I.INTRODUCTION AND ORGANIZATION OF TESTIMONY

Q. Please state your name and business address.

A. My name is Sarah J. Goodfriend. My business address is 701 Brazos, Suite 310, Austin, Texas 78701.

Q. Are you the same Sarah J. Goodfriend who filed direct testimony in this docket number UT- 000883?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my testmiony is to respond to the analysis and conclusions made by Dr. Glen Blackmon in his direct testimony. While I do agree with many of the points Dr. Blackmon makes in his testmiony, I find his analysis to be incomplete and subject to error. Therefore, I conclude that Staff's analysis cannot and does not support its recommendations in this proceeding.

Q. What is Staff's recommendation?

A. Staff makes two recommendations. First, Dr. Blackmon recommends that the Commission grant pricing flexibility to Qwest within the requested wire centers in four exchanges for customers served on a DS-1 or larger circuit. The requested wire centers for which Staff recommends granting flexibility are located in the Seattle, Spokane, Vancouver and Bellevue exchanges. Second, Dr. Blackmon provides an alternative recommendation, conditioned on Qwest following certain directives, under which he would permit competitive classification of services to small businesses.

Q. Has Staff properly analyzed effective competition in accordance with RCW 80.36.330?

A. Staff's analysis is far superior to Qwest's. Staff clearly understands the purpose of its analysis and has developed an organizing framework to apply. Moreover, Staff has identified relevant markets, calculated market concentration, and examined "ease of entry" of a sort. However, Staff's analysis is incomplete and, at times, contradictory.

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Q. What basic errors of analysis do you find in Staff's approach?

A. I find several basic errors in Staff's approach:

First, Staff has not demonstrated that business services incorporating DS-1 and higher capacity circuits are *not* provided to a significant captive customer base in the wire centers for which Staff recommends competitive classification.

Second, Staff has not provided justification for its selection of relevant product markets.

Third, Staff's justification for its use of an entire wire center as a relevant geographic market rests upon Staff's requirements for unimpeded entry using Qwest special access circuits; Staff's requirements are not fulfilled.

Fourth, Staff's measures of concentration are fundamentally uninformative concerning existing market concentration and the future competitive significance of CLEC entrants in Staff's identified relevant markets.

Fifth, Staff's entry analysis is incomplete and Staff has not and cannot use its adopted framework to assess the likelihood of CLEC entry into the relevant market in response to Qwest's attempted exercise of market power in products relying on DS-1 or higher capacity circuits.

Sixth, Staff has not provided evidence to support its use of the Commission's findings in the previously-decided high capacity case to justify its recommendation.

Seventh, Staff's analysis demonstrates why its recommendation would confer little or no benefit on the development of competition.

Eighth, Staff's analysis demonstrates that granting any portion of the Petition at this time will enhance Qwest's ability to discourage entry, damage competition in its infancy and entrench existing market power.

Staff's adopted framework and flaws in its analysis have simply led Staff astray.

Q. How is the remainder of your rebuttal testimony organized?

A. In Section II, I explain why Staff's framework and flaws in its analysis have led Staff to unsupportable conclusions. I provide an overview and critique of Staff's approach using a

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Merger Guidelines framework. I explain why the conditions upon which Dr. Blackmon's primary recommendation depends are not satisfied. I also discuss why the market concentration statistics upon which Staff relies are not a supportable basis for inference. In Section III, I discuss the limited benefit to competition of granting Qwest's Petition in any respect. In Section IV, I discuss why granting any aspect of Qwest's Petition at this time facilitates anticompetitive entry deterrence, and I briefly discuss Staff's alternative recommendation. My rebuttal of Qwest's Direct Testimonies is provided in my Direct Testimony and in my endorsement here of certain Staff findings.

I.II. STAFF'S FRAMEWORK AND OMISSIONS LEAD TO ERRORS

I. A. OVERVIEW OF STAFF APPROACH USING THE MERGER GUIDELINES FRAMEWORK

Q. How has Staff organized its analysis?

A. Staff provides a Market Structure Analysis and a Market Concentration Analysis. Staff's ultimate findings in these areas are provided in two exhibits. Exhibit __ (BGB-2) summarizes Dr. Blackmon's market structure analysis and Exhibit ___ (GB-3) provides Ms. Bhattacharya's market concentration analysis. Staff testimonies provide the commentaries and qualifications to these ultimate findings.

Q. What relevant market definition does Staff rely on in this proceeding?

A. In recognizing a boundary between the products Qwest lists in Attachment A of its Petition, Dr. Blackmon identifies two relevant product markets in this proceeding. He draws a product boundary between customers according to whether or not customer demands can be economically served by a DS-1 or higher capacity circuit.

Ms. Bhattacharya performs an analysis of market concentration at the exchange level. For her analysis, geographic markets are defined at the exchange level. Staff

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assigns the 31 or 32[1] wire centers of the Qwest Petition into nine exchanges.

Q. Is Staff's market concentration analysis based upon its definitions of relevant markets?

A. No, Staff did not have the data at its disposal to perform such an analysis.[2] Staff calculates CLEC and Qwest market shares using the number of business access lines by exchange.

Q. To what purpose does Staff put its market concentration analysis?

A. Staff uses the results of its market concentration analysis to draw a boundary creating two sets of exchanges (wire centers). Based on the numerical value of the HHI that Staff calculates for the exchange, Dr. Blackmon distinguishes exchanges according to whether the HHI value that Staff calculates is above or below 5000. For those Petition wire centers in the exchanges with HHI values below 5000, he recommends competitive classification for all products which Qwest provides using a DS-1 or higher capacity circuit; for Petition wire centers in exchanges with HHI values above 5000, he does not recommend competitive classification.

Q. Does Staff analyze ease of entry?

A. Yes, as Dr. Blackmon clearly recognizes, his market structure analysis and ultimate findings rest upon his conclusions about ease of entry. Examination of his summary exhibit, Exhibit ___ (BGB-2), indicates that Dr. Blackmon's recommendation for competitive classification hinges on his conclusions regarding the "ready availability and financial viability" of using Qwest special access facilities for entry and service to DS-1 and larger customers.

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[1] Qwest may actually be requesting competitive classification for 32 wire centers, based on the information Qwest supplied to Public Counsel after the filing of Intervenor direct testimony. The Petition lists the Tacoma Waverly wire center. Qwest has two wire centers with this name, Waverly 2 and Waverly 7 and Qwest supplied maps of both in response to PC 03-069. Ms. Jensen's Direct Testimony does not specify which Waverly wire center is being reported. See Direct Testimony of Teresa A. Jensen, page 1 and exhibits.

[2] See generally the discussion provided in pages 5 and 6 of Bhattacharya Direct Testimony.

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CRITIQUE OF STAFF APPROACH USING THE MERGER GUIDELINES FRAMEWORK

Q. How is this section of your testimony organized?

A. I discuss Staff's analytical approach in terms of the Merger Guidelines. Rather than impose the Guidelines framework and required sequence of analysis, for easier exposition, I will employ Staff's two-step approach. First, I discuss why Staff's two-step approach introduces error. Second, I discuss Dr. Blackmon's Market Structure Analysis to examine Staff errors in analyzing ease of entry. Third, I discuss Staff Market Concentration Analysis to examine Staff errors in identifying relevant markets and other sources of error which keep Staff from calculating competitively insightful market share statistics.

Q. How does Staff's two-step approach lead to error?

A. First, and fundamentally, the framework Staff employs is not equal to its task. Staff does not recognize the need to ask all the questions of an antitrust-type analysis to evaluate effective competition and customer captivity. Dr. Blackmon recognizes the intent of such an analysis. He says, "[It] is not enough to say that competitors *could* serve customers in any particular market; to grant competitive classification, the WUTC must conclude that effective competition *actually* exists in the market [emphasis in original]. [3] I agree with this statement.

In performing its analysis, however, Staff cannot address the question of whether effective competition actually exists throughout the relevant markets it has defined. Consistent with the analysis Staff actually performs is Dr. Blackmon's less ambitious standard. He says, "The key question in evaluating whether a service is a viable alternative is whether the service *can* constrain Qwest's ability to exercise market power by increasing prices." [4] [emphasis added]

A *can* standard is inherently ambiguous. In the Merger Guidelines (and for the economic theory upon which the Merger Guidelines rely), the phrase "can constrain"

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[3] Blackmon Direct Testimony, pages 17-18
[4] Blackmon Direct Testimony, page 13, lines 2-4.

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means "will constrain."[5]

Staff, however, has adopted an analytical approach which permits Staff to conclude at best that "access methods are readily available to constrain." As my discussion below demonstrates, Staff's approach, by construction, fails to pose the necessary questions and evaluations.

> To evaluate whether effective competition exists, both (1) CLECs' "capability to constrain" an attempted price increase in Qwest products, and (2) CLECs' ability to respond to (i.e., "will constrain") an attempted price increase in Qwest products require analysis. While I recognize that this proceeding is a case of first (or second) impression for Staff, and the first time the Commission has been required to order the production of evidence needed for Staff analysis, the fact remains that Staff's analysis is incomplete and misleading. The evidence relied upon by Staff and the analysis to which it is put is not sufficient to Staff's task. Staff's task includes evaluations of demand-side and supply-side substitutions required to render unprofitable an attempted exercise of market power by Qwest in the products and wire centers where Staff proposes competitive classification. Staff's analytical framework and omissions indicate that this task was not performed.
>
> Rather, Staff's standard for evaluation of this Petition presumes Staff's analysis is sufficient to render judgment: Staff recommends the WUTC deny the petition unless both the structural factors and the market share data support a finding of effective competition.[6] But Staff's presentation is not sufficient. Below, I identify the specific ways in which Staff's structural analysis and market share analysis does not and cannot support a finding of effective competition.

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[5] For example, See Goodfriend Direct Testimony at pages 18 and 44.
[6] Blackmon Direct Testimony, p. 17

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Q. Please discuss Staff's Market Structure Analysis.

A. First, it bears repeating that Dr. Blackmon acknowledges that his recommendation for a grant of flexibility rests fundamentally on his conclusions regarding the "ready availability and financial viability" of using Qwest special access facilities for entry and for providing service to DS-1 and larger customers which provides *effective competition* for the Qwest service.

Staff summarizes its Staff's Market Structure Analysis Framework in Dr. Blackmon's Exhibit ___(BGB-2). The focus of analysis in Exhibit (BGB-2) is the current state of viability of access methods used by competitors. Exhibit (BGB-2) provides three specific and one overall assessment by type of access (or potential entry) method. For each access type, Dr. Blackmon identifies limitations in three areas. He identifies limits to (1) the geographic locations that can be served economically, (2) the size of customer that can be served economically, and (3) he notes provisioning problems.

Concerning facilities-based competition using fiber rings, Dr. Blackmon notes that the ring covers less than the entire wire center. There is no access for customers off-ring. Customers located in buildings that are already connected to the ring can be economically served; off-ring single line businesses cannot, and he provides no judgment concerning any "in-between" cases. He notes that fiber facilities are expensive and time-consuming to install. (These are characteristics of what I define in Direct Testimony as an irreversible sunk investment.[7]) Dr. Blackmon's overall assessment of fiber as an entry method is that it is "too narrowly available to justify competitive classification for an entire wire center."

Q. Do you agree with Dr. Blackmon's assessment regarding fiber as a method of potential entry?

A. Yes. Although I take specific issue with Dr. Blackmon's conclusions regarding special access, I agree generally with his other assessments in Exhibit (GBG-2). His analysis confirms that a CLEC's entry strategy will reflect the characteristics of the CLEC's choice

[7] See Goodfriend Direct Testimony, pages 44-45.

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of entry method, and thereby dictate the customer location and customer size requirements for profitable and economical entry.

As he notes, and as I discussed in my Direct Testimony, CLECs making sunk investments to reach particular customers must find ways of recouping these costs. This fact dictates the nature of the customer that can be served. For example, using wireline technologies, an industry rule of thumb is that it is often uneconomical for a CLEC to extend its fiber to buildings with less than 250,000 square feet. (In applications where fixed wireless technology provides sufficient quality for the customer's application, somewhat smaller buildings can be served, i.e. buildings with only 125,000 square feet.)[8]

Dr. Blackmon's analysis brings to light these important distinctions that Qwest simply ignores. As I indicated in my Direct Testimony, CLEC entry methods identify the characteristics of customers that can be economically targeted, and the CLEC cost of capital and expansion potential rests on successful execution of strategy. Evidence which supports Dr. Blackmon's access distinctions summarized in Exhibit (BGB-2) and their implications for customer segmentation is provided in Exhibit SJG-4. Exhibit SJG-4 reproduces an interview with CLEC financial analyst Trent Spiridellis, initially published three days after the filing of intervenor direct testimonies in this proceeding.

Q. How does Mr. Spiridellis' discussion of the state of and challenges to CLEC profitability confirm Dr. Blackmon's access distinctions?

A. Mr. Spiridellis provides some concrete examples of the different market entry strategies individual CLECs are pursuing, and the implied strengths and weaknesses. Because of the problems that Dr. Blackmon identifies in provisioning and securing unbundled network elements, Mr. Spiridellis finds a facilities-based strategy more prudent than a strategy which relies on the ILEC for cooperation.[9]

Q. How does Mr. Spiridellis' discussion of the state of and challenges to CLEC profitability confirm the view, provided in your Direct testimony, that CLECs are

[8] These rules of thumb are provided in Exhibit SJG-4, page 4.

[9] Mr. Spiridellis distinguishes between a facilities-based, a smart-build (or ILEC network dependent) approach and total service resale. See Exhibit SJG-4, pages 1-2.

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focusing on selected market segments?

A. Mr. Spiridellis provides some specific examples and discussions of individual CLEC strategies. For example, Focal Communications is a CLEC investing in xDSL as a customer service, but also to reduce its transport costs. Focal's target market is Fortune 500 companies. Focal pursues a strategy of "account penetration," attempting to sell more and higher valued services to existing customers. Focal's average number of lines per customer has increased recently to 300 lines per customer. Focal's revenue per line is relatively high and increasing. Its corporate customers subscribe to an average of 66 access lines per customer. Thus, Focal's market strategy illustrates Dr. Blackmon's discussion of the "80-20" rule, whereby a CLEC can show "high" levels of market share measured in terms of total lines, yet be targeting its service to a very focused customer segment.[10] For (the former) Nextlink, Mr. Spiridellis' focus is on facilities expansion in Europe, which suggests to me that Nextlink's focus is also on profitably executing that expansion.[11]

Q. Given the limitations you and Dr. Blackmon see for fiber entry at this time, does Dr. Blackmon's recommendation rest on the ease and profitability of CLEC use of Qwest facilities?

A. Yes, he is very clear about this. Not only must this strategy permit entry, it must be so potent as to provide effective competition for Qwest products. Moving down Dr. Blackmon's overall assessments of entry methods, it becomes crystal clear that "ready availability of Qwest facilities" is Dr. Blackmon's touchstone for effective competition. <u>See</u> Exhibit (BGB-2), last column.

Dr. Blackmon's statements in his Direct Testimony are clear: "Staff believes that there is no evidence to suggest that small business customers have any viable alternative to Qwest's business exchange service, because none of the [access] methods I just listed is *reasonably available and financially viable for that market segment* [italics added].

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[10] See Blackmon Direct Testimony, page 22.
[11] Exhibit SJG-4, pages 4 and 5.

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However, the large business segment -- i.e. any customer whose demand can justify a DS-1 or larger circuit -- does appear to have reasonably available alternatives in some exchanges. ”[12]

Q. Is the "appearance" of reasonably available alternatives Staff finds for the large business segment a deception?

A. Not entirely. Undoubtedly, the small number of customers identified by wire center in Ms. Jensen's Attachment H which have left Qwest and stayed with a competitive entrant have found the CLEC alternative to be more than reasonable. Without knowing more about CLEC strategies and these customers -- the CLEC product found to be a good substitute, customer location in the wire center, etc. -- one cannot generalize from the mere existence of these customers. Thus, it is more accurate to say that Staff's incomplete analysis has yielded errors which support false appearances. That Staff analyses are incomplete, even by Staff's own standards, is the subject I address below.

I. C. NECESSARY CONDITIONS OF PRICING INDEPENDENCE AND READILY AVAILABLE SPECIAL ACCESS CANNOT BE DEMONSTRATED

Q. Does Staff operationalize its standard of "readily available" and "financially viable" entry using Qwest facilities to (effectively) compete?

A. No, not directly. Staff does not directly assess ease of entry as contemplated by the Merger Guidelines, even though Dr. Blackmon recognizes the fundamental evaluation required when he defines market structure analysis to include a consideration of how easy it is for firms to enter and exit the market and how easy it is for customers to change from one competitor to another.[13]

Staff does not discuss entry using Qwest Special Access facilities in Direct Testimony. In his summary evaluation, Dr. Blackmon comments, with respect to provisioning issues of special access, that ordering and provisioning systems are well-

[12] Blackmon Direct Testimony, page 12 lines 4-9.
[13] Blackmon Direct Testimony, page 11 lines 2-7.

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established.[14] Yet, he also remarks that "orders are more likely to be held or denied than are business exchange orders."[15] Dr. Blackmon does not explicitly relate these remarks to his standards and his necessary conditions, discussed below.

When Staff does specifically examine entry conditions for unbundled loops and UNE-P in this proceeding, Staff's examination indicates that entry is not "easy" and, in my view, shows exactly why a positive recommendation from the WUTC on Qwest's Section 271 petition necessarily *precedes* a grant of competitive classification.

Q. How does Staff support its conclusion that entry using Qwest special access facilities meets its "readily available" and "financially viable" standards for an entry method?

A. Dr. Blackmon identifies the necessary conditions for his standards to be met. Dr. Blackmon explains, first, that, as a general matter, he supports the idea that a competitor relying on the Qwest network to compete can be a viable competitor[16] *if* the access method is (1) priced independently of retail business exchange service and (2) readily available to competitors.

Q. Why does Dr. Blackmon require Qwest to price access independently of retail business exchange service as a necessary condition for his conclusion and recommendation?

A. Dr. Blackmon explains, "If Qwest is free to raise network access prices, that network access cannot constrain Qwest's ability to sustain retail prices above a competitive level." Thus, because resale discounts depend upon Qwest retail price levels, and perhaps for other reasons, Dr. Blackmon does not find resale of Qwest retail service a price-constraining means of effective competition. Exhibit ___BGB-2.

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[14] Dr. Blackmon does not specify whether his remark is intended to apply solely to the provisioning systems for Qwest retail customers or also to the provisioning of DS-1 circuits to CLECs for use in CLEC products or for direct resale.

[15] Exhibit BGB-2, Qwest Special Access, Provisioning Issues

[16] Recognize that the viable competitor is an example of an insufficient standard for inference of effective competition because a competitor can be a viable competitor without providing *effective competition* to Qwest, i.e., the ability to render a Qwest attempted price increase in a relevant product unprofitable. A reseller is one illustration of a viable competitor which is not an effective competitor in the sense of RCW 80.36.380.

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Q. Please explain why Dr. Blackmon requires that network facilities be priced independently from how Qwest prices its retail services?

A. If Qwest raises its retail price for a service and can raise the price of the access method needed by a potential competitor, the competitor will incur increased costs. In order to restore profitability, the potential competitor must pass such cost increases along in its retail price to potential customers. If the competitor did not increase its retail price, but attempted to absorb the higher cost of access, then Qwest places the competitor in a "price squeeze" such that its profit, the difference between costs and revenues, is diminished. Thus, the potential competitor faces two options. The competitor can either (1) follow Qwest pricing and increase its retail price or (2) exit the market which has become unprofitable to serve at prevailing prices. Either way, Qwest is able, ultimately, to accomplish its desired price increase without competitive response. Moreover, when Qwest squeezes a competitor relying on Qwest network access to compete, this competitor lacks irreversible sunk investment. Thus, forcing exit of this non-facilities-based competitor is attractive to Qwest because exit is complete: there are no facilities left in place to be purchased and used by other competitors.

Q. Why does Dr. Blackmon conclude that Qwest is <u>not</u> free to raise network access prices (in tandem with the retail pricing flexibility he now recommends)?

A. He observes that DS-1 circuits are either already classified as competitive or subject to continuing regulation by the WUTC. From this observation, he reasons that Qwest is not free to raise prices for DS-1 and higher circuits.[17]

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[17] Blackmon Direct Testimony at 13

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Q. Do you agree with Dr. Blackmon's reasoning that Qwest is not free to raise special access prices (and thereby increase competitors' costs of using Qwest special access to compete with Qwest)?

A. No, I do not agree for four reasons. Each of these reasons, standing alone, is sufficient to show that Qwest at present will be able to exploit market power when competitors must rely on Qwest special access to compete. The ready availability or easy access and the independent pricing Dr. Blackmon requires do not exist. Thus, Dr. Blackmon's recommendation for competitive classification is unsupported.[18]

I. 1. PRICING INDEPENDENCE AND READY AVAILABILITY REQUIRE COMPARABLE ACCESS

Q. What are your four reasons for believing that Qwest can now raise prices for special access, thereby affecting potential competitors' ability to compete and undermining the possibility of effective competition by entrants reliant on Qwest special access?

A. The first reason is that the "price" faced by competitors is more than the price listed on a tariff or on a price list. The price faced by competitors equals the total cost incurred by the competitor in attempting to provide the competitive service. In the absence of a Commission recommendation in favor of Qwest's Section 271 application before the FCC, *there is no evidence (provided in this proceeding or elsewhere) for the necessary finding that Qwest cannot discriminate in the provisioning of services to competitors using DS-1 and higher circuits*, thereby increasing their costs (price of access). In recommending pricing flexibility in advance of Qwest's ability to demonstrate satisfaction of all conditions necessary for competition and irreversible market opening, Dr. Blackmon has not only placed the cart before the horse, but as I discuss in Section IV, he has, in fact, hobbled the competitive horse.

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[18]. It is important to recognize, moreover, that if Dr. Blackmon became convinced that his necessary conditions of independent pricing and ready availability did not hold as he assumes, he would no longer consider special access as a potential source of price-constraining competition, and, logically, his summary conclusions in Exhibit ___ (BGB-2) would merit revision as would his recommendation(s).

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I. a. FINANCIAL VIABILITY AND READY AVAILABILITY REQUIRE A SHOWING OF COMPARABLE SERVICE. THE IRREVERSIBLE PARITY TO BE ESTABLISHED BY DEMONSTRATED SECTION 271 COMPLIANCE PRECEDES COMPETITIVE CLASSIFICATION.

Q. Does Dr. Blackmon apply a Section 271 standard of "ready availability" in this proceeding?

A. Yes, I believe he does, at least implicitly. First, in dismissing Qwest's justification for pricing flexibility due to its inability to offer in-region interLATA long distance, he makes an observation. Opening the local network to competition via 271 compliance he observes, "would also make it much easier for the WUTC to grant competitive classification of Qwest's business local exchange service."[19] He does not discuss this comment, but, of course, it follows that once the WUTC finds Qwest cannot discriminate in the provision of checklist items or in OSS in ways which directly violate the WUTC's and the FCC's Section 271 requirements, entrants reliant on Qwest to compete are assured of receiving the resulting level of comparability and parity of service. Thus, equally-efficient entrants no longer bear the risk of increased costs from service discrimination by Qwest. Morever, his alternative recommendation makes competitive classification contingent in time upon (only) FCC approval of Qwest's Section 271 Petition.

Second, Dr. Blackmon indicates that unbundled elements would be a viable source[20] of price-constraining competition "if [these elements] were readily available to competitors using *proven* ordering, provisioning, and repair systems -- in the way, for example, that switched access service and the primary interexchange carrier process is available to *long distance companies*... " [italics added][21]

Later in his testimony, Dr. Blackmon discusses local toll services, again

[19] Blackmon Direct Testimony, page 8

[20] Here is another example where the standard is not sufficient. That an access method becomes a viable "source" of competition is not sufficient to demonstrate that entry via the source is equivalent to effective competition.

[21] Blackmon Direct Testimony, page 14

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emphasizing that for local toll products, access methods had a "proven track record with well-known costs and operating systems" and noting the process for a customer to change long-distance companies was proven. While Dr. Blackmon does not say whether he required demonstrations of parity prior to his grant of competitive classification, it is the case that the FCC required dialing parity to precede its removal of inter- and intra-LATA toll services from price cap regulation.[22]

These comments and facts suggest that Dr. Blackmon is sympathetic to a showing of Section 271 compliance as a necessary condition for effective competition to exist. That a showing of Section 271 compliance should precede competitive classification simply reflects the FCC's position that ILEC satisfaction of Section 271 conditions constitute *necessary* market opening conditions in order to provide local exchange entrants "a meaningful opportunity to compete." Even if Section 271 conditions are satisfied, effective competition is *not* guaranteed for all ILEC-provided products and services.

Q. Above, you discuss Dr. Blackmon's example of proven provisioning systems for long distance services. Does Staff demonstrate that the standard of proven processes supporting long distance competition now exists for CLECs using Qwest's special access circuits?

A. Staff provides no evidence that this standard is satisfied. Moreover, as the Commission is aware, the Commission has found that Qwest has not yet satisfied Section 271 checklist items. Either the Commission has found the checklist to be unmet (e.g., Checklist Item 13) and/or the Commission has found, where ROC OSS testing is involved, the item to be satisfied "... subject to Commission review and evaluation of audited results of relevant performance measures and Qwest performance following the ROC OSS regional testing

[22] The FCC, to preclude price cap LECs from exploiting individual market power, required full implementation of inter-and intraLATA toll dialing parity, prior to removing these toll services from price cap regulation. FCC 99-206, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Interexchange Carrier Purchases of Switched Local Access offered by Competitive Local Exchange Carriers, Petition of US West Communications, Inc for Forbearance From Regulation as a Dominant Carrier in the Phoenix, Arizona MSA, Released August 27, 1999, paragraph 45

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process."[23]

Q. What evidence does Staff rely on to demonstrate that Staff's "readily available" or "financially viable" standard for special access entry can be met in the absence of Qwest's proven compliance with Section 271?

A. Staff does not rely explicitly on any evidence. The only potential basis I find in Staff Testimony is provided in Dr. Blackmon's discussion of the penalty structure of performance standards. Although it is not clear to what extent the performance penalties he discusses for unbundled loops even exist for special access provisioning, the basic weakness of any penalty structure is the same: it can be quite economically rational for an ILEC to discriminate against one or more CLECs in service provisioning at times. These times occur whenever the value of exercising discrimination to the ILEC exceeds the penalty.

Although the dollar penalty imposed can run to millions of dollars, this amount can be a small price to pay for raising the costs and harming the reputation of the CLECs most directly affected, while also establishing a marketplace reputation as a noncooperative incumbent with other CLECs, thereby discouraging potential entry. Until the Section 271 processes are both "locked down" and "irreversible" (and perhaps even after these conditions are satisfied), Qwest can rationally pursue noncompliance and incur penalty. The actual cost of rational noncompliance depends fundamentally on whether the OSS design and service provisioning process is easy to manipulate[24] and upon factors such as ease of detection, which again, depend on the specifics of the compliance, audit, and error-detection process (both statistical and operational). Simply put, penalties are no substitute for irreversible processes designed for neutrality in service provisioning.

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[23] See generally Revised Initial Order, Docket Nos. UT-003022 and UT-003040, issued August 31, 2000, and in particular Finding of Fact No. 131

[24] Ideally, Qwest should develop and engineer a system in which the ability to discriminate is absent. Under a truly blind system design, variation in treatment is truly random. See Affidavit of Sarah J. Goodfriend, In the Matter of Application of SBC Communications Inc., et al., for Provision of In-Region InterLATA Service in Texas, April 1, 1998

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I. b. IN STRUCTURING HIS ALTERNATIVE RECOMMENDATION, DR. BLACKMON ADMITS THAT A DEMONSTRATION OF COMPARABLE SERVICE IN RELEVANT MARKETS VIA SECTION 271 COMPLIANCE OUGHT TO PRECEDE A GRANT OF FLEXIBILITY

Q. What is your basis for saying that the structure of Dr. Blackmon's alternative proposal admits the need to show comparable service prior to a grant of competitive classification?

A. In crafting his solution, Dr. Blackmon recognizes that an FCC finding of Section 271 compliance addresses his concern that "service using unbundled loops … is a promising but still unproven source of competition for Qwest's retail service."[25]

Q. Does the structure of Dr. Blackmon' s alternative proposal appear to conflict with some of his preceding discussion of parity?

A. His discussion suggests a tolerance level for lack of parity, but his alternative recommendation admits none. For Dr. Blackmon, the lack of parity he finds means that Qwest cannot satisfy his "readily available" standard for UNE loops and UNE-P because CLECs are not getting comparable service. [26]

Q. Of what competitive significance is this lack of parity for Dr. Blackmon?

A. Dr. Blackmon recognizes that lack of parity forces CLECs to offer inferior services and creates "hurdles that any competitor would have to overcome in winning a potential customer." Yet, he seems also to say that differences in average installation intervals do not necessarily imply that customers are captive. I find his reasoning here inconsistent.

Q. Why do you find Dr. Blackmon's competitive analysis of parity inconsistent?

A. Dr. Blackmon appears to justify or establish some sort of tolerance level for lack of parity by observing that the service of a competitor need not be a perfect substitute for Qwest service. This reasoning is misplaced, since the ability of an incumbent to discriminate against a competitor, thereby raising the competitor's cost is a well-recognized

[25] Blackmon Direct Testimony, page 23

[26] See Blackmon Direct Testimony, discussion at pages 14 and 15.

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anticompetitive strategy (referred to as raising rivals' cost). Such discrimination does indeed impose a form of product differentiation, by making the competitor's product artificially inferior to the incumbent's product.

Q. What harm does Dr. Blackmon fail to recognize in his analysis of parity issues?

A. He fails to grasp that lack of parity for an entrant is not a matter of (imposed) product differentiation or simply a hurdle to overcome. Rather, lack of parity is a means by which Qwest raises an entrant's costs, reducing the entrant's ability to compete. Thus, customers cannot avoid Qwest's attempt to increase the retail price of services provisioned with DS-1 special circuits by switching to a competitor relying on Qwest special access circuits.

When the requested flexibility covers much of the economic activity in the State, as is the case here, the showing of statewide compliance required by Section 271 does not differ materially from a showing of compliance in the geographic areas of this Petition (where CLEC have concentrated their entry).

I. 2. ASSUMED PRICE CONTROLS DO NOT ASSURE PRICING INDEPENDENCE

Q. What role do price controls play in establishing pricing independence for Dr. Blackmon?

A. For Dr. Blackmon, either regulation or market forces preclude Qwest from raising prices. Dr. Blackmon suggests that for price listed services, the Commission's prior grant of competitive classification, and for tariffed services, WUTC continuing rate regulation can be relied on to preclude Qwest from raising prices for special access anticompetitively to create a situation where the potential competitors' costs of special access in a relevant market exceeds Qwest's costs. Dr. Blackmon's reliance on these forces is misplaced for two reasons, (independent of reason one considered above).

I find Dr. Blackmon's reliance misplaced because Qwest is not required to actively raise its own price in order to increase its competitors' costs of access above its own.

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Where Qwest gains efficiencies, thereby reducing its internal costs, neither the Commission's prior grant of competitive classification nor regulation force Qwest to pass on the cost reduction it experiences in the form of price list or tariff reductions. (This fact is true even if the Commission required imputation of prices or costs, which I understand it does not.) While it is perhaps obvious that regulated tariff prices provide no guarantee that Qwest must price its special access services independently from its retail services, the same is true of special access services classified as competitive and sold via price lists.

Q. Why does competitive classification not guarantee pricing independence?

A. In order to guarantee independence, Qwest must behave as a perfect "price-taker" in the business product markets where it competes with the entrants who rely on Qwest special access facilities to compete. Perfect price-taking behavior is observed when Qwest acts as if it can exert no control over the price it can charge in the product market or when Qwest chooses to exert no control because profits cannot be increased thereby. Facts including product differentiation and Qwest's existing ability to price in relation to the extent of competition using banded rates, special contracts, etc., attest to the fact that Qwest has some control over price in products incorporating Qwest DS-1 circuits.

For the Commission to have found Qwest to be a perfect price-taker in special access markets when granting competitive classification in UT-990022, at least two findings would have been necessary. First, the Commission would have had to define "a significant captive customer base" as any number of customers more than zero, and second, the Commission would have had to find that *no* practice of price discrimination by Qwest was possible or profitable. I discuss these extreme findings to illustrate how unrealistic the perfect price-taker assumption is for Qwest pricing of DS-1 special access circuits.

I. 3. STAFF CANNOT DEMONSTRATE PRICING INDEPENDENCE FOR DS-1 CIRCUITS

Q. Can a facility or product function like a "commodity" product for one set of buyers and a "differentiated" product for another?

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A. Yes, and this is important to understand when looking at DS-1 facilities, for example. Entrants use DS-1 circuits in their capacity as wholesalers, providing finished products and services to business customers. Thus, because the DS-1 circuit provides a transport functionality, these wholesalers recognize substitution possibilities between the essentially identical transport functions offered by DS-1 and higher capacity circuits. Thus, the WUTC has recognized that, at prevailing (price list) prices, DS-1 circuits become poor substitutes for DS-3 circuits at relatively low levels of DS-3 capacity use. (For a CLEC, the monthly cost of a DS-3 circuit is less than the monthly cost of 9 DS-1 circuits when 9/24ths of the DS-1 equivalent channels are actually used.) Recognizing these "commodity-like" substitution possibilities, the Commission found prevailing price ratios to provide a clear incentive for CLECs to substitute a DS-3 circuit for DS-1 circuits whenever these use conditions are satisfied. [27]

The perspective of customers using finished products which rely on DS-1 facilities differs from the perspective of CLEC's using Qwest DS-1 circuits as "inputs" to their finished products. Qwest markets a distinct set of products based on retail business customer use of DS-1 circuits; these correspond to particular service needs of the end-use customers. Thus, Qwest employs dedicated DS-1 services in a variety of customer-desired applications. Qwest literature identifies seven distinct applications: Internet Access, LAN connectivity, Integrated Data, Voice and Video, Voice-to-Voice, Bulk data and file transfer, Centralized networking for data processing, and Video conferencing.

In a business voice-to-voice application, DS-1 circuits can efficiently transport inbound calls connecting to a Digital PBX phone system, enhance management of Call Centers and provide dedicated IXC connectivity. Using the Digital Facility Interface, DS-1 circuits can be terminated on a switch in a single connection. Use of a high capacity digital termination to a business central office allows a business to provide Centron features to multiple locations over a metropolitan area. The simplest (and lowest volume) application depicted is the use of one DS-1 circuit (with interoffice mileage) to

[27] Revised Initial Order, page 61

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connect two US WEST Serving Wire Centers. Each US WEST Serving Wire Center has one of the business customer's PBX trunks located behind it.

DS-1 circuits also provide customers a way to efficiently integrate voice, video and data needs by "aggregating multiple voice and data services between multiple locations." The supporting DS-1 architecture depicts four DS-1 circuits used in this application. On the line side of the US WEST Serving Wire Center, the business has two geographically distinct locations. At each location, "behind" the CSU/DSU Multiplexer, the business has aggregated its PBX, data and video traffic. A DS-1 circuit runs from each Multiplexer to the same Serving Wire Center. On the trunk side of the Serving Wire Center, one DS-1 circuit connects to the internet, another DS-1 circuit sends voice traffic to an IXC. The two line-side and two trunk-side DS-1 circuits are interconnected in the Serving Wire Center. Interconnection is accomplished using a Digital Cross Connect System (DCS) equipped with the Command A link option.

Q. Does Qwest also provide a switched DS-1 product?

A. Yes. This product is Integrated T-1 Service. According to its tariff description, Integrated T-1 (IT1) Service provides a 1.544 mbps private line facility from the customer's premise to the USW serving wire center. IT1 includes a DS1 facility, common equipment, local exchange switching and 24 flat rated channels for access to the local exchange and toll networks.

IT1 service is a very flexible service; the customer can select various ways to configure the 24 channels, thereby providing the best mix of services. The 24 channels may be configured to provide one or more of the following services: (1) Basic Voice as two-way, in-bound or out-bound only; (2) Advanced Voice as In-Only with DID, Out-Only with Channel Supervision or Two-Way Channel with DID and Answer Supervision. (When a call has been either completed or answered, this feature passes answer back signaling from the central office switch to the customer's CPE); (3) Basic ISDN 2B+D Single Line Service, requiring use of three sequential distinct channels on the IT1, capable of carrying circuit-switched voice and/or data; (4) Basic Dedicated Digital Data

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Channel, providing point-to-point transport of synchronous serial data (at 56 kbps or 64 kbps); and (5) Frame Relay Dedicated Digital Channel, with dynamic allocation of bandwidth (at 56 kbps or 64 kpbs.)

Q. Will CLECs differ in ability to offer good substitutes for DS1-based end-user products?

A. Yes. A CLEC's ability to offer a good substitute depends upon the nature of the product. For example, a CLEC lacking in digital cross-connectivity at the necessary wire center cannot provide the dedicated integration product discussed above. A CLEC possessing the necessary digital cross-connectivity at the necessary wire center must own, have leased, or have access to leased facilities available in required locations.

Similarly, in the simplest of voice-to-voice applications, the CLEC must own, have leased, or have access to leased facilities between the relevant wire centers and be collocated in the relevant wire centers.

With respect to the switched service, IT1, the CLEC must be able to duplicate the individual services and combine them. This requires at a minimum that the CLEC be capable of duplicating the desired range of services or providing acceptable equivalents.

Q. What is the competitive significance of product differentiation in DS-1 dependent products?

A. As long as the costs and inconveniences associated with purchase of DS-1 circuits out of arbitration agreements require some CLECs to rely on price-listed or tariffed DS-1 circuits to provide retail products, a grant of competitive classification increases Qwest's ability to discriminate among customers who rely on Qwest DS-1 facilities to compete. Qwest will use this ability to discriminate among its competitors. With this flexibility, Qwest's pricing, terms and conditions for DS-1 service to wholesale CLECs and to retail business customers will be used to further Qwest objectives in DS-1 based retail products. By affecting potential rivals' costs of relying on Qwest facilities, Qwest can decide to reward or punish potential rivals by affecting rivals' production costs, and thereby seek to influence rivals' entry and pricing behavior to further Qwest objectives.

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I. 4. STAFF PROVIDES NO BASIS FOR APPLYING ITS RECOMMENDATIONS IN DOCKET NO. UT-990022 TO THE FACTS PRESENTED IN THIS PROCEEDING.

Q. Are you aware that the Commission, in Docket No. UT-990022, found DS-1 and higher capacity services to be subject to effective competition in the wire centers (and less than wire center area) included in US WEST's amended petition in that proceeding?

A. Yes. And this observation leads me to my fourth reason why Staff's "readily available and financially viable" standard is violated.

I note that Staff did not support the original petition in Docket No. UT-990022 as filed, but did support the petition with a change in requested wire centers. This indicates that Staff employed some sort of threshold for acceptance that US WEST did not originally meet.

In this proceeding, however, Staff provides no analysis to justify extension of pricing flexibility beyond the permitted areas in Docket No. UT-990022. For illustration, I have provided the Qwest wire center maps for these wire centers in Exhibit ___ SJG-5. To the extent Staff relies on previous Commission findings of competitive classification, Staff has provided in its Direct Testimony no evidence that explains why a finding which the Commission made in regard to the wire centers of the UT-990022 amended petition, namely, Seattle Main, Seattle Duwamish, Seattle Elliot, Seattle Campus and Bellevue Glencourt, applies now (but not in that proceeding to) Vancouver Orchards and Vancouver Oxford.

Staff's calculated value for the HHI statistic appears to be the only basis for Staff's recommendation that, in addition to the previously-rejected Vancouver wire centers, the Commission extend pricing flexibility for DS-1 and higher circuits to Seattle Atwater, Seattle Cherry, Seattle East, Seattle Emerson, Seattle Lakeview, Seattle Sunset, Seattle West, Bellevue Sherwood, Spokane Chestnut, Spokane Fairfax, Spokane Hudson, Spokane Keystone, Spokane Moran, Spokane Riverside, Spokane Walnut, and Spokane Whitworth. For illustration, I provide the Qwest wire center maps for these wire centers

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in Exhibit ___ SJG-6. The Staff-measured HHI, however, does not provide support for classifying DS-1 and higher capacity circuits as subject to effective competition in Staff's newly-recommended wire centers. I examine Staff's HHI calculations below.

I. D. MARKET CONCENTRATION RESULTS ARE NOT A RELIABLE BASIS FOR INFERENCE

I. 1. STAFF DOES NOT KNOW THE MARKET SHARE DISTRIBUTION IN ITS RELEVANT MARKETS

Q. Please describe staff's errors in market concentration analysis.

A. Great care must be taken when making inferences from data that does not correspond to the relevant product markets that Staff seeks to measure, in this case DS-1 and higher capacity circuits. Ms. Bhattacharya acknowledges that it would have been preferable to evaluate market shares separately for different services and to calculate market share by service by wire center using revenue information rather than capacity.[28] The fact that financial analysts evaluate average revenue per line as an indicator of a CLEC's ability to sell multiple and/or bundled services is a further acknowledgment that revenue and capacity measures provide differing information when products are differentiated.[29]

The FCC shares Ms. Bhattacharya's concerns. In contrast to the WUTC's acceptance of capacity measures for DS-1 and higher capacity circuits on UT-990022, the FCC found, in its analysis, that capacity measures provide an erroneous picture of CLEC competitive significance in the markets it examined. The FCC found that using a DS-1 equivalent (capacity) measure placed too much emphasis and weight on entrance facilities, which are usually DS-3 circuits. The FCC found that measuring competitors' presence on the basis of revenues gives a better picture of the extent to which competitors had made inroads into the market. Further, the FCC explained, "If we adopted a trigger

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[28] See Bhattacharya Direct Testimony, page 6.

[29] See Exhibit SJG-4, page 2. Mr. Spiridellis discusses the fact that access lines, collocation and revenue per line are useful measures of CLEC progress in market entry.

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based on percentage of demand measured in terms of DS-1 equivalents, then an ILEC might receive Phase I pricing flexibility for all dedicated transport services and all special access services other than channel terminations,[30] even though competitive alternatives may exist only for entrance facilities." [31]

The FCC recognized that when circuits are used by CLECs to support different products and services, capacity measures distort competitive reality and erroneously result in "product markets" that are overly-broad. Staff offers no justification for making inferences about competitive conditions in the products that DS-1 circuits support by measuring shares of business access lines. Thus, without knowing where competitive entry is concentrated, Staff simply does not know the distribution of market shares in relevant products, including the DS-1 and higher facilities in which it recommends flexibility.

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2. STAFF'S ANALOGY TO TOLL SERVICES RESULTS IS MISPLACED

Q. How does Staff bolster its conclusions using previous findings regarding toll service?

A. Perhaps to address the infirmities of its market concentration calculations, Staff uses its previous findings concerning local toll service competition to provide the critical step from the results of Staff HHI calculations to Staff inferences about the state of competition for DS-1 and higher capacity circuits among the exchanges. Staff explains that, in recommending that exchanges with Staff-measured HHI above 5000 be excluded

[30] The FCC set a more stringent threshold for showings in order to permit pricing flexibility for channel termination. The FCC found that channel terminations, unlike other special access and dedicated transport, did not involve carrying traffic from one point of traffic concentration to another. Rather, entering the market for channel termination services required more investment per unit of traffic and served only a single end user. Secondly, the FCC found that the competitor collocating in a LEC end office continued to rely on the LEC facilities for channel termination between the end office and the customer premise, at least initially, and so must rely on the LEC for unbundled loops. Thus, the FCC reasoned the entrant, lacking in sunk investments, is more susceptible to exclusionary pricing by the LEC because it lacks extensive sunk investments. See FCC 99-206, *Access Order*, paragraphs 100-104.

[31] See FCC 99-206, *Access Order*, paragraph 87.

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from competitive classification, Staff departs from its recommendation in the local toll services case. In the local toll services case, Staff recommended competitive classification be granted for HHI values "substantially above" 5000. Asserting that the local toll service HHIs have some meaning here, Staff explains that because of concern for deficiencies in market structure, Staff is only recommending competitive classification when its calculated HHI falls below 5000.

Q. What is wrong with this approach?

A. Analogy to toll services (and HHI values calculated there) is unsupportable for at least three basic reasons. The first reason is the logical error of reasoning to a numerical threshold that is, in this case, arbitrary. As I discussed in my direct testimony, relevant market definition controls subsequent analysis. Staff identifies DS-1 and higher circuits as a relevant product, but Staff measures market share using all business access lines. Thus, the 5000 threshold of the toll services case (and US WEST's and GTE's unilateral market share) has no identifiable numerical equivalent in this case. Assuming that Staff supported its use of such an HHI threshold, Staff doesn't know if it is using a higher or lower threshold than it used in the toll services case because Staff isn't measuring the relevant market it seeks to evaluate. Yet, no discussion, investigation, or allowance for the bias or error introduced by using all business access lines to measure DS-1 and higher circuits is provided by Staff.

Second, Dr. Blackmon should not simply trade off his concerns about customers' ability to find good substitutes or suppliers' ease of entry by "adjusting" his selected HHI thresholds. For sake of argument, assume the 5000 threshold here has meaning (in some undefined way) in terms of the HHI measure of 5000 in toll services. On this premise, Dr. Blackmon reasons that he can address his uncertainty by employing a more stringent requirement in this case for measuring concentration. Thus, he recommends for competitive classification only those exchanges with *less* measurable concentration than in the toll services case. This approach has no economic justification.

Thus, in the case of HHI and other measures of the distribution of market shares,

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implications which can be drawn from (appropriately) measured concentration statistics are implications or inferences about ease of coordinated pricing. Implications and inferences must be informed by simultaneous consideration of entry conditions.[32] Thus, for a properly-measured HHI, there is no basis for the assertion (in direct conflict with the Merger Guidelines) that the likelihood of the ability to exercise market power increases in a continuous and monotonically increasing manner with (properly measured) concentration. Dr. Blackmon's uncertainty about market structure -- i.e. whether it is easy for firms to enter and exit and for customers to switch -- cannot be "adjusted out" of his analysis through changes in HHI thresholds. Rather, these fundamental considerations are addressed formally, both prior to, and subsequent to measuring concentration.

If it is *not* easy for firms to enter or exit the relevant market (properly defined) or if it is *not* easy for customers to switch among products or companies, as Dr. Blackmon suspects, then he must acknowledge these fundamental conditions of demand and supply substitutability in an economically meaningful way -- to analyze the likelihood of effective competition. This is why the Merger Guidelines follow the sequential process that I explain in my Direct Testimony, so that its analysis results in an economically meaningful evaluation of the likelihood of effective competition.

I. 3. SENSITIVITY OF RESULTS TO MEASUREMENT ERRORS ARE UNKNOWN

Q. Does the Staff approach introduce errors that affect their conclusions?

A. Staff calculations result in a rank ordering of exchanges by Qwest percentage market share and by HHI statistic. This rank ordering separates the recommended from the not recommended wire centers. Because Staff is not measuring market share for its relevant product market, its ordering of exchanges by Qwest's unilateral market share or HHI concentration is unsupportable. As I demonstrate below, the rank ordering of exchanges

[32] Goodfriend Direct Testimony

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by market share could change, and any particular exchange could move above or below Dr. Blackmon's 5000 "threshold" if, for example, revenues by service or other informative measures of market concentration had been available.

Measurement errors can compound analytical errors. For example, Staff analysis may include resold lines in CLEC market shares. Use of resold lines varies significantly by wire center. [33] Dr. Blackmon admits that resale provides no competitive constraint. Thus, proper exclusion of resold lines will change concentration measures in uninvestigated ways.

The HHI measure may also include business lines controlled by CLECs which are Qwest affiliates as independent lines, in violation of the economic logic and instruction of the Merger Guidelines.[34] And finally, because the HHI measure bears so little relationship to what Staff is attempting to measure, pro-competitive changes can raise the calculated HHI. For example, consider the results for Bellevue and Issaquah. The measured HHI for Bellevue is 4561 and for Issaquah 5161. A merger of two smaller CLECs in the Bellevue exchange for the purpose of offering a stronger competitor could have the effect of raising the Bellevue HHI above 5000, thus excluding Bellevue from the recommendation. Said differently, the inclusion of Bellevue and the exclusion of Issaquah is arbitrary. Moreover, Qwest's unilateral market share in the two exchanges is essentially the same. Further consolidation among CLECs is anticipated, both because some are financially weak and because operational economies can be gained thereby.[35] A recommendation for competitive classification should not be sensitive "in the wrong direction" from CLEC strengthening. This aspect of Staff's approach indicates again that analogy to the 5000 threshold in a different market is misplaced.

Note also that for all nine exchanges, Qwest's share of total business lines far exceeds the 35% threshold for further investigation by the Merger Guidelines, discussed

[33] Direct Testimony of Theresa A Jensen, Exhibit TAJ-2C

[34] For example, Qwest has made a financial investment in Advanced Radio Telecom, one of the competitors listed by Qwest and contacted by Staff. See, Bhattacharya Direct Testimony, page 3.

[35] See Exhibit SJG-4 discussion, pages 3 and 7.

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in my direct testimony. I suspect that were the effect of DS-3 circuits removed from the data, the Qwest share in Staff's HHIs would be significantly higher than what we observe in Exhibit GB-3.[36]

In summary, Staff has not performed the analysis needed to draw supportable inferences from its concentration calculations.

I.III. BY STAFF'S ANALYSIS, GRANTING ANY PART OF QWEST'S PETITION, AT THIS TIME CONFERS, AT BEST, A NEGLIGIBLE BENEFIT TO THE COMPETITIVE PROCESS

Q. Does Qwest base its requests for flexibility on benefit to the competitive process now emerging?

A. No. Rather Qwest suggests that its loss of certain customers or the pace at which it is losing certain customers violates some principle of competitive fairness. Qwest asserts that it may need to increase rates to captive customers in the future to compensate for revenue losses.

Q. Does Dr. Blackmon appear to accept Qwest's equity reasons for grant of the Petition?

A. No. He dismisses Qwest's reasons. His investigation is based in Qwest's legal right to petition and to carry its burden to demonstrate effective competition.

Q. What is Dr. Blackmon's view of Qwest's existing ability to respond to competitive threats?

A. Dr. Blackmon provides a comprehensive response to Qwest's reasons for seeking additional flexibility for pricing and discrimination, rejecting each and every rationale the Company offers.

He discusses six mechanisms now available to Qwest. Specifically, he finds that Qwest can target promotions to particular types of customers and geographic areas; Qwest can make changes within banded rates that are "quick and easy," and for new

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[36] See generally Exhibit SJG-4.

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services, Qwest may set the price ceiling as it sees fit. Moreover, Dr. Blackmon finds that Qwest has the ability to limit any price decreases to specific areas, as it did in its withdrawn petition for the Spokane exchange in 1997.

Finally, he rejects Qwest's argument that its inability to offer long-distance justifies its request. Instead he considers Qwest's position ironic, recognizing that in satisfying the Section 271 requirements needed to obtain in-region long-distance authority, Qwest would "open[ing] its local network to competition [which] would also make it *much easier* [italics added] for the WUTC to grant competitive classification of Qwest's business local exchange service.

Q. Does it matter to Dr. Blackmon whether Qwest has availed itself of existing WUTC authorities granted to respond to competition?

A. No. Although he finds that Qwest has not relied on the pricing tools available to it, he recognizes that the statute does not require use of these tools prior to a grant of competitive classification. Although I agree with Dr. Blackmon that the WUTC should decide the Petition on a showing of effective competition, I believe that Qwest's lack of use of alternatives available to it to respond to competition does provide useful information to the Commission. I revisit some of Dr. Blackmon's observations when I address the effects on the emerging competitive process of a premature grant of flexibility in Section IV.

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I.IV. GRANTING ANY ASPECT OF THE PETITION AT THIS TIME CONFERS A SIGNIFICANTLY ENHANCED ABILITY FOR QWEST TO DISCOURAGE FACILITIES-BASED ENTRY

Q. How will the premature grant of flexibility recommended by Staff in this proceeding harm the competitive process?

A. My Direct Testimony identified the harm associated with profitable exercise of market power over captive customers. In this section, I discuss the invitation a premature grant of flexibility provides for (1) selective, anticompetitive discrimination and for (2) deterrence of facilities-based entry. These anticompetitive strategies entrench market power.

Q. Please summarize your position regarding Staff's failure to require Section 271 compliance prior to a grant of competitive classification.

A. Dr. Blackmon fails to demonstrate that parity now exists in Qwest provisioning of services in the wire centers he recommends for flexibility. Second, and more importantly, Staff fails to demonstrate that any parity which now exists is "irreversible." Said differently, he fails to consider the implications of his recommendation on the independence of pricing and availability he finds so necessary for competition via use of Qwest facilities to function as the source of price-constraining competition. In recommending flexibility prior to the "lock down," WUTC approval, and "irreversibility" of Qwest OSS processes, Dr. Blackmon invites Qwest to anticompetitively discriminate in service provisioning.

I. A. PREMATURE FLEXIBILITY INVITES QWEST TO MANIPULATE STAFF'S "FINANCIALLY VIABLE" AND "READILY AVAILABLE" FACILITIES STANDARDS

Q. Please explain why Dr. Blackmon invites anticompetitive service provisioning by his recommendations in this proceeding.

A. By permitting the pricing flexibility Qwest seeks prior to establishing the "irreversibility" conditions for competition required by Section 271 approval, he creates incentives for

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Qwest to design and manage its provisioning systems, not for impartiality, but to hide finely-tuned discrimination of the sort that is already difficult to detect.

Competitive classification provides Qwest an enhanced ability to raise (or lower) the price and change the terms and conditions Qwest offers to fit the circumstances of competition facing *each* distinct customer. Each customer may have a distinct next-best alternative supplier, and/or a distinct next-best alternative supply arrangement, (e.g., one customer will be served by a CLEC leasing a DS-1, the other customer will be served by CLEC facility-construction). Qwest can now fine-tune its discrimination in provisioning for competitive advantage but with less risk of detection. It has an incentive to design and/or manage its OSS systems to accomplish this result.

Q. Why does a premature competitive classification create incentives for Qwest to manage its provisioning to accomplish difficult-to-detect discrimination?

A. Quite simply, a grant of flexibility changes the payoff to Qwest from discrimination. The fact that Staff views lack of parity as simply a "hurdle" for entrants to overcome signals to Qwest that Staff may find differences in average installation intervals "tolerable." I agree with Dr. Blackmon's position that there may be no end to the performance metrics one could consider in gauging comparability of service. Thus, Qwest is now encouraged to identify and pursue those careful and surgical exercises of discrimination against CLECs that will show up ambiguously in the data as "white noise" or as other Staff-tolerated instances of variation in service quality.

Q. Dr. Blackmon believes that Qwest is encouraged to improve its performance in the provisioning of unbundled loops in the near future. Do you agree?

A. No, not where it counts, given the framework Staff is now offering to Qwest. I agree that Qwest is encouraged to improve its performance metrics generally in the way these metrics will be used by Staff and other intervenors to assess parity. Upon receiving the requested grant of flexibility at this time, as I explain above, Qwest has a new calculation to make: for example, when is intentionally slow service to selected CLECs economically rational?

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That is, given new flexibility to surgically target customers via unique offerings, when will discrimination in provisioning a competitor be worth the risk of discovery and thus required compensation to the CLEC and the state treasury? Said differently, $20 million dollars can be a small price to pay if Qwest not only demonstrates its ability to discriminate, thereby winning the immediate competition, but also establishes a reputation among entrants that it will "slowball' entrants with respect to particular Washington customers.

I. B. PREMATURE FLEXIBILITY PROVIDES QWEST NEW OPPORTUNITIES TO DISCOURAGE FACILITIES-BASED ENTRY

Q. What other anticompetitive opportunities are introduced by a premature grant of flexibility?

A. Enhanced flexibility to price and discriminate provides Qwest a means to preclude CLECs from obtaining the minimum efficient scale necessary for entry, and thus can raise entry barriers for CLECs. To enter a particular wire center or area, the CLEC may need to capture one or more large customers to build the level of demand needed to justify a facilities investment. Selective pricing allows Qwest to preclude the CLEC from reaching the necessary scale for entry. A generalization of this problem occurs when flexibility is granted on a wire-center-by-wire-center or piecemeal basis because the minimum efficient scale for some activities requires the aggregation of wire center demands. A mass marketing campaign is an obvious example of this requirement. When pricing flexibility has been granted in this piecemeal fashion, CLECs will find the expected profitability of entry on an exchange or multiple exchange basis lowered. In certain instances, the expected profits may be inadequate to justify the up-front sunk costs of entry.

The ability to lock up large customers needed for minimum efficient scale (volume) of (facilities-based) entry and/or the ability to lock up customers within the geographic area required for efficient entry, the FCC has recognized, forecloses competitive opportunities for the smaller and/or adjacent customers, too. The FCC also

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recognizes that either the ability to raise prices on rate-regulated products or the ability to raise prices through the exercise of market power provides the ILEC an ability to temporarily lower prices below cost to discourage entry, while simultaneously recouping the losses this strategy might otherwise entail. [37]

Q. Why Does Dr. Blackmon believe Qwest prefers to seek a grant of competitive classification in this proceeding rather than pursue competitive response by other means?

A. In observing that Qwest has not established an affiliated competitive LEC, Dr. Blackmon reasons that the downside for Qwest of this option is that the affiliated CLEC would have to "stand in line with other CLECs for interconnection, provisioning, and repairs." In other words, he suggests that Qwest would find the practice of selective discrimination more difficult with an affiliated CLEC than with premature competitive classification in this proceeding.

Second, he indicates that Qwest has claimed that prices reflect competition in past proceedings and that the Commission has rejected the idea that such prices reflect competitive conditions. [38] Third, he concludes that Qwest prefers not to use the many tools at its disposal "probably because they involve lowering prices for consumers."[39]

Dr. Blackmon's observations serve to underscore the fact that Qwest intends to use its incumbent powers and market dominance to exercise market power, discriminate and deter entry, thereby increasing profits while simultaneously pursuing WUTC and FCC requirements for re-entry into in-region interLATA long distance.

Q. Do you have any comments on Staff's alternative recommendation for small business customers?

A. Yes, basically the three requirements that Dr. Blackmon crafts as a "backstop" tariff

[37] FCC 99-206, paragraph 79. (By providing a new ability to raise prices to captive customers while lowering prices to selected customers below cost, a premature grant of flexibility permits increased profits and predatory pricing to occur simultaneously.)

[38] See Blackmon DirectTestimony, discussion of the 1997 proposed rate reduction for the Spokane exchange, page 7.

[39] Blackmon Direct Testimony, page 4.

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and/or set of protections very quickly and easily will become an irrelevant "backwater" tariff instead. Qwest may use its existing authorities legally and easily to circumvent the protections intended by his three requirements.

Of course, a strict application of condition number one, by freezing services at current levels, would likely violate his goal that small business customers be "no worse off" than prior to the imposition of his first condition. Qwest has the legal authority to, and naturally does, evolve its service offerings with improvements in switch technology, software and facilities investment, in keeping with Qwest's overall business strategy and product development goals for its small business customer segments. Thus, a strict application of requirement one would leave customers worse off.

On the other hand, permitting positive changes allows Qwest to circumvent the protections Staff is attempting to put in place. For example, through promotion campaigns, introduction of new tariffs, revisions in tariff prices and product definitions, Qwest can evolve its services into tariffs that even monopoly customers prefer. The exercise of market power is not most readily achieved by providing customers less preferred products; it is achieved by providing customers desired products and restricting competition, thereby charging customers prices in excess of Qwests' production costs, including an adequate measure of profit.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

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