

**BEFORE THE  
WASHINGTON UTILITIES AND TRANSPORTATION  
COMMISSION**

**IN THE MATTER OF THE PETITION )  
OF QWEST CORPORATION FOR COMPETITIVE )  
CLASSIFICATION OF BASIC EXCHANGE ) Docket No. UT-030614  
TELECOMMUNICATIONS SERVICES )  
)**

**Direct Testimony of Mark L. Stacy**

**On Behalf Of**

**MCI, INC.**

**August 13, 2003**

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1           **I. INTRODUCTION**

2  
3           **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

4           A. My name is Mark L. Stacy. My business address is QSI Consulting, 229 Stetson Dr.,  
5           Cheyenne, Wyoming, 82009.

6  
7           **Q. WHAT IS QSI CONSULTING, INC. AND WHAT IS YOUR POSITION**  
8           **WITH THE FIRM?**

9           A. QSI Consulting, Inc. (“QSI”) is a consulting firm specializing in traditional and non-  
10           traditional utility industries, econometric analysis and computer aided modeling. I  
11           currently serve as Senior Consultant and Partner.

12  
13           **Q. PLEASE DESCRIBE YOUR EXPERIENCE WITH**  
14           **TELECOMMUNICATIONS POLICY ISSUES AND YOUR RELEVANT**  
15           **WORK HISTORY.**

16           A. Before joining QSI, I was President of Stacy & Stacy Consulting, LLC. Like QSI,  
17           Stacy & Stacy is a consulting firm providing consulting services to domestic and  
18           international telecommunications carriers. During my tenure at Stacy & Stacy, I testified  
19           on behalf of a number of clients in regulatory proceedings in the Western United States  
20           on a wide range of subjects.

21                       Before joining Stacy & Stacy, I was employed by Kenetech Windpower, Inc.,  
22           where I was the regional manager of business and project development for the Rocky

23 Mountain Region. Before my tenure at Kenetech, I was the Chief Economist for the  
24 Wyoming Public Service Commission. While at the Wyoming PSC, I was responsible  
25 for providing the Commission with a wide range of policy, economic, and technical  
26 expertise regarding telecommunications and other public utility issues.

27 In addition to my occupational experience, I hold a Bachelor of Science degree  
28 in Geology and a Master of Science degree in Public Utility and Regulatory Economics  
29 from the University of Wyoming. Exhibit MLS-1 to this testimony is a summary of my  
30 work experience and education.

31  
32 **Q. HAVE YOU PROVIDED TESTIMONY AND ADVOCACY BEFORE STATE**  
33 **UTILITY COMMISSIONS IN THE PAST?**

34 A. Yes. Over the past 11 years, I have provided testimony and advocacy before state  
35 utility commissions in the following states: Arizona, Colorado, Connecticut, Florida,  
36 Idaho, Indiana, Montana, Nebraska, New Mexico, New Jersey, New York, North  
37 Carolina, North Dakota, Oklahoma, Oregon, South Dakota, Utah, Wisconsin and  
38 Wyoming.

39  
40 **Q. HAVE YOU EVER TESTIFIED BEFORE THE WASHINGTON UTILITIES**  
41 **AND TRANSPORTATION COMMISSION (“COMMISSION”)?**

42 A. No.

43

44                   **II.     PURPOSE OF TESTIMONY**

45           **Q.     WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

46           A.     The purpose of my testimony and that of my colleague Mr. Timothy Gates is to address  
47                   Qwest’s petition for competitive classification of basic business local exchange  
48                   telecommunications services (Petition Services).

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50           **Q.     ON WHOSE BEHALF WAS THIS TESTIMONY PREPARED?**

51           A.     This testimony was prepared on behalf of MCI, Inc.  
52

53                   **III.    ISSUES IN THIS PROCEEDING**

54           **Q.     PLEASE SUMMARIZE THE ISSUES IN THIS PROCEEDING.**

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56           A.     There are many issues to address in this proceeding. Generally speaking, however, the  
57                   burden that Qwest must meet in order to classify the Petition Services as competitive is  
58                   identified in the Revised Code of Washington, RCW 80.36.330. The essence of this  
59                   section, as it applies to Qwest’s application in this docket, is that Qwest must produce,  
60                   for the Commission’s consideration, evidence which would support Qwest’s petition to  
61                   classify services as competitive. The burden for Qwest being to demonstrate *effective*  
62                   *competition* for the Petition Services throughout the state of Washington in order to be  
63                   granted the regulatory freedom it seeks. As I will demonstrate in my testimony,  
64                   however, Qwest’s testimony and exhibits in this case do nothing of the sort. It is clear,  
65                   therefore, that deregulating the Petition Services at this time by classifying them

66 effectively competitive would not be in the public interest, would jeopardize the  
67 competitive advancements made to date in the Washington local exchange market, and  
68 would likely result in higher rates for Washington consumers.

69

70 **Q. WHAT REQUIREMENTS ARE IMPOSED BY RCW 80.36.330?**

71 A. The statute provides a set of guidelines for the Commission to follow in considering the  
72 classification of telecommunications services as effectively competitive, essentially  
73 requiring the Commission to find that a service is subject to effective competition in  
74 order to grant such classification. The statute sets forth a set of *minimum* standards for  
75 the Commission to adhere to in the form of factors to consider when making its  
76 decision, and permits the consideration of other relevant criteria. Those factors are set  
77 forth in paragraphs (1)(a) – (1)(d) below:

78 **RCW 80.36.330**

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

86

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

88

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

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

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- (d) Other indicators of market power, which may include market share, growth in market share, ease of entry, and the affiliation of providers of services.
- (2) When the commission finds that a telecommunications company has demonstrated that a telecommunications service is competitive, the commission may permit the service to be provided under a price list effective on ten days notice to the commission and customers. The commission shall prescribe the form of notice. The commission may adopt procedural rules necessary to implement this section.
- (3) Prices or rates charged for competitive telecommunications services shall cover their cost. The commission shall determine proper cost standards to implement this section, provided that in making any assignment of costs or allocating any revenue requirement, the commission shall act to preserve affordable universal telecommunications service.
- (4) The commission may investigate prices for competitive telecommunications services upon complaint. In any complaint proceeding initiated by the commission, the telecommunications company providing the service shall bear the burden of proving that the prices charged cover cost, and are fair, just, and reasonable.
- (5) Telecommunications companies shall provide the commission with all data it deems necessary to implement this section.
- (6) No losses incurred by a telecommunications company in the provision of competitive services may be recovered through rates for noncompetitive services. The commission may order refunds or credits to any class of subscribers to a noncompetitive telecommunications service which has paid excessive rates because of below cost pricing of competitive telecommunications services.
- (7) The commission may reclassify any competitive telecommunications service if reclassification would protect the public interest.
- (8) The commission may waive the requirements of RCW [80.36.170](#) and [80.36.180](#) in whole or in part for a service classified as competitive if it finds that competition will serve the same purpose and protect the public interest.

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**Q. DOES THE STATUTE RESTRICT THE COMMISSION IN WHAT IT CAN CONSIDER IN DECIDING THE ISSUES IN THIS CASE?**

A. No. The plain language of RCW 80.36.330 does not prohibit the Commission from considering factors in addition to those enumerated in the statute. In fact, clearly the intent of the law is to not limit the factors the Commission considers. This broad latitude gives the Commission ample flexibility to consider the extent to which effective competition truly exists in the market for local basic business services and to more easily achieve the Commission’s broader statutory requirement of regulating in the public interest. As I will discuss in subsequent sections of my testimony, the Commission has, in my opinion, interpreted the statute in such a manner that allows for the protection of the public interest in similar cases in the past.

**Q. HAS QWEST ADDRESSED THE ISSUES IN SUCH A WAY THAT DEMONSTRATES THAT EFFECTIVE COMPETITION EXISTS FOR LOCAL BUSINESS SERVICE?**

A. No. Qwest’s attempts to show that the Petition Services are effectively competitive under this statute fall well short. As I will show in subsequent sections of my testimony, it is impossible for Qwest to make such a showing, because the market has not reached a point where it can be considered to be fully competitive. Qwest’s case here is lacking, in large part, because the evidence required to support this application does not exist. Qwest simply cannot show that the market is strong enough to withstand the elimination of existing regulatory protections.



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**IV. SUMMARY OF FINDINGS AND RECOMMENDATIONS**

**Q. PLEASE SUMMARIZE YOUR CONCLUSIONS AND STATE YOUR RECOMMENDATIONS.**

A. After having reviewed Qwest’s testimony and exhibits, I conclude generally that the petition to classify Qwest’s basic business local exchange markets as competitive should be denied by the Commission. While some level of competitive activity is present in the state of Washington, the extent of that competition does not rise to the level of effective competition, does not constitute a fully competitive market, and certainly does not warrant the complete deregulation and reclassification of basic business local exchange services. Given the dependent nature of the competitive local exchange carrier (CLEC) industry, I believe that it is premature to grant Qwest the unrestricted pricing flexibility it seeks in this proceeding.

Further, the Commission should recognize that Qwest’s request for reclassification is premature in the sense that it precedes the release by the FCC of its Triennial Review Order – the outcome of which will, in large part determine how viable competitors will be in the future. Optimally, Qwest’s request for reclassification should not be considered until the impact on the industry and marketplace of this anticipated order is understood.

Should the Commission determine that it is appropriate to award Qwest some level of additional regulatory freedom, I recommend that such freedom be strongly

184 conditioned to prevent the potential for Qwest to engage in anti-competitive pricing  
185 strategies that could quickly eradicate the gains the competitive market has made in  
186 Washington in recent years. Specifically, I recommend, at a minimum, that the  
187 Commission impose a price floor consistent with RCW 80.36.330(3), below which  
188 Qwest would not be allowed to set retail rates. The Commission may choose one of  
189 several methods of setting a price floor. The goal is to set the floor to include the prices  
190 that Qwest charges other carriers for the same service or capability.

191 Generally speaking, the Commission should set the floor using, at a minimum,  
192 the following two cost components:

- 193 (1) *Imputed costs of all the UNEs used to provide the service.*  
194 This should be calculated by multiplying the quantity of the UNEs used  
195 to provide the service *times* the UNE TELRIC prices. Also included  
196 should be some recognition of the non-recurring charges to order  
197 UNEs.  
198  
199 (2) *A measure of minimum retail related costs.*  
200 An appropriate proxy for these retail costs could be established by  
201 using the Commission approved percentage for resale discounts. The  
202 Commission should recall that the resale discount is calculated based on  
203 Qwest's retail related expenses.  
204

205 **Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?**

206 A. In subsequent sections of my testimony, I will discuss the issues in this proceeding,  
207 address the extent to which the relevant Washington statute would permit Qwest's  
208 request for reclassification, address Qwest's filing and its shortcomings, and finally  
209 provide the Commission with recommendations.

210

**V. DISCUSSION OF ISSUES IN THIS PROCEEDING**

***Analysis***

**Q. PLEASE EXPLAIN YOUR THOUGHT PROCESS AS YOU ANALYZED THE ISSUES IN THIS CASE.**

A. When I began my analysis of this case, I began by asking the question – *What evidence would be sufficient to show that the market for basic business local exchange services is fully competitive?* After reviewing Qwest’s application and testimony, in the context of the Commission’s statutory obligations regarding service classification, I quickly came to the conclusion that the four standards to be considered by the Commission in making a determination regarding the competitive classification of a telecommunications service should be considered from two perspectives. First, the four standards should be reviewed from an historical perspective. In other words, using those four standards, make an assessment of the competitive landscape as it exists today, prior to any competitive classification of the Petition Services, and prior to Qwest becoming deregulated. The entirety of Qwest’s evidence is focused in this area, and Mr. Gates’ testimony in this proceeding focuses on this aspect of the Qwest filing.

The second is in the context of the future, if the Petition Services are classified competitive. After all, if a market is fully competitive, market protections are in place which protect competitors and consumers absent the regulation of Qwest. Hence, deregulation is justified. Additionally, it will be in the future that we will know whether a decision to classify these services as competitive truly serves the public interest. If after competitive classification, each of the four standards would continue to show positive

234 signs of competition, and there was no possibility that any of the competitive criteria  
235 would be degraded, the Washington market would be robust enough to withstand  
236 deregulation of the dominant carrier. The public interest would then not be harmed  
237 through classification of local business exchange service as competitive. If, on the other  
238 hand, it were not unequivocally clear that such circumstances would exist, such  
239 classification would be premature. Consequently, the public interest would be  
240 jeopardized and Qwest's Petition should be denied.

241

242 **Q. IS THE THOUGHT PROCESS YOU UTILIZED IN THIS CASE**  
243 **CONSISTENT WITH THAT OF THE COMMISSION IN PREVIOUS**  
244 **CASES INVOLVING COMPETITIVE CLASSIFICATION ISSUES?**

245 A. Yes. Qwest has previously petitioned this Commission in Docket UT-000883 for  
246 competitive classification of services. In the Seventh Supplemental Order in that  
247 docket, the Commission rejected Qwest's "more relaxed standard for determining  
248 effective competition" in that Qwest's interpretation of the standard did not provide the  
249 Commission with sufficient confidence that competitors *are* offering and *will* offer  
250 competitive services (original emphasis). This finding by the Commission appropriately  
251 allows the Commission to consider Qwest's Petition from a point in the future, and to  
252 make an assessment of any impact that a granting of the Petition may have on the  
253 marketplace.

254

255 **Q. WHY IS IT IMPORTANT TO DIFFERENTIATE BETWEEN A MARKET**

256           **IN WHICH SOME COMPETITIVE ACTIVITY EXISTS AND AN**  
257           **EFFECTIVELY COMPETITIVE MARKET?**

258       A.     The existence of competitors in a market does not necessarily translate to an effectively  
259           competitive marketplace. While it is obvious that some consumers of business  
260           telecommunications services in Washington currently enjoy the ability to choose from a  
261           range of providers, it is critical to stop and consider the environment in which such  
262           conditions developed. In Washington, since the passage of the Telecommunications  
263           Act of 1996, CLECs have had some *limited* success in making inroads into a market  
264           that continues to be dominated by Qwest. Over that past seven or so years, CLECs  
265           (as a group) have managed to eek out a small customer base in Washington (obviously,  
266           on an individual basis, CLEC market share is even more minuscule)<sup>1</sup>. What is critical to  
267           bear in mind is that this relatively inconsequential progress took place while Qwest was  
268           fully regulated. The question then becomes, *will progress be sustained in a*  
269           *completely different environment, where the dominant provider is no longer*  
270           *regulated?*

271  
272       **Q.     CAN YOU SPECULATE AS TO THE REASON CLECS HAVE ONLY BEEN**  
273       **ABLE TO MAKE FRACTIONAL GAINS IN THE MARKET SINCE 1996?**

274       A.     There are likely several reasons. For one, before it would make sense for CLECs to  
275           make significant investments in its own network and provide true facilities-based  
276           competition, competing companies must gain a market toehold, and establish a stable

277 customer base. CLECs are therefore, during this initial stage of market development,  
278 limited to competing through resale or UNE-based competition. Because Qwest is the  
279 sole supplier of these wholesale inputs, CLECs are the captive customers of Qwest,  
280 and Qwest is in the position to dictate what services end-use customers may choose  
281 from. This total wholesale market power may have contributed to the relatively small  
282 gains made by CLECs into the marketplace to date. During these initial stages of  
283 competition, when CLECs, and therefore the CLECs retail customers) are captives of  
284 Qwest, (as addressed in the statute) an unregulated Qwest would have the ability to  
285 manipulate the marketplace (as addressed below) further slowing or even reversing the  
286 competitive market development in Washington.

287

288 ***271 Proceeding***

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**Q. HASN'T THE COMMISSION ALREADY DETERMINED THAT THE LOCAL MARKET IS SUFFICIENTLY OPEN TO RECOMMEND THAT THE FCC GRANT QWEST RELIEF UNDER SECTION 271 OF THE TELECOMMUNICATIONS ACT OF 1996?**

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A. Yes, as discussed by Qwest witness David L. Teitzel beginning at page 13 of his testimony, based on the recommendation of this Commission, the FCC found that Qwest satisfied its requirements under Section 271. However, in a 271 filing, the focus is on the question of whether Qwest has *opened* its local exchange markets in

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<sup>1</sup> Mr. Gates provides more detail with respect to CLEC/Qwest market share in his testimony using the concept of concentration ratios.

298 Washington to competition, not on whether a service is subject to effective competition  
299 as is called for by Washington statute. By contrast, in the current proceeding, the focus  
300 is on, among other things, the question of whether the level of competition is (and will  
301 be) sufficient to curtail Qwest's market power as a dominant provider of local  
302 telecommunications services in Washington. As I will discuss subsequently, there is a  
303 significantly higher threshold to answer this question affirmatively.<sup>2</sup>

304

305 **Q. MR. TEITZEL, AT PAGES 13 AND 14 OF HIS TESTIMONY COMMENTS**  
306 **ON QWEST'S ABILITY TO ACT IN AN ANTICOMPETITIVE FASHION**  
307 **TO DRIVE ITS COMPETITORS FROM THE MARKET IN**  
308 **WASHINGTON. DO THE PORTIONS OF THE FCC ORDERS HE SITES**  
309 **HAVE RELEVANCE TO THAT POSSIBILITY IN THIS CASE?**

310 A. No. As I have noted, the FCC's findings in the Section 271 proceeding were focused  
311 on the openness of the market to competitive entry and its findings do not go to the  
312 extent to which a market is effectively competitive as is the focus of this proceeding.  
313 Further, Mr. Teitzel's comments with respect to Qwest's performance assurance plan  
314 (PAP) should be of little comfort to the Commission. Qwest received Section 271  
315 relief only recently, and to date, the effectiveness of testing whether the PAP is sufficient  
316 to prevent backsliding is still open to debate. Moreover, it would appear to be a risky  
317 proposition for the Washington Commission to rely on the FCC to have the last word  
318 on the success of competition in the business local exchange market here in Washington.

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<sup>2</sup> Of course there are also obvious differences in the analyses of the two statutes because the factors set

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320 **Q. WOULD QWEST VIOLATE ITS 271 OBLIGATIONS IF IT PRICES THE**  
321 **PETITION SERVICES IN SUCH A MANNER AS TO PRICE SQUEEZE ITS**  
322 **COMPETITORS?**

323 A. No. The SGAT which resulted from the 271 proceeding did not deal with retail prices  
324 whatsoever. In fact, when the Wyoming Public Service Commission<sup>3</sup>, asked Qwest if it  
325 would be willing to commit to maintaining a relationship between UNE prices and retail  
326 rates that would prevent price squeeze tactics, Qwest responded that it would not agree  
327 to incorporating such terms into the SGAT. Therefore, CLECs and the market in  
328 general have absolutely no protection through the SGAT or the PAP against Qwest  
329 reducing retail prices to levels that would not recover UNE costs.

330 In short, the Commission should not feel confident that Qwest is prevented from  
331 acting in an anti-competitive fashion and driving competitors from the market through its  
332 271 obligations.

333 ***Current Competitive Environment***

334

335 **Q. IS THE CURRENT LEVEL OF COMPETITION IN WASHINGTON**  
336 **SUFFICIENT TO CURTAIL QWEST'S MARKET POWER?**

337 A. No, and Mr. Gates will discuss this point in much more detail in his testimony. Though  
338 the competitive market has made some strides in Washington, it should be clear that

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forth in 47 U.S.C. Section 271 are not the same as the factors set forth in RCW 80.36.330.

<sup>3</sup> See transcript of Oral Argument on Group 5A, Before the Wyoming Public Service Commission Docket 70000-TA-00-599.



339 those strides were made in a framework in which Qwest was prevented from exercising  
340 its market power to prevent competition from developing. Therefore, what should be of  
341 the greatest concern to the Commission is not so much the current level of competition,  
342 but the impact on competition of approving Qwest's request for reclassification.

343

344 **Q. ARE YOU SUGGESTING THAT THERE IS NO COMPETITIVE ACTIVITY**  
345 **IN WASHINGTON?**

346 A. Absolutely not. There are signs of a developing competitive market in Washington.  
347 Significant initial strides have been made in Washington's telecommunications  
348 marketplace, and some of the evidence provided by Qwest, while not sufficient to  
349 support classification of the Petition Services as competitive, demonstrates that a  
350 competitive market may, in time, develop. Business consumers in some areas of  
351 Washington currently have a choice of providers, and a broad range of service  
352 offerings. These consumer benefits have been spurred by CLECs' limited success with  
353 entry into the local market in the state, and I believe, are a great benefit to the public  
354 interest. However, these strides related to the first stages of competition should not be  
355 mistaken for a marketplace that is fully competitive and able to hold up against the  
356 deregulation of the dominant carrier. As I will explain later in my testimony, approving  
357 Qwest's application at this time would place the first stages of a competitive  
358 marketplace and the attendant consumer benefits at grave risk.

359

360 **Q. HOW WOULD YOU CHARACTERIZE THE CURRENT LEVEL OF**

361 **COMPETITION IN WASHINGTON?**

362 A. From a theoretical standpoint, competition in Washington may be sufficient to prevent  
363 Qwest from raising rates (a sign that competition is developing and a weakening of  
364 Qwest's market power) in certain areas. Where other carriers exist in Washington, a  
365 price increase by Qwest may elicit a competitive response. However, as I will explain  
366 later in my testimony, the market is still too weak to prevent Qwest from exercising its  
367 market power and engaging in anti-competitive pricing tactics which can be used to  
368 eliminate the competition that currently exists. In other words, in the current regulated  
369 environment, Qwest prevented from using its market power to essentially eliminate  
370 competition, but those conditions are quite unlikely to be sustained if Qwest receives the  
371 regulatory relief it seeks in this docket.

372

373 ***Sustainability of Competitive Activity***

374

375 **Q. WHY ARE YOU CONCERNED THAT EVEN THOUGH THERE ARE**  
376 **SIGNS THAT A COMPETITIVE MARKET IS DEVELOPING IN**  
377 **WASHINGTON, CONTINUED SUCCESS WOULD BE JEOPARDIZED IF**  
378 **QWEST'S APPLICATION WERE APPROVED?**

379 A. One of my primary concerns is that the benefits of competition that Washington  
380 consumers have enjoyed to date have all occurred during a time when Qwest was  
381 regulated by the Commission and in an environment where the Petition Services were  
382 not classified as competitive. In fact, the benefits experienced by Washington's

383 consumers are directly tied to the steps taken by the Commission exercising its statutory  
384 authority to protect the competitive market and the public interest. My concern arises if  
385 the Commission gives up all or part of such authority, and essentially hands over the  
386 responsibility to protect the public interest to Qwest. This is because the Commission  
387 has an interest in promoting a competitive market and ensuring that CLECs have the  
388 ability to compete on even footing with the incumbent (Qwest). Such competition  
389 promotes consumer welfare, and is in the public interest. Qwest, on the other hand, has  
390 no such interest. In fact, Qwest's interests are diametrically opposed to the  
391 Commission's obligation to ensure that Washington consumers have a choice of  
392 providers. While the Commission's oversight of the development of the market in  
393 Washington has been driven by public interest objectives, Qwest's unregulated  
394 participation would be driven by financial objectives. Unfortunately the optimization of  
395 Qwest's financial objectives does not include the presence of real competitors or the  
396 protection of the public interest in a developing competitive market. In fact, Qwest can  
397 come closer to reaching its financial objectives by weakening its competitors and  
398 reducing consumer choice. The conclusion of that exercise would be when Qwest had  
399 eliminated its competition entirely. It is critical for the Commission to recognize that  
400 given Qwest's powerful market position, absent retail pricing restrictions set and  
401 enforced by this Commission, Qwest would have both the ability and the incentive to  
402 control the strength and viability of its competitors, and thus, the strength and viability of  
403 the competitive market forces which protect ratepayers in Washington.

404

405 **Q. DON'T CLECS HAVE THE SAME OBJECTIVES – TO WIN AS MANY**  
406 **CUSTOMERS AS POSSIBLE?**

407 A. Of course, however, competitive carriers are generally constrained in their own retail  
408 pricing of their services by the cost of the services and elements which they must  
409 purchase from Qwest. Qwest obviously does not face the same obstacles. This  
410 unequal footing is a critical point that should be weighed heavily by the Commission in  
411 its decision in this case.

412  
413 **Q. WHAT SORT OF PRICING TACTICS BY QWEST SHOULD THE**  
414 **COMMISSION BE CONCERNED ABOUT?**

415 A. In general, given Qwest's market position, there are two forms of pricing strategies that  
416 should concern the Commission in granting Qwest pricing flexibility. Absent existing  
417 restrictions, Qwest could do either one or both of the following:

- 418 (1) *Increase* its retail rates and earn supra normal profits at the expense of  
419 ratepayers; and/or,  
420  
421 (2) *Lower* its retail rates below a relevant price floor in select circumstances to  
422 defeat competitors.<sup>4</sup>  
423

424 It is important to note that these two pricing strategies are not mutually exclusive. To  
425 the contrary, the two strategies are most effective for Qwest if they are executed  
426 simultaneously. In that manner, Qwest would be able to fend off competitors by  
427 selectively lowering rates for certain services in the pockets where it faces some

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<sup>4</sup> Once Qwest has defeated its competitors through anticompetitive pricing, it will be able to raise its retail rates to the detriment of ratepayers.

428 competition and/or it knows that CLECs have facilities, while remaining optimally  
429 profitable by raising rates for customers not subject to competition. This is of particular  
430 concern in Washington given the fact that competitive activity is not pervasive  
431 throughout the state. A carrier with a significant market dominant position (such as  
432 Qwest) may view short term losses as a cost of doing business that would be more than  
433 recovered in the long term, when competition is eliminated.

434

435 **Q. PLEASE EXPLAIN HOW QWEST COULD ELIMINATE ITS**  
436 **COMPETITION ENTIRELY USING ANTI-COMPETITIVE PRICING**  
437 **TACTICS.**

438 A. If Qwest's application for reclassification were to be approved by the Commission,  
439 Qwest would have the ability to price local exchange service in such a way that it would  
440 be impossible for competitive carriers to respond profitably. Under these conditions,  
441 competitors would have a disincentive to enter or remain in the market. Qwest can  
442 accomplish this objective by engaging in classic price squeeze tactics.

443

444 **Q. PLEASE DEFINE AND DISCUSS THE CONCEPT OF A PRICE SQUEEZE.**

445 A. A price squeeze is created when a vertically integrated firm (such as Qwest) has  
446 unrestrained retail pricing freedom to compete against companies (such as CLECs) in  
447 retail markets while controlling critical inputs that its competitors are dependent upon.  
448 In this situation, the vertically integrated firm can use the price squeeze as an  
449 anticompetitive device by lowering the price for the retail service to or below the price

450 which it charges for the wholesale elements necessary for competitors to compete, thus  
451 squeezing the dependent competitors' margins between retail rates and wholesale rates,  
452 and reducing or eliminating their ability to recover their costs. This strategy is called a  
453 price squeeze and can more formally be defined as follows:

454           Considering a situation in which a monopoly supplier is  
455 integrated downstream, a price squeeze [is] the situation in  
456 which "the monopoly input supplier charges a price for the input  
457 to its downstream competitors that is so high they *cannot*  
458 *profitably* sell the downstream product in competition with the  
459 integrated firm<sup>5</sup>" (Emphasis added.)  
460

461           The FCC discusses the price-squeeze strategy and notes that it occurs when a  
462 dominant firm with downstream competitors that rely on facilities and services from the  
463 dominant firm is "charging prices for inputs that preclude[] competition from firms  
464 relying on those inputs."<sup>6</sup> The upshot of a price squeeze is that competitors would have  
465 to pay more to their wholesale provider than they can charge to their end-users, thereby  
466 losing money on every customer. In this Docket, the dominant firm (Qwest) is  
467 obviously not seeking to increase the price of its competitors inputs (UNEs), as those  
468 have been previously set by the Commission. Nevertheless, what Qwest *does* seek in  
469 this Docket (unrestricted retail pricing capabilities) would provide Qwest with the very  
470 same opportunities to execute a price squeeze.

471  
472 **Q. CAN YOU PROVIDE AN EXAMPLE OF HOW QWEST COULD EXECUTE**

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<sup>5</sup> Jean Tirole, "The Theory of Industrial Organization," The MIT Press, Cambridge, Massachusetts, 1988, page 186. Tirole quotes from Joskow, P. 1985. Mixing Regulatory and Antitrust Policies in the Electric Power Industry: The Price Squeeze and Retail Market Competition. In "Antitrust and Regulation: Essays in Memory of John J. McGowan," ed. F. Fisher. City: Publisher.

473 **A PRICE SQUEEZE BY MANIPULATING RETAIL PRICES IN A**  
474 **DEREGULATED ENVIRONMENT?**

475 A. The table below provides a simple example of how Qwest could execute a price  
476 squeeze in Washington using the retail pricing freedom it seeks in this case. By setting  
477 its retail prices at levels that are lower than the levels at which its UNE elements which  
478 make up the service are priced, Qwest would put its competitors in an extremely  
479 difficult position in which the CLEC would be faced with one of two options: (1) price  
480 its retail service to end-users at levels higher than Qwest (significantly reducing the  
481 opportunity for attracting new customers and likely losing existing customers to Qwest),  
482 or (2) set prices at a level which would be competitive with Qwest, but would not  
483 recover the costs of providing the service (taking a loss on each existing and/or new  
484 customer). Obviously, neither option would be attractive to any CLEC and would have  
485 a chilling effect on competition in Washington.

486  
487 **PRICE SQUEEZE EXAMPLE**

<b>QWEST'S WHOLESALE INPUT PRICE</b>	<b>QWEST'S RETAIL PRICE</b>	<b>CLEC LOSS</b>
\$15	\$12	-\$3

488  
489  
490 In this manner, Qwest could squeeze competitors out of the marketplace and eliminate  
491 any and all competition by simply setting prices at levels that do not recover the costs of  
492 offering the service.

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<sup>6</sup> *Sprint v. FCC*, 274 F.3d 549, 551 (2001).

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**Q. CAN YOU EXPLAIN IN MORE DETAIL THE PRICE SQUEEZE TACTIC WHICH CONCERNS YOU?**

A. Yes. In simple terms, most CLECs live or die by the margins between the wholesale rates for unbundled network elements (“UNEs”) and their retail rates. That margin must cover the CLECs’ own costs and provide a return on investment, if the CLECs are ever to become effective competitors. The larger the margin between the wholesale rates CLECs pay to Qwest and the retail rates they can charge in the market place, the larger will be their profits – if any – or the smaller will be their losses. If that margin shrinks, so will the CLECs’ ability to operate in Washington. Thus, if Qwest is granted the nearly unrestricted downward retail flexibility it is asking for, Qwest will be able -- at will -- to increase or decrease the margin available to its dependent competitors. As such, Qwest is largely in control of the strength and viability of its competitors, which -- coming full circle -- are the very companies that Qwest claims will protect customers from a deregulated Qwest. The construct underlying Qwest’s proposed reclassification is deeply flawed: *to be sure, if granted as proposed, it will “place the fox in charge of the hen house.”*

**Q. DOESN’T MR. REYNOLDS TESTIFY THAT QWEST’S RETAIL RATES ARE CURRENTLY HIGHER THAN UNE RATES?**

A. Yes. However, this testimony only serves to provide an explanation as to why competitive activity *currently* exists, because the relationship Mr. Reynolds describes



515 must exist in order for CLECs to offer retail services profitably. As I have noted,  
516 CLECs relying on Qwest to provide UNEs in order to offer retail service could not be  
517 in the market if Qwest's UNEs were priced higher than Qwest's retail rates. That  
518 relationship exists because both Qwest's UNE prices and its retail prices are subject to  
519 regulation by this Commission. Mr. Reynolds' testimony regarding this issue should give  
520 the Commission no confidence whatsoever regarding whether CLECs will have the  
521 ability to continue to offer retail service in competition with Qwest. This is due to the  
522 fact that Qwest would have the power to reverse the current UNE/retail rate  
523 relationship, and would therefore have the ability to control when and if CLECs could  
524 compete in the retail market in the future.

525

526 **Q. DO YOUR OBSERVATIONS AND CONCLUSIONS APPLY TO BOTH**  
527 **QWEST'S WHOLESALE CUSTOMERS THAT PROVIDE RETAIL**  
528 **SERVICE BY PURCHASING UNBUNDLED NETWORK ELEMENTS**  
529 **(UNES) FROM QWEST AS WELL AS CLECS THAT HAVE ELECTED TO**  
530 **COMPETE USING THEIR OWN FACILITIES?**

531 A. Yes. While all competitors could potentially be harmed if Qwest was given the freedom  
532 to engage in anti-competitive pricing strategies, the most vulnerable are, obviously the  
533 carriers who are reliant either partially or entirely on purchasing wholesale inputs from  
534 Qwest.

535 However, Qwest's ability to price at anti-competitive levels could be potentially  
536 damaging to facilities-based CLECs as well. Facilities-based competitors are often not

537 facilities-based for 100 percent of the facilities which they use to serve their customers.  
538 They often purchase collocation, UNE loops, transport, dark fiber, and other elements  
539 which they use in conjunction with their own facilities to provide a finished retail service  
540 to their customers. As such, they would be very vulnerable if Qwest were to move its  
541 own retail prices down closer to the prices which they pay Qwest for the elements they  
542 must have to compete. In addition, facilities-based competitors have generally made  
543 very substantial investments in switches, collocated equipment, and other plant to  
544 provide service to their customers. Should Qwest be given the freedoms it seeks and  
545 exercises its ability to squeeze its competitors from the market, these carriers would  
546 have no way of recovering this massive investment.

547 In short, both facilities- and non-facilities-based CLECs would suffer as a result  
548 of reclassification. Needless to say, Washington consumers would suffer as well if  
549 Qwest were permitted to undo the emerging consumer benefit of competition which has  
550 been a goal of this Commission for many years.

551  
552 **Q. TO THIS POINT, YOUR ANALYSIS OF CARRIER INCENTIVES COULD**  
553 **DESCRIBE EITHER QWEST, OR ANY OTHER CARRIER IN**  
554 **WASHINGTON. WHY IS YOUR CONCERN RELATED TO QWEST?**

555 A. As I alluded to previously, all firms seek to gain as many customers as possible, and  
556 even to take customers from other firms. That is the essence of price competition, so  
557 long as lower prices are achieved through a more efficient use of existing resources,  
558 resulting in lower production costs. However, Qwest's ability to lower prices to

559 predatory levels and drive consumers from the market has nothing to do with efficiency.

560 This is because Qwest is well situated to engage in such tactics without making any

561 efficiency gains whereas competitive carriers are not. This is due to several reasons,

562 including:

563 • Even though there are pockets of competition in Washington, competition is not  
564 pervasive throughout the state. Therefore, Qwest can selectively target  
565 customers in the competitive pockets, charging below cost rates in those areas  
566 while keeping rates at existing levels or even increasing rates in the areas where  
567 competition is less intense or nonexistent. Supra competitive profits generated  
568 by Qwest in these non-competitive areas can be used to offset short-term  
569 losses in the competitive areas until the objective is achieved – competition is  
570 eliminated. Clearly, this market power is enjoyed by Qwest, but not its  
571 competitors. What should be noted is that this market superiority is not the  
572 result of Qwest's efficiency, but of the ability of Qwest to target the most  
573 lucrative markets while continuing to enjoy the profits in the rest of the markets  
574 which it dominates.

575 • Qwest receives revenues from its competitors in the form of access charges. It  
576 is well recognized that these charges are far in excess of cost. These supra-  
577 competitive profits are also a source of revenues to be used by Qwest to offset  
578 short term losses associated with the price squeeze strategy. This revenue  
579 stream is not generally available to CLECs. (My colleague, Timothy Gates will  
580 provide additional detail regarding this issue).

581

582 In short, while any firm in any marketplace has a strong incentive to attract as

583 many customers as possible, in this situation, Qwest not only has the incentive to

584 dominate the marketplace, but also has the *ability* to do so through anti-competitive

585 means. Given both the incentive and the ability to do so, the conclusion is that Qwest,

586 absent the protective regulations currently imposed by this Commission, would likely  
587 regain its monopoly market power and Washington consumers would suffer.

588

589 **Q. AREN'T LOWER RETAIL PRICES A BENEFIT TO CONSUMERS?**

590 A. In the short run the answer is obviously yes. However, after competing firms have been  
591 driven from the marketplace through Qwest's below cost pricing, Qwest would no  
592 longer be constrained by competitive pressure from raising prices to levels well in  
593 excess of cost. In other words, once the price squeeze has successfully eliminated  
594 competitors, Qwest could freely increase prices to monopoly profit maximizing levels  
595 without any threat of a competitive response. In the long run, consumers would  
596 therefore not experience prices that are competitively driven. Rather if the Petition  
597 Services are classified effectively competitive, customers could expect to experience  
598 prices well in excess of cost, and (since alternative providers have exited the market)  
599 have no alternative but to pay those prices. Even in the short term, Qwest's pricing  
600 tactics would not likely provide widespread benefits to customers in Washington. This  
601 is because the temporary price reductions would likely be limited to the CLEC's largest  
602 customers whom Qwest is most interested in winning back. In short, although a pricing  
603 strategy that includes reductions in retail rates appears on its face to be appealing from a  
604 consumer perspective, in actuality, such a scheme will result in higher, rather than lower  
605 rates and in much narrower choices of providers and services for consumers.

606

607 **Q. IS THE COMPETITIVE ACTIVITY CURRENTLY SEEN IN**

608           **WASHINGTON SUSTAINABLE IN AN ENVIRONMENT WHERE THE**  
609           **PETITION SERVICES ARE CLASSIFIED COMPETITIVE?**

610       A.    No.  As I have discussed, Qwest has strong financial incentives to eliminate its  
611           competitors.  Because Qwest not only has the incentive, but also the financial ability to  
612           accomplish this goal, it is unlikely that even the current level of competitive activity in  
613           Washington would be sustained into the future if the Petition Services were classified  
614           effectively competitive at this time.

615

616                           **VI.    WASHINGTON STATUTE**

617

618       **Q.    HOW DOES YOUR DISCUSSION TO THIS POINT RELATE TO THE**  
619           **COMMISSION’S OBLIGATION TO CONSIDER THE FOUR FACTORS**  
620           **YOU IDENTIFIED EARLIER IN YOUR TESTIMONY?**

621       A.    The statute contains language that is key to the success of competition in Washington,  
622           occurring in paragraph (1)(d) which deals with indicators of “market power.”  As I  
623           alluded to at the beginning of the previous section, to appropriately evaluate Qwest’s  
624           application, and in order to ensure the continued development and sustainability of  
625           competition in Washington, the Commission should assess Qwest’s Petition by not only  
626           considering what has happened, but also what is likely to happen, should Qwest obtain  
627           the freedom it seeks.  Currently, Qwest is prevented (through regulation by this  
628           Commission) from acting in an anti-competitive manner as I have described.  With this  
629           filing, Qwest seeks freedom from Commission oversight, oversight which prevents

630 Qwest from eliminating competition altogether. Before removing this only roadblock to  
631 Qwest's anti-competitive behavior, the statute requires that the Commission be certain  
632 that Qwest:

- 633 1. Does not have the incentive to engage in anti-competitive pricing strategies  
634 which could drive competitors from the market.
- 635 2. Does not have the ability to engage in anti-competitive pricing strategies  
636 which could drive competitors from the market.
- 637 3. Provides assurances that it will not act on its incentive to engage in anti-  
638 competitive pricing strategies which could drive competitors from the  
639 market.
- 640 4. Provides assurances that it will not act on its ability to engage in anti-  
641 competitive pricing strategies which could drive competitors from the  
642 market.

643 Absent such evidence or assurance from Qwest, it is clear that Qwest could in fact  
644 behave in the manner I have suggested, and the market is not yet strong enough to  
645 prevent such action. Without these assurances, Qwest's Petition should be rejected.

646

647 **Q. IS THERE ANOTHER SECTION OF RCW 80.36.330 WHICH THE**  
648 **COMMISSION SHOULD CONSIDER?**

649 A. Yes. RCW 80.36.330 (3) dictates that prices or rates charged for competitive services  
650 shall cover their costs. Qwest has failed to mention this critical section of the statute in  
651 its testimony, but, should the Commission determine that classification of the Petition  
652 Services is justified, it is critical that this condition be met. Qwest, to date, has given the  
653 Commission no assurance with respect to this section of the statute.

654

655 **Q. DOES THE STATUTE PROVIDE THE COMMISSION GUIDANCE IN**  
656 **DETERMINING THE PROPER COSTS?**

657 A. No. Other than the requirement that rates must preserve affordable universal service,  
658 the Commission is only required to determine the “proper cost standards.” This  
659 determination is critical in that the extent to which Qwest could execute a price squeeze  
660 on its competitors is dependent upon the retail rates Qwest is allowed to charge.  
661 Elsewhere in my testimony, I have provided the Commission with a price floor  
662 calculation which would prevent Qwest from executing a price squeeze. The price floor  
663 calculation I have provided complies with the requirements of RCW 80.36.330(3).  
664

665 **VII. DISCUSSION OF QWEST’S FILING**  
666

667 **Q. HAS QWEST PROVIDED ANY OF THE EVIDENCE OR ASSURANCES**  
668 **YOU DISCUSSED IN THE PREVIOUS SECTIONS OF YOUR TESTIMONY**  
669 **THAT SHOULD GIVE THE COMMISSION CONFIDENCE THAT**  
670 **COMPETITIVE ACTIVITY WILL BE SUSTAINED INTO THE FUTURE**  
671 **SHOULD THE PETITION SERVICES BE CLASSIFIED COMPETITIVE?**

672 A. No. Qwest has, predictably, focused on historical information, which is of little value in  
673 predicting how the market would respond to deregulating Qwest. The content of  
674 Qwest’s filing is predictable because, as I noted previously, it is just not possible for  
675 Qwest to show that it lacks the incentive or ability to use its dominant position to drive  
676 competitors from the market.

677           The anecdotal, historical evidence presented by Qwest in this proceeding is of  
678           little value to the Commission in that none of the areas Qwest points to as evidence that  
679           the market is fully competitive would even exist absent the regulatory oversight of the  
680           Commission. The state of the local exchange market today is not the result of the  
681           competitive market reaching maturity, to the point that Qwest no longer poses a threat  
682           to the continued development and sustainability of competition, but due to the continued  
683           careful oversight of the Commission, which has precluded Qwest from acting on its  
684           incentive and ability to resist and/or eliminate all competition from the marketplace.

685           As I noted previously, the first stages of competition should not be mistaken for  
686           a marketplace that is effectively competitive and able to hold up to the deregulation of  
687           the dominant carrier. This Commission has actively overseen the first stages of such  
688           development, but Qwest has both the ability and the incentive to take back the gains  
689           that the limited competitive market has made in Washington.

690

691           **Q. AT PAGE 5 OF HIS TESTIMONY, QWEST WITNESS MARK S.**  
692           **REYNOLDS TESTIFIES THAT THE PUBLIC WOULD BENEFIT BY**  
693           **COMPETITIVE CLASSIFICATION OF THE PETITION SERVICES.**  
694           **COULD YOU COMMENT ON THAT TESTIMONY?**

695           A. Yes. Mr. Reynolds testifies that in order for customers to experience the benefits of a  
696           competitive market, Qwest must be able to respond to its competition. What Mr.  
697           Reynolds fails to mention in his testimony is that Qwest already has such freedoms. Mr.  
698           Gates discusses this issue in greater detail in his testimony, but I would note that this



699 Commission has already addressed this issue with Qwest in Docket UT-000883,  
700 finding that Qwest has the ability absent the classification it seeks, to compete with other  
701 providers.<sup>7</sup> The question then becomes – *Why does Qwest want (or need) the*  
702 *additional freedom that would come with reclassification?*

703

704 **Q. IS CLASSIFICATION OF THE PETITION SERVICES AS EFFECTIVELY**  
705 **COMPETITIVE IN THE PUBLIC INTEREST?**

706 A. No. Such classification would jeopardize the developing market in Washington,  
707 penalize carriers that have made significant investment in network facilities, and most of  
708 all deprive Washington consumers of the benefits of competition.

709

## 710 **VIII. CONCLUSION AND RECOMMENDATIONS**

711

712 **Q. WHAT ARE YOUR RECOMMENDATIONS?**

713 A. I recommend that the Commission deny Qwest's application to reclassify local  
714 exchange service in Washington for the following reasons:

- 715 1. Qwest has strong economic incentives to eliminate competition for business  
716 local exchange services in Washington.
- 717 2. Qwest has the financial ability and the incentive to execute price squeezes  
718 on its competitors in order to eliminate any competitive challenge.

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<sup>7</sup> In The Matter of the Petition of Qwest Corporation for Competitive Classification of Business Service in Specified Wire Centers, Seventh Supplemental Order Denying Petition and Accepting Staff's Proposal, paragraph 70.

- 719 3. The availability of unbundled network elements is a significant factor in the  
720 continued development of competition in Washington. The upcoming  
721 release of the FCC's Triennial Review Order may have a significant impact  
722 on this availability. As such, considering additional regulatory freedom for  
723 Qwest is premature at this time.
- 724 4. The factors set forth in 47 U.S.C. Section 271 are not the same as the  
725 factors set forth in RCW 80.36.330. In a 271 filing, the focus is on the  
726 question of whether Qwest has *opened* its monopoly local exchange  
727 markets in Washington to competition, not on whether a service is subject  
728 to effective competition as is called for by Washington Statute. Therefore,  
729 the recent relief awarded to Qwest by the FCC under Section 271 of the  
730 Telecommunications Act should not give the Commission any confidence  
731 that the Petition Services are effectively competitive. Additionally, neither  
732 Qwest's SGAT nor its PAP would prevent it from setting retail rates at  
733 price-squeeze levels and eliminating its competitors.
- 734 5. Qwest has not previously used its existing pricing flexibility to respond to  
735 competition in Washington. This suggests that either Qwest does not truly  
736 feel competitive pressure, (and therefore additional flexibility is not  
737 necessary), or that Qwest has some ulterior motive to eliminate competitors  
738 in Washington.
- 739 6. Qwest's request for reclassification would place in severe jeopardy the  
740 ability of Washington carriers to recover investments made in order to

741 provide telecommunications service to Washington consumers.  
742 7. In summary, I do not believe that the criteria established in RCW  
743 80.36.330 have been met by Qwest. Qwest has neither provided  
744 assurances that effective competition currently exists, nor that effective  
745 competition would be sustained under the classification Qwest seeks. The  
746 Commission should reject Qwest's request for the Commission to apply a  
747 "more relaxed standard for determining effective competition" in this case  
748 as it did in Docket UT-00083.

749

750 **Q. IN THE EVENT THAT THE COMMISSION DETERMINES THAT THE**  
751 **HISTORICAL EVIDENCE PRESENTED BY QWEST IS SUFFICIENT FOR**  
752 **QWEST TO RECEIVE SOME LEVEL OF ADDITIONAL FREEDOM DO**  
753 **YOU RECOMMEND THAT THE COMMISSION PLACE CONDITIONS**  
754 **ON THAT FREEDOM?**

755 A. Yes. Even in the event that the Commission determines that it is appropriate to grant  
756 Qwest's request, I recommend consistent with RCW 80.36.330(3), that the  
757 Commission impose a price floor, below which Qwest would not be allowed to set  
758 retail rates. The price floor should include, at a minimum, the following two cost  
759 components:

760 (1) *Imputed costs of all the UNEs used to provide the service.*  
761 This should be calculated by multiplying the quantity of the UNEs used  
762 to provide the service *times* the UNE TELRIC prices. Also included  
763 should be some recognition of the non-recurring charges to order  
764 UNEs.  
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(2) *A measure of minimum retail related costs.*  
An appropriate proxy for these retail costs could be established by using the Commission approved percentage for resale discounts. The Commission should recall that the resale discount is calculated based on Qwest's retail related expenses.

These minimum requirements are consistent with the findings of the Commission in Docket No. UT-020406, where it found that the object of a price floor is to assure that prices include what a vertically integrated carrier (Verizon) would charge others for necessary services.<sup>8</sup>

**Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

A. Yes, it does.

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<sup>8</sup> Before the Washington State Utilities and Transportation Commission, Docket No. UT-020406, Eleventh Supplemental Order at para. 80, August, 2003.