Exhibit No. _____ (CRD-1T)
Docket No. UT-020406

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

AT&T COMMUNICATIONS OF	**)**	
THE PACIFIC NORTHWEST, INC.,	**)**	
COMPLAINANT	**)**	**DOCKET NO. UT-020406**
v.	**)**	
VERIZON NORTHWEST INC.,	**)**	
RESPONDENT	**)**	

DIRECT TESTIMONY OF

CARL R. DANNER

ON BEHALF OF
VERIZON NORTHWEST INC.

DECEMBER 3, 2002

I. INTRODUCTION

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

A. My name is Carl R. Danner. I am a Director with Wilk & Associates/LECG LLC, 100 Bush Street, Suite 1650, San Francisco, CA 94104.

Q. PLEASE SUMMARIZE YOUR BACKGROUND AND QUALIFICATIONS.

A. I was the Advisor and Chief of Staff to Commissioner (and Commission President) G. Mitchell Wilk during his tenure at the California Public Utilities Commission (CPUC). Since leaving the CPUC, I have provided consulting services to various clients on regulation and policy, with emphases on the telecommunications and energy industries. I hold a Masters and Ph.D. in Public Policy from Harvard University, where my dissertation addressed the strategic management of telecommunications regulatory reform. At Harvard I served as Head Teaching Assistant for graduate courses in microeconomics, econometrics and managerial economics. I hold an AB degree from Stanford University, where I graduated with distinction in both economics and political science. My experience includes researching and teaching regulation, advising regulators, testifying in regulatory proceedings, and advising clients on regulatory issues. My complete resume is attached Exhibit CRD-2.

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

A. Verizon Northwest Inc. (Verizon) asked me to review and comment upon the complaint filed by AT&T Communications of the Northwest, Inc. (AT&T) regarding Verizon's access charges, as well as the direct testimony of AT&T and Commission Staff. My testimony sets forth the results of my review. Specifically, my testimony explains that –

(1) the Commission should not, as a matter of policy, reduce Verizon's access charges unless it allows Verizon to raise simultaneously rates for local residential service on a revenue-neutral basis;

(2) AT&T is wrong in claiming that Verizon's current access charges are anti-competitive and result in a price squeeze, and that Verizon's toll rates fail the Commission's imputation test;

(3) Staff's claim that Verizon and Qwest should have similar costs and rates is erroneous; and

(4) Staff's proposal to offset access charge reductions with a per minute-of-use (MOU) charge assessed upon end-users for every toll call they make is economically unsound and conflicts with other positions Staff has taken in this docket.

Finally, my testimony supports Verizon's proposal to increase basic residential rates on a revenue-neutral basis if the Commission chooses to make any reductions to Verizon's access charges.

II. THE COMMISSION MUST ENSURE REVENUE-NEUTRALITY

Q. IN THIS CASE, AT&T HAS PROPOSED, AND STAFF HAS AGREED, THAT VERIZON'S ACCESS CHARGES SHOULD BE REDUCED BY MORE THAN $30 MILLION PER YEAR. SHOULD THE COMMISSION REDUCE VERIZON'S REVENUES BEFORE IT ALLOWS VERIZON TO INCREASE BASIC RATES ON A REVENUE-NEUTRAL BASIS?

A. No. The fundamental principle of regulation – and a principle this Commission has followed – is that the regulated company must have an opportunity to recover its costs, including a reasonable cost of capital. Particularly in the context of the traditional rate-of-return regulation that applies to Verizon in Washington, this means that a regulator should not reduce a company's revenues unless and until it proves the company is over-earning. The public policy behind this principle is obvious: if a company is not given an opportunity to recover its costs and to earn a reasonable return, it will not be able to continue to provide quality service.

The testimony of Verizon witness Nancy Heuring shows that Verizon is not over-earning in Washington; indeed, it shows that Verizon is *under*-earning. Also, she calculates that Verizon's rate of return would decrease to .73% if the Commission required the company to reduce its access revenues by $32 million without allowing an offset. This is obviously not compensatory.

Q. ARE THERE ANY OTHER ADVERSE CONSEQUENCES OF SUCH A DECISION?

A. Yes. If the Commission reduces a company's earnings in such a manner, it will send a message to the financial markets that the investment climate in Washington has deteriorated significantly. This is because all regulated companies will face a risk they have never faced before to my knowledge in Washington, i.e., the possibility that the regulator will unilaterally slash earnings to *any* level, including a negative return. This will encourage the financial markets to require a significant "risk premium" with respect to additional investments in this state that may fall under the Commission's jurisdiction.

While I cannot speak for Verizon's management in this regard, under the foregoing scenario it would also be perfectly consistent with principles of prudent corporate management for Verizon to attempt to minimize any further investments it might make in its Washington operations under the Commission's jurisdiction. Appropriate capital budgeting within a corporation must consider each investment (e.g., as between different states) by comparison to the specific risks it entails – which would be greater in Washington under the scenario I described above, and which would therefore point towards making discretionary investments in places (or opportunities) other than Washington.

Q. HAS AT&T RECOGNIZED THAT WHERE, AS HERE, ACCESS CHARGES ARE REDUCED, AN ILEC MUST BE ALLOWED TO INCREASE RATES FOR OTHER SERVICES?

A. Yes. AT&T has presented testimony that supports the very point I make. Specifically, in a Pennsylvania access charge investigation, AT&T's Director of Law and Governmental Affairs, Mr. Blaine Darrah, testified that if an incumbent's access charges are reduced, the incumbent is entitled to recoup its lost revenues by raising the rates of other services:

> [L]et's assume we're not in a situation where we've got any over-earnings. We're in a company that's within the regulated base, then I am supportive of revenue neutral changes for the company which would mean one of a couple of things. Either when you lower access, you at the same time receive funds from the universal service which was the example we just talked about or you could also lower access while doing some rate rebalancing in terms of raising residential rates or some other rates within the company. *In other words, we [AT&T] agree that access is an implicit subsidy going to support residential local service. And, no, you shouldn't have that taken away and reduce access independently . . . .*[1]

Clearly, this AT&T analysis supports Verizon's position on revenue-neutrality. I understand Verizon raised this point in a previous pleading and that AT&T's only response was that Mr. Darrah's testimony was "taken out of context." But the "context" is the same: here, as in the situation addressed in AT&T's prior testimony, Verizon is not overearning.

[1] Testimony of G. Blaine Darrah III, Director--Regulatory, AT&T Law and Government Affairs Division, Tr. 612-13, *In re Generic Investigation of Intrastate Access Charge Reform,* Docket No. I-00960066 (Pa. Pub. Util. Comm'n.) (transcript of Sept. 11, 1997) (emphasis added).

III. AT&T's CLAIMS ARE WRONG

Q. AT&T CLAIMS THAT VERIZON'S CURRENT ACCESS CHARGES ARE ANTI-COMPETITIVE AND RESULT IN A PRICE SQUEEZE, AND THAT THE COMPANY'S TOLL RATES FAIL THE COMMISSION'S IMPUTATION TEST. PLEASE COMMENT.

A. AT&T is wrong on all counts. First, Dr. Selwyn's claim that Verizon's access charges are anti-competitive and create a "price-squeeze" disregards a fundamental principle of economics – that of opportunity costs. Specifically, Dr. Selwyn argues that because Verizon does not actually pay itself access charges in cash, Verizon and its long distance affiliate can underprice competing interexchange carriers (IXCs). In other words, he claims Verizon's long distance offerings are not "burdened" by the cost of access, and therefore Verizon can underprice IXCs' offerings and still make a profit. This position, however, ignores the fact that whenever Verizon (or an affiliate) captures a minute of long distance service from an IXC through competition, Verizon *foregoes* the access charges the IXC would have paid, and therefore has to consider that foregone payment the same as an "actual cash out-of-pocket cost" (to use Dr. Selwyn's phrase).

Of course, even if we ignore the fundamental principle of opportunity costs, the Commission's rules require Verizon's toll rates to pass an explicit imputation test.[2] According to the Commission, the purpose of this rule is to avoid a "price squeeze."[3] Given this, AT&T's various claims of "anti-competitive behavior" and "price squeezes" boil down to one question: Whether Verizon's rates for its long-distance services pass imputation. Verizon witness Terry Dye explains that Verizon's rates do, in fact, pass the Commission's imputation test. I have reviewed Mr. Dye's testimony and *Imputation Study* attached to it, and I agree with the approach he has taken (while deferring to him on the specific sources of relevant costs and related calculations). In particular, I note that Dr. Selwyn's testimony attempts to include a number of costs that do not belong in a proper imputation analysis; in that manner, what Dr. Selwyn is really attempting is to establish an anti-consumer price umbrella so that his client can charge more for its long distance service in Washington. The Commission should reject this inappropriate attempt.

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[2] Given the reality of opportunity cost, claims of a "price squeeze" usually amount to a claim of predatory pricing – i.e. that an ILEC would willingly lose money through economically irrational discounts in order to drive its IXC competitors out of the market, and then remonopolize the market to raise long distance prices to much higher levels in order to repay the cost of the predation and earn a subsequent profit. As the U.S. Supreme Court has recognized,

> "..the success of such schemes is inherently uncertain: the short-run loss is definite, but the long-run gain depends on successfully neutralizing the competition. Moreover, it is not enough simply to achieve monopoly power, as monopoly pricing may breed quick entry by new competitors eager to share in the excess profits. The success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain. Absent some assurance that the hoped-for monopoly will materialize, and that it can be sustained for a significant period of time, "[t]he predator must make a substantial investment with no assurance that it will pay off." Easterbrook, Predatory Strategies and Counterstrategies, 48 U. Chi. L. Rev. 263, 268 (1981). For this reason, there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful." (Matsushita Elec. Indus. v. Zenith Radio Corp., 475 U.S. 574, 589-90 (1986)).

There are good reasons to believe that successful predatory pricing would be even more difficult for a regulated telephone company to accomplish, and thus why no preemptive imputation rule should be necessary. Nonetheless, the Commission's existing imputation rule does protect against even this possibility.

[3] WUTC "First Supplemental Order Granting Competitive Service Classification With Conditions," Docket No. UT-970767 (September 29, 1997), pages 12-13.

As Mr. Dye correctly notes, Dr. Selwyn does not wish to use Verizon's own Washington incremental costs for imputation, but instead wishes to employ figures based on selected affiliate transaction payments and cost estimates from other jurisdictions. The result of Dr. Selwyn's claims would be to establish an unreasonably high price floor, contrary to what the Commission's imputation rule requires. Additionally, Dr. Selwyn claims, in essence, that Verizon should impute costs as if it were providing stand-alone long distance service only, rather than providing a bundle of services to customers to which long distance service would be incremental. Dr. Selwyn makes this claim in two ways. First, he objects to including only the incremental costs of interLATA billing in the incremental cost study, claiming that other "joint" costs of billing should also be considered. But imputation is supposed to address the question of whether Verizon is making economically rational decisions in offering its long distance service – i.e., whether the additional costs of offering this service are at least compensated by the additional revenue it yields. Costs Verizon would incur anyway (even without offering long distance) are not relevant. Second, the retailing cost estimate Dr. Selwyn proposes to import (in this instance, from Minnesota) appears to address the retailing costs for stand-alone IXCs. But Verizon is not a stand-alone IXC, and the economies it gains as a provider of multiple services allow it to provide many of those services at a lower incremental cost than might a stand-alone provider. This fact creates a benefit, not a problem, because customers are advantaged when providers can cut costs and increase convenience by offering a number of services in combination – as Dr. Selwyn's client is vigorously pursuing through its bundled offers of advanced cable TV services, broadband Internet access, and local telephone service. Indeed, if AT&T were subject to an imputation test for one of the services in its bundles, that test should be conducted on the same basis – considering truly incremental costs only.

Q. DR. SELWYN, HOWEVER, CLAIMS THAT IMPUTATION "OFTEN INTERFERES" WITH ILECS' OVERALL PROFIT INCENTIVES (P. 19), AND CITES A PAPER ON "DOUBLE MARGINALIZATION" AS AN EXAMPLE OF THIS POINT. PLEASE COMMENT.

A. Here Dr. Selwyn flip-flops – he goes from arguing that Verizon doesn't care enough about access charge revenues from IXCs, to claiming it cares too much. The fallacious "price squeeze" claim was that ILECs don't regard lost access charge revenue as real money when taking business away from IXCs, the claim I debunked above. This claim – also fallacious -- is that ILECs are so focused on access charge revenue that they would somehow destroy the long distance market in its pursuit.

In any event, the simple response to Dr. Selwyn's claim is that Verizon's rates pass the Commission's imputation test. The imputation requirement stands in the way of below-cost pricing, whether due to Dr. Selwyn's alleged "double marginalization" effect or for any other reason.

IV. <u>QWEST'S COSTS AND RATES ARE NOT RELEVANT</u>

Q. DR. BLACKMON STATES THAT BECAUSE VERIZON'S ACCESS CHARGES ARE HIGHER THAN QWEST'S, THEY RESULT IN (A) HIGHER STATEWIDE

TOLL RATES AND LOWER IXC PROFITS, AND (B) LOWER LOCAL EXCHANGE SERVICE RATES AND HIGHER ILEC PROFITS (P. 4). HE SAYS THAT THIS RESULT IS "UNFAIR, UNJUST, AND UNREASONABLE." DO YOU AGREE?

A. No. I agree that higher access charges generally result in higher toll rates and lower local exchange service rates, but this has nothing to do with "profit." First, Verizon's rate of return is regulated by the Commission, and the fact is that Verizon is not earning its cost of capital today. Under this form of regulation, the Commission will continue to have the opportunity to limit Verizon's earnings after access charges go down and basic rates go up on a revenue-neutral basis. Second, IXCs claim that they pass through all of the access reductions to their end-users by way of reduced long distance rates. If true, this would make IXC profits relatively indifferent to the level of access charges.[4]

Also, as Verizon witness Mr. Fulp explains, Mr. Blackmon's claim that Verizon's access charges are "unfair, unjust and unreasonable" because they are higher than Qwest's access charges is contradicted by the Commission's express finding in the *Merger Order* that Verizon's current access charges are "just, reasonable, and compensatory." (If such concerns were triggered by the mere fact of a difference between the access charges by Verizon and Qwest – as Dr. Blackmon now claims -- then the Commission would have refused to approve the merger settlement at that time.)

[4] Access charge levels do affect the overall size of the long distance market by influencing customer calling volumes; other things equal, a larger long distance market may offer more profit opportunity for carriers, although the extent of competitiveness is also a factor (i.e., a smaller, less-competitive market may be more profitable for carriers than a larger, more-competitive market). In any event, I understood Dr. Blackmon's assertion to relate to the margin between the retail long distance price and the access charge, rather than the overall size of the market.

Q. IS DR. BLACKMON'S CONCERN ABOUT VERIZON "EXPORTING COSTS" TO THE CUSTOMERS OF OTHER CARRIERS OVERSTATED (p. 4)?

A. Yes. Cross-subsidies have been endemic in regulated telecommunications markets for decades; many of those cross-subsidies between customers (and companies) exist not inadvertently, but as the explicit objective of policy. For example, the Commission's "ITAC" universal service access charge element shifts costs from smaller, high-cost local exchange carriers to Verizon's customers in the same manner Dr. Blackmon criticizes here. It is clearly desirable to reduce cross-subsidies in telecommunications (and Verizon's proposal addresses the "export" of costs), but Verizon does not deserve criticism in this regard.

V. <u>STAFF'S OFFSET PROPOSAL IS FLAWED</u>

Q. DR. BLACKMON STATES THAT IF VERIZON IS ALLOWED TO OFFSET ANY ACCESS REDUCTIONS BY INCREASES TO OTHER RATES, IT SHOULD IMPOSE A PER MOU "RETAIL SWITCHED ACCESS CHARGE" UPON ITS LOCAL EXCHANGE CUSTOMERS (P. 8). THIS CHARGE WOULD BE ASSESSED WHENEVER A VERIZON CUSTOMER MAKES AN INTRASTATE LONG DISTANCE CALL REGARDLESS OF THE LONG DISTANCE PROVIDER (p. 9). PLEASE COMMENT.

A. Frankly, I don't understand the logic behind this proposal. Earlier in his testimony, Dr. Blackmon explains that because Verizon's intrastate access charges are higher than its interstate charges, intrastate long distance calls are more expensive than interstate calls.

According to Mr. Blackmon, "this is unfair to customers making intrastate calls and contributes to illogical rate structures in which calls to nearby cities are more expensive than calls to some foreign countries" (pp. 7-8). But on the very next page of his testimony, he proposes a per MOU adder to intrastate long distance calls *that produces the very result he just criticized* – just for a smaller (but still large) number of customers. In other words, his per MOU proposal results in intrastate calls being more expensive than interstate calls, which, according to Dr. Blackmon, is "unfair to customers making intrastate calls and contributes to illogical rate structures." In fact, Dr. Blackmon's proposal would result in end-users in Verizon's territory paying significantly *more* than they do today for intrastate long distance calls (Verizon estimates about 3.2 cents per minute more), thereby exacerbating the alleged problem Mr. Blackmon identifies.

Moreover, this proposal is anti-competitive because Verizon would be the only company required to impose a special fee on long distance calls, thereby degrading the value of its service to customers. Customers would be given an artificial incentive to use other carriers, even if the other carriers were less efficient.

Finally, his proposal would be economically inefficient because it would use MOU-based rates to recover fixed costs. As I discuss below, the costs that access charges now cover are essentially the fixed costs of the local loop, which should be recovered through fixed monthly charges.

VI. VERIZON'S OFFSET PROPOSAL SHOULD BE ADOPTED

Q. PLEASE SUMMARIZE VERIZON'S PROPOSAL TO OFFSET ANY ACCESS REDUCTIONS.

A. Verizon's proposal is simple: if the Commission reduces Verizon's access charges, then it should increase Verizon's rates for residential service on a revenue-neutral basis. As discussed by Mr. Dye, if the Commission reduces access charges by $32 million as proposed by Staff, then Verizon's basic residential flat rates would increase by $4.56 per month (from about $13 to $17.56 per month). In addition, Verizon proposes to increase its basic residential measured rates from $7.25 to $11.81 per month.

Q. DO YOU AGREE WITH THIS PROPOSAL?

A. Yes, because it reflects established principles of economics and, as an added benefit, would satisfy all of Staff's concerns.

One of the most fundamental principles of economics is that the price of a service should at least cover the service's incremental cost to avoid economic waste. Also, the price of a service should recover an appropriate share of fixed or common costs, either as determined administratively (through Commission ratemaking) or as the competitive market permits. These costs are real costs that telephone companies (and other companies with economies of scale and scope) incur and must recover. This point has been widely recognized in mainstream economics, and particularly in the economics of utilities, information and telecommunications.[5] The amount of fixed and common costs a particular service should (or will) recover – the amount of the "markup" – depends on that service's price elasticity. Generally, this involves charging the highest markups to the services whose usage will be least affected, and lower markups to services whose usage is more sensitive (price elastic) to price increases. Again, in my experience, there is a broad consensus supporting these principles among economists who study the telephone industry. I support Verizon's proposal because it reflects these principles.

I agree with reducing Verizon's access charges because recovering the fixed costs of network access through access charges (as is now occurring in Washington) is economically inefficient, and causes economic losses to customers and the economy. Economists have quantified large losses in economic welfare due to such pricing practices in telecommunications. Shifting that cost recovery to basic local service is the appropriate response.[6] Also, asking customers to pay the costs they impose by demanding service is fair and equitable.

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[5] See, for example, Baumol, William J. and J. Gregory Sidak. Toward Competition in Local Telephony (The MIT Press, 1994), chapter 3 (regarding recovery of common costs in telecommunications); Kahn, Alfred E. The Economics of Regulation (The MIT Press, 1988), chapter 5 (regarding pricing in the presence of utility scale economies); Teece, David J. Managing Intellectual Capital (Oxford University Press, 2000), chapter 9 (with Mary Coleman) (regarding the necessity of an opportunity for economic rents to sustain innovation); Shapiro, Carl and Hal R. Varian. Information Rules: A Strategic Guide to the Network Economy (Harvard Business School Press, 1999), generally (regarding the need for, and competitive management of markups or rents to sustain information industries of all kinds).

[6] Note, however, that the Commission previously found Verizon's current access charges to be just and reasonable at a time these economic concerns also applied. The Commission has the option of making the same finding in this docket if it believes other reasons are more important for leaving access charges at current levels.

Q. PLEASE EXPLAIN HOW VERIZON'S PROPOSAL REFLECTS THESE PRINCIPLES.

A. The testimony of Mr. Dye shows that Verizon's current rates for basic residential service are priced well *below* long-run incremental cost. Verizon proposes to increase these rates so that they are closer to, even though they still do not exceed, the incremental cost of service. As I just explained, the price of a service should at the very least equal incremental cost. Verizon's proposal is the only one that comes closer to achieving that principle.

Q. BUT WHY SHOULDN'T VERIZON BE REQUIRED TO INCREASE, SAY, BUSINESS RATES?

A. For the simple reason that basic business rates are already priced above TSLRIC. For example (as Verizon witness Mr. Tucek's analysis demonstrates), the cost of providing basic residential service (R-1 service) is actually higher than the cost of providing single line business service (B-1 service), yet Verizon's B-1 rates are substantially higher than Verizon's R-1 rates. Requiring Verizon to increase its B-1 rates and further misalign R-1 and B-1 rates would, to paraphrase Dr. Blackmon, "contribute to illogical rate structures." This is especially true when we consider retail rates in the context of wholesale unbundled network element (UNE) rates. In Washington, CLECs pay the same price for a UNE-loop or UNE-Platform regardless of whether the CLEC uses the UNE to serve a residential or business customer. Given the current retail rate structure, CLECs are artificially encouraged to serve business customers because that's where the money is.

Any proposal to increase business rates instead of residential rates only exacerbates this rate arbitrage problem.

Q. BUT DR. BLACKMON CLAIMS THAT VERIZON'S BASIC SERVICES ARE ALREADY "PRICED WELL ABOVE TOTAL SERVICE LONG-RUN INCREMENTAL COST, IN WHICH THE COST OF THE LOOP IS NOT AN INCREMENTAL COST OF EITHER LOCAL EXCHANGE SERVICE OR EXCHANGE ACCESS SERVICE" (P. 7). PLEASE RESPOND.

A. Dr. Blackmon is incorrect and, in any event, the rate design result should be the same.

The local loop provides access to the network, which is a part of basic service, and therefore is a direct (incremental) cost of providing basic service. No less an authority than Professor Alfred Kahn has summarized the relevant economic principles in the following way:

> 1. The concept of "cost" has no meaning in either economics or logic except in terms of causation. When we say that drunk driving "costs" us so many lives per year or so many dollars in property damage, we can only mean that the practice *causes* us, individually and/or collectively, to suffer these consequences. Similarly, when we say that the "cost" of a subscriber loop is some amount, it can mean nothing except that some act of purchase by a consumer *causes* a telephone company and society to incur that cost. In order to set efficient prices we must then determine *which* act of purchase has that effect.
>
> 2. Consumers impose the cost of a loop on a telephone company and on society by the act of subscribing to telephone service. The causation principle therefore requires that the cost of providing the loop be fully incorporated in the cost of basic service, that is, a flat one-time or periodic charge. Conversely, if as I understand to be essentially the case, actual use of the loop for local or long distance calling or for other services imposes *no* loop costs on the supplier and if subscribers were to refrain from

> placing those call or using any of those other services it would not save any of those costs, there is no sense in which usage or other services can be held causally responsible for them.[7]

AT&T and MCI have endorsed the same analysis:

> More than a legal question, a statutory construction question, or a policy question, the issue of whether the cost of the loop is a direct cost of providing BLS [basic local service] or is a joint or common cost to be allocated among BLS and other services <u>must be decided first and foremost on the basis of sound economics</u>.
>
> As Dr. Harris testified during cross-examination at the hearing, essentially every credible economist agrees on this issue. Under basic economic principles of cost causation, the cost of the loop is a direct cost of providing BLS. Indeed, the entire telecommunications industry – incumbent monopolists, CLECs, and IXCs – all agree that, as a matter of sound economics, the cost of the loop is a direct cost of providing BLS. The entire industry also agrees that competition in the local exchange market will not develop effectively if the cost of the loop is improperly allocated as a joint or common cost among BLS and other services.[8]

Please note, however, that the appropriate rate design does not depend on whether the loop is an incremental cost or a common cost. Even if we start from the (mistaken) assumption that the loop is a common cost, then either basic service or access service must be marked up to capture this cost. Dr. Blackmon makes this point in his testimony, where he states that "[t]o the extent the markup of access service is greater than the markup of local service, this would suggest that access charges should be reduced relative to local rates" (p. 7). If, as Dr. Blackmon posits, the current markup on access charges is too high and the current markup on basic service is too low, then the obvious solution is

[7] Kahn, Alfred E. <u>Letting Go: Deregulating the Process of Deregulation</u> (Institute of Public Utilities and Network Industries, Michigan State University, East Lansing, Michigan, 1998), pages 71-72 (emphases in original; notes omitted).

[8] "Joint Submission of Proposed Form of Order" by AT&T Communications of Indiana and MCI Telecommunications Corporation, Indiana Utility Regulatory Commission Cause No. 40785, June 8, 1998, page 3 (emphasis in original).

to reduce the markup on access and increase the markup on basic service. This is precisely what Verizon proposes.

Q. YOU MENTIONED EARLIER THAT VERIZON'S PROPOSAL, IN ADDITION TO REFLECTING WELL-ESTABLISHED ECONOMIC PRINCIPLES, ALSO WOULD SATISFY ALL OF STAFF'S CONCERNS. PLEASE ELABORATE.

A. If the Commission reduces Verizon's access rates and adopts Verizon's proposal to offset these reductions by increasing R-1 rates, then –

(1) Dr. Blackmon's proposal for Verizon to recover its costs from its own customers will be satisfied;

(2) Dr. Blackmon's concerns about the differences between Verizon's and Qwest's access rates will be satisfied; and

(3) Mr. Zawislak's uncertainty over imputation will be clarified and should disappear.

VII. CONCLUSION

Q. PLEASE SUMMARIZE YOUR TESTIMONY AND RECOMMENDATIONS.

A. Criticisms of Verizon's current access charges by Dr. Selwyn and Dr. Blackmon are overstated and in some instances inappropriate. At the same time, if the Commission wishes to reduce access charges, Verizon has offered a beneficial proposal to do so in a revenue-neutral fashion that respects the Commission's obligation to permit Verizon a compensatory return on investment in Washington.

Q. DOES THIS COMPLETE YOUR DIRECT TESTIMONY?

A. Yes.