Exhibit No. T-200 (CRD-3T)
Docket No. UT-020406

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

AT&T COMMUNICATION OF THE PACIFIC NORTHWEST, INC.	)	
	)	**Docket No. UT-020406**
Complainant,	)	
v.	)	
VERIZON NORTHWEST INC.	)	
Respondent	)	

SURREBUTTAL TESTIMONY OF

CARL R. DANNER

ON BEHALF OF

VERIZON NORTHWEST INC.

FEBRUARY 24, 2003

Q. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.

A. My name is Carl R. Danner. I am a Director with Wilk & Associates/LECG LLC, 100 Bush Street, Suite 1650, San Francisco, CA 94104.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. In responding to the recent round of filings by Staff and AT&T, I do two things. First, I attempt to bring some consistency and clarity to the issues in this proceeding, as the relatively simple story of this case can be obscured by many pages of muddled and inconsistent argument. Second, I respond specifically to a number of assertions offered by AT&T and Staff.

Q. HOW IS YOUR TESTIMONY STRUCTURED?

A. My testimony is divided into three parts. Part I responds in general to the showings of AT&T and Staff by providing an overall perspective on their rebuttal testimony. Part II responds to Dr. Selwyn, and is organized in the same three broad categories as his testimony: "Verizon's Switched Access Rates"; "Verizon's Earnings Analysis"; and "Verizon's Revenue-Neutral Rate Rebalancing."[1] Part III responds to Staff's specific criticisms of my direct testimony.

[1] In light of the Commission's order deferring any specific rate changes to a subsequent phase of this proceeding, my response to Dr. Selwyn's discussion of revenue-neutral rate rebalancing is limited to the relationship between Dr. Selwyn's arguments and AT&T's claims regarding the reasonableness of access charges. The section is accordingly titled, "The Undeniable Relationship Between Access Charges and Other Service Costs."

PART I: GENERAL RESPONSES TO AT&T AND STAFF

Q. WHAT IS THE SIMPLE STORY OF THIS CASE?

A. Like many states, Washington has for years kept Verizon's residential basic rates below cost by requiring above-cost prices for other services, including access. AT&T and Staff now propose to sharply reduce one of the above-cost prices that provides substantial support, at a time when Verizon's telephone operations are earning approximately nothing under the Commission's jurisdiction. If pursued, this proposal requires an offsetting price increase (from sources to be discussed at a later phase of this proceeding, if necessary) to make up the lost revenue the Commission has until now required Verizon to collect from access charges. The response testimony filed by AT&T and Staff has not changed this story.

I understand, pursuant to a recent Commission order, that the question of any resulting rate changes (to access charges or to other rates) will be taken up in a subsequent phase of this proceeding, if necessary. In responding to what other witnesses have put forth, the testimony that follows is not intended to present a specific proposal for increased rates to offset any access charge reductions. The need for such increases from some source, however, is undeniable and remains a central premise of my testimony. In considering whether to modify current access charges, one must similarly consider the full context in which they were established as just and reasonable rates by this Commission's order, as well as the

Commission's fundamental regulatory obligation towards Verizon. These access charges were not set in a vacuum, and they should not be changed in one either.

Q. DO AT&T AND STAFF RECOGNIZE THIS SIMPLE STORY?

A. No. They complicate matters in their testimony by taking inconsistent positions on the fundamental issues in this case. For example, Dr. Selwyn, in his direct testimony, states that switched access charges subsidize basic local exchange service and that such subsidies are unlawful (Selwyn Direct at 9-10). But in his rebuttal testimony, he claims that basic service is fully "compensatory" when you examine the revenue from "all rate elements associated with basic service," including the revenues from access charges (Selwyn Rebuttal at 47-50). His rebuttal testimony thus argues that access charges do not subsidize local service.

Staff also is inconsistent on this point. Staff witness Blackmon claims that loop costs are not part of the cost of basic service because the loop is used to provide multiple services, including interexchange toll services (Blackmon Rebuttal at 15). If this is true, then access charges should include a portion of loop costs, but Dr. Blackmon seems to argue against this by asserting that terminating access charges should be at the same level as local interconnection (Blackmon Direct at 10). Yet Dr. Blackmon also offers a half-hearted proposal (in which "Staff believes," at page 8 of his Direct, but which he is "not proposing" in Rebuttal at 11) that Verizon's originating access charges rise sharply if the Commission agrees to a rate offset for access charge reductions.

These contradictory opinions cloud the simple fact that the costs that the Commission has required access charges to recover go beyond those directly attributable to the access service itself; and the Commission has found the resulting rates just and reasonable as recently as 1999. Presumably, the recovery of other costs through access charges has also been the case ever since these rates were first established in Washington.

Q. HAS AT&T OR STAFF ANALYZED THE STATE OF THE TOLL MARKET FOR EVIDENCE OF ANY HARM TO DETERMINE IF VERIZON IS ENGAGING IN A PRICE SQUEEZE OR PREDATORY PRICING?

A. No; in fact, they appear to ignore the state of the market, which is a remarkable omission given the subject matter of this case. There appears to be no such data in any of the rebuttal testimony filed.

The Commission should always keep in mind that the purpose of imputation is to prevent predatory pricing related to the provision by one firm of an input (in this case, access) to its competitors. The concern is this: An ILEC sells retail toll service, while also selling access to its IXC toll competitors. Because access charges carry a significant markup (related to regulatory pricing, as I discussed above), in theory an ILEC might price its retail toll service so as not to recover, through its toll prices, the same access charge it is levying on its competitors. Resulting low ILEC toll prices might drive those competitors out of the market.

This is one of the two contradictory stories about this subject that Dr. Selwyn has alleged in his various filings.[2]

But let's examine this scenario more closely, as I suggested in my direct testimony at page 7. By reducing its toll price as described above, the ILEC would be giving up revenues – because it would have made more money from access charges paid by IXCs, than from selling its own toll service at the lower prices. One has to ask – why would an ILEC voluntarily give up money in this manner? One answer is that it wouldn't, which I believe to be the correct answer under any reasonable circumstances in today's regulated telephone industry. However, at least in theory, an ILEC might pay this cost in order to disadvantage its long distance rivals and drive them out of the market through predatory pricing:

> "A price is predatory if it is so low that all three of the following are true: (1) the price will reduce the long-run earnings of the firm unless it succeeds in eliminating or reducing competition; (2) the price can drive other firms out of business or prevent the entry of efficient rivals; and (3) after the exit of competitors or the prevention of entry, it can be expected that it will now be possible to raise the price sufficiently above the competitive level and for a sufficient time to recoup the earlier profit sacrifice and more. In sum, the price in question is predatory only if it has no legitimate business reason and its profitability is entirely contingent on eliminating rivals."[3]

[2] Dr. Selwyn's imputation argument is that Verizon is giving up contribution from access charges in order to make more money on toll. Dr. Selwyn's "double marginalization" argument is that Verizon is giving up contribution from toll in order to make more money on access charges.
[3] Baumol, William J. and J. Gregory Sidak. Toward Competition in Local Telephony (The M.I.T. Press, 1994), page 63.

Q. DOES THE RELEVANT MARKET FOR TOLL SERVICE IN WASHINGTON DEMONSTRATE THE INCREASE IN VERIZON'S MARKET SHARE THAT WOULD PRESUMABLY RESULT DUE TO A PREDATORY PRICE SQUEEZE?

A. No, not in the least. Verizon Northwest has only a small share of the market. Thus, the market itself shows no signs of damage consistent with Dr. Selwyn's claims. As a practical matter, this is as far as the Commission needs to go to dismiss Dr. Selwyn's price squeeze claims.

Furthermore, there are practical reasons why a predatory price squeeze is a far-fetched possibility, even without an imputation rule:

1. It is unrealistic to believe that Verizon could drive all IXC competitors out of the toll business in its Washington service area through such a tactic. Verizon has a minority share of the market and competes against firms of international scope such as AT&T, Sprint and WorldCom.
2. Even if Verizon somehow succeeded in driving all IXC competitors out of its service area, it has no way to prevent them from re-entering the market once toll prices were raised to monopoly levels to attempt recoupment of its losses. Even if low toll prices for toll service in one part of Washington drove these international competitors out of business, their network assets would be acquired by other competitors and remain available for use against Verizon should it attempt to charge monopoly prices.

3. If it became apparent that Verizon was driving its competitors out of the toll market in Washington, the Commission would intervene to interfere with Verizon's conduct by placing limitations on Verizon's toll pricing, or other measures. There would never be a payoff to Verizon to offset its costs and risks of predation.
4. The Commission looks to Verizon's toll revenues to determine Verizon's earnings. Thus, if Verizon were to take over the toll market and generate enormous profits, it wouldn't be able to keep them.

Because of the foregoing, there is no reason for any Verizon executive to rationally expect the firm to profit from at predatory pricing, so there would be no reason for Verizon to attempt it.

Q. IS THERE A DANGER TO CONSUMERS IN OVERREACTING TO CLAIMS OF PREDATORY CONDUCT?

A. Clearly so. Antitrust policy recognizes that predatory pricing is "rarely tried, and even more rarely successful," as the U.S. Supreme Court noted in an excerpt I provided in note 2 at page 7 of my direct testimony. By contrast, antitrust authorities and courts have emphasized the danger *to consumers* of over-reacting to allegations of predatory pricing, since the harm that is alleged is that competitors are charging consumers too little. Antitrust enforcement (and analogous regulatory action) therefore tends to raise prices, to the detriment of consumers. But vigorous competition – including promotions, discounts, and low-priced offerings of excess capacity – benefits consumers in ways that are likely to be frustrated by a too-ready willingness of government to intervene when competitors cry "foul" and point fingers at one another.

Indeed, I presume it has not escaped the Commission's attention that AT&T's entire argument in this case amounts to a claim that Verizon should charge AT&T less, and be required to charge higher toll prices, so that AT&T can charge consumers more. That's nice work if you can get it. Neither is AT&T apparently interested in being a low-price competitor to benefit consumers, having "..committed to manage the [AT&T Consumer] business for cash."[4]

Q. HAS AT&T PRESENTED ANY EVIDENCE OF ACTUAL FINANCIAL HARM TO ITS BUSINESS – OR TO THAT OF ANY CARRIER -- DUE TO VERIZON NORTHWEST'S ACCESS CHARGES AND TOLL PRICING?

A. None that I can see. Dr. Selwyn's hundreds of pages of material seem fact-free with respect to AT&T's actual costs, revenues, margins, or pricing practices in Washington, or to those of any other actual carrier. Yet, AT&T's imputation claim amounts to a theoretical argument that competition is being harmed by Verizon Northwest's pricing in Washington. I and other Verizon witnesses have described the numerous faults with AT&T's theory, including its disregard for the

[4] Statement by AT&T CEO David Dorman during fourth quarter 2002 Wall Street analysts earnings call, accessed at http://www.att.com/ir/efr/#curdata on February 19, 2003. On the same call, John Palumbo of AT&T stated that AT&T's Consumer "..will continue to carefully, and strategically, price up where it makes sense. "

Commission's own imputation rule (a point with which the Staff generally seems to agree, without stating it in such terms). But it is also important to observe – as a matter of proof related to AT&T's central claim – that AT&T presents *literally no genuine market evidence of harm to any competing firm.* In its recent procedural order, the Commission applied Washington law to conclude that AT&T's complaint could not be dismissed prior to hearing for a lack of demonstrating "direct damage to the complainant." But I believe the Commission can, and should, give the absence of any such evidence considerable weight in its final order in this proceeding.

Q. WHAT IS VERIZON'S "COST" OF PROVIDING INTRASTATE SWITCHED ACCESS SERVICE?

A. First, we need to define "cost." The Commission did not do so in its *Fifth Supplemental Order*, and therefore a brief discussion on this point is warranted.

One measure of cost is long run incremental cost (LRIC). In general terms, most economists believe that the price for a service should be at least equal to its LRIC. All services, however, cannot be priced at LRIC, because a company such as Verizon incurs significant common costs. Therefore, the price of a service generally reflects two types of costs: (1) the LRIC plus (2) a portion of common costs, which is also called "contribution" to common costs. Another measure of cost is the total economic cost a company incurs in providing service. That cost includes its operating expenses, a market-based cost of capital for its net investment (return on investment), and recovery of depreciation expense to compensate for the as plant and facilities lose economic value in use (return of investment). For a firm to be viable over the long term, its revenues must recover total economic costs – i.e., the incremental costs of its services plus enough contribution to make up the rest of its economic costs.

Q. HAS VERIZON CALCULATED THE LRIC OF ITS INTRASTATE SWITCHED ACCESS SERVICES?

A. Yes. Mr. Tucek provides that calculation in his testimony.

Q. VERIZON'S ACCESS CHARGES EXCEED LRIC. DOES THIS MEAN THEY ARE UNREASONABLE?

A. No. To the extent they are priced above LRIC, they provide "contribution" to the firm's other costs. This point is obvious, and is proven by Verizon's current low intrastate earnings level. Verizon is not now recovering its total intrastate costs; without the current contribution provided by access, Verizon's shortfall would grow even larger.

Q. STAFF AND AT&T ARGUE THAT ACCESS CHARGES SHOULD NOT PROVIDE ANY CONTRIBUTION; THAT IS, THEY SHOULD EQUAL, BUT NOT EXCEED, LRIC. PLEASE COMMENT.

A. We can begin with the arguments of Staff and AT&T, which are inconsistent on this point. For example, Dr. Blackmon claims that the cost of the loop is a common cost that should be allocated among all services. On a similar note, Dr. Selwyn claims that basic service is compensatory because one must look at *all* the services and revenues allegedly associated with basic service, including access. If Dr. Blackmon is correct, then access charges must include some loop costs; if Dr. Selwyn is correct, then access charges are just one component of basic service and generate "contribution" for this service. *Under either position, the price of access should include something more than just long-run incremental costs – as has always been the case for Verizon's access charges under the Commission's ratemaking in Washington.* This is a critical point, because Dr. Blackmon's and Dr. Selwyn's arguments indicate that access charges should *not* be reduced, or, at the very least, that they should be significantly higher than LRIC.

Furthermore, as Dr. Blackmon points out, the Commission has, to date, treated loop costs as "common," and has, in effect, allocated portions of these costs to access charges. Given this, Verizon's current access charges are "just, reasonable, and sufficient" because they recover their LRIC and they provide a contribution to other costs.

Q. LEAVING ASIDE THE CONFUSING POSITIONS OF AT&T AND STAFF, WHAT COSTS DO ACCESS CHARGES RECOVER IN WASHINGTON, AND HOW DOES THAT RECOVERY RELATE TO APPROPRIATE ECONOMIC PRINCIPLES?

A. Access charges are cost-based in that they have been set by the Commission to recover the direct cost of access, plus some combination of a contribution to common costs and a portion of the cost of providing basic service to residential customers. Regardless of how expressly this was debated or understood in 1999, that is the undeniable fact of the merger order under proper economic principles if basic residential service is the only important service Verizon offers whose price is subsidized (as I understand it to be). This helps explain how the Commission's actions brought us to the situation we face today.

Q. TURNING FROM THE FACT OF HOW THESE COSTS ARE RECOVERED, CAN WE ALSO HAVE A HYPOTHETICAL DISCUSSION (ALSO BASED ON ECONOMIC PRINCIPLES) TO EXPLORE WHETHER THESE COSTS CAN BE RECOVERED IN A BETTER MANNER?

A. Yes, we can turn to whether it might be possible to improve on this situation by recovering these costs in a different manner. In doing so we could look in two directions for guidance from economics: (1) understanding what is required, from an economics standpoint, to have a viable telephone company to provide any service at all over the long term; and (2) assuming a viable company, understanding what might be the best way to set its prices.

Q. WHAT IS REQUIRED, FROM AN ECONOMICS STANDPOINT, TO HAVE A VIABLE TELEPHONE COMPANY TO SERVE CUSTOMERS?

A. Assuming we are in this for the long term (i.e., the object is not to strip Verizon's assets from its shareholders, or somehow try to force Verizon to cross-subsidize its Washington jurisdictional operations from other sources outside Washington), Verizon must have a reasonable opportunity to recover its full economic costs – i.e. all of its operating costs, plus a full rate of return on its assets, plus a timely recovery of capital as investments reach their economic obsolescence. But for this, in time, it would be economically irrational for anyone to invest money in the business. This priority comes first. Any realistic discussion about what a phone company should charge has to begin with the assurance that a phone company will actually be there in the first place.[5]

Q. GIVEN ADEQUATE REVENUES TO SUPPORT A PHONE COMPANY, HOW SHOULD PRICES BE SET FROM THE STANDPOINT OF ECONOMIC PRINCIPLES?

A. First, each service should recover at least its marginal or incremental cost. For regulatory purposes it seems that long-run incremental costs have often been adopted for this purpose, which is not always correct, but is good enough for the present discussion. Second, because telephone companies have substantial common costs that must be recovered in addition to incremental costs, there must be markups on these service prices sufficient to allow the firm to recover its full economic costs (as I noted above).

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[5] Of course, the recognition of this principle in constitutional law is the basis for the prohibition against confiscation of utility assets through regulatory decisions.

Q. WHAT CAN ECONOMIC PRINCIPLES TELL US ABOUT DETERMINING APPROPRIATE MARKUPS?

A. There are two general prescriptions for common cost recovery for a multi-product firm. First, in a monopoly situation the appropriate markups are based on Ramsey pricing principles, i.e. higher markups for services whose customer demands are relatively price-insensitive, and lower markups for more price-sensitive offerings. Second, in a competitive situation there is no general rule except to note that the firm will try to recover its markups wherever it can – which is likely to involve situations in which the demands it faces (as influenced by the pressures of its competitors) allows higher markups without threatening too great a loss of sales.

Q. HOW DO THESE PRINCIPLES COMPARE TO WHAT THE COMMISSION DID IN DETERMINING VERIZON'S CURRENT ACCESS CHARGES AND BASIC RESIDENTIAL RATES?

A. The Commission followed the first principle (provide sufficient revenue) while ignoring the second (price each service at least at incremental cost plus economically rational markups). It did so, presumably, out of some combination of historical practice combined with the usual political sensitivity many regulatory commissions feel towards raising previously-subsidized basic residential rates. Since that time, the prices the Commission requires have fallen out of compliance with even the first principle, given Verizon's low and declining earnings. However, Verizon is not asking for a remedy for that problem in this complaint case, only that the Commission not make it worse.

Q. CAN YOU OFFER SOME SPECIFIC COMPARISONS TO ILLUSTRATE HOW THESE ECONOMIC PRINCIPLES APPLY TO VERIZON'S CURRENT RATES AND COSTS?

A. Yes, I can. With respect to the first principle, Verizon's current rates are $120 million/year too low to recover its total economic costs, because as Ms. Heuring reported, that amount of additional revenue would now be needed to permit Verizon to recover its operating costs, cost of capital, and depreciation expense.[6] As a further comparison, we can break that shortfall into two parts – an annual dollar amount by which basic residential service is being subsidized, and an annual dollar amount by which Verizon is falling short in recovering contribution needed to cover its total economic costs. As Mr. Dye calculates, the total annual subsidy (extent by which retail revenues fail to cover incremental costs) of basic residential service is $46.7 million/year. Assuming that the residential subsidy was not funded in any manner, the remainder of the shortfall in economic cost recovery ($120 million/year minus $46.7 million/year equals $73.3 million/year) would thus be a contribution shortfall.

Now we can turn to the access charges side of the equation. We know that Verizon's current access charges (including the ITAC) yield $61.8 million/year, as against an incremental cost of $6.2 million/year; thus, the total contribution from access charges is $55.6 million/year. As access charges have always been

[6] As Ms. Heuring's testimony indicates, the use of an economic rate of depreciation (which is also a proper component of economic cost) would increase the required revenues further above those that result from using the Commission's prescribed depreciation rates. This would increase the shortfall above $120 million/year.

intended to support basic rates (a proposition also made explicit through the ITAC in Washington), we can compare this contribution to the current subsidy to basic residential rates, and find that access charge revenues now cover the entire residential basic rate subsidy plus provide a contribution of $8.9 million/year. However, this analysis would still leave the same $120 million/year deficit in covering total economic costs – it would just be attributed differently, in this instance entirely to a contribution shortfall, since the first use for access charge revenues would be to support basic residential rates.[7]

Q. THEREFORE, WHAT OVERALL CONCLUSION CAN THE COMMISSION DRAW FROM THE EVIDENCE IN THIS CASE, ECONOMIC PRINCIPLES AND THE POSITIONS OF STAFF AND AT&T?

A. The Commission can conclude that Verizon's existing access charges are just, reasonable, and sufficient because they (1) recover LRIC and (2) contribute to the recovery of the company's other costs (including common costs, and recovery of

[7] Other variations on the analysis are possible, but always end up with the same result of a $120 million shortfall split in some combination between an unfunded residential rate cross-subsidy, and contribution shortfall. For example, since Verizon has other services that are priced to yield a contribution, it might be said that they also help fund the cross-subsidy to basic residential rates. While this is possible, it would not change the overall answer. If, for example, one were to say that basic business rates provided $5 million of the cross-subsidy, that would also reduce – by the same $5 million -- the amount of contribution basic business rates provide to overall economic costs. Thus, reallocating calculated levels of cross-subsidy and contribution among various services is a zero-sum game whose overall results stay the same. Additionally, there are good reasons to think that the cross-subsidy is funded by access charges, to wit: (1) access charges were originally created as a source of cross-subsidy for basic rates; (2) the level of markup over incremental cost carried by access charges is consistent with serving as a source of cross-subsidy, and not just contribution; (3) the Commission has made access charges an explicit source of cross-subsidy through the ITAC, whose revenues are included in the calculations referenced above.

basic residential service costs).[8] In this sense, they are "cost-based" just as they were when the Commission first determined them. Such a conclusion simply affirms the Commission's findings in the *Merger Order*, where it held that Verizon's current access charges are, as a matter of fact and law, just and reasonable.

PART II: RESPONSE TO DR. SELWYN

Verizon's Switched Access Rates

Q. DR. SELWYN CLAIMS THAT VERIZON HAS ADVANCED "TWO CONTRADICTORY OPINIONS" ON WHETHER ITS SWITCHED ACCESS CHARGES SHOULD BE LOWERED: THE TESTIMONY OF MR. FULP, WHO SAYS THAT CURRENT CHARGES ARE "JUST AND REASONABLE"; AND THE TESTIMONY OF DR. DANNER, WHO SAYS THAT RECOVERING THE FIXED COST OF NETWORK ACCESS THROUGH ACCESS CHARGES IS "ECONOMICALLY INEFFICIENT" (SELWYN AT 6). PLEASE COMMENT.

A. Dr. Selwyn is wrong – he equates "just and reasonable" with "economic efficiency," while also taking a narrow and self-serving view of the issue. The price of a service can be "just and reasonable" in that it satisfies the Commission's pricing objectives while allowing a company to recover its costs, even if that price is not the most economically efficient. Indeed, as Dr. Selwyn

[8] While this still leaves Verizon with a large shortfall in attempting to recover its total economic costs of service, Verizon has not asked to make up that amount at this time.

points out in his testimony (Selwyn at 10-11), the WUTC historically has set prices that are not the most economically efficient but that are "just and reasonable" under Washington law. Without proposing a specific rate change at this time, it also bears noting that it is not just the price of access that could be improved from the standpoint of economic efficiency; it is also the price of basic residential service, which is below cost and thereby creates its own set of economic problems including impairing local competition.

What links these points together is the fact that the Commission has decided to collect some of Verizon's costs from access charges rather than charges for basic service. The one (the level of access charges) is just the flip side of the other (the level of basic monthly rates). One cannot understand Verizon's access charge pricing – and the prior actions of the Commission in finding that pricing just and reasonable – simply by looking at the specific costs of the access function itself. Obviously, by the rate levels it has set, this Commission has previously agreed that it is just and reasonable for access charges to recover other costs as well.

Q. DR. SELWYN CLAIMS THAT ALTHOUGH VERIZON'S ACCESS CHARGES WERE "JUST AND REASONABLE" FROM 1998 TO 2001 PER THE GTE/BELL ATLANTIC MERGER ORDER, THEY ARE NO LONGER SO BECAUSE OF "CHANGES IN MARKETPLACE CONDITIONS" (SELWYN AT 7). PLEASE COMMENT.

A. Here, too, Dr. Selwyn is wrong. The only "changes" in marketplace conditions he mentions are (1) a trend toward setting prices at levels closer to economic cost, and (2) that Verizon's current access charges are higher than UNE rates for local interconnection (Selwyn at 7). Even if we assume his argument is factually correct, these alleged changes began *before* the Merger Order. For example, Dr. Selwyn refers to a 1996 arbitration decision by the WUTC to support his claim of a "trend" toward cost-based pricing, but he ignores the fact that the 1996 decision was issued two years *before* the 1998 Merger Order.

Nor is the economic analysis of cost-based pricing anything new. For example, I recall a mid-1980s presentation by Dr. Gerald Brock (then of the FCC) on the costs to the economy of overpriced long distance calling presented during a graduate seminar at Harvard. Professor Jerry Hausman's outstanding quantitative analysis of the harmful impacts of mispricing on universal service and consumer welfare was published in 1993.[9] With Dr. Bob Tanimura of GTE, I participated in a workshop before this Commission on August 24, 1998, and presented the results of a variety of research documenting the economic benefits of better pricing. Despite this history (and that of many other analyses of regulated pricing), the Commission determined in the Merger Order to set Verizon's access and basic local service prices where they stand today. It would have been better for access charges to be lower and residential basic rates to be higher, but that was just as true then as it is now.

[9] Hausman, Jerry, Tardiff, Timothy, and Alexander Belinfante. "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," American Economic Review 83, Volume 2 (May, 1993), 178-184.

Q. DR. SELWYN CLAIMS THAT VERIZON'S ACCESS CHARGES ARE UNREASONABLE BECAUSE THEY ARE HIGHER THAN THE RATES FOR "FUNCTIONALLY EQUIVALENT SERVICES," E.G., TERMINATING LOCAL TRAFFIC (SELWYN AT 10). PLEASE COMMENT.

A. This is just a re-hash of his argument that access charges must be equal to local interconnection rates. Verizon's direct testimony explained why this is not true and that the Commission's Merger Order supports Verizon's position. Also, Verizon's Motion to Dismiss, filed April 24, 2002, explained the legal differences between access charges and local interconnection, and pointed out that Congress expressly recognized that such services could be priced differently

Imputation

Q. DR. SELWYN CRITICIZES VERIZON'S IMPUTATION STUDY CLAIMING THAT IT ERRONEOUSLY USES DIRECT TRUNK TRANSPORT RATE ELEMENTS (SELWYN AT 18). PLEASE COMMENT.

A. Dr. Selwyn is upset that Verizon imputes the price of direct trunked transport into its price floor for some toll service that AT&T provides using that method of transport, but which Verizon provides using a somewhat different set of facilities. But Dr. Selwyn's claim contradicts both himself and the Commission's imputation rule.

For example, in his direct testimony in this proceeding, Dr. Selwyn made quite clear his view that Verizon must impute the access charges that AT&T actually pays, even when the specific facilities used for access may differ between Verizon and its competitors:

> when a call is handled by an IXC, Verizon may provide as many as four switching functions (tend end office switching operations and two access tandem switching operations). When Verizon Northwest provides the same call end-to-end, the route may involve no or only one tandem switching operation. Thus, where Verizon Northwest is the retail toll service provider, its costs may actually be less than the costs it incurs in furnishing access services to a competitor. This is why Verizon Northwest is required to impute *the access charge* that its competitors pay rather than its own costs for equivalent functionality in determining whether its retail price satisfies the imputation price floor.[10]

This contradicts Dr. Selwyn's claim in rebuttal that Verizon should not impute the price of the access facilities AT&T actually uses. The only thing the two arguments have in common is an apparent desire to argue the point of the moment in a way that disadvantages Verizon.

Verizon witness Terry Dye discusses this point in his surrebuttal testimony, and I agree with his analysis.

Q. SHOULD THE COMMISSION BE CONCERNED ABOUT THE IMPUTATION OF INTER-OFFICE TRANSPORT COSTS?

[10] Selwyn direct, page 18, note 27 (emphasis in original).

A. I don't believe this is a significant issue, because transport facilities do not appear to be essential. As Staff witness Tim Zawislak notes in his rebuttal testimony, the Commission's imputation test is intended to address "essential" facilities provided by the ILEC to its competitors, and that the price to be imputed will be the tariffed rate the competitor pays Verizon for use of those facilities. Transport facilities do not appear to be essential, as I understand that AT&T can either provide these facilities itself in place of Verizon's offering in Washington, or obtain them from other providers. **Indeed, AT&T's website proudly proclaims that it has "the largest, most sophisticated communications network in the world." (http://www.att.com/network/#facts).**

Therefore, Verizon's imputation analysis is conservative in that it produces a price floor that reflects the price of transport, when it should instead produce a lower price floor by imputing only the incremental cost of transport.

Q. DR. SELWYN ALSO CLAIMS THAT THE VERIZON'S ASSIGNMENT OF "INCREMENTAL" BILLING AND COLLECTION (B&C) COSTS TO ITS TOLL PRICE FLOOR IS INAPPROPRIATE, AND THAT 100% OF THE "GAINS FROM JOINT PRODUCTION OF A REGULATED AND NON-REGULATED SERVICE" SHOULD "INURE TO THE REGULATED SERVICE" (SELWYN AT 19-20). PLEASE COMMENT.

A. This appears to be another attempt to try to hijack the imputation rule to force Verizon to raise its toll prices in order to give AT&T a competitive benefit at the expense of consumers. Second, it appears to be one of several attempts by Dr. Selwyn to inflate Verizon's reported earnings.

With respect to setting price floors, the appropriate cost terms in economics are "marginal" or "incremental" with respect to everything except essential facilities purchased by competitors that are subject to imputation. There is no room for "gains from joint production" to "inure," nor should there be. A price is not economically irrational (and therefore, potentially predatory) unless the firm actually loses money by offering it, a standard that is tested through incremental costs and imputation where required.

Distilled to its essence, Dr. Selwyn's argument is that price floors should be set based upon some version of stand-alone costs, not incremental costs. Here again, Dr. Selwyn is essentially arguing against the existence of integrated telecommunications providers – including AT&T – that may serve particular customers with a variety of services. Those providers may have systems or functions that relate to multiple services, and so are not incremental to any one of them. Having such systems is one important way such firms can reduce costs. But with respect to any particular service, the appropriate price floor is its incremental cost plus any necessary imputation, and that is all.

Q. DR. SELWYN CLAIMS THAT VERIZON'S RETAILING/MARKETING COST OF TOLL IS UNDERSTATED BECAUSE: (1) VERIZON ASSIGNS

ONLY "INCREMENTAL" RETAIL/MARKETING COSTS; (2) DR. SELWYN'S COST OF $0.03 IS SUPPORTED BY A VERIZON FILING IN AN FCC PROCEEDING; AND (3) DR. SELWYN'S COST OF $0.03 IS SUPPORTED BY A RECENT *NEW YORK TIMES* (NYT) ARTICLE. PLEASE RESPOND TO EACH OF THESE CLAIMS.

A. Dr. Selwyn is wrong on all counts. First, his "incremental" retail/marketing costs argument is the same as his "incremental" B&C cost argument, and it fails for the reasons I just discussed.

Second, the Taylor-Kahn affidavit filed in the FCC's *Special Access* proceeding[11] does not support his use of a $0.03 retailing/marketing cost for Verizon in this proceeding. The Taylor-Kahn affidavit is quite clear: it presents an estimate of retailing and marketing costs for IXCs that provide intra-LATA toll, inter-LATA toll and interstate toll services, and that estimate is based on nationwide-average data. Here, the relevant B&C costs are Verizon's costs to provide intraLATA toll service in Washington. The Taylor-Kahn estimate is therefore irrelevant. Furthermore, the very page of the Taylor-Kahn affidavit that Dr. Selwyn believes supports his position (p. 11) makes clear that the authors' cost estimates "are obviously averages and *vary a great deal* across jurisdictions, times of day and technologies" (p. 11, n. 22) (emphasis added).

[11] *In the Matter of AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM No. 10593. Declaration of Alfred E. Kahn and William E. Taylor On Behalf of BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and Verizon.

Third, the NYT article that Dr. Selwyn mentions also is irrelevant. That article sets forth an investment analyst's estimate of access and non-access costs based on information purportedly supplied by IXC "industry contacts."[12] These cost estimates appear to be based on nationwide-average data of selected (although unidentified) IXCs that provide, among other things, interstate toll services. The analyst's specific cost estimates are as follows:

access charge (one-way)	$.0125
outside plant upgrade	$.0100
outside plant maintenance	$.0175
switch software upgrade	$.0100
billing & customer service	$.0050
Total cost/minute	**$.0550**

According to Dr. Selwyn, this estimate generally supports his use of $0.03 for Verizon's retail/marketing costs (Selwyn at 23). But the only cost estimate that appears to be even remotely related to retail/marketing costs is the $0.0050 estimate for "billing & customer service." This estimate is 83% less than Dr. Selwyn's figure. And again, all of the analyst's estimates appear to reflect the nationwide-average costs of companies that provide much more than just intraLATA toll service, and therefore these estimates are irrelevant.

In sum, Dr. Selwyn's calculations are based on unproven, unsupported data that reflect the costs of companies that provide different services than Verizon. In contrast, Verizon's calculations are based on the costs associated with Verizon's

[12] "Bells – More Negatives Than Positives" *Friedman Billings Ramsey*, Technology Industry Update, by Susan Kalla, January 14, 2003.

actual and verifiable retailing/marketing activity in Washington for its intraLATA toll products.

Q. DR. SELWYN CLAIMS THAT AT LEAST $300 PER CUSTOMER SHOULD BE IMPUTED TO VERIZON BECAUSE THAT IS THE "MOST CONSERVATIVE ESTIMATE" OF THE "FAIR MARKET VALUE" OF THE RETAIL AND MARKETING ACTIVITIES VLD AVOIDS (SELWYN AT 32). PLEASE RESPOND.

A. First, it is curious that Dr. Selwyn did not simply ask his client what its actual marketing cost was, and use that figure in his argument. This is another example in which AT&T could have presented information about its real operations, but chose not to. In any event, Dr. Selwyn's $300 figure regarding customer acquisition costs is contradicted by a recent stock analyst report that concludes AT&T's customer acquisition cost ("cost per gross long distance customer addition") is only $75.[13] Another way to recognize the unreasonableness of this proposal is to consider the standpoint of accurate reporting of financial results (a particular concern given recent accounting scandals). Would it be accurate to represent to Verizon's investors that $300-$600 should be added to its revenues for each successful referral? Absent evidence that such revenues would result, the answer is clearly not.[14]

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[13] "AT&T Consumer: A Base Case Ahead of The Triennial Review" *Credit Suisse First Boston*, February 5, 2003, page 8.

[14] If AT&T actually believed Dr. Selwyn's analysis, it could benefit by offering Verizon $300 for each new long distance customer successfully referred to AT&T. A pattern of such referrals would also solve Dr. Selwyn's problem of having no credible source of data for this figure.

<u>Verizon's Earnings Analysis</u>

Q. DR. SELWYN CLAIMS THAT VERIZON SHOULD HAVE IMPUTED YELLOW PAGE REVENUES. DO YOU AGREE?

A. The separate testimony of Verizon witness Dennis Trimble addresses this issue, but I would observe that Yellow Pages is a publishing business that is open to competition in which competitors all receive access to phone numbers on the same basis. I believe that imputing these earnings today gives a misleading picture of Verizon's performance as a telephone company.

In any event, even an imputation adjustment for Yellow Pages still leaves Verizon's Washington earnings far below a compensatory level, thus preserving the essential link the Commission previously created between Verizon's access charges, an earnings level needed to avoid unfair regulatory confiscation, and rates for other services.

Q. FINALLY, IN ADDITION TO HIS SPECIFIC EARNINGS ADJUSTMENTS, DR. SELWYN CONCLUDES THAT THE WUTC SHOULD CONSIDER VERIZON'S "INTER-TEMPORAL FINANCIAL FLOWS." PLEASE COMMENT.

A. Dr. Selwyn's testimony is very confusing on this point, but he appears to argue that the WUTC should consider Verizon's earnings over time, because low earnings in one period might be offset by high earnings in another period. If this is his point, then he should refer to Verizon witness Nancy Heuring's testimony, which shows that Verizon's earnings have *decreased* over time. Thus, Dr. Selwyn's "inter-temporal" argument supports Verizon's position that it is not over-earning. Indeed, since I understand that retroactive ratemaking is not allowed, the only inter-temporal perspective that matters is that of the future, for which Verizon's earnings will be even lower if the trend continues.

<u>The Undeniable Relationship Between Access Charges and Other Service Costs</u>

Q. DR. SELWYN CLAIMS THAT VERIZON'S BASIC RESIDENTIAL SERVICE RATES ARE ALREADY "COMPENSATORY." HOW DOES THIS ARGUMENT RELATE TO AT&T'S CLAIM THAT ACCESS CHARGES ARE TOO HIGH?

A. Dr. Selwyn's argument cuts against the fundamental premise of AT&T's complaint regarding access charge levels. Dr. Selwyn grudgingly admits that the "relationship between the basic R-1 rate elements and costs may exist as Verizon has presented it" (Selwyn at 46), i.e., R-1 rates are well below long-run incremental cost, but he then proceeds to redefine R-1 service to include *all* the services provided by a local exchange carrier, including toll services, switched access services, vertical services, and other services (Selwyn at 56). In Dr. Selwyn's words, "From an economic standpoint, when comparing costs and revenues for local exchange service, it is appropriate to consider the costs and revenues of *all services* provided by a local exchange carrier" (Selwyn at 56 (emphasis in original)).

Dr. Selwyn's analysis leads to an interesting result with respect to AT&T's claim that access charges are too high. If, as Dr. Selwyn claims, Verizon's R-1 rates are not "below cost" when one considers the costs and revenues attributable to access charges (and other services), then Verizon's access charges are not "above cost" when one considers the costs and revenues attributable to R-1 service (and other services). In simpler terms, under Dr. Selwyn's analysis, Verizon's access charges present no issue so long as Verizon is not overearning. As we discussed earlier, Verizon is not overearning; therefore, Verizon's access charges are of no concern.

In any event, Dr. Selwyn's analysis about costs and rate levels is contradicted by AT&T's Chief Executive Officer. In a recent article, AT&T CEO David Dorman said SBC should be forced to raise rates for basic dial tone service in California because its current rates are below cost and thus impair competition: "Regulators have to look at rebalancing the rates…You can't encourage competition when you have heavily subsidized rates."[15] Mr. Dorman also said that SBC charges "exorbitant markups for added calling features," such as caller ID and call waiting, which, under Mr. Dorman's analysis, are *not* a part of basic service. Evidently, the chief executive of his client does not seem to agree with Dr.

[15] "SBC Selling Service at Below Cost, AT&T Says," San Francisco Chronicle (Feb. 4, 2003). In a follow-up letter to the editor, an AT&T executive identifying herself as the firm's "Chief Spokeswoman" asserted that Mr. Dorman was misinterpreted on the point of whether Pacific Bell's rates are below cost and was speaking about a "hypothetical situation" of below-cost pricing, which would be something "regulators need to examine." (Letter to the Editor from Constance Weaver, San Francisco Chronicle, February 9, 2003). The Chronicle stated that it had reviewed the recording of the original interview and stood by its story, although even Ms. Weaver's assertion would not affect the applicability of Mr. Dorman's analysis to this proceeding.

Selwyn's assertion that "when comparing costs and revenues for local exchange service, it is appropriate to consider the costs and revenues of *all services* provided by a local exchange carrier." Applied to this context, Mr. Dorman's analysis reinforces the fact that access charges have been set at "just and reasonable levels" to recover other costs.

Q. DR. SELWYN CLAIMS THAT VERIZON'S ACCESS CHARGES CAN BE REDUCED BY $44 MILLION PER YEAR AND THAT "THE PROFITS GENERATED IN THE RESIDENTIAL SECTOR WOULD STILL BE MORE THAN SUFFICIENT TO OFFSET THIS ACCESS REVENUE DECREASE" (SELWYN AT 56). DO YOU AGREE?

A. No. Dr. Selwyn's analysis is fundamentally flawed, and it contradicts his earlier testimony on Verizon's earnings. Here, Dr. Selwyn assumes that "profits" equal total revenues minus total long-run incremental costs (Selwyn at 49, 56). This analysis, however, ignores Verizon's joint and common costs, as well as Verizon's net book costs. In reality (as I discussed above), the difference between revenue and incremental cost is recognized as contribution that can go towards covering other costs of the firm, and perhaps (after other costs are covered) providing a profit. In other words, Dr. Selwyn's analysis assumes that Verizon's revenue requirement is the sum of its long-run incremental costs. This is not true.

PART III: RESPONSES TO STAFF

Q. DR. BLACKMON CLAIMS THAT VERIZON HAS NOT CHALLENGED HIS RECOMMENDATION AS TO AN APPROPRIATE LEVEL FOR TERMINATING ACCESS CHARGES (BLACKMON REBUTTAL AT 2). DO YOU AGREE?

A. No. I don't believe that my prior testimony or that of Mr. Fulp can be read to support Dr. Blackmon's statement. We have said that the Commission has found the current level to be just and reasonable, and that it could continue to do so. I have also stated that a reduction in access charges is desirable from the standpoint of economics, but not recommended a particular level – in part, since offsetting price increases must also be provided to Verizon and their extent will limit what reductions could be reasonable

Q. DOES DR. BLACKMON'S "SIMPLE OBSERVATION" ABOUT HIS COMPARISON BETWEEN THE COSTS OF VERIZON AND QWEST CONSTITUTE USEFUL EVIDENCE FOR CONSIDERING THE APPROPRIATE LEVEL OF ACCESS CHARGES? (BLACKMON REBUTTAL AT 5)

A. No, it does not. Mr. Fulp and I presented numerous reasons for questioning Dr. Blackmon's comparison. While he disagrees with our responses, Dr. Blackmon presents no contrary analysis based on actual booked costs, revenues or investments – indeed, he specifically disdains Verizon's financial statements as involving "complex and potentially self-serving allocations of cost," suggesting that he has instead provided a kind of "reality check" the Commission "should not ignore." Regardless of how Dr. Blackmon wishes to characterize his vague assertion, to turn it into useful information for assessing Verizon's costs or for considering desirable access charge levels would have required a follow-up analysis that Dr. Blackmon did not perform.

Q. IN YOUR DIRECT TESTIMONY, YOU EXPLAINED THAT THE COMMISSION SHOULD NOT REDUCE VERIZON'S ACCESS CHARGES UNLESS IT PERMITS REVENUE-NEUTRAL INCREASES IN OTHER RATES. DR. BLACKMON CLAIMS THAT YOUR PROPOSAL "EQUATES TO A 'PROVE-IT' STANDARD" THAT WOULD REQUIRE THE COMMISSION TO INCREASE RATES WHENEVER VERIZON'S COSTS INCREASED (BLACKMON REBUTTAL AT 8-9). DO YOU AGREE?

A. No, I do not. If a company incurs higher costs and needs to increase its rates for that reason, it must file a rate case under the rules I understand apply to Verizon in Washington. In that instance, the burden of proof is on the company, not the Commission. Here, AT&T is seeking to reduce Verizon's rates and overall earnings, and therefore the burden of proof should be on AT&T. Thus, my direct testimony makes the simple observation that the "prove it" standard should be applied consistently. Where the Commission has approved rates that yield "sufficient" revenues, the party seeking to change rates should have the burden of proof.

Q. DOES THERE APPEAR TO BE SOME CONFUSION WITH RESPECT TO STAFF'S POSITION REGARDING CROSS SUBSIDIES? (BLACKMON REBUTTAL AT 10)

A. Yes. Dr. Blackmon objects to the "export of costs" by Verizon through access charges, while at the same time stating that "it is good policy to allow companies to spread their universal service costs, but not other costs." Of course, in both instances the objective is the same, to keep basic residential rates at below-cost levels. Indeed, the modern regime of access charges came into being at the time of the AT&T divestiture, when it was recognized that basic rates would have to increase sharply unless a method was found to preserve the cross-subsidies from toll and long distance calling that until then had occurred internally in the old, integrated AT&T. Access charges clearly meet Dr. Blackmon's criterion of a "cross-subsidy with a public purpose."

Relatedly, in another recent proceeding, Mr. Bob Shirley of the Staff testified with enthusiasm that highly costly line extension projects are worth pursuing even though most of their cost would be recovered through the same access charges that trouble Dr. Blackmon. As I testified in that proceeding, I saw nothing in Staff's filed testimony that suggested any limits to the amounts it would require to be spent for line extension projects. Indeed, I was struck by Mr. Shirley's expressed hesitation in cross examination about whether it might be too costly to move ahead with a project that might cost as much as one hundred million dollars to reach a few customers. Mr. Shirley ultimately opined that $100 million was too much, but that he "didn't know where he would stop" (i.e., consider the cost appropriate) if one were to begin to reduce this staggering sum in single dollar increments.[16] Of course, anything close to a hundred million dollars would exceed the entire annual amount Verizon now receives from the access charges at issue to help keep basic rates low for all its Washington customers.

It appears that Dr. Blackmon prefers to limit his definition of appropriate costs to those used to support only some basic residential rates, but not others. If the Commission wishes to preserve subsidized basic rates for what it sees as universal service reasons, then this support would seem equally suited to recovery through access charges according to Dr. Blackmon's position. Indeed, that's what the Commission's prior ratemaking decisions have effectively found by how they set these prices.

Q. EVEN THOUGH THE COMMISSION HAS ORDERED THAT NO SPECIFIC RATE CHANGES WILL BE CONSIDERED IN THIS PHASE OF THE PROCEEDING, WHY IS IT IMPORTANT TO RECOGNIZE THE CORRECT TREATMENT, FOR COSTING PURPOSES, OF THE COST OF A LOOP?

[16] UT-011439 Transcript, Volume VII, 1/24/03, pages 686-687.

A. Beyond the fact that this is a subject that Dr. Blackmon addresses in his testimony (to which I am responding), a misunderstanding about the proper treatment of the costs of the loop could lead one to misunderstand what costs the Commission requires Verizon to collect from "just and reasonable" access charges.

Let me expand on this point. Dr. Blackmon claims that the cost of the loop should be allocated among all services, including toll. Likewise, Dr. Selwyn claims that basic service is compensatory because one must look at *all* the services and revenues allegedly associated with basic service, including access. If Dr. Blackmon is correct, then access charges must include some loop costs. If Dr. Selwyn is correct, then access charges are just one component of basic service and generate "contribution" for this service. Under either position, the price of access should include something more than just long-run incremental costs – as has always been the case for these Verizon access charges under the Commission's ratemaking in Washington. This is a critical point, because Dr. Blackmon's and Dr. Selwyn's arguments suggest that access charges should *not* be reduced.

Q. FOLLOWING UP ON YOUR OBSERVATION, DR. BLACKMON ASSERTS THAT "MUCH OF THE COST OF THE NETWORK IS FIXED. USING PER-MINUTE CHARGES TO RECOVER THESE COSTS IS NOT THE THEORETICAL IDEAL…MOREOVER, IT ALSO IS ECONOMICALLY INEFFICIENT TO RECOVER FIXED COSTS OF

THE NETWORK USING PER-LINE CHARGES." IS THIS CORRECT AS A MATTER OF ECONOMIC PRINCIPLES?

A. No, it is not. In the first instance, Dr. Blackmon's statement is confused. By rejecting both fixed or variable charges, he seems to endorse no method of recovering fixed costs. But since these costs are real, and must be recovered, this advice is not helpful.

The fact that the loop is a cost of network access (and thus basic service) leads directly to the efficiency of per-line charges for recovering these costs, and helps to demonstrate why some of these costs are now being recovered in access charges. Dr. Blackmon's assertion is also incorrect even if one were to accept his erroneous conclusion that the costs of the loop are not a cost of basic service. According to economic principles, the best way to recover fixed costs that are common is through markups on less elastic services, and the demand for basic monthly service has long been recognized as the least elastic of the principal telephone services consumers buy.[17]

Q. DR. BLACKMON TAKES ISSUE WITH YOUR CHARACTERIZATION OF THE LOOP AS A COST OF BASIC SERVICE. (BLACKMON REBUTTAL AT 14) PLEASE COMMENT.

[17] Even though competition and competitive alternatives are now presumably increasing the demand elasticity for basic service from historical levels.

A. Dr. Blackmon isn't taking issue just with me, he is also taking issue with the numerous authorities who agree with this analysis, as the citations in my opening testimony highlighted and as AT&T has previously affirmed with considerable emphasis. I recognize that this can be a confusing topic; however, if the Commission has previously reached an erroneous conclusion in this regard, this proceeding would be a useful opportunity to correct that misunderstanding.

The core of Dr. Blackmon's confusion arises from mixing up two concepts: how something is used, versus what actions actually cause a cost to be incurred. As well, it matters whether a facility is dedicated to a particular subscriber, or whether it is a used on a common basis to provide a good or service to numerous customers.

What causes the entire cost of the loop to be incurred is the decision by a customer to have telephone service at all; and the fixed cost of that loop is the same whether it is used intensively by the customer, or just sits idle. For a telephone dedicated to a particular customer, the economically appropriate way to recover that cost is through a price tied to the cost-causing action, i.e. a fixed charge for the network connection the customer asks for when ordering basic service. Requiring that cost to be recovered instead from usage charges creates a mismatch between the customer's actions that actually cause the cost, and how its price is charged.

Q. IN A VARIATION OF AN ARGUMENT ALSO OFFERED BY DR. SELWYN, DR. BLACKMON STATES THAT CUSTOMERS BUY A VARIETY OF SERVICES FROM VERIZON AND SO, ESSENTIALLY, THE INDIVIDUAL PRICES OF THESE SERVICES SHOULD NOT BE IMPORTANT SO LONG AS THE TOTAL CUSTOMER BILL COVERS COST. (BLACKMON REBUTTAL, PAGES 15-16) PLEASE COMMENT.

A. Beyond the response I offered above to Dr. Selwyn and comments in my earlier testimony, I would simply reiterate several related points. Yes, competitors interested in offering a full variety of services will presumably consider likely total revenues from customers, but the story goes much farther than that.

Basic service and other offerings are priced separately and purchased in varying quantities by customers in the market. Competition for these various services has similarly occurred in a differential manner, often by different companies and at different times, and customers routinely mix and match basic service from one provider with other offerings from competitors. For their part, regulators have treated basic service and other services as distinct offerings, and have insisted for decades that customers using an ILEC access line also be able to purchase individual services from a variety of providers. Residential subscriber purchases are not just one big market or bundle, and the prices that are charged for individual services make a difference to competition, and to customer welfare. Historical patterns of entry and competition in telecommunications have obviously been influenced by individual service prices, and their relationship to cost. There are important reasons why the individual prices of these services should be based on cost, and these reasons do not come out in the wash of a customer's total bill.

Ultimately, if all that matters to the market is the total package of services a customer buys, then it is difficult to justify having an argument about the price of one component of that package (namely, access charges). **Neither Dr. Blackmon nor Dr. Selwyn seem to recognize this essential contradiction in their positions.**

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. Notwithstanding the arguments raised by AT&T and Staff (which tend to confuse, rather than clarify the issues), the story of this proceeding remains the same. The Commission is being asked to reduce the recovery of revenue from a source upon which, until now, it has required Verizon to rely in order to keep basic residential rates low. If access charges are to be reduced at a time when Verizon's finances are in such poor shape in Washington, the Commission must allow Verizon to recover offsetting revenues from another source – with appropriate decreases to access charges, and offsetting increases in other rates, to be determined in a subsequent phase of this proceeding as the Commission has now ordered.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL?

A. Yes.