BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of Review of Unbundled Loop and Switching Rates and Review of the Deaveraged Zone Rate Structure.	DOCKET NO. UT-023003

COMMISSION STAFF'S REPLY BRIEF

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1 The Washington Utilities and Transportation Commission (Commission or WUTC) Staff (Commission Staff or Staff) replies to the arguments raised in the initial briefs. Commission Staff reiterates the arguments set forth in its initial brief and does not reply to every argument raised by the parties in their initial briefs.

I. INTRODUCTION AND EXPLANATION OF TELRIC PRINCIPLES

2 In this docket, the Commission is asked to establish the prices for unbundled network elements (UNEs) pursuant to the Telecommunications Act of 1996 (federal Act). The Commission opened its first such "generic cost docket" in 1996, and is very familiar with the obligations and limitations imposed upon it by the federal Act and the Federal Communication Commission's (FCC) rules implementing the Act. While the FCC's rules have undergone refinement and substantive change, the Commission's task remains the same: to set cost-based rates that conform to the FCC's total element long-run incremental cost (TELRIC) methodology. The FCC requires that state commissions base UNE rates on "the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wirecenters." *47 C.F.R. § 51.505(b)(1)*.

3 In its initial brief, Verizon Northwest Inc. (Verizon) quotes heavily from the FCC's pending rulemaking regarding UNE pricing.[1] In this NOPR, the FCC tentatively

[1] *In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, Notice of

has concluded that the most-efficient network should more closely account for the real-world attributes of the routing and topography of an incumbent local exchange company's (ILEC) network, while "ensur[ing] that a reformed TELRIC methodology does not swing in the other direction and give incumbents undue advantages." *NOPR*, ¶ 52.

4 In setting TELRIC-based rates, this Commission consistently has endeavored to set rates that are economically efficient. This Commission has held that:

> Economic efficiency dictates that the cost floor be established in a manner which maximizes society's welfare and is consistent with the Act's requirement that the rates be just and reasonable. . . . Setting economically efficient prices will provide the right signal to competitive local exchange carriers (CLECs). Most importantly, it will help them in making their decision either to construct their own network or to lease facilities from the incumbent local exchange carrier (ILEC). If the price of an unbundled network element is set too high, a CLEC may build facilities when society's scarce resources would be better employed if it had rented facilities from the ILEC. On the other hand, if the price of unbundled network elements is set too low, a CLEC may rent facilities from an ILEC rather than build. This would reduce society's well-being, because the least cost supplier is not the one who is building and maintaining the network facilities. In order to maximize society's welfare, resources should be directed toward the supplier that can construct a network at the lowest cost to society.

Eighth Supplemental Order, ¶ *12*.[2]

Proposed Rulemaking, 18 FCC Rcd. 18,945, FCC 03-224 (2003) (*NOPR*). The FCC's tentative conclusions in the NOPR are not binding.

[2] *In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale, et al.*, Docket Nos. UT-960369 *et al.*, Eighth Supplemental Order; Interim Order Establishing Costs for Determining Prices in Phase II (April 16, 1998) (*Eighth Supplemental Order*).

5 The Commission must be careful not to place too much emphasis on the ILECs' existing networks, otherwise the efficiencies that TELRIC seeks to gain from a forward-looking, economically and technologically efficient network will be lost. Thus, the TELRIC methodology necessarily must remain hypothetical in some respects in order to capture these efficiencies.

II. COST OF CAPITAL

6 In its initial brief, Verizon states that the Commission Staff recommended that the Commission adopt the capital structure established in a 1994 rate of return proceeding. *Verizon's Initial Brief, at 15.* However, the Commission Staff testified that the Commission should use Verizon's current capital structure, which is 63 percent equity and 37 percent debt. This capital structure is forward-looking because it is the result of on-going review and adjustment by the company's management. *Exhibit 1065T, at 5, ll. 16-18 (Spinks); Tr. at 1092, ll. 11-18 (Spinks*).

III. DEPRECIATION

7 Verizon argues that the Commission should adopt the depreciation lives the company has used in its financial reporting—its GAAP (Generally Accepted Accounting Principles) lives. *Verizon's Initial Br. at 24.* Verizon further argues that the currently prescribed depreciation lives would violate TELRIC. *Id.* at 27-29. Verizon is wrong.

8 First, the FCC firmly rejected Verizon's arguments in its *Triennial Review Order*.[3] The FCC refused to mandate the use of financial lives for establishing depreciation expense under TELRIC. *Id., ¶ 688.* State commissions have broad discretion with respect to the asset lives they use in calculating depreciation expense under TELRIC. *Id.*

9 Second, contrary to Verizon's contention, use of Verizon's currently authorized depreciation lives is not prohibited by the federal Act. *See Verizon's Initial Br. at 28 (citing 47 U.S.C. § 252(d)(1)).* Verizon ignores that its regulatory depreciation rates are economic depreciation rates, which is what TELRIC requires. 47 C.F.R. § 51.505(b)(3); *Exhibit 1065T, at 3, ll. 1-15 (Spinks).* Verizon's currently authorized depreciation rates are forward-looking and comply with TELRIC.

10 Finally, Staff did not "acknowledge" that the Commission should use updated depreciation rates. *See Verizon's Br. at 28-29.* Verizon's selective quotation from Staff's testimony is misleading. Staff testified that no adjustment to depreciation rates is required by the TRO, and that <u>if</u> the FCC or state commissions were to accelerate recovery of an asset, a number of issues must be first be resolved. *Exhibit 1067T, at 12, l. 19 through 13, l. 7.* Staff's questions about updating Verizon's depreciation rates refer to the issue of whether an acceleration method could be applied. *Id.* at 13, ll. 4-7.

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[3] *In the Matter for Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, et al.*, CC Docket Nos. 01-338 *et al.*, Further Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd. 16,978, FCC 03-36, ¶¶ 686-88 (2003) (*Triennial Review Order* or *TRO*).

Accordingly, the Commission should reject Verizon's proposed GAAP lives and adopt the company's currently authorized deprecation rates to set TELRIC-based rates.

IV. COST MODELS

11 The Commission Staff advocates that the Commission choose a model. Consistent with its testimony, Staff advocates that the Commission adopt the HM 5.3 model to set TELRIC-based rates in this docket. *See Exhibit 1056T, at 5-7.* Staff's recommendation is based on the fact that HM 5.3 is "transparent, rational, stable, consistent, and understandable . . . " (*id. at 5, ll. 3-4*), and because HM 5.3 complies with TELRIC in that it models a network that uses the most efficient technology available and the lowest cost network configuration, given the existing location of Verizon's wirecenters. *See 47 C.F.R. § 51.505(b)(1).*

12 The Commission should not adopt VzCost because the model does not remotely satisfy the Commission's criteria for cost models. Contrary to Verizon's arguments, VzCost relies significantly on proprietary data that are not available to users. *Tr. at 1236, ll. 2-24 (Verizon Panel); Verizon's Initial Br. at 45-49 (Verizon's contentions regarding VzCost).* In fact, VzCost relies on data that resides on Verizon's mainframe computers that are located all over the country. *Tr. at 1239, l. 24 through 1240, l. 20.* In our initial brief, Staff explained the difficulty in using VzCost. *Staff's Initial Br. at 17-19.*

13 HM 5.3 best advances the Commission's criteria for cost models. The model is adjustable and verifiable. *Exhibit 851T (Mercer), at 30, l. 9-12.* The model uses publicly

available data to a great extent. *Exhibit 855, at 79.* HM 5.3 operates quickly and is easy to use. *Id. at 95.* Plainly, it superior to VzCost with respect to the Commission's criteria.

14 Verizon contends that HM 5.3 performs poorly regarding its estimation of loop lengths. *Verizon's Initial Br. at 52-53.* However, Verizon ignores Staff's proposed loop length adjustment, which remedies any concerns about the loop lengths modeled by HM 5.3.

15 According to Verizon, HM 5.3 produces excessive loop lengths. *Id.* at 53. Staff's loop length adjustment normalizes the HM 5.3 loop lengths to a ratio of 1.0, which ensures that investments are reconciled to existing loop lengths. *Tr. at 1086, l. 6 through 1087, l. 9 (Spinks)*. It is the ease with which users can adjust HM 5.3 that makes it a better choice than VzCost.

16 Verizon incorrectly states that this Commission has "previously recognized" that "cost models should approximate the 'real world.'" *Verizon's Initial Br. at 54 (citing Eighth Supplemental Order, ¶ 21).* Verizon misquotes the Commission. In the Eighth Supplemental Order, the Commission acknowledged Commission Staff's statement that "an analytical model is a simplified representation of some aspect of the real world." *Eighth Supplemental Order, ¶ 21.*

17 Staff agrees that both HM 5.3 and VzCost are simplified representations of some aspect of the real world. HM 5.3 is designed around existing customer locations and existing demand, and models an efficient network to serve the customers. VzCost is

designed to model a network that replicates Verizon's existing network by assuming that the placement of pedestals, cabinets, and other outside plant would not change. VzCost's fatal flaw is that it models a network that is larded with the inefficiencies that TELRIC was enacted to avoid.

18 Verizon also criticizes HM 5.3 for not taking into consideration natural and man-made obstacles such as bodies of water, rivers, and highways.[4] While HM 5.3 does not explicitly model cable routes, it estimates a cost for the necessary distance, which takes into account such barriers. *See Tr. at 1636, ll. 13-19 (Mercer).*

19 Verizon's position is that the better cost model is one that most accurately replicates the existing network. *Verizon*'s *Initial Br. at 63-65* However, where it better suits Verizon to adopt hypothetical assumptions, rather than "real world" information, the Company is quick to adopt hypothetical inputs. For example, Verizon tells the Commission that it must start with a purely hypothetical cost of capital, rather than a cost of capital that reflects the current state of competition, or even the competition that might exist in the future. *Id. at 11.* Verizon also argues that the Commission should not adopt the company's currently authorized depreciation lives because those lives were established in order to allow Verizon to recover its embedded costs. *Id. at 28.* But, the

[4] Verizon also improperly cites to Staff testimony that was withdrawn prior to the hearing. *Verizon's Initial Br. at 72, n.346 (citing Exhibit 1056T).* Nevertheless, at no time did Staff assume that the only clusters that must be corrected are those that fall within bodies of water.

company also argues that the same embedded costs be used to judge the validity of a cost model. *Id. at 60-61.* Verizon cannot have it both ways.

20 Another problem with VzCost is that it does not appear to be sensitive to input changes. In its response to Bench Request No. 16, the Company made fairly substantial changes model inputs at the Commission's request. *See Exhibit 1166.* As Verizon has acknowledged, these changes had little impact on the investment. *See Verizon's Initial Br. at 67 & n.326.* This degree of insensitivity shows that VzCost is designed to produce a very high estimate of UNE costs, regardless of how one adjusts the inputs.

V. TAKINGS

21 As set forth in Staff's opening brief, Verizon can establish that Commission rate order is an unconstitutional taking only if the end result of the decision causes confiscation. *Staff's Initial Br., ¶ 65 (citing Duquesne Light Co. v. Barash, 488 U.S. 299, 310, 109 S. Ct. 609, 102 L. Ed. 2d 646 (1989)).* Verizon has not discussed how any decision in this docket will affect the company beyond the UNEs at issue.

VI. CONCLUSION

22 As argued above and in the Staff's initial brief, the Commission should adopt HM 5.3 for purposes of setting UNE rates. HM 5.3 is open, transparent, and relatively easy to use. The model can be adjusted to reflect the Commission's preferred inputs. The model complies with TELRIC. The Commission should not adopt VzCost or set rates derived from that model because the model relies too heavily on the company's

legacy network, with all of its inefficiencies. The model also is cumbersome to use and fails the Commission's criteria for openness and transparency. The Commission should adopt Staff's recommended rates.

Respectfully submitted,

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