BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. U S WEST COMMUNICATIONS, INC., Respondent.	DOCKET NO. UT-950200 VOLUME 21 Pages 2020 - 2272

A hearing in the above matter was held at 9:00 a.m. on January 15, 1996, at 1300 South Evergreen Park Drive Southwest, Olympia, Washington before Chairman SHARON L. NELSON, Commissioners RICHARD HEMSTAD, WILLIAM R. GILLIS and Administrative Law Judge C. ROBERT WALLIS.

The parties were present as follows:

U S WEST COMMUNICATIONS, by EDWARD SHAW and DOUGLAS OWENS, Attorneys at Law, 1600 Bell Plaza, Seattle, Washington 98191 and JAMES VAN NOSTRAND, Attorney at Law, 411 - 108th Avenue Northeast, Bellevue, Washington 98004.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION STAFF, by STEVEN W. SMITH and GREGORY TRAUTMAN, Assistant Attorneys General, 1400 South Evergreen Park Drive Southwest, Olympia, Washington 98504.

FOR THE PUBLIC, DONALD TROTTER and ROBERT MANIFOLD, Assistant AttorneyS General, 900 Fourth Avenue, Suite 2000, Seattle, Washington 98164.

Cheryl Macdonald, CSR, Court Reporter

APPEARANCES (CONT.)

AT&T, by DANIEL WAGGONER, Attorney at Law, 1501 Fourth Avenue, Suite 2600, Seattle, Washington 98101 and SUSAN PROCTOR, Attorney at Law, 1875 Lawrence Street, Denver, Colorado 80202.

WITA, by RICHARD A. FINNIGAN, Attorney at Law, 1201 Pacific Avenue, Suite 1900, Tacoma, Washington 98402.

TRACER, by ARTHUR A. BUTLER, Attorney at Law, 601 Union Street, Suite 5450, Seattle, Washington 98101-2327.

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I N D E X

WITNESSES:	D	C	RD	RC	EXAM
MAYO	2023	2026	2121	2122	2095
SELWYN	2125	2127		2205	2186
LUNDQUIST	2221	2225			

EXHIBITS:	MARKED	ADMITTED
365T	2024	2025
366, 367T	2025	2025
368	2025	
369	2025	2072
370	2026	2072
370C	2026	2072
371-374	2079	2080
380T, 381, 382	2125	2127
385T, 385C, 386F, 387C	2221	2225

P R O C E E D I N G S

JUDGE WALLIS: Let's be on the record, please, for our January 15, 1995 session in the matter of docket UT-950200, U S WEST Communications Inc. At this point we are interrupting the company's case to receive evidence from witnesses who have scheduling difficulties or conflicts, and AT&T has called witness Mayo to the stand.

Whereupon,

JOHN MAYO, PhD

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

DIRECT EXAMINATION

BY MR. WAGGONER:

Q. Morning. Dr. Mayo, could you please state your name and address for the record.

A. My name is John Winston Mayo. My business address is Department of Economics, University of Tennessee, Knoxville, Tennessee 37996.

Q. And do you have in front of you your prefiled direct testimony dated August 11, 1995?

A. Yes, I do.

Q. And did you prepare that exhibit?

A. Yes, I did.

Q. And is it true and correct to the best of your knowledge?

A. Yes.

MR. WAGGONER: Your Honor, at this time we would offer Dr. Mayo's prefiled direct testimony.

MR. SHAW: Is counsel going to offer his rebuttal, Your Honor?

MR. WAGGONER: Yes, Your Honor.

Q. Dr. Mayo, did you also cause to be prepared your rebuttal testimony in this case?

A. Yes, I did.

Q. And is that testimony true and correct to the best of your knowledge?

A. Yes.

MR. WAGGONER: Your Honor, we would offer both the direct and rebuttal testimony of Dr. Mayo at this time.

JUDGE WALLIS: We'll mark the direct as Exhibit 365 for identification.

(Marked Exhibit 365T.)

JUDGE WALLIS: Did you verify that JWM-1 is an accurate representation of his experience?

MR. WAGGONER: Yes.

JUDGE WALLIS: That's 366 for identification. And the rebuttal testimony would be

367T for identification.

(Marked Exhibits 366 and 367T.)

MR. WAGGONER: We would offer those at this time.

JUDGE WALLIS: Is there objection? The exhibits are received.

(Admitted Exhibits 365T, 366 and 367T.)

MR. WAGGONER: At this time Dr. Mayo is prepared for cross-examination, Your Honor.

JUDGE WALLIS: We'll begin with the company, and I understand the company has some exhibits that it would enter on cross-examination. May we mark those at this time, please.

MR. SHAW: Your Honor, I have three separate exhibits. The first one in the packet is Wall Street Journal article of December 5 entitled AT&T Targets Home Markets Of Baby Bells, one page.

JUDGE WALLIS: That's 368 for identification.

(Marked Exhibit 368.)

MR. SHAW: Next is one page, a copy of a letter to the editor from the Wall Street Journal by Dr. Kahn.

JUDGE WALLIS: 369 for identification.

(Marked Exhibit 369.)

MR. SHAW: And the last is five pages, excuse me, including the cover sheet of the AT&T's responses, supplemental responses, to the company as first data requests, and as I scribbled in hand on the second page I understand through oral representation of Mr. Proctor that AT&T considers the second page confidential.

MR. WAGGONER: That's correct, Your Honor.

JUDGE WALLIS: Very well, we will mark the document as 371 for identification and identify the second page as 371C.

MR. TROTTER: Would that be 370 or 371?

JUDGE WALLIS: 370, excuse me.

(Marked Exhibits 370 and 370C.)

JUDGE WALLIS: Thank you very much.

CROSS-EXAMINATION

BY MR. SHAW:

Q. Good morning, Dr. Mayo, my name is Ed Shaw. I represent U S WEST Communications.

A. Good morning.

Q. Dr. Mayo, I would first like to talk to you about markets, and I gather from your testimony that from an economist viewpoint when analyzing economic issues one of the first things that you need to do is to define a market. Would that be correct?

A. For purposes of market power assessment, yes.

Q. And I also believe you indicated in your testimony that you don't consider usage for small business customers, residential, and toll customers to be separate markets.

A. Is this local usage or long distance usage?

Q. Well, I was --

MR. WAGGONER: Dr. Mayo, you will need to pull the microphone closer to yourself to be heard.

Q. Just relating to your testimony, do you recall in your direct testimony you made the statement that usage for separate customer groups in telecommunications shouldn't be considered separate markets?

A. There was a passage. Perhaps you could point me to it.

Q. For right now, do you recall making that statement?

A. I remember making a statement to that effect in the context of a larger discussion of, I believe it was, and if you will point me to the testimony, where it was in the context of a discussion of market power and the use of market share statistics.

Q. My question is do you consider residential service to be a separate market from business service?

A. Are we talking about usage?

Q. No.

A. We're just talking about access to those customers.

Q. Do you understand that in regulation local exchange companies have long been regulated in the form of a residential rate for access and a business rate for access that are markedly different?

A. Yes, I am aware of that.

Q. Do you consider those two categories of customers, residential customers as a group and business customers as a group, to be two separate markets?

A. Again, conceivably, it depends on -- that's why I was asking the question about whether it was usage or access. I think the answer may be it depends. If we're talking about, for instance, the provision of toll services to residential and business customers in general the answer is they compete in the same market I think because of the ease with which one might market to or provide toll services to residential or business services customers. On the other hand, if you're talking about access to business versus residential services or customers, it conceivably -- and I haven't done the market power exercise necessary to answer this definitively but conceivably it could be separate markets. That is to say, if you were to raise the price, let's say, of residential service above its cost by some small -- small but significant and nontransitory amount is the language used by the Department of Justice, would providers of business service be able to substitute and supply that service in sufficient quantity to residential customers to defeat the price increase. If the answer to that question is yes, then they compete in the same market but it's not quite clear that that is the case. I didn't mean to muddle what seemed to be a straightforward question but I think the answer is it really depends.

Q.   Are there such things as geographic markets?

A.   Yes, there are.

Q.   And a geographic market could be the city of Seattle, for example?

A.   Conceivably it could, yes.

Q.   And it could be the entire state of Washington?

A. Yes, depending on the service you're talking about.
Q. Or it could be the entire country?
A. Yes, it could.
Q. Or it could be the entire world?
A. Yes. Again, depending on the good or service at issue.
Q. If it depends on whether residential and business are separate markets do you consider the provision of a local exchange service a single market?
A. Again, I haven't done the market power exercise necessary to answer that in any sufficient detail in the state of Washington, but in general people do talk about local exchange service as a market, and I think it does not violate certainly the spirit of the exercise to think that local exchange -- network access certainly would constitute an identifiable service in market.
Q. So we're not talking about economic analysis now. We're just talking about common understanding. Are you applying a different intellectual discipline to deciding whether or not local exchange service is a market?
A. No. It depends on what we're after here, but if we're talking about the position or the

possession of significant monopoly power, then the relevant term of art is the economic one of a market. And if you look at the provision of, let's say, local exchange service there's an independent demand for it. There's an independent supply of it. If you were to go through a market power exercise and ask yourself the question could a hypothetical monopolist of local exchange service raise price by a small but significant and nontransitory amount and profitably sustain that price increase, I believe the answer is yes, which suggests that or indicates that it is an economically relevant market.

Q. How are you defining local exchange service when you make that statement?

A. Well, that's why I was asking you the question earlier about whether we meant service or access. The particular case that I was referring to is the provision of dial tone service.

Q. You agreed that a market can be defined in geographic terms, so I take it that an element of the definition of local exchange service is the geographic area that it encompasses?

MR. WAGGONER: Dr. Mayo, you're still going to need to get the microphone closer.

A. Yes.

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Q. Are you familiar with this Commission's rules setting up the threshold tests of whether or not an EAS route should be established?

A. No.

Q. Assume with me for the purposes of these questions that this Commission by rulemaking has defined the need for EAS in the context of an individual in the state of Washington should be able to, on average, place 80 percent of their calls without incurring a toll or per usage charge. Do you have that in mind?

A. Okay.

Q. From that a relevant indicator of local exchange service is whether or not the service is flat rated or usage rated, would you agree?

A. If I understand the question, right, yes. That if a call is flat rated it's local and if a call is measured it's toll is what you were just saying I think.

Q. And in defining that, a call can either be toll or local, depending upon the public policies of the state and of the pricing initiatives and strategies of the offering company, correct?

A. Yes.

Q. So at the state level it's certainly

conceptually possible that with the current LATA restrictions on companies such as U S WEST local exchange service could be LATA-wide?

A. If by the definition of local we just mean flat rated, yes, it could conceivably made to be LATA wide.

Q. Do you have any other definition of local exchange service other than the way it is rated in mind?

A. I don't object to your definition. I fail to note, though, or I would point out that what is called local service and what is called toll service under those definitions may not comport with our earlier discussion of what constitutes an economically relevant market. That may be your point as well, but I just want to make that connection.

Q. Assume with me that in Washington that local exchange companies offered LATA-wide flat rated service, and that a toll call by definition, under public policy, was limited to an interLATA call. Would such a pricing approach violate any economic principles of what should be a market?

A. I don't know that it has really anything to do with the market definition exercise that we talked about earlier. It certainly would violate a number of economic principles of efficient pricing. And to the extent that the usage of telephone service calls that travel some distance, local and increasingly intra, would formerly in your context intraLATA toll services, have caused by incremental usage the pricing of those on a flat rate basis would engender various economic efficiencies that I would object to.

Q. Do you agree that the cost of usage, the cost related to distance, have markedly declined in telecommunications technology over the last decade or so?

A. My understanding is that the distance sensitivity of cost has flattened, yes, flattened and fallen.

Q. And that single phenomenon is responsible for the tremendously declining incremental costs, putting access charges aside, but thinking incremental costs, of providing of what is typically thought of as long distance service or interstate service, isn't it?

A. I'm not sure that's the single most important factor but it is a factor.

Q. Historically, the cost of long distance, first microwave, and then fiberoptics, has brought incremental cost of long, long distance service down markedly, hasn't it?

A. Yes.

Q. And in fact that phenomenon has been responsible for the separations allocations of local loop plant at increasing levels over the years, has it not? As the cost of long distance went down an increasing amount of loop plant was allocated through the separations process to the interstate jurisdiction?

A. I think that's the interpretation of a lot of students of the industry.

Q. You agree that there are usage and distance costs for any telecommunications call whether it's rated toll or local, do you not?

A. That's my understanding, yes.

Q. Do you have any idea of how those costs increase with distance? Is it twice as expensive for 100 miles as opposed to 50 miles, just for example? Do you have any idea of the magnitude?

A. I've seen studies that have done those estimates but I have no independent study or knowledge of that.

Q. Do you agree that a LATA per se is not an economically defined market?

A. Well, certainly no one had in mind when LATAs were created the idea to have a LATA comport with what economists call an economically relative market. I think there were a lot of other economic considerations. That was not one of them.

Q. But for the consent decree defining that, would there be any doubt in your mind that the industry wouldn't have naturally gravitated to such a distinction?

A. Yes, I would agree that that's the case.

Q. Would you agree that telecommunications services defined as originating a telephone call for a customer and terminating it at the site of another consumer is a market, a provision of telecommunications services?

A. Well, again, as a first pass at this there is in fact an independent demand for usage for originating calls at one point, terminating them at another, and there's an independent supply of usage, and that would seem to to suggest that one might start a market definition exercise with that as a plausible market definition.

Q. Do you agree that at the state level companies like U S WEST and General Telephone provide telecommunications services offering to originate and terminate the calls of their customers over any distance within the LATA in the case of U S WEST and

hold themselves out to their customers as offering that service?
A. Yes.
Q. And whether you call next door or you call all the way across the LATA, local exchange companies, the larger ones, provide a unified service of origination and termination across the LATA but make a distinction in rates charged between what is commonly known as a local exchange call and what is commonly known as a toll call?
A. Yes.
Q. But the service is the same, it's only a function of distance, correct?
A. From a technological perspective there are a great number of similarities between a local call, an intraLATA call, and a long distance call. There are some additional switches functions and transport function that have to be conducted, and given the nature of consumer demand and supply in this industry they're very similar functions, yeah.
Q. With the stroke of a pen as we earlier discussed you can convert a locally rated call into an EAS call?
A. Certainly that has been done a number of places.

Q. And vice versa, you can convert a toll call into an EAS call or a local call?
A. Yes.
Q. Let me switch subjects here and talk about your imputation discussion. Would you agree that, based on the evidence produced in this record or offered to be produced in this record, that there is no toll price squeeze between the access charges that U S WEST charges and its intraLATA toll rates?
A. I have not looked at the numbers to be able to answer that in the affirmative. I'm sorry. I discuss the principles of imputation as were raised in the case but I have not made a detailed study of the relationship between intraLATA toll rates for specific types of calls and the imputation standard.
Q. So you're not here alleging that there is such a price squeeze and as a result access charges need to be reduced or toll rates need to be raised or a combination of the two?
A. I think there are other people that have raised those issues. I've described the principles raised and have discussed the need for and the merits of an imputation standard and one that is well designed and enforced and applied correctly.
Q. I gather from your direct testimony from

page 26 you discuss what has come to be an apparent cliche, as many times as it's brought up in these kinds of proceedings, that in competitive markets prices will be at LRIC in the long run. Is it your testimony that in competitive markets prices will be at long-run incremental cost?

A. Well, there seems to be some confusion about that, and let me perhaps explain that.

Q. First answer the question. Is that your testimony and then go ahead and explain?

A. Sure. In the long run equilibrium, yes. At any point in time, obviously this is very straight up. In competitive markets what I am saying, and this is standard competitive analysis, is that prices have a propensity, a strong propensity, to be driven toward in a long run equilibrium to their long-run incremental costs. This is not a particularly controversial proposition. It's very standard economics. At the principles of economics levels at the advanced level and everything in between. Clearly, at any point in time, at any point in time there will be demand surges or demand contractions, supply surges, supply contractions that may lead to a situation where prices are above, at or below incremental cost. We know that that market pressures in competitive markets are sufficiently powerful to always drive prices back toward their long-run incremental cost. So it is in this long run equilibrium that prices are at their incremental cost levels, and we know that that creates, as I described in my testimony, a number of very beneficial effects. It sends consumers the right price signals for the costs that are caused by consuming a product. It sends investors the correct price signals regarding the cost of providing the market supply. It's consistent with cost causation, and so in long run equilibrium, which is what I am describing, yes, prices do go to their incremental cost levels, and given that regulation and competition are substitutes or surrogates for one another it is that standard that is suggested here as efficient standards or efficient pricing.

Q. Do you agree that no multi-product firm in a competitive market, or a noncompetitive market for that matter, can price all of its services at long-run incremental cost with no markup for either shared or common costs and remain viable?

A. Here again, there's an issue that has some confusion, and if I can explain, I will try to be direct in answering your question. The answer is maybe that a multi-product firm can in fact break even by pricing at increment costs. If you look back again at the theory of competition, prices set at marginal costs allow in competitive markets firms to break even. How does that happen? As you recall in even single product industries there are fixed and common costs, what we call fixed and common costs. The answer is that incremental costs, marginal costs, may apply above are average cost. If it does then pricing at that incremental level allows contribution to be generated for all what economists refer to as inframarginal units. And so the answer is yes, it can happen. But it also might not be the case. It could be the case that a firm, let's say, in the classic example is a natural monopoly. If a firm is a natural monopoly with incremental costs that lie everywhere and ubiquitously below average cost then it may be that a firm fails to break even by pricing all, all of its services, at incremental cost.

That raises of course a very important practical question at this point in time and that is is this a natural monopoly industry. Is this an industry where a single firm is least cost provider of total industry output and competition is therefore not in the public interest, and in the state of Washington there seems to be a number of public policy signals that suggest that competition is in the public interest. At least policy makers at the state legislature and at this Commission have pointed toward the merits of competition, and letting competition have an opportunity to succeed. What I am suggesting is let's set price to maximize the likelihood that we get economic efficiency. We send consumers the right price signals, correct investment signals and so on. By doing so you will have recovered all costs that are caused incrementally by the provision of a particular service and you may very well -- let me put it this way. There is no compelling argument I see that suggests that it will cause necessarily a firm to go out of business.

Now, having said that, let me clarify one thing about my recommendation here. When I suggest --

Q. I think I will ask another question at this point. I think we're a long way from --

A. I only have one sentence if I can finish. I promise I will not ramble on. I only wanted to say that I'm not suggesting that U S WEST have all of its services set at their incremental cost, only those services for which they have significant monopoly power as an input to other downstream providers.

Q. Let's assume that the decree is lifted, either by the judge or by Congress, and U S WEST is now able to be in the worldwide and country-wide, as well as statewide, toll business. Do you agree that U S WEST, because of divestiture has no facilities for the provision of interstate service?

A.   I'm not sure that's correct given that U S WEST operates within a number of states, and may very well -- I'm not a network engineer but may have the ability to transport calls across state boundaries. In general if you're asking do they have the ability to carry widespread interstate calls from here to Florida, I think the answer is no.

Q.   Let's assume then for the purposes of this discussion that -- let me ask it this way. We can at least agree that U S WEST has no facilities between its region and other areas of the country and the world?

A.   That's right.

Q.   Would you agree that for U S WEST to enter the interstate intraLATA business on any expeditious timetable it would have to lease or rent services or facilities from existing providers?

A.   Yes.

Q.   In such a case you define that as an essential input that it would have to get from another provider to its provision of retail long distance service?

A. It would be an important input that is required to provide, let's say, interstate service between here and Florida, yes.

Q. And your testimony is then that that input should be provided at LRIC cost?

A. No.

Q. Let me ask you a question because your answer is no. Is that because U S WEST could choose from two or more providers, for instance, AT&T, MCI and Sprint? Just answer the question.

A. You're heading the right direction, but no. The reason is that the transmission services that it would seek are provided under conditions of effective competition, and where I hope I've been clear in my testimony, where markets are effectively competitive regulation does not need to establish prices, and I make that recommendation for that service and I would make it for U S WEST services that face effective competition.

Q. Let's go back to state of Washington. You agree that the city of Seattle can be defined as a market, correct?

MR. WAGGONER: Objection, Your Honor,

that's mischaracterizing his testimony.
JUDGE WALLIS: The witness is asked to respond whether it's correct or not.
A. As my counsel indicated I don't think I suggested that the area of Seattle is a market. I suggested that any number of geographic areas might be construed to be economically relevant markets depending on the particular good or service that we are talking about.
Q. Well, I perhaps misunderstood you then. I thought we agreed that the city of Seattle could be defined as a market as well as the state?
A. Perhaps I misunderstood some of your earlier questions but I thought you were asking me earlier could, as in conceivably could, a geographic area like a city, like a LATA, like a state, like the country or world be a geographic market and the answer to that was yes, they conceivably could and it depends upon the particular good or service that we're talking about. So as a conceptual matter, absolutely. If you're asking me for a particular statement to agree that now we've defined for some unspecified service Seattle as a relevant geographic market I can't agree that I said that.
Q. Assume that in the city of Seattle there

are multiple providers, facilities-based providers, contesting for the downtown Seattle business market. Do you have that in mind?
A. Yes. I do understand the question. Again, now you've used the term market as though there is a downtown business market, and that may or may not be a relevant market for purposes of market power analysis, but go ahead.
Q. I understand that your response is that it depends. Assume with me that that is defined as a market. Do you have the assumption in mind that there are multiple facilities-based providers contesting for the telecommunications business of the residents of downtown Seattle?
MR. WAGGONER: Excuse me, Your Honor.
A. Residents or business?
Q. I don't mean to mislead you. The customers that are in downtown Seattle, business and residents.
A. So now it's a business and residential market in a geographic area called downtown Seattle.
Q. And we're going to assume that there are multiple facilities-based providers that can contest for the provision of telecommunications services in that geographic region?
A. Yes.

Q. In that case no one of those providers should be required to provide AT&T in its role as a toll provider access at LRIC?

A. If access is provided subject to conditions of effective competition, no, the price of access should not at that point be regulated at all. The market would be sufficient to drive prices inexorably toward and in the long run equilibrium to sufficient prices.

Q. And I take it you consider the interstate long distance market with three facilities-based competitors to be effectively competitive, three primary facilities-based competitors?

A. Well, two things. One, with respect to the example that we're talking about, the mere existence of multiple facilities-based providers doesn't necessarily insure effective competition. Nor does the characterization of it only being there in the interexchange market, which I think is factually inaccurate, insure there is not effective competition. The latter market with respect to the interexchange market has been very extensively studied over the last decade and it's been found by both economists and public policy makers consistently around the country to be subject to conditions of effective competition but it's been -- that analysis has been drawn not simply based on account of the number of facilities-based providers but a far, far more detailed look at a number of conditions that exist in that market.

Q. So is your answer, yes, you consider the interstate market to be effectively competitive, your answer is yes?

A. Well, the answer is --

Q. It's a simple question. Do you or do you not consider it effectively competitive? Don't anticipate that I've asked you a question to compare it to something else. Just answer the question.

A. My statement is that I do consider the interexchange marketplace to be effectively competitive. I don't draw that conclusion, however, based upon your earliest question of there being only three facilities-based carriers. That's all I'm trying to say.

Q. Let's talk about some other markets. Do you consider the provision of automobiles and light trucks to be an effectively competitive industry globally?

A. I haven't made a formal market power assessment. I think in general people would consider the provision of automobiles to be an effectively

competitive market.
Q. Is there any doubt in your mind that it's effectively competitive?
A. In general, no. There may be particular anti competitive problems that arise from time to time but in general.
Q. Would you agree that the best selling vehicle in that market domestically is the Ford F150 pickup?
A. I saw an advertisement that said the Taurus was the leading car sold in America the other day, but -- trucks outsell cars? I'm surprised. Call it the Taurus or call it the F150.
Q. You don't know that, I take it, so let me ask you this. Do you know that the competitors in the automobile and light truck market sell trucks at substantial markups and have for many, many years?
A. Define markup for me.
Q. I take it you have no knowledge of the cost price relationships of a pickup as compared to, say, a compact automobile?
A. No, it's not something I've studied. The reason I asked the question a moment ago is that markups can be defined in a number of ways and depending on the accounting that's done things might

look like a substantial markup and not be or look like a small markup and in fact be substantial, depending on how we define the term markup.

Q. Based upon your earlier general observations, would you expect pickups to be priced at LRIC in the automobile industry?

A. Well, for the reason I described earlier, and maybe I wasn't as clear as I should have been, the answer is at any point in time prices may deviate considerably from, let's say, their incremental cost. That happens all the time in competitive markets. Wal-Mart is an example of a firm that has consistently earned relatively large profits year after year after year with prices over cost but the way they've done that is by providing quality service, prices that are very competitive. They've managed themselves very, very well. They've introduced a variety of new services. But it's not because they don't face competition. It's because they continue to stay a bit ahead of the competitors in that regard, but competition will drive prices toward their costs. At any point in time you may observe that the price of pickup trucks may be above, at or above a particular cost measure like incremental cost.

Q. So any point in time could be 20 years or more that the competitive providers can sustain prices above cost, LRIC cost, based upon consumer perceptions and willingness to pay.

Q. If, for whatever period of time we're talking about, the particular provider in a competitive market continues to be innovative and efficient and satisfy consumers better than its rivals that it may continue to earn efficiency rents for a considerable period of time, yes. But that does not mean that we can look at the existence of prices over their incremental costs at a point in time and say uh-huh, this firm has sufficient monopoly power. That's what I was saying.

Q. We could go through many examples, couldn't we, in the real world where firms in competitive markets -- you've mentioned one, Wal-Mart, I've discussed one, automobiles -- where the product is sustained at levels far above LRIC for many years, correct?

A. Yes.

Q. Name one product or service in the American economy that you know to be priced at LRIC where the market equilibrium has been reached.

A. I can't point toward an industry that at any point in time I can say is in long run equilibrium and people have gone out and measured the price and measured the cost. What we do know is that there are some very, very powerful economic incentives and economic pressures in place in effectively competitive markets to drive prices toward and it has been demonstrated time and time and time and time again that in the long run equilibrium prices will be driven to competitive equilibrium, that is, incremental cost levels in competitive markets. We know that's the case. And it's exactly that sort of competitive pressure that I think is beginning to emerge in telecommunications markets. It's farther ahead in some markets than others.

In the interexchange market it's there, we've got effective competition. Some amount of competition is beginning to arise in telecommunications markets that are local and intraLATA. For those services where effective competition exists my recommendation is to allow considerable pricing flexibility and those pressures will drive prices toward costs. Where market power exists, where significant monopoly power exists that is the role of the Public Utility Commission to then establish a set of prices that would exist in long run competitive equilibrium and there are numerous benefits of that.

MR. SHAW: Your Honor, I'm going to ask you to instruct the witness to stay at least within shouting distance of the question. I am quite willing to allow him some explanation but he continually exceeds that.

MR. WAGGONER: Your Honor, I would simply point out that Mr. Shaw's questions have been extremely broad and the witness certainly is entitled the latitude in answering extremely broad questions.

JUDGE WALLIS: I agree that the witness should be allowed some latitude to answer the question, but I would ask the witness to listen carefully to the question, respond to the question and then if you feel it's necessary to explain it, do so, and I would urge you to stay within an explanation of the question and not go after questions that weren't asked. Thank you.

THE WITNESS: Sure.

Q. AT&T since divestiture has never priced a service whether offered to a competitor or an end user customer at LRIC, has it?

A. I don't know.

Q. Directing your attention to page 3 of Exhibit 370, do you see AT&T's answer to the question of what their LRIC prices are or LRIC costs are, excuse me?

A. I apologize. If you could tell me what Exhibit 370 was.

Q. In that package, if you haven't yet had it, Exhibit 370 is AT&T's responses to data requests?

A. Okay.

Q. And then on the third page, response of the second question, have you read that previously?

A. This question 2 A or 2 B or 2 C? I may be on the wrong page.

Q. Page 3, the response to 2 A.

A. What is your economic price floor using long run incremental costs, is that the question?

Q. That's the question and have you read the answer?

A. Give me just one second. I've now read the answer.

Q. Would you agree that from that answer there is no evidence, at least offered by AT&T in response to this data request that it in fact in its competitive market prices at TS LRIC?

A. I think what it says is that it establishes its prices based on market conditions and that for some services -- some customers that the prices may be at or near TS LRIC but they're unable to quantify that or identify that because they haven't looked at their incremental cost.

Q. Would you believe it prudent for any firm in a competitive market where it's providing multi products to have some idea of its TS LRIC costs to make sure that it is not making imprudent business decisions about maintaining or expanding a service?

A. Some general understanding of the incremental cost associated with expanding or contracting output I think is good business practice. As a practical matter businesses typically do not precisely quantify those incremental costs.

Q. Do you consider Alfred Kahn to be a noted and respected economist and authority on the telecommunications industry?

A. Yes, I do.

Q. And you have in fact cited to his works on three separate occasions in your testimony, have you not, footnote at page 5, a footnote at page 17 and in your rebuttal a footnote at page 11?

A. Yes.

Q. Directing your attention to what's been marked as Exhibit 36, which is the letter to the Wall Street Journal from Professor Kahn, have you seen that letter?

A. I did see this letter. I read it some time ago.

Q. Would you agree that based upon the historic pricing in a monopoly environment that has been long practiced in telecommunications that in order for truly economically efficient competition to transpire, to exist, that the underlying rates have to be rebalanced, that access and toll have to come down and local exchange have to come up, assuming that the revenue requirements and the costs of the company are not lower?.

MR. MANIFOLD: Your Honor, I'm going to object to that question as beyond the direct testimony of this witness.

MR. WAGGONER: I would simply point out that this witness has certainly testified as to the appropriateness of dealing with revenue requirement in the current telecommunications markets, and that's what I understood Mr. Shaw's questions to go to. It was a little difficult to track, frankly, but that's what I thought he was asking.

MR. SHAW: I guess Mr. Waggoner is defending against the objection, and I will throw in my two bits and say that obviously the witness cites Dr. Kahn. This is a public statement of Dr. Kahn, and

I think I am entitled to explore on cross to what extent he agrees with it.

JUDGE WALLIS: The witness may respond.

A. A couple of points. I thought your question is really a stand-alone question independent of what Professor Kahn has said or not said. So I'm going to set that aside for a moment because I think what you asked me was -- and stop me if I'm going to answer the wrong question -- but what I thought I heard you ask me was, over time, in a monopoly environment has it been the case that we have put in place a set of relatively inefficient pricing of telecommunications services wherein the price of access and toll services were established at rates many, many times their relevant economic costs, and local exchange services were residually priced and at least historically were below cost, and that is it not necessary for competition to emerge that that inefficient pricing be changed.

Hearing that you are not objecting to my rephrasing of your question, let me suggest the answer is yes. That consistent with my testimony I am suggesting that where prices of access services have been held to be many, many times their incremental costs, that that creates economic inefficiencies. It has discouraged the use of toll services. It has discouraged or dampened the ability of the market to generate economic welfare and it has discouraged competition, and the full benefits of that competition that exists in the interexchange industry.

At the same time, historically, the practice of residually pricing local exchange services I think is troublesome, and we need to move away from that.

Q. So it's just as important to get the local exchange rates correct as it is to get the access rates correct?

A. Given the opportunity to correct both I would recommend doing that, yes. I would suggest examining each for their efficiency and their ability to achieve efficient pricing.

Q. So the bottom line is you agree with the fundamental economic arguments made by Dr. Kahn in this letter in Exhibit 369?

A. Well, let me hold off on that because it's been quite a while since I read that letter, and there were -- as I recall there were certain parts of that letter with which I was in fundamental agreement and there were some passages that I was in disagreement with, and so let me just let my statements stand on their own and I will let Professor Kahn's statements stand on their own if that's all right with you.

Q. Do you agree with this statement of Dr. Kahn, and I quote -- and if you want to read along with me, three full paragraphs up from the end of the letter starting with obviously. "Obviously AT&T is not interested in providing basic residential dial tone for its own sake, and the economic feasibility of its doing so does not depend on its ability to do so at a profit any more than it does for the local telephone companies themselves." Do you agree with that statement?

A. If I understand the statement correctly I do disagree with it, in the sense that -- certainly I don't disagree with the proposition that AT&T is not interested in providing basic residential dial tone for its own sake. It would do so for a profit. It would seek to do it at a profit and not just because AT&T is altruistic. However, when suggesting -- the latter part of the sentence says that "the economic feasibility of doing so does not depend on the ability to do so at a profit," I would disagree with that because clearly firms don't enter markets unless they're going to try to get a profit, and if you're talking about a standup competition for residential service it has to be looking at that as a compensatory set of prices to go into and it has to stand on its own merits. AT&T does not have the luxury of having monopoly ratepayers from whom to extract rents to subsidize its competition or its entry into the local exchange business.

Q. Let me refer you to the Exhibit 368, the Wall Street Journal article entitled AT&T Targets Home Markets Of Baby Bells. Do you have that?

A. I do.

Q. And directing you to the discussion under the heading long-term initiative under Mr. Mandell's picture there, and the statement, "AT&T aims to offer consumers and businesses a new kind of communication service that would use a simplified pricing setup, perhaps one flat rate regardless of the type of call, and bundled together local long distance and wireless services." Do you see that statement?

A. Yes.

Q. First of all, do you agree that that is a correct news report of AT&T's emerging local exchange strategy?

A. I have no idea. I am not privy to AT&T's strategy plans. You will have to ask someone else about that.

Q. This was a major business newspaper, and do you have any reason to disagree that AT&T confirmed that its growth 2005 strategy is in fact its local exchange strategy?

MR. WAGGONER: Objection, Your Honor. Asked and answered. He already said he has no idea about AT&T's internal strategic memos.

MR. SHAW: Your Honor, this question is a little different. I asked him whether he had any reason to disbelieve this newspaper report.

MR. WAGGONER: I don't know what the evidentiary status of him not believing something --

JUDGE WALLIS: I'm not sure what that would prove. The objection is sustained.

MR. SHAW: I will withdraw the question.

Q. Do you agree that AT&T could adopt a business strategy that bundled together local long distance and wireless services and make a profit in that business?

A. You're asking me could AT&T conceive of a strategy whereby they would provide local long distance and wireless service together and make a profit. Yes, they could do that. They could wish for that. Whether it happens or not is an entirely different matter.

Q. So you would agree, then, with Dr. Kahn's

statement then for both of these parties, referring to AT&T and the local exchange company, signing up residential subscribers at a loss is feasible and attractive only because that gives them the first shot at obtaining the business that is priced far above cost. Do you agree with that statement?
A. Tell me where that is.
Q. That's following the previous statement that we talked about in the paragraph starting with obviously.
A. I would agree that if and to the extent that prices are below their cost for residential service that there's no incentive as a stand-alone -- on a stand-alone basis to enter that market, and as a result if you were to see entry -- and it's not a set of prices that I would recommend. I do recommend compensatory prices for local exchange service. That's the best way to fix that problem as opposed to the implication here of continuing to perpetuate inefficient prices of pricing various services well above their cost in hopes that someone might go after that market and tag along and we'll get competition in local exchange markets as a stepchild phenomena. It makes very little sense to do that and I don't think that's what Professor Kahn is recommending here, but

there's a very simple way to fix that problem and that is to have prices go to their relevant cost.

Q. That is Dr. Kahn's recommendation in the final paragraph of his letter, correct?

MR. WAGGONER: I'm going to object. The witness has already said that he hasn't spent the time to study this letter. He's being asked to assume things about one paragraph without having an opportunity to read the whole thing in context. If Mr. Shaw wants to point to a particular sentence and ask him if he agrees with it or particular paragraph, but not sort of a general conclusory question like that.

JUDGE WALLIS: I heard the question to refer to a specific paragraph, and I believe the witness can respond.

A. You asked me about the last paragraph?

Q. Yes, Dr. Kahn's conclusion on what should be done?

A. He's referring to a solution and it's a solution to something that's identified above, and I'm not comfortable knowing what the solution -- what the problem identified above is since it's been a while since I read this, so take off the first part of that sentence, "the solution is of course" in the first line, and I would suggest that we would be in agreement that I would recommend getting the price of basic residential rates right. That part I agree with, and I would agree that in general it is unnecessary to, when you suggest taking care of poor people with direct subsidies, again, we agree on that point.

Q. Would you agree --

A. I disagree with -- I have nothing to add about the next sentence, the sentence beginning "until that happens what AT&T and others are demanding is a free ticket into a rich market with local companies paying for the ticket." I strongly disagree with that in the sense that in the context of this case to bring it into this case, what I am suggesting is that all parties, consumers and long distance consumers and local consumers, be made to pay the cost that they cause to be incurred for the local exchange company and society in general. That's not asking for a free ticket. That's trying to get prices right and efficient, and that will maximize competition. That's not a free ride for anybody.

Q. Do you agree that the use of another company's local exchange facility's network loop distribution plant by a competing company is very

valuable to that competing company? It allows them to provide services to consumers that have the potential for a high profit?
A. That may be the case. I have not studied that particular issue.
Q. Do you agree that in the economy at large, and in telecommunications as a pricing exercise that it is appropriate to price based upon the value of the service to that consumer, and in relation to the elasticity of demand for that service?
A. No, not in general. Firms may desire to do that. They may desire to price to the value to consumers. In competitive markets that is unobjectionable, but in services that are provided subject to significant monopoly power, providing a service and pricing it to reflect the value to consumers means that consumer welfare is extracted from consumers, that people can be made to pay for the value as opposed to the cost. When that value exceeds the cost you're simply transferring sources away from consumers into shareholders of a firm offering the product subject to sufficient monopoly power. It's not efficient.
Q. Let's go back to our earlier discussion. Based upon your principles, then, what if any service

should U S WEST be allowed to price above its long-run incremental cost?

A. Well, if we break it down --

Q. Specifically.

A. If we break it down into two counts those services that are offered subject to effective competition and those services that are offered subject to significant monopoly power. For all services that U S WEST offers subject to effective competition it should be granted pricing flexibility and that includes the ability to price above TS LRIC should they feel that that is warranted by market conditions.

Q. What specific services are those?

A. If I could just finish and then ask me again.

Q. That was the question. I asked you what specific services, toll, local, private line, voice mail? What specific services, in your opinion, can U S WEST price above long-run incremental cost in keeping with the principles that you have talked about today?

A. For any service and all services that U S WEST offers subject to effective competition I would advocate allowing them the latitude to price based on market conditions. I have not done a specific market power analysis of specific U S WEST services so I can't answer the question about whether it ought to be Centrex service or private line toll services or intraLATA MTS services. I know there is a mechanism in this state to allow U S WEST to make a case for that effective competition and to garner exactly that pricing flexibility that I recommend. It has made the case I gather in some cases and not in others.

Q. You do not know which services have been classified as effectively competitive by this Commission of U S WEST?

A. I have not studied the specific services that they have offered subject to conditions that have been named to be effectively competitive, no.

Q. Is it your testimony that whatever those services are that all other services that have not yet been classified as effectively competitive should be priced at LRIC?

A. If there are services that are effectively competitive that are misclassified then I would urge U S WEST and the Commission to move expeditiously to reclassify those services and to grant the pricing flexibility that U S WEST would seek in that case. But given that at least historically, at least historically

U S WEST has offered a variety of services subject to conditions of monopoly, I think the presumption has been that those services are offered subject to significant monopoly power absent making a case of effective competition.

Q. If those prices do not sum to U S WEST's revenue requirement which service should make up the difference?

MR. WAGGONER: Your Honor, I think it's important for the record that Mr. Shaw be explicit about which prices he's referring to.

MR. SHAW: Well, I will review it with the witness.

Q. You've testified that prices that are not effectively competitive should be set at LRIC, correct?

A. Yes.

Q. You've testified that prices for service that are profitably considered effectively competitive could be set above long-run incremental cost?

A. That's right.

Q. If the sums of those prices, which presumably encompass all the services of the company, do not equal the company's revenue requirement, what prices should be increased to make up the difference?

Which services should be increased to make up the difference?
A. That's a good question. And here I think it depends on whether you really believe that all costs have been squeezed out of the company that can be squeezed out consistent with a competitive market standard. Assuming that's been done then what I would certainly hope is that the set of prices would be compensatory for the firm that exists that would be consistent with an underlying cost structure that suggests that this market could be effectively competitive. If it didn't, if it didn't, then you would start as an economist to look at the necessity of raising prices above incremental cost perhaps in inverse relationship to the price elasticity of demand. You would seek a way of minimizing whatever economic distortions necessarily have to be brought out because of a shortfall. It's unclear that that's going to be the case in this particular proceeding, but that is where an economist would suggest that the Commission look is to try to minimize those distortions to economically efficient pricing.
MR. SHAW: That's all I have, Your Honor. I would move the admission of Exhibits 368, 369, 370.
MR. WAGGONER: Your Honor, no objection to

370. As to 369, the letter from Alfred Kahn, I would have no objection to it being admitted solely for illustrative purposes because it has been referred to, obviously it doesn't really have any evidentiary status since the witness hasn't identified that he knows that Professor Kahn wrote it or anything like that. As to Exhibit 368 we would object to that. This is obviously not the proper witness to try and admit this exhibit through since he doesn't know anything about it.

MR. MANIFOLD: Your Honor, I join in the objection to 369 and I have no objection to 370.

MR. WAGGONER: Did you mean 369 or 370?

MR. MANIFOLD: I object to 369, is the letter that purports to be from Alfred Kahn for a newspaper and I have no objection to the data request.

MR. SHAW: Your Honor, in regard to the Kahn letter, this witness has repeatedly in his testimony cited to the writings of Dr. Kahn for authority for statements that he makes. This is a statement of Dr. Kahn. I don't think that there's any doubt that he made it. It also goes directly to the core issues in this case in terms of the relative pricing. As I understood him he agrees in part and disagrees in part with the assertions of Dr. Kahn. I'm not offering it for the truth of every word in it but I think it is a valuable addition to the record given the foundation that was laid.

I think there's an adequate foundation also on 368. The fundamental issue here goes to whether or not, as far as this witness is concerned, is whether or not AT&T should be required in prices to pay for services that it desires from U S WEST relative to the value for services. And AT&T's own documents, as disclosed in the paper, talk about its desire to compete on a selective basis and on an unbundled basis at the local exchange level, that it will not be directly related to the cost of access to the local network so I think all three exhibits are relevant to support the cross-examination.

MR. WAGGONER: Very quickly, Your Honor. Obviously as to 368 I could go copy a piece of paper out of a newspaper and just sort of shove it in front of a witness and he would no nothing about it. This has no evidentiary status as well. There would be further AT&T witnesses if Mr. Shaw wants to try to introduce it through somebody else. That's his choice. As to 369 I would simply point out that obviously Dr. Mayo has not read or disagreed with all portions of 369.

JUDGE WALLIS: 370 is received. I believe that the witness has acknowledged his view of the authenticity of 369 and that the record explains his understanding of it and I believe it's admissible. 368 I think has an insufficient foundation to be received at this time except for conceivably for illustrative purposes.

(Admitted Exhibits 369, 370 and 370C.)

MR. BUTLER: Can I ask about your ruling with respect to 369? That article contains some factual assertions for which no foundation has been offered. There's been no testimony that Professor Kahn either examined or is aware of the relationship of prices to costs for services offered by U S WEST in the state of Washington, nor has there been any testimony that Dr. Mayo has made such a study. My understanding is he was simply asked whether he agreed with certain statements about principles in that article. Is your ruling to the effect that this article is admissible for purposes of establishing the truth of the factual assertions contained in it?

JUDGE WALLIS: No. Let's take a 10 minute break.

(Recess.)

JUDGE WALLIS: Let's be back on the record. I'm not sure whether the ruling on the last exhibit was clear. The document reflects a letter to a publisher from Alfred Kahn and I'm satisfied that it's authenticated as Dr. Kahn's letter and it was discussed in the testimony of the witness. If Dr. Kahn cites a fact, the credibility of that fact depends upon the credibility of Dr. Kahn, and the fact that it was published doesn't prove a fact. Is that clear? Let's move on in the examination of Dr. Mayo. Continue questions from public counsel.

CROSS-EXAMINATION

BY MR. MANIFOLD:

Q. Morning, Dr. Mayo. My name is Rob Manifold. We met a little earlier. I'm an assistant attorney general, I represent public counsel in this case.

A. Good morning.

Q. I would like to pick up where the company left off, you were talking about elasticities. Do I understand that what you're saying is if everything else is equal is the elasticity generally lower for monopoly services than it is for competitive services?

A. The firm level elasticity is, yes, price elasticity of demand, yes.

Q. So if I understand it you're recommending that those services with low elasticities, which would be the monopoly services, be priced above incremental costs and those services with higher elasticities, such as those purchased by AT&T in your testimony, be priced at incremental cost?

A. Well, there was a big contingency. If you would go back to the questions, my recommendation would be first and foremost for economic efficiency purposes for effectively competitive services let the market handle it. For services that are offered subject to a significant monopoly power let's look at the competitive benchmark and say we need regulation to do what a competitive market is not in a position to do, and that is to establish prices that are efficient. For those services I would recommend pricing at TS LRIC to generate allocative economic efficiency, to send consumers the right price signals, to send signals regarding efficient investment and so forth. That recommendation carries with it a number of economic benefits including the promotion of competition which has been so vital in this state.

What we were talking about a moment ago or I was discussing with U S WEST counsel was a contingency, and it's not clear that that contingency is going to be realized in the state of Washington, and that's a contingency that says, if by doing so, if by setting efficient pricing, which we know carries all sorts of benefits with it, you've got a revenue shortfall, you're not going to have a situation where the firm is financially viable, then you're stuck in a dilemma of how do you handle that and where do you raise prices or alter prices in a way to minimize distortions to economic efficiency. Again, if you look at the sorts of services that that we're talking about, let's say access services that are 1200 percent higher than their incremental cost and the question is can you bring those things down toward their cost, do local exchange services cover their costs, and there's been a fair amount of discussion and debate about that, it appears that at least for a far wider set of customers than might have previously been thought, prices appear to be compensatory.

So, in that particular case, it's not -- again it's not clear that you're going to have to deviate from the conditions that I just suggested. If, however, if, however, you did, then standard economic logic suggests that you establish prices and have them deviate from their incremental cost levels in a way to minimize distortions to usage, to usage, that would occur under conditions of complete economic efficient pricing. And that requires that you raise prices more on the services that would be less elastic than on those services that are more elastic. So it's a long winded answer but I thought it was important to condition where we were when I answered that question.

Q. Are you familiar with the term Ramsey pricing?

A. Yes, I am.

Q. Could you define that or explain it?

A. Sure. Ramsey pricing is a term that was -- well, the term wasn't developed by Ramsey. Ramsey was the father of the notion, and it stems back to the 1920s from public finance taxation. It was repopularized by professors Baumol and Bradford in 1970. What it said in the context of public utility pricing is this: If you have a natural monopoly, if you have a natural monopoly so that pricing at the levels that I just suggested we ought to in competitive markets are absolutely and unequivocally noncompensatory, that is to say, that marginal costs lie ubiquitously below average cost, so that it is absolutely necessary to raise prices above cost, how might we raise prices above cost in a way that minimizes distortions to economic efficiency.

Assuming that you charge a single price, that it's five cents per apple for all the apples that you sell as opposed to volume discounts or increases on volume.

Q. An example of volume discounts would be different charges for different rate blocks of electric service?

A. Exactly. That, let's say in the electric utility industry you charge more for incremental units of kilowatt hours as you increase purchases, let's say. But if you're in the world of uniform pricing where the price is constant depending on how much you purchase, then what Baumol and Bradford suggest, following Ramsey back to the 1920s, is that to minimize distortions to economic efficiency that you would raise price in inverse to the price elasticity of demand for those services, and that's Ramsey pricing.

Q. Do they relate that to the pricing strategy that a monopolist would employ, the preferred pricing strategy?

A. There is a relationship because if you took an unrestrained monopolist and allowed it latitude to engage in price discrimination across various services it too would take advantage of those elasticities to set prices higher for goods that have a lower elasticity demand.

Q. Do you have any opinion on the elasticity of demand for residential local service?

A. Yes.

Q. What is that?

A. For the demand for access to the local -- the demand for access to the telecommunications network is very, very price inelastic, somewhere in the neighborhood of minus .01 to minus .07 would be a range of estimates, but it's very near zero. That's based on studies that I've done and studies that other people have done. It's very inelastic. That is to say, you could raise price and not very many people would drop off the public switch network.

Q. So would you agree that a monopolist who was not restrained would have an incentive to maximize profits by increasing prices most to those inelastic portions -- those most inelastic portions of its services and lowering prices to its relatively more elastic portions?

A. In a relative sense, yes.

Q. Do you have in front of you the proposed exhibits I handed you earlier?

A. Yes, I do.

MR. MANIFOLD: Your Honor, I would like these to be marked if I could. There are four.

JUDGE WALLIS: Are these the order in which they're presented, the order in which you want them marked?

MR. MANIFOLD: It isn't the order I was going to mention them but it doesn't really matter.

JUDGE WALLIS: Exhibit 371 for identification is assigned to request No. PC 19. The document designated request No. PC 22 is designated as 372 for identification.

Let's be off the record.

(Discussion off the record.)

JUDGE WALLIS: Document identified as data request No. 45 is marked as 373 for identification. Document identified as data request No. 46 is marked as 374 for identification. Document -- that concludes it. Very well.

(Marked Exhibits 371 - 374.)

Q. Dr. Mayo, do you have in front of you what's been marked as Exhibits 371, 372 and 373 and 374?

A. Yes.

Q. And do those represent your answers to certain data requests asked by public counsel and AARP?

A. Yes.

Q. And are they true and correct to the best of your knowledge?

A. Yes.

MR. MANIFOLD: Your Honor, move for the admission of Exhibits 371, 372, 373 and 374.

MR. WAGGONER: No objection.

JUDGE WALLIS: The documents are received.

(Admitted Exhibits 371, 372, 373 and 374.)

Q. Is it the case that you are not testifying as to whether or not the incremental costs of all of U S WEST's services in monopoly markets and its allowed prices in those markets that have been classified as nonmonopoly or competitive, you are not testifying as to whether or not all of those add up to its revenue requirement or not?

A. No, I'm not. No, I am not. I am encouraged to note some of the cost statistics in that regard but I have not added up those.

Q. Do you differentiate between joint and common costs?

A. Yes.

Q. Could you explain the difference.

A. Often it is thought that a set of -- that there may be an underlying asset or good or service that provides goods or services, multiple goods or services, but that those multiple services sometimes are produced in fixed portions and sometimes produced in variable proportions. If they are produced in fixed proportions then it is said to be a joint cost. If they can be produced in variable proportions then sometimes it is referred to as a common cost.

Q. The most common example or a common example of what's cited as a common cost is the president's salary?

A. Sometimes, yes.

Q. Depends on what he does?

A. It does depend on what he does.

Q. Or she does?

A. Yes, these days.

Q. Do you think it's appropriate for joint costs to be shared by the services which use the joint costs?

A. Ask the question again, please.

Q. Do you think that it's appropriate for those products which use the joint cost, that is, which are produced in fixed proportion to particular set of costs to bear a portion of those costs?

A. Well, you're asking a pricing question here about the pricing of multiple products and the existence of joint costs. Pricing is a very, very difficult issue when it comes to joint, truly joint, costs. That if you've got some asset that produces something in absolutely fixed proportions then there's no variation in the relative outputs of those and it's really not possible to then establish a set of prices on a cost causality basis for variations in any particular output because there is no -- there's no way to link the costs that are observed and the particular output.

Q. So is your testimony that you would exclude joint costs from a consideration of the incremental costs of those services or a product?

A. For a particular service, yes.

Q. But you would exclude it from the calculation of all of those products that related to that joint cost?

A. Yes. It's not part of the incremental cost attributable to any particular product in that case.

Q. Would you agree that when a customer orders telephone service at a particular location they are generally ordering both local service and access to toll, interstate toll, and the ability to receive calls from those areas' types of services?

A. The way I think about this is that customers -- and this is I think relatively common analysis among economists these days, is that there is a demand for access to the telecommunications network. Consumers have a bona fide demand for access and when they call up they get that access and when they continue to stay on the public switched network they cause various costs to be incurred. There are, additionally, demand for local usage.

Q. Perhaps you could answer the question and then give your qualifications on it. I'm not sure if you're saying, yes, no, or it depends.

A. Perhaps rephrase the question so I don't go off from where you want me to go.

Q. Would you agree -- fortunately it's written down here -- would you agree that when a customer orders telephone service at a particular location in general they are ordering not just local service but also telephone service that includes access to toll, interstate toll and the ability to receive incoming calls from those various services?

A. Yes. That's my point is that they are purchasing, there's a demand for access, there's additionally a demand for usage of local and long distance.

Q. Are you aware of any tariff in this state, in U S West's territory that prices or offers simply access to the switched public telephone network?

A. I think that's what the dial tone rate would be is by purchasing that on a monthly basis you purchase access. It turns out that it is also, through the mechanism of bundling, bundled with local usage, so that you also purchase the ability to use local telephone -- network for local usage. But it certainly purchases access to the network.

Q. What about the services that the interexchange companies buy? Aren't they purchasing access as well?

A. They're purchasing access to the public switched network. They don't purchase usage for that, that's right.

Q. Did I understand in your earlier responses that value is not a concept that you as an economist would normally include in setting appropriate prices?

A. That's correct. As we described earlier in our discussion of monopoly pricing, monopolists price to reflect the value that they can extract from consumers. Competitors are driven to price to the costs that are caused by the act of subscription or usage.

Q. And that would be what we would might call monopoly rents, the former?

A. Yes, if you're allowed to price at the value of service, although sometimes value of service pricing has been constructed historically through the regulatory process as well.

Q. On page 12 of your second set of testimony, Exhibit 367T, you discuss some testimony by Mr. Dunkel, you're not suggesting by this testimony, are you, that Mr. Dunkel was suggesting that reducing access charges would not lead to reduced toll rates to customers but rather that was one of several scenarios that he was covering of all of the possible outcomes?

A. I think that's correct. I certainly didn't mean to project an image of Mr. Dunkel saying something that he didn't. What I was saying here is simply that if costs fall to competitive enterprises that those costs will, by the competitive process, be driven to be passed along to consumers.

Q. Over the long run, in an optimal situation?

A. I think in the interexchange industry they would be passed along. And the long run may be very short. It may be a relatively short period of time and at least history or history of the last ten years has borne that out.

Q. Just to verify on elasticities what we mean when we talk about elasticities is that if you have a

price reduction that will cause a higher demand than you would have had if you had no price reduction?
A. Technically it will cause a change in the quantity demanded as opposed to demand. It's a technical difference but other than that qualification, yes.
Q. Have you had occasion to examine at all the revenue impact that U S WEST has calculated from its proposed decrease in switched access price reduction to the IXCs.
MR. SHAW: I think I'm going to object. That's totally beyond the direct or the rebuttal. There is no mention of it whatsoever.
MR. MANIFOLD: That's why I asked him. I'm not sure if he included that in his review or not.
JUDGE WALLIS: The witness may respond.
A. Was the question am I aware of?
Q. Yes.
A. I am aware of -- I have read the testimonies in this case or at least attempted to read almost all of them and I know that, for instance, Ms. Wilcox, I believe it is, looks at the issue of reducing carrier access charges and what the impact would be on U S WEST.
Q. And linking this to your earlier responses

to Mr. Shaw regarding elasticities of various customer categories, would you expect a reduction in price of switched access to interexchange carriers to affect the quantity of demand by those customers?
A. Yes, I would. The exact mechanism would be that if the costs fell what would happen as the price of interexchange services can reasonably be expected to fall, and as the price falls, because there is some elasticity of demand.
Q. Positive elasticity?
A. Well, it's actually negative because as prices are going down and quantity demand goes up there will be an expansion of output of long distance services in this state and that's, by the way, one of the reasons I made the recommendation I did because reducing prices toward their incremental cost you see that expansion of output which is good for consumers.
Q. Putting that in perhaps more common English is what you're saying that if the prices charged by AT&T go down you would expect more people to make more or longer long distance calls?
A. Yes. I'm sorry I didn't say it in English.
Q. That's not your job, that's my job. I think I should stop with plain English. Thank you.
JUDGE WALLIS: That concludes your

examination?

MR. MANIFOLD: Yes.

JUDGE WALLIS: Mr. Roseman, you had a few questions?

MR. ROSEMAN: Yes, I do.

he (MAYO - CROSS BY ROSEMAN)

CROSS-EXAMINATION

BY MR. ROSEMAN:

Q. Good morning, Dr. Mayo. My name is Ron Roseman. We met earlier. I represent the American Association of Retired Persons.

A. Good morning. Good to see you.

Q. I'm interested in whether you have looked at any correlation between age and toll usage or income and toll usage.

A. My own studies have not broken down age and toll usage. With respect to income and toll usage what I find is that I have in the past examined that. There is, to put it in not so common English a positive income elasticity of demand for toll usage. But to put that in English, as income goes up the demand for long distance goes up.

Q. Are you aware of a study produced by AT&T the Consumer Federation of America and the American

Association of Retired Persons called the joint telecommunications project that looks at this issue?

A. No. I'm sorry, I have not looked at that.

Q. Would you accept subject to check that according to this study --

MR. SHAW: Objection, Your Honor. He just said that he's not familiar with it. Be totally inappropriate for counsel to try to put words into this witness's mouth.

MR. ROSEMAN: The study was done by AT&T. This is an AT&T witness. I will tell him what at least two lines of what the study says and he is free to check it at a later time. If I am incorrect on it or misstating it he can or his counsel can correct the record.

MR. SHAW: Totally inappropriate. Counsel is testifying is all it is.

JUDGE WALLIS: I'm going to allow the question.

Q. I believe it is consistent with your study which says that low income households report lower toll usage and it also says that the elderly households report lower toll usage. With that in mind, I want to talk about your universal service testimony that I believe is at page -- it's in your rebuttal testimony, page 18 and with an answer on 19. I'm not going to refer to that directly but I just wanted to kind of give you an indication of where my questions were coming from.

I presume that you're assuming that -- and if I'm incorrect please tell me, that if toll usage goes down -- I'm sorry. If the price of toll goes down due to, I think, maybe a reduction in access charges, or for whatever reason, and the local service rate for residential customers goes up that generally customers will not drop off of the system because their total bill would be approximately the same. Is that a fair summation of your view on universal service as related to page 18?

A. In general I think the answer is yes, but let me elaborate just a bit, because this is a relatively new area of research for economists and I think it's an important one. We've assumed on a public policy front for a long, long time that prices needed ubiquitously to be low for local exchange customers to promote universal telephone service, and that there was really no cost to be borne from raising the price of long distance service for that, that that was okay. What I have found in my own research, and it's been corroborated in a couple of other places, is that it turns out that the price of long distance service actually does matter with respect to household penetration rates. That if the price of toll service is driven higher through attempting to garner revenue flows from, let's say, access charges, it really does drive people off the network. That there's a price to pay for that pricing distortion not only in terms of allocative efficiency and economic efficiency but also harms universal service to jack up long distance rates to maintain high long distance rates. That's a very fundamental result I think, very powerful.

It's also the case that price elasticity of demand for local service is quite low, which means that if we needed to raise local rates -- and again it's really far from clear in this particular case when you look at the relationship of rates to some of the cost estimates -- that that has to happen. But if it had happened that you would pay a very small, a very, very small price in terms of people dropping off the network because that price elasticity of demand for local service is so low. And the third thing I think that is important and fundamental here is that in my own research we've now documented the very important nature of targeted assistance schemes. We've now verified that targeted assistance schemes like Life Line and Link Up, which I know are both part of the pricing structure in Washington, are very important in maintaining people on the network and that provides, then, a very credible option for policy makers to encourage and promote universal service. To not worry, as I've said here in my testimony, my written testimony at page 18 that -- we don't have to worry about competition and the movement to efficient pricing harming universal service. I'm very, very comfortable about the maintenance and promotion of universal service as we move to efficient pricing and competition.

Q. So are you saying to me that due to the elasticities that if toll goes up there would be very little -- there would be a great loss of people dropping off the system. That it would affect universal service, but if local service went up from I think the average of 10.50 in this state up to $26 in a month is the proposal from U S WEST, that it would have very little effect on universal service?

A. No. I didn't put it in terms of a great impact or a small impact. I certainly did not mean to suggest that a movement from $10 to $26 on local service wouldn't have an impact on universal service on household penetration rates. It would. The price elasticity of demand is relative small for local exchange services. As a result, there wouldn't be a very, very great impact. If it were necessary. Again, other people can speak to this but if you look at the relationship of rates to incremental costs that have been offered in this proceeding I think, again, one of the real messages here is that a far smaller set of residential customers seem to have prices that are below cost than one might have thought a year ago or two years ago.

But what I am saying is that there is a price to pay for maintaining access prices and toll rates above their economically efficient levels. That's what I'm saying. It may be possible to, for instance, fully embrace efficient pricing for local services, pricing it to reflect its incremental cost that would not involve a price increase reducing the price of toll services to reflect its incremental cost or access to reflect its incremental cost to maintain an active policy of targeted assistance to those households who are in need of assistance, in fact to be more compassionate than we are today. And we would have accomplished all of those things. It would have increased and enhanced universal service. And you would have promoted competition and efficient pricing

to boot.
Q. But as you said earlier it was really the total bill, the combination of the toll and the residential service that one looks at and for those customers that use little toll or no toll they would see only a large increase in residential rates with no offsetting reduction in toll. Are those individuals vulnerable to leaving the system?
A. By and large I think the answer is no. If it happens -- again it may not have to happen in this case but for prices to be compensatory you may not need the sort of rate increases that are being advocated and championed by U S WEST. You may not need any. But if costs are above prices then the standard economic prescription -- and I will stick to this -- is to move prices to reflect those costs, and if there are customers that don't use a lot of long distance service then I think it is both efficient -- it is still efficient to have those prices reflect the costs and it is fair to have the price reflect the costs because those customers are causing those costs to be incurred. If there are customers who are vulnerable because, let's say, they have low income then I think again the basic research here, and it's a very important message is that we should be very

compassionate and help those people who need that targeted assistance. I strongly endorse that, but there is absolutely no reason in the world for someone in the San Juan Islands who has an income of $250,000 a year to not pay the full cost associated with subscribing to the local telephone network.
Q. I thought compassion was out during these times?
A. I realize that and I'm a bit out of sync in that.
Q. Let me ask you, have you done any calculations to determine how much reduction in toll would be necessary to offset a $16 a month increase in residential rates?
A. No.
MR. ROSEMAN: Nothing further.
JUDGE WALLIS: Any further questions from counsel? Commissioners?
COMMISSIONER HEMSTAD: I will pass.

EXAMINATION

BY COMMISSIONER GILLIS:
Q. Hi. I have a couple, I wanted to follow up a little bit on some questions that Mr. Roseman was asking about universal service. I think you answered

these to some extent, but I would like to make sure I understand your position on it. On page 39 of your direct testimony on line 3 and 3 through 6, that area, you state "there are a number of reasons to believe that the emergence of competition will have no adverse impact on the achievement of universal service." And I would like to ask you if that statement is premised on the assumption that there is sufficient safeguards in place to prevent cost shifting from customers in competitive market segments to customers in less competitive market segments?

A. I didn't have that in mind when I wrote that. I guess what I -- and I will stall while I think of the answer in that direction, but what I had in mind, what I really had in mind here is that there has been an historic concern over the last ten years -- we're really dating back over the divestiture -- that incumbent firms have traditionally -- including AT&T when it was the single provider of interexchange service -- they have said don't let competition happen because if you let competition happen there will be cream skimming and our ratepayers will be harmed and people will drop off the network. That claim was made 15 years ago and it's still being made today. It was made in 10 XXX competition cases for intraLATA around the country. They said oh, please, don't let there be competition. Not saying it happened here but I'm saying around the country it happened. Don't let there be competition in intraLATA toll markets because what will happen is there will be this entry by these evil cream skimmers. It will lead to the erosion of our revenue base, and local rates will be raised and universal service will be harmed. It turns out that that hasn't come to pass for a variety of reasons. What happens is competitors do respond to -- incumbent firms do respond to new entrants. They respond by offering better services and competitive prices. Prices are generally driven down and consumers have stayed on the network. In Washington the universal service rate, household penetration rate, has increased from 93 something to 96, almost 97 percent today. It's happening in an era when we have been opening markets to competition. It's that reason, that general study of the industry that gives me confidence that at least in part that universal service won't be harmed. It is also true that some safeguards have been put into place in the form of these targeted subsidies schemes, Life Line, Link Up, WATAP has been put in place.

Now with respect to your question are there sufficient regulatory safety guards to present that cost shifting. That's unclear. Particularly if you are in a rate of return regulated environment firms will have an incentive to bury those costs in monopoly services and to allow financing of competitive ventures through below cost pricing. Those incentives are in place, and I'm not sure that they haven't on occasion been tested and abused. I guess by and large they've been relatively successful. I suspect you have been here in Washington or I would have heard about it in the testimonies.

Q. Let me ask it with a more specific example, an extreme case example of that, of most I guess analysts things that I've read, suggests that competition is emerging more quickly in the urban areas than, say, isolated rural markets?

A. Yes.

Q. And that there is a potential to, within -- if we were to leave it to the market anyway, as you're suggesting -- the costs to be shifted from the customers in the competitive markets, which in this case, in the simplified case let's say is the large urban centers to the customers in the isolated rural segments where competition isn't present, and given all of those assumptions, is that something you worry about? Is it something you're assuming away in making the statement?

A. No, it is something that I worry about and again in the context of this specific case, let me give you an example. It doesn't necessarily involve cost shifting but alteration of prices to accomplish it precisely the phenomenon that you're talking about. There is a recommendation to enact zone access pricing, it's made I think by Ms. Wilcox from U S WEST, that says what we would like to see is to be able to price carrier access service at a lower rate in urban areas than in rural areas. Now, the consequence of course is that those higher costs, those prior prices ultimately get passed along to rural customers and lower prices would get passed along to urban customers. This recommendation is made completely independent of cost differences. There are the sole recommendation for that recommendation is that there appears to be emerging competition in the urban areas but not in the rural areas. So the recommendation is admittedly price discrimination. That's not saying that all price discrimination is bad. Some price discrimination can be procompetitive but dating back to 1914 with the passage of the Clayton Act we have a current price discrimination when it is conducted by firms with significantly monopoly power. So you've got a firm with a significant monopoly power suggesting that it wants to alter prices that have nothing to do with costs but only have to do with the present emergence of competition. Acknowledges that the only reason it is not lowering the price in the rural areas is because there's no competition in the area. Acknowledges that in the urban areas the only reason the price is as low as they are proposing is because of the prospect of emerging competition. What you've got there, then, is an attempt, clearly, to truncate the emergence of competition in the urban areas to allow the prices to be high where competition has emerged and as a result you really have the worst of both worlds because what you've done is establish a set of prices that deny the full benefits of competition that is emerging. You're saying I will only allow you to get the benefits of competition as a customer if there is a viable alternative, and it doesn't pass along the benefits of that competitive emergence to those customers who aren't right there on the margin of being there served. So it's exactly the same phenomena as a cost shifting scheme.

Q. Let me see if I can summarize what you said

to make sure I understand it and you tell me yes or no. The statement you made, there are a number of reasons to believe that the emergence of competition will have no adverse impact on the achievement of universal service, and as I understand your answer putting together the pieces is that that's conditioned on the assumption that the market or in combination market and regulation will result in a performance that's similar to what we would expect from efficient market competition in all markets?
A. That is precisely my point is that if you do your job of, I think, of establishing efficient pricing and promoting competition and enacting the safeguards that I've talked about in my testimony I'm confident that universal service will not be harmed. If you do not, then I would be far more fearful for precisely the sort of example that I mentioned.
Q. I think what I said was that the market would perform in a result that would be similar to what we would receive from competitive markets which would -- it's a little different but --
A. Okay. I didn't mean to twist your words.
Q. I'm not stating that. I'm asking you; is that correct?
A. Yes, that is the case.

Q. How successful has been traditional universal service policies in your opinion, one to ten, with ten being very successful and zero being the other extreme in this country?

A. Let me give it a six by accident. And it's got to be greater than five because we have high penetration rates and there's no contesting that. In Washington I said it's almost 97 percent today. So you can't really quibble with the outcome. What I take considerable exception to is the fact that we waste so many resources on accomplishing that and we could -- we don't need to, at least historically we have not needed to offer residually based pricing for local telephone service to every citizen in the state of Washington. Certainly I would just guess that there's not a single soul in this hearing room that would ever need a subsidy on their telephone bill to be able to stay subscribed. So if, for instance, there is anybody here who happens to reside in the area where their cost of serving that customer is above the price, then moving that subsidy, if you will, is wasted because that customer could pay the full cost and would stay on the network anyway. And there's a cost to be paid, as I said, because any pricing of access services up above their incremental cost is causing harm to long distance pricing and universal service. So we waste a lot of money with these relatively -- at least historically -- with these relatively gross subsidy flows. We should, I think, in general target assistance to those people who need the subsidy to remain on the network and finance it very, very broadly. That's a standard economic prescription. Target the assistance and finance it broadly. If you think about it, though, what we've done is precisely the opposite in telecommunications. We've targeted all consumers through a policy of residual pricing yet we've financed it very narrowly on long distance services which it turns out have a cost. So that's why I would not give it any higher marks.

Q. Let me restate it and you tell me if I'm right. What you're saying I think is that you feel that performance of universal service has been adequate or maybe good in terms of the penetration rates and affordability if we can call it that but the efficiency in reaching that performance has been not what you would like to have seen?

A. Abysmal, I think.

Q. And your position is that through competitive markets we can be more efficient in achieving those goals?

A. I do think that's correct.

Q. Different set of questions. I didn't quite understand your definition of effective competition.

A. Effective competition is the absence of significant monopoly power which of course begs the question what do you mean by significant monopoly power. But there we have long distance literature and economics and antitrust law of what constitutes significant monopoly power and how you measure whether a firm has significant monopoly power. Fortunately, for you that literature is really congruent with I think it's called the regulatory flexibility act that suggests that you look at a variety of criteria to determine whether there is effective competition in this state. It's very congruent with the economic definition of effective competition or the absence of significant monopoly power. I also have a textbook that deals with this if you want to look at it.

Q. I guess what I'm after is I think what I had heard you say -- wrote down an approximate quote -- that monopoly power is when a firm can raise prices in a substantial fashion -- I think you had another word in there -- and sustain those price increases for a long term. Is that what your --

A. Yes.

Q. Is that necessarily -- is it possible with that definition to have market power with multiple firms as well as just one monopoly? In an oligopolistic situation, for example?

A. Sure. Typically there are two types of monopoly power that one can talk about. One is single firm or unilateral monopoly power and that's I think been the issue primarily in this particular case. What we might refer to as a contrived monopoly situation can in markets generally also exist in that it would be a case of collusion among a set of oligopolists, let's say, to achieve anticompetitive results that they can achieve by acting independently.

Q. I guess what I'm getting at, though, to be sure I understand you, that just simply the act of introducing more firms to a market isn't necessarily going to reduce or eliminate the market power of a dominant company?

A. That is absolutely the case. If you were to only look at the number of firms, if that were the only thing you were looking at, well, in saying as we move from one to two then we move from monopoly to effective competition that would be far too simplistic an approach or from two to three.

Q. Following that down the chain a little bit you emphasize the need to set prices for maximum economic efficiency. You spent a lot of time on that?

A. Yes.

Q. If we accept the assumption that certain services are currently priced above TS LRIC, does efficient pricing rules make it necessary for us in the regulatory community to allow downward price flexibility to the companies if they're priced above at the present time TS LRIC?

A. That's a good question. In the case of if the service is effectively competitive then not only would downward pricing flexibility be warranted but upward as well, but downward, too.

Q. Even if it's not effectively competitive.

A. Right. There you have to be a bit more cautious about it. I think certainly some downward pricing flexibility to respond to competitors may very well be warranted to the extent that it's competition on its merits. The reason you need to be a bit careful is because of proposals where there's not effective competition, like the one I mentioned a moment ago with zone pricing wherein some amount of flexibility might be enacted not as a step toward really competitive pricing in a marketplace but rather as an attempt to preempt the emergence of competition. So you need to be very cautious about those sorts of promises.

Q. If we don't as a regulatory community allow downward flexibility in a market that has emerging competition but is not yet competitive, are we running the risk of encouraging uneconomic bypass?

A. Yes, you are, and that's precisely why we're in a gray area here. There are two offsetting things going on. One is the need to allow the firm to respond to bona fide competition to compete on its efficiency merits. And the other is that if the firm retains significant monopoly power, it's not a pure monopolist but it retains significant monopoly power, then there is at least the prospect that particular pricing proposals that are brought forth may not be, may not satisfy the goal of advancing competition on its merits but rather really wind up being only a very selective and targeted response that truncates the emergence of the competition that we would all like to see. So it's a very gray area to be completely honest with you.

Q. That I guess raises a dilemma for us that we face in this case and you've provided some testimony on, at what level do we set those prices?

A.   Right. An area -- one area that springs to mind in that regard might be intraLATA toll pricing, for instance, and here you have the emergence of a number of competitors that technically at least at this point can provide intraLATA toll services, and there may very well be a bona fide need by the incumbent firm to respond to that competition. There are certain things that I think again going back to our earlier discussion, there are certain things that you can do to remove that dilemma a bit. For instance, I think that once you have eliminated the dialing disparity in intraLATA toll that you've essentially put all competitors on an equal footing of one plus dialing. Then it surprises me that U S WEST would have a relatively strong case to be made for the existence of effective competition at marketplace and you could move pretty much forthwith to allow the firm pricing flexibility in that regard. So there may be things that you can do to avoid making that dilemma as harsh as it might otherwise be, and I would like for those areas --

Q.   It's the dynamics that are confusing, and if I heard you right in your testimony, and I read it, is that you're suggesting that in general services should be set at TS LRIC. Is that right?

A. For services that are subject to significant monopoly power, particularly those inputs that are necessary predicates for competition to emerge at the retail level, because if you start marking up the price you will not only have damaged economic efficiency but competition.

Q. That I can follow but I'm thinking about these particular services that are priced above TS LRIC at the present time that are provided by a monopoly in an environment where we are assuming we don't yet have effective competition but is emerging competition?

A. Right.

Q. And the challenge that you discussed earlier with me was that if we don't allow downward price flexibility we risk the -- the possibility of uneconomic bypass by new entrants. At the same time do we want to price those at TS LRIC or do we want to price it at some level above TS LRIC to accomplish the competitive goals. So where do we price them?

A. Well, clearly for economic efficiency purposes, pricing those to reflect the incremental cost creates a number of benefits. It sends consumers the right price signals. It sends investors the right price signal so you avoid that uneconomic bypass. It is consistent with cost causation and so on. Now, if for some reason whether it's -- and I can't second guess what might this be in your heads, but if you feel compelled to say we need to have some prices above that level, above incremental cost, whether it's to provide some element of contribution, so-called contribution, to joint common costs or overheads or what have you, then you can do that.

What I am trying to point out is simply that as you move prices increasingly above incremental cost that consumers will respond by getting poor price signals. Investors will respond by potentially possibly entering the market even though they're less efficient than the incumbent firm. That you will move away from principles of cost causation and so on. But if you feel like you need to do that for, let's say to maintain the financial viability of the firm, the concerns that U S WEST has raised, then do it by -- mark up those rates three percent or five percent or eight percent but cognizant of the economic costs that you're bearing when you do that. I'm not in your job. I have the job of providing economic counsel here and telling you what the economic benchmarks are. I really think that's a tough job when it comes down to actually setting those prices. I'm just asking you to be very cognizant of what those economic benchmarks are when you do set those prices.

Q. I'm monopolizing the conversation so this is going to be my last question, but what I would like to pursue is whether or not I hear you correctly that there's I guess a potential tradeoff in this dynamic situation here of environment I just described of uneconomic -- inefficiencies of uneconomic bypass of new entrants by setting the prices too high on the services versus the potential of inefficiencies of allowing the incumbent providers to set prices above TS LRIC for those particular services. They're competing, competing goals or competing inefficiencies that need to be weighed. Am I hearing you right?

A. I think so. Yes, I believe you are. We talked about this dilemma and tradeoff of pricing in emergingly competitive markets, markets where competitors are emerging and the need of firms to responsible. Clearly if you've got effective competition my recommendation is -- and there's a vehicle to do that. They can bring those petitions to you, they have a way of handling that. In the area of significant monopoly power in general I would recommend that you pay a lot of attention to those economically efficient guideposts, cognizant, though, of the need for the incumbent firm to respond with bona fide responses, legitimate responses to the emergence of that competition.

Q. As I hear your testimony, the TS LRIC for a service of the type we're discussing would be a clear price floor that we would want to use because we would be, for all the reasons of preventing cross subsidies and other inefficiencies, but what's less clear is how much of an increment above TS LRIC is appropriate in an emerging competitive market for an incumbent service?

A. Let me put it this way. You've drawn an important distinction. For purposes of preventing cross subsidization it is clear that TS LRIC constitutes a price floor. My recommendation regarding prices that reflect incremental cost is predicated -- it turns out to use the same term but it's predicated on another fundamental concept and that is that pricing at incremental costs generates allocative efficiency. It generates that efficiency by sending consumers the accurate signals regarding the costs that they are causing the firm or more generally society to incur from the consumption of that good or service. So that if a long distance consumer uses more long distance service and causes the local exchange company in the process to incur incrementally some additional costs then it ought to be the case that that long distance consumer pays the price that accurately reflect the costs that are -- that he or she is causing the local exchange company to incur. That's very important. That's a benchmark that I think is unwavering.

What I am trying to I think agree with you on is that while those economic principles are unwavering that -- and I think they are very compelling -- that I don't want that -- those benchmarks to be seen as a complete take it or leave it proposition. That if you say, well, that's all very well and good but if we don't -- we're not in -- we're not going to set prices to precisely equal TS LRIC because we're concerned that it might not generate enough revenue for the firm in the case of, in the context of a rate case. Then I'm saying that if you have to move rates above those costs for services like carrier access then do so cognizant of the fact that you are causing economic efficiencies, moving it up three percent, moving it up five percent, eight percent. Today they're 1200 percent above their cost. That honest to goodness creates millions of dollars of welfare losses to the citizens of Washington. That's what I'm saying. That it may not have to be a take it or leave it situation but please pay attention to the economic guideposts, and I have no reason to believe that you're not going to based on reading things like the interconnection orders.

Q. Thank you. That was interesting.

MR. WAGGONER: Given the hour I will try and be very brief with redirect.

JUDGE WALLIS: Commissioner Hemstad.

EXAMINATION

BY COMMISSIONER HEMSTAD:

Q. I believe you testified that there may not be a need for any local residential price increase, if I heard you correctly?

A. Yes.

Q. And that's reflecting your review of the testimony from others in this proceeding. Do you have an opinion based upon your approach to cost and price analysis whether whether U S WEST local residential prices are currently above their cost?

A. Well, I have read the same testimony that I think you've read in this regard. Three years ago I had the opinion that along with a wide variety of other people that by and large local exchange rates were below cost. As various studies have emerged around the country, including here, it appears that a far smaller set of customers than I might have envisioned actually have prices that are less than their cost. There's a variety of cost estimates on the table. U S WEST has one set, staff has another. There's a study done by Hatfield and Associates that has another that generates a set of costs that are out there. At least with the Hatfield study what you find is that costs are a bit sensitive to whether you live in a rural area or an urban area, but that for the majority of customers prices tend to be compensatory today. That there are customers for which price is below costs it's a much smaller set than we used to believe and it's primarily those folks that are living in very rural areas. If that's the case then you don't quite so much have to worry about the need to -- a tradeoff of rebalancing rates but you can just start looking at creating efficient prices generally without having to go through the considerable angst of raising dramatically local rates. That you can enact efficient toll carrier -- toll and carrier access rates without dramatic adjustments to local exchange rates.

Q. Does that reflect your reassessment of the

-- of your assumption about what is occurring with regard to cost or does it reflect an assessment that costs are relatively rapidly declining?

A. I think it more reflects the latter, but it's just an intuitive feel from being a student of the industry that costs have been declining quite rapidly. Switching costs and the efficiencies of not just switching but labor costs as well in the forms of local exchange companies and interchange companies and the like becoming more efficient over time. There may be considerably more that can be done in that regard but I think costs are generally falling and that may be the reason why we see rates that appear now to be compensatory when they weren't or weren't considered to be five or eight years ago.

Q. Well, your testimony would have us very substantially reduce access --

A. Yes.

Q. -- charges to local residential service. Assuming it would follow from that that the revenues for the company would decline measurably unless in turn the company is to make that up in some additional volume sales. Won't there be a revenue shortfall?

A. Well, I'm not part of the entire case here, so that's ultimately your judgment about whether the revenues that would be received in that world of efficient pricing of, let's say, carrier access would allow the firm sufficient revenue under this rate case to go forward and to be approved. If local rates are below their cost then certainly it may be necessary to -- and I would advocate -- moving those prices to reflect their cost together with a very targeted but very compassionate scheme for those people who might be at risk associated with price increases. If prices -- if you judge prices to be compensatory for the large part of the customers -- that is to say that local exchange prices currently exceed their costs and are generating that revenue -- then it's unclear that anything negative will happen as a result of reducing those carrier access prices. It's very, very uncertain. And what is certain that there will be a lot of benefits associated with that in the form of generating economically efficient pricing for toll services that, again -- and I can't stress this enough -- will create millions of dollars of benefits for the consumers of the state of Washington. It has been remarkable to see the explosion of long distance usage over the last ten years that have been brought about by in part reductions in carrier access charges. It doesn't seem to me to be just fine in a world where

we're trying to promote competition to take cost elements like the carrier common line rate and the residual interconnection rate for which there is no incremental cost and to continue to glom those on to input prices that are ultimately being paid by consumers in the state of Washington and are seriously detracting from the usage of those services. I think that's a little longer answer than perhaps you wanted but that's the full context of it.
Q. Switching to a discussion of universal service, you would be an advocate of targeting subsidies to individual low income families rather than to companies?
A. Yes, I think so. And that's why, part of the reason why, I gave that lower rating. In the past what we've done is flow through revenue subsidies to companies and say go do good things with this as opposed to giving it directly to the people who are in need of those subsidies who we have seen are responsive to the receipt of those subsidy flows.
Q. Well, companies that provide a service to rural areas argue that subsidies need to flow to the companies so they can have some predictability for purposes of their building of those networks. What is your response to that?

A. It may be the case that a subsidy flow to a company in that regard helps not so much on the demand side of getting consumers to subscribe but by building a better infrastructure that they might somehow enhance universal service. Conceptually I will agree with you on that, or with those companies, that it is possible that that's the case. My own research has not found that, those relatively broad subsidy flows.

In the case of Washington I looked at the numbers a couple of days ago, but I looked at a database that looks at universal service funding by state, which goes primarily to those rural telephone companies. In Washington I think it's about $20 million a year that flows to those companies. Nationwide it's almost three quarters of a billion dollars. I haven't been able to find that that's had a measurable impact on household penetration rates and I've tried. I just can't find it. Targeted assistance seems to matter; untargeted assistance seems not to matter. That's what I'm finding. It's a straight up look. From a city's perspective it's a nice opportunity to say let's study the effectiveness of alternative subsidy schemes. I entered into that exercise as an academic exercise, has a very clear message about whether you want to go forward with untargeted subsidy schemes in the future, given that they're A, ineffective, and B, very well may distort competition, the emergence of competition.

Q. With regard to the issue of support for low income families, do you have a view as to whether that should be supported by an assessment against ratepayers or should it be generated from general tax revenues?

A. The broader the financing source the better from an economics perspective. And so as a general proposition, the most general advocacy I would have is that it should be funded out of general fax revenues. That may or may not be feasible in a particular state and I don't know how feasible that may be here in Washington or whether it has been seriously discussed. In some states it has. Missouri, for example, has a general tax funding mechanism for a targeted assistance program. If it is funded from the telecommunications industry it should be assessed as broadly as possible within the telecommunications industry. That would be my recommendation.

COMMISSIONER HEMSTAD: That's all I have.

JUDGE WALLIS: Now, Mr. Waggoner.

REDIRECT EXAMINATION

BY MR. WAGGONER:
Q. I'm just going to ask one short question on redirect and you had a discussion about EAS and local and toll and the possible of a LATA wide local calling area. Let me just ask, is it your opinion that local access is a relevant market?
A. If you're meaning access to the telecommunications network by consumers which is provided by U S WEST I think the answer there is yes, it is a defensible market definition to say that this is a service that has some independent supply supplied by U S WEST, and there is a bona fide and independently identifiable demand for that service. It's been estimated by a number of economists over time and it passes the standard market definition to exercise offered by the Department of Justice, that is to say -- the exercise goes as follows, let's ask ourselves the question if a hypothetical monopolist of the provision of local exchange access were to raise price by a small but significant and nontransitory amount could that price increase be profitably sustained. I won't go through the entire analysis but I think the answer to that is yes. To the extent that the answer is yes, it identifies a relevant economic market.

Q. And is it your opinion that U S WEST has significant monopoly power or market power in that relevant market in this state?

A. Yes.

MR. WAGGONER: No further questions.

JUDGE WALLIS: Are there any followup questions?

MR. SHAW: I have a couple, Your Honor.

RECROSS-EXAMINATION

BY MR. SHAW:

Q. In regard to questions from Commissioner Gillis about costs differences, I understand you two agree that the evidence is overwhelming that costs are higher in rural areas than they are in urban areas?

A. That's certainly I think a consensus opinion.

Q. Both for local exchange service and for local exchange access service?

A. Yes, not so much for toll by the way but for local exchange access, certainly.

Q. And for toll access service also?

A. Yes.

Q. You have done yourself no TS LRIC studies of residential costs in Washington, I take it?

A. No, I have not. I know Dr. Mercer has done such a study.

Q. And I do take it from your testimony that you're a fervent believer in the relevant cost standard is TS LRIC costs?

A. Yes. I think that's a bona fide cost target.

Q. And to identify those studies, unlike AT&T has done, you would have to actually do a study to identify the costs?

A. As I said I have not done such a study. There were a number of studies that have been done in this proceeding. The Hatfield group did one, U S WEST did one. I believe staff has also done cost estimates.

Q. Is it your testimony that the so-called Hatfield study being offered by AT&T in this case is a TS LRIC study of Washington state U S WEST local exchange costs?

A. My understanding is that it is meant to be consistent with the spirit of TS LRIC costing, yes. But I will let Dr. Mercer speak to that.

Q. So you're not here to defend or to put forward the Mercer study?

A. No. I think Dr. Mercer is the author of that testimony and I think a contributor if not full developer of the cost model.

MR. SHAW: Thank you.

JUDGE WALLIS: Further questions? It appears that there are none. Thank you for appearing today, you're excused from the stand. Let's be off the record for a scheduling discussion.

(Lunch recess taken at 12:15 p.m.)

AFTERNOON SESSION

1:00 p.m.

JUDGE WALLIS: Let's be back on the record following our noon break. I want to express appreciation to everyone for the abbreviated break so that we can get the witnesses on and off the stand today. Staff is calling witness Lee Selwyn.

Whereupon,

LEE SELWYN, PhD,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

JUDGE WALLIS: In conjunction with Mr. Selwyn's appearance he has prefiled his direct testimony that is marked as Exhibit 380T for identification. The Commission staff has distributed a brief errata sheet to the direct testimony which is marked as 381 for identification, and the exhibit LLS-1, figures and tables is marked as 382 for identification. Commission staff has also distributed today a replacement page for page 7 of 10 in LLS-1, table 3 interexchange carrier revenues.

(Marked Exhibits 380T, 381 and 382.)

DIRECT EXAMINATION

BY MR. SMITH:

Q. Dr. Selwyn, would you please state your name and give us your business address?
A. My name is Lee L. Selwyn. My business address is One Washington Mall, Boston, Massachussetts.
Q. By whom are you employed and in what capacity?
A. I'm president of the consulting firm of Economics and Technology Incorporated.
Q. Do you have before you what has been marked for identification as Exhibit 380T?
A. Yes.
Q. Do you recognize that as your prefiled direct testimony on behalf of the Commission staff in this docket?
A. Yes.
Q. Do you also have before you an errata sheet identified as Exhibit 31?
A. 381.
Q. I'm sorry, 381?
A. Yes.
Q. If I were to ask you today the questions contained in Exhibit 380T as corrected by Exhibit 381, would your answers be the same?
A. Yes, they would.
Q. And you also have before you what's been

marked for identification as Exhibit 382?

A. Yes.

Q. And is that the exhibit to which you refer in your direct testimony?

A. It is.

Q. Was it prepared by you or under your direction and control?

A. Yes, it was.

MR. SMITH: Your Honor, move for admission of 380T, 381 and 382.

JUDGE WALLIS: Let the record show there is no objection and the documents are received.

(Admitted Exhibits 380T, 381 and 382.)

MR. SMITH: Dr. Selwyn is available for cross-examination.

CROSS-EXAMINATION

BY MR. SHAW:

Q. Good afternoon, Dr. Selwyn.

A. Good afternoon.

(Discussion off the record.)

Q. Dr. Selwyn, is it your testimony in this case that U S WEST in Washington in the past has had an exclusive franchise right and guaranteed opportunity to recover its investment?

A. I don't know that that's my testimony. It's probably a legal question. If you can refer me to where I might have said that.

Q. Reference you to your page 14 where you state, quoting in part, "When considering the advantages and disadvantages of U S WEST and the other incumbent LECs in Washington vis-a-vis their potential local service competitors" -- and then you go on to say "historically these carriers" -- and I presume Washington carriers -- "have prospered under a unique and protected position under the public utility forum of regulation with exclusive franchise rights and guaranteed opportunities to recover their investments." Did you state that?

A. Yes.

Q. Is it your testimony that U S WEST in Washington has had in the past an exclusive franchise right and guaranteed opportunity to recover its investment?

A. That has been the effect of regulation from an economic perspective. As to the precise legal status of its rights I do not offer an opinion.

Q. Have you read the opinion of the Supreme Court in the state of Washington in the consolidated ELI cases?

A. No.
Q. Are you aware of that decision?
A. No.
Q. You've never had it pointed out to you by staff counsel or any member of the staff?
A. I might have. I don't recall.
Q. Would it surprise you, then, that the court found in Washington that U S WEST had never had an exclusive franchise right because this Commission and the -- this Commission was forbidden to grant such and the constitution of the state forbids such?
A. It wouldn't surprise me but it also would not change the substance of my previous answer which is that we were looking at a de facto condition and I was not offering an opinion as to the legal status of the franchise.
Q. Would you agree, looking at the history of how telephony grew in this country, that the predecessor of the Bell system entered Washington and with entrepreneurial incentive started the business of providing telephone service in at least some portions of the state?
A. I'm generally familiar with the process of entry prior to the formation of the Bell system, not specifically familiar with what might have happened in

Washington, but as a general matter your statement is correct. There was entreprenurial activity. In fact there might have been entreprenurial activity in the same geographic area by multiple providers and at some point a system of economic regulation was introduced so as to effectively confer monopoly status upon the provider in exchange for the provider agreeing to be subject to constraints on its ability to set prices and to generate monopolistic earnings.

Q. State precisely how this Commission or its predecessor or any state entity conferred an exclusive right to serve in Washington?

A. I can't answer that question with respect to Washington. I don't know precisely how that occurred.

Q. So the fact is is that any entrepreneur or any other carrier has always been free to provide service in competition with U S WEST anywhere in the state; isn't that correct?

A. If I accept your characterization of the ELI decision, which I think it was a fairly recent decision, the court may have in that decision found this to be the case, but one can assume that prior to the decision to which you referred the prevailing view was not consistent with that and certainly if ELI or other recently arrived competitors challenged the legal basis for what was a de facto monopoly and recently were accorded the opportunity for entry as a result of such challenge, that would not in any way alter, in fact I think would strengthen, the position to which I've articulated to which you've cited on page 14 that there was de facto monopoly in operation. After the fact if the court decides in sometime perhaps the 1980s or 1990s or whenever the decision took place, that this was wrong, well, that's all well and good, but up until that point in time a de facto monopoly was in place, and I assume that U S WEST contested ELI's claim and apparently lost again, from your characterization.

Q. You assume but you do not know that U S WEST contested ELI's claim. Is that your testimony?

A. Well, someone must have contested it if it got to the Supreme Court.

Q. Would it surprise you to know that U S WEST urged upon this Commission in the ELI proceeding that it did not have a monopoly and that the Commission should grant ELI's entry into any market it wished to serve?

A. Nothing in this industry surprises me any more.

Q. In fact you cannot cite to any statement or document issued by U S WEST that it asserted a unique and protected exclusive franchise right in the state of Washington, can you?
A. I don't know. Certainly not as I sit here I can't cite to such a document. Whether or not such a document might exist I can't say.
Q. To the extent that your testimony relies upon your assumption that there was an exclusive legal franchise right and a guaranteed opportunity to recover investment in the state of Washington, that testimony is in error, isn't it?
A. Well, my testimony does not, as I've indicated, does not rely upon a legal condition but rather on a de facto regulatory practice in which there was an expectation, and even as recently as this morning in your cross-examination of Professor Mayo, continuing expectation of some ability on the part of U S WEST to earn its revenue requirement. And in that context I think that the position that I've articulated correctly relates to the conditions extant in this jurisdiction over the past 30, 40, 50 years.
Q. Do you know whether or not the constitution of the state of Washington declares any company that provides then telephone and now telecommunications

services to be a public service company?

MR. SMITH: Your Honor, I will object to the extent it's calling for a legal conclusion.

MR. SHAW: I asked him if he knew.

JUDGE WALLIS: The witness may respond.

A. I don't know.

Q. Assume with me that that is the constitutional declaration in the state of Washington and that the government asserted the right to regulate the prices of all public service companies providing telecommunications services in the state of Washington.

A. That's two separate assumptions that you want me to make?

Q. No, just one assumption, that is the constitutional mandate, that companies providing telecommunications services are by definition public service companies and that the state has asserted by statute the right to control the prices of all telecommunications companies?

A. I'm asking, that's a second assumption then?

Q. If you like. And directing your attention to footnote 11 on page 14 of your testimony, isn't it true that as a matter of constitutional law in this country that if the state asserts the right to control a company's prices that the company has a constitutional right for the opportunity to earn a fair return on its investment dedicated to the public service?

A. I think the constitutional right, for example, as articulated by the Supreme Court fairly recently in the Duquesne case goes to the right to be protected against confiscation of its property. And I think that in Duquesne the Supreme Court perhaps modified the fair return standard and instead focused more specifically on the issue of confiscation and in that ruled that there was not confiscation despite a denial by Public Utilities Commission of an amortization of the course of an abandoned nuclear power plant. So, I guess I would modify your characterization focusing instead on the issue of confiscation.

Q. You cited Bluefield Waterworks and Hope Natural Gas in your footnote 11 for the proposition that a public service company has a constitutional right to an opportunity for a fair return on its investment, correct?

A. That's what those cases say, yes.

Q. Is it now your testimony that the Supreme Court has overruled or partially overruled Bluefield

Waterworks and Hope Natural Gas in the Duquesne case?

A. I think Duquesne does modify that standard, yes.

Q. I take it you'll readily admit you're not a lawyer, you're an economist?

A. You're the one asking the question, but I'm not a lawyer.

Q. If you're not a lawyer why were you citing to Bluefield and Hope Natural Gas and characterizing them in your testimony?

A. Well, these are economic issues that are addressed in these decisions. The standard that would constitute me taking a standard that would constitute either a fair return or the ability to permit the utility to earn a fair return are factual issues that would be decided in a constitutional context and it's reasonable for me to have knowledge of that.

Q. Are you equally as familiar with the decisions of the Washington state Supreme Court on the fundamental right of a public service company for the opportunity to earn a fair return on its investment?

A. No, I'm sorry, I'm not.

Q. Are you aware of the statutes in the state of Washington that give this Commission the power to order a public service company to make investment against its will?

A. I will accept subject to check that such statutes might exist. Doesn't necessarily mean that they've been applied or to the extent they have been applied I don't know how much of the existing investment that we're speaking of would be subject to such application.

Q. Isn't that fundamental public utility regulation and law that on the one hand the company is expected to provide service on demand to all customers in its service area and therefore make the investment necessary to provide that service and, on the other hand, the state is obligated as a matter of constitutional law to provide that carrier an opportunity to earn a fair return on its investment made to provide that service?

A. I would agree with that as a general matter, but I don't think that it can be applied to cover every possible type of investment that a public utility might make, and moreover, I think that it can at best be applied to investments that are expressly required to satisfy that component of the total service offering that fairly falls within a public interest standard such as basic dial tone service to provide it to residential and business subscribers. I don't think it could be fairly read as applying to investment made, for example, to supply Centrex. And on the fair return side, I think one has to similarly look, and I think the Duquesne decision would support this view, one has to look at all of the elements of the regulatory paradigm that provide compensation to the utility, including, for example, revenues and profits from the provision of Yellow Pages. So that --

Q. I knew you would get that worked in somewhere so let's go right to that. In your testimony you assert that the business of Yellow Page advertising was developed under an exclusive franchise granted to the company by the state?

A. I'm having difficulty memorizing every word in here and it would be very helpful if you could give me the page cite --

Q. Page 85 and 86.

A. -- and not asking to accept your characterizations as they stand.

Q. I will quote for you at line 10 on page 85. "U S WEST developed its Yellow Pages business as a derivative of its government-granted franchise to provide local telephone service on an exclusive monopolistic basis." Do you see that statement?

A. Yes.

Q. And in fact that statement is simply not true, is it Dr. Selwyn, because there never was a government granted franchise to provide local telephone service on an exclusive monopolistic basis in the state of Washington, was there?

A. Assuming that the Washington Supreme Court so determined in a recent case doesn't alter the fact that the company was operating as a de facto monopoly during which period of time it developed its Yellow Page business as part of its overall monopoly activity. It relied upon its customer base, it relied upon its customer relationships and it established the Yellow Pages directory in that context.

Q. We alluded to early history of the telephone business earlier. Do you agree that the predecessor of the Bell system, and therefore U S WEST, competed head to head with other companies to provide telephone service in the state of Washington and in many states?

A. Well, I don't know that for a fact in the state of Washington but that certainly was the -- was common in other parts of the country.

Q. And in fact the business in Washington sorted itself out to where the companies no longer

competed head to head with each other to provide local service. Does that sound reasonable to you?
A. Yes. They were assigned or acquired nonoverlapping exclusive territories.
Q. Do you know of any order of this Commission or its predecessor that assigned exclusive territories to the predecessor to U S WEST or any other local exchange company?
A. I don't know of such an order. I don't know that it does exist. I don't know that it does not.
Q. So it evolved on its own, did it not?
A. I don't know precisely how it involved, but it evolved.
Q. You make an analogy to Ticketmaster on page 85 and 86 of your testimony and you make the statement starting at line 2 on page 86, "fact remains that companies like Ticketmaster did not receive any exclusive right or franchise from any government body to provide their service. They simply developed their business from scratch and happened to win the race for what was probably inevitable dominance by a single provider." Do you have that statement in mind?
A. Yes.
Q. And in fact that's precisely the

description of the history of telephone service in the state of Washington, isn't it?

A. I don't agree with that.

Q. Let's review. Do you agree that the predecessor of U S WEST was not granted an exclusive right or franchise from any government body in the state of Washington?

A. I said I didn't know.

Q. Assuming that it was not, and that it built its business in the state of Washington based upon its own abilities and investment, why is U S WEST's operation in Washington any different than Ticketmaster's operation?

A. Well, I think you perhaps gave a reason yourself in one of your earlier questions to me this afternoon and that is your suggestion, I believe you asked me to assume, and I will take it that this assumption is a correct statement of the law, that the Washington constitution declares telephone and telecommunications companies to be public service companies, are not aware of the fact that they are, and I would be surprised to learn that there is a similar provision in the Washington constitution with respect to somebody in the business of selling sports tickets. So there is a clear distinction, and the operation of the implementation of that constitutional provision by this Commission acting as the administrative body that would oversee both whatever governing statutes or constitutional requirements may prevail with respect to telecommunications companies in the state, maintain practices and develop practices that had the effect of operating to exclude entry by others, and that is very different from a situation where a firm identifies a type of business that is characterized by externalities and, as I indicated here, happens to win the race to become the inevitable dominant or sole provider. I would mention there may be antitrust issues and certainly antitrust issues have been raised with respect to Ticketmaster that go to other aspects of monopolization, but I think there's a very clear distinction and I think the distinction is rooted in the very legal standard that you asked me to assume.

Q. You agree that as a general principle of state authority that a state, either constitutionally or by legislation, can declare almost any line of business to be a public service company subject to regulation by this state?

MR. SMITH: Your Honor, I am going to object to the extent it calls for a legal opinion by this witness.

MR. SHAW: If he knows?

A. I was going to answer that I don't know the legal status of a state's ability to arbitrarily declare any particular line of business or industry to be a public service business. I am certainly not prepared to agree with that.

Q. Have grain elevators in the past been declared to be public utilities or public service companies?

A. In some states they have, yes.

Q. Have graveyards --

A. At least in states that have grain.

Q. Have graveyards been declared by some states to be public service companies or public utilities?

A. Graveyards have been subject to regulation. I'm not sure they've been subject to price regulation but I believe they are certainly subject to some form of regulation. Many industries are subject to varying forms of regulation not necessarily pricing or earnings regulation.

Q. I'm talking about regulation by an entity such as this Commission. Has milk been declared in states to be a business imbued with the public interest and treated as a public utility and regulated by an entity like this Commission?

A. Yes.

Q. Conceptually if the political will decided that it should be so, a company like Ticketmaster that took on inevitable dominance of an industry could be declared a public utility and its rates could be regulated, couldn't it?

A. I would agree with that. Now subject to possible legal challenge by Ticketmaster, the merits of which I can't speak to, but certainly I can see that happening, yes.

Q. And if Ticketmaster had an advertising business that it ran in conjunction with its business of procuring and selling tickets, would the mere fact of it being declared a public service company then make the revenues from its advertising business available to subsidize its ticket business?

A. That would depend upon the process and the legislation by which Ticketmaster was declared to be a public service company and the scope of that legislation. The answer is certainly possible, yes.

Q. So you would agree then that the ability of the state to impute the revenues of an unregulated subsidiary, of a public service company, to the regulated operations of that public service company is a matter controlled by relevant law and not a matter of economics?

A. It is a matter that is controlled by law and by economic policy. The determination to incorporate such revenues within the scope of the overall regulatory -- means by which earnings are measured I think is fully contemplated in the existing legal and economic -- structure of economic regulation. The existence of these revenues in a separate subsidiary is a recent development. It has not historically been the case, and certainly the scope of -- the means by which fair return, confiscation and other standards relating to the overall level of rates has historically been examined by this Commission and other commissions has embraced the Yellow Pages activity. The mere fact that this particular activity is sliced off by a self serving decision by the utility to place in a subsidiary in and of itself doesn't change anything. What is more relevant is whether or not this is a legitimate regulatory asset which, if it is to be dismembered from the ambit of the regulated company, would require some compensation to be paid. And as long as we're citing cases to each other I will call your attention to Democratic Central Committee against Washington Metropolitan Transit Authority in which the DC Circuit Court of Appeals basically adopted the principle of reward follows risk in determining that the appreciation and value of a regulatory asset inures to the regulated companies. So if U S WEST wants to in effect remove an asset from regulation it has an obligation to reimburse the regulated part of its business for the fair market value of that activity. I will have no real problem if that type of restructuring with respect to Yellow Pages were done, but the simple removal or attempt to remove a regulatory asset that clearly has experienced an appreciation in market value I think is not consistent with any economical or legal standard that I am aware of.

Q. Let's go back to the question. The question was do you agree that it's a matter of state law whether an unregulated subsidiary, advertising subsidiary of Ticketmaster, can be -- its revenues can be used to subsidize its regulated ticket business. And let me ask you this --

A. I don't think that was the question.

Q. -- is it your assertion that the business of Yellow Page advertising has ever been regulated by this Commission?

A. Oh, yes, absolutely. No question about that.

Q. Are the rates for the Yellow Page advertising regulated?

A. The rates, the specific rates, have not been regulated but the revenues minus the costs of the Yellow Pages business have been included in determining overall revenue requirement of the telephone company by this Commission, and this condition has prevailed for many years. And therefore the fact that the Commission may forbear from regulating individual prices is really inconsequential to the larger question of whether or not this is a regulatory asset of the telephone company, which it clearly is.

Q. Is it your assertion that the business of Yellow Pages advertising is a telecommunications service?

A. It's an asset, it's a regulatory asset of the telephone company.

Q. When you say it's a regulatory asset, are you referring just to the fact that in the past the rate base investment in directory was in the rate base?

A. Yes, among other things.

Q. What is the rate base investment of a

Yellow Page advertising line of business?

A. I don't know if there is any such investment at this point because of the transfer of that to a separate subsidiary. But when it was part of the telephone company, it is my belief that the -- whatever capital was associated with that business activity was included in rate base.

Q. In fact, investment in Yellow Page advertising is virtually nil, isn't it?

A. I don't care if it's only a dollar. The Yellow Page advertising activity was organizationally integrated. It occupied space in telephone company buildings which was certainly included in the rate base if they were owned by the telephone company, and the employees use desks and they use typewriters and they use telephones and they used office equipment. It happened to be a very high profit business, but notwithstanding that it was part of the telephone company. And the relationship to that, to the telephone company was reiterated by Judge Green in his ruling in the aftermath of the Tunney Act proceeding following the MFJ in which the Yellow Pages business was expressly awarded to the regional Bell companies precisely because it provided contribution to support basic services.

Q. We'll return to that in a minute. CPE has historically been in the rate base of a regulated telephone company?

A. Yes.

Q. Was that investment removed?

A. By regulatory decision it was. It was removed as a consequence of the FCC's second inquiry.

Q. So the fact of historical inclusion in rate base is not determinative of whether or not it should remain in rate base?

A. The CPE -- well, this is a very good example.

Q. Well, just answer the question. The fact of historical inclusion in rate base of a line of business is not determinative of what the future treatment of that should be, is it?

A. It is determinative except to the extent that a regulatory decision may alter that condition. It is not determinative of an affirmative regulatory decision to alter that condition but it certainly is determinative of any self serving actions.

Q. So, was CPE profitable to the Bell system?

A. So it was claimed at the time.

Q. And in fact regulatory agencies protested and appealed the attempt of the FCC to preemptively

deregulate CPE?
A. They did.
Q. On the basis that it was profitable and provided extensive contribution to the common overheads of the company?
A. Among other things, yes.
Q. Take another business. Has it been common for electric and natural gas public service companies to provide on an integrated basis furnace, storm windows, and other appliance businesses?
A. I believe it's less common today but some companies were in that business years back. Some even provide -- one electric company even provided light bulbs.
Q. And it's common that that line of business is not included in the regulated results of operations today, is it not?
A. I don't know for a fact that it ever was one way or the other so I'm not able to advise you on that. I do know for a fact that the Yellow Pages was. In any event I think those appliance businesses were probably money losers which is not the case with Yellow Pages which is a very valuable asset worth many, many times its book value.
Q. So the determination of whether or not an

unregulated line of business should be offered on an integrated business with a regulated line of business is whether it's profitable or not? Is that the only criterion?

A. No, that's not what I meant. In the case of Detroit Edison which was handing out free light bulbs as part of its electric service, my recollection is that there was a court decision, might even have been a Supreme Court decision, that required the company to discontinue that practice because it constituted in effect a bundling of the lightbulb with the electric service.

With respect to the electric and gas utilities that were in the business of selling appliances or providing furnace installations and other things of that sort, if those were rate base activities, and I suspect that many of them were not, but if they were, and if they were abandoned by the utility simply because they were no longer cost-effective, given the proliferation of discount stores and other sources of supply, then it would not surprise me in the least if the utility attempted and perhaps in some cases was successful in recovering losses associated with the abandonment of those lines of business from their regulated services to the extent that they were rate base items to begin with.

Q. In Washington specifically do you know whether this Commission has allowed regulated companies to recover the losses of abandoning their appliance and storm window businesses?

A. I do not.

Q. It's true, is it not, Dr. Selwyn, that there is no statute or regulation administered by this Commission which requires any company to provide Yellow Page advertising directories?

A. That requires it? I doubt that there is is but I don't know that for sure.

Q. In fact the only directory that is required is a white pages directory, is it not?

A. That's correct.

Q. Do residential ratepayers place Yellow Page ads?

A. Generally they do not, at least with respect to the residential service.

Q. Is it your testimony that Judge Green in deciding to award the line of business of Yellow Page advertising to the divested local operating companies by that decision preempted any state law that would forbid a regulatory Commission to impute the revenues from an unregulated line of business to a regulated line of business?

MR. SMITH: Your Honor, I will object on the grounds that it calls for a legal conclusion.

MR. TROTTER: Your Honor, I will join the objection. It also seems like counsel is relitigating the legal issue that has already been resolved against the company so I will object for that additional reason.

MR. SHAW: Well, this legal issue has not been resolved against the company. It's the witness who extensively quotes from Judge Green to the effect that Judge Green gave the business to the ratepayers, and if he is going to cite legal opinions I think he's going to have to be subject to cross-examination on them.

JUDGE WALLIS: The examination, based on the witness's direct testimony, is I think permissible.

MR. SMITH: Your Honor, the only objection I have is to the extent it calls for Dr. Selwyn's opinion on preemption which is a constitutional legal question to which he does not refer in his direct testimony.

JUDGE WALLIS: The witness has established I think that he is not a lawyer and I think he can be asked as to his lay perception but not as to his legal opinion regarding matters.

Q. Do you have the question in mind?

A. Could you repeat it, please.

Q. By citing and quoting from the opinions of Judge Green in the divestiture proceeding, is it your testimony that Judge Green by that decision lawfully preempted any state law that would forbid a regulatory Commission from imputing the revenues from an unregulated line of business to a regulated line of business?

A. I don't know. That is definitely a legal question that is far beyond my ability to offer an opinion on.

Q. Page 89 of your testimony you urged this Commission to, as I understand it, make the Yellow Page imputation revenue amount portable. Is it your testimony that when ELI for example, competes away customers from U S WEST that U S WEST should pay ELI an amount per access line that equals the Yellow Page per access line imputation in the state of Washington?

A. Yes, for residential access lines.

Q. When TCG competes away those customers from ELI then U S WEST would pay that amount to TCG?

A. Just to make it clear when we say pay that amount, not necessarily proposing that checks be written but in calculating rates for interconnection and other services that U S WEST would be providing to competing local carriers, that the transfer of the Yellow Pages subsidy to residential customers of those competing carriers would be accomplished. Administratively, how it is accomplished is not the issue, but the answer is yes.

Q. If TCG bought any telecommunications services from U S WEST, U S WEST would have to lower the tariff charges by the amount per access line of the Yellow Page imputation?

A. That's correct.

Q. When cable company competes away the residential service of U S WEST, the same would apply, payment in cash if there was no services taken from U S WEST, but if there were services taken from U S WEST a discount from the tariff rate?

A. By some process the subsidy would be made portable, yes.

Q. Can this Commission, in your opinion, order U S WEST to be in the Yellow Page advertising business?

A. I don't know, and I don't think the issue has any relevance. The issue is that U S WEST is in the Yellow Page advertising business. It poses a valuable asset which qualifies as a regulatory asset. The company decides to abandon the Yellow Page business entirely by just sort of walking away from it or selling it to the highest bidder and getting out of it that way, the fair market value of that activity appropriately should be used as an offset to rate base.

Certainly in the context of discussing issues such as stranded investment or universal service subsidies there's no question but that the Yellow Page revenue or Yellow Page imputation and the fair market value of the Yellow Page business are relevant and that's what's at issue. Really doesn't matter at this point whether the Commission has the ability to order U S WEST to embark upon a new Yellow Page business. We're looking at what's here.

Q. I didn't ask you about a new Yellow Page business. I asked you a very simple question. Is it your view that this Commission can order U S WEST to remain in the Yellow Page business, advertising business, so that it can continue to expropriate those revenues and award them to its competitors?

A. This Commission has the authority, in my opinion, to order U S WEST to impute either on a recurring basis or on a one time basis the fair market value of the Yellow Page business back to regulated services, and to utilize the revenues accomplished through that imputation, either for purposes of subsidizing U S WEST services or for making the subsidy generally available to support all universal -- provision of all universal service however the Commission ultimately determines that universal service and carrier of last resort issues will be resolved. And I am not speaking here about simply giving the subsidy to anybody who happens to walk along. The Commission has the right, and I believe should, to establish criteria for qualification to receive support. To the extent that the Commission determines that residential service should continue to be subsidized in some way and that that subsidy should come from Yellow Pages the Commission does have the authority to make a determination as to how that should take place, and if U S WEST wants to determine that it wants to get out of the Yellow Pages and sell it off to Dun & Bradstreet or any other number of potential providers of that service then it certainly is free to do so, but the fair market value of that asset would have to flow back as an offset to rate base in the regulated entity.

Q. It's correct, is it not, that U S WEST, the regulated telecommunications company, has no ownership interest in the Yellow Pages? That is a function of U S WEST Direct and that this Commission approved those transfer of assets. That's correct, isn't it?

A. I have not read the Commission order approving the transfer of assets. I don't know what conditions were set on it and what representations were made to the Commission at the time of that transfer with respect to the continued availability of revenues. To the extent in applying for the transfer of the company represented to the Commission that ratepayers would not be affected by the transfer then certainly there is an economic interest on the part of ratepayers in continuation of that activity.

Q. So it is your testimony that this Commission can order U S WEST C back into the Yellow Page business and order it to provide Yellow Page advertising to provide revenues which it would transfer to its competitors when it lost customers to its competitors. Is that your testimony?

A. Let me tell you what my testimony is because I'm not sure I would totally agree.

Q. Just answer that one yes or no and then we'll go on from there.

A. I don't think that's a fair characterization.

Q. So you disagree with that characterization?

A. If you're forcing me to accept it either in toto or not at all then I can't accept it in toto.

Q. So then U S WEST is free -- U S WEST C is free to not be in the Yellow Page business and not to produce such a revenue stream in order to subsidize the operations of its competitors?

A. I didn't say that.

Q. When a retail telephone directory in competition with U S WEST -- in fact the regional telephone directory that competes here in Washington -- competes advertising away from U S WEST, does it now have to provide a payment to U S WEST C or any other company that's providing the local exchange service some percentage of the residential customers in the area where it provides Yellow Page advertising services?

A. Your question assumes a fact of which is clearly not in evidence and that is that there's no evidence that any such regional directory does in fact compete advertising away from U S WEST. It may in fact be successful in attracting a limited number of advertisers but it is not at all obvious that those

advertisers would then discontinue their ads in the U S WEST directory.
Q. Were you here when U S WEST witness testified about the BOCs that U S WEST Direct competes against right here in the Olympia area?
A. I wasn't here but I read her testimony.
Q. And if the competing book in the Olympia area contains as much Yellow Page advertising as the U S WEST book, would you agree that the consumers of Yellow Page advertising are likely splitting their advertising dollar between U S WEST Direct and the regional telephone directory if not giving all their advertising business to the other company?
A. No. I don't think you could reach that conclusion. You would need to know, among other things, what the rates, the advertising rates, are for the U S WEST directory versus the competing directory. I would surmise and expect that the competing directory's rates are substantially lower than the U S WEST rates which would mean that the split, if there is a split it's certainly nothing close to 50/50. And secondly, you would need to know whether or not any revenues that were or any payments that were made by advertisers to the competing directory in fact were diverted from the U S WEST directory versus other

advertising media.

I don't recall that there was any evidence presented in Ms. Koehler-Christensen's testimony that suggested that there was a net loss of lineage or pages or whatever by any normal measurement standards of advertising to competitors. Only that competitors existed, and that's really not the relevant question. U S WEST reported a very significant sustained growth in Yellow Page revenues over the past seven or eight years. The amount is a proprietary number but it is a consistently high level of growth and certainly not consistent with any serious competitive threat. So I don't think one could draw any conclusion from the presence of such directories. I get three, four, five, six times a year solicitations that are even in the form of -- they look like invoices from so-called competing Yellow Page directories and I never pay them but I imagine some people do. There are a lot of people that purport to be publishing directories but the fact of the matter is that virtually every effort that I am aware of on the part of competing Yellow Page providers to enter the telephone company Yellow Page market have resulted in failure.

Q. Have you made a study of the telephone directory business and the competitors of U S WEST Direct in the state of Washington as opposed to like your anecdotes that you might get in the mail in Boston?

A. No.

Q. You have absolutely no idea what the financial strength is of the Yellow Page competitors that do exist in the state of Washington, do you?

A. I don't believe any evidence as to the financial strength of the Yellow Page competitors has been presented in this case.

Q. I asked you whether you had any evidence at all of that?

A. I certainly don't but neither does the Commission. If they had any strength I would assume that the company would have so advised the Commission.

Q. Is it your testimony that no matter how many competitive providers of telephone books there are, Yellow Page advertising books, and no matter how many competitive providers of telephone service there are, two of which may not be related, this Commission should find some way to continue the historic subsidy of Yellow Page advertising revenues to all local exchange consumers in the state of Washington?

A. That's a multi part question so let me take it one part at a time. If it could be demonstrated that by any normal standard economically valid standard for measuring the effectiveness of competition, if there was actual competition in the Yellow Page directory advertising business, then one would expect there to be a significant erosion in the sustained high level of profit, super competitive profits that are being generated by the U S WEST Yellow Pages. And at the same time at that point I think it probably would be fair for the Commission to no longer -- not only fair but actually necessary for the Commission to no longer rely upon Yellow Pages as a major contribution source. That simply isn't the case. Yellow Pages profitability and revenue growth is undiminished and Yellow Pages are not a competitive activity and the existence of U S WEST in the Yellow Page business, as I've indicated in my testimony, stems from the franchise Yellow Pages business as a regulatory asset and for all of the reasons that I've given Yellow Pages has to be treated -- Yellow Page revenues have to be included in revenue requirement by imputation directly or by some means.

With respect to your second question, there are a number of ways in which the Yellow Pages subsidy can be transferred in a competitively neutral manner to the residential subscriber. It can be used, as you have suggested, to simply flow cash to whichever provider is actually furnishing service to an individual customer. That would be one way it would be competitively neutral. Other competitively neutral methods would be to make the Yellow Page revenues available, for example, to explicitly support the provision of high cost -- services in high cost areas where competing firms would then be able to bid in effect to serve areas that were costly to serve, withdrawing subsidy support from a high cost fund that was funded in whole or in part by Yellow Pages revenues. That would be another method of achieving competitive neutrality while flowing the Yellow Pages support to the appropriate recipients.

So there are other means by which this can be accomplished but one way or the other the two bedrock points are that the Yellow Page revenues should continue to flow to support residential services and that that flow should be accomplished in a competitively neutral manner.

Q.   CPE revenues, as we previously discussed, provided subsidy flows to residential services historically, correct?

A.   Well, that's actually arguable because what was really going on there was that the revenues -- turn out as it turned out to be some combination of CPE and inside wire recovery and what we saw happening at the time of CPE deregulation was an unbundling of the CPE revenue into an equipment rent component and an inside wire component. So if we look at the sort of pure CPE revenues it's not really clear that they were producing substantial contribution. The inside wire component was producing a large element of contribution and then that was eliminated through amortization of the inside wire investment.

Q. In fact the Bell system rented CPE at very high rents per month to consumers and those rents were used to keep down the cost of the transport and switching service, were they not?

A. That's correct, just as for example, call waiting rates and other premium service rates today are used essentially for that same purpose.

Q. Indistinguishable from Yellow Page advertising revenues in your analysis CPE revenues at very high profitable levels were used for many years to hold down the rates that would otherwise have to be charged for the actual transport service. Isn't that correct?

A. I would agree with that, yes.

Q. AT&T was awarded its CPE and telephone equipment business at the time of divestiture; is that correct?

A. That's correct. Well, let's be clear. AT&T was awarded embedded CPE and new CPE was deregulated entirely at the time of divestiture so it wasn't awarded to anybody and in fact the regional companies were permitted if they so chose to get back into the new CPE business.

Q. And AT&T is free to be in the Yellow Pages business, correct?

A. As a legal matter anybody is, but as a practical matter they can't be because of the entrenched monopoly that's held by the local companies.

Q. AT&T is spinning off its equipment, telephone equipment, and whole Western Electric manufacturing line of business, is it not?

A. To my understanding, yes.

Q. Is AT&T asking the permission of this Commission to spin off profitable lines of business that could be used to subsidize either local exchange service or toll service? Just answer the question. Is it asking permission of this Commission?

A. There are an awful lot of facts in your question. I'm going to answer the question is AT&T asking the permission of this Commission for the reorganization, the answer to that is no. With respect to any other assertions that may have been included in that question I don't agree with many of them and I don't have the factual basis upon which to agree with or disagree with others, but AT&T is not asking to the best of my knowledge this Commission to approve the reorganization that would involve the spinoff of the equipment business.

Q. I believe your testimony is the fact that the shareholders of U S WEST should accept any losses occasioned by competition or the need to cut its rates to meet that competition. Do you recall that testimony at page 13 of your testimony, lines 17 and 18?

A. Yes, I see that.

Q. You state there that "The company's shareholders should accept responsibility for any revenue losses caused by the competitively motivated rate reductions that it initiates." Is the company free to not make any rate reductions in order to respond to competition and under rate of return regulation request fair and reasonable and sufficient rates that give it an opportunity to earn a return on its investment?

A. Would you read that question back, please.

Q. Let me restate it. Is the company free to not unilaterally make rate reductions in response to competition and ask for rates that are sufficient to give it an opportunity to earn a fair return on its investment?

A. I'm just concerned that there's a double negative in there and I'm trying to make sure I understand your question correctly.

Q. Do you want me to repeat it again?

A. No, I think I have it. The company is certainly free to request that this Commission under rate of return regulation allow it to earn a fair return, give it the opportunity to earn a fair return, on used and useful investments made by the company in support of its public service obligations. The Commission is also free to determine whether or not any portion of those investments were made by the company in pursuit of competitive lines of business that may not have necessarily been motivated by or required by the company in order to fulfill its public service obligations.

Q. So the company is free not to invest and provide services beyond basic exchange services?

A. Company has obligations, has different levels of obligations. The company, for example, does not have a public service obligation to provide Centrex service, to the best of my knowledge. And to the extent that the company may be over-investing in outside plant so as to remain competitive in the Centrex market, that might be a source of the perceived need to increase the revenue requirement of the company without necessarily having been driven by any public service obligation to provide high quality basic service.

Q. Is the company then in your view free, in the staff's view, free to withdraw from Centrex service at any time?

A. I don't know precisely what the legal requirements are with respect to withdrawing from provision of a service. Certainly if the company chose to withdraw from the provision of Centrex service the staff would be -- Commission would be free to make detailed allocations of plant as between the plant that was installed, required for purposes of providing Centrex versus plant that was required to provide the service that would not be discontinued and to make an appropriate adjustment to rate base to reflect that.

Q. Is the company free not to invest to provide ISDN service?

A. Given the way the company is pricing ISDN service I'm not sure it matters.

Q. That's very funny but could you answer the question. Is the company free not to provide ISDN service if the prices that this Commission establishes in the company's view are not sufficient?

A. Well, that's a different question than the question you asked me before.

Q. The question I'm asking you, Doctor --

A. The question you're asking me is -- I think I would probably agree with that. If the Commission were to require you to offer ISDN service at a price that you don't believe is compensatory, given the investment that has already been made in digital switching equipment -- only talking about the prospective increment, incremental investment to support ISDN -- over and above investment that has already been made for the basic digital platform, and you could demonstrate that that were the case, I certainly think that I would probably agree with you. I don't think I would agree with the factual conclusion, however, but if you came to that conclusion, misguided as it might be I suppose that you would be free not to offer.

Q. If the company decides to offer ISDN prescribed by this Commission and fails to sell sufficient amount of it to recover its investment, does the shareholder bear the entire risk of the loss of that investment?

A. Under rate of return regulation if ISDN is considered by this Commission to be a monopoly service, which I think it is, and the Commission approves the introduction of the service at a particular rate and for whatever reason, whether it be that nobody wanted the service or that the rate was too high, that the company and/or the Commission mis-judged the demand for that price -- whatever the reason might be for those conditions under rate of return regulation -- I think the company would be entitled to be made whole. Under an alternative form of regulation, however, the story would be different.

Q. Assume all of these questions are under traditional rate of return regulation. Would the same analysis apply to private line service, and in particular, any kind of a design circuit?

A. Again, if we're talking about service that are considered by the Commission to be monopoly service I would agree with that. If they're considered by the Commission to be competitive services I would not agree.

Q. So your testimony is any service that is classified as effectively competitive, the company must bear all the risk of loss related to that investment.

A. Yes. And there's a real problem there where competitive and monopoly services are furnished using joint plant because it becomes very difficult to assign costs as between the two. Was that digital switch acquired for purposes of providing plain old telephone service. Was it acquired for purposes of providing ISDN which is a monopoly service. Was it acquired for the purposes of providing Centrex which is a competitive service.

Q. Is it your testimony it's your view that the competitive classification of a service of a local exchange company in the state of Washington puts all the risk of the associated investment on the shareholder. Do you believe that to be the requirement of the law or is your testimony a policy recommendation to the Commission without any assumption of what the law is?

A. No, it's certainly the latter. As to whether or not -- it would seem logical to me that the law would have to be interpreted that way because or else the law would be saying to this one competitor, yes, this is a competitive service but we're going to protect you from losses and any of your competitors out there, we will not similarly -- the law will not similarly protect. That doesn't make for a fair competitive marketplace. So I would surmise that it's both a legal requirement as well as good policy.

Q. But you don't know that?

A. I will stand on my answer.

Q. You testify at page 48 that stranded plant is not a problem with competitive entry because the company can just merely scale back its investment and reduce its investment in the state of Washington as it loses market share. Do you recall that testimony at lines 11 through 19?

A. Yes.

Q. Is that a fair characterization of your testimony that I just made?

A. Yes.

Q. Are you aware of testimony of Ms. Beaton of the staff in this case that U S WEST is not investing nearly enough in the state of Washington currently?

A. I believe that her testimony goes to the issue of investments required to provide high quality service which would be very specifically targeted in certain areas where service problems may arise, and I don't see any consistency between that position and the position I've articulated here.

Q. Have you read Ms. Beaton's testimony?

A. I have not.

Q. So you're surmising on what she testifies to?

A. I have discussed it.

Q. Did Ms. Beaton testify that the alleged reduction by U S WEST in its overall investment in the state of Washington from the 300 to 350 million annual range that you cite in your testimony to something less than that is unacceptable?

A. I don't know specifically whether that statement was made. I will accept it subject to check that she said that.

Q. Are you aware of what the service quality issues are in this case?

A. Generally but not specifically.

Q. Do you agree that generally that the Commission is concerned about increasing levels of held orders for basic exchange service and for design service and an increasing interval of time to make repairs?

A. I believe that's generally correct, yes.

Q. Do you agree that investment level of the company is directly related to its ability to minimize held orders and minimize time between the reporting and the fixing of an out of service problem?

A. I would not agree with that precisely. Certainly the issue of time may have to do more with available personnel than with capital investment, so I'm not sure that there's a connection there between the time that trouble is reported until it's corrected. And with respect to the former there may well be problems with respect to the general maintenance of the company's plant. It may not be spending enough on maintenance for example, preventive maintenance. That's again not a capital item, it's an operating cost item. And even where there is an investment deficiency involved it may be very specifically targeted in certain areas. The company may be spending a lot of money but in the wrong places and I'm not sure that I would agree that you could generalize that merely because U S WEST is not throwing enough money at Washington state that that explains the source of the service problems. I think that it doesn't necessarily follow that even if U S WEST were putting more capital money into the state that without being specifically directed at improving the service quality shortcomings that it doesn't follow that more investment translates necessarily into better service.

The other point that needs to be made here is that we are talking about conditions that exist as of right now when in fact we have not experienced significant local competitive erosion and the statement that you cited in my testimony is looking to the future. Whatever market share erosion occurs is going to occur very slowly because competitors are going to have to build up their own infrastructures. That's going to take time. They're going to have to ramp up their marketing and customer service activities. That's going to take time, and I would expect that the company as it loses market share will have opportunities both to divert existing plant to serve new customers and to perhaps even improve service quality as well as to avoid investment.

Q. So your testimony is that to the extent that the staff suggests to other witnesses that the company today and in the future is not investing enough money in the state of Washington that testimony is simply in error?

A. If the staff testimony is read that the company is not investing enough money in the state of

Washington in the right places I would agree with that. As to a general statement I don't know that you could draw that linkage.

Q. I don't understand your answer. To the extent that other staff witnesses in this case are suggesting that the general level of investment of the company in the state of Washington is insufficient today in going forward, is that staff testimony in error?

A. I guess my answer is that I think that the addressing and correcting service quality problems is more a function of where the capital dollars and operating expense dollars are directed rather than the general level of investment, and if the staff is concerned that not enough money is being directed into places in which additional investment would result in a service quality improvement, I can't disagree with that, but there may well be other areas in which investment is being made or is expected to be made that could be reduced or eliminated or scaled back or postponed or some other modification in the baseline program to accommodate market share losses that would not impinge upon service quality, and therefore I don't believe there's any inconsistency between the staff's position on service quality issues and the

statement that I've made here.
Q. Do you have any evidence that this company in Washington is currently investing any portion of its 300 million plus yearly investment in this state in the wrong places or on the wrong services?
A. I don't believe that's what I just said.
Q. I'm asking you a question. Do you understand the question?
A. Well, I don't think I've made that specific allegation.
Q. So you don't have any evidence of that and you in fact, because you have no evidence, make no such allegation. Is that your testimony?
A. My testimony is that if there are market share losses some of those investments could be curtailed or postponed without affecting service quality.
Q. That's based upon your personal opinion that competition will come very slowly for the foreseeable future?
A. If it comes faster then even more of those investments could be curtailed or postponed. The point of the matter is there is a relationship -- well, let me come at this slightly different way. If you refer to table 3 in my exhibit, which is the table that I

submitted a revision to this morning, what that table shows --

JUDGE WALLIS: Mr. Selwyn, excuse me, can you speak more directly into the microphone?

A. What table 3 shows and if you refer to the column marked AT&T net, this represents AT&T net interexchange service revenues for the period -- for each year from 1984 to 1994 net of access charge payments made to local exchange carriers. And what this column shows is that despite substantial market share losses over that period to AT&T, rent running down from close to 90 percent at close to the beginning of the period to approximately 60 percent at the end of the period, and incidentally despite price reductions net of access charges that occurred during that same period, AT&T continuously experienced a net gain in business volume, which would indicate that in fact at no time during this period did this seemingly large, very large, market share loss produce any net reduction in demand. Now, it doesn't follow that merely because U S WEST experiences market share losses that in fact it will not still require plant to support absolute growth. In other words, market share loss doesn't necessarily translate into demand decrease. In the case of AT&T market share loss still resulted in a net absolute increase in demand each year over the previous year. However, if there is a net reduction in the absolute demand for U S WEST services it follows that U S WEST should be able to make accommodations in its plant construction to reflect that, particularly if, as the company alleges, its competitors will be very targeted in specific geographic areas. If there's a lot of competition in downtown Seattle, for example, and that the market share loss is greater in downtown Seattle than in other parts of the state then presumably that would be an area where U S WEST would have adequate facilities to accommodate the remaining demand without having to place new facilities in that area, and therefore it could cut back on its capital spending programs. And that's what I'm speaking of here.

We're talking about a condition where the investment base and the rate of investment bears some relationship to the rate of market growth and if competition reduces the rate of growth or even turns it negative it would be reasonable to assume, and I think the Commission has a right to expect, that the company will make adjustments in its investment program to accommodate that.

Q. So in the face of competition in downtown

Seattle, the company is free to reduce its investment in Seattle and take higher held orders in anticipation of a declining need for future investment, correct?

A. If the Commission is going to rely on competition and encourage the development of competition, then if U S WEST chooses to adopt a business strategy that results in a deterioration of its service quality then presumably that will just give more reason for customers to switch to competitors. If that's what you want to do you're free to do it and I don't think the Commission should interfere with that if the market is competitive.

Q. In the AT&T example, AT&T sells interchange service by the minute?

A. Yes.

Q. U S WEST sells flat rated local exchange service by the loop, correct?

A. Yes.

Q. Directing your attention to -- maybe it would be easier in your exhibit. Look in your exhibit at page 4, page 5, and these two exhibits, Dr. Selwyn, support your testimony, do they not, that a study of telephone companies from 1993 FCC report support in your view an allocation of common overheads to U S WEST residential service of 16.41 percent?

A. Page 4 does, not page 5.
Q. Yes. I miscited, I'm sorry. It's page 8.
A. Yes.
Q. Would you agree that the study would be more accurate for U S WEST's Washington operations if you compared U S WEST's booked accounts over a period of time rather than 30 different companies for one year?
A. I'm not sure I would agree that it would be more accurate, but I think it would reach a similar result. The benefit of the approach -- the cross sectional approach that I've used here is that we get a very wide range of company sizes from very small to very large and we see exactly the same relationship, but I would expect that over time this relationship would persist as well.
Q. Would it then surprise you if you took your exact methodology using the same accounts for U S WEST Communications in each year, 1988 through 1994 that you would get a T statistic of less than one, therefore indicating that there was no correlation between total overhead expenses and total direct expenses; is that right?
A. One of the disadvantages of looking at this

over time is there are other things going on such as support for consolidations and downsizing. U S WEST during that period was consolidating itself, and engaged in consolidating its operations in Denver and cutting back in overhead functions and staff function in the individual states and in the three individual operating companies that formed U S WEST after the divestiture so that if we were to examine the account relationships over time we would have to in effect correct for these one time events.

The benefit of doing this on a cross-sectional basis is we have a very similar phenomenon going on across the industry. All of the regional Bells are pursuing the same kinds of consolidation, so by taking a single snapshot year we in effect eliminate that problem. I think the issue is not so much what happens over time but what happens with respect to size and scale of operations and if we could correct for nonrecurring organizational restructuring, downsizing and other activities that could affect the condition over time then a time series would produce a reasonable result, but that is unfortunately not the case for the period that we cited.

Q. Your page 8 you list the companies that you

used in your study?
A. Yes.
Q. And it consists of a mix of small companies, independent companies, as well as a couple of regional companies?
A. It's a complete list of all companies that reported this data to the FCC in this form.
Q. You agree that your page 4 shows two different clusters of data points, and that the one relates to the small companies in your sample and the other relates to the larger companies?
A. Well, there are more small companies than large companies so that there appears to be more dots down there. I wouldn't necessarily agree that the large companies are in a cluster.
Q. Do you disagree that your exhibit clearly shows different scatter patterns based on company size?
A. I didn't test for that so I can't answer whether it clearly shows or what the statistical effects would have been.
Q. Wouldn't it have been prudent to do a study of just the comparable companies to the U S WEST, the large regional companies, and test for the threshold value of T just on comparable companies?

A. No. That would have completely defeated the purpose of this analysis. The whole point of this analysis was to test to see whether or not a similar relationship existed for companies of all sizes, small and large, because what we're trying to show is what happens to overheads as the direct costs change, and if I had simply excluded the small companies and just put in a handful of the very largest companies I would probably not have had enough data points to reach any particular conclusion.

Q. If you used the large companies you would not meet a critical threshold of T, would you?

A. If I used the large companies I wouldn't have enough degrees of freedom in the regression analysis to reach any statistical conclusion. There aren't enough companies to do this kind of a study, and it would not have made any sense to do that given the objective of the study and the hypothesis that was being examined.

Q. What is the minimum amount of companies in your opinion that is needed to do a valid study such as you attempted here?

A. This as I indicated was not a sample. We used all companies that reported to the maximum extent of their disaggregation. If you refer to table 8, what you will notice there, for example, is that some of the regions, such as Bellsouth, U S WEST and Southwestern, reported region-wide, but for example, Pacific Telesis reported separately, NYNEX reported separately, AT&T and New York Tel. Bell Atlantic reported separately for each of its companies and the Ameritech companies reported separately for each of their companies. So we used -- if we had this aggregated data for the U S WEST companies we would have used it. We didn't have it.

Q.   There are upwards of 1700 telephone companies in the country, would you agree?

A.   I think it's less than that now but it's a big number.

Q.   That order of magnitude?

A.   I think it's around 12 or 1300. They keep getting bought up although one large operating company has been selling off exchanges too.

Q.   I believe your testimony is that the companies that reported this data that was made available to you is the right sample but any subset of those companies would be an insufficient sample?

A.   The issue is not the sample. The issue is to develop data on a range. If all I had were, for example, the aggregate data for the seven regions all of which are roughly the same size I wouldn't have done this study because I wouldn't have had enough variation across the regions to give me a meaningful result. Ideally it would have been nice if I had state operating data for each of the U S WEST, Bellsouth and Southwestern jurisdictions, that would have made things more comparable but I didn't.

MR. SHAW: Thank you. That's all I have.

JUDGE WALLIS: Mr. Butler.

MR. BUTLER: No questions.

JUDGE WALLIS: Are there other questions for the witness? Commissioners?

EXAMINATION

BY COMMISSIONER HEMSTAD:

Q. Dr. Selwyn, with regard to Yellow Pages on page 81 of your direct testimony at line 13, you apparently conclude that when you say, "nothing has changed since the adoption of the MFJ as modified by Judge Green to warrant a change in that policy, and any action that the Commission takes with respect to the present application should not alter or diminish the continued role of Yellow Page revenues in supporting low priced basic telecommunications service." Is it fair to say that the assumption behind the decision at the time by Judge Green to allocate the Yellow Page asset to the Bell operating companies was that local service was priced substantially below its cost?

A. The assumption was, yes, that local service was priced below its cost and that the Yellow Page revenue was necessary to maintain that condition.

Q. Well, is it fair to characterize the staff's case as concluding that local residential service today is priced above its cost?

A. That is a correct characterization. The staff's case, at least with respect to forward looking incremental costs, but the company's case is based upon an embedded revenue requirement. If the Commission were to adopt the company's revenue requirement as it has been requested then the rate design proposal that the staff has put forth would require modification, and in effect we would continue to need the Yellow Page revenue support. The staff's case is predicated on the notion that the revenue requirement, among other things, will be reduced by the amount of the Yellow Page, the full amount of the Yellow Page imputation. If the Yellow Page imputation were, for example, to be discontinued then that money would be recovered from some services, and typically if one were to invoke the kind of inverse elasticity approach that Professor Mayo was talking about this morning, which I would agree is sort of an efficient way -- probably the most economically efficient way to proceed in that situation, then the residential rate would be the one that would have to get the increase if toll rates are to be reduced.

Q. Well, I guess the point I was trying to get to is in the some 14 years since Judge Green's MFJ order do you have an opinion as to what has happened to the incremental cost for providing local service?

A. The incremental cost for providing local service has gone down and revenues in the local service category, particularly from things like optional services like call waiting and the like, if anything, have been on the upswing. The problem here is that we're living -- when I say nothing has changed we have to view that in the context of ultimately an embedded cost revenue requirement and as long as we maintain an embedded cost revenue requirement that has to be satisfied, if that's the legal standard for fair return, then it's appropriate for the Yellow Page revenue imputation to be included in that. If we were, for example, to go to a forward looking incremental cost basis, and abandon the historic revenue requirement approach then we could revisit the Yellow Page imputation in that situation.

Q. And assuming for the purposes of discussion that as a result of this rate case all of U S WEST's services on a forward looking basis would be priced at least as high as incremental cost, then what would you do with Yellow Page revenues?

A. Well, the Yellow Page imputation is proposed here in the context of a revenue requirement. There is no proposal that would explicitly reduce the residential rate, for example, below incremental cost by the amount of the Yellow Page subsidy. There's no recommendation to my knowledge by staff that would actually end up with the residential rate being set below incremental cost by virtue of the presence of the subsidy, but the ability of the staff to set the residential rate at the level that has been proposed by staff is contingent upon the Yellow Page imputation as an offset to the embedded cost revenue requirement. If you take that away then the rate would go up.

Q. Have other states excluded Yellow Page revenues from the calculations of revenue requirement?

A. I think a few have but for the most part they haven't. Even for example, California which is really a good example whereby statute Yellow Pages were effectively removed from regulation some years ago, the Yellow Page revenues are in their entirety -- that is the revenues less costs -- are in their entirety included in revenue requirement. In California's case if my recollection is correct it's close to around a half a billion dollars a year. It may have been that they modified it or reduced it. I don't believe that the amount incidentally that is included in the staff revenue requirement estimate, the amount of the imputation, strikes me as being significantly less than the actual profit. In other words, if one were to take the gross Yellow Page revenues for Washington state and subtract the costs, the net profit would be higher than the imputation that's proposed. Under, for example, the California standard all of that profit would be available not just some predetermined imputation.

Q. I guess I don't understand how the staff calculates the imputation.

A. It's my understanding it wasn't a staff calculation. It's a company calculation. It's my understanding that the imputation is the result of an agreement between U S WEST and U S WEST Direct that called for a payment to be made to be imputed back in

conjunction with the transfer of U S WEST's Yellow Pages to the affiliate.
Q. Is that a static amount?
A. I believe that it grows by formula, but I don't think that the formula is specifically tied to earnings. It may be tied to either some fixed growth rate or to some other metric that changes over time.
Q. Apparently well, one of your recommendations or suggestions to look at is to have a substitute for the Yellow Page imputation of $4.27 a month. Is that a fair characterization of your condition?
A. Yeah, although I think I would perhaps modify that as I did in response to one of Mr. Shaw's questions to really be focusing more on the fact that the subsidy needs to be handled in a competitively neutral manner. It wouldn't make any sense to expect the competitor, for example, to be forced to compete with U S WEST when U S WEST's customers receive the benefit of $4.27 a month and the competitor's customers do not. And similarly, it would not be appropriate for U S WEST to use the Yellow Page imputation for purposes of, for example, funding marketing programs or other pricing initiatives that would improve its competitive position vis-a-vis competitors.

At the same time I certainly could understand perhaps a visceral reaction on the part of the company to not having to write out checks to competitors for the Yellow Page payment, but there are other ways in which this can be addressed. For example, the Yellow Page imputation could be applied toward certain types of costs of getting to a competitive market such as the costs of achieving true number portability. It could be applied to support, as I indicated, to Mr. Shaw, the development of a competitively neutral universal service and high cost support mechanism. There are other ways in which it can be used. The key point is it should be competitively neutral.

Q.   Has any state in the country adopted an arrangement such as you are proposing?

A.   I know this is an issue elsewhere. I'm not specifically aware if it has been resolved.

COMMISSIONER HEMSTAD: That's all I have.

EXAMINATION

BY COMMISSIONER GILLIS:

Q.   Dr. Selwyn, I have a couple of additional questions. I'm looking at your executive summary of your testimony on page 13 and your response to the question, what in general should be the Commission's response to U S WEST's rate rebalancing proposal, lines 14 through 18. You make a statement about halfway through that that reflects your larger testimony that rate increases should not be permitted for services that are not facing price constraining competition. Is that statement conditioned on the assumption that the services in question are covering their direct costs or their TS LRIC?

A. Yes, with the following caveat. When we speak of recovering their incremental cost we're looking at all of the elements of revenue from that service, not necessarily individual rate elements. For example, residential service is covering its costs because the revenues associated with residential service include the monthly flat rate, the interstate subscriber line charge, the interstate and intrastate carrier common line charges as well as other revenues that are in some way tied to the residential dial tone line such as for example call waiting. You can't have a U S WEST residence dial tone service and get call waiting from another provider. If you want call waiting you get it from U S WEST and that's a service element that's priced immensely in excess of its marginal cost.

So if you take all of those components together and compare them with the costs of providing the basic residential dial tone service you conclude that the rate is in excess of the cost. If you looked only at the monthly rate you might conclude that it's less but that would be an incorrect comparison.

Q.   But what I wanted to make sure of is that you're not suggesting a black and white statement that it is appropriate for us to assure ourselves that the direct costs are being covered and if they weren't then perhaps your statement might be amended?

A.   I would agree with that but with the caveat that merely because -- and the specific example I have in mind is residential dial tone -- merely because the dial tone rate element is not recovering cost does not mean that the revenues associated with that cost is not recovering cost.

Q.   I understand your caveat. From your discussion of toll revenues and pricings, I had concluded that you would agree that a reduction in rates for certain service could in fact be rolled in a revenue increase as opposed to a decrease; is that correct?

A.   Yes.

Q.   The statement that you make in your summary that "company shareholders should accept responsibility for any revenue losses caused by competitive motivated in rate reductions it initiates," does it work in reverse is my question. Do shareholders in your opinion, should they gain the full benefit of rate increases from rate reductions or from revenue increases from rate reductions, kind of the inverse of what you just stated in your testimony?

A. I think probably I have to clarify this point because perhaps there's some confusion. I'm not suggesting that a rate reduction, for example, such as the toll rate reduction that has been proposed and with which staff concurs, which really constitutes rate rebalancing -- in other words, the elimination of uneconomic pricing -- I'm not suggesting and my testimony should not be read as suggesting that the net reduction in toll rates should be charged to shareholders. That's not the staff's position.

Staff's position would be that if, for example, the company were granted pricing flexibility with respect to a downward pricing flexibility with respect to a specific service, and the company is currently charging $10 a unit for a service and reduces its price to $8 and as a result it experiences some net erosion of revenues even though it might have helped to protect its market share a little bit, it would be improper for the company to then turn around, having made that decision to reduce its rate from $10 to $8 as a competitive response and turn around and have an expectation that whatever shortfall in revenues it gets from that it can recover from someplace else.

Q. That helps. Do you agree that with U S WEST that some services will have to be priced above TS LRIC in order to provide U S WEST with a reasonable and sufficient rate of return?

A. Well, once again, this gets to the question of the embedded -- use of the embedded revenue requirement. Certainly that is possible. I mean, even the toll rates that are being proposed are above TS LRIC and the residential rate that's being proposed together with the other elements of the residential revenue base are above TS LRIC. I don't necessarily think that in the context of rate of return regulation we have to get every rate to TS LRIC. I agree that rates that are set for bottleneck essential facilities that are used by others should be set very close to TS LRIC. I'm including in TS LRIC the overhead loading component that I was just discussing with Mr. Shaw at the very end of his cross-examination, which I think helps to recover some of the gap between what the company calls TS LRIC and the revenue requirement, but if there is still a gap then certain rates should be set in order to satisfy the revenue requirement net of the Yellow Page imputation and any other adjustments that the Commission determines are appropriate.

Q. Do you have any recommendations for the Commission about how we should apply practice, reconcile the difference between TS LRIC prices and any potential need that may need to be added into the formula to account for revenue requirements of the company?

A. I guess the first point I would make is that I would make sure that the TS LRIC cost base includes the 16 point whatever --

Q. Let's just assume that by some magic we actually have a cost figure that agrees up. Take that away.

A. That would be magic. Assuming that were the case and there were still a gap then I would generally agree with the recommendation that Professor Mayo made with respect to applying the inverse elasticity rule, but I would emphasize that the inverse elasticity rule has to be applied with respect to the ultimate consumer, not necessarily to or, I should say, and not to the immediate buyer of the service. In other words, if the company has an essential facility that a competitor needs in order to be in business that competitor may have a relatively low price elasticity, exhibit a relatively low price elasticity for that essential facility despite the fact that the competitors in service may itself find a relatively high price elasticity.

What's relevant for applying the inverse price elasticity rule is not the price elasticity confronted by the telephone company but the price elasticity applicable to the final product. So, on that basis, the essential facility would have to be priced relatively close to TS LRIC even though individual end services of the company that do not confront competition and that exhibit relatively low price elasticity could be priced above TS LRIC.

Q. I follow that. So when you say that TS LRIC is a clear price floor, though, for both essential and nonessential services --

A. And assuming that the magic that you described.

Q. And assuming the magic. So for the nonessential, the nonessential services, if that's the right word, not sure it's the right term, but the ones other than the essential facilities the competitors use in the inputs, if some of those were to be priced above TS LRIC to cover revenue requirements, if that was something that was desirable, we run into the problem of what level to set them at. I had this discussion with Dr. Mayo. I think you might have been in the room and I would like to ask you pretty much the same thing. How do we determine what that level should be, and in particular in setting those rates, should we take into consideration what the relevant cost of the competitor would be in providing that same service?

A. If there's actually a competitor then the chances are that the price elasticity could be somewhat higher than zero in which case the pricing would tend to be more toward -- tend to be closer to TS LRIC under the application of the inverse elasticity rule. If there's not a competitor you are then confronted with the dilemma of how to price service that is considered an essential public service such as residential dial tone versus other elements that are more discretionary. Now, the traditional way that this has been done has been to unbundle the residential offering into multiple components so that, for example, that discretionary components like call

waiting, which presumably would be attractive to only those people who tend to have a higher willingness to pay for the overall service, are stripped off of the basic package and are sold separately at a price that is considerably in excess of their cost.
The alternative which the Commission adopted, for example, with respect to touch tone some years ago is to take this optional feature and simply make it standard.

Now, what you need to do is sort of strike a balance. If the objective is to maintain a low entry price while at the same time as a general matter recovering the residual from the total low price elasticity category such as residential, then the present scheme of separate pricing for premium features is appropriate. If, on the other hand, the objective is to make the premium feature as widely available as possible, such as the Commission did with touch tone, then what you might decide to do is to raise the rate level overall and include the premium feature as part of the basic package.

And this is to me a completely legitimate policy decision that the Commission should make and can make in terms of the way it prices these services.

Q. Your discussion with Mr. Shaw on the

scatter plotting in your exhibit piqued my curiosity. I don't know the exhibit number on that. Page 4 of 10?

A. The graph is on page 4, I believe.

Q. Right. The X axis on that says total direct expenses return in taxes, is that an approximate revenue, is that what it says?

A. What it is is revenues less the accounts that were identified as overhead.

Q. I see what you mean. Would it be correct to interpret that then as that there are no economies of size or scope with respect to overhead or even appears there's diseconomies?

A. I think the conclusion is that there are no economies. That the overhead associated with the big company and the overhead associated with a small company are roughly the same, and that while we may be talking about, sure, if one more customer arrives on the scene and orders telephone service this afternoon that's not going to affect overhead but when the company makes a decision as to whether or not it's going to, for example, be in the business of providing retail services or be in the Centrex business or be in the voice mail business, in other words, when it's making large scale business decisions in terms of identification of a line of business activity or a scale of business activity, that affects overhead. And it's appropriate, that's why we believe it's appropriate to treat that as part in the context of a total service long-run incremental cost. We try to look not at the change that is affected by a small -- change in course that's affected by a small change in quantity but the change in course that's affected by the decision either to offer or to cease offering an entire service and that the impact on overhead is appropriate to include, and this analysis suggests that overhead is not something that benefits from scales of economy.

Q. I just found that interesting.

A. I had a long study of this just from anecdotal examination of course studies and we finally last summer sat down and attempted to perform this analysis and to demonstrate one way or the other how this effect is based.

Q. Would it be a big leap of logic to take from that that the minimum efficient market share is relatively small for telephone entry?

A. No, because this only goes to the items that are classified in these overhead accounts which basically are your traditional president's desk type of overheads. They don't go to joint plant. We're not speaking here about central office plant or outside plant that's used jointly to provide monopoly and competitive service for example. We're speaking here about overheads, advertising, marketing, customer support, various -- well, not even customer support functions because those would tend to be direct, but just your sort of garden variety corporate overheads.

Q. I just found it interesting. Thank you.

EXAMINATION

BY COMMISSIONER HEMSTAD:

Q. I have one other question. There is certainly a very substantially different view of the world between the staff and yourself and support of the staff and the company with respect to what should be the appropriate pricing for the local residential service. Staff says statewide price of $10 is sufficient to cover costs. Company is saying a price of $21 and $26 is required to recover those costs. Assuming that the company strongly and firmly believes that its cost analysis is correct and this Commission were to agree with you and the staff and order a basic service residential service at $10 a month, would it be rational and economic behavior on the part of the company then to seek to exit the local residential market?

A. No, I don't think it would be. The staff's analysis is based upon -- and let me explain the sources of difference between the staff's position and the company's. The company is comparing the dial tone rate with the total cost of residential service and is excluding other revenue elements that are specifically earmarked to support residential service and that are tied to the existence of residential service such as the ones I mentioned. Both the nonoptional ones such as the federal subscriber line charge as well as other things like the carrier common line charges, state and federal, optional service revenues and the $4.27 from Yellow Pages, when you put all that together and you compare it with the company's own incremental cost of residential service, it's fairly clear that the service is compensatory, and this is not a fully distributed cost type of analysis where we're making some arbitrary allocation of toll and local costs or anything of that sort. We're looking at the costs the company has provided and we're looking at the revenues that support those costs.

The other major difference between the company's number and the staff's number is what the company is doing is attempting to recover all of the residual revenue requirement which it claims it needs from this particular category of service. So if you were to set an array of say, $21 to $26 for the dial tone line and then started adding in all of the other pieces of the residential service that I mentioned you would probably now be looking at a number that might be something between $30 and $40 and that's the correct basis for comparison with the incremental costs and it's on that basis that the staff rejects the company's position.

COMMISSIONER HEMSTAD: That's all I have.

MR. SMITH: No redirect.

MR. TROTTER: I have one question stimulated from the bench's questioning.

RECROSS-EXAMINATION

BY MR. TROTTER:

Q. Turn to page 80 of your testimony and on lines 16 through 20 you were quoting from Judge Green. Do you see that. He does not say there that basic exchange service is priced below cost, does he?

A. Not within this quote, no.

Q. Are you aware that he did say so in his decision anywhere?

A. I don't know.

MR. TROTTER: Nothing further.

RECROSS-EXAMINATION

BY MR. SHAW:

Q. Dr. Selwyn, at page 51, I believe, you discuss your concept about the need to count the appropriate revenues in deciding whether or not residential service covers cost, and you just had a discussion with the bench about that. As I understand your views, not only the $10 a month for the service needs to be counted, but that both the interstate and the intrastate carrier common line rates paid by interexchange carriers need to be counted and the subscriber line charge and any vertical services should properly be counted towards the revenues derived from universal service. Is that a fair summary of your testimony?

A. I would qualify that to the extent that I am speaking here of any vertical services that become linked -- that are linked specifically to the residential dial tone, and that once the customer takes dial tone from the phone company, assuming there were competitive alternatives for the dial tone, it would at that point be offered to him only by the telephone company. So, for example, call waiting would fall in that category but speed calling would not because speed calling is something that could be supported by CPE.

Q. And it's competitively classified in this state, speed calling?

A. I don't know that it is or isn't, but it could be supported by CPE. So I would not include revenues from speed calling but I would from call waiting or selective ranging or call trace or service of that sort which are linked to the residential dial tone.

Q. In the state of Washington only the local exchange companies can provide intraLATA toll on a one plus dial basis, correct?

A. At this time, yes.

Q. And toll is not classified as an effectively competitive service for local exchange companies, is it?

A. I don't believe it is, no.

Q. Same rationale, then, that you would claim all of the vertical services that you just discussed as residential revenues all intraLATA toll revenues generated from one plus dialing from residential subscribers should be counted towards covering the cost of 1FR service?

A. Well, let's see exactly what I did say and didn't say because I think it probably does not follow from the logic. I've suggested that the carrier common line charges should be included. I have specifically not suggested that the traffic sensitive local access, local switching and local transport elements of access service.

Q. That wasn't my question. My question was the toll revenues. Could you answer the question first, please.

A. The question was predicated on my previous testimony, so I just wanted to clarify it --

MR. SHAW: Your Honor --

A. -- with respect to toll.

MR. SHAW: Can I have an instruction to the witness to answer the question.

JUDGE WALLIS: I am going to ask the witness to answer the question first, if you can. If you cannot answer it state that you can't and then state the basis for your statement.

A. To be consistent my answer would be that I would impute into intraLATA toll the equivalent of a carrier common line charge and include that as part of the residential revenue, but that any additional revenues associated with toll in the same vein as my treatment of switched access revenues other than the CCLC would be associated with toll service.

Q. Have you read this Commission's order analyzing whether or not there is a price squeeze between the rates charged for a PAL line or a public access line and the 25 cents charged for a local pay phone call?

A. No, I have not.

Q. Please accept for purposes of this discussion that the Commission excluded from that imputation test any revenues derived from a local pay phone other than the 25 cent local call, excluded the operator call, the toll calls, all other revenues derived from that pay phone. Is it consistent to deem residential service of cost by counting the revenues derived from services other than residential service and to deem a price squeeze in the situation of pay phone by only looking at one piece of the revenue that is derived from that service?

THE WITNESS: Can I have that question read back.

(Record read as requested.)

A. I don't see any particular inconsistency if we're speaking of -- and I am not familiar with the issues of the record in that case, but I presume we're speaking of a public pay phone which does not have a monthly access element but does have a coin slot and the principal use of the coin slot is for local calls, I don't think they're in the same category and I don't see any inconsistency.

Q. If this Commission were to accept your recommendation and count all of the revenues that you've discussed in your testimony in here this afternoon towards testing whether residential service covers its cost or not as offered by U S WEST there would be no price squeeze on that competing company?

A. No, absolutely not, and the reason there wouldn't be is because the competing company would be in a position to collect each and every one of those same revenue sources from its own customer. If I were a competing company and I were offering dial tone service to you, Mr. Shaw, and you for whatever reason decided to buy it from me then I would be able to charge the interexchange carrier that you used for your long distance service for access and I would be able to recover the equivalent of a carrier common line charge. I would be able to charge you for call waiting and recover revenues for call waiting. I would be able to charge you a rate that contemplated, that was based upon the SLC being otherwise applicable to you if you had taken dial tone service from U S WEST. That's specifically why I am including services that are tied to the residential dial tone but excluding anything that would be competitive. I'm excluding speed calling because speed calling I have no assurance as the dial tone provider that you would buy speed calling from me. You could go out and buy a piece of CPE but I do have assurance that if you want call waiting you will have to buy it from me. And if U S WEST charges two and a half dollars that I probably could charge something pretty close to that. So there's no price squeeze at all. I should be able to capture each and every one of those revenue sources.

Q. In the case of a pay phone site provided by U S WEST and a competing pay phone service provider competes away that site, replaces U S WEST pay phone with its pay phone and buys presumably essential input from U S WEST to do that, PAL line at 1FB rates, that pay phone provider now has access to all of the revenues generated by that telephone, local calling, operator assisted calling and toll calling, correct?

A. Yes.

Q. Therefore, in making any kind of a imputation analysis to decide whether or not that competitive provider is in a price squeeze between the quarter charged by U S WEST and the PAL line at the 1FB rate would have to take into account the additional revenues available to that competitive provider to cover the expenses of its operation just as in your discussion of a competitor for a local exchange service, correct?

A. I'm not sure these cases are analogous. You're speaking there of setting a rate to replace foregone revenues and I'm speaking here of just testing to see whether or not a rate is compensatory.

Q. You're testing to see whether a rate -- excuse me. You're testing to see whether the cost of a service is covered by the available revenues that that customer may produce, correct?

A. That's correct.

Q. And in analyzing whether or not the revenues from a pay phone site cover costs you would reasonably include the revenues that can only be provided by that pay phone, would you not?

A. If I were trying to develop the cost of a pay phone, yes, but I thought you were talking about a PAL line, which from the company's perspective is 1MB. Doesn't have a coin box on it. There's no process of collecting, maintaining, servicing or doing

other things with a coin box. There's no investment of however much a coin box costs. It's not a comparable situation. A PAL line is just a pair of wires coming into a jack of some sort.
Q. In computing the cost revenue relationship of U S WEST's pay phone service you would impute a PAL line at the tariffed rate, would you not?
A. I would impute a PAL line at the tariff rate along with all of the costs associated with in maintaining the coin box.
Q. And deciding whether or not that pay phone operation is profitable on the revenue side you would look at the 25 cents, the operator assisted surcharges from that pay phone and the toll sold from that pay phone, would you not?
A. Yes, I would.
Q. Do you agree with the following statement made by Dr. Kahn in a letter to the Wall Street Journal in Exhibit 369? And I will read it to you. "Obviously AT&T is not interested in providing basic residential dial tone for its own sake, and the economic feasibility of its doing so does not depend on its ability to do so at a profit any more than it does for the local telephone companies themselves, for both of these parties signing up residential

subscribers at a loss is feasible and attractive only because that gives them the first shot at obtaining the business that is priced far above cost." Do you agree with that statement?

MR. SMITH: Your Honor, I am going to object to the question as being beyond the scope of any question that was asked by the bench or Mr. Trotter.

MR. SHAW: Well, Your Honor, this precisely goes to the discussion with the bench, what revenues do you count in making cost price decisions.

JUDGE WALLIS: The witness may respond.

A. Would you read that again, please.

Q. "Obviously AT&T is not interested in providing basic residential dial tone for its own sake, and the economic feasibility of its doing so does not depend on its ability to do so at a profit any more than it does for the local telephone companies themselves, for both of these parties signing up residential subscribers at a loss is feasible and attractive only because that gives them the first shot at obtaining the business that is priced far above cost."

A. I don't agree with that. I don't agree with the statement.

Q. And your disagreement with that statement is consistent with your assertion that U S WEST should count revenues beyond the 1FB rate in determining whether or not its residential service covers cost?

A. It's not inconsistent with it. I think you're confusing several different issues in suggesting that there's an inconsistency. I was speaking to rate structure. For public policy reasons the carrier common line charge and the equivalent of it as a component of the toll rate have been set explicitly as subsidy elements. If we were to eliminate the carrier common line charge as, for example, California did and incorporate that revenue into an end user charge both from access and toll, I would support that in which case the dial tone line rate would go up and the CCL would go down.

The issue to which Professor Kahn, who incidentally did not disclose in that Wall Street Journal that he is currently a paid consultant to the Bell companies on a number of issues relating to the ones that he discusses in the letter, but I will disclose it to this Commission, the issue he's attempting to suggest is that it would make sense for AT&T to lose money on dial tone lines in order to get customers for its toll services. I don't see the linkage there.

I think we've now had a period of some ten years or close to getting on to ten years of delinking the local service provider and toll and it does not specifically make sense to me that AT&T would want to enter into widespread provision of local services on a loss basis on the theory that it might make it up through toll. Toll is a competitive service. The margins on toll service are getting smaller and smaller as competition increases in the interexchange market, and I think that that kind of statement is predicated on a misconception that is currently being fomented by his client that the interexchange market is not competitive. If you buy the story that the interexchange market is not competitive then you presumably believe that it can maintain a condition of super competitive profits. But if the interchange market is not competitive then why does AT&T need to lose money on dial tone in order to protect its position in the market that's noncompetitive. In other words, it just doesn't make any sense. His analysis, while it may support the political agenda of the BOCs, does not make any economic sense and I strongly disagree with it.

Q. Read you one more statement from this letter to the Wall Street Journal in reaction to your statement that Dr. Kahn did not disclose that he is a consultant to RBOCs. "Since I have in later years represented the latter companies" -- referring to the baby Bells -- "in litigation over some of these issues I am in a position to describe some of the counter situations that your stories neglect. I have done so as objectively as I can." Do you still assert that Dr. Kahn has tried to hide the fact that he has acted as a consultant to baby bells?

A. I think he is not disclosing that he is currently engage as a consultant. The implication is he has in the past acted as a consultant.

Q. Are you acting as a consultant to the adversary staff of this Commission?

A. I am acting as a consultant to the trial staff of this Commission.

Q. Does that make you less credible?

A. No.

MR. SHAW: Nothing further.

MR. TROTTER: I have a question.

RECROSS-EXAMINATION

BY MR. TROTTER:

Q. Is it true that dial around or accessing alternative carriers occurs more frequently from pay phones than from 1FR service?

A. I believe that is the case if for no other reason than because that type of activity is actually affirmatively promoted by interchange carriers whereas it's typically not promoted with respect to residential services.

Q. So a pay phone provider cannot be assured of getting the toll revenue from a pay phone?

A. That's correct.

Q. Did I hear you correctly that you are supporting the elimination of the CCLC or not?

A. I'm not supporting it in the sense that it is not part of the recommendation that the staff is making in this case. What I am saying is that were the decision made to shift residential revenues from CCLC to an end user charge I would support that.

MR. TROTTER: Thank you.

JUDGE WALLIS: Is there anything further of the witness?

MR. SHAW: Just a question prompted by Mr. Trotter's question.

RECROSS-EXAMINATION

BY MR. SHAW:

Q. Do you have any data to support your assertion that there is more dial around traffic from a pay phone than from a residential phone or is that just your assumption?

A. I actually probably do have that data, but it will take some digging. There was an information request that I wrote which was served on interexchange carriers in California several years ago in the Commission's implementation rate design case specifically involving the use -- the amount of dial around activity and as a general matter in jurisdictions in which local -- I'm sorry, intraLATA toll competition had been authorized. It had not at the time been authorized in California, and it is my recollection that the response that was provided at least by AT&T at that time and possibly by one of the other IXC's was to the effect that the traffic was -- that the dial around activity was occurring in the pay phone area. If you want I can try to dig that up but it may be at the warehouse because it's about three years old but I do have that response.

Q. Frightening to think you have warehouses of data.

A. I have it going back to the 1970's. I haven't reviewed it at all recently though.

Q. Have you reviewed in this proceeding Exhibit 371C, data request response from AT&T to U S WEST about its promotion of dial around?

A. No, I have not.

MR. SHAW: Nothing further.

JUDGE WALLIS: It appears that there's nothing further for you, Dr. Selwyn. Thank you for appearing today. You're excused from the stand. Let's take a 20 minute recess.

(Recess.)

JUDGE WALLIS: Let's be back on record, please, following an afternoon recess. The Commission staff has called Scott Lundquist to the stand.

Whereupon,

SCOTT LUNDQUIST,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

JUDGE WALLIS: I am marking the following documents. The direct testimony of Mr. Lundquist is marked as Exhibit 385T. There is an errata sheet to the direct testimony which I am marking as 386. The attachment SCL-1 tables and figures is marked as 387 for identification, and the confidential testimony is marked as 388C for identification.

MR. SMITH: I'm sorry, what was 388C?

JUDGE WALLIS: Confidential testimony. Let's be off the record.

(Discussion off the record.)

MR. SMITH: Yes.

JUDGE WALLIS: Let's be back on the record to reiterate the identification of exhibits for witness Lundquist. We have the direct testimony, 385T. We have excerpts from the direct testimony obtaining confidential information separately marked as 385C. We have the errata sheet marked as 386 and the attachment SCL-1 tables and figures is identified as 387C.

(Marked Exhibits 385T, 385C, 386, 387C.)

DIRECT EXAMINATION

BY MR. SMITH:

Q. Would you please state your name and address for the record.

A. That's Scott C. Lundquist, and my business address is One Washington Mall, Boston, Massachussetts 02108.

Q. By whom are you employed and in what capacity?

A. Economics Technologies, Incorporated and I'm a senior consultant.

Q. You have before you what has been marked for identification as 385T and 385C?

A. Yes, I do.

Q. Do you recognize those as your prefiled direct testimony on behalf of the Commission staff in this proceeding?

A. Yes.

Q. Do you also before you an errata sheet identified as Exhibit 386?

A. I don't believe I have a copy but I've seen it.

JUDGE WALLIS: Let me hand this to the witness.

A. Yes.

Q. And in addition to the corrections noted on the errata sheet, do you have any other corrections or additions to make to Exhibits 385T or C?

A. Yes, I do. If we could turn to Exhibit 387.

Q. Before we do that can I ask you if Exhibit 387 is the exhibit you refer to in your direct testimony?

A. Yes.

Q. And is it prepared by you or under your direction or control?

A. Yes, it was.

Q. Please continue.

A. Table 2, first of all there's a correction to make. The proposed monthly rate appears as 7.40. That should be 7.70, and the reason for that is because a proprietary cost number appearing on --

JUDGE WALLIS: I'm going to enter up to this point and ask that we go off the record.

(Discussion off the record.)

JUDGE WALLIS: Let's be back on the record, please.

A. I was mentioning that the proposed monthly rate should be revised from 7.40 to 7.70. That reflects a change in the underlying proprietary NTS-COE cost appearing on the previous -- appearing on the same page. What occurred was a transcription error from my underlying work paper which was provided in response to public counsel set 01 question No. 20, and that appears -- my work paper is attachment B and that's a proprietary work paper.

Q. Just to be clear, Mr. Lundquist, if we increase the line that says NTS-COE by the same 30 cents shown for proposed monthly rate that that would be the proper number in that line?

A. That would be and that would correspond to the number that I had given in the proprietary work paper appearing in attachment B at line 15. The proposed rate is also referenced in my testimony, page 28, line 12.

Also, I have a second correction on page 15 of my direct testimony, Exhibit 385T, footnote 24. In attempting to correct an error by the company witness, Ms. Wilcox, I also erred and the correct number that should appear in the footnote is $154,590 instead of 3.1 million. That number also appears in several places in my direct testimony and in my exhibit. Affects page 3, line 20.

JUDGE WALLIS: Perhaps rather than taking up the time right now we could ask you to submit a revised errata sheet.

MR. SMITH: That will be fine, Your Honor. Apologize for the delay.

Q. Mr. Lundquist, if I were to ask you the questions today contained in Exhibit 385T and 385C, with those changes, would your answers be the same?

A. Yes, they would.

MR. SMITH: Your Honor, move for admission of Exhibits 385T, 385C, 386 and 387C.

JUDGE WALLIS: Is there objection?

MR. OWENS: No objection.

JUDGE WALLIS: The documents are received in evidence.

(Admitted Exhibits 385T, 385C, 386 and 387.)

MR. SMITH: Witness is available for cross-examination.

MR. OWENS: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. OWENS:

Q. Good afternoon, Mr. Lundquist, I'm Doug Owens representing U S WEST Communications.

A. Glad to meet you.

Q. I don't want to belabor the correction you just made, but I just want to make sure I understand the full import of it. For example, directing your attention to page 20 of your Exhibit 385T where you describe the impact of the calculation of your recommendations regarding the company's access rates as a difference of $12.0 million less than what would be generated under the initial rates assumed to be adopted in the LTR proceeding, would we correctly assume that that number also would have to be corrected by the difference between the $3.1 million that you had previously testified was the effect of the company error on independent ILEC charges and what you now testify is the $154,000 number?

A. Yes. It would flow through to that number, too.

Q. Thank you, that's very helpful. Shortens things. Like to talk to you a little bit about your testimony about the company's proposal for zone pricing of access. Do you have that in mind?

A. Yes.

Q. You begin discussing that at page 8 of your Exhibit 385T, correct?

A. Yes.

Q. And just like to talk to you a little bit, you mention in the beginning of that paragraph in the -- middle of the paragraph you state, "Thus the company admits that its zone-based deaveraging proposal for switched access is primarily intended to be a strategic response," and then you contrast that to being driven by cost differences. Did you intend to suggest by characterizing that as an admission that the company is engaging in something reprehensible in making this proposal to the Commission?

A. I would not characterize it as reprehensible. It certainly would be in the company's self interest. It would be an example of price discrimination.

Q. Well, not all price discrimination is unreasonable or unlawful, would you agree with that?

A. Not necessarily, although in this case I would characterize it that way. Not as unreasonable.

Q. In fact we have many examples of where identical services are priced differently for various reasons, isn't that true, to different people?

A. Generally, yes.

Q. For example basic local exchange service whether it's provided to a business customer or a residence customer is essentially the same service. Isn't that true?

A. Essentially -- you might want to define essentially the same service, but yes, as interpreting the fact that the customer is getting the ability to make calls in its local calling area, yes.

Q. And the dial tone?

A. Yes.

Q. And yet the price that one class of customers, namely residence customers, pays for that service is considerably less than the price that another class, namely business customers, pays; is that correct?

A. That's correct, and that has a long standing history of being the case and relates to public policy considerations of -- and also actually historically you could point to a value of service pricing philosophy that companies such as U S WEST have had in the past wherein customers who are perceived to obtain greater value from the service, and in this case that would be business customers because they're able to use that service to generate revenues of their own, were perceived as -- that it was perceived as reasonable to have them pay higher rates for the exchange service.

Q. And this is notwithstanding the fact that your own exhibit, confidential exhibit -- and I won't ask you for a confidential number but the Exhibit 387C, page 2 shows that on a relative basis, without necessarily saying whether you believe those numbers are absolutely correct or not, the costs to provide the business service is less than the cost to provide the residence service; is that correct?

A. That is true.

Q. That's using the staff's numbers or the staff's adjustment of the company's numbers; is that correct?

A. Uh-huh, and I'm using in particular TS LRIC, our best estimate at this point for TS LRIC.

Q. So would you agree with me that at least in this situation there has been perceived to be, at least one would assume, historically a sufficient reason to depart from rates that are either at cost or bear some fixed relationship to cost, at least in the relationship of residence to business basic exchange service?

A. There has certainly been in this case, yes, although I would have a difficulty in trying to translate this case into the case -- into some support for zone-based deaveraging of switched access rates.

Q. Well, nobody has asked you to do that yet, so I'm just asking you to agree with me that at least historically in this regard there has not been any perceptible requirement that these particular rates bear some proportional relationship to the relative cost of providing the service. Would that be fair?

A. That is fair, but I would also point out that the rates for the service are -- well, also we're looking specifically in my exhibit we're looking at one portion of the total local exchange service as well, but even if you did look at the total service, local exchange service again we're looking at incremental costs and not necessarily embedded costs of the company. But given that.

Q. Now, have you analyzed the company's access

charge proposal, the zone pricing proposal?
A. Yes.
Q. And have you analyzed the company's exhibit and backup that it's provided on the costs that it incurs to provide the access service?
A. Yes, I have.
Q. And so would it be fair that you understood that the rates that the company is proposing for both of these zones that are involved are both considerably above the incremental cost that the company, at least, has calculated that it incurs to provide those services?
A. Yes, that's true. There's certainly a high market contribution contained in switched access rates at this point and would continue to be under the company's proposal.
Q. And taking the question of what you just mentioned, high amount of contribution, that contribution is available then to meet the company's common costs, then, would that be correct?
A. That's generally how contribution is defined, yes. There are certain elements within the switched access rates that have been defined that way.
Q. And so other things being equal, comparing the alternative of having a switched access minute

sold by the company compared to having it sold by a competitor, are the company's other ratepayers better off if the company sells that minute than if a competitor sells that minute?

A. Just taking within isolation all other things being equal that would be true.

Q. Now, you described this proposal by the company as -- you quote Ms. Wilcox's testimony as saying that it's been targeted for lower access prices because these are the areas in which we feel the greatest competitive pressure and the need to meet that pressure with lower prices in order to retain business, and you haven't yourself undertaken to analyze whether the company's perception of the competitive pressure is reasonable or unreasonable in your testimony; is that correct?

A. I have reviewed the company's representations regarding competition in this proceeding and I've certainly reviewed Dr. Selwyn's testimony on that issue, but I have not spoken to competition per se in my -- the extent of competition per se in my direct testimony.

Q. So it's fair to say that the reason that you're recommending that the Commission not approve the company's proposal has nothing to do with any judgment that you've included in your testimony that the company has proposed to over-react or that the competition the company says it perceives isn't really there; is that correct? You haven't proposed that yourself?

A. That's true.

Q. And now let's take the next question. I had asked you a minute ago whether, other things being equal, if the company sells a minute of use compared to having a competitor sell the minute of use of switched access, that the rest of the ratepayers are better off and you agreed with me, taking that alone that that would be true. You can clarify after I ask you the question. Let's take the next step which is comparing in a situation where the company would have to lower the price of that minute of access a certain amount but still obtaining considerable contribution or, alternatively, have that minute of use sold by a competitor, are the other ratepayers better off if the company sells that minute at a lower price than they would be if that minute were sold by a competitor?

A. Well, I guess I would have to -- when I agreed with you I was also making the assumption -- when I agreed with the original question I think I was accepting an assumption that was in that question that the fact that the company is able to obtain that additional minute of switched access rather than having a competitor obtain it would mean that other customers would end up paying lower rates. Just wanting to say again that is an assumption and it's not necessarily that that would be the case. However, if we have that assumption made explicit that there would be a flow through of that additional revenue to some other customers' rates, then, yes, the customer, that other customer of U S WEST would be better off if U S WEST had obtained that minute of switched access rather than a competitor. But, you know, I think that's just one way of looking at what happens to the revenues that U S WEST obtains from switched access and certainly there's no one to one flow through like that.

There are also other considerations here which is that one of the goals of this Commission is to have competition proliferate and if there was -- in the kind of case that you described it may well be that over the long run, as competitors are able to obtain -- to grow their own services that customers in U S WEST territory in general will be made better off because of the fact that they have alternative service providers and then also because that does place pressure on the company itself to increase the efficiency of its services and be more innovative and more responsive to customers. So there's a lot of factors that need to be taken into account here when you start making an equation between the loss of a switched access minute to a competitor and how that would affect customer welfare in general.

Q. Let me see if I can get back to where I thought we last had agreement on something and then ask you a different question. We are both talking about the current environment where the company is regulated on a rate base rate of return principle; is that correct?

A. I will accept that assumption, sure.

Q. And so assuming that you have determined your revenue requirement the next job of a Commission is to determine the mix of rates that when multiplied by volumes to be produced during the rate effective period will equal the revenue requirement, correct?

A. Yes. I can work with that assumption, sure.

Q. And so under that assumption, and bearing in mind again that -- well, let me ask you a prepatory question. Historically, is it your understanding that particularly residence rates have been priced on a residual basis?

A. Yes.

Q. And what that means is that rates for other services such as toll and access are set and the anticipated volumes are used to generate an amount of revenues and then whatever part of the revenue requirement is left over is divided by the applicable units of service for those services that are residually priced; is that right? That's how you get the per service charge for those, generally?

A. I would say generally true.

Q. So under the assumption again that the access charges contain the contribution, would you agree with me that the residual pricing methodology does cause this flow through of benefit of that contribution above a LRIC cost to other services that are residually priced when we're in a ratemaking environment?

A. Under those assumptions, yes, the sums you've given when we're determining prices for services at the same time we have determined the company's revenue requirement -- and we're assuming that, for instance, your local exchange services were residually priced -- then, yes, I would agree with you.

Q. And would you further agree with me that access, switched access, is a service that has the nature of a commodity in that it's very difficult to differentiate one provider's access service from another in a way that would build some kind of brand loyalty?

A. Not necessarily. I think there can be not only differences in terms of responsiveness to customers. For instance, I think one of the reasons that there have been some inroads to U S WEST from what I understand, U S WEST's provision of special access services, for instance, to the extent there are some, and I believe there have been some, would be because the competitors are able to provide the services that customers require more quickly.

Q. Well, how about switched access? Is there anything about a U S WEST switched access minute of use that would differentiate it from, let's say, an ELI switched access minute of use?

A. No. The minute of use -- possibly reliability, but I'm talking about in terms of the service being offered you certainly could have the same differences in terms of responsiveness to a customer, changes in the service or ordering or things like that.

Q. Well, is there any reason to believe that from what you've testified that if faced with a lower price for the ELI switched access minute of use customers would nonetheless choose to buy the U S WEST switched access minute of use?

A. I think there's a lot of reasons. I don't think that customers -- and here I imagine we're talking about interexchange carriers -- are going to immediately transition their services to competitors to U S WEST. I think it's a process that would take some time to occur, and I think that it's not something that would happen instantaneously that all the switched access traffic would be transferred to a competitor.

Plus, of course the fact is right now there are only a few competitors that have the facilities in place to provide the service in very limited areas.

Q. But aside from the fact that today, as we sit here in the hearing room in early 1996 there may not be facilities available to handle all the available traffic what other reasons are there why, in your mind, customers would choose to buy the more expensive U S WEST switched access minute as opposed to the less expensive ELI switched access minute?

A. Other than the fact that the facilities aren't there, I think for one it takes time to develop a reputation for providing service, providing reliable service and there's an expense in moving to another supplier of service, and there has to be -- obviously the price differential is an incentive to change, and that's one reason why when you do have new entrants into businesses controlled by U S WEST and other LECs they generally have to provide a pretty significant price discount to incent customers to try their services, but it's not something that happens overnight.

Q. So aside from the fact that it simply physically takes time to change circuits over from one provider to another and the fact that the new entrants, as we sit here again in early 1996, may not have developed a reputation that would give the customers confidence in changing over all their services, is there any other reason you can think of why they would continue indefinitely to buy the more expensive U S WEST minute than the less expensive ELI minute?

MR. PROCTOR: Excuse me, Your Honor. I want to interpose an objection at this point. I think the witness's testimony clearly identifies that questions concerning the competitive conditions and policy recommendations that are appropriate, and obviously the underlying facts concerning competition in the marketplace, were addressed by Dr. Selwyn. I think this witness made very clear that that is not within the scope of his testimony.

Furthermore, looking at his qualifications, with all due respect, Mr. Lundquist, it appears that he does not hold himself out as someone who studies market conditions and has made any particular analysis in this case. Therefore I submit that asking him these questions is merely speculation on his part and clearly beyond the scope of his testimony and his qualifications.

MR. OWENS: Well, I'm interested that AT&T is defending the staff witness on the basis of qualifications and outside the scope of his testimony. I think it's clearly within the scope of testimony that's directed towards trying to convince the Commission not to approve a proposal that the testimony itself identifies as a competitive response. I think this is certainly legitimate cross to determine whether whether the reasoning of this witness should be given weight by the Commission.

JUDGE WALLIS: Mr. Smith, do you have any comment?

MR. SMITH: I so far don't have any objection.

JUDGE WALLIS: Objection is overruled.

A. Why don't you restate the question.

Q. I'm just trying to finally tie down, I think we probably have gone as far as I need to go on this, but aside from what I think you identified as the factor it physically takes time to transfer circuits from one provider to another and the fact that as we sit here in early '96 the new entrants haven't yet developed the reputation that would give an interexchange carrier confidence in transferring all the service over to them, can you think of another reason why the interexchange carriers would indefinitely continue to buy the more expensive U S WEST minute, assuming that it were more expensive, compared to the less expensive ELI minute?

A. Well, I think one other consideration would be that, and I've seen this in other markets, private line markets, for instance, customers are probably -- and I think it would apply equally to interexchange carriers. As the importance of telecommunications grows to end users everyone is becoming more and more concerned with reliability of their services, and I think one way to increase reliability -- and as I said it has been a device used in other markets -- has been to split your services between different carriers, which provides redundancy, and I think that's another thing that will happen.

I think as competitors come into the market they will obtain some market share that will be related to this desire to have redundancy of circuits, and yet since they already have a lot of -- basically 100 percent of their switched access circuits with U S WEST that would make sense that they maintain some of those circuits with the incumbent.

Q. That's an interesting point. They would maintain some but presumably they would disconnect others. Would that be correct?

A. That's what competition is all about. Of course the other side of it is is that we would expect, as there has been, growth in the retail market. The toll market will cause demand for switched access to grow in general so that there is also greater demand for circuits so some of that additional demand may be met by those competitors.

Q. Now, have you yourself examined the locations where the new competitors are building their facilities in the state of Washington?

A. Have I examined them and am I familiar with them?

Q. Yes.

A. I've seen some of them have been identified in other testimony in this case, predominantly metro areas, downtown Seattle, in particular.

Q. So would you say it's roughly fair to say that the areas where U S WEST is proposing the zones that would have the lower switched access charges coincide with the areas where the competitors are focusing their activities on building their facilities?

A. Well, that certainly is consistent with Ms. Wilcox's testimony and it makes sense to me. That's what the company is intending to do, yes.

Q. You don't have any evidence that the company has singled out areas where no competitors are building or are likely to build and is proposing that for the lower zone price; is that correct?

A. Yes, true.

Q. And I guess correlated to the fact that you know the competitors are building primarily in the metro areas, is it fair to say that you don't know any competitive providers of local exchange service that are building in the rural areas of the state?

A. New entrants, no, I'm not aware of any.

Q. Yes, that's what I meant. Did you understood when I said my prior questions that I was talking about competitors?

A. Yeah, I knew you were talking about new entrants.

Q. Is there any example that you're familiar with in the telecommunications industry of a company that modifies its prices to meet competition?

A. In other competitive markets?

Q. In the telecommunications industry generally. Is this a common or an uncommon practice?

A. Oh, sure. In the toll market, in the interstate toll market, which is quite competitive, there are certainly lots of instances of adjusting prices to meet competition, contract pricing, for instance.

Q. Directing your attention now to your discussion at page 12 of Exhibit 385T on the carrier common line, the application of the originating carrier common line to 800, 900 and feature group A foreign exchange traffic, you say that suffers from precisely the same shortcoming as the proposed geographic deaveraging of the carrier common line charge that you've just been discussing, and looking back to that discussion, the only thing I can see about your statement there is you say there's no justification for selectively reducing the carrier common line charge in those areas the company considers to be more competitively impacted, but the company isn't proposing the geographic deaveraging for the issue of the application of the originating carrier common line charge to these specific services. Is that correct?

A. That's correct, but what I would refer you to is lines 2 and 3 on that page as well where I say it's an element. Well, instead of that I thought that was referring to the CCLC. The previous page, lines 9 to 12, the fact that the CCLC is a pure contribution element, it's the same case here. The problem has been that the company is proposing to deaverage rates without any respect to the underlying costs, and I am saying here that we have the same problem. The CCL is an element that has been defined to just be producing contribution. It's not related to a particular cost of switched access, and I'm saying that that has the same problem here.

Q. Then I take it the basis of your criticism isn't, in this situation, that you're saying that the company should have produced some kind of relationship to costs in order to support its proposal, is that

right, since by definition the carrier common line charge has no relationship to cost?
A. Right. It could not justify it on the basis of cost, and there's no possible justification relationship to cost because it's not an element that relates to a specific cost incurred by the company. Relates to the recovery of nontraffic sensitive costs.
Q. I'm sorry, had you finished?
A. Yes.
Q. Well, then is your position that essentially for all time the carrier common line charge should be applied to these four services in the way that it was determined that it should apply some years ago? There's no circumstance under which it could be justified to change it?
A. It can be justified to change, but the problem here is the company's proposal is another device to selectively decrease the amounts charged to certain services that are viewed as competitive by the company, and the traditional mechanism that was used was to charge the terminating CCL to these services so that those services could not escape providing their own contribution through the CCL mechanism.
Q. And that policy was created during a time when an access line with a special class of service

had to be used to identify it as an 800 line on the switch. Isn't that true?

A. Yes, right.

Q. And isn't it true that today an ordinary business line can be used for the purpose of the closed end of this 800 type service?

A. Yes, and Ms. Wilcox discusses that. However, we have to look at the whole evolution of the market which includes not only the fact that for certain customers, smaller customers, they're able to receive that traffic over their common access lines, but also you had very rapid growth of services using DS1 connections. So, for instance, Megacomm type services and for those services it's even more of a problem because there's no CCL collected on those services.

Q. So it's irrelevant?

A. No, it's not irrelevant. It's more of a problem because it's not applying the terminating CCL, as is done now, would allow those CCL revenues to continue to be collected.

Q. They wouldn't be collected from the services that terminate on DS1s, right? Neither one would be charged?

A. It would be collected on the open end of the service.

Q. Right. And isn't it true that under the current circumstance for those customers that do use an ordinary business line as the closed end, they wind up paying the terminating CCL charge at both the originating and terminating ends of the call?

A. It's collected that way and then from what I understand of Ms. Wilcox's testimony there's an adjustment made so there's a credit applied.

Q. Do you have any reason to disagree with her testimony on that point?

A. No.

Q. And she also testifies that it's a burdensome administrative procedure to create and apply this credit, does she not?

A. She does, but if you don't use that mechanism then those customers who are using the Megacomm type services would not be paying the terminating charge.

Q. But she's proposed a different solution, hasn't she, rather than not using that mechanism?

A. Yes.

Q. You have no reason to disagree with her testimony that it is a burdensome administrative procedure; is that correct?

A. Well, I don't think she's quantified the burden, but I would expect there's some administrative expense associated with it, yes, sure.

Q. Now, turning to your testimony about switched access revenue at page 17, you describe what you would characterize as a potential problem with the company's test year access revenue calculations as that the company has not applied a price elasticity of demand effect to its calculation; is that correct?

A. Yes.

Q. I've looked and I haven't found any kind of quantitative study in your testimony associating any specific price elasticity of demand with any specific access charge change. Did you introduce any kind of evidence on that point?

A. My testimony was that --

Q. Can you just answer yes or no whether you have a quantitative study showing a particular demand elasticity associated with an access charge change?

A. I have not performed such a study, no.

Q. Nonetheless in the context of this case it is the staff that's the proponent of the existence of that effect and your testimony requests that the company be required to make an adjustment to reflect those effects or show affirmatively why no such adjustment is necessary; is that right?

A. Well, I did find it very unusual that the company has included elasticity effects in its revenue calculations for other services, including its toll service, as Dr. Selwyn has testified to, and then also including private line services from what I understand, and it seems to me that this is a service that also has significant revenues associated with it and it should -- there is certainly likelihood that the elasticity effects will occur here which would have the effect of reducing the amount of revenue loss associated with the toll reductions that have been proposed by the company and the alternative toll reductions proposed by staff.

Q. So is the answer to my question, yes, you in the context of this case are asserting the existence of these demand elasticity effects for access and have requested that the company either make such an adjustment or be required to show affirmatively why it is not necessary?

A. That was my testimony if you refer to page 18.

Q. Yes. It's true, isn't it, that in a prior case involving U S WEST's predecessor, U-75-40, the company proposed a price elasticity of demand adjustment for toll and the staff took the position that the company had not, even though it introduced econometric studies of that phenomenon, met its burden of proof; is that correct?

A. I can't comment on that.

Q. Can you accept subject to check that that's the case? It's in the Commission's official file.

A. Yes.

Q. And the Commission agreed with the staff in that regard in its order. Can you also accept that subject to check?

A. Yes.

MR. SMITH: Just for clarification, are we to accept some particular level of proof or case that was put on by the company? It's not clear to me what we're checking.

MR. OWENS: Well, you could check the fact that the company put on two separate econometric studies, one cross-sectional and time series supported with expert testimony on the record, and that was held to be insufficient to meet the burden of proof to demonstrate that there would be a change in the quantity demanded resulting from the change in the price that was assumed.

A. Subject to check that could have occurred,

but of course the quality of such studies, I'm just not aware of them and couldn't comment at this time.
Q. You haven't attempted to present any econometric analysis to quantify the relationship you assert that exists; is that correct, at least for access?
A. Yes. I'm not an econometrician. I haven't attempted to do that.
Q. Now, is the nature of the adjustment that you're asking the company be required to make in the nature of a proforma adjustment?
A. In the sense that given the company's proposals to phase in its switched access rates over two years I would expect that the impacts of elasticity effects should be recognized in a test year, and so if you want to characterize it as a proforma adjustment I would agree.
Q. The price change involved in the 1975 case was an increase in toll. Does the staff's position have anything to do with the fact that the price change here is a reduction have anything to do with the staff's different position?
MR. SMITH: Your Honor, may I interpose an objection? Mr. Lundquist cannot possibly speak to staff's position 21 years ago. It's unfair to put

that kind of question to him.

MR. OWENS: He can say he doesn't know.

JUDGE WALLIS: The witness may respond.

A. Like I said, I'm not aware of that case. However, I would remind you that in this case the staff has accepted the fact that there should be elasticity adjustment for toll and Dr. Selwyn has testified in great detail about that.

Q. Now, price elasticity of demand is a manifestation of consumer behavior, is that correct, the reaction to a change in price and the quantity that is purchased? Is that a fair statement?

A. Yes.

Q. And so in order for there to be a change in the quantity purchased there must be a perceived change in the price on the part of the person or entity that's doing the purchasing. Would that be a correct statement?

A. I do not believe that's true, no. There is -- I'm trying to recall the precise economic term for it, but there is not necessarily a need for the consumers to explicitly recognize a price difference nor to have a demand response to that.

Q. So your testimony is people can respond to a change in price without knowing that there's a change in price in terms of their behavior of purchasing different quantities of the good or service?

A. That's my understanding, yes.

Q. But you can't recall the term for that?

A. I haven't studied that type of phenomenon in detail but I know it does exist. It's a pretty well understood economic concept.

Q. Well, would you agree with me that switched access minutes are something that interexchange carriers can't warehouse, that, in other words, they purchased switched access minutes in response to decision of their customers where somebody picks up a phone and makes a long distance call?

A. Yes, it's true.

Q. And access is one of a number of costs of doing business that those interexchange carriers have. Isn't that true?

A. Yes. It's a large part of costs, sure.

Q. And have you studied the prices of the major interexchange carriers over the last five or six years, let's say, at the interstate level?

A. I'm familiar with the general trends, sure.

Q. Now, I'm talking about their basic MTS prices for customers with less than a thousand hours.

Are you familiar with those?
A. Uh-huh.
Q. Isn't it correct that following the institution of price cap regulation for AT&T in 1989 there was an initial reduction in the long distance rates in that category for all the major carriers?
A. That sounds right, yes.
Q. And that following that, beginning in about 1991, there have been increases in those long distance rates of those carriers?
A. If you're referring to the strict MTS rate schedule, without looking at particular discount programs that may have been developed, and we know there's many of those for targeting particular customer types within the overall market, I would agree with that. But there's been such a proliferation of different discount programs and marketing strategies that it's hard for me to make a generalization about that.
I would say that there certainly has been more price competition and rate reductions overall for the more competitive segments of the industry which would tend to be larger users of service rather than smaller users.
Q. Well, would you agree with me that doing

what you suggest U S WEST should be required to do would put U S WEST in the position of attempting to estimate or forecast how exactly, as a first step, the interexchange carriers will react in all of their various discount programs to the access charge reductions the company is proposing in this case?

A. I don't think so. I think you could make -- I would expect that the company, if I was in the company's position I certainly would have been trying to analyze for my own purposes the demand for switched access and demand responses for switched access over time. I think you might have the ability to estimate in aggregate what the demand response would be to the price changes you're proposing.

Q. You say you think that might be possible but you don't know, do you?

A. I would certainly expect that you could perform an econometric study to do that, analyzing differences in switched access rates and you could do this obviously by looking at other markets for switched access as well to get an understanding of that.

Q. So it's your testimony -- I just want to make sure I understand this. It's your testimony that the company could make a reasonable estimate of the demand response for its change in switched access price without also having to estimate the behavior of your interexchange carriers in their pricing decisions. Is that your testimony?

A. No. You were referring to whether the company would have to analyze and understand in detail the responses -- the way I interpret your question was that they would have to analyze and understand in detail the pricing responses of the interexchange carriers for each of their detailed rate structures, and I'm saying, no, I don't believe that's true. I think you could analyze the demand response in aggregate, and that's my understanding of the normal way it's done is looking at the total amount of demand and analyzing what demand responses occurred after a price change. This is not -- these studies are done -- I assume the company's study for toll, for instance, obviously the company has a great number of services in its toll rate structures, and I would expect that there was an aggregate, an evaluation of the demand response for toll based on aggregate demand.

Q. Well, toll is a product that U S WEST sells directly to end users, correct?

A. Yes.

Q. But U S WEST does not sell directly to end users its access product; is that correct?

A. That's true.

Q. And it has no control over how much or if any of its access price reductions will actually be reflected in the retail price of toll that is sold by interexchange carriers; is that correct?

A. Yes, that's true.

Q. And in fact at least one interexchange carrier earned 40 percent on equity in 1994, AT&T; isn't that correct?

A. I am not aware of that particular figure, but you're saying in Washington state, its Washington state operation?

Q. No, total, its total operations. Are you not aware of that?

A. I wasn't aware of that. I haven't seen the figures recently.

Q. An analysis like you're talking about or such as you're talking about would require U S WEST to consider the existence of any substitutes for its access product, would it not?

A. To the extent those substitutes are widely available and make a significant impact in the sense that there would be customers would respond to a price

change by moving from one of those competitive services to U S WEST in this case, then, yes, you would. That would actually increase the demand response in this case because we're talking about a rate reduction.
Q. But it's possible, isn't it, that there could be other products introduced or made more widely available at the same time at a lower price than the U S WEST new access price; is that correct, substitutes?
A. That's theoretically possible, sure.
Q. And so U S WEST would have to know about those in order to gauge the response to its price change, wouldn't it?
A. No. I don't think so at this point. If we're looking to determine an estimate of the price response to -- the demand response to the company's price reduction proposals at this point I think the impacts of that kind of consideration would be fairly small and would not really impact the bottom line results, because in truth elasticity estimates are just that. They're estimates, and I think those effects would fall within the range of error of a study in any case. I think they would be pretty minimal.
Q. Well, but have you yourself examined a

study of this type ever?
A. I have looked at these kinds of studies, yeah.
Q. For which company?
A. I participated in a review of some studies that were performed by the Manitoba Telephone System, and we were doing that work on behalf of the Manitoba Public Utilities Board in Manitoba.
Q. When was that done?
A. I'm not sure of the year but I think it was 1990 time frame.
Q. Is there extensive competition in Canada for telecommunications at this time or at least in 1990 was there?
A. No.
Q. And would the availability of competitors' substitute products be having -- you would have to consider in evaluating the demand response of price change in your service?
A. As I said, theoretically you could and should do that but I don't think the effects in this case would be significant because the level -- right now there is essentially from my understanding of the testimony in this case and my own experience there is essentially no competition for switched access at this

point, and therefore I don't expect over the next two years when you were proposing price reductions that you're hypothesizing other competitors coming in and offering prices even lower than the company's and what that effect will be on the company's revenues. I just don't think that's going to be that significant here.

Q. Can private lines be cross-elastic with switched access for some interexchange carriers?

A. Yeah.

Q. Wouldn't you have to factor in proposed changes in private line in order to make that kind of a demand analysis?

A. I think you could certainly include that.

Q. Well, wouldn't you have to in order to have a reliable estimate?

A. It would depend upon the amount of private line services that would be used for that purpose.

Q. You criticize the company's effort to evaluate the type of local transport that would be used by interexchange carriers if the company's local transport local restructure rates had been approved in the local transport case; is that correct, page 17? You recite a credibility challenge by AT&T?

A. Yes. That's what I do here.

Q. And in your view -- strike that. You've

mentioned that the U S WEST access charge reductions are scheduled to phase in over a period of time; is that right?
A. Yes.
Q. And it's possible, isn't it, that there can be new entry or growth of existing entrants over that period of time?
A. Certainly possible. Expect to have some entry, yes.
Q. So wouldn't you need to make some assumptions about that factor in terms of the assumed growth in demand occasioned by U S WEST price change for switched access?
A. Well, in that case you should also consider the general growth in demand for switched access the company would forecast over a two-year period. Actually that is another factor which would lead under the company's current analysis to an under estimate of its revenues from service. In other words, if you're looking at what the revenue impact even irrespective of elasticity effects the fact is over two years the company's switched access services demand should grow and that that also wasn't reflected in the company's demand analysis here. The company just used the same units in both phase 1 and phase 2. I am referring to

its two part rate reduction.

Q. But it's possible that new competitors could have a significant effect over this two-year period in terms of the company's actual ability to secure these access minutes. Isn't that true?

A. No. For the reasons I stated earlier I don't believe that's true. The fact is that it's going to take time for that competition to develop and the facilities are not in place yet, and I don't think -- my opinion would be there would not be a significant impact on demand from competitive entry in switched access.

Q. And you know that that's the case to a certainty; is that right?

MR. SMITH: Your Honor, I'm going to object. Asked and answered. We've been through this a couple of times already.

MR. OWENS: I don't think it's been asked and answered. He said it was his opinion. I'm trying to find out if it's a fact or if it's just speculation.

JUDGE WALLIS: He has indicated that it is his opinion.

A. It can't be a fact because it's something that's going to occur in the future, but to the best of

my knowledge that's what I would expect.
Q. Page 1 of your -- I'm sorry, page 3 of Exhibit 87 you have, and this is not a confidential page, up in a box in the schematic diagram called colocated equipment. Is that intended to represent physically colocated equipment?
A. Not at this point. That would be a virtual colocation arrangement because that is what is allowed in the state at this point.
Q. Finally, are you aware of the use of Internet access as a substitute for what would otherwise be switched access or toll communications, that's the technical capability to do that?
A. I understand there have been some trials in limited use of the Internet to provide some voice communications. It still seems to be at a very, very early stage at this point but it's an interesting application of the technology.
Q. And under that technology is it correct that a call which would otherwise be transported over the company's access facilities appears to the company as an ordinary local call?
A. Appears to --
Q. To U S WEST.
A. You're assuming that it's being conveyed

from the last server to the end customer over a local exchange line, that's what you're talking about appearing to the company?
Q. Yes, either at the originating or terminating end it appears as a local call?
A. That's true, yes.
Q. And so the company would never really know that it was transporting a call that otherwise would have generated switched access minutes of use; is that correct?
A. It is true that if that call had been completed over the normal telecommunications services it would have been completed through switch access and then also a toll service by an interexchange carrier, but really this is a very new use of Internet and my understanding it's an interesting application. It probably has some potential to have an impact on the company, but I haven't studied in detail what the projected growth of that service would be. At this point I don't believe there's anyone who offers a service per se based on that.
Q. Just ask you one or two more questions about that and then I think we can call it a day as far as I'm concerned. Would you agree with me that essentially by definition since to the end user as far

as any payment to the local exchange company is concerned that's a flat rated service, the change in access charge prices really would have no effect on whether they increased or decreased their use of switched access?

A. Let me just say you're assuming a case where a customer has decided to use the service for all of his toll calls and he's not using any normal toll service.

Q. On a given toll call to somebody who is equipped at the other end to receive the call, yes.

A. On a given toll call then, yeah, there's no special access facilities are not being used and there's no collection of switched access revenues in that case.

Q. We've been talking about this as a voice product but is it true that people actually use the Internet today also for communication just between computers without regard to the voice capability?

A. That's the traditional use of it.

Q. And have you yourself used the Internet to communicate with the staff?

A. We've used it for E-mail. It's been fairly effective.

Q. And those are calls that theoretically otherwise could have been connected on a modem to modem basis over the public switched network?

A. There would be many ways that those communications could have been done. They could have been done by faxes incidental to a phone call or specific phone call, yeah.

Q. And if they were faxes incidental to a phone call they could have generated switched access minutes?

A. They could have, yes.

MR. OWENS: Thank you, nothing further.

MR. TROTTER: Just a few questions.

CROSS-EXAMINATION

BY MR. TROTTER:

Q. Sticking with that last example you could have used the U.S. Mail or Federal Express?

A. Sure, there's a range of communications.

Q. On the Internet situation is it true that both users must own a personal computer?

A. A PC, yes.

Q. And is it also true that they both must be logged on to the Internet at the same time in order for the communication to occur?

A. That's true, too.

Q. Is it also true that only one person can speak at a time?
A. I would accept that subject to check. I haven't used these services and so I don't know.
Q. Have you read any reviews of the nature of the transmission quality that exists on what has been characterized as a, quote, service, unquote?
A. I have and I am mostly familiar with it through discussions.
Q. What is your understanding?
A. My understanding is that it's --
MR. OWENS: I'm going to object to this discussions with unnamed persons. We have no idea whether it's second, third, fourth or however many generations removed from the actual users. It seems to me this is really not probative of anything.
MR. TROTTER: I will ask him to present his understanding and the basis for it.
JUDGE WALLIS: The witness may respond.
A. I'm just trying to recall if I've read any trade press on the issue and none comes to mind, but it is an area of discussion. I will have to ask my company and the various analysts and consultants there so I would expect it would be in consultation with the other consultants at the company who are using Internet

services, and I think I actually did discuss it with Dr. Selwyn at one point as well. He was referring to that service, that capability of using the Internet for that purpose. To get back to the question about quality, my recollection is that it is a really new innovation, new innovative use of the Internet, and I believe there's even difficulties in making sure that you have a continuity of the voice transmission, because underneath the Internet is actually a packet data service, so it's not necessarily guaranteed that you're going to have a continuous transmission of those packets in a way that's going to allow you to have the same kind of voice quality you have over a normal toll service.

Q. And if you are logged on to the Internet but the person you are trying to contact is not, is there any way that your PC can contact them to make a connection?

A. Not through a voice transmission, no.

Q. You referred to fax communication. That goes over a phone line, am I correct?

A. Yes.

Q. And does that generate switched access minutes?

A. Yes.

Q. Turn to page 20 of your testimony, line 24. And I missed this at the beginning where you were correcting that 3.1 million figure?

A. I missed your page reference.

Q. Page 20. Line 24, does that 62 and a half million figure change based on your correction earlier?

A. Yes. That would basically be reduced by the 3.1 million as well.

Q. So the resulting test year revenues for switched access under the scenario that you are referring to here in your testimony would be 62 and a half million less 3.1 million?

A. Well, there's rounding also so it actually would be 59.4 million.

Q. And what is the new figure in place of 12 million on that line?

A. That's 15.1 million.

Q. You were asked some questions about competing interexchange carriers or alternative exchange carriers. Assume that an interchange carrier is paying U S WEST a dollar a month for switched access to a given location. And assume that that switched access is using the same loop of U S WEST that also provides local services, and assume that the loop costs $10 a a month for all companies if they were to replace that plant. Under those assumptions it would not be economic for the alternative exchange carrier or the IXC to put in their own loop if all they could provide to that location over that loop was switched access. Would that be correct?

A. Yes, that's true.

Q. So if that alternative carrier or IXC could not get the end user to change from U S WEST to its own local service then that alternative carrier's switched access could not be economic; is that right?

A. It wouldn't be profitable for the company, yes.

Q. And if U S WEST charged -- received $2 a month for access it would still not be economic; is that right?

A. For the company to try to obtain that service, yes.

MR. TROTTER: Thank you.

JUDGE WALLIS: Commissioners.

COMMISSIONER HEMSTAD: No.

COMMISSIONER GILLIS: No.

MR. SMITH: No redirect.

MR. OWENS: Just have one question following up on Mr. Trotter's question. He asked you about whether there was a guaranteed continuous transmission on the Internet. Can you accept subject to check that Seattle radio station King FM broadcasts continuously on the Internet?

THE WITNESS: I would accept that. I don't necessarily think that contradicts the possibility of having voice communications. Let me think that over. I would accept that, but my understanding was that there were some problems with continuity of voice communications.

MR. OWENS: Well, can you accept subject to check that's a classical music station?

MR. SMITH: Your Honor, I don't mean to quibble, but these things are going to be kind of difficult for us to run around and call radio stations to check this kind of stuff. It's nothing that we have here that we can look up readily --

MR. TROTTER: I will object to the question because what we were talking about here was two-way communications not one-way.

MR. OWENS: We were talking about continuity. He already asked the witness if he knew whether it was two-way or one-way.

That's fine. Nothing further.

JUDGE WALLIS: It appears that there are no further questions for Mr. Lundquist. Mr. Lundquist, I earlier handed you the official copy of your errata sheet, and I'm wondering if before you leave today you would add the corrections to not only your testimony but the included exhibits on that page and put your initials on it and then we will see that it is duplicated and distributed to the parties as the amended Exhibit 386.

THE WITNESS: Yes, sir.

JUDGE WALLIS: Anything further of Mr. Lundquist? It appears that there's not. Mr. Lundquist, you're excused from the stand. Let's be off the record for a moment for scheduling.

(Hearing adjourned at 5:50 p.m.)