I. INTRODUCTION

On June 7, 2000, Qwest[1] filed with the Commission a petition for an order classifying its basic business exchange services as competitive pursuant to RCW 80.36.330 and WAC 480-120-023. The business services at issue are set forth in Attachment "A" to the company's petition. (Ex.12-C). They include services that provide access to the network (business lines, Centrex services, and Private Branch Exchange) and discretionary business features (software enhancements available as access line or trunk options). (Ex.12-C at 4). The company seeks competitive classification for those business services offered in 31 wire centers in the state.[2]

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[1]The petition identifies U S West Communications, Inc. as the petitioner because the company filed its petition prior to approval of its merger with Qwest Corporation.

[2]The wire centers at issue are set forth, by exchange, in Attachment "A" to this brief. *See* Exhibit 66 for the wire center boundary maps.

By contrast, Commission Staff urges the Commission to adopt its recommendation that competitive classification be granted to Qwest in the wire centers of only four of the nine exchanges where such classification is requested: Bellevue, Seattle, Spokane, and Vancouver.[3] Staff further recommends that the requested pricing flexibility be limited to those customers served on a DS-1 or larger circuit in each of the four exchanges. In the alternative, Staff recommends that, if the Commission decides to classify as competitive all of the business services set forth in attachment "A" to the petition, in each of the four exchanges, the Commission should then impose conditions to protect small business customers as outlined in Staff's testimony (which includes a price cap to which Qwest has agreed). The alternative approach better reflects the specific characteristics of the small and large business markets (Tr. 699, ll. 17-20, Blackmon) while addressing the variations in degree of competition within this broader product market definition. Qwest, on rebuttal, has agreed to Staff's proposed conditions. Staff recommends denial of the petition as to the remaining exchanges and wire centers. (Ex. 201T-C at 10, Blackmon).

Public Counsel and Telecommunications Ratepayers Association for Cost-Based and Equitable Rates ("TRACER") jointly recommend that the Commission deny the petition in its entirety. Public Counsel and TRACER assert that Qwest has neither identified relevant markets nor provided the data and analysis necessary to evaluate the state of competition in the products and geographic areas included in its petition. They argue that the data Qwest provided in support of its petition does not reflect forward-looking marketplace conditions because Qwest does not

[3]An exchange represents a grouping of wire centers. These four exchanges encompass 23 of the 31 wire centers for which competitive classification is sought.

address the competitive implications of either: (1) its current contracting and pricing flexibilities, or (2) the implementation of deaveraged unbundled network element ("UNE") rates. (Ex.166T-C at 6, Goodfriend).

Intervenors MetroNet Services Corporation ("MetroNet") and Advanced TelCom Group ("ATG") also recommend that the Commission deny Qwest's petition and require that Qwest file, with any future petition, supporting data that is specific to those areas in which Qwest currently faces facilities-based competition for the services in question. (Ex. 241T-C at 38, Wood). If the Commission decides to grant a portion of Qwest's petition, then MetroNet's and ATG's recommendation is that restrictions be imposed as follows: (1) competitive classification should be granted only for those wire centers within which Qwest faces significant facilities-based competition; (2) all competitive offerings made to a business customer served by a wire center must be made to all customers served by that wire center; (3) Qwest's ability to deaverage its prices must be limited to the ability of a competitor using UNEs to deaverage; and (4) requirements should be applied to ensure that resale remains available as a source of competitive alternatives for consumers and as an entry vehicle for competitors. (Ex. 241T-C at 38-40, Wood).

XO Communications (formerly "Nextlink") also offered testimony recommending that the Commission deny Qwest's petition and asserting that effective competition does not and cannot exist because Qwest is not providing adequate access and interconnection to its network. (Ex. 281T at 10, Anderson). Lastly, Eschelon recommends that the petition be denied unless and until

Qwest's current business customer contracts have expired or Qwest changes its contracts to make it financially feasible for customers to move to alternative providers. (Ex. 261T at 3, Davis).[4]

It is against this backdrop of divergent opinion that the Commission must evaluate Qwest's petition. The Staff case presents the most moderate and balanced approach to pricing flexibility, and it is the only one that successfully addresses the entire range of competitive conditions within the business exchange service segment. Staff's recommendation would further the state's telecommunications policy goal of advancing the efficiency and availability of telecommunications services while protecting those small business ratepayers that remain captive to Qwest's services. It should, for these reasons, be adopted by the Commission.

II. LEGAL FRAMEWORK

A. Statutory Requirements

[4]The Public Service Commission of Utah recently granted pricing flexibility to Qwest Corporation for specified retail business services in the areas served by ten central offices, pursuant to a Stipulation among the parties to that case. The Commission approved the Stipulation which provides that pricing flexibility for the same services may be extended to six additional central offices upon satisfaction of certain conditions.

Although the statutory standards for competitive classification of services in Utah differ from those in Washington, it is noteworthy that those parties joining the Utah Stipulation included Qwest Corporation, the Division of Public Utilities, Nextlink Utah, Inc., Electric Lightwave, Inc., McLeodUSA Telecommunications Services, Inc., and AT&T Communications of the Mountain States, Inc. *In the Matter of the Petition of U S West Communications, Inc. for Pricing Flexibility,* Docket No. 99-049-17 (Sept. 2000).

RCW 80.36.330 authorizes the Commission to classify a telecommunications service provided by a telecommunications company as competitive if it finds that the service is "subject to effective competition."[5] The statute defines "effective competition" to mean "that customers of the service have reasonably available alternatives and that the service is not provided to a significant captive customer base." RCW 80.36.330(1) enumerates four factors that the Commission "shall consider" in determining whether it will exercise its discretion to classify a telecommunications service as competitive:

> (a) The number and size of alternative providers of services;
>
> (b) The extent to which services are available from alternative providers in the relevant market;
>
> (c) The ability of alternative providers to make functionally equivalent or substitute services readily available at competitive rates, terms, and conditions; and
>
> (d) Other indicators of market power, which may include market share, growth in market share, ease of entry, and the affiliation of providers of services.

RCW 80.36.330(1).

"These four factors are not exclusive, and there may be other factors that bear on the Commission's determination in individual cases." *In the Matter of the Petition of U S West Communications, Inc. for Competitive Classification of its High Capacity Circuits in Selected Geographical Locations*, Eighth Supplemental Order Granting Amended Petition for Competitive Classification, at 4, Docket No. UT-990022 (Dec. 1999) ("High Capacity Case").

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[5]The applicable statute and rules are set forth in Attachment B to this brief.

The consequence of competitive classification is that the company is free to offer and price the services at issue subject only to the pressures of competition and the statutory requirement that such services must recover the costs of providing them. RCW 80.36.330(3). With competitive classification, the company is no longer bound by the rates set out in its tariffs but is free to charge customers less or more than the tariff would allow.

Whether, and to what degree, the company is permitted to engage in price discrimination under competitive classification is not as simple. Statutory prohibitions against undue preference and rate discrimination do not apply to *contracts* for services classified as competitive under RCW 80.36.330. *See* RCW 80.36.170 and 180. With respect to competitive services offered *under a price list*, on the other hand, the Commission has the discretion to waive the statutory prohibitions against undue preference and discrimination to whatever extent it finds that competition will serve the same purpose and protect the public interest. RCW 80.36.330(8). As discussed below, the Commission's authority to waive the prohibitions on discrimination and preference only to the extent appropriate provides the authority to impose the conditions that Staff proposes in this case.

"The Commission is given considerable latitude in classifying competitive services. . . ." *WUTC v. U S West Communications, Inc.*, Fourth Supplemental Order Denying Complaint; Accepting Tariffs Conditionally; Requiring Tariff/Price List Refiling, at 6, Docket Nos. UT-911488; 911490; 920252 (Nov. 1993). The declared policy of the state is to "advance the efficiency and availability of telecommunications service" and "[p]ermit flexible regulation of competitive telecommunications companies and services." RCW 80.36.300(2) and (6). The Commission previously established in the High Capacity Case that competitive classification can

be as to a specific geographic area, instead of the whole state. Indeed, the statute refers to "the relevant market" rather than "the state." RCW 80.36.330(1)(b). Docket No. UT-990022 (Dec. 1999); (Tr. 691, Blackmon).

The Commission also has broad authority to determine whether a service is subject to effective competition. In making this determination, it is essential not to focus solely on market share analysis to the exclusion of market structure analysis which suggests that Qwest's pricing is likely to be constrained by competitors, at least with respect to large customers. For, as even Dr. Goodfriend, for TRACER and Public Counsel, acknowledges, the statute does not require a finding that competing firms presently hold a substantial share of the market with respect to each service. (Tr. 613, *see also* Tr. 701; Ex. 168T at 6-8, Goodfriend). Moreover, the Commission in its local toll classification proceeding gave no weight to market share, but focused instead on an analysis of market structure – that is, whether there were any significant barriers to entry that would prevent firms from competing against the incumbent in a relatively short period of time (particularly if the incumbent were to raise its prices, thereby inviting such market entry by a competitor). (Tr. 705, Blackmon).

In fact, market share is listed as merely one of the "other indicators" of effective competition that the Commission may consider under the statute. Significantly, the "other indicators" are fourth in order following consideration of the number and size of alternative providers, the extent to which services are available from alternative providers, and the ability of alternative providers to make substitute services available. Chairwoman Showalter's questioning of Dr. Blackmon highlighted this distinction in Staff's analysis as compared with the Intervenors'. (Tr. 700-707, Blackmon).

At hearing, there was considerable discussion surrounding the correct standard to be applied in determining whether competitors "can" or "will" constrain prices in the market. Dr. Goodfriend is of the view that "will" should be the standard that is applied. (Tr. 612-13, Goodfriend). In an attempt to distinguish the two, she testified that "the company's position . . . is that the capability exists to constrain, a 'can,' as opposed to a behavioral result, ['a will']. (Tr. 611-12, Goodfriend).

It should be noted that the governing statute, RCW 80.36.330, says nothing about a "can" or "will" standard. The statute does not require that degree of rigidity. In fact, the statute enumerates certain factors *for the Commission's consideration*. Notwithstanding the Commission's broad discretion in this area, Staff agrees with Dr. Goodfriend to the extent that she recommends that the Commission should interpret RCW 80.36.330(1)(b) and (c) to mean, in part, that competitors are actually in the market, offering service. *High Capacity Case* at 12, Docket No. UT-990022 (Dec. 1999) ("Staff argues that it is necessary to look beyond market share numbers to the structure of the market itself and whether competitors are actually offering service in the relevant market").

Dr. Blackmon pointed out that economists dispute whether mere potential entry is:

> enough to constrain prices, even if, in fact, no entrant has actually taken that step versus a stricter standard, and one that I prefer, which is that we have to actually see their faces, they have to be in the market offering service, so that it is readily available, and that's the standard that I think I have testified to. When I use the word 'can' I did not mean it in any way as a hypothetical or a conditional ability . . . So to me, 'can' and 'will' are the same.

(Tr. 701-02, Blackmon). In addition, one may safely assume that competitors are rational economic actors. Accordingly, if a competitor can constrain prices, given the opportunity, it will. (Tr. 702, Blackmon).

Dr. Taylor, on behalf of Qwest, asserts that "other parties'" (presumably he is referring to Dr. Goodfriend) market share analysis misses the point by demanding evidence of current market share for product categories that are too narrow. (Ex. 231T at 5, 6). Dr. Taylor argues that this approach ignores the fact that the Merger Guidelines actually take a broader view of the product scope of the market to consider services that are outside of a defined set of products that might be substituted for the products in the defined set in the event of a price increase. *Id.* Dr. Taylor argues that the FCC goes beyond the Merger Guidelines to recognize "substitutability in both demand and supply as instruments for identifying the product scope of the market." *Id.*

The foregoing debate demonstrates that Qwest and the Intervenors, not surprisingly, have divergent views on how much and what kind of evidence should be required for the Commission to grant Qwest its requested pricing flexibility. Dr. Blackmon, like Dr. Goodfriend, urges the Commission to look not only to the *possibility* of price constraining competition from CLECs, but also to the current presence of competitors as demonstrated by evidence of market share that is presently held by Qwest's competitors. But Dr. Goodfriend (and Mr. Wood, on behalf of

CLECs ATG and MetroNet Services), contrary to Dr. Blackmon, would insist on a more minute examination of market share and existing capacity of competitors in more particularized product and geographical segments of the business services markets. Staff's position represents a middle ground that reconciles, to a substantial degree, valid arguments made by both sides.

Staff's disagreement with Dr. Goodfriend is more a matter of degree than of basic philosophy. Admittedly, Staff is willing to accept a more broad-brushed analysis of market share than that advocated by Dr. Goodfriend and Mr. Wood. Dr. Goodfriend advances the Department of Justice's Antitrust Merger Guidelines[6] as the model for the highly detailed analysis that she recommends for petitions filed under RCW 80.36.330. (Ex. 168T at 6-7, Goodfriend). Washington's competitive classification statute, however, has a different emphasis than what likely concerned the policymakers who formulated the Merger Guidelines. One obvious distinction is that this statute provides a ready and flexible means of reversing a competitive classification in subsection (7).[7] The comments of Mr. Wood aside, (Ex. 241T-C at 5, Wood), reversing a competitive classification is not like "unscrambling an egg," a metaphor that is more apt to the problem of reversing approval of a merger.

Several considerations militate against applying the rigid approach that Dr. Goodfriend suggests is required by an antitrust merger analysis. As Dr. Blackmon testified, Qwest already possesses tools that would enable it downward pricing flexibility that it could use to be more competitive with other providers of local exchange service. (Ex. 201T-C at 4, Blackmon).

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[6]The Department of Justice's Antitrust Merger Guidelines are discussed in detail in Section III.B.1.

[7]The Commission possesses considerable latitude in reclassifying competitive services. RCW 80.36.330(7) provides that "[t]he Commission may reclassify any competitive telecommunications service if reclassification would protect the public interest."

Qwest could introduce new services, offer promotions, offer winback incentives, use banded rate tariffs, lower prices in response to competition or offer business service through a competitive affiliate. *Id.* at 5-7. Thus, the new rights that Qwest would obtain are not as significant as the Intervenors' apparent level of anxiety suggests.

Qwest argues that it needs pricing flexibility to be at parity with its competitors who are at liberty to price as they see fit on ten day's notice by filing a price list, subject only to the requirement that prices cover cost. Qwest's competitors respond to Qwest's case with sarcastic ire that if Qwest truly wants parity with its competitors, it would have to be rendered wholly dependent on the goodwill of its chief competitor to provide many of the necessary inputs to its services. (Ex. 241T-C at 9-11, Wood). Much of the advocacy in the CLECs' testimony concerns ongoing problems with the provisioning of UNEs. Staff's position acknowledges these serious problems and carves out the small business customer market segment – the primary beneficiary of the UNE approach to competition – for special and necessary protection. The inequities inherent in the current market structure, many of which must be resolved if Qwest is to obtain approval to offer interLATA toll service, should cause Qwest's plea for parity to ring hollow with this Commission.

The CLECs raise policy concerns that Qwest may use the market power it still possesses in segments of the business market to defend its dominant market share by decreasing prices for competitive services, while making up the difference in revenue by increasing prices for less competitive services or for customer segments that have fewer choices. Mr. Wood claims that a premature grant of pricing flexibility will enable Qwest to erect new barriers to entry in this way. (Ex. 241T-C at 25, 32, Wood). While it is true that the company presently lacks the ability to

increase prices above tariff rates, and that it would be free to raise its prices for business services in the designated areas if its request is granted, the Commission will retain, as noted above, the ability to reverse the competitive classification if it is in the public interest to do so. RCW 80.36.330(7).

Additionally, the Commission is authorized by RCW 80.36.330(8) to partially maintain the prohibition against discrimination by imposing Staff's recommended conditions. These conditions would prevent price increases to small business customers and consequently provide a further disincentive to lower costs to large businesses solely to keep out competitors.

Qwest has the burden to establish that the record evidence, taken as a whole, supports a finding that the services for which Qwest seeks competitive classification are subject to effective competition. WAC 480-120-022(7). Qwest has partially satisfied that burden in this case and has agreed to Staff's proposed conditions. The Commission should adopt Staff's recommendation.

B. Relationship to Requirements of Section 271 of the Telecommunications Act

Section 271 of the Telecommunications Act of 1996 sets forth a 14-point competitive checklist, the satisfaction of which will enable the regional Bell Operating Companies ("RBOCs") to begin offering interLATA long-distance service to their customers. 47 U.S.C. § 271(c)(2)(B). Absent FCC approval, RBOCs are prohibited from offering such services. Here, Dr. Goodfriend argues that Section 271 approval is a necessary predicate to a grant of competitive classification.[8] (Ex.168T at 12, ll. 8-9, Goodfriend).

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[8]It should be noted that the competitive classification statute applies not only to Qwest, Washington's resident RBOC, but to all telecommunications companies in Washington. It follows then, that Section 271 approval cannot be a prerequisite to a grant of competitive

Staff disagrees with Dr. Goodfriend that Section 271 approval is or should be a predicate to competitive classification, but agrees that the relevant market should either be defined to exclude the small business segment (for whom UNE-based competition is particularly important) or that conditions should be imposed to protect small business customers until Qwest has provisioning programs in place that overcome the Section 271 hurdle. Staff and Intervenors have offered considerable evidence that there presently are serious impediments to the use of unbundled network elements ("UNEs") and the unbundled network element platform. In fact, the evidence shows that companies that compete with Qwest using UNEs continue to be beset with provisioning and maintenance problems – that is, the speed with which Qwest provides UNEs to competitors and the speed with which it responds to maintenance problems with UNEs provided to competitors versus the services it provides to its own customers. (Ex. 201T-C at 15-16, Ex.157-C, 158-C, 159-C, Blackmon; Ex. 202). Consequently, the number of UNEs that Qwest's competitors actually use for applications other than DSL Internet access is not large. (Ex. 241T-C at 22, Wood).

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classification under RCW 80.36.330. In any event, the standards for a grant of competitive classification under RCW 80.36.330 are not the same as for approval of a Section 271 application. *See* Tr. 601, Goodfriend.

UNE-based competition is not yet viable largely due to the same kinds of considerations that would be germane to a Section 271 proceeding. (Ex. 201T-C at 16, Blackmon). Staff acknowledges that if Qwest already had Section 271 approval, the company would carry a far lighter burden in this case.[9] Dr. Blackmon points out that the Section 271 process may spur improvement in installation time and maintenance (as may merger conditions), but that has not yet happened. (Tr. 720, Blackmon).

Finally, Staff agrees that a finding by this Commission that Qwest has established an ongoing program for providing nondiscriminatory access to unbundled network elements would eliminate the structural concerns that are of paramount importance to Staff in this case. That is why Staff is proposing that its conditions terminate upon Qwest's obtaining Section 271 approval by the FCC. (Ex. 201T-C at 24, Blackmon).

III. EVALUATION OF QWEST PETITION BY WIRE CENTER

A. Definition of Relevant Market

As all parties agree, defining the market is the critical first step in an analysis of the level of competition that exists for a given service. Because competition in providing a telecommunications service may be intense in certain geographic areas or with respect to certain kinds of customers, but entirely nonexistent in other areas or with respect to certain "captive" customers, it is important not to define the relevant market too broadly. (Ex.166T-C at 14, Goodfriend).

Markets typically are defined with reference to a particular product market and a particular geographic area. The relevant market "may entail product, service, geographic, or

[9]Nonetheless, Qwest has partially satisfied its burden under RCW 80.36.330, the competitive classification statute.

perhaps even temporal aspects of definition." *High Capacity Case* at 5, Docket No. UT-990022 ; (Tr. 691, Blackmon).

1. Relevant Geographic Market

Qwest defined the relevant geographic market by wire center. (Ex. 12-C at 1). Staff analyzed the market at the exchange level rather than the wire center level, primarily because competitors define the market more broadly than by individual wire center. Exchanges are parts of Qwest's network that are made up of one or more wire centers. The Commission already has determined that it is appropriate to look at specific geographic areas under RCW 80.36.330, as noted above.

Once Staff decided to define the market at an exchange level, market structure and market concentration analyses were performed on the aggregated wire centers. The market concentration information showed that five of the nine exchanges exceeded the 5,000 threshold of the Herfindahl Hirschman Index ("HHI") market concentration index. After review of the market structure in these exchanges, it was determined that the five exchanges should not be considered for competitive classification. *See* Section III.B.2. below (HHI).

Dr. Goodfriend acknowledges that wire centers are a "convenient unit of observation" and that they create a focus on CLEC wire center collocation which is likely to be a broad indicator of growing competition for all telecommunications services. (Ex.166T-C at 28, Goodfriend). She argues, however, that wire centers fail to capture business customer demands that cross wire centers, and that they have "no direct relationship with a CLEC's ability to supply alternatives for Qwest products listed in Attachment A." (Ex. 166T-C at 28, Goodfriend).

Mr. Wood would go the other direction and demand a more minute geographical analysis than even by wire center. (Ex. 241T-C at 24, 25, Wood).

Staff's choice of how best to define the relevant market – both product and geographic – was shaped not only by judgments about how services are actually bought and sold in the market, but also by how competitors define the market for their own internal purposes. The competitors identified by Qwest in its petition maintain and analyze information about output (necessary for market share determination) only on an exchange level. Given this limitation on the available evidence, Staff's analysis is by exchange rather than wire center. The Intervenors' insistence on a smaller geographic market comes close to placing an impossible evidentiary burden on an incumbent and is squarely at odds with the reality of how competitors define the market for their own purposes.

2. Relevant Product Market

Qwest defines the relevant product market as business services. This includes several distinct services. Most are "add-ons" to three basic types of service – PBX, Centrex, and basic business exchange services. While one might, in theory, examine PBX, Centrex, and basic exchange services separately, that is neither possible nor desirable here. The competitors do not operate as if these were separate markets and thus were unable to report volume and revenue amounts separately. Moreover, each of the three types of services can be a substitute for the other two, at least in some circumstances. While Staff disagrees with the implications of the MetroNet/ATG arguments, they support the conclusion that Centrex is a substitute for the other two types of business service and is not a distinct product market.

The more difficult question by far is whether, within any geographic market, there exist separate product markets for business exchange service provided to different types of customers. Is it all one business exchange market, or are there separate markets for service to large customers and small customers? Staff recommends that the Commission define the relevant product market as being all business services, but impose the following conditions to ensure that small business customers are no worse off than they would have been had their service remained under tariff. These conditions are:

> (1) Qwest may not revise the terms under which it offers service within the wire centers within the four exchanges;
>
> (2) Qwest must continue to offer all customers the customer service guarantees offered under its consumer bill of rights tariff; and
>
> (3) Qwest may not increase prices or reduce availability, relative to the levels currently in its tariff, of any business local exchange service within these wire centers. Staff's proposed conditions would expire, and Qwest would have unconditioned pricing flexibility of its business local exchange service in these wire centers, upon approval by the FCC of Qwest's application to provide long-distance service under Section 271.

(Ex. 201T-C at 23-24, Blackmon).

In the alternative, the Commission should define the relevant product market to be only those services offered to large business customers served by DS-1 or larger circuits. Under either scenario, within the four most competitive exchanges identified by Staff, the business services at issue are subject to effective competition as defined in RCW 80.36.330. (Tr. 692-95; 736-39, Blackmon). Staff recommends, as its preferred alternative, that the Commission define the relevant product market to include all business services, and not attempt to distinguish between

those services that are offered to large and small customers. The reason is that there is no clean break between large business services and small business services:

> [I]t depends on *how you define the market* . . . we have concerns about making too much of the distinction between large business and small business and treating those as separate markets, because there are ways that one can sort of substitute one of those services for the other and one market for the other, depending on how you provision your service or depending on, from the customer side, how you choose to order your service. And so, since the line between those two is fuzzy, then there's a judgment call that needs to be made about whether to treat it as a single market, in which case it has mixed levels of competition, or to say, well, no, we can separate those two, and that's how we should proceed."

(Tr. 694, ll. 9-24, Blackmon). (Emphasis added).

In response to a question from the Chairwoman, on the relationship of conditions to a finding of effective competition, Dr. Blackmon explained:

> The difficult question here is whether the relevant market should be . . . broken down further by the size of the customer. And if you take that approach, then, and you say that there are two markets here, the small business and the large business, that you should only classify the large business market as competitive. On the other hand, you may conclude that the best approach is to define the market as being the offering of [all business] services in these geographic areas, in which case you have a market that, I think, is undeniably mixed in terms of the degree to which customers have access to competitors. And you could . . . decide that, looking at that market as a whole, . . . that the whole thing should remain as a regulated tariff service.
>
> We would recommend that you not do that, but that you instead look at that market as one that is subject to effective competition, looking at it [with] a broad view, but also recognizing that, within it, there are somewhat inseparable pieces where competition is not yet fully effective. So safeguards need to be put in place for those subsets of the market.

(Tr. 691-92, ll. 24-25, 1-25, 1-14, Blackmon).

If the Commission adopts this approach and defines the relevant product market to include service to business customers of all sizes within a particular geographic area, it must next

evaluate the highly variable level of customer choice within that market. The market share values indicate that, taken as a whole, the Seattle, Bellevue, Spokane, and Vancouver exchanges have substantial levels of competition. (Tr. 695, Blackmon). Competitors have captured 30 - 40 percent of the lines in these areas. (Tr. 697, Blackmon). However, Staff also has presented evidence – well supported by the public testimony of small business owners (*e.g.*, Tr. 564-71, Paxhia) – that this level of competition is not uniform within all strata of customer size.

The Commission thus is faced with a factual circumstance in which competition is vigorous in one customer segment and nascent in another and separate markets cannot be cleanly drawn between the two. Staff argues that, in such a circumstance, a thumb's-up/thumb's-down answer to Qwest's petition would result in an inappropriate level of regulation for some set of customers.

Staff's recommendation that the pricing flexibility requested by Qwest be limited to those customers served by DS-1 or larger circuits in each of the four exchanges is based on the telecommunications services that competitors are actually offering in each of the four exchanges. (Tr. 722, Blackmon). The evidence in the record demonstrates that competitors make their service offerings from the DS-1 or larger circuit. This, too, is consistent with what competitors are ordering from Qwest. They are ordering DS-1 or T-1 circuits from Qwest, in part, because those circuits provide a reliable method of gaining access to the network, whereas individual unbundled loops from Qwest do not. (Tr. 723, Blackmon).

The DS-1 or larger circuit benchmark is further supported by the highly confidential business plans submitted to Staff in response to Staff's Data Request No. 3, in which Staff asked the CLECs to "provide all documents that describe, report, or analyze each of your client's efforts

to acquire and retain customers for business exchange service, including all documents relating to each company's objectives for the geographic location, size, or type of customers for business exchange service."

(HIGHLY CONFIDENTIAL)

(Ex. 297-HC).

(HIGHLY CONFIDENTIAL)

(Ex. 298-HC).

(HIGHLY CONFIDENTIAL)

(Ex. 299-HC).

(HIGHLY CONFIDENTIAL)

(Ex. 300-HC).

Finally, in addition to investigating the competitors' business cases, Staff examined their actual business practices. Staff's findings further bolster its recommendation regarding both the DS-1 benchmark and the need to protect the small business customer. Staff's investigation revealed, in part, that GST, for example, offers services to medium- to large-sized business customers and that GST offers local telephone services over a T-1 (DS-1) or larger circuit. (Ex. 201T-C at 20, Blackmon). In addition, when asked how one would go about getting two business lines in downtown Spokane, Electric Lightwave replied that it was unable to offer service to customers ordering less than a full T-1 (DS-1) circuit. (Ex. 201T-C at 21, Blackmon). In Staff's view, these real-world company responses are particularly relevant to the Commission's evaluation of Qwest's petition because the companies cited are among the most active providers of competitive local exchange service in the state. *Id.*

a. Do Customers Have Reasonably Available Alternatives?

The answer to the question whether customers have reasonably available alternatives must be tempered by a recognition of the fact that a differentiation of products in the market does not indicate a lack of competition. Even Dr. Goodfriend concedes this point. (Ex. 166T-C at 17, Goodfriend). Therefore, the Commission should be not be overly concerned with finding that there is a perfect alternative available from competitors for every service being offered by Qwest. Nor should the Commission be overly concerned with finding that every customer in an area has identical competitive options in order to make a finding of effective competition. (Tr. 695-96, Blackmon).

Intervenors contend that not every feature or element of the Qwest business local exchange service is offered by competitors. Qwest argues that the competitors *could* offer these features using their existing switches, a position the MetroNet/ATG witness characterizes as "arrogant." (Ex. 241T-C at 23, Wood). Staff believes that the proper resolution of this difference is to acknowledge that the disputed, switch-based features are not separate from dial tone service. Qwest has properly included within its definition of business local exchange service the basic dial tone and the features that could not be provided without that dial tone. The fact that Qwest is offering certain features where competitors are not – even competitors with switches serving the same geographic areas – does not demonstrate of the lack of competition but rather indicates that Qwest and its competitors have different ideas about what potential customers want in the way of features. This might be seen as using a "potential competition" standard when Staff generally argues for an "actual competition" standard, but it is the appropriate standard when one reaches the level of vertical features of already installed switches.

b. Does Qwest Have A Significant Captive Customer Base?

Not every single customer in an area has to have identical competitive options in order for the Commission to make a finding of effective competition, as noted above. (Tr. 695-96, ll. 21-25, 1-2, Blackmon). Nevertheless, Staff and Intervenors agree that small business customers – when viewed as a separate group – remain captive customers. However, Dr. Blackmon testified that with a broader view of the market and with his proposed conditions in place, the captive customer base is less substantial or significant. He assured the Commission that the conditions concerning service to the small business segment would enable the Commission to "worry less" about the captive customer. (Tr. 693, ll. 1-6, Blackmon).

> [I]f you have conditions . . . I think you can give less weight to that captive customer base, and thereby conclude that the market as a whole is subject to effective competition."

(Tr. 695, ll. 12-15, Blackmon).

Dr. Goodfriend, on behalf of TRACER and Public Counsel, argued that very large customers, like Boeing and Group Health, should be considered another captive customer group because only Qwest possesses the scope and scale to meet all their telecommunications service needs as a sole provider. (Ex. 166T-C at 22, Goodfriend). Her arguments should be rejected.

First, there are obvious limitations to using a handful of TRACER members as a surrogate for all large business customers. Dr. Goodfriend impliedly conceded this point. On cross-examination, Dr. Goodfriend could identify but three TRACER firms that she interviewed in preparing her testimony. (Tr. 594). To support her testimony regarding the product demands of very large buyers, she interviewed the same three TRACER members. (Tr. 594-95). Second,

she admitted that she interviewed no non-TRACER members as a part of her analysis. (Tr. 595). Yet, at page nine of her revised direct testimony, she lists the top ten private sector firms[10] by number of employees. (Ex. 166T-C at 9). Only two of those listed are TRACER members. (Response to Record Requisition No. 4). Neither Dr. Goodfriend, nor her few TRACER-member clients can speak for *all* "very large" business customers in the state.[11]

Dr. Goodfriend then shifted her focus to that of the CLEC. She testified that CLECs lack the ability to serve large business customers (Ex. 166T-C at 23), that CLECs find very large customers unattractive (*Id.* at 24; Tr. 598), and that CLECs are discouraged from entering the market of very large business customers (*Id.* at 25; Tr. 600). But when asked on cross-examination to identify the CLECs she interviewed to support her testimony, she replied: "I didn't speak with any CLECs." (Tr. 598-600). The business plans submitted by the CLECs belie Dr. Goodfriend's testimony. Those plans are discussed in detail in Section III.A.2, above. Dr. Goodfriend's testimony should be accorded little weight by the Commission on this issue.

B. Market Concentration

A petition for competitive classification should be denied unless both the structural factors and the market share data support a finding of effective competition. The structural factors are similar across the nine exchanges, since competitors are operating in each area and have similar access to collocation space and unbundled network elements. (Ex. 201T-C at 17, Blackmon). However, at least in this case, it is not sufficient to state that competitors *could* serve

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[10]The data offered by Dr, Goodfriend does not include educational institutions and governmental agencies. (Ex. 166T-C at 9).

[11]In fact, one of the three TRACER firms interviewed by Dr. Goodfriend receives its local business services from a CLEC. **HIGHLY CONFIDENTIAL** a very large business customer, utilizes eight (8) DS-1s from XO (formerly Nextlink) for local business services in downtown Spokane. (Response to Bench Request No. 6; Ex. 906-HC).

customers in any particular market; to grant competitive classification, the Commission must conclude that effective competition *actually* exists in that market. (Ex. 201T-C at 17-18, Blackmon).

Market share is generally measured by a firm's "output" in the relevant market as a percentage of the output of all firms in the market. (Ex. 191T at 2, Bhattacharya) There are numerous ways to estimate a firm's share of the relevant market. Staff chose to review the number of access lines. Examining revenues would have been another way to try and find a suitable answer to the question, but that was impossible as a practical matter because of how CLECs maintain information. Billed telephone numbers is another valid indicator of market share. Unless the measures produce a substantially different result, however, nothing is gained from belaboring them. *See* Ex.191T at 6, Bhattacharya.

Market concentration is of greater importance to TRACER and Public Counsel than it is to Staff. For Staff it is a check, albeit an important check, on the structural considerations – that is, those considerations that tell one how easy or difficult it would be for an alternative provider to capture market share quickly in the event of a price increase by Qwest. As discussed above, Dr. Goodfriend asks the Commission to adopt a standard (the "will" standard, as opposed to the "can" standard of price constraint) that would require more evidence of present market share by Qwest's competitors. (Tr. 612-13, Goodfriend).

1. Antitrust Merger Guidelines

Both the U.S. Department of Justice, when it is reviewing a proposed merger, and the Commission, when it is reviewing a pricing flexibility petition, must consider the degree of market power of the applying firms. In the course of these reviews, the relevant market must be

characterized, the market structure must be analyzed, and the degree of market concentration must be measured. Given the similarity of the steps in these two types of investigation, it is inevitable that guidelines so well known (at least among economists and attorneys) as the DOJ Merger Guidelines would be used as a reference point. As Dr. Blackmon explained:

> [I] think the relationship between the two is simply that you're looking at market structure and market concentration in two different settings with two different legal standards, two different sets of concerns, though, in both cases, I think ultimately your concern is the undue exercise of monopoly power, market power.

(Tr. 703, Blackmon).

It does not follow, however, that the similarities in analytical method should lead to the application of the same conclusions in a pricing flexibility case as in a merger case. Qwest is not proposing to acquire XO Communications, Electric Lightwave, AT&T, GST, WorldCom, or any of the other 31 firms identified as competitors. Qwest is proposing to have greater flexibility in its pricing. It is obvious that different standards apply; otherwise, Congress would have instructed the DOJ to regulate the prices of any firm that unsuccessfully sought approval of a merger. Not only is that not the law, but the Merger Guidelines' strongest proponent in this proceeding acknowledges that it is not good policy. (Tr. 641, Goodfriend). One good reason for this difference in public policy is that, unlike in a merger context, the Commission here has the ability to reclassify services should it desire to do so. RCW 80.36.330(7).

In the context presented here, a petition for competitive classification, the proper analysis proceeds under RCW 80.36.330. Dr. Goodfriend agrees that the test for competitive classification need not be identical to that for merger approval. (Tr. 610, Goodfriend). The Merger Guidelines are just that: guidelines, nothing more. The test is not whether a grant of

pricing flexibility is warranted under the Merger Guidelines, but whether such a grant is warranted under the applicable statute.

The Herfindahl Hirschman Index ("HHI") (discussed below) has become closely identified with the Merger Guidelines over the years. Such identification is misplaced. As Dr. Blackmon testified:

> [T]he Herfindahl Hirschman Index has become very closely associated with the Merger Guidelines, so much so that it seems to invite a conclusion that if one is using the Herfindahl Hirschman Index, one should use the Merger Guidelines in general, and I don't think that's true at all. That index has been around a lot longer than the current Department of Justice Merger Guidelines have been, it pre-dates sort of the theoretical basis for the Merger Guidelines. It was used as a tool by the Department of Justice because it's a very useful summary statistic of market concentration, but that's all it is. It's just a summary statistic that's useful and it's useful in more than one subject.

(Tr. 704, Blackmon).

Finally, Dr. Goodfriend, Dr. Taylor agrees that "the main value of the Merger Guidelines is telling us how to define a market." (Tr. 800, ll. 3-4, Taylor).

2. HHI Analysis

The HHI is the most commonly used measure of market concentration. It is used as an aid in the interpretation of market data. (Ex. 191T, Bhattacharya). Staff performed HHI analysis because it provided an easy way to gauge, from available evidence, the market concentration from available evidence of the relative output of firms in a given market. Paying heed to the Commission's comments regarding a lack of broad participation from the industry in its Order concerning high capacity circuits (Docket No. UT-990022), Staff here sought data from each of the competitors identified in Qwest's petition pursuant to the Commission's authority under

RCW 80.36.330(5). (Ex. 191T at 3, Bhattacharya); (Tr. 677, Bhattacharya); *see* Ex. 12-C at Attachment F.

The HHI may range from zero in a perfectly competitive market to 10,000 in a perfect monopoly market. Staff chose a threshold of 5,000 for this particular market structure and acknowledged that different levels of market concentration would be acceptable with different market structures. Although any specific standard could be seen as arbitrary, the threshold one chooses "needs to be informed by one's understanding of the market structure." (Tr. 705, Blackmon). An HHI of 5,000 reflects the index that would be produced when there are two firms of equal size in the market. (Ex. 191T at 7, Bhattacharya); (Tr. 706, Blackmon). Although 5,000 certainly exceeds the threshold set forth in the Merger Guidelines, the Commission must not overlook the fact that there exist many examples in the economy today where two firms are competing against one another, and the government does not regulate the prices of either one. (Tr. 706, Blackmon).

Staff's HHI analysis proceeded, not based on revenues, billed telephone numbers, or numbers of customers per se, but rather on the number of access lines. This was due in part to the difficulty of obtaining other meaningful measurements for use in the market concentration calculation, namely revenues. The vast majority of the CLECs polled did not maintain revenue figures on an exchange level basis. (Ex. 191T at 6, Bhattacharya). Staff's request for data resulted in Exhibit 193. That Exhibit indicates that in four of the nine exchanges in which Qwest is seeking competitive classification, the market concentration figure falls below 5,000.[12] Stated

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[12]They are as follows: Bellevue (4561), Seattle (4458), Spokane (4167), and Vancouver (4534). (Ex. 193).

another way, Staff chose to limit its recommendation to approve pricing flexibility only in those exchanges in which "in the range of 30 to 40% of lines had either moved to competitors or new business had sprung up and just gone straight to the competitors."[13] (Tr. 697, ll. 17-22).

C. Market Structure

For Staff, the most persuasive evidence on the question of effective competition pertains to market structure. (Tr. 696, Blackmon). Staff placed emphasis on how practical it is for competitors to enter the market and offer service on an equal footing with Qwest. *Id.* Staff's market structure analysis was then supplemented through the use of various "reality checks," including market concentration numbers. *Id.* When questioned at hearing concerning the evidence on revenue loss, line loss, and billed telephone number loss from Qwest to competitors, Dr. Blackmon stated:

> We didn't give a lot of weight to those loss of customer numbers, but some combination of the loss of lines and the loss of customers, billed telephone numbers as a proxy for that I think would be the most useful statistic in that area.

(Tr. 696, ll. 4-15; *see* Tr. 687-688, ll. 25, 1-13, Blackmon).

Staff gave more weight to market share in its analysis in this case than it has in previous cases (high capacity and local toll) because the structural analysis did not give Staff as much

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[13]The data supplied by the CLECs in response to the Commission's request for completion of the form (Ex. 192) did not include the number of resold lines. (Tr. 676, Bhattacharya). As Dr. Blackmon explained:

> In terms of, for instance, market concentration or looking at whether there are services that are readily available that are good substitutes for Qwest service, resold service ought not count, in my opinion, because it's priced to the reseller on a percentage basis. Any time it [Qwest] raises its retail price, the price that the resellers pay will go up by exactly the same percentage amount." (Tr. 709-10, Blackmon).

reason for confidence as in those prior cases. (Tr. 697, Blackmon). In Staff's view, the weightiest indicators of market share or increasing market share were not the loss of customer numbers, but rather, a combination of loss of lines and the loss of customers. (Tr. 696, Blackmon).

Staff points out that pending changes in the structure of the market likely will make it easier for firms to enter the market for small business customers. One such change is the recent direction from the FCC that Qwest and other incumbent local exchange companies must offer the unbundled network element platform. Another is Qwest's effort to obtain approval for long-distance services by demonstrating its compliance with the competitive checklist set forth in 47 U.S.C. § 271, including the establishment of proven ordering, provisioning, and repair systems. *See* Ex. 201T-C at 13-14. Still another is Qwest's commitment to lower the prohibitive nonrecurring charges that CLECs must pay for UNEs when they obtain a new customer. (Tr. 700, Blackmon).

1. Ease of Entry

Under Staff's analysis, the objective of looking at the structure of the market is to determine how easy or difficult it would be for an alternative provider to enter the market by offering consumers a service that they would recognize as a competitively priced substitute for a Qwest service, in response to Qwest's raising the price for its service.

Ease of entry for competitors can, in part, be seen through the amount of loss incurred by the incumbent. When competitors enter the market, readily and easily, they begin to take away customers that were once held captive by the incumbent. Competition may therefore be measured by loss, such as line loss and loss of customers.

Resold line loss can be used to determine the number of business lines formerly belonging to Qwest that are now used by competitors. The purchase of lines from Qwest indicates that competitors are vying to serve customers in specific Qwest exchanges and that competitors are implementing market entry. ("[I]t's a legitimate form of competition to use the facilities of the incumbent to provide the retail service.") (Tr. 710-11, ll. 13-15, 21-25, 1-4, Blackmon).

Exhibit 12-C and Attachments G and H to Qwest's petition, help provide a picture of the magnitude of line loss Qwest has experienced in each of its 31 wire centers. Line loss is best determined by the total number of resold business lines. Aggregated into four exchange areas, Qwest line loss information as of February 1, 2000, is as follows:

Exchange	***Percentage of Qwest Line Loss***
Bellevue	**HIGHLY CONFIDENTIAL**%
Seattle	**HIGHLY CONFIDENTIAL**%
Spokane	**HIGHLY CONFIDENTIAL**%
Vancouver	**HIGHLY CONFIDENTIAL**%

In Bellevue, eight companies have purchased **(HIGHLY CONFIDENTIAL)** percent of Qwest's business lines. These eight companies include **(HIGHLY CONFIDENTIAL).** In Seattle, sixteen companies have purchased **(HIGHLY CONFIDENTIAL)** percent of Qwest's business lines. These sixteen companies include **(HIGHLY CONFIDENTIAL)**. Competitors

in the Spokane and Vancouver exchanges have taken away **(HIGHLY CONFIDENTIAL)** percent of Qwest's lines in each of those exchanges. The seven companies in Spokane that purchase Qwest resold lines include **(HIGHLY CONFIDENTIAL)**. The seven companies that purchase Qwest lines in Vancouver are **(HIGHLY CONFIDENTIAL)**.

Qwest line loss information as of June 30, 2000, indicates that in each of the four exchanges the percent of lines lost to competitors has increased:

Exchange	***Percentage of Qwest Line Loss***
Bellevue	**HIGHLY CONFIDENTIAL**%
Seattle	**HIGHLY CONFIDENTIAL**%
Spokane	**HIGHLY CONFIDENTIAL**%
Vancouver	**HIGHLY CONFIDENTIAL**%

As of June 30, 2000, Qwest has lost lines to seven companies in Bellevue, including **(HIGHLY CONFIDENTIAL)**. In Seattle the fifteen companies that purchase Qwest lines are **(HIGHLY CONFIDENTIAL).** In Spokane the six companies are **(HIGHLY CONFIDENTIAL)**. In Vancouver the ten companies which have purchased **(HIGHLY CONFIDENTIAL)** percent of Qwest lines are **(HIGHLY CONFIDENTIAL)**.

Another measure of competitive loss is based on the number of customers that have left Qwest to seek service from a competitive company. Qwest was unable to provide accurate figures identifying the number of lost customers. Therefore, a proxy must be devised using

billed telephone numbers. As Dr. Blackmon opined, "[I]n general, I believe that billed telephone number data would be useful in assessing the loss of customers." (Tr. 687-688, ll. 25, 1-13, Blackmon). Billed telephone numbers indicate the number of customers who no longer receive bills from Qwest for business service. Even though one billed telephone number may contain more than one line, one can generally assume that the ratio between a billed telephone number and a customer is one-to-one. (Tr. 425, Teitzel). The information revealing the loss of customers and the loss of lines for Qwest provides the "factual basis for finding that there is effective competition, . . . some combination of the loss of lines and the loss of customers, *[with]* billed telephone numbers as a proxy for that, I think would be the most useful statistic." (Tr. 696, ll. 4-15, Blackmon). (Emphasis added).

The following indicates the approximate number of customers (based on billed telephone numbers) that Qwest has lost between January 1, 1999 and December 31, 1999. The information has been aggregated into four exchange areas.

Exchange	***Approximate Number of Qwest Customer Loss***
Bellevue	**HIGHLY CONFIDENTIAL**
Seattle	**HIGHLY CONFIDENTIAL**
Spokane	**HIGHLY CONFIDENTIAL**
Vancouver	**HIGHLY CONFIDENTIAL**

Across the four exchange areas Qwest loses an average of thirty-four customers a month and resells five percent of its access lines. This information is based on line loss and customer

loss data. Along with the evidence found in Exhibit 193, which indicates market share losses of 30 - 40 percent from new customers and former Qwest customers, we see that many end-users elect to receive service from competitors. Dr. Goodfriend also notes that CLECs are targeting customers [other than existing Qwest customers]: "This suggests that the CLECs have been capturing new growth opportunities in the geographic areas." (Ex. 166T-C at 31, Goodfriend). This exemplifies the ease of entry. (Tr. 697, Blackmon).

Competitors have access to many methods of entering the market. Staff reviewed the best evidence available about how easy or difficult it is for competitors to use Qwest's network to offer competitive retail services to business customers. (Ex. 201T-C at 9, Blackmon). "[Competitors] have the opportunity to resell existing Qwest services, to buy UNE loops, to build their own facilities and deploy those facilities, to use facilities of other providers as well as new technology, such as fixed wireless service. In the High Capacity Case, Docket UT-990022, the Commission found that there was no barrier to existing businesses to reach new locations." (Tr.145, ll. 3-10, Jensen).

Notwithstanding Staff's previously stated concerns about UNE provisioning, with so many alternatives accessible and the opportunity to expand the network available, the argument that competitors require a ubiquitous network in order to effectively compete is becoming increasingly less persuasive. The most telling example of effective competition using the facilities of the incumbent to provide retail service can be found in long-distance service.

> [E]verybody's been very comfortable with the decision to classify Qwest's long distance service as competitive, because everybody else is out there providing that service. Well, most of the intraLATA toll service, the local toll service, goes over Qwest's own network. The competitors buy access service from Qwest, they may provide a switching function along the way or they may not, but the call that

goes, say, from here to Olympia -- from here to Seattle relies very heavily on Qwest's own network, even when it's AT&T or WorldCom or Sprint that's providing the service.

(Tr. 170-71, Blackmon).

As was seen before in the long-distance market, indicators show that Qwest's competitors for basic business services are acquiring lines and customers from the incumbent and that often they are doing so over the incumbent's own network.

2. Exercise of Market Power

The economist's term "market power" refers to the extent to which a firm can raise its price above cost without loss of revenue because customers have no other substitute firm to turn to for the service.

Obviously, unless the products that different firms are selling are exactly the same (i.e., completely fungible) or are something the consumer could easily do without, all firms in the market probably will enjoy some degree of market power (i.e., "inelasticity of demand"). Thus, the first question we must pose becomes one of degree – that is – does the firm in question have too much market power? Second, at what point does a customer's dearth of alternatives turn him or her from a customer with choices, to a "captive" customer? And finally, how quickly could a competing firm respond to such a price increase by rolling out a lower-priced product that the customer will recognize as a substitute for the monopolist's product?

As discussed above, the Merger Guidelines offer one definition of market power. (Ex. 231T at 13, Taylor). The Merger guidelines are applied, however, in a different policy context than what is presented under RCW 80.36.330, the competitive classification statute. (Tr. 703-04,

Blackmon). The question in the merger review context is – will the new, larger firm have too much market power? The question here is – will the firm that was previously subject to economic regulation have so much market power that the presumed benefits of deregulation (including increased innovation and lower prices) outweigh the risk that the incumbent will extract windfall profits from captive customers? Before addressing the issue of market power, one must address the issue of captive customers.

As evidenced by Staff's market share information, in each of the four exchanges at issue, competitors are garnering 30 - 40 percent of the market. (Ex.193). Customers in these exchanges not only have alternatives, they are using the alternatives to a large degree. Staff acknowledges, however, that within the relevant market as defined by Staff, not all customers may be subject to the same level of competition and that there may be some customers that are more captive than others. To mitigate these concerns, Staff recommends the Commission impose its conditions. Dr. Blackmon advised the Commissioners that they will be able to "worry less about the captive part, in terms of whether it's substantial, if there are conditions that protect that segment than [they] could if there were no conditions there." (Tr. 693, ll. 3-6). Therefore, without a significant captive customer base, the risk of harm from the competitive classification of specified services is minimized. Dr. Blackmon stated, "If I thought that the market were not competitive, then I, too, would be concerned about giving them pricing flexibility, because I would think they would use it to the detriment of the customers and the competitors." (Tr. 709, ll. 3-9).

As shown above, the competitors' ability to enter the market demonstrates that competition in the four exchanges currently exists:

> I believe that the criticisms or the forecasts of anticompetitive behavior on the retail side really are premised on an assumption or a belief that there's not competition in those retail services. Because if there were competition in the retail service, then I think, almost by definition, whatever ability they had to engage in price discrimination or selective marketing would be considered fair play and the competitive companies would not challenge that for risk that their own behavior would come under the same restrictions.

(Tr. 708-09, ll. 18-25, 1-2, Blackmon).

Competitors are in the market as rational, economic actors and they will constrain prices if they are able to. (Tr. 702, ll. 17-20, Blackmon). In sum, Qwest has little incentive to exercise whatever market power it may hold.

3. Resellers and Whether Resale Is An Effective Measure of Competition

In its petition, Qwest asserts that resellers should be considered evidence of competition in the relevant market. Dr. Blackmon and all other parties counter that the presence of resellers cannot be taken as evidence of price constraining competition because the latter depends on retail prices.

In Staff's view, the key question in evaluating whether a service is a viable alternative is whether that service can constrain Qwest's ability to exercise market power by increasing prices. (Ex. 201T-C at 13, Blackmon). Staff's analysis did not focus on resale competition but instead examined evidence of facilities-based competition. (Tr. 710, Blackmon). Staff took this approach primarily because if resellers were in the market to try to compete with Qwest on a price basis, they would have a difficult time, since their costs will go up in tandem with Qwest's

costs so that they would struggle to ever get a meaningful advantage over Qwest on price. (Tr. 714, ll. 3-8, Blackmon). That is one reason why the Commission "should not be focused on the resale competition as much as the facilities-based competition." (Tr. 714, Blackmon).

Staff's market concentration analysis did not include resold lines for the simple reason that resold services do not constrain prices:

> In terms of, for instance, market concentration or looking at whether there are services that are readily available that are good substitutes for Qwest service, resold service ought not count, in my opinion, because it's priced to the reseller on a percentage basis. Any time it [Qwest] raises its retail price, the price that the resellers pay will go up by exactly the same percentage amount.

(Tr. 709-710, ll. 17-22, 25, 1-2, Blackmon); (Tr. 676, l. 24, Bhattacharya). Mr. Wood, on behalf of MetroNet and ATG, agreed: "It supports what I believe is Dr. Blackmon's point, which is also my point, that you should not rely on resale at all, because it cannot constrain prices and cannot protect customers." (Tr. 886, ll. 7-10, Wood).

In addition to the facilities of the competitors (which, taken alone would not justify Staff's recommendation), one also must consider the competitor's ability to use special access or private line circuits of Qwest to extend their reach beyond their own facilities as a measure of available options providing effective competition. (Tr. 720, Blackmon).

IV. RECOMMENDATIONS REGARDING DIFFERENT PROPOSALS

A. Qwest Proposal (Including Staff Conditions) Regarding Thirty-One Wire Centers

Qwest seeks competitive classification of the basic business exchange services it offers in 31 wire centers. By way of compromise, Qwest agreed to Staff's proposed conditions to protect the small business customer. Staff recommends that the Commission grant Qwest's petition for

competitive classification in only four of the nine exchanges for which competitive classification is sought. Staff offers two alternatives for the Commission's consideration, as discussed both above and below. The Commission should recognize the uneven levels of competition among customer segments. Such recognition should lead the Commission to partially grant Qwest's petition. Qwest has not satisfied its burden under RCW 80.36.330 to establish that its business services are subject to effective competition in each of the 31 wire centers for which it seeks competitive classification. The Commission should deny the petition outright as to eight of those wire centers, for the reasons discussed above.

1. Variation: Lift Conditions Upon State Approval of Section 271 Application

The Commission should lift the conditions intended to benefit the small business customer, only upon approval by the FCC of Qwest's application to provide long-distance service under Section 271. (Ex. 201T-C at 24, Blackmon). In its rebuttal testimony, Qwest expressly agreed to Staff's proposal. Ms. Jensen testified:

> Q. DOES QWEST ACCEPT THE EXPIRATION TERM ASSOCIATED WITH THE ABOVE CONDITIONS?
>
> A. Yes. Qwest accepts the expiration term as defined by Dr. Blackmon. As stated in his testimony, Qwest is aggressively moving forward with pursuing approval for long distance entry in Washington. Therefore agreement to these conditions until Qwest has received approval by the Federal Communications Commission (FCC) of its application to provide long-distance service under Section 271 of the Telecommunications Act of 1996 is not objectionable.

(Ex. 7T at 11, Jensen).

At hearing, Qwest revised the above testimony. Now, it argues that it should be afforded unconditioned pricing flexibility of its business exchange service upon approval by *this* Commission of its application to provide long-distance service under Section 271. The company's argument that it should not be required to wait the ninety days it may take the FCC to review Qwest's application should be rejected. Approval by both this Commission and the FCC would strengthen Qwest's commitment to provide nondiscriminatory access to unbundled network elements. The Commission should grant Qwest unconditioned pricing flexibility of its business exchange service only upon approval by the FCC of its application to provide long-distance service under Section 271.

B. The Staff Alternatives

Commission Staff urges the Commission to adopt its recommendation that competitive classification be granted to Qwest in the requested wire centers of only four of the nine exchanges where it is requested: Bellevue, Seattle, Spokane, and Vancouver. This represents a smaller geographic area than the company has requested. As outlined in Section III.A.1. above, Staff's recommendation excludes exchanges in which Staff's market share analysis indicated that existing competition was not at least equivalent to what would exist between two firms of equal size. The Commission should deny the petition as to the remaining exchanges and wire centers. (Ex. 201T-C at 10, Blackmon).

Turning to the services for which Qwest has requested competitive classification within the specified geographic areas, Staff has two alternative recommendations -- again with the purpose of scaling back the petition in recognition of the uneven levels of competition among customer segments as discussed in Section III.A.2, above.

1. Four Exchanges: Services Over DS-1 or Larger Circuits

In Dr. Blackmon's direct testimony, he recommended that, within the four effectively competitive exchanges, the requested pricing flexibility be further limited to customers served on a DS-1 or larger circuit because the evidence clearly demonstrates that CLECs are not actively competing for customers who demand less than that quantity of services. The DS-1 or larger circuit benchmark is supported not only by the publicly available evidence of CLEC marketing plans presented in Dr. Blackmon's direct testimony, but also by the highly confidential business plans submitted to Staff in response to Staff's Data Request No. 3, in which Staff asked the CLECs to "provide all documents that describe, report, or analyze each of your client's efforts to acquire and retain customers for business exchange service, including all documents relating to each company's objectives for the geographic location, size, or type of customers for business exchange service."

2. Four Exchanges: All Business Services

As an alternative to the DS-1 or larger restriction, Dr. Blackmon testified that if Qwest were willing to accept conditions designed to ensure that small business customers are no worse off, Staff could then endorse competitive classification of all of the business services set forth in attachment "A" to the petition, in each of the four competitive exchanges. Because Qwest has subsequently agreed to the conditions, Staff recommends that the Commission adopt the broader product market definition (i.e., all three business access services and all of the discretionary services listed in the petition) but impose the conditions to which Qwest has agreed for the protection of small business customers. The reason Staff prefers the broad product market definition is that it better reflects the fact that there is no clear break between large business

services and small business services because all of the business access services are, at least from the large business customer's perspective, substitutes for one another (Tr. 699, ll. 17-20, Blackmon). Staff's recommendation that the Commission grant competitive classification of all the business services, but subject to conditions, is therefore the best proposal for addressing the variations in degree of competition within this broader product market definition.

> The conditions are:
>
> (1) Qwest may not revise the terms under which it offers service within the wire centers within the four exchanges;
>
> (2) Qwest must continue to offer all customers the customer service guarantees offered under its consumer bill of rights tariff; and
> (3) Qwest may not increase prices or reduce availability, relative to the levels currently in its tariff, of any business local exchange service within these wire centers. Staff's proposed conditions would expire, and Qwest would have unconditioned pricing flexibility of its business local exchange service in these wire centers, upon approval by the FCC of Qwest's application to provide long-distance service under Section 271.

(Ex. 201T-C at 23-24, Blackmon).

Staff's recommendation presents the most moderate and balanced approach to pricing flexibility, and it is the only one that successfully addresses the entire range of competitive circumstances within the business exchange service segment. Staff's recommendation would further the state's telecommunications policy goal of advancing the efficiency and availability of telecommunications services while protecting those small business ratepayers that remain captive to Qwest's services. It should, for these reasons, be adopted by the Commission.

C. MetroNet/ATG Proposed Conditions

MetroNet/ATG contend that the conditions proposed by Staff and accepted by Qwest are insufficient to prevent Qwest from creating a price squeeze for resellers, offering differential discounts, discouraging entry through selective price reductions, and freezing in place the number of customers with competitive alternatives. (Ex. 243T at 6, Wood). They argue for significantly more restrictive conditions that would tie Qwest's retail prices to its unbundled loop prices and forestall any effort to offer different prices to different customers within a wire center.

Staff believes that these additional conditions are unnecessary and should be rejected. Staff cannot predict whether Qwest would seek to vary its prices within a wire center, but its ability to do so should generally be governed by the same discrimination and preference statutes that apply to other providers of competitive service. Staff admits an exception to this general policy with its proposal to prohibit price increases for small business customers, but the MetroNet/ATG provisions would go beyond the level of regulation that applies today to a non-competitive service offered under tariff. MetroNet/ATG have made no showing that such an extraordinary level of regulation is justified.

Similarly, MetroNet/ATG ask for a level of protection for resellers that goes beyond what they can expect today with a tariff. The "price squeeze" that they identify is between two retail services, Centrex and basic business exchange service. The Commission should ensure that all retail services are priced to avoid a squeeze between the retail and wholesale levels, but MetroNet/ATG would have the Commission regulate, within a competitive market, the price of one retail service relative to another. The purpose of this regulation would not be to protect customers – who could switch to other providers if they become dissatisfied with their current

company. Rather, it would be to protect a niche for resellers. Staff believes that the Commission should vigorously protect resale by ensuring that all telecommunications services are available for resale and that the resale discount properly reflects the costs Qwest avoids in a resale transaction. However, the Commission has no responsibility to protect resellers *per se*.

D. Whether to Deny Petition In Its Entirety

1. Public Counsel and TRACER

Public Counsel and TRACER would have the Commission deny Qwest's petition outright. As discussed above, Staff is opposed to such a narrow view of the market for business services. In addition, TRACER has failed to explain why a grant of competitive classification would be harmful to the TRACER members. On the one hand, TRACER argues that there is a lack of CLEC alternatives for very large customers; yet, on the other hand, TRACER fails to offer an explanation as to why Qwest would offer special contracts with lower rates to those supposedly large captive customers. Presumably, if the TRACER members were truly captive, Qwest would not lower its rates to meet nonexistent competition. (Tr. 715-18; 733, Blackmon).

Finally, as stated above, the telecommunications needs of TRACER members are not unique when compared to other large firms that operate in two different ILEC territories. Although to date, the vast majority of TRACER members have chosen only the incumbent provider, that does not mean that those members do not have other alternatives available to them. They may use a combination of telephone companies or use a provider other than the incumbent provider. (Tr. 718, Blackmon). Evidently, they choose not to.

2. Eschelon

According to Mr. Davis, Eschelon has experienced difficulty attracting small or medium-sized business customers to Eschelon. (Ex. 261T, Davis). The reason for this, he asserts, is that Qwest successfully ties up customers for a number of years through the use of long-term contracts that include stiff termination penalties. The Commission should dismiss Eschelon's arguments on this point for the simple reason that the Commission already has addressed the very issues raised by Eschelon. In late 1999, a group of CLECs filed with the Commission a petition requesting that the Commission adopt a new rule that would release customers of Qwest from having to pay a termination penalty in the event those customers desired to cancel their service contracts with Qwest. *See* Docket No. UT-991476; (Ex. 85). The Commission denied the petition in November 1999. Both then and now, the CLECs failed to point to even one example where a potential customer refused to leave Qwest because of the existence of a long-term contract containing a termination penalty. (Tr. 664, Davis). Moreover, on cross-examination, Mr. Davis conceded that CLECs themselves use term contracts, many of which contain termination penalties. (Tr. 664-65, Davis). Eschelon's renewed plea for a "fresh look" at long-term contracts containing termination penalties should be denied.

V. APPROPRIATE COST STANDARD

MetroNet and ATG argue that the Commission must first determine the proper cost standard before approving any aspect of Qwest's petition. (Ex. 241T-C at 5, Wood). Commission Staff disagrees, particularly since Qwest is not proposing any rate changes in this proceeding. In the past, the Commission has relied on the cost studies on file with the Commission that support current rates. It should here, as well.

One need only read the applicable law to realize that the MetroNet/ATG requirement for a demonstration of cost is unnecessary and premature. RCW 80.36.330(3) requires that, "[p]rices or rates charged for competitive telecommunications services shall cover their cost." That standard applies once the Commission determines that a particular service is competitive; it is not part of the test, in RCW 80.36.330(1), for determining whether a service is competitive.

The current rates for Qwest's basic business exchange service were supported by cost studies demonstrating rates were above costs of providing the service, and after investigation, were approved by the Commission. As with the competitive classification of toll services, "the initial price lists filed pursuant to competitive classification of these services should mirror the current tariff rates. Thereafter, any rate changes must continue to cover its related costs and pass the imputation test." *In the Matter of the Petition of U S West Communications, Inc. for Competitive Classification of its IntraLATA Toll Service*, Commission Order Granting Petition, Docket No. UT-990021 (Jan. 1999).

The MetroNet/ATG approach would lead the Commission to an outcome clearly contrary to public policy, which is that competitive services should not be priced below cost. Under their approach, a service that was priced below cost could not be classified as competitive, *even if it is a competitive service*. This would perpetuate the objectionable pricing structure when the competitive classification process was designed to eliminate it by, in the first instance, determining whether a service is competitive and, in the second instance, requiring that such a service cover its cost. Their approach should be rejected.

VI. CONCLUSION

For the above reasons, the Commission should adopt Staff's recommendation that competitive classification be granted to Qwest in the requested wire centers of only four of the nine exchanges where it is requested: Bellevue, Seattle, Spokane, and Vancouver. It is Staff's recommendation that the requested pricing flexibility be limited to those customers served on a DS-1 or larger circuit in each of the four exchanges. In the alternative, Staff has recommended that, in the event the Commission decides to classify as competitive the business services offered to both large and small customers in each of the four exchanges, the Commission should impose conditions to protect the small business customer as outlined in Staff's testimony (which includes a price cap to which Qwest has agreed). The alternative approach better reflects the specific

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characteristics of the small and large business markets. Qwest, on rebuttal, has agreed to the proposed conditions. Staff recommends denial of the petition as to the remaining exchanges and wire centers.

Respectfully submitted this 17th day of November, 2000.

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Attachment B -- Applicable Statute and Rules

RCW 80.36.330 Classification as competitive telecommunications, services–Effective competition defined–Prices and rates–Reclassification.

(1) The commission may classify a telecommunications service provided by a telecommunications company as a competitive telecommunications service if the service is subject to effective competition. Effective competition means that customers of the service have reasonably available alternatives and that the service is not provided to a significant captive customer base. In determining whether a service is competitive, factors the commission shall consider include but are not limited to:

(a) The number and size of alternative providers of services;

(b) The extent to which services are available from alternative providers in the relevant market;

(c) The ability of alternative providers to make functionally equivalent or substitute services readily available competitive rates, terms, and conditions; and

(d) Other indicators of market power, which may include market share, growth
in market share, ease of entry, and the affiliation of providers of services.

(2) When the commission finds that a telecommunications company has demonstrated that a telecommunications service is competitive, the commission may permit the service to be provided under a price list effective on ten days notice to the commission and customers. The commission shall prescribe the form of notice. The commission may adopt procedural rules necessary to implement this section.

(3) Prices or rates charged for competitive telecommunications services shall cover their cost. The commission shall determine proper cost standards to implement this section, provided that in making any assignment of costs or allocating any revenue requirement, the commission shall act to preserve affordable universal telecommunications service.

(4) The commission may investigate prices for competitive telecommunications services upon complaint. In any complaint proceeding initiated by the

commission, the telecommunications company providing the service shall bear the burden of proving that the prices charged cover cost, and are fair, just, and reasonable.

(5) Telecommunications companies shall provide the commission with all data it deems necessary to implement this section.

(6) No losses incurred by a telecommunications company in the provision of competitive services may be recovered through rates for noncompetitive services. The commission may order refunds or credits to any class of subscribers to a noncompetitive telecommunications service which has paid excessive rates because of below cost pricing of competitive telecommunications services.

(7) The commission may reclassify any competitive telecommunications service if reclassification would protect the public interest.

(8) The commission may waive the requirements of RCW 80.36.170 and 80.36.180 in whole or in part for a service classified as competitive if it finds that competition will serve the same purpose and protect the public interest.

WAC 480-120-022 Classification proceedings.

(1) Rules of practice and procedure applicable. The rules of practice and procedure before the commission, chapter 480-09 WAC, shall apply generally to proceedings to classify a telecommunications company as a competitive telecommunications company or a service as a competitive telecommunications service.

(2) Initiation of classification proceedings. A telecommunications company shall initiate a classification proceeding by filing a petition with the commission. The commission may initiate a classification proceeding on its own motion by order instituting investigation.

(3) Notice to affected companies and public counsel. The commission shall serve a copy of the petition or its order upon all telecommunications companies which may be affected by the proceeding, and upon the public counsel section of the office of the attorney general. Service by the commission shall be made as provided in WAC 480-08-060(4). Alternatively, the commission may direct petitioner to serve a copy of the petition upon such parties as the commission directs. Service by petitioner shall be made in accordance with WAC 480-08-060(3).

(4) Notice to customers of classification proceeding. The commission may require a telecommunications company to give notice of the pendency of the classification proceeding. The commission shall determine the manner and distribution of notice.

(5) Appearances and intervention. Any person desiring to participate in a classification proceeding may petition to intervene as provided in WAC 480-08-070.

(6) Commission may require appearance. In any classification proceeding the commission may require all regulated telecommunications companies potentially affected by the proceeding to appear as parties to determine their classification.

(7) Burden of proof. In any classification proceeding, the telecommunications company shall have the burden of demonstrating that the company or services issue are subject to effective competition. Effective competition means that customers of the service have reasonably available alternatives and that the service is not provided to a significant captive customer base. In determining whether a service is competitive, factors the commission shall consider include but are not limited to:

> (a) The number and size of alternative providers of services;
>
> (b) The extent to which services are available from alternative providers in the relevant market;
>
> (c) The ability of alternative providers to make functionally equivalent or substitute services readily available competitive rates, terms, and conditions; and
>
> (d) Other indicators of market power, which may include market share, growth in market share, ease of entry, and the affiliation of providers of services.

A telecommunications company will not be classified as competitive unless it demonstrates that the telecommunications services it offers are subject to effective competition.

WAC 480-120-023 Content of petition for classification of competitive telecommunications services and companies.

In addition to the requirements of WAC 480-08-050(13), a petition for classification of a competitive telecommunications service or a competitive telecommunications company shall, a minimum, be accompanied with the following:

(1) Name and address of the petitioner;

(2) A description of the services it offers;

(3) Names and addresses of any entities which would be classified as "affiliated interests" of the petitioner pursuant to RCW 80.16.010;

(4) A statement of the services the petitioner contends are subject to effective competition, and with respect to each such service the following information shall be provided:

(a) Descriptions of all services in the petitioner's definition of the relevant market for the service;

(b) Names and addresses of all providers of such services known or reasonably knowable to the petitioner;

(c) Prices, terms, and conditions under which such services are offered to the extent known or reasonably knowable to the petitioner;

(d) A geographical delineation of the relevant market;

(e) An estimate of petitioner's market share and any past or projected change in market share;

(f) A description of ease of entry into the market;

(g) A statement of whether petitioner has a significant captive customer base and the basis for any contention that it does not;

(h) A verifiable cost of service study supporting the contention that the price or rate charged for the service covers its cost. A petition which contends that all of a company's services are competitive and does not seek classification for some services if others are denied classification is exempted from this requirement;

(i) The manner by which notice of price list changes will be provided to customers and the commission.