BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

In the Matter of the Petition of QWEST CORPORATION

To be Regulated Under An Alternative Form of Regulation Pursuant to RCW 80.36.135.

DOCKET NO. UT-061625

DIRECT TESTIMONY OF ROBERT LOUBE, Ph.D. (RL-1TC)

ON BEHALF OF

PUBLIC COUNSEL

CORRECTED CONFIDENTIALITY DESIGNATION (PAGES 64 & 65)

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I. INTRODUCTION

Q: Please state your name and business address.

A: My name is Robert Loube. My business address is 10601 Cavalier Drive, Silver Spring, Maryland 20901.

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

A: I am the Director, Economic Research, Rhoads and Sinon, LLC.

Q: On whose behalf are you testifying?

A: I am testifying on behalf of the Public Counsel.

Q: Please describe your professional qualifications.

A: I received my Ph.D. in economics from Michigan State University in 1983. In my current position I have testified or filed testimony on behalf of the Pennsylvania Office of the Consumer Advocate, the Maine Office of the Public Advocate, The Utility Reform Network (TURN), the staff of the Nevada Public Utilities Commission and the staff of the South Carolina Public Service Commission. I also filed testimony on behalf of the Public Counsel and the AARP in the Washington Utilities and Transportation Commission Docket No. UT-040788. Previously, I worked for the Federal Communications Commission (FCC) where I helped to establish the criteria for choosing the universal service economic cost model, evaluated and modified telephone cost models, and determined the input values used in the FCC's Synthesis model.

While I worked at the Indiana Utility Regulatory Commission and at the Public Service Commission of the District of Columbia, I testified on the validity and usefulness of a number of incremental and embedded cost studies and on the conditions required for competition in telephone markets. I have lectured on cost modeling and pricing in telecommunications at the NARUC Annual Regulatory Studies Program. My vita is attached to this testimony as Exhibit No. ___ (RL-2).

II. PURPOSE OF TESTIMONY

Q: What is the purpose of your testimony?

A: The purpose of my testimony is to identify the conditions under which an AFOR would meet the policy goals specified in RCW 80.36.135. The Qwest proposal does not meet those goals and therefore should not be adopted. I propose an alternative set of conditions that, if adopted, will allow the Commission reasonable assurance that the AFOR policy goals can be achieved.

Q: Please summarize your testimony.

A: My testimony begins with an examination of the reasons for adopting an AFOR, including a discussion of the conditions necessary to achieve the AFOR public policy goals. Next, I rebut the testimony of Qwest witnesses Mr. Mark S. Reynolds and Mr. David L. Teitzel. With regard to Mr. Reynolds' testimony, I demonstrate that the Qwest proposal would not be consistent with the AFOR public policy goals because it contains no commitments to facilitate the deployment of advanced services to underserved areas or to underserved classes of customers. The Qwest proposal is anti-competitive because it increases rates in non-competitive markets. The proposed rate increases are unfair and unjust and are unduly prejudiced against residential customers. With regard to Mr. Teitzel's testimony, I show that effective competition does not exist in the residential primary-line market. The lack of effective competition would allow Qwest to exert monopoly power in that market. Finally, I review Qwest's earnings reports and find that Qwest incorrectly assigns substantial amounts of interstate special access investment to the intrastate jurisdiction. The proper assignment of the special access investment to the interstate jurisdiction would reduce the intrastate rate base and expenses, allowing Qwest to report a reasonable rate of return in the intrastate jurisdiction.

III. THE GOALS OF AFOR REGULATION

Q: What is the reason for adopting an AFOR?

A: An AFOR may be adopted if the Commission finds that the alternative regulation meets the changing circumstances under which companies operate and is better suited than traditional rate of return regulation as a means to achieve the policy goals of 80.36.300 and the AFOR statute. These new circumstances include changes in technology and the structure of the telecommunications industry.

Q: What are the public policy goals that the Commission shall consider in determining whether to adopt any proposed alternative form of regulation?

A: The state telecommunications public policy goals set out in RCW 80.36.300 are preservation of affordable universal telecommunications service, efficiency and availability of service, ensuring that customers pay only reasonable charges, avoiding subsidy of competitive ventures by regulated services, promoting diversity of supply, and permitting flexible regulation of competitive services. The specific goals of the AFOR statute require that a plan:

(a) Facilitate the broad deployment of technological improvements and advanced telecommunications to underserved areas or underserved customer classes;
(b) Improve the efficiency of the regulatory process;
(c) Preserve or enhance the development of effective competition and protect against the exercise of market power during its development;
(d) Preserve or enhance service quality and protect against the degradation of the quality or availability of efficient telecommunications services;
(e) Provide for rates and charges that are fair, just and reasonable, sufficient and not unduly discriminatory or preferential; and
(f) Not unduly or unreasonably prejudice or disadvantage any particular customer class.[1]

Q: Does the Qwest proposed AFOR meet the AFOR goals?

A: No. First, the Qwest proposal does not include a plan to deploy enhanced services to underserved areas or to provide these services to underserved customers classes. It does not even have an incentive mechanism that would induce Qwest to provide better service to underserved areas or to underserved customers. Second, the Qwest plan seeks to eliminate regulation rather than improve its efficiency. Third, the Qwest plan would thwart competition. Fourth, there are no assurances in the Qwest plan that service quality would be maintained or improved. Fifth, the plan does not ensure that rates will be fair, just, and reasonable. Moreover, by only increasing the rates for basic service customers the Qwest plan is unduly discriminatory and is unreasonably prejudiced against the basic residential customer class.

Q: Is it possible to identify underserved areas?

[1] RCW 80.36.135.

A: Yes. It is possible to divide the Qwest service territory into wire centers where DSL service is available to 75 percent or more of the customers and wire centers where DSL service is available to less than 75 percent of the customers. In wire centers where DSL is available to more than 75 percent of the customers, **[Begin Confidential]** ** ** *********************************[2] **[End Confidential]** In the Qwest wire centers where DSL available to less than 75 percent of the customers, **[Begin Confidential]** ** *** ******************************.[3] **[End Confidential]**

Q: What type of commitment would Qwest have to make to achieve a minimum of 75 percent DSL availability in every wire center?

A: Qwest would have to commit to enhancing the number of lines that are DSL capable by **[Begin Confidential]** *******************************.**[End Confidential]**

Q: Should the Commission obtain a commitment from Qwest to ensure that a minimum of 75 percent of its lines in every wire center are capable of providing DSL service?

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[2] Qwest's Response to PC Data Request No. 48.
[3] *Id.*

A: Yes. If the Commission approves an AFOR, that AFOR should ensure that currently underserved areas are provided adequate service. The goal of 75 percent DSL availability is a conservative goal.

Q: Is it possible to determine whether there is an underserved customer class?

A: While I have not been able to determine the percentage of low-income families that do not have DSL service in Washington itself, on a national basis, use of the Internet increases with income. For example, a National Telecommunications and Information Administration study reported that broadband Internet use in the home for individuals in families with an annual income of less than $25,000 was less than 9.3 percent, while broadband Internet use in the home for individuals in families with an annual income greater than $75,000 is more than 45 percent.[4]

Q: Is there a way to reach the underserved low-income customer class?

A: Yes. Qwest could commit to offering a broadband lifeline service. This service is especially important to school children and their families because teachers are placing assignments, educational materials and information for parents on-line.

Q: How can an AFOR support a more efficient regulatory environment?

A: An efficient regulatory environment is one where the Commission has the needed information to evaluate the performance of the regulated carrier without placing undo burden of reporting on that carrier. The fact that the Commission requires Qwest to provide it more information than it requires from CLECs does not, by

[4] NTIA, A Nation on Line: Entering the Broadband Age, September 2004, Appendix Table 1: Internet Use from any location by Individuals Age 3 and Older, September 2001, and October 2003 and living in a Home with Internet Broadband Age 3 and Older, October 2003.

itself, support a claim that the current regulatory environment is inefficient. While Qwest is no longer a monopoly carrier, it is still the dominant carrier in its service territory. A dominant carrier still has the ability to influence price and affect an overwhelming majority of the consumers in its market. Moreover, if the Commission adopts an AFOR with a specific endpoint, it would need to collect sufficient information that would allow it to evaluate the AFOR before deciding to either return to rate of return regulation or to inaugurate the next AFOR.

Q: If the Commission adopts an AFOR, should the AFOR have a specific endpoint?

A: Yes. If the Commission adopts an AFOR, the AFOR should end in four years. Nine months prior to the end of the AFOR, the Commission should open an investigation to determine whether the AFOR has been successful or whether the Commission should return to rate of return regulation or whether the Commission should establish another AFOR with different requirements for Qwest. No matter which alternative the Commission decides to follow, it is necessary to continue to require Qwest to maintain and file all of its current reports so that the Commission would have the information required to make its future decision.

Q: Does Qwest's proposed AFOR preserve or enhance competition?

A: No. The Qwest proposal allows it to increase the rate for basic residential service. Qwest dominates this market. It could only sustain such an increase if it has monopoly power in that market, and it is only rational to ask for the authority to increase the basic residential service rate if it plans to exercise its market power. Increasing the residential basic service rate would provide Qwest with additional revenue that it could use to reduce prices in more competitive markets. That unfair price reduction would harm competition rather than enhance it.

Q: Does the Qwest proposed AFOR preserve or enhance service quality and protect against the degradation of the quality of telecommunications services?

A: The issue of service quality is addressed by Public Counsel witness Ms. Mary Kimball.

Q: Does the Qwest proposed AFOR support fair rates, and rates that do not unduly or unreasonably prejudice or disadvantage any particular customer class?

A: No. The Qwest proposal is unfair and prejudiced against customers who purchase basic local service independent of the Qwest packages because Qwest is proposing to increase the stand-alone rate, while maintaining or even increasing the discounts associated with its packages.

Q: Please describe some of the discounts that Qwest offers to customers that purchase packages?

A: As evidence that customers are not prejudiced by current regulation, I will describe three of Qwest packages, as known as bundles. First, there is Home Entertainment. This package includes high-speed Internet service, Direct TV, unlimited local and long distance calls to anywhere in the U.S. and Canada, and the choice of any three calling features. The undiscounted cost of this service is

$139.97. Qwest is offering this service for $96.97, or at a discount of $43 per month. Second, Qwest offers a total convenience package. This package includes high-speed Internet service, Direct TV, a 500-minute wireless plan, unlimited local and long distance service to anywhere in the U.S. and Canada, and the choice of any three calling features. The undiscounted cost of this service is $179.96. Qwest is offering this service for $119.96, or at a discount of $60 per month. Third package is Home and Wireless Phone Service. This package includes a 500-minute wireless plan, unlimited local and long distance service to anywhere in the U.S. and Canada, and the choice of any three calling features. The undiscounted cost of this service is $89.98. Qwest is offering this service for $79.98, or at a discount of $10 per month.

Q: If the Commission were to adopt an AFOR, what type of rate plan would you recommend it adopt?

A: I would recommend that the Commission maintain the current residential rate of $12.50 for the duration of the AFOR. This rate freeze would protect stand-alone residential service customers from Qwest's ability to exercise it monopoly power. At the same time I would allow Qwest to continue to determine whether and how much to discount its service packages. The package service pricing would allow Qwest to effectively address its potential competitors, and the freeze of the stand-alone rate would prevent Qwest from extracting funds from a class of customers that have limited choices. Qwest should also be precluded from charging more for a bundle than sum of the stand-alone component prices.

Q: If the Commission chooses to adopt an AFOR what components should it include?

A: If the Commission adopts an AFOR that AFOR should include the following:

- The rate for stand-alone residential local service should remain at $12.50 for the term of the AFOR.
- Rates for any installation or connection rates associated with stand-alone residential local service should not be increased.
- Residential local service and other component services within Qwest bundles or packages should remain available as an independent service ("a la carte") which can be purchased without purchasing other Qwest services.
- Prices for Qwest bundles should not exceed the sum of the prices for the stand-alone components of the bundle.
- Increases in rates for residential exchange service features purchased independently of Qwest packages should be capped at a reasonable level to preclude pressure to purchase bundles. A reasonable annual cap would be no more than the change in the Consumer Price Index less 2 percent.
- Residential local service should include one free-call allowance to directory service.
- The AFOR should last no more than four years and should then expire unless extended or modified by Commission order. If it wishes to extend or modify the AFOR, nine months prior to end of the AFOR, Qwest should file with the Commission any plan that it wishes the Commission to adopt for the future.

- The Commission should retain authority to require reporting and Qwest should continue to file reports associated with Qwest's financial and public safety activities. Qwest should be required to maintain clear, accurate, and accessible price information on its website for competitive services.
- Qwest should ensure that, at minimum, 75 percent of its lines in each and every wire center are broadband capable.
- Qwest should commit to offer a broadband lifeline service. As an example, the Company could offer broadband service at $10 per month to families eligible for free or reduced price school meals.
- An AFOR should include a service quality incentive plan and continuation of the customer service guarantee program as proposed by Public Counsel witness Mary Kimball
- Revenue associated with Qwest's packages that include interstate or non-regulated services should be allocated such that the discount associated with the package is allocated to the interstate jurisdiction or the non-regulated sector. Qwest should file a quarterly report that verifies that it is following such an allocation principle in its books of account.

This is not an exclusive list. Because discovery and discussions between parties are on-going, Public Counsel may develop and propose additional recommendations for an AFOR framework.

Q: Why should the Commission adopt these AFOR components?

A: The Commission should adopt my recommendations because they meet the policy goals enumerated in RCW 80.36.135, while the Qwest AFOR proposal fails to meet those policy goals.

IV. THE TESTIMONY OF MR. MARK S. REYNOLDS

Q: Please summarize the testimony of Mr. Mark S. Reynolds.

A: Mr. Reynolds' testimony specifies that Qwest wishes to be regulated as if it were a competitive carrier. Mr. Reynolds asserts that such a reclassification is necessary because Qwest needs the flexibility to respond to the effective competition it faces in both residential and business markets. He notes that Qwest's competitors are not subject to the same regulatory standards that Qwest is held to, and that Qwest is constrained in its ability to respond to competitors because of the current regulatory environment in which it operates. He catalogs the regulatory relief that Qwest wishes to obtain. Mr. Reynolds describes the Qwest proposal as having a transition period of four years. During the transition period, he states that a limited number of Qwest services will remain rate regulated and Qwest will continue to provide the Commission with selected reports. All other services will be considered competitive. Finally, Mr. Reynolds discusses how Qwest's AFOR proposal meets the required AFOR policy goals.

Q: Does Qwest face effective competition in all of its markets?

A: No. Qwest does not face effective competition in the residential primary-line market. My analysis shows that Qwest is the dominant carrier in that market and that it can exert monopoly power to increase the price and sustain the price increase.

Q: What is the basis for your claim that Qwest does not face effective competition?

A: As explained in detail below, Qwest does not currently face effective competition from cable providers, wireless firms and other CLECs. I estimate that Qwest serves 75 percent of the non-lifeline residential market, calculated as the ratio of Qwest non-lifeline primary lines and the estimated number of households in the Qwest service territory less the lifeline households. Cable providers only serve 4 percent of that market. The major cable provider, Comcast, charges $39.95 or $54.95 for telephone service depending on whether the customer purchases other Comcast services.[5] Prices of $39.95 and $54.95 cannot discipline a carrier such as Qwest that wishes to increase the rate for stand-alone residential service from $18.34 (the local service rate plus the SLC) to $20.34. Most of the wireless service is used as a complement to Qwest's wire line service.[6] It is now estimated that there are 4,177,196 wireless subscribers in Washington. Only a very small number of those subscribers have actually cut-the-cord and rely only on wireless service for their basic communications. In the Qwest service territory, I estimated that the number of households that have cut-the-cord is 123,187 or 8

[5] Comcast also advertises a triple-play (voice, data and video) service with a rate for telephone service of $33. However, that rate is misleading because, first, each service is advertised at $33, yet the total cost of the package is $102 (3 times $34), and because, second, that rate is only for the first year of service. In the second year of service, the rate increases to $133.15.
[6] Parents can now bother their children on the playground day and night, and travelers can avoid excessive hotel long distance charges.

percent of the Qwest service territory non-Lifeline households. Again this market penetration does not limit Qwest's ability to increase the basic local rate. In addition, other CLECs, such as AT&T and MCI, have stopped expanding or have started contracting their services in the residential market and thus, will have a smaller impact on Qwest in the future than they do today.

Q: Should dominant carriers be subject to different levels of regulatory requirements than non-dominant carriers?

A: Yes. Dominant carrier can influence the market, affect the well-being of consumers and affect the level of competition offered by alternative carriers. Non-dominant carriers are subject to market discipline that constrains their ability to control the market for their services. These differences are embedded in law and regulation. For example, dominant non-rural carriers have an obligation to provide unbundled network elements in instances where those elements are necessary to provide service by competitors or when the failure to provide the element would impair the ability of the competitor to provide telecommunications services. On the other hand non-dominant carriers, as Mr. Reynolds noted, such as carriers with less than 2 percent of the access lines, are not required to file monthly service quality reports in Washington. Thus, to the extent Qwest still dominates markets in the state of Washington, it is reasonable to establish a different regulatory environment for Qwest than is used to regulate Qwest's competitors.

Q: Should Qwest be allowed to terminate any of its current reporting and record keeping with regard to its earnings?

A: No. The Commission must continue to require Qwest to report its earnings on a regular and uniform basis because those filings allow the Commission to determine if Qwest is either over-earning or if Qwest earnings have sunk so that the current rates could be considered confiscatory. The Commission needs these reports because over-earnings are a clear indication that Qwest is not subject to competition in many of its markets. On the other hand achieving significant under-earnings would indicate that the Commission may have to change the regulatory environment in short order.

Q: If the Commission did not have to worry about a potential confiscation claim would your rate recommendation be different in this proceeding?

A: Yes. If the Commission were not concerned with a potential confiscation claim, then I would recommend that the stand-alone rate for residential service be reduced to the incremental cost of that service. My recommendation is based on the principle that "the single most widely accepted rule for governance of the regulated industries is regulate them in such a way as to produce the same results as would be produced by effective competition, if it were feasible."[7] Effective competition drives price to incremental cost. Therefore, my recommendation would be that the Commission, in a market where there is no effective competition such as the residential primary-line, should establish the price for

[7] Alfred E. Kahn, The Economics of Regulation: Principles and Institutions, Volume 1, Economic Principles , John Wiley and Sons, Inc. 1970, p.17.

stand-alone residential service at the incremental cost of that service. My initial estimate of the incremental cost of residential service, discussed below, shows that the cost is $7.98. Thus, I would recommend a decrease in the stand-alone rate of $4.52. I refrained from that recommendation because of my concern for the stability of the company and its ability to earn a reasonable return. If the Commission were to agree with Qwest that rate of return regulation is "a vestige of a bygone era," then the Commission should not be concerned with the level of Qwest earnings and should adopt rates that are equal to the incremental cost of service.[8] However, I am recommending the stand-alone residential rate freeze not only to protect consumers from Qwest's ability to exert its monopoly power but also to stabilize Qwest's earnings.

Q: Are there other regulations that the Commission should maintain in order to be able to ensure that Qwest does not unfairly adjust its earnings statements?

A: Yes. The Commission must retain its power to supervise Qwest's affiliate transactions, property leases, and securities transactions in order to ensure that Qwest does not inappropriately affect the results of its state jurisdictional operations.[9]

Q: Are there other regulations that the Commission should retain?

A: Yes. In order to protect the public safety, the Commission should retain its authority associated with the investigations of accidents. The Commission also

[8] Reynolds testimony, p. 5, l. 11.
[9] RCW 80.04.520; RCW 80.08; and RCW80.16.

should retain its authority associated with ensuring that mergers and property transfers must be in the public interest.[10]

Q: Do the changes in technology automatically require a change in the regulatory environment?

A: No. Changes in technology may produce conditions that require a change in the regulatory environment, but it is not automatic. Change may be needed if new technologies resulted in effective competition. New technologies such as wireless have brought a major and substantial increase in our communications capabilities but not effective competition for residential wire line telecommunications. Changes in regulation have allowed competitors to enter markets, many times with the same technologies that Qwest uses or technologies that are available to Qwest. The changes in regulation that allow entry include the use of the unbundled element loop (UNE-L) to serve business customers or the right to overbuild the facilities of the incumbent with alternative facilities.

Q: Has cable VoIP telephony provided conditions that require a change in the regulation of the residential stand-alone service rate?

A: No. Mr. Reynolds asserts that VoIP technology is part of the reason that regulation must change. He states that "providing VoIP telephony service on cable is a relatively small incremental cost compared with the cost to provide traditional circuit switched telephone service." This assertion implies that Qwest should be regulated according to its AFOR proposal because Qwest now

[10] RCW 80.04.460 and RCW 80.12.

faces a low cost competitor. Mr. Reynolds' comparison suffers on both a factual and logical level. First, in order to provide telephone service, cable providers not only had to purchase packet switches but they also had to substantially upgrade their outside plant facilities. These outside plant upgrades required an investment of almost $100 billion.[11] Second, if packet switching and Internet Protocol is substantially cheaper than circuit switching, there is nothing that prevents Qwest from adopting the new technology and achieving the same low incremental cost. Third, Mr. Reynolds appears to be comparing the incremental cost of VoIP to the total cost of circuit switching. This is an improper comparison. Given that the circuit switches are already purchased, most of their costs are sunk and thus, the incremental cost of using the circuit switch can also be very low.

Q: Please describe the rate relief that Mr. Reynolds is requesting.

A: Mr. Reynolds is requesting competitive treatment of all services with the exception of an itemized list that includes stand-alone residential exchange services, rates associated with low-income programs, emergency service rates, and wholesale rates such access, interconnection, resale and unbundled network elements. Mr. Reynolds asserts that Qwest needs this pricing freedom to compete in the current telecom market. In addition, the Qwest proposal includes the authority to increase the stand-alone residential exchange rate to $14.50, with the

[11] In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 05-255, Twelfth Annual Report, FCC 06-11, released March 3, 2006, (FCC Cable Report) ¶ 48.

rate increase for the service limited to 50 cents per-year for the four-year period of the AFOR.

Q: Please comment on the request to increase the stand-alone residential rate.

A: The request to increase the stand-alone residential rate conflicts with the claim that the residential market is competitive. If that market were competitive, the rate increase would be self-destructive. Customers would leave Qwest and the rate increase would cause a revenue decrease. Thus, requesting the authority to increase the rate is an admission that the market is not competitive. In addition, in order to keep the total cost of purchasing stand-alone residential service at a reasonable level, services that must be purchased to obtain residential service, such as a connection charge, should be frozen along with the freeze on the stand-alone rate itself. Other services that are used in conjunction with local service, such as Residential exchange service features, should be limited to reasonable annual price increases. This is intended to avoid excessive pricing of a feature as a means of forcing customers on to bundles. An appropriate limitation would be increases of no greater than the change in the Consumer Price Index less 2 percent.

Q: Please comment on the rate proposal for other residential services such as Qwest residential packages.

A: Because there appears to be more competition for Qwest's triple play offerings and more competition in the long distance markets, I recommend that Qwest be allowed to price its bundles as it chooses. However, Qwest should be required to place rate information for these services on its website in clear and accessible fashion so that consumers have an adequate information source for prices and so that the Commission can monitor the market. Moreover, whenever a package contains a mixture of state jurisdictional services and either interstate services or non-regulated services, the state jurisdiction should be credited with the revenue associated with the retail rate for the service and the discount associated with the package should be assigned to either the interstate jurisdiction or the non-regulated services. This requirement will ensure that the Commission fulfills its obligation under the Telecommunication Act that "… the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[12] Qwest should be required to file a quarterly report that demonstrates that it is assigning the revenue according to my recommendation.

Q: Please comment on the rate proposal for business services?

A: Because I have not performed an economic analysis of the business markets, I do not have a recommendation regarding the proposed business rates at this time.

Q: Should the AFOR include a transition period?

A: No. The AFOR should have a defined period with an explicit set of conditions. The defined period should be four years. At the end of the four years the Commission would have the option to revert to rate of return regulation, extend

[12] Communications Act of 1934 as amended by the Telecommunications Act of 1996, §254(k).

the conditions of the current AFOR or adopt new conditions. The decision regarding which option to choose should be made by the Commission that exists four years from now without any pre-conditions established by the current AFOR. There can be significant changes in four years. Four years ago, an independent AT&T and an independent MCI using UNE-P to enter the market were probably the major competitive threats that Qwest faced. UNE-P is no longer available and AT&T and MCI are no longer independent entities.

Q: Do you agree with Mr. Reynolds' assertions that the Qwest AFOR proposal satisfies the RCW 80.36.135 public policy goals?

A: No. The Qwest proposal does not preserve affordable telecommunications because it allows for increases in the rate for residential service. The basic premise behind the Qwest proposal is that an increase in the non-competitive stand-alone residential rates would provide Qwest with sufficient funds to maintain its state-wide average rates and to alter residential package rates and its business rates whenever it is necessary to meet potential competitors. This type of pricing is inefficient because it requires the definitely non-competitive market to support rate flexibility in the alleged competitive markets. While there may be private cost reductions associated with the proposed streamlined reporting requirements, the proposed changes are publicly inefficient and costly because they would reduce the ability of the Commission to review and understand the dominant firm's ability to adjust its state earnings reports, and to ensure that Qwest maintains or enhances its quality of service.

Q: Can the Qwest AFOR ensure that customers pay only reasonable charges for telecommunications services?

A: No. The proposed AFOR cannot ensure that customers pay only reasonable charges because the carve-out for stand-alone residential service increases the rate for stand-alone service above a reasonable rate. The increase is designed to ensure that rates for non-competitive services subsidize Qwest's competitive ventures.

Q: Does the Qwest proposal facilitate broad deployment of technological improvements to underserved areas or underserved customers classes?

A: Nothing in the AFOR shows any commitment from Qwest to deploy technological improvements to underserved areas or to attempt to serve any underserved customer classes. There are no programs or commitments. There are no incentive plans that would entice Qwest to provide better service in underserved areas or to ensure that underserved customer classes are provided the capability to use the technological improvements.

Q: Do you agree with Mr. Reynolds that the Qwest proposal begins a transition that further develops effective competition?

A: No. The Qwest plan allows Qwest to use its monopoly power to undermine competition. This occurs because rates in the non-competitive residential market increase, allowing Qwest to support its strategies in its other markets. Such a strategy ensures that rates are not fair, just and reasonable and also ensures that rate changes are unreasonably prejudiced against the stand-alone residential class.

V. THE TESTIMONY OF MR. DAVID L. TEITZEL

Q: Please summarize the testimony of Mr. David L. Teitzel

A: Mr. Teitzel reviews the recent changes in the telephone markets. He highlights the entry and expansion of non-incumbent local exchange carriers. The initial catalyst for this entry is the Telecommunications Act of 1996, the FCC rules associated with local competition and state commission decisions regarding UNE rates and interconnection agreements. He also asserts that the type of competition is changing. Facilities based and intermodal competitors are becoming the leading competitors of incumbent local exchange carriers (ILECs) such as Qwest. He notes that the impact of competition has been a substantial loss in Qwest switched access lines since 2000.

However, he does not provide a complete and organized discussion of the market. Instead, he provides a scatter gun approach with a fact pulled from here and placed there. He reports a huge increase in the number of wireless subscribers as a sign of competition, but later admits that wireless service is not always a substitute for wire line service. He accepts the prophecies of cable providers as axioms of truth and does not investigate the reality underneath those prophecies. He alleges that the AT&T and Verizon mergers would adversely affect Qwest without recognizing that these carriers have begun to pull back from their out-of-territory residential customers. He echoes the analysts' remarks regarding independent VoIP without revealing that to reach an independent VoIP provider it is necessary to purchase an expensive stand-alone DSL service from Qwest or to purchase cable modem service from a cable provider. Most importantly there is nothing in Mr. Teitzel's testimony that supports Qwest's request to increase the residential basic service rate. If competition is as fierce as Mr. Teitzel claims, then increasing the residential basic service rate would be self-defeating because customers would flee Qwest in droves. In addition, Mr. Teitzel fails to discuss the fact that Qwest only needs pricing freedom to match cable bundles, and thus the additional pricing freedom to increase the stand-alone residential rate is unnecessary to meet the intermodal competition.

Q: Has competition had an effect on Qwest's ability to sell its products?

A: Yes. There has been a change in the competitive environment in which Qwest operates. However, that change is different from the one discussed by Mr. Teitzel. It is a change that needs to be evaluated in a more precise manner before deciding on how to allow Qwest to respond to the competition.

Q: How would you describe the impacts of competition on Qwest?

A: I would enhance Mr. Teitzel's description by acknowledging that the decline in Qwest's switched access line sales has been offset by an increase in the sales of other products and was not entirely caused by competition. I would note that the increase in sales of alternative products is an increase in the total level of communications activity rather than a decrease in ILEC activity. I would evaluate the residential market in terms of its sub-parts rather than confuse the issue of competition by insisting that the residential market is just one market, and I would investigate each alternative provider type to understand how those alternatives compete with Qwest. By completing the history and analysis, I will fill in what Mr. Teitzel has left out and I will show that the residential primary-line stand-alone market is a separate market where competition is not effective and that Qwest still has monopoly power in that market. By using its monopoly power, Qwest can successfully increase the price in that market and sustain that price increase.

Q: How has Qwest's decline in switched access line sales been offset by the sale of other Qwest products?

A: Qwest has made progress in selling its Digital Subscriber Line (DSL) services and special access services. From December 2000 to December 2005, the number of DSL lines increased **[Begin Confidential] **********************************[13] [End Confidential].** During that period, the number of special access voice grade equivalent lines increased by 261,176. The increase in special access lines is greater than the decline of 259,483 business switched access lines that occurred between December 2000 and December 2005. [14]

Q: Why have you asserted that the general level of communications services has increased in Washington?

A: An examination of Mr. Teitzel's table, Washington In-Service Quantities 12/00 vs 12/05, clearly shows that the general level of communications services has increased in Washington. First, even if the number of ILEC lines had stayed constant over the period, the ILEC percentage would have declined from 58 percent to 39 percent rather than the decline to 34 percent as reported by Mr. Teitzel. Second, consumers are obviously using their wireless phones as a

[13] Qwest's Response to Public Counsel Data Requests Nos. 5 and 6.
[14] FCC ARMIS 43-08 Reports, Table III Access Lines in Service By Customer.

complement to their wire line phones. If a substantial majority of consumers viewed wireless and wire line phones as substitutes, the number of wire line phones would have sunk to a very low number. Third, the growth in high speed lines marks a substantial increase in service quality and efficient use of resources as compared to using dial-up Internet over traditional wire line services. Qwest has shared in the growth in broadband lines. In addition, the growth in CLEC lines is a combination of two trends that hides the stagnation of non-cable CLEC providers.

Q: What evidence supports your assertion that non-cable CLECs have stopped growing?

A: There are two sets of data that support the claim that non-cable CLECs have stopped growing. First, Qwest's wholesale sales, the combination of UNE-P, UNE-L, QPP, and resold lines, peaked in December 2004 at **[Begin Confidential] **.**[15] **[End Confidential]** Second, the total number of non-cable CLEC lines in Washington is estimated to have peaked in December 2004 at 444,987 lines and to have declined to 431,778 lines by December 2005.[16]

Q: Has Mr. Teitzel presented any misleading information?

A: Yes. First, the table on page 8 of his testimony notes that Comcast offers a $12.25 stand-alone residential rate. While that rate is correct, it is a grandfathered

[15] Qwest's Response to Public Counsel Data Request No. 4.
[16] The estimate of total non-cable CLEC lines is estimated by multiplying 1 minus the percent cable lines, estimated on a national level by the number of Washington CLEC lines. FCC Local Competition Report Tables 5 and 9.

rate. The rate is only available to existing customers effective August 17, 2001. No customers since August 2001 have been able to purchase service at that rate.[17] Second, he compares the number of lines provided by facilities-based CLECs, estimated at **[Begin Confidential] ************************************ ************[18] [End Confidential]** to 514,149 CLEC lines and concludes that facilities-based CLECs control over half of the CLEC lines in Washington. There are two problems with this comparison. First, the data for facilities-based CLECs is for June 2006 and the total CLEC count is an estimate as of December 2005. Second, only 28 percent of the CLEC lines in Washington, or 143,962 lines, are residential lines.[19] Comparing the 143,962 total residential lines to the number of facilities-based CLEC residential lines that Mr. Teitzel estimated requires that the non-facilities based CLECs sell a negative number of residential lines, clearly an impossible task. Moreover, Mr. Teitzel's estimate of residential lines is an estimate of the facilities-based CLEC residential lines in the Qwest service territory. The 143,962 estimate is for the entire state of Washington. Therefore, to accept Mr. Teitzel's estimate, it is necessary to assume that facilities-based and non-facilities based CLECs operating outside of the Qwest territory are serving negative residential lines.

Q: How are facilities-based CLECs such as cable providers offering service in the Qwest service territory?

[17] Comcast Tariff, Section 5, Original Page 2.1.
[18] Tzeitzel Testimony, p. 10.
[19] FCC Local Competition Report, Tables 9 and 12.

A: Cable providers such as Comcast offer telephone service as an add-on to its existing services. As Mr. Teitzel explains, "residential customers [are] served via the Comcast network at a standard price of $39.95 for customers already subscribing to Comcast cable television and high speed Internet service. For customers with either Comcast cable television service or high speed Internet service, Comcast prices its digital voice service at $44.95 per month. If the customer wishes to subscribe only [emphasis in the original] to Comcast digital voice service, Comcast's monthly rate for the service is $54.95."[20] In addition, Comcast offers a triple-play package (voice, data and video) of $102 in the first year of service and $133.15 in the second year of service.

Q: What are the implications of the Comcast prices for Qwest?

A: First, the Comcast price of $54.95 for stand-alone service cannot provide any pricing discipline for the Qwest stand-alone residential rate of $18.34 (the local rate plus the SLC). Even if Qwest increases its local rate to $14.50, the difference between the Comcast rate and the Qwest rate is still $34.61 (the difference between $54.95 and $20.34).

Q: Doesn't the Comcast stand-alone residential service provide more than local residential service?

A: Yes. The Comcast service includes unlimited long distance calling service and a number of calling features. However, Qwest also offers similar packages under its Digital Voice service offerings. The Qwest price for packages similar to the

[20] Teitzel Testimony, p. 25.

Comcast offer is either $50.83 or $55.83 (including the SLC charge).[21] Thus, customers that want only a local and long distance package have the alternative of a cheaper offer from Qwest than from Comcast. The customers who want the stand-alone local service offer can only obtain that service from Qwest.

Q: What percentage of Qwest's residential customers choose the stand-alone local service?

A: At this time I do not know how many customers choose the stand-alone service. However, I do know that approximately **[Begin Confidential] ********** [End Confidential]** of Qwest's customers choose one of Qwest's packages.[22] These packages include not only the combination of local and long distance service but also combinations of call features that can be added on to the stand-alone residential local service. Therefore, the minimum percentage of Qwest residential customers who purchase stand-alone local service is **[Begin Confidential] ** ******* [End Confidential].**

Q: How would you interpret Mr. Teitzel's assertion that Comcast will take a significant number of customers away from Qwest?

A: Mr. Teitzel suggests that Comcast may attract approximately 400,000 Qwest lines in the near future.[23] First, while this is a large number, it is still only 26 percent of the non-lifeline households in the Qwest service territory. Second, the Comcast number is a statewide number and not all of the Comcast gains would be in the

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[21] http://www.qwest.com/residential/products/digitalvoice/index.html, Qwest lists prices of $44.99 and $49.99 without the SLC.
[22] Qwest Response to Public Counsel Data Request No. 23. Public Counsel is awaiting additional discovery responses on this point.
[23] *Id.*, p. 24.

Qwest service territory. Third, the Comcast gains could be losses for other CLECs and not necessarily entirely Qwest losses. Fourth, there is no time period associated with the Comcast claim. Another study of cable entry into the telephone market provided an estimate that cable could achieve a 35 percent share of market, but that it would take until 2015 for that percentage of the customer base to be achieved.[24] Fifth, it is important to note that the cable industry also is not performing as well as it had in previous years. For example, cable subscribers as a percentage of households passed has decreased from 67.5 percent in 1999 to 59.6 percent in June 2005.[25] If that trend also is occurring in Washington and continues into the future, then the future number of Comcast telephone customers has probably been over-estimated.

Q: How would you summarize the impact of the entry of Comcast and other cable providers on Qwest?

A: Comcast and the other cable providers will probably have a significant impact on the Qwest residential market. However, this impact will be on customers who want to purchase packages of services that include video, data and telephone. The cable competition will have only a minimal impact on whether Qwest can sustain an increase for its stand-alone service and obtain a significant revenue increase from that sustained rate increase. Therefore, the existence of cable competition

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[24] Michael D. Pelcovits and Daniel E. Haar, Consumer Benefits from Cable-Telco Competition, Micra, The report was commissioned by the National Cable and Telecommunications Association.

[25] In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 05-255, Twelfth Annual Report, FCC 06-11, released March 3, 2006, Table 1: Cable Television Industry Growth: 1999 – June 2005 (in Millions).

would not be strong enough to discipline Qwest's ability to exert its monopoly power.

Q: Can Qwest counter the cable competition without having the right to increase its stand-alone residential basic service rate?

A: Yes. Qwest currently resells DirectTV service as part of its triple play offering Home Entertainment and Total Convenience. The Home Entertainment package includes voice, video and data, while the Total Convenience package includes voice, video, data and wireless. Its Home Entertainment package is priced at \$96.97 plus the SLC of \$5.84 equals \$102.81. In the second year of service, if the DirectTV discount is reduced, the price increases to \$107.81. The Comcast equivalent first and second year prices are \$102 and \$133.15. Thus over the two year period, Qwest's prices are lower than Comcast's prices. Qwest could also build out a fiber network and self-supply television services rather than resell DirectTV. AT&T and Verizon are implementing a self-supply strategy along with a resale program. However, to date, Qwest has decided not to build a fiber network and self-supply television services.[26]

Q. Besides price, what other advantage does Qwest telecommunications service have over the service of intermodal competitors?

A: Qwest has a significant technological advantage in terms of reliability. Qwest basic wireline telephone service continues to operate when electrical service is not working, for example, due to storm-related power outages. As a general

[26] Qwest Response to Public Counsel Data Requests Nos. 37 and 70.

proposition, however, cable telephony, cable modem based internet access and VoIP are not operable without electrical current. Wireless phones require electrical current to be re-charged. In addition, wireless phones also rely on a functioning public switched network for their operations. During the December storm events in the Puget Sound region, hundreds of thousands of customers region-wide experienced extended power outages. Comcast also experienced significant outages, with between 500,000 and 600,000 Comcast customers losing service during the storm, according to press reports.[27] In some cases, these outages continued even after power was restored.[28] On the other hand, Qwest outages were limited. Qwest reported to Seattle area media that it had approximately 3000 customers reporting loss of service.[29] This experience reflects a major advantage in terms of reliability of wireline telephony. Continued availability of telephone service takes on great significance in major storm events like that of December 14-15. Customers have a critical need for communication with utility companies, fire and medical providers, friends and neighbors, local government, and vendors such as electricians, roofers, and tree workers. In this respect, internet and cable telephony are not currently comparable services. Not only is this difference of competitive significance, but it highlights the central public service role that the wireline communications network plays in Washington state's ability to deal with major emergencies. Any AFOR plan adopted should

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[27] Seattle Times, December 27, 2006, *Comcast's response to storm draws criticism.*
[28] *Id.*
[29] Qwest Response to Public Counsel Data Request No. 71. After an initial objection, Qwest agreed to respond to Public Counsel's request for storm outage information and provided an initial response on Friday evening, January 26. Qwest indicates that it is conducting further research on the request.

ensure that service quality, reliability, and adequate investment in this network continue to be maintained.

Q: Do you agree with Mr. Teitzel that the recent mergers of AT&T/SBC and Verizon/MCI will have a detrimental effect on Qwest's position in the primary-line residential line market?

A: While the mergers may affect the market for large business customers, they should not have a detrimental effect on Qwest's position in the residential primary-line market because the carriers no longer wish to serve mass-market customers. Mass-markets customers include residential and small business customers.

Q: What evidence do you have that AT&T and MCI have reduced their presence in the mass market portion of the market?

A: MCI and the old AT&T (the AT&T prior to being acquired by SBC) announced that they were pulling out of the mass-market markets. In mid-2004, AT&T decided to cease actively competing for new mass-market customers.[30] It further decided to increase its rates and allow customer churn to erode its customer base.[31] These actions are not short-term activities. Rather, AT&T believes that "those actions are so extensive that AT&T's decision is now irreversible as a practical matter."[32] Similarly, MCI decided to exit the mass-market portion of the

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[30] SBC Communications Inc. and AT&T Corp, public interest statement, WC 05-65, In the Matter of SBC Communications Inc. and AT&T Corp., Applications for Approval of Transfer of Control Attached Declaration of John C. Polumbo, ¶ 2.
[31] Id., ¶ 9.
[32] *Id.*, ¶ 2. See also SBC Communications Inc. and AT&T Corp, public interest statement, WC 05-65, In the Matter of SBC Communications Inc. and AT&T Corp., Applications for Approval of Transfer of Control, p. 49.

industry in 2004.[33] MCI has also decided to increase rates for long distance residential customers.[34]

Q: Why did the old AT&T and MCI decide to exit the mass market?

A: AT&T and MCI have provided several reasons for leaving the mass market. They have stated that it is very important to be able to compete in more that just the stand-alone long distance market. For example, AT&T asserted that to remain an active competitor it had to find a viable means "to match other wireline and wireless providers' attractive 'all-distance' offerings."[35] Verizon/MCI stated that "to the extent that customers continue to purchase wireline local and long-distance services, they are increasingly purchased and supplied on an integrated basis, from a single provider."[36] Both carriers asserted that the only way that they could match the "all-distance" or "single-provider" standard was to combine their long distance service with UNE-P based local service.[37] Therefore, once the UNE-P option was eliminated, the carriers left the market.

[33]Verizon Communications Inc. and MCI Inc., public interest statement, WC 05-75, In the Matter of Verizon Communicatiosn Inc. and MCI INC., Applications for Approval of Transfer of Control, p. 4. In the Verizon/MCI merger docket in Washington, MCI asserted that it had decided to "fade from the mass consumer market for local exchange service." *In the Matter of the Joint Application of Verizon Communications Inc. and MCI Inc for Approval of Agreement and Plan of Merger*, UT-050814, Order No. 07, ¶ 72.
[34] *Id.*, Attached Declaration of Wayne Huyard, ¶ 18.
[35] *Id.,* ¶ 6.
[36] Verizon Communications Inc. and MCI Inc., public interest statement, WC 05-75, In the Matter of Verizon Communicatiosn Inc. and MCI INC., Applications for Approval of Transfer of Control, p. 35.
[37] Declaration of Wayne Huyard,, ¶¶ 10-11; AT&T response to Set One of OCA's Interrogatory OCA-1, Attached affidavit of John C. Polumbo, ¶¶ 6-7.

Q: Is there evidence to suggest that AT&T and MCI are withdrawing from the mass-market in Washington?

A: Yes. These companies, as noted immediately above, serve the mass-market by purchasing UNE-Ps or the replacement for the UNE-Ps, the Qwest wholesale service QPP. AT&T purchases of these services has decreased from **[Begin Confidential] ** *******************. [End Confidential]** MCI purchases of these services has decreased from **[Begin Confidential] *********************************** ************************************.[End Confidential]** These declines show that the carriers are withdrawing from the mass-market.[38]

Q: Do you agree with Mr. Teitzel that the VoIP market is a competitive option for an increasingly large customer base?

A: No. While VoIP products appear to provide many new options, the customer base for independent VoIP providers will not be large enough to provide competitor pressure on Qwest's ability to extract monopoly profits from its primary-line residential market.

Q: Why do you assert that independent (non-facilities based) VoIP providers would not be able to become effective competitors in the residential primary-line market?

[38] Qwest's Response to Public Counsel Data Request No.4.

A: The major factor hindering the expansion of VoIP service is the need to purchase either a DSL or cable modem service from Qwest or from a cable provider in order to reach its customers. For example, Mr. Teitzel compares the Vonage $24.99 service to the Qwest stand-alone basic service rate of $18.34 ($12.50 local service rate plus the $5.84 subscriber line charge (SLC) (also known as an end-user common line charge (EUCL)). Mr. Teitzel notes that the Vonage services include unlimited long distance service and a number of vertical features such as Call Waiting.[39] However, Mr. Teitzel does not mention that in order to get Vonage a customer must pay Qwest an additional $36.95 for stand alone DSL service.[40] Thus, the real price comparison is $61.94 for Vonage versus $18.34 for Qwest.

Q: Are Qwest's sales of stand-alone DSL significant?

A: No. Qwest's sales of stand-alone DSL service to residential customers were **[Begin Confidential] **. End Confidential]** [41] These extremely low numbers indicate that sales of independent non-facilities based VoIP providers are very low in the Qwest service territory.

Q: Is it possible for customers of independent VoIP providers to use cable modem service?

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[39] Teitzel Testimony, p. 30.

[40] $36.99 is the lowest price stand-alone DSL service. Faster speeds can be purchased for $46.99. Moreover, this is only the price in the first year. In the second year the prices increase to $49.99 and $59.99. Also because these prices are not regulated there is no guarantee that Qwest would not increase the prices in the future. Qwest Response to Public Counsel Data Request No. 21.

[41] Qwest's Response to Public Counsel Data Request No. 21.

A: Yes. However, the price of cable modem service is more than the price of DSL. For example, Comcast's stand-alone modem service is $57.95, making the total cost of Vonage service $82.44. Comcast video customers pay $42.95 for modem service. Thus, if you are already a Comcast video customer and you want Vonage service, the additional cost is $67.94 to obtain Vonage. Thus, Vonage is very expensive to customers who want to purchase a service that is similar to their stand-alone residential service.

Q: Are your comparisons misleading because you included the entire cost of the high-speed broadband service to the Vonage local service price?

A: No. My comparison is reasonable because it is based on the price that a customer would pay if the customer only desires local service. If the customer wants more than local service, it is necessary to compare the bundles offered by each provider.

Q: Have you made comparisons of the bundles offered by various companies providing service in the Qwest service territory?

A: Yes. My Exhibit No. ___ (RL-3) compares the triple-play bundle rates for Qwest, Comcast and Vonage. A triple-play means that the customer purchases voice, data service and video service. While Vonage does not offer the triple-play, a Vonage customer can add Direct-TV or cable video service to its data and voice service. The results of this comparison show that a Qwest customer would pay $102.81 for service in year one and $107.81 for the second year. The Comcast customer would pay $102 for service in year one and $133.15 in the second year, and the Vonage customer would pay between $101.97 and $129.18 in year one and between $119 and $129.18 in the second year. Thus, year one discounted prices are almost same. In the second year, Qwest's triple rates are less than the rates of the other carriers. Thus, Qwest's current rates are less than its competitors' rates for both the stand-alone service and the bundled service.

Q: If Qwest prices are lower than its competitors, why has Qwest lost so many residential access lines?

A: There are a number of reasons why Qwest has lost residential access lines. First, many of the lines lost were non-primary lines. From 2002 to 2005, non-primary lines declined by 40 percent, the steepest decline of any customer group. These lines were most likely lost to high-speed services and wireless carriers as customers dropped their second lines and choose different types of communications services. Second, long distance CLECs were the innovators in selling flat-rated long distance service. Customers shifted to those products and away from Qwest. That market grew very fast until UNE-P was eliminated in 2004. While that particular market is now stagnant, there are still many customers using those services. Third, customers purchasing packages of services have chosen the cable package. Because the price of the cable package is similar to the Qwest package, customers' decisions regarding which provider to use would probably be influenced by service quality, the difficult of combining and using the service package and their general impressions of the carriers. However, nothing in this analysis supports allowing Qwest to increase its stand-alone residential service price in order to meet the competition in the market place.

VI. COMPETITION IN THE RESIDENTIAL STAND-ALONE SERVICE MARKET

Q: What general analytical framework should the Commission use to measure the level of competition in the Qwest residential telecommunications market?

A: I recommend that the Commission rely on the U.S. Department of Justice and the Federal Trade Commission's Horizontal Merger Guidelines[42] (Merger Guidelines) to evaluate the proposed merger.

Q: What is the purpose of the guidelines?

A: The purpose of the Merger Guidelines is to determine the circumstances in which a merger is likely to substantially reduce competition. The Merger Guidelines do not automatically require action by either the Department of Justice or the Federal Trade Commission. However, when a proposed merger is shown to exceed certain statistical measures, the merging firms should expect strict scrutiny of the merger by the agencies.

Q: Please discuss the statistical measures used by the Merger Guidelines.

A: The Merger Guidelines rely on the Herfindahl-Hirschman Index (HHI). This index is a measure of the concentration within a market. It is calculated as the sum of the square of the market share of each firm in the market. For example, if the market consists of four firms with market shares of 40 percent, 20 percent, 20 percent and 20 percent, the HHI is equal to 2800 ($40^2 + 20^2 + 20^2 + 20^2$). The HHI ranges from 0 to 10,000. As the value approaches 10,000, the existence of a monopoly is indicated. Low values indicate competitive markets. In perfect

[42] http://www.usdoj.gov/atr/public/guidelines/horiz_book/hmg1.html.

competition, where each firm's market share is equal to 1 percent or less, the HHI would be at or below 100. The number of effective firms in a market can be determined by dividing the HHI into 10,000. For example, if there are five firms, each with a 20 percent share of the market, the HHI will be 2,000. Dividing 2,000 into 10,000 produces five effective firms.

Q: How do the Merger Guidelines use the HHI?

A: The Merger Guidelines develop general standards that reference three different levels of post-merger measurement. First, if the post-merger HHI is less than 1000, the Guidelines suggest that the proposed merger is unlikely to have an adverse effect on competition and no further analysis is necessary. Second, when the post-merger HHI is between 1000 and 1800, mergers that will increase the post-merger HHI by less than 100 points relative to the pre-merger level are considered to be unlikely candidates for investigation. On the other hand, if the post-merger HHI increases by more than 100 points, then the merger may potentially raise concerns. Third, if the post-merger HHI is above 1800, then the market is considered highly concentrated. Mergers producing increases of only 50 points may raise anti-competitive concerns. When the post-merger HHI is above 1800, mergers generating a 100 point HHI increase are presumed to create or enhance market power.[43]

Q: How should the Commission apply the merger guidelines to measure competition in the Qwest residential market?

[43] Merger Guidelines, 1.51 General Standards.

A: The Commission should use the merger guidelines to determine whether there is effective competition in a market. In particular, it should use the HHI as an indicator of effective competition. An HHI of approximately 1,800 to 2,000 indicates that a market is effectively competitive. For example, if a market consisted of 5 firms and each firm had 20 percent of the market then the HHI would be 2,000. In a market with five equally-sized firms, the firms usually will discipline a price increases attempted by one firm unless there is a general increase in cost in the industry.

Q: Can you provide an example of an industry where the HHI indicates the existence of effective competition?

A: Yes. The automobile industry in the United States operates under effective competition conditions. General Motors, the leading firm, has only a 23.5 share of the market. The shares of its close competitors, Ford, Toyota and Chrysler, are 17.4, 14.6, and 13.7 respectively.[44] A HHI based on these four firms would be 1,255. If the next three firms had the highest market share possible, then the industry would be approximately 1,637.[45] This HHI value is below the Justice Department's guideline, 1,800, for investigating mergers.[46] The leading firms are in relative parity and can constrain the activities of each other.

[44] "Press to Lead Toyota Motors of North America" by Gary Gentile, The Associated Press, June 2, 2006, www.washingtonpost.com. Since the time of the article, it is my understanding that the Ford share has decreased and the Toyota share has increased.
[45] This value is calculated using the leading firms, plus three additional firms with shares of 13.6, 13.5 and 3.7 percent.
[46] Merger Guidelines, p. 16.

Q: Please summarize your HHI calculation.

A: A detailed discussion of my HHI analysis is contained in Exhibit No. ___ (RL-4) along with additional analysis of the participation of cable, wireless and VoIP providers in Qwest's residential market. My HHI calculation shows that the HHI for the residential primary line market in the Qwest service territory stands at 5,693. As shown in Table 1, this value sums the contribution of Qwest, cable providers, non-Cable CLECs, wireless carriers and VoIP providers. The HHI calculation is dominated by Qwest's 75 percent market share. The rest of the carriers make up a competitive fringe that does not significantly impact the value of the HHI. In Table 1, the reported market shares are the combined market shares for carriers in each category. Because Qwest is one carrier and the cable industry is treated as if it is one carrier, it is possible to square the reported market share value to obtain the reported sum of squared share value. However, because there are many non-cable CLECs, wireless and VoIP providers, the reported combined market share cannot be squared to obtain the reported squared share. Instead, as described above, the lines for each category are allocated to the

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carriers in each category, determining the market share and squared share for each carrier.

Table 1: Residential Primary-Line HHI				
Carrier	Lines	Market Share	Sum of Squared Share	HHI
Qwest	1,158,249	75.22%	0.56579	5,657.92
Cable	54,399	3.53%	0.00125	12.48
non-cable CLEC	44,115	2.86%	0.00009	0.90
wireless	123,187	8.00%	0.00166	16.64
VoIP	46,195	3.00%	0.00049	4.86
not assigned	113,689	7.38%		
Total	1,539,833	100.00%		5,693

Q: Please discuss the "not assigned" category in Table 1.

A: The "not assigned" category includes the number of lines in the residential primary-line market that I could not directly assign to a specific category using the calculations that I have described above. However, because the calculation of the HHI is dominated by Qwest's share of the market, my inability to assign all of the lines in the market has no effect on my conclusions related to the HHI value.

Q: Please explain how the Qwest market share dominates the calculation.

A: Because Qwest has a 75 percent market share, the HHI can only vary between 5,658 and 6,272. This range of values is the limit of the calculation whether if I know nothing about the size distribution of the other carriers in the market or if I know the exact number of lines served by each carrier. My calculation provides a best estimate of where the HHI lies within that range.

Q: Why is 5,658 the minimum HHI value?

A: The HHI calculation cannot produce a number less than the square of Qwest's share. That share is 75.22 percent. The square of Qwest's share is 0.565792 or a HHI of 5,657.92, which I rounded to 5,658. If the rest of the market is made up of tiny firms, each with an extremely small share of the market, the HHI would increase by a very small amount.[47] However, those firms cannot decrease the HHI below the amount determined by Qwest itself.

Q: Why is 6,272 the maximum HHI value?

A: Given the Qwest share, if the market has only two carriers, the other carrier would have a 24.78 market share. The HHI is 6,272 when there are only two carriers, one with a 75.22 share and the other with a 24.78 share.

Q: What conclusions can you draw from your calculations of the HHI for primary-line residential market?

A: An evaluation of the HHI calculations supports the following conclusions. First, the primary-residential market is highly concentrated because the HHI of 5,698 is more than three times higher than 1,800, the threshold for determining a highly concentrated market. Second, the rest of the industry is made of a competitive fringe. There is no single other carrier that has a substantial impact on the HHI calculation. Third, because the result of dividing the HHI of 5,698 into 10,000 is only 1.76, this implies that there are less than 2 effective competitors in the market.

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[47] If the rest of the market is composed of 1000 firms each serving an equal share of the market, then the HHI would increase from 5,657.92 to 5,658.53.

VII. MONOPOLY POWER AND THE QWEST RESIDENTIAL PRIMARY-LINE MARKET

Q: Please define the term "monopoly power".

A: Monopoly power, also known as economic power, is the ability to increase a price above cost and to maintain that price increase.

Q: Does the HHI that you have calculated prove that Qwest can substantially exert monopoly power?

A: The calculation does not prove that Qwest has monopoly power. Rather, it shows a strong likelihood that Qwest can increase the price of basic residential local service.

Q: Is there additional evidence that will show that Qwest can exercise monopoly power?

A: Yes. The Merger Guidelines also seek to address the question of whether the firm can exercise monopoly power. The Merger Guidelines suggest that a firm can exercise monopoly power if the firm can impose a small but significant and non-transitory increase in price (SSNIP). The firm would have an incentive to do so if the increase in price would lead to higher profits.

Q: Is it possible to determine whether a firm can impose a SSNIP that will enhance its profits?

A: Yes. An increase in price will enhance profits if the additional revenue is greater than the additional cost. Therefore the monopolist must understand the relationship between his profit margin and impact of the change in price on the quantity of goods and services sold.

Q: How do you define the relationship between price and quantity change?

A: The economic relationship between the price change and the quantity change is measured by the elasticity of demand, which is defined as the percentage change in quantity divided by the percentage change in price. That is, for a 10 percent change, the elasticity will determine the percentage change in quantity. If the quantity also changes by 10 percent, then the elasticity is 1. If the elasticity is 1, the increase in price will not change total revenue because the price increase is directly offset by a decrease in revenue. If the elasticity is greater than one, then the relative quantity change is greater than the relative price change, and revenue decreases are associated with price increases. A monopolist would be willing to accept the revenue decreases as long as costs are declining faster than revenue.

Q: Is it possible to determine a relationship between the elasticity of demand, a given price change and a profit margin to determine whether it is possible for a firm to impose a profitable SSNIP?

A: Yes. It is possible to determine a critical elasticity. The critical elasticity is the highest elasticity that will allow the firm to impose a profitable SSNIP. If the measured elasticity of a service is higher than the critical elasticity, then sales decreases lead to profit declines. However, if the measured elasticity is less than the critical elasticity, then the increase in price is profitable and sustainable. It is profitable because it is based on the firm's price/cost relationship. It is sustainable because the firm is earning a profit and because the change in demand relative to the change in price is reasonably measured by the elasticity of demand.

Q: How do you calculate the critical elasticity of demand?

A: The critical elasticity of demand depends on the type of demand relationship that exists for the service, the price/cost margin and the size of the price increase. Two general types of relationships are usually investigated, a linear and an iso-elastic relationship.[48] The price/cost margin (m) is the difference between the price and cost divided by the price. A small but significant price change (t) is usually assumed to be 5 percent. The critical elasticity is

E = 1/(m+2t) for the linear relationship and

E = (1+t)/(m+t) for the iso-elastic relationship

Where:

t = the small but significant price increase

m = the price/cost margin[49]

Q: How do you calculate the price/cost margin?

A: The price/cost margin equals price minus cost divided by price. For the residential market the price is $12.50. The cost should be the long-term incremental cost because of the requirement that the SSNIP be profitable. The long-term incremental cost is measured by the cost of UNE elements for port, switching and transport plus retail incremental costs. The sum of the UNE costs is $3.97.[50] Retail incremental costs are $4.01.[51] The sum of the Retail cost and the UNE cost is $7.98. Loop costs are excluded from incremental service cost because the

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[48] A linear relationship can be expressed as quantity = a-b*price. An iso-elastic relationship can be expressed as quantity = a* price^{b}. Iso-elastic relationship has the property that the elasticity is constant at all levels of price and quantity.

[49] The algebraic derivations of these relationships can be found in Gregory J. Werden, "Demand Elasticities in Antitrust Analysis," 66 Antitrust L.J. 363 (1998).

[50] See the NRRI UNE Matrix, http://www.nrri.org/, Based on using 1,000 switching and transport minutes.

[51] AT&T ex parte and NASUCA comments in SLC Cost Proceeding.

Commission has ruled that the loop cost is a cost of all of the services that use the loop and should not be assigned to a particular service. Therefore the price/cost margin is .3616 (($12.50-$7.98)/$12.50).

Q: What are the critical elasticities?

A: The critical elasticity for a linear relationship is 2.16 and 2.55 for the iso-elastic relationship.

Q: What is the current elasticity of demand for residential telephone service?

A: A recent study of telephone elasticity measured the elasticity of the second telephone. It determined that price elasticity for the second line is 0.62.[52] Given that second lines appear to face significant competition from aDSL and cable modem service and that non-primary residential lines in Washington have decreased in the recent past, it is reasonable to assume that elasticity of demand for the primary-line is less than the elasticity for the second. In addition, Rodini et. al. assert that previously the elasticity of demand for the primary-line has been estimated to be 0.1.[53]

Q: What can you conclude from the level of the measured elasticity and the critical elasticity of demand?

A: Because the critical elasticity of demand is greater than the measured elasticity of demand, Qwest can profitably impose a SSNIP in the primary-line market. This

[52] Mark Rodini, Michael Ward, and Glenn Woroch, "Going Mobile: Substituability between fixed and mobile access," Prepared for the Conference on "Competition in Wireless: Spectrum, Service and Technology Wars," (2002).
[53] *Id.* 17.

means that Qwest has the ability to exercise monopoly power and reduce competition in that market.

Q: Is there evidence that Qwest believes that it has monopoly power?

A: Yes. Qwest is requesting that the Commission give it the right to increase its stand alone local service rate by 50 cents per year for four years such that the rate could increase from the current \$12.50 to \$14.50. While this request is a cap on rate increases and not a specific increase, it indicates that Qwest believes that it may be able to increase the rate to that level. The requested increase is an annual four percent increase for four years or a combined increase of 16 percent. To sustain such an increase, Qwest must have monopoly power. On the other hand, if the market is effectively competitive as Mr. Teitzel asserts, then Qwest would not only lose customers but also face decreases in revenue associated with the rate increase. In an effectively competitive market, it does not make sense to request a rate increase, or to attempt to implement a rate increase.

Q: Has Qwest implemented an equivalent of a local rate increase?

A: Yes. Qwest increased its federal subscriber line charge (SLC) from \$3.50 to \$5.84 following the FCC decision in the CALLS proceeding.[54] The SLC increase is the equivalent of a local rate because it is flat recurring charge that cannot be avoided by a residential customer requesting local service from Qwest.

Q: Was Qwest required to increase the SLC?

[54] In the Matter of Access Charge Reform, CC Docket No. 96-262, Sixth Report and Order, FCC 00-193, released May 31, 2000.

A: No. The change in the FCC rules only raises the maximum allowable charge, or the cap on the rate. Any carrier can voluntarily charge less than the maximum rate. It is my understanding that Qwest charges the maximum amount. If Qwest believed that it was facing effective competition, it could have reduced to the SLC in an attempt to retain customers or to attract customers of other carriers. However, it is my understanding that Qwest charges the maximum amount. Therefore, Qwest's pricing behavior supports the claim that it has monopoly power.

VIII. SEPARATIONS PROCEDURES AND QWEST'S INTRASTATE EARNINGS

Q: Please summarize this section of your testimony.

A: This section of my testimony quantifies the impact of the Qwest's failure to directly assign special access and DSL facilities and equipment to the interstate jurisdiction. The failure to directly assign plant to the interstate jurisdiction means that excessive and unwarranted amounts of plant and expenses are recorded as intrastate plant and expenses. This failure leads to an extremely low reported rate of return in the intrastate jurisdiction. The direct assignment of plant is still required even though there is a general freeze on separations changes. The section demonstrates that Qwest is not directly assigning plant. It shows how this failure has led to a reduction in the plant that would have been assigned to the interstate jurisdiction. An alternative value for interstate directly assigned investment is provided, and the impact of the alternative interstate investment on separations factors, and expenses. After the transfer of the plant and expense to the interstate jurisdiction, the intrastate rate of return increases substantially to 8.71 percent. This rate of return is reasonable close to the last authorized rate of return of 9.367 percent. Moreover, the causes of the adjustment, the growth in DSL service and the growth in special access service, are likely to continue into the future, creating an even greater adjustment, and a further increase in intrastate rate of return. Therefore, it is not reasonable to authorize a general rate increase to close the small gap between the last authorized return and the return that I have calculated.

Q: What is the function of the separations process?

A: The separations process allocates a carrier's investments, expenses and revenue between the intrastate and interstate jurisdictions. Once allocated, the FCC (for the interstate jurisdiction) and the state commissions (for the intrastate jurisdiction) determine the framework through which the carrier is allowed to recover its costs, establish rates and earn a return on its investments. One purpose of the separations rules is to ensure that the carrier does not over-recover the same costs from the interstate and intrastate jurisdictions. Separations rules also ensure that the carrier is not placed into financial distress because the federal and state commissions permit the recovery of less than the carrier's entire costs.

Q: How do the separations rules fit into the general scheme of FCC rules?

A: The FCC separations rules are part of a four-step process. There are two steps prior to the application of the separations rules and, in the interstate jurisdiction, one step after the application of the separations rules. The first step entails recording the carrier's investments, revenues and expenses according to the

FCC's Part 32 rules.[55] For example, a section of copper cable that is attached to telephone poles would be recorded in Account 2421.[56] The second step assigns investments, revenues and expenses to non-regulated and regulated activities. The interstate rules that assign costs among the non-regulated and regulated activities are codified in the FCC's Part 64.[57] The regulated investment, expenses and revenue are then separated by the Part 36 rules between the interstate and intrastate jurisdictions. The interstate investments are then further allocated according to the FCC Part 69 rules. This allocation provides the foundation for the interstate access charges. The remaining intrastate costs form the starting point for state rate investigations.

Q: Please explain, in general, how the Part 36 rules separate investment between the interstate and intrastate jurisdictions.

A: The first step in the separation process is to divide the investment into categories. These categories generally group equipment according to function or service provided. For example, switching equipment is divided by switches providing local end-user service and switches providing tandem service. Cable and wire facilities are grouped according to whether the cable is used to connect end-users to wire centers (Category 1), to connect local offices and provide wide-band services (Category 2), to provide toll message and private line services (Category 3), or to connect host and remote switches (Category 4). The categories can be

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[55] 47 C.F.R. Part 32.
[56] §32.2421.
[57] 47 C.F.R. §§64.901-904. It is possible that a service and its related investments, revenue and cost can be non-regulated in the interstate jurisdiction and regulated in the intrastate jurisdiction.

further divided into subcategories. For example, cable and wire Category 1 is divided into state private lines (Subcategory 1.1), interstate private lines (Subcategory 1.2), and subscriber loops (Subcategory 1.3).

The second step in the separations process is to apportion each category between the jurisdictions according to an allocation factor or by direct assignment.

Q: Please describe allocation factors.

A: Allocation factors can be either relative use factors or fixed factors. A relative use factor measures the use of a particular type of facility or equipment. For example, dial equipment minutes (DEM) measures the use of the local switching equipment. If a switch has 100 minutes of use and 15 minutes are used for interstate services and 85 minutes are used for intrastate services, then the interstate DEM would be 15 percent, and 15 percent of the investment would be assigned to the interstate jurisdiction.[58] A fixed allocator does not change over time. An example of a fixed allocator is the 75/25 percent gross allocator used to assign subscriber loop (Category 1.3) between the jurisdictions. Accordingly, 75 percent of subscriber loop plant is assigned to the intrastate jurisdiction and 25 percent is assigned to the interstate jurisdiction.

Q: What is meant by direct assignment?

A: Under direct assignment, the carrier allocates the investment directly to a category, and because the category is 100 percent assigned to one jurisdiction, the

[58] For a carrier with multiple switches the DEM is measured across the multiple switches.

investment is directly assigned to that jurisdiction. This type of direct assignment occurs with regard to intrastate private line investment, Subcategory 1.1.[59]

Q: Please describe recent changes in the FCC's separations rules.

A: The FCC released its latest separation order on May 22, 2001.[60] In that order, for large carriers such as Qwest, the FCC adopted an interim freeze of the Part 36 category relationships and jurisdictional cost allocation factors.[61]

Q: How does the interim freeze work?

A: In general, the freeze maintains the calendar-year 2000 category relationships and cost allocation factors.[62] For example, if in the calendar-year 2000, the cable and wire facilities accounts were allocated 60 percent to Category 1, 20 percent to Category 2, 10 percent to Categories 3 and 4, then all cable and wire investment from July 1, 2001 forward would be allocated to the categories on that basis. Then the calendar-year 2000 jurisdictional allocation factors are applied to the categories. This means that for every $100 of cable and wire investment, $60 would be assigned to Category 1. Moreover, if Category 1 has a jurisdictional cost allocation factor of 70 percent, then the carrier would place $42 ($60 times 70 percent) into the intrastate jurisdiction.

Q: Are there any exceptions to the general freeze rule?

A: Yes. Carriers are required to continue to allocate investment on the basis of direct

[59] Freeze Order, f. 13.
[60] Supra, f. 2.
[61] Freeze Order, ¶ 2.
[62] *Id.*, ¶ 9.

assignment for those categories that use the direct assignment method. The Order states:

> Categories or portions of categories that have been directly assigned in the past, however, will continue to be directly assigned to each jurisdiction. In other words, the frozen factors shall not have an effect on the direct assignment of costs for categories, or portions of categories, that are directly assigned.[63]

Included among the categories to which direct assignment refers is Cable and Wire Facilities-Category 2, Wideband and exchange trunk. A substantial portion of the special access cable and wire facility investment is assigned to Cable and Wire Facility-Category 2.[64]

Q: To what portion of the carrier's investments and costs does the freeze apply?

A: The general freeze applies only to investment that is allocated on the basis of relative use or fixed factors.[65]

Q: Has Qwest directly assigned cable and wire facilities?

A: No. Qwest has frozen the cable and wire facilities category allocation at their calendar-year 2000 level. The effect of this freeze is shown in Exhibit RL-5. The exhibit shows the investment in cable and wire facilities and the category allocation of that investment for the years 2000 through 2004. Note that the percentage of cable and wire investment allocated to Category 1 remained at 91.23 percent, the 2000 level, for the years 2002 through 2004. The year 2001

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[63] *Id*, ¶ 23.
[64] *Id*. f. 60.
[65] *Id*.

differed from the other years because the freeze was not effective until July 1, 2001.

Q: Are Qwest's accounting practices consistent with the FCC rules?

A: No. Qwest's accounting practices are inconsistent with the FCC Part 36 rules that require carriers to directly assign investment that was directly assigned prior to the adoption of the freeze order.

Q: Are there organizations and commissioners that agree with your assertion that the Freeze Order still requires direct assignment?

A: Yes. The National Association of Regulatory Utility Commissioners (NARUC), the National Association of State Utility Consumer Advocates (NASUCA) and the state commissioners on the Federal-State Joint Board on Separations agree that the Freeze Order requires direct assignment of special access facilities.

Q: When did NARUC state that the Freeze Order requires direct assignment?

A: In February 2006, NARUC adopted its "Resolution Relating to Separations Reform" in which NARUC declared that "[t]he FCC should clarify that all carriers must continue to directly assign all private lines and special access circuits based on existing line counts…."[66] (emphasis added).

Q: When did state Joint Board commissioners state that the Freeze Order requires direct assignment?

A: The State Members of the Separations Joint Board asserted in their comments to the FCC that direct assignment is still required. In particular, they stated that

[66] *NARUC Resolution Relating to Separations Reform, (Adopted by the NARUC Board of Directors, February 15, 2006).*

"Some carrier equipment today is directly assigned. For example, private line equipment is assigned entirely either to the interstate or the intrastate jurisdiction…." [67]

Q: When did NASUCA state that the Freeze Order requires direct assignment?

A: NASUCA agreed that the Freeze Order requires direct assignment when it stated that:

> States should, however, exercise their right to expeditiously remove non-regulated activities from intrastate rates and to direct carriers to directly assign private line investment…The Commission [FCC] should consistent with NARUC's resolution, "clarify that all carriers must continue to directly assign all private lines and special access line circuits based on existing line counts," and that states can require their carriers to do so.[68] [footnotes omitted]

Q: Do members of the industry recognize that the current industry practice of freezing the allocation of cable and wire facilities distorts the accounting results associated with those investment allocations?

A: Yes. SBC stated:

> "Yet pursuant to the Freeze Order [as implemented by the BOCs], the BOCs have been unable to allocate any of the additional investment and expenses *actually used* [italics in original] for interstate special access services to the ARMIS reported special access element. The result is a complete mismatch between these severely underreported costs and the accurately reported revenues for these services. The "special access" rate

[67] In the matter of IP-Enabled Services (WC Docket No. 04-36) and In the Matter of Vonage Holding Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission (WC Docket No. 03-211), Late-filed Comments by State Members of Separations Joint Board, Section , p.13 (Oct. 26, 2004).

[68] In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board, CC Docket No. 80-286, Comments of the National Association of State Utility Consumer Advocates, The New Jersey Division of Rate Counsel, and the Maine Office of the Public Advocate, August 22, 2006.

of return figure that can be calculated from ARMIS is thus meaningless.[69] [footnotes omitted]

Q: Can you calculate the reported return for Special Access earned by Qwest Washington in 2005?

A: Yes. Using the FCC instructions to the ARMIS 43-01, I calculated that the Qwest return on capital associated with its provision of Interstate Special Access services was 101.9 percent.[70] This extremely high rate of return is an example of the type of rates of return that the SBC comments characterized as meaningless due to the distortion caused by the Freeze accounting practices.

Q: Is it possible to remove the distortion?

A: Yes. While it is not possible to directly assign all of the special access investment, it is possible to directly assign part of the special access investment, and for the rest of the special access investment, is possible to match the special access revenue to special access cost as proxy for the special access direct assignment.

Q: Why do you attempt to match special access revenue and cost?

A: I matched special access revenue to cost because that is the general principle behind separations procedures. It is not necessary to exactly assign each cost to a particular service. Instead, the goal in separations has been to have a reasonable match between revenue and cost.

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[69] In the Matter of Special Access Rates for Price Cap Local Exchange Carriers, WC Docket No. 05-25, Comments of SBC Communications Inc., June 13, 2005.
[70] See Exhibit No. ___ (RL-6).

Q: How did you remove the distortion associated with the failure to directly assign special access?

A: I divided the task into two parts. First, for the non-DSL portion of Special Access services, I equated the ratio of carrier special access investment to carrier regulated investment that is subject to separations (the investment ratio) to the ratio of carrier special access revenue to carrier regulated revenue that is subject to separations (the revenue ratio). I contend that matching these ratios matches revenues to cost because jurisdictional cost is driven by jurisdictional investment in the separations process. Second, for DSL lines I was able to follow the NARUC suggestion to assign investment on the basis of line counts.

Q: How did you determine the revenue ratio?

A: I started with the revenues that are published in the ARMIS 43-01 report. That report shows the revenue for the regulated carrier by jurisdiction, and within the interstate jurisdiction revenue is allocated to common line, traffic sensitive, special access, billing and collections and interexchange baskets. To obtain non-DSL special access revenue, I subtracted the DSL revenues from the reported special access revenue. Next, I divided the result of the subtraction by the total revenue to obtain the revenue ratio.[71]

[71] Exhibit No. ___ (RL-7).

Q: How did you determine the investment ratio?

A: I divided the 43-01 reported special access investment by the total investment. I did not have to adjust the special access investment for DSL investment because Qwest does not assign any DSL investment to the special access interstate basket.

Q: How did you adjust the level of special access investment?

A: Total special access investment is the sum of cable and wire special access investment, circuit equipment special access investment and an allocation of general support facilities. I developed a procedure that adjusts each part of the special access investment.

Q: Please describe the procedure you used to adjust the cable and wire special access investment.

A: The procedure I used contains a series of calculations. First, I identified and sum the special access investment using the ARMIS 43-04 Reports. Second, I multiplied the special access investment by a preliminary adjustment factor. Third, I reduced the non-special access investment through a pro-rated adjustment to offset the increase in special access adjustment. These three steps determine a preliminary special access adjustment. The final adjustment is made in coordination with the adjustment to circuit equipment and general support investment.

Q: Please describe the procedure you used to adjust the circuit special access investment.

A: I used the same procedure to adjust circuit equipment investment that I used to adjust the cable and wire facilities investment. The initial process determined a preliminary estimate because the final number is dependent on the interaction of the components.

Q: How did you adjust the general support investment assigned to special access investment?

A: The general support investment assigned to special access is an allocation of the general support investment allocated to the interstate jurisdiction. The separations procedures split general support investment between the jurisdictions on the basis of the "Big Three" expenses. The "Big Three" expenses include plant specific expenses, network operations and customer operations expenses. The plant specific expenses include cable and wire facilities expenses and central office expenses. When cable and wire facilities investment and circuit equipment investment is adjusted as described above, the related plant-specific expenses change, changing the "Big Three" expenses which in turn changes the allocation of general support facilities between the interstate and state jurisdictions. Once the interstate general support facilities investment is set, I use the FCC Part 69 rules to allocate the interstate general support facilities to the special access category.

Q: How did you determine the final level of non-DSL special access investment adjustment?

A: The preliminary adjustment factor drives the entire set of adjustments to cable and wire facilities investment and circuit equipment investment, the "Big Three" expenses and the general support facilities investments. I changed the preliminary adjustment factor to a level that forced the investment ratio equal to the revenue ratio.

Q: How did you determine the DSL special access investment adjustment?

A: I adjusted the Category One cable and wire facilities investment by transferring investment from subcategory 1.3 to subcategory 1.2, and circuit equipment subcategory 4.13 plant from joint use plant to directly assigned interstate special access plant. Transfer was calculated as the number of DSL lines times to the average investment per-line investment in Category One and in subcategory 4.13.

Q: Why did you directly assign the investment to the interstate jurisdiction?

A: The direct assignment of the DSL investment is based on the FCC finding that DSL service is an interstate special access service and that special access lines are directly assigned to the interstate jurisdiction.[72]

Q: Did the FCC's recent decision regarding Title I treatment for broadband Internet access services change the accounting treatment of DSL services?

A: No. The FCC ruled that for the purposes of FCC accounting practices, the carriers should continue to treat the DSL service that it had determined to be non-regulated as if it were regulated.[73]

Q: Does the direct assignment of DSL investment have further consequences for other investments and expenses?

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[72] GTE Tel. Operating Cos. GTOC Transmittal No. 1148, CC Docket No. 98-79, FCC 98-292, Memorandum and Order (rel. Oct. 30, 1998) (GTE DSL Order), ¶¶ 1 & 23.
[73] In the Matter of the Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, CC Docket No. 02-33, *Report and Order and Notice of Proposed Rulemaking*, FCC 05-150, released September 23, 2005, ¶¶ 128-144.

A: Yes. As I described above an adjustment to investment will cause plant specific expenses, "Big Three" expenses, and general support investment to shift into the interstate jurisdiction. Another consequence of the "Big Three" expense change is that additional corporate operations expenses are allocated according to the adjusted "Big Three" expenses, and thus to interstate corporate operations expenses, due to the shift in special access investment.

Q: What is the total shift of investment due to the requirement to directly assign special access investment?

A: The total shift in investment is $424.8 million. The DSL investment shift is $157.9 million and the non-DSL investment shift is $266.9 million. The investment shifts by category type are reported in Exhibit No. ___ (RL-8).

Q: Did the investment shift affect annual depreciation expenses?

A: Yes. Annual depreciation expenses are equal to the gross investment times the depreciation rate. The change in annual expenses is equal to the change in investment times the depreciation rate.

Q: How did you calculate the change in annual depreciation expenses?

A: First, I calculated the depreciation rate for each category of plant as the ratio of annual depreciation divided by the gross plant using data found in the ARMIS 43-04 report. Then I multiplied changes in the investment by the calculated depreciation rates. The total depreciation expense change is $30.9 million. The depreciation expense changes by account are reported in Exhibit No. ___ (RL-8).

Q: Please explain how the special access investment shift affected plant specific expenses.

A: The shift in special access investment from the intrastate to the interstate jurisdiction reduces the percentage of total investment assigned to the intrastate jurisdiction. That percentage is also known as the state factor. Intrastate expenses are the product of total expenses and the state factor. Total plant specific expense changes are $13.4 million. The plant specific expense changes by account are reported in Exhibit No. ___ (RL-9).

Q: Please explain how the special access investment shift affected corporate operations expenses.

A: Corporate operations expenses are allocated by the “Big Three” expense factor. The changes in plant-specific expenses changed the “Big Three” expense factor, leading to a decrease in intrastate corporate operations expenses of $3.5 million.[74]

Q: How did the special access adjustments affect Qwest’s rate base?

A: The immediate impact of the special access adjustments was to lower the intrastate gross plant by $424.8 million. However, the gross plant decrease was offset by changes in accumulated depreciation and deferred taxes. I adjusted accumulated depreciation and deferred taxes by the gross plant percentage change. The result of that calculation reduced the rate base by $125.6 million.

Q: What was the impact on the intrastate rate of return of your adjustments to rate base and expenses?

A: The rate of return increased from **[Begin Confidential] ****[End Confidential]** to 8.71 percent. The rate of return calculation and a summary of all of the other adjustments are reported in Exhibit

[74] See Exhibit No. ___ (RL-10).

No. ___ (RL-11C). As I noted above at the beginning of this section, this rate of return analysis means that Qwest cannot justify a revenue increase and, accordingly, its proposal to allow unreviewed rate increases for four years should not be approved.

Q. Should the WUTC conduct a full rate case prior to implementation of an AFOR?

A: Yes, ideally that would be the best approach. The general principle is that price cap or AFOR plans begin with a full rate review to ensure that rates at the beginning of the AFOR are set at a level that is known to be fair, just, and reasonable based on the most current information. Qwest has not had a rate case since 1997, and had a rate freeze in place under the US West – Qwest merger agreement through 2003.

Q: Why do you not recommend a full rate case here?

A: I do not have any objection to the Commission conducting a full review of Qwest's rate levels. The practical reality, however, is that Qwest has not provided adequate information in the record for that review to occur. Notwithstanding this failure, the AFOR statute requires the Commission to consider whether or not the rates under the AFOR will be fair, just, and reasonable. The best approach, therefore, is for the Commission to continue in effect the current rate, which is deemed to be fair, just, and reasonable until changed by the Commission after a rate case either on its own motion, upon petition of the Company or by a third party. I offer evidence in this case that at current rate levels, Qwest is currently earning close to its authorized rate of return and that the current basic rate is well above long run incremental cost. Moreover, the fact that Qwest agreed to maintain rates at the $12.50 level in the merger settlement agreement and has not filed to increase rates after the merger rate freeze expired gives a further indication that the $12.50 rate level remains reasonable.

By the same token, I believe that there is no basis in the record for the Commission to adopt an AFOR which allows Qwest to automatically increase rates when there has been no recent thorough evaluation of Qwest's earnings in Washington. If Qwest wishes to increase the revenues it gains from the residential market, where the evidence shows it still exercises market power, it should file a rate case prior to establishing an AFOR. If it chooses not to do so, it must accept that for the life of the AFOR, the current residential rate represents the just and reasonable level.

Q: Are there any other factors to be taken into account with respect to the Qwest proposal for upward flexibility in the basic rate as part of the AFOR?

A: Yes. In the settlement in the Qwest DEX sale docket in Washington, approved and adopted in August 2003 by the Commission, Qwest agreed to compensate Washington ratepayers for their share of the proceeds of the sale of the valuable classified Yellow Pages directory business.[75] The net present value of the

[75] *In the Matter of the Application of Qwest Corporation Regarding the Sale and Transfer o f Qwest Dex to Dex Holdings, LLC, a non-affiliate*, Docket No. UT-021120, Tenth Supplemental Order (DEX Settlement Order).

Washington ratepayers' share of the gain on sale of the Yellow Pages was estimated to be $942 million.[76] Of this, Qwest was required to share $67 million with ratepayers by immediate application of credits to customer bills. To provide the remaining benefit to ratepayers, Qwest was also required to book annual revenue credits for 15 years. The amount of the benefit for 2004 through 2007 was $110 million per year. For the years 2008 through 2018, the amount of the benefit is $103.4 million annually.[77] Significantly, the parties agreed that no party "will argue that the annual revenue credit is inapplicable in any current or future review of Qwest's earnings or revenues, including but not limited to general rate cases, alternative forms of regulation proceedings, and competitive classification proceedings."[78] The relevant portion of the agreement regarding the annual revenue credit reads in full:

> **2. Annual Revenue Credit.** In the event of one or more future rate cases, earnings investigations, or other proceeding that includes a review of Qwest's earnings, and for purposes of reporting intrastate financial results to the Commission for these or any other purposes, there will be an annual revenue credit for a period of 15 years, after which the credit shall end. *This credit shall be recognized by the Commission in any proceeding before it where Qwest's earnings or revenues are under examination during the 15 year period.* A revenue credit of $110 million shall be added to Qwest's Washington intrastate regulated revenues beginning on January 1, 2004 and ending on December 31, 2007, and an annual revenue credit of $103.4 million (in replacement of the $110 million) shall be added to Qwest's Washington intrastate regulated revenues beginning on January 1, 2008 and ending on December 31, 2018. The Parties agree that they will not initiate any request to change the annual revenue credit and will oppose any change. *Nor will the Parties argue that the annual revenue credit is inapplicable in any current or future review of Qwest's earnings or*

[76] *Id.*, ¶ 27.
[77] *Id.*, ¶ 28.
[78] *DEX Settlement Order*, Appendix B, Stipulation and Settlemetn Agreement, p. 5, ll. 15-17.

revenues, including but not limited to general rate cases, alternative forms of regulation proceedings, and competitive classification proceedings.[79]

The Commission basis reports filed by the Company reflect the settlement revenue credit. My calculation that Qwest is currently earning close to its authorized return in Washington likewise incorporates the assumption that the credit is reflected on the books. Under Qwest's AFOR proposal, however, the benefit of the revenue credit is diluted or lost. Allowing the rate to increase is, in effect, allowing Qwest to disregard the agreed revenue credit and to "make up" the gap with new ratepayer dollars in violation of the DEX Settlement Order. This is another reason that Qwest's proposal for allowing automatic rate increases during the AFOR should be rejected. Without a review of Qwest's earnings and revenues there is no way to determine when an increase occurs whether Qwest's obligation to provide revenue credits has been met. Any AFOR adopted by the Commission should also expressly recognize that the revenue credit obligations of the DEX Settlement Order remain in effect during and after any AFOR through 2018.

IX. CONCLUSIONS AND RECOMMENDATIONS

Q: Please summarize your conclusions and recommendations.

A: I recommend that the Commission not approve Qwest's AFOR proposal because it does not satisfy the factors detailed in Washington's AFOR statute. If the Commission believes it is appropriate to adopt an AFOR in this docket, it should

[79] *Id.,* p. 5, ll. 4-17 (emphasis added).

incorporate the following components to address the statutory criteria:

- The rate for stand-alone residential local service should remain at $12.50 for the term of the AFOR.
- Rates for any installation or connection rates associated with stand-alone residential local service should not be increased.
- Residential local service and other component services within Qwest bundles or packages should remain available as an independent service ("a la carte") which can be purchased without purchasing other Qwest services.
- Prices for Qwest bundles should not exceed the sum of the prices for the stand-alone components of the bundle.
- Increases in rates for residential exchange service features purchased independently of Qwest packages should be capped at a reasonable level to preclude pressure to purchase bundles. A reasonable annual cap would be no more than the change in the Consumer Price Index less 2 percent.
- Residential local service should include one free-call allowance to directory service.
- The AFOR should last no more than four years and should then expire unless extended or modified by Commission order. If it wishes to extend or modify the AFOR, nine months prior to end of the AFOR, Qwest should file with the Commission any plan that it wishes the Commission to adopt for the future.
- The Commission should retain authority to require reporting and Qwest should continue to file reports associated with Qwest's financial and public

safety activities. Qwest should be required to maintain clear, accurate, and accessible price information on its website for competitive services.

- Qwest should ensure that, at minimum, 75 percent of its lines in each and eve
- ry wire center are broadband capable.
- Qwest should commit to offer a broadband lifeline service. As an example, the Company could offer broadband service at $10 per month to families eligible for free or reduced price school meals.
- An AFOR should include a service quality incentive plan and continuation of the customer service guarantee program as proposed by Public Counsel witness Mary Kimball.
- Revenue associated with Qwest's packages that include interstate or non-regulated services should be allocated such that the discount associated with the package is allocated to the interstate jurisdiction or the non-regulated sector. Qwest should file a quarterly report that verifies that it is following such an allocation principle in its books of account.

As noted above, this is not an exclusive list. Because discovery and discussions between parties are on-going, Public Counsel may develop and propose additional recommendations for an AFOR framework.

Q: Does this conclude your testimony?

A: Yes.