Exhibit No. ___ HCT (GB-1HCT)
Docket UT-081393
Witness: Glenn Blackmon
REDACTED VERSION

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Verizon Select Services, Inc.; MCImetro Access Transmission Services, LLC; MCI Communications Services, Inc.; Teleconnect Long Distance Services and Systems Co. d/b/a Telecom USA; and TTI National, Inc., **Complainants,** **v.** **United Telephone Co. of the Northwest,** **Respondent.**	**DOCKET UT-081393**

TESTIMONY

OF

GLENN BLACKMON

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

June 5, 2009

HIGHLY CONFIDENTIAL PER PROTECTIVE ORDER

TABLE OF CONTENTS

LIST OF EXHIBITS

I. QUALIFICATIONS

Q. Please state your name and business address.

A. My name is Glenn Blackmon, Ph.D. My business address is 203 20th Ave. SE, Olympia, Washington 98501. My e-mail address is *mail@glennblackmon.com*.

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

A. I am self-employed as an economic and policy consultant in the telecommunications and utilities field. I have been retained by Staff to examine the reasonableness of United's access charges in light of Verizon's complaint and to testify in this proceeding.

Q. What are your education and experience qualifications?

A. I hold Ph.D. and master's degrees in public policy from Harvard University and a bachelor's degree in economics from Louisiana State University. From 1995 until 2006 I was employed at the Washington Utilities and Transportation Commission (hereinafter referred to as "Commission" or "UTC"). I was the Commission's economics advisor in 1995-96, during which time I advised the commissioners in the interconnection case, UT-941464, and the U S WEST general rate case, UT-950200. From 1996 to 2004 I was Assistant Director for Telecommunications. From 2004 to 2006 I was Director of Regulatory Services.

Prior to working at the Commission, I was a consultant in private practice, where my clients included both regulated companies and consumer advocates, and an analyst for the Washington State Senate Energy and Utilities Committee. I have presented testimony as an expert witness before this Commission, as well as the Illinois and Idaho commissions.

I am the author of a book, *Incentive Regulation and the Regulation of Incentives* (Boston: Kluwer Academic Publishers, 1994). I have authored or co-authored articles on utility regulation and economic theory published in *American Economic Review, Journal of Regulatory Economics*, *Yale Journal on Regulation*, *Journal of Risk and Uncertainty*, and *Public Utilities Fortnightly*.

Q. Please describe the expert testimony that you have previously provided to this Commission on telecommunications issues.

A. I have testified on the appropriate level and structure of reciprocal compensation arrangements between interconnecting carriers, reform of access charges, rates for unbundled network elements, de-averaging of UNE loop rates, the extent of competition in local exchange markets, competition policy, the effect of mergers and assets sales on public policy, service quality performance and measures, and other issues.

Q. Please describe your experience in the Commission's proceedings to reform access charges and establish universal service policy.

A. With Tim Zawislak, who is also a witness for Staff in this proceeding, I managed the Commission's rulemaking process that led to the adoption in 1998 of the access charge rule, WAC 480-120-540. I was closely involved in the implementation and revision of that rule over time. I was a witness for Staff in the complaint case against Verizon Northwest, Docket UT-020406, in which the Commission determined that Verizon

Northwest's originating access rates were unlawful to the extent they exceeded the comparable rates of Qwest Corporation. With respect to universal service, I led the Commission's efforts in 1998 and subsequent years to develop a universal service mechanism and to present that recommended program to the Legislature.

II. SUMMARY OF TESTIMONY

Q. Please summarize your testimony.

A. Staff has carefully reviewed the arguments and evidence put forward by Verizon and AT&T in favor of reducing Embarq's intrastate access charges and United's arguments and evidence in support of existing rates. Staff recommends that the Commission grant a portion of the relief requested by Verizon. United's originating access rates should be reduced to the level currently charged by Qwest. This recommendation is consistent with and based on the Commission's decision in Docket UT-020406 to order Verizon Northwest to reduce its originating access charges. With regard to the interim universal service terminating access rate, Staff believes that this rate should be eliminated with a phase-out period of three years. Staff believes that United has failed to justify this rate on universal service grounds. The company has overstated both its obligations to serve customers in high-cost locations and its actual cost of providing such service. United also has persisted with a retail rate structure that fails to place primary responsibility for the cost of service on those customers who are actually receiving the service.

Q. Please summarize the other testimony being offered by Staff.

A. Staff is also submitting testimony from Mr. Zawislak on issues relating to United's retail rates, from Mr. Rick Applegate on United's assumptions regarding cost of capital, and from Ms. Jing Liu regarding universal service policy.

III. ORIGINATING ACCESS CHARGES

Q. Why does it matter that United's originating access charges are higher than those of Qwest and Verizon Northwest?

A. It matters because the excess access charges of United allow it to export costs of the United local network to the customers of Qwest, Verizon Northwest, and/or the interexchange companies that offer intrastate toll service. United's pricing structure results in some combination of higher statewide toll rates and lower interexchange company profits. It allows United to enjoy some combination of higher profits and lower rates for its local exchange services. It also can distort competition in the long-distance market to the disadvantage of any company that chooses to offer long-distance service to United's local exchange customers. This is unfair, unjust, and unreasonable.

Q. Please explain how United can export its costs through high access charges.

A. Access charges are paid, in the first instance, by interexchange companies that provide long-distance services and, ultimately, by the customers who pay for those long-distance services. It is obvious that high access charges lead to high long-distance charges, but what is less obvious is that this effect goes beyond the long-distance charges of United's own customers. The high access charges levied by United affect the long-distance rates of all customers of wireline local exchange companies. The reason for this effect is the practice of statewide averaging of long-distance rates. While intrastate long-distance prices can vary from one long-distance company to another (i.e., AT&T may charge more or less than Verizon), each long-distance company charges the same price in all areas of the state (i.e., AT&T charges the same prices in Seattle and Sunnyside). This means that United's high access charges cannot lift only the long-distance prices paid by United's local exchange customers; they must lift the long-distance prices of all customers in the state.

Q. Does United's testimony take issue with your contention that access charges allow a company to export its costs to other customers?

A. No. United's defense of its rate structure implicitly acknowledges the export of costs. Its witnesses do not deny that originating access charges have the effect of shifting responsibility for some of United's costs to customers of other companies. Instead, they seek to justify that shift of cost responsibility through claims that it is necessary for United to meet its universal service responsibilities. Those claims cannot reasonably justify a high originating access rate, because the place to collect funding for universal service – if any funding is justified – is on terminating access service.

Q. Please explain how United's high access charges can adversely affect competition in the long-distance market.

A. Many companies compete for the long-distance business of the local exchange customers of larger local exchange companies, specifically Qwest and Verizon Northwest. Some of these companies – most notably Qwest itself – may not offer long-distance service to United's local exchange customers. Other competitors, such as AT&T or Verizon, may offer long-distance service to customers of Qwest, Verizon Northwest, and United. United's high access charges put the latter group of companies at a disadvantage relative to the former group of companies. In the extreme case, with enough price competition from Qwest, companies like AT&T and Verizon would be forced to absorb the excess access charges of United, or they would have to exit either the Qwest market or the United market. A carrier would exit the Qwest market in order to raise its retail rates to a level sufficient to cover United's high access charges. It would exit the United market in order to lower its access costs to a level sufficient to compete in the lower-cost Qwest market.

Q. Why don't the interexchange carriers maintain their competitive parity in the Qwest market by charging lower prices there and higher prices in the United market?

A. This would be a reasonable response to a distinct difference in costs, not unlike the utilities' practice of charging higher rates in cities with high local utility taxes. However, federal statute and rule requires statewide averaging of intrastate long-distance rates, so it is not an option for relief. (*See* 47 C.F.R. 64.1801.) Interexchange carriers cannot pass

United's high access charges through to their United customers exclusively; they must either absorb those excess costs or raise their rates statewide.

Q. How should the Commission weigh the relationship of United's access charges to its corresponding charges for interstate service and to the long-run incremental cost of access services?

A. These are both relevant points of comparison in that each suggests United's intrastate access charges are too high. It raises issues of undue discrimination whenever a regulated company is charging different prices for the same service, and that is what United is doing with access services. United charges substantially more for access to the local network if the destination of the call is within the state of Washington than if the destination is outside the state, yet the two calls make the same use of United's local network. This is unfair to customers making intrastate calls and contributes to illogical rate structures in which calls to nearby cities are more expensive than calls to some foreign countries.

I believe the comparison of United's access prices to total service long-run incremental cost is worth noting but is ultimately of less significance in determining whether the charges are excessive. I believe United's rates for originating access should not be lowered to the incremental cost level, because it is reasonable to recover a portion of shared and common costs in originating access rates. Pricing originating access at the level recommended by Staff achieves that result.

IV. COMPETITIVE FACTORS

Q. Please summarize your understanding of the general arguments being made by United's witnesses with respect to competition.

A. United's witnesses rely on two general arguments in which competition is said to be a factor. One is related to the claims that United is a company with obligations to serve in high-cost locations. United claims that competition limits its ability to cover its own costs through charges to its own customers. For example, Mr. Dippon testifies that United cannot rely on local rates as a replacement for access revenues because of strong competition in more populated areas and emerging competition in rural areas. A second competition-related thread relates to whether there is any competition for long-distance services and, if so, whether that competition is distorted or harmed by high access charges. For example, Mr. Dippon contends that "internal subsidies" (of local by access) mostly cancel each other out and do not benefit United relative to long-distance carriers. Mr. Felz claims that bundled offerings have rendered separate long-distance providers "virtually extinct."

Q. Please respond to United's contention that competition in the market for local service prevents it from recovering its costs through end user rates.

A. The claim that United cannot sustain an increase in local rates due to competition is simply not supported by Mr. Dippon's analysis. He acknowledges that United faces less competition in its more rural exchanges and that those exchanges have lower local rates than the purportedly more competitive exchanges. This rate structure is completely upside down to the cost-based rates that one would expect under competition. A company responding to price-constraining competition would be charging more in the higher-cost, lower-competition areas than in the lower-cost, higher-competition areas. Mr. Dippon attributes United's price structure to "the legacy of value of service pricing," (p. 23) but he accepts this pricing structure as a given. Qwest eliminated the historical practice of pricing service in small exchanges below prices in large exchanges in 1996.[1] Verizon Northwest did likewise in 2001.[2] Mr. Dippon contends policies applied to Qwest and Verizon Northwest "cannot simply be ported" to United, but this is no explanation for why United persists in an upside-down rate structure more than a decade after the Commission eliminated it for Qwest.

Q. Do the intermodal competitors cited by United (wireless, cable voice, and Internet voice) compete with United on the basis of the price of local service?

A. No. Prices for the services that United cites as its competition are substantially higher than United's rates for basic local service. These firms all offer local service as part of a larger, higher-priced package, along with services such as broadband Internet access, voice messaging, caller identification, and unlimited interexchange calling. They simply do not offer a service that is similar in price and features to the basic local exchange service offered by United. United likewise does not market its basic local service as an alternative to these $30 to $50 voice packages. Instead, United advertises bundles –

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[1] Docket UT-950200, 15th Supplemental Order, April 11, 1996. Qwest (then known as U S WEST Communications) proposed to set rates higher in high-cost exchanges than in low-cost exchanges. The Commission rejected this structure, based on the specific evidence in that proceeding, but adopted a rate design in which local service was priced the same in all exchanges.

[2] Docket UT-981367, 6th Supplemental Order, June 1, 2001.

various combinations of dial tone, features, toll, and Internet access – at prices similar to those of its intermodal competitors.

Q. Is it reasonable to expect that United's profits would decline if it raised its prices for local exchange service?

A. No. An increase in local rates would narrow the difference between the price of standalone local service and the price of bundles – both United's bundles and those of its intermodal competitors. That could result in some shift of customers from the standalone service to the bundled service. This would benefit United to the extent customers shifted to its bundles, and many other customers would simply pay the higher local rate.

Q. The other competition-related argument of United is that competition with other long-distance providers does not provide a rationale for limiting its access charges. What is your response?

A. Mr. Dippon contends that interexchange carriers (IXCs) are not put at a competitive disadvantage by high access charges, because those charges are reflected in United's retail toll rates as well. Mr. Felz goes a step further, suggesting that IXCs are no longer a relevant part of the industry structure. The suggestion seems to be that access charges do not matter because the money simply goes from the long-distance business to the local business of the same company. While it is true that United is selling bundles to an increasing number of customers, United clearly overstates the case that long-distance service is extinct as a separate product from a separate provider. Mr. Felz testifies:

> At the time of that proceeding (Docket UT-020406) there were interexchange carriers. Specifically, there were stand-alone interexchange carriers that were

> unaffiliated with incumbent local exchange carriers ("ILEC"), and these interexchange carriers were attempting to compete, head-to-head, with Verizon Northwest for the provision of long distance service. Today the market in Washington could not be more different. … As a stand-alone service, long distance is virtually extinct. In this proceeding, Verizon and AT&T advocate a solution to a problem that no longer exists. (Felz testimony, pp. 15-16.)

It is clear from United's operating statistics that long-distance service from non-affiliated providers continues to exist. In 2007 the toll calls originated by United's affiliate, Embarq Communications, Inc., accounted for [redacted] of all originating intrastate access minutes. Likewise, [redacted] of United's residential customers and [redacted] of United's business customers selected Embarq Communications as their long-distance carrier. While Embarq Communications enjoys a large market share, it is not accurate to say that high access charges no longer matter. Furthermore, customers benefit from having the option to use a stand-alone long-distance provider, because it provides them with an alternative to the pricing and service of the ILEC. Today customers can, depending on their circumstances, make an intermodal choice, i.e., choose wireline service from United or wireless service or service from a cable operator. They also can make an intramodal choice within the wireline option, by selecting a combination of United's local service and another provider's long-distance service. United's high access charges discourage competition for customers' long-distance revenues.

Q. Mr. Dippon maintains that variations in access rates and local rates largely cancel each other out through the use of packages. Please respond.

A. High access charges benefit the local exchange provider and harm its competitors in the market for interexchange or long-distance services. That harm is only partially addressed by the requirement that the local exchange provider impute access charges in setting its toll rates. The imputation requirement is insufficient because of the statewide averaging of toll rates. United does not offer toll services in Qwest and Verizon Northwest areas, so it can pass its high access charges through in its retail toll rates without concern about making its toll service unattractive in areas served by Qwest and Verizon Northwest. As I discussed earlier, other carriers are squeezed by United's high access charges, since they must also meet retail pricing driven by the lower access charges of Qwest and Verizon Northwest. In addition to this competition with other IXCs, high originating access charges also harm IXCs in their competition with the interexchange services of wireless, cable voice, and broadband voice providers. An increase in originating access charges raises costs to the IXC without affecting the costs of these competitors.

V. UNITED'S OBLIGATIONS AS A "CARRIER OF LAST RESORT"

Q. United's witnesses contend that its access rates are justified by its obligations as a "carrier of last resort" (COLR) to provide service to people in high-cost locations. Are these obligations a reasonable basis to support United's access charges?

A. A local exchange company's service to customers in high-cost locations can, in some circumstances, serve as a justification for its access rates, but United's witnesses have both overstated that obligation and misapplied it with respect to access charges. One could conclude from United's testimony that the company has to be ready to serve anyone anywhere anytime and that the entire cost needs to be recovered through access charges. This is an overstated picture of the universal service or COLR obligations of United. United has an obligation under its tariffs and under Washington law to provide service in its service area, but that obligation is tempered by a universal service policy that balances the interests of customers in high-cost locations with the interests of all other customers. Furthermore, United's analysis fails to distinguish between the role of originating access and the role of terminating access in the recovery of costs related to service to customers in high-cost locations.

Q. Does United's obligation to serve rural areas arise from a policy that "by helping to keep the population dispersed, it contributes to reduced social and psychological tensions?" (Dippon testimony, page 14, quoting Kahn.)

A. No. That has not been a factor in the establishment of universal service policy in this state.

Q. Does Washington State universal service policy hold that making telephone service available "on the farm … benefits city dwellers as well because it holds down urban congestion?" (Dippon testimony, page 14, quoting Kahn.)

A. No. Urban congestion plays no part in the Commission's decisions about whether to support service in rural areas. If anything, the state's growth management policies disfavor the subsidization of infrastructure in rural areas because of the concern that it will contribute to sprawl and reduce the availability of non-urban environments.

Q. Does United have an obligation to serve every customer in every location within its service area?

A. No. As Mr. Felz notes, the obligation to serve is found in RCW 80.36.090. This statute requires companies such as United to provide service to those customers "who may be reasonably entitled" to service. The law does not place an absolute or unreasonable obligation to serve on United. As a practical matter, the Commission has interpreted this statute in a way that does not require service to all applicants in all locations. The Commission has recognized that in some circumstances the cost of serving a location would be an unreasonable use of society's resources and that in some circumstances other service providers could meet the applicant's needs more cost-effectively. Moreover, the obligation to serve that United bears is one that is shared with other companies that have been designated as eligible telecommunications carriers under federal universal service law.

Q. Could you provide an example of how the Commission has implemented this policy of limiting incumbent carriers' obligation to serve?

A. Yes. The line extension rule (WAC 480-120-071) sets out the obligations and process of a company such as United when an applicant requests basic residential service at a location where the company has no existing distribution plant. The rule allows a company 13 months to complete an extension, and it allows the customer to charge the applicant for costs beyond the first 1,000 feet of an extension. The company can even charge the applicant for any extraordinary costs incurred in constructing the first 1,000 feet of an extension.

Q. Does the line extension rule require United to bear the cost of service extensions to serve business locations or to provide residential services other than basic service?

A. No.

Q. Does United's tariff reflect these limitations on its carrier of last resort obligations?

A. Yes. These provisions are set out in Schedule AE-10 of United's Tariff WN U-3.

Q. In adopting this rule, did the Commission intend to limit the need for subsidies of customers in high-cost locations?

A. Yes. Immediately prior to adoption of the current rule in 2008, the Commission's line extension rule placed more emphasis on affordability of service, in that it limited the required customer contribution and provided for recovery of the residual cost through a terminating access charge rate element. When proposing this rule revision in 2008, the Commission stated:

> By requiring applicants to bear the cost of extending service beyond 1000 feet, or when extension costs are extraordinary, the amendments would reduce current level of subsidy for lengthy line extensions. The amendments provide the correct balance of obligations among customers, local exchange service providers, and interexchange carriers. **(**WSR 08-10-102, May 7, 2008.)

Even under the prior rule, the Commission did not impose an unqualified obligation on incumbent local exchange companies to serve customers in high-cost locations. For example, in one case the Commission found that it would cost $27,500 per customer to extend service to a location and that these applicants were not reasonably entitled to service under state law. Docket UT-011439, 12th Supplemental Order, April 23, 2003.

Q. Is United's obligation to provide service in high-cost locations otherwise limited?

A. Yes. Another factor that United's witnesses neglect to consider is the existence of other carriers in its service area who have been designated eligible telecommunications carriers (ETCs) by the Commission, pursuant to federal law. The Commission has designated three wireless carriers as ETCs in United exchanges: United States Cellular Corporation; Sprint Nextel Corporation; and Cingular Wireless, LLC d/b/a AT&T Wireless. These carriers have obligations to provide basic service in exchanges where they have been designated. While these designations do not relieve United of its obligations, they are considered by the Commission when it interprets the "reasonably entitled to service" provision in RCW 80.36.090.

Q. You also testified that United's analysis fails to distinguish between the role of originating access and the role of terminating access in the recovery of costs related to service to customers in high-cost locations. Please explain.

A. The Commission's access charge rule, WAC 480-120-540, provides for a company such as United, if authorized by the Commission, to recover universal service costs through access charges. The rule provides for universal service costs to be recovered through an additional rate element on terminating access service:

> If a local exchange company is authorized by the commission to recover any costs for support of universal access to basic telecommunications service through access charges, it shall recover such costs as an additional, explicit universal service rate element applied to terminating access service. (WAC 480-120-540(1)(b).)

Despite this provision, United is using its claims of high-cost customers to justify its high originating access rates. The terminating access rate is the only place in a company's access rate structure where universal service costs can be justified. It is appropriate to consider United's cost evidence in determining whether to continue the interim universal service rate element, but those costs have no place in the analysis of originating access rates. Rates for originating access service can be evaluated based on the actual cost of those specific services and the effect of those rates on customers and competitors. This is precisely the approach undertaken by the Commission when it examined the originating rates of Verizon Northwest in Docket UT-020406, and United has presented no evidence sufficient to support deviation from that approach in this case.

Q. Given this critique of United's analysis, how would you recommend that the Commission factor universal service obligations into its determination of whether United's access rates are fair, just, and reasonable?

A. I recommend that the Commission set aside universal service considerations in evaluating United's originating access charges and instead follow the same analytical process that it used in Docket UT-020406 to evaluate the originating charges of Verizon Northwest. Universal service issues are relevant in the analysis of terminating access rates, but the analysis should be grounded in what United is actually doing and not an overly broad statement of obligations. Moreover, the terminating rate analysis should be based on what United can demonstrate as its actual expenses and investment and whether the terminating rate mechanism itself is reasonable and viable. Finally, the terminating rate analysis should recognize that the universal service goal is not to preserve existing rates as they are but instead to provide service based on standards of reasonable entitlement, affordability, and reasonable comparability.

Q. Using this approach, what is your conclusion regarding United's originating access rates?

A. United's originating rates are excessive. As the Commission concluded in 2002 with respect to Verizon Northwest, it is inappropriate for a local exchange company to use high originating access charges when interexchange carriers are expected to charge uniform statewide rates. United is able to use its originating rates to export a portion of its costs to the customers in other parts of the state who make intrastate toll calls. United should be required to reduce its originating access rates to the level charged by Qwest Corporation, which is $0.15817 per minute. This should be accomplished by eliminating United's carrier common line charge, which is $0.01 per minute, and by lowering United's LS1 and LS2 originating premium access rate from $0.020740 per minute to $0.015817 per minute. At this level, United's originating access service will still be priced above incremental cost and therefore will provide a contribution to the recovery of shared and common costs of the network.

VI. UNITED'S COST ANALYSIS

Q. United's witness, Mr. Roth, contends that the company's access charges are justified because the cost of access service is greater than the revenues it receives from access service. Is this contention supported by United's testimony and exhibits?

A. Mr. Roth asserts that "costs exceed the revenue associated with [intrastate access] services in Washington, therefore, […] United's current intrastate switched access rates are just and reasonable." (Exhibit No. ___ (HJR-1T), page 6, line 5.) Later, he states:

"United's intrastate switched access service revenues are less than the total of its switched access costs." (Exhibit No. ___ (HJR-1T), page 8, line 10.) However, United's evidence actually does not show access rates to be below cost. A substantial portion of what United characterizes as a cost of switched access is simply an arbitrarily assigned portion of the company's loop costs.[3] United would require loops even if it did not offer switched access service, so it is inappropriate to include loop costs in a measure of the incremental cost of switched access service. Once the arbitrary loop cost allocation is removed, it is apparent that United's switched access services are priced substantially above cost and would continue to be priced above cost at the rates recommended by Staff. At the Staff-recommended level, United's originating rate would be $0.015817; the TSLRIC of switching service, as calculated by United's model, is [redacted]. This provides a markup of approximately [redacted].

Q. Mr. Roth (p. 9) quotes from the Commission's order in the 1995 U S WEST case. Is the Commission's decision in this case consistent with his claim that loop costs should be included in the cost of access services?

A. No, not at all. Mr. Roth is correct in observing that the Commission found the loop to be necessary for the provision of switched access services, but if one reads the entire paragraph from which he pulls that sentence, it becomes apparent that the Commission

[3] The "loop" is a shorthand term for the telecommunications network that connects a customer's premise to the switch or central office. Examples of loop facilities include circuit equipment, poles, conduits, feeder and distribution cable, drop wires, and network interface devices. These are also referred to as "outside plant." The other major elements of a telecommunications network are the switching equipment and the interoffice transport facilities, which connect switches to one another. The investment, maintenance, and operation of loops comprise the majority of a local exchange company's costs.

reached an entirely different conclusion about the more important issue of how shared costs should be treated in cost studies and rate setting:

> The Commission finds, consistent with the presentations of Public Counsel/AARP, and other parties that the cost of the local loop is not appropriately included in the incremental cost of local exchange service. The local loop facilities are required for nearly every service provided by the Company to a customer. Neither local service nor in-state long distance service nor interstate long distance nor vertical features can reach a customer without the local loop. Should USWC cease to provide any one of these services, its need for a local loop to provide the remaining services would remain. The cost of the local loop, therefore, is not incremental to any one service. It is a shared cost that should be recovered in the rates, but no one service is responsible for that recovery. (Docket UT-950200, 15th Supplemental Order, pp. 83-84.)

The Commission in UT-950200 expressly rejected the approach of assigning shared costs to services on a percentage basis, which is the approach United is using in its cost study in this case. The Commission set rates for access services, local exchange service, and other services so that the company's overall revenues were sufficient to cover its costs, but it did not treat loop costs as an incremental cost of any service and did not adopt an arbitrary assignment of loop costs to services.

Q. Has the Commission made this distinction between costing and pricing again since its decision in the U S WEST case?

A. Yes, most notably in the access charge rule (WAC 480-120-540), which United has cited in its witness' testimony. The rule makes it clear that loop costs are not part of any service-level incremental cost. It requires pricing of terminating access service at total service long-run incremental cost (TSLRIC) plus a reasonable contribution to common or overhead costs, which is essentially the same standard used to set rates for unbundled network elements and transport and termination of interconnection traffic. The rule specifically says that "local loop costs are considered 'shared' or 'joint' costs and must not be included in the cost of terminating access." The Commission goes on to say that loop costs may be recovered through charges for originating access. The Commission also uses the TSLRIC standard in setting the price floor for competitive services in WAC 480-120-266.

Q. What is the distinction between "common costs" and "joint or shared" costs?

A. It may be helpful to start by explaining how they are similar. Common, joint, or shared costs are similar in that they are not incremental costs. In a firm providing multiple products or services, a cost is "incremental" with respect to a service if that cost is incurred only if the firm provides a particular service. For example, assume that a firm provided two services, A and B, for a total cost of $100 and that if it provides a third service, C, its total cost would be $120. In that circumstance, the incremental cost of service C is $20. In a multi-product firm, the sum of the individual services' incremental costs often is less than the total cost of the firm. This is sometimes called economy of scope. In this circumstance, the costs that are not incremental to any particular service are either common costs or shared/joint costs. Shared or joint costs are incremental to some subset of services. For example, if the firm operates a machine at a cost of $50 that allows it to produce both service A and service B, that $50 cost is a shared cost. It is not incremental to either A or B, but it is a shared cost of the two services. Common costs are those costs that are incurred regardless of which services are produced; they can be avoided only by not operating.

Q. Does United's cost analysis reflect these distinctions between common, shared, and incremental costs?

A. It does to an extent. United has identified costs that it considers to be common costs. This approach is reasonable and consistent with the Commission's prior decisions on costing methods. However, United characterizes some shared costs as incremental costs, which is inconsistent with economic theory and the Commission's prior decisions.

Q. Could you explain how the shared costs of the loop network are to be included in prices if they are not part of incremental cost?

A. The recovery of shared costs is really an exercise in pricing or rate design and not part of the process of establishing service-level incremental costs. While economists can offer theories on superior and inferior ways of including shared costs in prices, the exercise is essentially one of fairness and economic efficiency. The Commission has recognized that each service should cover its own long-run incremental cost. It has also recognized the fairness of having each service that uses the loop pay a portion of the loop costs, but it has abjured the use of formulas and factors. Loop costs can be recovered in rates for local service, broadband service, and access service, as well as any other service that requires the loop.

Q. In Exhibit No. ___ HC (HJR-2HC), page 1, line 8, column F, Mr. Roth states a figure for the "TSLRIC with Common" of the Terminating USF Additive rate element. What is your assessment of this calculation?

A. This result is essentially meaningless and provides no justification whatsoever for United's current Interim Universal Service Fund Additive of $.064851 per minute. United arrives at this number by taking model results that do not accurately reflect actual investments, that use unreasonable and unauthorized capital recovery factors, and that do not accurately reflect state policy regarding the responsibility for serving remote locations. United then allocates an arbitrary portion of loop costs from all of its exchanges – not just its high-cost exchanges, dividing those costs by the sum of originating and terminating access minutes. United then characterizes that result as a terminating rate element. It does so with no consideration of what customers in high-cost locations should expect to pay themselves under the federal universal service standard of "affordable" and "reasonably comparable to rates charged for similar services in urban areas." (47 U.S.C. 254(b).)

Q. Please explain your point that United's cost model results do not accurately reflect actual investments.

A. The model results reflect a level of investment and expenditures significantly in excess of what United has actually incurred. The cost figures reported in Mr. Roth's exhibits are, as he explains, derived from a forward-looking cost model. Such a model will not necessarily yield overall cost results that match a company's actual expenses and investment. This is not a criticism of cost models, either in general or specific to the one submitted by United. It could be that rebuilding the network would cost more than was invested in the present network. This could be due to rising prices over time and to modeling a network that is more advanced than the company's existing network.

Nonetheless, the difference between model results and United's actual investment is significant. The model estimates that a new network would require an investment of [redacted], but United's actual telephone plant in service is [redacted]. A similar result is apparent if one compares the monthly cost figures calculated by United's model to the company's actual income statement. The total cost of providing service in Washington state, according to the cost model results, exceeds [redacted] per year. United's actual expenditures, plus return on investment, are approximately [redacted] per year. (Exhibit No. ___ HC (GB-2HC).)

Q. How do United's forward-looking cost calculations compare to its rates for unbundled network elements?

A. The cost calculations presented by United in this case are substantially above the rates approved by the Commission for unbundled network elements (UNEs). This is shown in Exhibit No. ___ HC (GB-3HC), which compares United's model results to the unbundled network element rates used in interconnection agreements. UNE rates are available on a zone basis rather than by specific exchange, so for purposes of comparison current United's wire center cost estimates are aggregated into weighted average zone values. From this comparison it is apparent that United's cost model is producing high cost estimates across the entire spectrum of exchanges, and the variance increases in the less dense, higher-cost zones.

Q. Why does it matter that the calculated forward-looking costs are higher than actual embedded costs or the rates charged for UNEs?

A. It matters because United seeks to use results from the model to set rates that will be paid by IXCs and their customers. Even if the model were perfectly accurate in calculating the cost of building a new network, the fact remains that United has not actually spent that much. It charges its own retail customers based on embedded costs, but it would justify the charges to IXCs and their customers based on forward-looking costs. United's calculations in effect give the entire embedded cost benefit to its own retail customers and charge IXCs the full forward-looking cost through the universal service rate.

Q. Do you have any concern about the accuracy of United's model as a measure of forward-looking costs?

A. Yes. Staff does not have the resources to conduct an exhaustive review of the model's inputs and calculations, which involve approximately 17,000 network element locations, but there are some concerns about its accuracy. I identified 10 customer premise locations that appeared to be extreme outliers in terms of calculated investment cost. The effect of these 10 lines on the calculated incremental loop cost is more than $12,000 per line per month.

Staff requested the actual service address associated with each location and compared that service address to the location (as defined by latitude and longitude coordinates) used in the model. In many cases there is a significant difference between the actual location and the location used to calculate costs. In one case, the service location is a business within the city limits of Stevenson, but the model calculates cost based on a total route distance of 18 miles. In another case, the model routes 10 miles of cable to reach the Whitstran office, even though the customer is located 3.5 miles from the Prosser central office. The actual route length to the customer is 4 miles. A customer location just off U.S. 101 near Quilcene is geocoded to a location 7.8 miles into the Olympic National Forest. A business customer with a service address on Bickleton Highway is geocoded to a location 13 miles from the highway. Exhibit No. ___ HC (GB-4HC) provides more details on this review.

Q. Please explain your point that United's cost model results do not reflect United's actual cost of capital and depreciation.

A. United's errors in overstating its capital investment levels are compounded by using unreasonable and unauthorized capital recovery rates to convert capital investment amounts into monthly or annual costs. As Mr. Applegate explains in his testimony, United uses values for cost of capital that do not reflect the Commission's decisions in prior cases and that do not reflect current financial conditions. United's inflated rates, particularly for debt, result in a substantial overstatement of annual costs associated with capital investment. The annual capital recovery rates are further overstated by using depreciation parameters that have not been approved by the Commission and are not justified in United's testimony. The Commission has examined the question of appropriate depreciation rates for use in economic cost studies, such as in Docket UT-980311. United has offered no explanation for why the depreciation parameters previously authorized by the Commission are invalid.

Q. What is the approximate magnitude of the effect of United's use of overstated capital recovery factors?

A. United's capital recovery factors result in an overstatement of TSLRIC of approximately 28 percent, as shown in Exhibit No. ___ HC (GB-5HC). This figure is calculated using the cost of capital values recommended by Mr. Applegate and the depreciation parameters authorized by the Commission in Docket UT-980311.

Q. Please explain your point that the United cost model results do not accurately reflect state policy.

A. United calculates its network costs assuming that every customer would get service from the wireline network and including the full cost of extending service to every customer location. The result is a cost estimate that includes the full investment cost for some customer locations that are very expensive to serve. Approximately [redacted] of the total voice-grade outside plant investment costs calculated by United's model is attributable to customer locations that, according to United's model, require an investment of more than $100,000 per line.

It may be the case that those locations are receiving wireline service today, but it does not follow that in a forward-looking analysis they would receive service under the Commission's current policies. The locations are often extremely remote, such as in a national forest or several miles from any highway and in some cases the customer is a business rather than a residence. As I discussed earlier, the Commission has limited the extent to which extraordinary costs are to be incurred by customers generally. In a forward-looking analysis, it would be reasonable to assume that these locations would be served only if the excess cost of doing so were incurred by the customer.

Q. Are you suggesting that United should not be allowed to recover in rates the investment that it has actually made to serve customers in these remote locations?

A. No, even if the customer would be expected under current rules to pay a substantial portion of the costs, I am not suggesting that United acted imprudently in building facilities to these locations. In reality United is already being repaid for these investments, through depreciation expense, return on investment, and rate base. However, United has offered a forward-looking analysis, and a forward-looking analysis should reflect the current rules and policies.

Q. Please explain your point that United's calculation of universal service costs includes loop costs from every wire center, not just high-cost locations.

A. The costs that Mr. Roth includes in the Terminating USF Additive (Exhibit No. ___ HC (HJR-2HC), page 1, line 8, column F) are loop costs. They are not, however, exclusively the cost of expensive loops. Rather, they are [redacted] of all the loop costs in every wire center that United serves in its Washington state service area, including wire centers that do not have high-cost characteristics. Poulsbo, Grandview, and Wapato, for example, are non-rural wire centers, but a portion of the loop costs from these wire centers is included in the calculation of the Terminating USF Additive cost. Indeed, about [redacted] of the total universal service amount represents loop costs from these three wire centers. This method would produce a non-zero Terminating USF Additive regardless of whether it has any customers in high-cost locations.

Q. Please explain your point that United has not considered the ability of customers in high-cost locations to pay their own costs under a standard of affordable and reasonably comparable rates.

A. The purpose of any universal service rate should be to provide service to customers in high-cost locations at rates that are "affordable" and "reasonably comparable to rates charged for similar services in urban areas." (47 U.S.C. 254(b).) A universal service rate that resulted in rural rates that were below urban rates would provide more support than is reasonable or necessary. In other words, it would be too favorable to customers in those high-cost locations and would unfairly transfer costs to all other customers. This problem exists in United's rates today. United charges $8.90 for residential local exchange service in Stevenson, yet it is asking customers in other parts of the state who are paying twice that rate to fund a subsidy. Earlier, I discussed how United's upside-down rate structure is contrary to what one would expect from a company facing price competition. It also is contrary to what one should expect from a company asking for a subsidy. In terms of buying down rates for customers in high-cost locations to an affordable and reasonably comparable level, United has overshot the mark.

Q. How should the Commission judge whether any particular rate meets the test of being affordable and reasonably comparable to rates charged to urban customers?

A. This is a necessarily subjective test for the Commission, but "reasonably comparable" is generally easier to judge than "affordable." There are some clear benchmarks that are useful in measuring reasonable comparability. First, United's rates for basic local service in one exchange can be compared to the rates that it charges for the same service in other exchanges. In Poulsbo United charges $16.40 for basic residential service and $32.10 for basic business service. Staff is aware of no concerns regarding the affordability and comparability of these rates. Therefore, to charge these rates in other United exchanges would satisfy the tests of affordability and comparability.

A second benchmark is to compare United's rates for basic local service to the rates charged by other incumbent local exchange companies. There is a great disparity among incumbent local exchange company rates in Washington state and across the nation, with some below United's rates and others above United's rates. The Washington state rates of Verizon Northwest, Inc., are $16.90 for basic residential service and $33.60 for basic business service. While there are higher rates charged in this state, this one is particularly relevant because the Commission has certified to the federal regulators that the non-urban residential rates of Verizon Northwest (as well as those of Qwest) are reasonably comparable to urban rates, pursuant to Sec. 254(b)(3) of the Federal Telecommunications Act.[4] Since Verizon Northwest's rates pass the comparability test and raise no apparent concerns about affordability, it is reasonable to believe that those rates would also satisfy these tests if applied to United's customers.

[4] Letter dated September 15, 2008, Docket UT-083036. Available at: http://www.utc.wa.gov/rms2.nsf/177d98baa5918c7388256a550064a61e/905baf7ee815d7be882574c7006cb4e7!OpenDocument

Q. Would it be reasonable to consider local rates above the level charged by Verizon Northwest?

A. Yes. The standard of affordable and reasonably comparable is expressed in federal law and therefore is a national standard. The Federal Communications Commission annual conducts an “urban rates survey,” which collects data on incumbent local exchange company residential and business rates in 95 urban areas across the nation. This survey shows a very wide range of rates that can be considered when judging whether rates paid by a rural customer are reasonably comparable to rates paid in urban areas. Exhibit No. ___ (GB-6) shows the portion of this survey that relates to local residential rates. Of the 95 urban areas surveyed, 29 have rates higher than the $16.90 rate that is charged by Verizon Northwest in this state.

Q. What is the implication of your comparison of United’s local rates to those of local exchange companies providing service in urban areas?

A. The revenues that United is collecting through its interim universal service rate could be collected from its own retail customers without resulting in rates that violate the standard of affordable and reasonably comparable. If United were simply to charge all customers what it already charges customers in Poulsbo or what Verizon Northwest charges its customers, the additional revenue would offset most of the need for a universal service rate. The revenue from the interim universal service rate could be offset entirely by charging local rates (as presented by Mr. Zawislak as the “Full ITAC Offset Rate”) that are well within the range of urban rates found in the nationwide comparison.

VII. INTERIM UNIVERSAL SERVICE FUND ADDITIVE

Q. **You have testified that United's calculations do not support or justify the company's current Interim Universal Service Fund Additive of $.064851. In your view, what would be required for United to demonstrate that this rate is just and reasonable?**

A. To justify the continuation of a universal service rate element, United should demonstrate that it is actually incurring costs to serve customers in high-cost locations that cannot be recovered from its customers without exceeding the standard that rates for telecommunications services be "affordable" and "reasonably comparable to rates charged for similar services in urban areas." (47 U.S.C. 254(b).) A universal service rate element may be justified if there is an excess between what it costs United to serve customers in high-cost locations and what United can recover directly from those customers through affordable and reasonably comparable retail rates.

Q. **Exhibit No. ___ HC (HJR-2HC), page 4, provides a comparison of costs and revenues by exchange. Please explain why this is not sufficient to justify the universal service rate.**

A. The revenues shown in this exhibit illustrate the point that United is not limiting its universal service request to the amount above what customers in high-cost locations can pay under a standard of affordable and reasonably comparable. The cost figures shown in this exhibit include loop costs from exchanges that do not require universal service support, forward-looking costs in excess of what United has actually incurred, and costs of serving extraordinarily high-cost locations.

Q. Are there others factors, beyond the revenues and costs associated with customers in high-cost locations, that are relevant to the question of whether United's terminating universal service rate element is fair, just and reasonable?

A. Beyond the serious concerns discussed earlier with United's cost calculations and rate design, there are questions about whether the approach of using terminating access rates to recover universal service costs remains consistent with public policy. In adopting WAC 480-120-540, the Commission did not give a blanket authorization for the use of this mechanism, and it has been more than a decade since the Commission authorized United to assess a universal service rate on an interim basis. The first concern is the disparity that the universal service rates creates between local interconnection rates and terminating access rates. Even at the time it authorized the universal service rate element, the Commission recognized concerns about the artificial distinction that resulted. The Commission expressed this concern at the time it initiated its access charge reform rulemaking (Docket UT-970325, WUTC Staff Report, January 1, 1998):

> The first and most important step is to establish the objective of access charge reform, which should be to price all network interconnection -- i.e., charges paid by one carrier to another carrier for completing a call -- the same and at cost. This does not mean that all carriers would charge the same rate for interconnection but rather that each carrier would charge the same rate to all carriers with which it interconnects. Each carrier's rate would be based on its own costs. Except for high-cost areas, which should be funded explicitly, each carrier should be expected to recover the cost of its network from charges paid by its own customers. This objective can be achieved by establishing the same rate for terminating all calls regardless of whether they originate within the exchange or in another exchange.

and in its adoption order:

> High access charges also create an artificial distinction between "local" and "toll" service that is not based on differences in cost. Toll calls originally were priced higher because they cost more; that difference has largely dissolved. Access charges were created when the toll and local

> parts of the business were separated, and the purpose was to have toll calls contribute to the cost of the local network. Today a "local" call simply is a call that -- with regulatory permission -- is not required to pay access charges, and a "toll" call is one that does pay access charges. (Order R-450, Sept. 23, 1998, p. 6. Order attached as Exhibit No. ___ (GB-7).)

The objective of pricing local interconnection and terminating access at the same rate was expressed again at the time the Commission reviewed tariffs implementing the access charge reform rule in 1998. Exhibit No. ___ (GB-8).

The parity concerns have magnified over time with the growth in wireless service and VOIP services. (In the Commission's order adopting WAC 480-120-540, it enumerated the stakeholder groups and did not include wireless, cable voice, or Internet voice providers in its list.) This disparity between local and access termination rates is one of the underlying causes of the "phantom traffic" problems that incumbent carriers have presented to the Commission. The arguments for setting a single rate for all terminating traffic – whether local, wireless, Internet-based, or traditional access – are stronger today than it was in 1998.

A second concern with the current terminating rate element is that, since it was an interim measure, there were virtually no safeguards placed on the mechanism. The Commission, on behalf of the Federal Communications Commission, requires detailed reporting and certification from companies that receive federal high-cost support. There is no comparable process for funds collected through the terminating universal service rate. Beyond the fact that a company must make a tariff filing to change its rate, there are no provisions to ensure that funds raised are actually used for the provision and maintenance of service in high-cost locations, that service is actually made available to those who apply and are reasonably entitled thereto, or that customer rates meet the test of affordable and reasonably comparable.

A third concern is whether the funding base of terminating access charges continues to be equitable. In 1998 the equity issues were largely limited to customers who made long-distance calls versus those who did not. The former paid for universal service; the latter did not. Most people used at least some long-distance service, which contributed to the equity of the mechanism. With the growth of wireless services and Internet-based communications, the practice of using access charges to fund universal service presents bigger equity concerns.

A final concern is that the existing access charge-based mechanism suffers on sufficiency grounds. One of the principles from federal law is that a universal service mechanism should be sufficient. In the current environment, a mechanism that relies on intrastate access charges does not provide sufficient and predictable support for universal service. As discussed above, Staff does not believe United has demonstrated a need for universal service support, but if it were to demonstrate such a need, the current access charge mechanism would not provide it on any reliable basis. United's revenues from its interim universal service rate have declined significantly over time – even more quickly than its access line counts have declined.

Q. What is Staff's recommendation regarding United's interim universal service terminating rate?

A. This rate element should be phased out. United has not justified this rate based on any calculation of costs that it actually incurs in the provision of service, nor has it demonstrated that the revenues from this rate are necessary in order to preserve affordable and reasonably comparable rates. Staff recommends a three-year phase-out period, with the first reduction to occur on January 1, 2011. A phase-out approach provides United with a reasonable opportunity to correct the deficiencies in its rate structure that are identified above and, should it wish to do so, to propose some other method of funding demonstrated universal service requirements.

Q. Does Staff recommend any changes to other elements of United's switched access rates?

A. No. United's other rate elements appear to be reasonable, and Staff recommends no changes. The only other rate that raises even a superficial concern is the local switching rate for terminating access, which is $0.004663 per minute. This cost of this service, as calculated by United's cost study, is [redacted]. While the rate appears to be [redacted] below cost, the result can be attributed to the overstatement of costs in United's model, as discussed earlier. Therefore, no change in the rate is justified based on this cost study.

VIII. CONCLUSION

Q. Does this conclude your testimony at this time?

A. Yes.