLOCATION NUMBERS BY WIRE CENTER.**

A. First, it is not clear that the reported collocation numbers (or pending collocation numbers by wire centers reported in response to a Staff data request) are adjusted for demands for collocation associated with the provision of DSL using unbundled loops.

Second, collocation predates the federal introduction of local exchange competition with the Telecommunications Act of 1996 (TA96). Initially collocation was a means for competitive access providers to efficiently provide alternative transport for interexchange carrier long distance products. Increasing demand for these products can stimulate additional demands for collocation. In implementing TA96 and its mandate to promote deployment of advanced services, the FCC has expanded the range of products, including multi-functional products, that can be collocated on ILEC premises and thus the demand for collocation.[25] It is important to know what business

[23] See Direct Testimony of Theresa A. Jensen page 7

[24] Note also that alternative providers who *only* purchase unbundled loops are not included in the totals summarized at Attachment G. Direct Testimony of Theresa A. Jensen, page 10

[25] For example, CLECs may collocate transmission equipment including optical terminating equipment and multiplexers, DSLAMs, routers, ATM multiplexers and remote switching nodules. See Order on Reconsideration and

(continued...)



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considerations are driving collocation and the nature of the collocation. This is because CLECs will tailor their entry strategies to reflect the size of customer they seek to attract. Collocation, per se, doesn't provide information about what business segment the CLEC is pursuing.

**Q. FOR MS. JENSEN, THE ABILITY TO PORT NUMBERS WITHOUT USE OF UNBUNDLED LOOPS PROVIDES AN INDICATOR OF THE LARGE EXTENT TO WHICH ENTRANTS ARE USING THEIR OWN FACILITIES FOR SERVICE. WHAT IS YOUR REACTION?**

A. I think she is correct. The lack of use of unbundled loops for voice as well as data services revealed by the Qwest data in Attachment H is disturbing. Use of unbundled loops supports and is evidence of a marketing strategy which allows CLECs to acquire very small business customers incrementally. In contrast, considerations such as expansion of CLEC fiber facilities or purchase of DS-1s to business customers needing 24 voice channels at a location are indicative of a CLEC market entry strategy in pursuit of larger business customers. This kind of observed expansion indicates there are distinct customer segments, of a certain size, demand, and location, which are profitable to serve using this geographic expansion strategy. As discussed in considering the demands of very large firms, expanding CLEC fiber backbone facilities incurs distance -sensitive costs; leasing of DS-1 pipes requires that the business customer so served buy hundreds of dollars worth of services.

(...continued)
Second Further Notice of Proposed Rulemaking in CC Docket No. 98-147 and Fifth Further Notice of Proposed Rulemaking in CC Docket No. 96-98, ¶ 71 and ¶ 72 FCC 00-297 released August 10, 2000. The FCC is in the process of responding to the D.C. Circuit ruling vacating and remanding portions of its collocation rules.

**Q. PLEASE EXPLAIN YOUR CONCERN.**

A. Small business customers addressable by use of unbundled loops are not being targeted by entrants. The evidence provided by Qwest and developed by staff indicates that CLEC entry strategies are focusing on other business customer segments. It is these business segments that are finding alternatives to Qwest products. The small numbers on Attachment H for unbundled loop used by CLECs, plus the small levels of penetration by CLECs using resale or porting numbers off the ILEC network, suggest to me that CLEC entry strategies are still largely focused on acquiring high volume business customers. These are customers CLECs can either serve directly on-net using their own fiber or serve by leasing facilities larger than unbundled loops. Cost considerations alone concerning ease of access to unbundled loops and prices for loops may be a significant barrier to greater CLEC use of unbundled loops.

**Q. BASED ON YOUR DATA ANALYSIS IS THERE ANOTHER GROUP OF BUSINESS CUSTOMERS THAT CLECS ARE TARGETING FOR SERVICE?**

A. Yes, and it could explain some data inconsistencies. While Attachment G shows very small percentage shares for former Qwest business customers lost to CLECs, the Staff market share data reported in the Wall Street Journal/Northwest on September 6, 2000 shows market shares in the teens and above for the reported areas. This suggests that the CLECs have been capturing new growth opportunities in the geographic areas. This CLEC focus is consistent with announced CLEC strategies.

CLECs are focusing on newly-minted "data centric"[26] small businesses (e.g., the dot.com upstart). These customers are attractive because they represent more of

[26] See Comments of Joe Basile at footnote x.



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a "level playing field." Because these customers have less legacy ties to US WEST as their incumbent provider, customer acquisition costs via advertising and marketing are more likely to be on par with Qwest's costs of acquisition. These customers are likely to be more willing to accept a new carrier, and they tend to be "early adopters" of new technology. These customers also present excellent opportunities for selling more products and increasing volume as the business grows. Moreover, this CLEC acquisition strategy is consistent with "high" observed levels of collocation, because the collocation reflects interconnection needs rather than a strategy of accessing unbundled network elements.

**Q. WHY IS THE LACK OF A CLEC STRATEGY TO USE UNBUNDLED LOOPS FOR VOICE SERVICE TO BUSINESS CUSTOMERS OF CONCERN TO YOU?**

A. Resale provides no capability to provide the differentiated product Mr. Teitzel finds to be the centerpiece of competition. For a reseller, the resale product is a necessary add-on to a bundled service. For a reseller who is not a Qwest Strategic Agent,[27] resale is a strategy that goes nowhere unless the reseller intends to migrate customers to its own product.

Use of unbundled loops is a strategy which permits the CLEC to use its own switch or platform and build volume incrementally among relatively low volume business customers and/or business customers located at a distance from CLEC facilities (assuming loop rates are not distance-sensitive). From the data provided it appears we may be too early in the development of CLEC entry to see CLECs pursue a

[27] Qwest Strategic Agents operate as small business "consultants and advocates" and sell equipment from companies other than Qwest and resell Qwest products and services. Moreover, with respect to the resale counts reported in Attachments to the Qwest Petition, it is not clear from the Qwest testimony whether Qwest considers its resale Agents to be affiliates under RCW 80.36.330, and whether sales by Qwest Strategic Agents are reported in Qwest Exhibits). See, http://www.uswest.com/small business/services/agents (visited 9/9/00).



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mass marketing approach to business voice services. Small volume, low margin customers and customers located at distance from CLEC facilities would seem to be natural targets of a UNE loop strategy. Thus, it appears these customers are not yet attracting much CLEC entry. A proper geographic market definition would identify the very small business customer segment for further analysis as participating in a geographic market separate from larger business customers.[28]

**Q. ARE THERE GENERAL INDICATORS THAT BUYERS ARE NOT ALL SIMILARLY-SITUATED WITH RESPECT TO COMPETITIVE OPPORTUNITIES?**

A. Yes, there are several. First, Qwest's existing banded rate tariffs authorized by the Commission under RCW 80.36.340 and Qwest's use of Special Contracts under tariff authorized by WAC 480-80-330 indicate that not all customers are similarly-situated with respect to competitive opportunities. Instead, there are groups of similarly-situated customers.

Use of banded rate tariffs and Special Contracts permit Qwest to select its offer price for the product based on the buyer's alternatives. For buyers with similar product demands, differences in prices that Qwest can charge for the same product reflect differences in competitive opportunities available to buyers because of access to alternative sellers. For example, **confidential[29]**

[28] Merger Guidelines at 1.22.
[29] Contract provided in Qwest’s response to Public Counsel Data Request PC 01-012.



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Second, another basic indicator of uneven competitive opportunities for business customers is provided indirectly by the differences in competitive entry by wire center. Such information appears in Confidential Exhibit TAJ-2C, Competitive Presence in Each Competitive Geographic Area as of 6/30/00. Uneven competitive opportunities could be suggested by Exhibit DLT-2C, which reports lost telephone numbers separately for large and small businesses, if this data were disaggregated into meaningful business segments. Variations in market share by wire center, i.e., how the percentages of business lines lost by Qwest and captured by CLECs vary by wire center would be useful information *if* the product and customer composition of retained versus lost market share were made available. An aggregation of market share losses by business access lines only hints at underlying differences in reasons for differences in the extent of competitive entry by wire center.

### C. Measurement of Market Concentration

**Q. WHAT IS THE PURPOSE OF MEASURING MARKET SHARES AND OTHER INDICIA OF MARKET CONCENTRATION, SUCH AS THE HERFINDAHL -HIRSCHMAN- INDEX (HHI)?**

A. If relevant markets have been defined accurately, then these measures indicate the size distribution of firms participating in the market. These measures may be used to assess whether existing market structure is consistent with an ability to exercise market power by a group of market participants acting collusively or an individual firm acting unilaterally.

#### 1. HHI -- Collusive Exercise of Market Power

**Q. WHAT INFORMATION IS PROVIDED BY THE HHI?**

A. When analyzing a merger for its ability to transform a market (usually presumed to be



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functioning competitively) into a market where it is profitable to exercise market power, authorities examine the HHI of concentration. The HHI is a piece of evidence useful for evaluating the applicability of theories which explain how "high" market concentration may facilitate coordinated interaction by market participants. With coordinated interaction, firms recognize the interdependence of their actions and may be able, depending upon other market characteristics, to tacitly or explicitly collude, thereby increasing profits for the colluding firms.[30]

The HHI is a particular way of measuring the number of suppliers participating in the market and their relative sizes with a single number. The Guidelines classify markets with HHIs above 1800 as "highly concentrated" markets. In markets which have post-merger HHIs below 1000, "unconcentrated markets," the Guidelines indicate that no further analysis is likely to be necessary except in certain instances.

### 2. Market Share -- Unilateral Exercise of Market Power

**Q. FOR WHAT CIRCUMSTANCES DO THE GUIDELINES INDICATE THAT ANTITRUST AGENCIES WILL CONTINUE AN INVESTIGATION OF A MERGER, EVEN IF THE POST-MERGER HHI INDICATES AN "UNCONCENTRATED MARKET"?**

A. The Guidelines recognize the ability of a single firm to act unilaterally in exercising market power. Where sellers are distinguished primarily by differentiated products so that products sold by different participants are not perfect substitutes, the DOJ or FTC will continue its investigation if the merging firms sell "close substitutes" and the market share of the combining firms is at least 35%.[31] Unlike markets where products are not differentiated and all firms provide similar commodity-type products, when

[30] By contrast, other models of firm behavior indicate conditions under which each firm's best strategy is to ignore the actions of other firms. This can lead to a competitively-functioning market where no firm can profitably exercise market power.

[31] The exact requirements can be found in Section 2.2 of the Merger Guidelines.



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products are highly differentiated, antitrust authorities recognize that the "distance" in the minds of buyers that firms strive to create can result in unacceptable market power. Whether products are differentiated or not in the mind of buyers also influences the choice of units of measurement.

Affiliated firms under common ownership and control are considered a single firm for purposes of market share measurement, unless there are reasons why affiliated firms would not have common profit objectives, recognize their natural interdependence and behave cooperatively. Similarly, changes in market share and market share growth provide other relevant information about firms in the market.

### 3. Measurement Issues

**Q. WHAT UNITS OF ANALYSIS SHOULD BE USED TO MEASURE CONCENTRATION?**

A. The choice of dollar or physical units is governed by which measure is thought to provide the better indicator of a firm's future competitive significance. Dollar sales or dollar value of shipments are preferred if firms are distinguished primarily by product differentiation. Physical terms are generally preferred for undifferentiated products.

**Q. THE STAFF HAS PERFORMED AN ANALYSIS WHICH DEVELOPS CONCENTRATION MEASURES USING A CAPACITY MEASURE, NUMBER OF BUSINESS ACCESS LINES. ASSUME STAFF HAD ACCESS TO SALES NUMBERS TO CAPTURE PRODUCT DIFFERENTIATION, AND IN SUCH AN ANALYSIS, STAFF FOUND THE COMBINED MARKET SHARE OF CLECS TO BE EVEN HIGHER THAN WHAT STAFF FOUND USING BUSINESS ACCESS LINES AS A UNIT OF MEASURE. WHAT WOULD THIS MEAN TO YOU?**

A. I expect to see this outcome. CLECs are going after high margin customers. This suggests that the CLECs average sales or revenue per business access line should be higher than Qwest's. It is consistent with leaving the low margin and smaller business customers for "another day" (if at all). If CLECs are successfully bundling data or other



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products with voice products, then voice-only revenues or sales may not fully reflect the higher-average-sales-per-business-customer I expect to see. Rather, this would be more fully captured by analysis of the bundled product.

**Q. WHAT IS THE MOST IMPORTANT IMPLICATION OF YOUR HYPOTHETICAL?**

A. Absent accurate definition of relevant markets, "market" concentration data can give a totally misleading impression of market participation.

### 4. Supply side entry into a relevant market

**Q. ARE THERE CONDITIONS UNDER WHICH IT COULD BE PROPER TO AGGREGATE ALL PRODUCTS AND ALL ENTRANTS INTO A SINGLE ANALYSIS BY WIRE CENTER AS QWEST'S DIRECT TESTIMONY SUGGESTS BE DONE?**

A. No, not when there are distinct relevant product and geographic markets below "all products" and individual wire centers. However, there are conditions, under which suppliers not now producing a good substitute for a Qwest product could be included in a properly defined market, because of supply elasticity considerations.

**Q. PLEASE IDENTIFY THE CONDITIONS UNDER WHICH THESE SUPPLIERS WOULD PROPERLY BE INCLUDED.**

A. Supplier substitution by suppliers not participating in the market is considered at two distinct junctures in market power analysis. The first is when identifying participation in a relevant market. In defining markets, the DOJ-FTC recognize that sellers not currently providing the relevant product can decide to enter the market and to sell the product in response to an attempted price increase. If such a seller is technologically capable of providing the product, will not be subject to expenditures of significant sunk costs of entry and exit, can enter in one year and likely *would* enter (given non-sunk but necessary expenditures), then this seller *will* be included in the relevant market. If the seller would enter, then this seller is identified as an "uncommitted" entrant.



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"Uncommitted" is used to stress the fact that the seller incurs no sunk costs in entering or exiting the market. Sellers with existing excess capacity to produce the product in question are logical candidates for this analysis, because they already have sunk costs and may incur no additional sunk costs upon entry or exit.[32]

**Q. ASSUME THAT ENTRANTS HAVE ENOUGH EXCESS CAPACITY TO BRING SIGNIFICANT SUPPLY INTO A PRODUCT MARKET. IF SO, WOULD IT THEN BE CORRECT TO INCLUDE ALL SELLERS OF ALL PRODUCTS IN A WIRE CENTER IN A SINGLE MARKET?**

A. No, excess capacity, even enough to make an otherwise profitable exercise of market power unprofitable, cannot be double, triple or quadruple counted. If diverted in response to a price increase into one product, the excess capacity cannot be simultaneously available to render an attempted price increase in another product unprofitable. If such capacity existed, Qwest could render it ineffective if it were to raise price in more than one product market at a time. To illustrate, Qwest could pursue a "divide and conquer" strategy with respect to any excess capacity. If Qwest were to raise prices simultaneously in several products, entrants could effectively be "peeled off," each bringing its excess capacity into its most profitable product. In this way, the excess capacity thus engaged could actually be used to allow the entrant to participate in the exercise of market power under the pricing umbrella created by Qwest. However, the plausibility of this hypothetical, like any conjecture about the profitability of exercising market power, would need to be subjected to an analysis of ease of entry.

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[32] Sunk costs are non-recoupable fixed costs. Tirole defines sunk costs as those investment costs that produce a stream of benefits over a long horizon but can never be recouped. Jean Tirole, *The Theory of Industrial Organization*, 1997 p. 308.

The role of excess capacity in analysis of commodity markets is very important. The FCC in its decision to declare AT&T non-dominant in long distance, and more recently in its analysis of forebearance of regulation for high capacity services, stressed the fact that alternative sellers, collectively, had more than enough excess capacity to absorb all of the dominant firm's customers in the even the dominant firm attempted to increase price. (The FCC non-dominance order in long distance addressed only the possibility of the unilateral exercise of market power by the dominant firm.)



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### D. Conditions of Entry In The Relevant Market

**Q. DOES ANALYSIS OF EASE OF ENTRY REQUIRE ACCURATE RELEVANT MARKET DEFINITION?**

A. Yes, otherwise the particular conditions affecting ease of entry may be ignored or passed over. Entry analysis examines means of entry that might be practicably employed and is defined by the actions that a firm must take in order to produce and sell in a market. If product markets are defined too broadly for example, then evidence of entry into one product market can be misunderstood as applying more generally than it does.

**Q. PLEASE EXPLAIN WHY CONDITIONS OF ENTRY INTO THE RELEVANT MARKET ARE IMPORTANT IN DRAWING INFERENCES ABOUT THE LIKELY EXERCISE OF MARKET POWER?**

A. Entry can render an otherwise profitable exercise of market power unprofitable. The idea is simply that, if the supply response is rapid enough and sufficient, then there is no profit in exercising market power. Moreover, if market participants know that rapid and sufficient entry is likely, then even the anticipation of entry will prove adequate so that, regardless of market structure, participants will behave like "price takers." Under such conditions, the exercise of market power is irrational.

#### 1. Entry must be rapid

**Q. HOW ARE THE "LIKELY," "RAPID" AND "SUFFICIENT" ASPECTS OF ENTRY EVALUATED?**

A. I will begin with "rapid" since it is the easiest to discuss. The timeliness of entry must satisfy the standard that:

> In order to deter or counteract the competitive effects of concern, entrants must quickly achieve a significant price impact on price in the relevant market. The Agency generally will consider timely only those committed entry alternatives



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that can be achieved within two years from initial planning to significant market impact. [footnote omitted][33]

**Entry must be likely**

**Q. DO YOU BELIEVE ENTRANTS ARE LIKELY TO PROVIDE PRODUCTS AND SELL TO CUSTOMERS WHO ARE NOT PART OF THEIR EXISTING MARKET ENTRY STRATEGY IN RESPONSE TO A "SIGNIFICANT AND NONTRANSITORY PRICE INCREASE" BY QWEST TO NON-TARGETED PRODUCTS AND CUSTOMERS IN A WIRE CENTER WITHIN THE TIMELINESS FRAME ESTABLISHED BY THE MERGER GUIDELINES?**

A. No. I have two related reasons for my view. The first is the financial opportunity cost entrants are likely to face in responding to Qwest's attempted exercise of market power by pursuing non-targeted customer products and areas. The second is the cost of exit because of the requirement to sink assets specific to the new market.

**a. Financial opportunity cost is a barrier to entry into non-targeted markets.**

**Q. EXPLAIN FINANCIAL OPPORTUNITY COST.**

A. Opportunity cost is the diminution in value when an asset is applied in its next-best rather than its first-best use. By "financial opportunity costs of expansion" I mean the *risk* of experiencing increased cost and lower sales because of a departure from the CLEC's existing business plan in response to a price increase by Qwest. Presumably, each CLEC is following its profit-maximizing strategy. Financial opportunity cost is the risk that profits will diminish from diversion of strategy. And, in turn, that the CLECs terms and conditions of access to capital will change unfavorably.

Entrants' current facility build, expansion and facility location decisions reflect rational economic decision making. Profit is maximized by targeting customers for acquisition

[33] Guidelines Section 3.2 Timeliness of Entry.

with the highest incremental revenue and service potential in relation to incremental investment and acquisition costs. Earlier in this testimony, I considered this profitability imperative for CLEC strategy with respect to build out of CAP facilities, and I have also tried to suggest those business customer segments I believe CLECs are targeting generally.

Whether CLECs are stand-alone or are affiliated with large or small companies, their management is under pressure to prove they have a profitable entry strategy, in Washington, nationally, and for some CLECs, internationally. For both Mr. Basile of the former GST and Mr. Williams of AT&T, the floodgates of capital for future expansion remain open only if the CLEC delivers on its promises of profitability. Many of the smaller CLECs, for example, are currently not profitable (using the accounting measure of EBITDA)[34] and aim to become EBITDA positive over the next one or two years.

**Q. WHY DO YOU SAY THAT PROFITABILITY IS LINKED TO EXECUTION OF THE CLECS EXISTING ENTRY STRATEGY?**

A. The diversity of business customers in terms of their needs and the cost of delivering voice, data and other desired communications services to them means that these customers represent different business profit opportunities. While CLECs' strategies will differ according to individual attributes, I have suggested why very large firms are too high cost and very small firms are too low margin to be targeted yet. I believe that, if Qwest had not acquired these customers and the network which serves them through merger with an ILEC, Qwest would not have bothered (yet) to acquire them.

Qwest faces the sort of pressure to target and execute its business plan that each

[34] EBITDA is earnings before interest, taxes, depreciation and amortization.



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facilities-based CLEC faces. With respect to Qwest, a Banc of America Securities company analyst comments,

> Well, with respect to Qwest, [in our valuation methodology] we consider the value of each individual access line that the company has; we consider its existing networking plan and, likewise, the business we believe Qwest can drive on-net from its current and future operations...We consider the types of customers coming on-net, e.g., we consider the value of an Internet-enabled customer to be greater than that of an enterprise customer, and an enterprise customer to be greater than that of an individual consumer. We segment customers according to the margins we believe the company can derive from them coupled with the degree to which they will demand bandwidth going forward. So its generally a confluence of different factors that go into our valuation assumptions.[35]

**Q. BUT, IF QWEST RAISES PRICES TO CERTAIN CUSTOMERS, WON'T THAT CHANGE CLECS' POTENTIAL PROFIT MARGINS AND THEREBY ATTRACT ENTRY?**

A. No. If the Petition is granted, Qwest will use its new flexibilities to manage entry. Discovery responses indicate that Qwest, as expected, gathers market intelligence internally and contracts externally with parties who "provide Qwest with competitive intelligence on competitors' network facilities."[36] With competitive classification, Qwest will have the ability to fully discriminate in its pricing, increasing prices to individual customers based on Qwest's evaluation of the prospect of entry.[37] Qwest will

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[35] Andrew Hamerling, Banc of America Securities, Wireline Telecom Services, Analyst Interview, Wall Street Transcript excerpt, by permission, August 28, 2000.

[36] Qwest response to Public Counsel Data Request PC 01-017.

[37] RCW 80.36.170 and RCW 80.36.180, which prohibit undue preferences and undue discrimination, respectively, both provide: "This section shall not apply to contracts for services classified as competitive under…RCW 80.36.330." Thus, Qwest could offer discriminatory, customer-specific contracts to those customers who have available choices and change a high price list price to those customers who do not have those choices.



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tailor its price increase to avoid entry. This exercise of market power is particularly attractive in the present situation in which a "little" price increase to a numerically large existing customer base can create "a lot" of added revenue. With added flexibility to discriminate, Qwest can price using the knowledge that CLECs have costs of acquiring Qwest's existing customers that Qwest does not face.

In my view, a CLEC's best financial strategy is, at this early stage of market development, to stick to the plan upon which it has been financed. CLECs should have "tunnel vision" with respect to activities or market developments which do not impact these business plans. The CLEC needs to keep doing what it does well, (or find what it does well) and basically ignore what Qwest does with its captive business customers, including its very large and very small business customers.

**The Cost of Exit is a barrier to entry into non-targeted market segments, because of the requirement to sink assets specific to the new market segment**

**Q. WHY IS THERE A COST OF EXIT IF A CLEC ENTERS NON-TARGETED MARKET SEGMENTS?**

A. A specific asset is one that cannot be employed in an alternative use or can only be deployed at diminished value in an alternative use. (That salvage costs exist illustrates this idea). The existence of specific assets is suggested by product differentiation, customer diversity and the fact that different network technologies "lock in" the supplier to certain strengths and weaknesses relative to alternative technologies. One example of a specific asset is the pre-product investment in focus groups, sales force training and advertising which precedes a new product launch. As discussed earlier in the section addressing very large customers, the entrance facilities into a downtown corporate office occupied entirely by a single company are still there at the end of the contract and can't be put to use elsewhere. The only way an entrant can avoid the cost of exit in this case


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is to require a fully compensatory payment upfront or over time in a term contract.

Facility based CLECs have already sunk costs into entering their preferred market segments. If they fail, they will face exit costs. The likelihood of failure increases when a CLEC enters a market segment it has no plan to serve. Unlike an established firm, it has not developed a base of information and experience in serving the market.

### 1. Entry must be sufficient

**Q. DO YOU BELIEVE ENTRANTS ARE LIKELY TO PROVIDE PRODUCTS AND SELL TO CUSTOMERS WHO ARE NOT PART OF THEIR EXISTING MARKET ENTRY STRATEGY IN RESPONSE TO A "SIGNIFICANT AND NONTRANSITORY PRICE INCREASE" BY QWEST TO NON-TARGETED PRODUCTS AND CUSTOMERS IN *EACH* WIRE CENTER WITHIN THE TIMELINESS FRAME ESTABLISHED BY THE GUIDELINES?**

A. Assuming for the sake of illustration, that some entry would be stimulated by Qwest's attempted price increase, entrants would respond first in the area where entry was easiest. If Qwest believes that a price increase would be unprofitable in Seattle Main because of entry, it may believe that the same price increase in Waverly 7 would attract no, or insufficient entry. Thus, the sufficiency criterion requires that entry be sufficient to make each and every attempted exercise of market power in Petition wire centers unprofitable. This appears to be a daunting challenge for entrants to execute at this stage of competitive development.

## IV. CONCLUSION

### A. Significant Captive Customer Base

**Q. HAS QWEST DEMONSTRATED THAT IT DOES NOT HAVE A SIGNIFICANT CAPTIVE CUSTOMER BASE AMONG ITS BUSINESS CUSTOMERS IN ANY OF THE 31 WIRE CENTERS IN THIS PETITION?**

A. No. Qwest has not adequately identified "customers of a service," thus it has not addressed whether these customers have reasonably available alternatives. Until such time as Qwest meets this basic burden, the Commission should presume all existing Qwest business customers served under general business tariffs (at regulated or upper band prices) are captive. The Commission has already determined that certain customers, services and conditions of service are such that Qwest has been permitted Special Contract or Banded Rate authority.

**Q. HOW MIGHT THE COMMISSION IDENTIFY A "SIGNIFICANT" CAPTIVE CUSTOMER BASE?**

A. I believe there is a qualitative dimension to identifying a "significant" captive customer base, which recognizes the history of public interest regulation in Washington.

First, in identifying ratepayers as the customers to whom the phrase "captive customer" applied, the Court of Appeals in US WEST v. Utilities Comm'n 86 Wn. App. 719, 728, 937 P.2d 1326 (1997) reviewed the legislative history of RCW 80.36.320 and found that the legislature's focus was on the ratepayer. The Court noted that the report of the House Committee on Energy and Utilities states that the Committee recommended retaining "the monopoly ratepayer" as the focus of regulation. Second, the Commission is allowed to waive regulatory requirements under title RCW 80.36.320(d)(2) when it determines that competition will serve *the same purposes as public interest regulation*. That effective competition ought to be operating as a "good substitute" for public interest regulation is also suggested by the policy declaration in RCW 80.36.300(3) to ensure that customers pay only reasonable charges for telecommunications service. In contrast to a purely economic focus, public interest regulation is concerned with issues of discrimination and transfers of wealth from consumers to producers. (Such concerns are dismissed in a purely economic framework if outcomes are economically efficient).



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Third, the Washington statute provides a detailed test for considerations of competitive classification. These factors suggest that, in addition to simply counting noses or measures of economic activity affected, the Washington Commission may want to recognize its history of effectively administering cost-based public interest regulation and, thus, set a low threshold for identifying a "significant" captive customer base.

Of course, the Commission has the discretion to establish a tolerance level for the income transfer and economic welfare loss of residual market power. With respect to the business customers I have identified, the measures of business counts and employment levels establish the quantitative significance of these customers. I want to stress that I do not believe these are the only kinds of business customers that would be captive if the Commission were to grant Qwest's Petition.

### B. Existing Pricing Flexibility

**Q. WHAT BANDED RATE AUTHORITY DOES QWEST HAVE?**

A. Under its statutory authority, in Docket No. UT-950200, the Commission authorized banded rates for any service US WEST chooses, setting the top of the band by the UT-950200 Order and allowing any level above incremental cost as the lower band. Within the band, US WEST may change prices on ten days notice to customers and the Commission, exactly the same notice requirements imposed on competitors. The Commission said: "This flexibility gives the Company the ability to drop prices where competition requires, while restraining its ability to raise the rates of captive customers."[38]

**Q. WHAT CONTRACTING AUTHORITY DOES QWEST HAVE?**

[38] WUTC Docket No. UT-950200, Fifteenth Supplemental Order, Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling, page 10-11.



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A. As acknowledged by Qwest in its response to Staff Data Request WUTC 04-006, under RCW 80.36.150 and WAC 480-120-330, "Washington has extremely flexible contracting requirements. Because the Commission can only reject a contract if it does not meet a customer specific cost standard, the Commission has exercised little oversight over contracting provisions." Also as acknowledged by Qwest in that data response, "[c]ontracts can offer rates, terms and condition that differ from tariffed rates upon a statement of competitive necessity or specific customer needs." However, each contract for non-competitively classified services "must not result in undue or unreasonable discrimination between customers receiving like and contemporaneous service under substantially similar circumstances." As noted above, this contrasts with Qwest's authority to offer contracts for competitively classified services. In that case. Qwest can offer customer-specific contracts that are unduly or unreasonably discriminatory, because the prohibitions against undue preference or undue discrimination do not apply to contracts for competitive services. See RCW 80.36.170 and RCW 80.36.180.

**Q. WHAT AUTHORITY DOES QWEST HAVE TO OFFER PROMOTIONS AND CUSTOMER WINBACK INITIATIVES?**

A. Qwest has considerable authority to offer promotions and customer winback initiatives without undue regulatory burden. For example, the Commission does not have the authority to suspend a filing for a new service, and the Commission recognizes a new combination of existing services as a new service. Thus, a tariff filing for a new package of services becomes effective after 30 days notice, unless the filing fails to cover cost or is unlawful. Moreover, under the terms of RCW 80.36.110, the Commission can always allow changes in rates on less than 30 days notice for good cause. Also, Qwest may file a tariff that reduces a price with ten days notice without receiving a special order from the Commission as long as Qwest does not seek an



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offsetting increase for a year. Finally, as specified in RCW 80.36.130, the Commission may accept a tariff that gives free or reduced rate services for a temporary period of time in order to promote the use of the services

**Q. WHAT CONCLUSION DO YOU REACH?**

A. Qwest's current use of banded rate authority permits Qwest to price products at cost. Qwest's has not shown its existing banded rate authority, ability to offer Special Contracts under tariff, promotions and customer winback initiatives allowed by this Commission are inadequate or are hindering the development of competition. These existing capabilities strike the right balance between allowing Qwest to respond to competitive threats where they exist and protecting captive ratepayers. Qwest's Petition should be denied.

**Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

A. Yes it does.

[1] Contracts for services classified as competitive are not subject to the discrimination and unreasonable preference conditions of RCW 80.36.170 and RCW 80.36.180.



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