BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

Rebuttal Testimony Of Timothy J Gates

On Behalf Of

MCI, INC.

August 29, 2003

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I. INTRODUCTION

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

A. My name is Timothy J Gates. My business address is QSI Consulting, 917 W. Sage Sparrow Circle, Highlands Ranch, Colorado 80129.

Q. WHAT IS QSI CONSULTING, INC. AND WHAT IS YOUR POSITION WITH THE FIRM?

A. QSI Consulting, Inc. (QSI) is a consulting firm specializing in traditional and non-traditional utility industries, econometric analysis and computer aided modeling. I currently serve as Senior Vice President.

Q. ARE YOU THE SAME TIMOTHY GATES WHO FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

II. PURPOSE OF REBUTTAL TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal is to address the position of Staff Witness Mr. Thomas Wilson. I disagree with the conclusions Mr. Wilson has reached in this proceeding. Specifically, I disagree that Qwest is subject to effective competition and that its Petition should be granted.

Q. WERE YOU SURPRISED BY STAFF'S COMPLETE SUPPORT OF QWEST'S POSITION IN THIS PROCEEDING?

A. Yes. It is really hard to conceive how, based on the evidence, Staff could reach the conclusion it does. Staff apparently concludes that the evidence is not in the least equivocal, despite what is at a minimum rather compelling evidence of Qwest's continuing overwhelming market dominance throughout its service area. In reaching its conclusion, Staff has gathered and considered additional evidence in this case, that was not filed by Qwest.

Q. ARE YOU SUGGESTING THE STAFF REQUEST FOR CLEC DATA WAS SOMEHOW IMPROPER?

A. No, not at all. I think the request for CLEC data was and is critical to the case. Without the information on CLEC-owned lines, the true extent of effective competition would not be known. All of the parties and the Commission will benefit from this critical addition to the record.

Q. HOW DO YOU EXPLAIN THE DICHOTOMY OF POSITIONS IN THIS CASE?

A. The extreme difference in the positions derives from the interpretation of the data. As a previous commission employee, I understand the desire to effectuate meaningful competition.[1] In fact, my goal as a consultant is to create circumstances within which effective competition can develop. As such, I see great similarity in the goals and intentions of the Staff, Public Counsel and the CLECs in this case.[2] Despite this common goal and the review of similar information, the parties have reached disparate conclusions.

Q. HOW SHOULD THE COMMISSION INTERPRET THIS DICHOTOMY?

A. The Commission should weight the competitive significance of the different forms of market entry. Resale and UNE-P offerings do not rise to the level of

[1] By this comment I am not suggesting that I am a previous employee of the WUTC, only that I have worked at two other commissions in the past.

"effective competition" under the statute. Resale and UNE-P offerings exist only by virtue of the use of Qwest's network, and Qwest benefits from CLECs using those services. While those services do provide some benefits of competition, they should be given no weight in determining the existence of effective competition.

Q. PLEASE SUMMARIZE YOUR FINDINGS AND CONCLUSIONS.

A. My rebuttal testimony makes the following findings and conclusions:

- Staff's support of Qwest's Petition is based on a flawed interpretation of the RCW 80.36.330 criteria and the CLEC line data.
- An "open" market is not by definition an "effectively competitive" market. In a similar vein "choice" in and of itself is not an indicator of price constraining, effective competition.
- Staff has failed to distinguish the competitive significance of the different forms of market entry.
- Resale and UNE-P lines should be excluded from the calculation of market shares for purposes of evaluating the RCW 80.36.330 criteria.
- The data in this case show that Qwest is still the dominant carrier in the state and that CLECs have only a minimal presence in the vast majority of the Qwest exchanges. Under these circumstances, Qwest's Petition should not be granted.
- The Commission should adopt the proposed parameters of effective competition as identified in this testimony.
- The TRO will definitely impact the CLECs' use of UNEs in the future. The Commission should not base any decision on factors that may dramatically in the future.

IV. APPLICATION OF RCW 80.36.330 STANDARDS

Q. PLEASE RESTATE THE STATUTORY CRITERIA THAT CONTROL THE OUTCOME OF THIS PROCEEDING.

[2] Qwest's goal in this proceeding is to achieve competitive status for the services in the Petition. While I understand the goal from an economic perspective, approval of the Petition would not be in the public

A. The Commission summarized the requirements as follows:

> RCW 80.36.330 authorizes the Commission to "classify a telecommunications service provided by a telecommunications company as a competitive telecommunications service" if it finds that the service is "subject to effective competition." The statute defines "effective competition" to mean "that customers of the service have reasonably available alternatives and that the service is not provided to a significant captive customer base." RCW 80.36.330(1) enumerates four factors that the Commission "shall consider" in determining whether it will exercise its discretion to classify a telecommunications service as "competitive":
>
> (a) The number and size of alternative providers of services;
>
> (b) The extent to which services are available from alternative providers in the relevant market;
>
> (c) The ability of alternative providers to make functionally equivalent or substitute services readily available at competitive rates terms, and conditions; and
>
> (d) Other indicators of market power, which may include market share, growth in market share, ease of entry and the affiliation of providers of services.[3]

Q. IS THE COMMISSION'S INVESTIGATION LIMITED SOLELY TO THESE CRITERIA?

A. No. While the Commission must consider the factors identified above, it may consider any other factors that it deems relevant to the case. The Commission may also exercise its judgment in evaluating the weight of the evidence in this docket.

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interest at this time.

[3] See In the Matter of the Petition of Qwest Corporation for Competitive Classification of Business Service in Specified Wire Centers; SEVENTH SUPPLEMENTAL ORDER DENYING PETITION AND ACCEPTING STAFF'S PROPOSAL; Docket No. UT-000883; dated December 18, 2000; at 3. Hereinafter referred to as "*Commission's 2000 Order*."

Q. ARE THERE SOME SITUATIONS WHERE THERE IS NO DISPUTE REGARDING THE APPLICATION OF THE STATUTORY STANDARDS?

A. There should be no dispute over the status of the Elk exchange. Even Staff agrees that there are no CLECs offering service in the Elk exchange. Qwest's evidence in the case suggested that there were five exchanges – one of which was Elk -- wherein no CLECs were offering service.[4] The CLEC data collected by the Commission showed some CLEC customers in all exchanges except Elk.

Q. ARE THERE OTHER EXCHANGES IN WASHINGTON WHERE CLECS HAVE NO OWNED OR UNE-LOOP LINES?

A. Yes. As can be seen in Exhibit MLS-Reb-1, there are 20 exchanges/wire centers in which CLECs have no owned or UNE-Loop lines.[5] In those exchanges, the HHI index is 10,000, indicating a perfect monopoly.[6]

Q. IS STAFF RECOMMENDING CLASSIFYING QWEST'S SERVICES AS "COMPETITIVE" IN THE ELK EXCHANGE?

A. At page two of his testimony, Mr. Wilson states, "Staff recommends that the petition be approved because the services listed are subject to effective competition." Despite this recommendation, Mr. Wilson recognizes at several places in his testimony that there is no CLEC presence or alternative service available in Elk.[7]

[4] See the Direct Testimony of Mr. Teitzel at pages 9-10.
[5] Aberdeen, Easton and Ephrata, Eastern Towns N-P (7), Eastern Towns S-W (3), Elk, Moses Lake, Sequim, Walla Walla – Touchet, and Western Port Towns (2).
[6] This assumes the market shares are calculated based on facilities-based entry only – without resale or UNE-P lines included. The use of HHI is discussed later in this testimony.
[7] See, for example, the Direct Testimony of Mr. Wilson at pages 4 and 20.

Q. HOW DOES STAFF JUSTIFY A COMPETITIVE CLASSIFICATION FOR ELK?

A. At page 21 of Mr. Wilson's testimony he states "To the best of Staff's knowledge, nothing prevents a CLEC from serving a customer in Elk." He also suggests at page 26 that "…a CLEC could relatively easily enter Elk."[8] While these suggestions are subject to debate, it is clear that the circumstances in the Elk exchange do not warrant competitive classification. In fact, the Staff seems to be ignoring the Commission's directive from the previous case. In that case the Commission stated:

> Qwest asks us to apply a more relaxed standard for determining effective competition. Qwest asserts that the statute is met if competitors exist in the market who are *capable* of providing ("can" provide) alternative services. We are unable to accept this standard. In our view, we must also have confidence that competitors *are* offering and *will* offer competitive services. This determination turns on the presence of competitors, their actual current availability to customers, and a judgment, from their current behavior and the current market structure, that they do, can, and will provide alternative service to end-users.[9] (emphasis in original)

It is clear that the Elk exchange has no alternative providers that *are* offering and *will* offer competitive services. As such, there is no support whatsoever for a finding of effective competition in the Elk exchange.

Q. BASED ON YOUR STATEMENT ABOVE, ARE YOU AGREEING WITH THE STAFF THAT THE OTHER EXCHANGES SHOULD BE CLASSIFIED AS COMPETITIVE?

[8] See attached article entitled "Phone Giants Keep Monopoly but Strive to Make it Regional". Obviously entry is not easy.
[9] See paragraph 66 of the *Commissions 2000 Order*.

A. No. The Elk exchange is simply the most extreme example of a statewide problem – the lack of effective competition. It is clear that the Elk exchange fails in every respect, the test of effective competition. The other exchanges, however, also fail the test.

V. MODES OF MARKET ENTRY – FACILITIES-BASED V. RESALE

Q. MR. WILSON STATES THAT CLECS CAN COMPETE EFFECTIVELY WITH RESALE, UNE-LOOP AND UNE-P. HOW DO YOU RESPOND?

A. Mr. Wilson assumes that all modes of entry are equal in their ability to provide competition to Qwest's services. This is not correct. The various modes of entry have very different effects in the market place, and should be weighted accordingly.

Q. **PLEASE EXPLAIN HOW THE COMMISSION SHOULD CONSIDER OR WEIGHT THE DIFFERENT MODES OF ENTRY.**

A. The Telecommunications Act and the FCC's Orders discussed the different entry strategies. In the FCC's *Local Competition Order* it states:

> The Act contemplates three paths of entry into the local market -- the construction of new networks, the use of unbundled elements of the incumbent's network, and resale. The 1996 Act requires us to implement rules that eliminate statutory and regulatory barriers and remove economic impediments to each. We anticipate that some new entrants will follow multiple paths of entry as market conditions and access to capital permit. Some may enter by relying at first entirely on resale of the incumbent's services and then gradually deploying their own facilities. This strategy was employed successfully by MCI and Sprint in the interexchange market during the 1970's and 1980's. Others may use a combination of entry strategies simultaneously -- whether in the same geographic market or in different ones. Some competitors may use unbundled network elements in combination with their

> own facilities to serve densely populated sections of an incumbent LEC's service territory, while using resold services to reach customers in less densely populated areas. Still other new entrants may pursue a single entry strategy that does not vary by geographic region or over time. Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy.[10]

While the Act does not express a preference for one form of entry over the other, it is clear that facilities-based competition is the ultimate goal. Carriers use resale and UNEs to quickly enter the market, gain customers and hopefully some profits, to allow them to build their own facilities over time. It is only with facilities-based competition that new entrants can gain their independence from Qwest and truly differentiate their services from those of the incumbent. As such, the Commission should give significant weight to facilities-based entry (owned loops and UNE-Loops) and no weight to resale-based entry (resale and UNE-P loops).

Q. WHY IS FACILITIES-BASED COMPETITION IMPORTANT TO THE DEVELOPMENT OF EFFECTIVE COMPETITION IN TELECOMMUNICATIONS?

A. As discussed in the testimony of my colleague Mr. Stacy, there are two markets which directly impact retail competition in Washington – the retail market and the wholesale market. Qwest is the sole supplier of wholesale inputs for CLECs providing retail services via UNE-P and/or resale.

Without a network of its own, a carrier is relegated to a "resale" role in the market. Successful marketing normally requires product differentiation and price competition. It is difficult, if not impossible, for a carrier to differentiate its

[10] Before the Federal Communications Commission; *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Services Providers*; CC Docket Nos. 96-98 and 95-185; **FIRST**

product when it is reselling all or part of the incumbent's product. The reseller is dependent upon the underlying carrier for quality of service, features, speed to market, and facilities. Just as important, the reseller is dependent upon the underlying carrier for its cost of service. In other words, the cost that the reseller pays Qwest becomes the most important cost of the reseller, and is probably the only cost over which the reseller has no control or influence whatsoever.

Qwest's Wholesale Product Catalog describes the activities of CLEC resellers as "Resale CLECs purchase Qwest's products and services, at a resale rate either through a separate negotiated agreement with Qwest or a tariff, and resell these products and services to their end-users."[11] Because of Qwest's complete monopoly in the wholesale market, it is not appropriate to include services offered by CLECs through resale or UNE-P in any market share analysis.

Q. ACCORDING TO MR. WILSON'S EXHIBIT (TLW-C-5), RESALE IS THE LEAST PREVALENT MODE OF MARKET ENTRY BASED UPON LINES. PLEASE COMMENT.

A. This is not a surprising result. The resale discounts are insufficient (about 14 percent) and are applied to Qwest's retail rates. Even the most efficient providers would have difficulty covering their internal costs (for example, marketing, billing and collection) and making a profit via resale. UNEs, however, are priced at TELRIC levels, which more accurately reflect economic costs. Again, because of pricing and the inability to distinguish the reseller's service from that of the incumbent, resale is the least effective form of competition.

REPORT AND ORDER; Released August 8, 1996; hereinafter referred to as the *Local Competition Order,* at ¶ 12.

[11] See [Link to Qwest | Wholesale Description of CLEC Resellers]

Q. BUT DOESN'T RESALE PROVIDE AT LEAST SOME FORM OF COMPETITION FOR QWEST?

A. Yes, it does. The resellers, who can enter the market quickly and with minimal sunk investment, act as retailers. To the uninformed consumer, it appears that the resold offering is an alternative to Qwest's service. To that end, if the service is priced competitively and well marketed, resellers can attract customers.

Q. WHY THEN DO YOU DISAGREE WITH MR. WILSON AS TO THE EXISTENCE OF EFFECTIVE COMPETITION?

A. The distinction between the *existence of competition* and *effective competition* is based on the ability to control Qwest's activities in the market place. Since Qwest benefits whether it sells the service or a reseller sells the service, resellers are not effective competition. The only difference between Qwest's retail revenues from serving the customer directly and Qwest's wholesale revenues through serving the customer via the reseller, are the retail costs which the Commission has determined that Qwest avoids when it sells the finished service to the retail reseller. In other words, the net revenue to Qwest is the same for retail and total service resale. While I'm sure Qwest would prefer to have all services and all customers, the Commission has in effect determined that when Qwest loses a customer to a reseller that has no net impact on Qwest's bottom line.[12]

Q. MR. WILSON SAYS "QWEST FACES SUBSTANTIAL COMPETITION STATEWIDE, AND BECAUSE CONSUMERS HAVE CHOICES, QWEST

[12] Most if not all CLECs have a "wholesale" department. This is recognition that a piece of the pie is better than losing the whole pie.

CANNOT EFFECTIVELY EXERCISE MARKET POWER." DO YOU AGREE?

A. No. As discussed above, resale provides a "choice" to consumers, but such choice is limited to the service offerings of Qwest. The CLEC resale offerings may have different names, different descriptions and different rates, but the underlying services are still Qwest services. Further, because it is resale, Qwest maintains a compensatory revenue stream even though it has ostensibly "lost" a customer. Because Qwest is still utilizing its network, achieving complete cost recovery from the reseller and controlling the cost and quality of service for the reseller, the supposed competitor is not able to impact Qwest in a way that would eliminate Qwest's market power.

Q. ARE THE CUSTOMERS OF PURE RESELLERS AND THE CUSTOMERS OF CLECS USING RESALE AND UNE-P STILL CAPTIVE CUSTOMERS OF QWEST?

A. Yes. If there are no facilities-based alternatives, businesses utilizing the services of a pure reseller or a CLEC using resale or UNE-P, are still captive customers of Qwest. Even though the businesses are exercising choice in their selection of providers, since the underlying network, features and quality are those of Qwest, the customer is still captive.

Q. PLEASE DISCUSS UNE-BASED SERVICES AND WHETHER THEY PROVIDE EFFECTIVE COMPETITION FOR QWEST.

A. Carriers providing services with UNEs are also a form of competition for Qwest. The CLECs purchase UNEs or combinations of UNEs to provide finished services to consumers and businesses. A UNE platform offering, or UNE-P, is just another form of resale. The CLEC uses the existing loop, switching and transport of Qwest and offers it under the CLEC name. As Qwest states in its product catalog,

> Qwest Unbundled Network Elements-Platform (UNE-P) services are combinations of Unbundled Network Elements (UNEs) *provided to end-users* ***on behalf of*** *Competitive Local Exchange Carriers (CLECs)* that are functionally equivalent to Qwest's comparable retail service offerings."[13] (emphasis added)

In fact, at Qwest interconnection service centers, where UNE orders are processed by Qwest, the typists refer to UNE orders as "resale."

Q. WHAT IS THE PRIMARY DIFFERENCE BETWEEN UNE-P SERVICES AND RESOLD SERVICES?

A. The primary difference is the pricing. As noted above, resold services are sold at the Commission prescribed discount from Qwest's retail rates. UNEs, however, are priced at TELRIC rates. There are some other differences, primarily from a provisioning and implementation perspective, but it is clear that both resale and UNE-P results in the CLEC using the finished services of Qwest. Both types of offerings result in some consumer benefits, and allow the new entrants to gain customers and hopefully profits, which may later be used to invest in facilities.

Q. PLEASE DESCRIBE UNE-LOOP OFFERINGS.

A. UNE-Loops are just that – Qwest's unbundled loops. CLECs order UNE-Loops from Qwest and the traffic is routed over the loop to the CLEC collocation space.[14] A variety of unbundled loops are available including basic voice grade loops, DSL compatible loops, and high capacity loops (i.e., DS1, DS3). The CLEC is then responsible for getting the traffic from its collocation space at the

[13] See Link to Qwest | Wholesale UNE-P Description

Qwest facility to its own switching facility. By using its own switch, the CLEC is able to differentiate its service from that of Qwest. As such, a UNE-Loop offering is partially facilities-based, and is not total resale.

Q. DO CLECS USING UNE-LOOPS RESULT IN EFFECTIVE COMPETITION FOR QWEST'S SERVICES IN WASHINGTON?

A. No, but they offer more market discipline than resale or UNE-P, and should be viewed as a competitive alternative by the Commission.[15] By virtue of the CLEC investment in switching facilities, the CLECs can differentiate their services and develop their own efficiencies in the provision of service. While the CLEC is still dependent upon Qwest for the loop, at least part of the service is being provided directly through investment. Over time, CLECs may deploy their own loops where economics support such a decision. When that type of investment occurs, and businesses are attracted to alternative offerings provided over that network, a lost customer is truly a lost customer in every sense of the word. Qwest loses the relationship with the business and receives no revenues from the business once the business selects the CLEC. This type of competition is what truly motivates and disciplines Qwest's behavior in the market. If Qwest's competing retail services are prematurely deregulated, however, this type of competition is unlikely to occur.

Q. HAVE YOU CALCULATED THE CLEC MARKET SHARE USING ONLY THE CLEC OWNED AND UNE-LOOP LINES?

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[14] See Link to Qwest | Wholesale Description of Unbundled Loop Offerings

[15] UNE-Loops, even though they also utilize the switching facilities of the CLEC, are still under the control of Qwest. If Qwest were to change its hot cut procedures, or change its rates (recurring or nonrecurring) or requirements for collocation, the CLEC's ability to use that UNE-Loop effectively would be compromised. As such, while UNE-Loop services include some investment by the CLEC, they are still a form of resale.

A. Mr. Stacy has made those calculations. We conclude based on this more appropriate measure that the CLEC market share in Washington is about 16 percent.

Q. IS THE CLEC OWNED AND UNE-LOOP MARKET SHARE OF 16 PERCENT SUFFICIENT TO JUSTIFY COMPETITIVE CLASSIFICATION FOR QWEST'S SERVICES?

A. No.

Q. YOU SEEM TO BE STATING THAT SOME FORMS OF COMPETITION ARE MORE IMPORTANT THAN OTHERS. HOW SHOULD THE COMMISSION CONSIDER THE EVIDENCE IN THIS PROCEEDING?

A. I recognize that this is a difficult but important decision for the Commission. It is not possible to remove the exercise of judgment from the analysis of the data in this case. But it is critical for the Commission to recognize that different forms of market entry have different values in terms of controlling Qwest's ability to exercise market power. Staff's suggestion that all forms of competition are equivalent is not the appropriate standard. Staff's roll-up of CLEC data further distorts the true competitive nature of the market. The Commission must give the appropriate weight to the different forms of competitive entry in Washington. Resale and UNE-P should be given little weight, while UNE-Loop and CLEC owned lines should be considered formidable competition for Qwest. When one views all the evidence with the appropriate weights, it is clear that the limited competition in Washington is not sufficient to justify an effectively competitive classification for Qwest's services.

VI. MARKET CONCENTRATION – COMPETITIVE SIGNIFICANCE

Q. CAN YOU POINT TO A SYSTEM THAT IS IN USE TODAY THAT CONSIDERS THE WEIGHT OF COMPETITIVE EVIDENCE?

A. Yes. The Commission regularly considers the weight of evidence in each case.[16] Another good example is the United States Department of Justice Horizontal Merger Guidelines.[17] As noted therein:

> Although the Guidelines should improve the predictability of the Agency's merger enforcement policy, it is not possible to remove the exercise of judgment from the evaluation of mergers under the antitrust laws. Because the specific standards set forth in the Guidelines must be applied to a broad range of possible factual circumstances, mechanical application of those standards may provide misleading answers to the economic questions raised under the antitrust laws. Moreover, information is often incomplete and the picture of competitive conditions that develops from historical evidence may provide an incomplete answer to the forward-looking inquiry of the Guidelines. Therefore, the Agency will apply the standards of the Guidelines reasonably and flexibly to the particular facts and circumstances of each proposed merger.

The results of the market concentration analyses are tempered by the "competitive significance" of the provider. In other words, the Department of Justice must determine, through judgment and analysis, whether the current market share of a particular firm "…either understates or overstates the firm's future competitive significance."[18]

Q. ARE YOU SUGGESTING THAT THE COMMISSION EXERCISE ITS JUDGMENT IN DETERMINING THE COMPETITIVE SIGNIFICANCE OF THE DATA IN THIS CASE?

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[16] See the Commission's 2000 Order in which it states, "The weight we give to these factors will vary from case to case." Paragraph 73.

[17] See Link to DOJ/FTC 1992 HORIZONTAL MERGER GUIDELINES

A. Yes, I am. As noted in the Merger Guidelines, other things being equal, market concentration affects the likelihood that a firm could successfully exercise market power.[19] I am suggesting that Qwest's market share of at least 84 percent is evidence of its ability to exercise market power.[20] Indeed, the Merger Guidelines provide significant guidance on how to view the data in this case.

Q. PLEASE EXPLAIN.

A. The Merger Guidelines suggest that under certain circumstances, a market share of 35 percent is evidence that consumers would be adversely affected. For instance, at Section 2.211 of the Merger Guidelines it states:

> Where market concentration data fall outside the safeharbor regions of Section 1.5, the merging firms have a combined market share of at least thirty-five percent, and where data on product attributes and relative product appeal show that a significant share of purchasers of one merging firm's product regard the other as their second choice, then market share data may be relied upon to demonstrate that there is a significant share of sales in the market accounted for by consumers who would be adversely affected by the merger.

Q. WHAT ARE THE "SAFEHARBOR REGIONS" IN THE MERGER GUIDELINES?

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[18] See Horizontal Merger Guidelines at Section 1.52.

[19] Section 2.0 of the Merger Guidelines states "The smaller the percentage of total supply that a firm controls, the more severely it must restrict its own output in order to produce a given price increase, and the less likely it is that an output restriction will be profitable." It is clear in this case that Qwest controls the majority of supply (at least 84 percent – Qwest lines, resold lines and UNE-P lines) and that this market presence provides both the incentive and ability to exercise market power in the absence of regulation. The phrase "exercise market power" refers to the ability of the provider to price or control the market in a manner that would harm the public interest.

[20] See the Rebuttal Testimony of Mr. Stacy for the calculation of this market share.

A. Section 1.51 addresses the use of the Herfindahl-Hirshman Index (HHI) calculations of market concentration.[21] The safeharbor regions are the HHI concentrations listed below:

> a) Post-Merger HHI Below 1000. The Agency regards markets in this region to be unconcentrated. Mergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and ordinarily require no further analysis.
>
> b) Post-Merger HHI Between 1000 and 1800. The Agency regards markets in this region to be moderately concentrated. Mergers producing an increase in the HHI of less than 100 points in moderately concentrated markets post-merger are unlikely to have adverse competitive consequences and ordinarily require no further analysis. Mergers producing an increase in the HHI of more than 100 points in moderately concentrated markets post-merger potentially raise significant competitive concerns depending on the factors set forth in Sections 2-5 of the Guidelines.
>
> c) Post-Merger HHI Above 1800. The Agency regards markets in this region to be highly concentrated. Mergers producing an increase in the HHI of less than 50 points, even in highly concentrated markets post-merger, are unlikely to have adverse competitive consequences and ordinarily require no further analysis. Mergers producing an increase in the HHI of more than 50 points in highly concentrated markets post-merger potentially raise significant competitive concerns, depending on the factors set forth in Sections 2-5 of the Guidelines. Where the post-merger HHI exceeds 1800, it will be presumed that mergers producing an increase in the HHI of more than 100 points are likely to create or enhance market power or facilitate its exercise. The presumption may be overcome by a showing that factors set forth in Sections 2-5 of the Guidelines make it unlikely that the merger will create or enhance market power or facilitate its exercise, in light of market concentration and market shares.

Q. STAFF CALCULATED THE HHI INDICES FOR THE WASHINGTON MARKET AND FOUND THAT THE MARKET IS "HIGHLY

[21] The HHI index is the most popular summary measure of concentration in markets. See, for example, F.M. Sherer and David Ross, "Industrial Market Structure and Economic Performance" (Houghton Mifflin Company, Boston: 1990) at 72.

CONCENTRATED." HOW DO THE RESULTS OF THAT CALCULATION FIT INTO THE GUIDELINES ABOVE?

A. First of all, the Staff calculations are incorrect because they include resale and UNE-P lines in the market share calculations. Even with that data included, however, the Qwest HHI results all **exceed 5,000**.[22] The guidelines indicate a "highly concentrated" market when the HHI exceeds **1,800**.

Q. SHOULD THE RESULTS OF STAFF'S ANALYSIS BE OF GREAT CONCERN TO THE COMMISSION?

A. Yes. Nevertheless, both Staff and Qwest argue, "…the results of the HHI analysis do not provide the best representation of the market."[23] In order to preserve their positions in the case, Staff and Qwest must try to discount these results. If Staff had considered only the CLEC-owned and UNE-Loop lines, the concentration ratios would have been much higher. Mr. Stacy provides an analysis of the results with more reasonable inputs.

Q. THE HHI RESULTS INDICATE THAT QWEST IS THE DOMINANT PROVIDER. IS THAT AN IMPORTANT FINDING?

A. Absolutely. Some academics suggest that dominance in the market is more of a problem than oligopoly. For instance, William Shepherd states,

> Another interesting HHI property is that dominance has very high values. Thus a share of 60 percent has an HHI of 3,600, which is much higher than the tight-oligopoly threshold value of 1,800. This suggests, correctly on the whole, that dominance is a much more serious problem than even tight oligopoly.[24]

[22] See Direct Testimony of Mr. Wilson at Exhibit TLW-C-8. See also the Direct Testimony of Mr. Shooshan at pages 8-9.

[23] See Direct Testimony of Mr. Wilson at page 24.

[24] See, William G. Sheperd, "The Economics of Industrial Organization", (Prentice Hall, Englewood Cliffs, New Jersey; 1990), at 67.

Q. STAFF AND QWEST ARGUE THAT THE CALCULATED HHI INDICES ARE OVERSTATED. DO YOU AGREE?

A. No. As noted above, if anything, the HHIs are understated. First, including resale and UNE-P lines (which are not competitively significant) overstates CLEC market share, which is results in a lower HHI. Second, Staff calculates an HHI based on an erroneous assumption – that the cumulative market share of all CLECs, is the appropriate measure of competition faced by Qwest. This assumption – taking all CLECs together as opposed to individually – dramatically understates the HHI.

Q. PLEASE EXPLAIN.

A. By taking the total market share of all CLECs, Staff's analysis assumes that the CLECs are working together -- using their combined resources in a coordinated manner -- in one statewide, orchestrated attack against Qwest,. This is clearly not the case. The CLECs are competing against Qwest, but they are also competing against one another. To group all CLECs together suggests a much more effective competitive threat to Qwest than is actually occurring in the State. As discussed by Mr. Stacy, Qwest enjoys a market share exceeding 95 percent in more than three-quarters of the exchanges at issue in this proceeding.

Q. THE MERGER GUIDELINES DISCUSS POST-MERGER CHANGES IN HHI AS INDICATIVE OF COMPETITIVE CONCERNS. IS THAT RELEVANT HERE?

A. Yes. The guidelines state that there would be "…significant competitive concerns" if concentration increases over time. Indeed, where the post-merger – or in this case, post competitive classification – HHI exceeds 1,800, "…it will be presumed that mergers producing an increase in the HHI of more than 100 points are likely to create or enhance market power or facilitate its exercise."[25] That section also notes that mergers producing an increase in the HHI of more than 50 points in a highly concentrated market raise significant competitive concerns.

Q. WOULD YOU EXPECT THE HHI TO INCREASE BY MORE THAN 50 POINTS IF QWEST RECEIVES COMPETITIVE CLASSIFICATION?

A. Yes. If Qwest receives the regulatory flexibility it seeks in this case, I would expect it to use that ability to win back customers. Even if we assume the worst-case scenario, where Qwest has only 75 percent of the market, a one percent increase in market share will result in a 151 point increase.[26] This result, which is very conservative given Qwest's market presence and resources, is three times higher than the Merger Guideline for raising "significant competitive concerns."

Q. IF QWEST'S MARKET SHARE SHOULD GO DOWN AFTER RECEIVING COMPETITIVE CLASSIFICATION WOULD THAT BE CAUSE FOR CONCERN?

A. First of all, I doubt that Qwest's market share would go down if the Commission granted Qwest's Petition. But even if it did go down, that would not necessarily mean that Qwest was harmed.

One of the benefits of competition is the stimulation that occurs as a result of rivalrous behavior. Not only do consumers see new and innovative services, better customer service and lower prices, but the market itself grows. In other words, one of the results of competition is growth in the "pie." This growth in

[25] See Horizontal Merger Guidelines at Section 1.51.
[26] HHI for 75 percent market share would be 5,625. HHI for 76 percent market share would be 5,776. The difference would be 151.

the market may actually mask Qwest's growth in revenues even in the face of a market share decrease.

Q. IS THE ELIMINATION OF RESALE AND UNE-P LINES FROM THE HHI CALCULATION CONSISTENT WITH THE MERGER GUIDELINES?

A. Yes. The Merger Guidelines would consider both resale and UNE-P providers to be "uncommitted entrants."[27] Only CLECs utilizing CLEC-owned or UNE-Loop lines should be considered "market participants."

Q. HAVE YOU DISCUSSED YOUR UNDERSTANDING OF THE MERGER GUIDELINES WITH THE DEPARTMENT OF JUSTICE?

A. Yes. I discussed the situation in Washington with a Department of Justice employee who deals with the application of the Merger Guidelines. He confirmed my understanding of how the guidelines would be applied in a "resale" situation. Pure resellers would not be considered market participants, or if they were included in the analysis, they would be given little "competitive significance."

VII. STAFF'S RELIANCE UPON OTHER FACTORS

Q. HOW DO YOU RESPOND TO MR. WILSON'S STATEMENT "IT IS WORTH NOTING THAT JUST NINE YEARS AGO, CLEC MARKET SHARES WERE ZERO IN EVERY EXCHANGE IN WASHINGTON."[28]?

A. The question that Staff should have asked in this proceeding is "Why is there only minimal market entry after nine years?" Moving from zero to 16 percent in nine years is hardly a success story. While the change in market share over time is one

[27] See Horizontal Merger Guidelines at Section 1.32.
[28] See Direct Testimony of Mr. Wilson at page 4.

indicator of competition, it is also a historical fact that sheds little light on what might occur in the future.

Q. STAFF ALSO POINTS OUT THAT QWEST HAS RECEIVED 271 APPROVAL IN WASHINGTON.[29] DOES 271 APPROVAL INDICATE THAT EFFECTIVE COMPETITION EXISTS?

A. No. All of the parties, including the Commission and its Staff, worked hard over the last few years helping Qwest to meet its obligations under the Act.[30] The industry and hopefully consumers will benefit from Qwest's efforts to eliminate barriers to competition. But 271 approval means only that Qwest has met the minimum requirements for opening its markets to competitors, not that CLECs are competing effectively in that market.

Q. MR. WILSON DESCRIBES OTHER FACTORS TO BE CONSIDERED IN THIS CASE OTHER THAN MARKET SHARE. PLEASE COMMENT.

A. Mr. Wilson discussed what he referred to as "the 11 prerequisites to effective local competition" that the Commission recognized in 1995. In my review of that order it appears that Staff identified these issues as "…issues to overcome before effective competition occurs in the local exchange."[31] The 11 issues are as follows:

1. central office interconnection arrangements
2. connections to unbundled network elements
3. seamless integration into local exchange company interoffice networks
4. seamless integration into local exchange company signaling networks
5. equal status in/control of network databases,

[29] See Direct Testimony of Mr. Wilson at page 5.

[30] By "help" I am suggesting that many parties were directly involved in evaluating Qwest's efforts in the 271 proceeding. Naturally Qwest deserves the credit for meeting the competitive checklist requirements and satisfying the many other legal and regulatory requirements.

[31] *In the Matter of the Petition of Electric Lightwave, Inc., for an Order Granting Competitive Telecommunications Company Classification*, Docket No. UT-940403, Order Granting Petition at 4 (January 11, 1995).

6. local number portability
7. reciprocal inter-carrier compensation arrangements
8. equal rights to/control over number resources,
9. cooperative practices and procedures
10. economically efficient pricing signals, and
11. intraLATA equal access.

It is clear that these were pertinent issues, but they were not specifically discussed or adopted by the Commission in its Order. The 11 items are not all unique to local competition and are more appropriately labeled as prerequisites to opening the market. The competitive checklist in the Telecommunications Act of 1996 ultimately subsumed these issues from the perspective of local competition.

Q. ARE THESE HISTORICAL REFERENCES HELPFUL TO THE CASE?

A. It is always helpful to understand history for purposes of putting facts and situations into perspective. I believe that may be why Mr. Wilson has provided this information. It is not particularly helpful, however, in analyzing the facts in this proceeding. In this proceeding we are evaluating the nature of competition today and in the near future. The statutory guidelines (RCW 80.36.330), and the data required to meet those requirements, should be the focus of this proceeding.

Q. MR. WILSON SPENDS CONSIDERABLE TIME DISCUSSING ALTERNATIVE TECHNOLOGIES THAT MAY PROVIDE COMPETITION IN THE FUTURE. IS THAT INFORMATION RESPONSIVE TO RCW 80.36.330?

A. No. As the Commission stated in the previous Qwest proceeding, "In our view, we must also have confidence that competitors *are* offering and *will* offer competitive services. This determination turns on the presence of competitors, their actual current availability to customers, and a judgment, from their current behavior and the current market structure, that they do, can, and will provide alternative service to end-users."[32] (emphasis in original)

Mr. Wilson's discussion of VoIP, Wi Fi, digital cable and other technologies is interesting, but he has not shown that those alternative technologies are substitutes for Qwest's basic business services today. For instance, nowhere in Staff's testimony does it address the cost of these offerings, or the upfront investment required for SIP[33] phones or fixed wireless antennae. There are many reasons why VoIP is not a good substitute for Qwest basic business services, but those issues were ignored. Even Qwest recognizes the problems with VoIP telephony today:

Voice Over Internet Protocol (VOIP)

What is it? VOIP is a new breed of phone service that operates over the Internet. The technology allows you to use your computer as a telephone or use the Internet to transmit your call over ordinary phone lines.

What's the big deal? VOIP bypasses AT&T, Sprint, and MCI for long-distance calling. That means you can place domestic calls that are either free or cost mere pennies a minute, and international rates are almost as low. VOIP is also a step toward the geek dream of "convergence," a technological nirvana in which Web, E-mail, phone, fax, radio, and TV come together in one device. That's big enough for Microsoft to promise phone features in its next operating system.

What can I use it for? You can cut your phone bill substantially, especially if you have branch offices, multiple call centers, or overseas customers. Flexibility is another plus. Instead of calling the phone company to order special features, you can reconfigure your phone service as often as you like over the Web -- for example, screening out a persistent bill collector or forwarding only your best customer's call to your cell phone.

What'll it cost me? Pricing is volatile, variable, and not regulated by the Federal Communications Commission. You can download Net2Phone's

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[32] See paragraph 66 of the *Commission's 2000 Order*.

[33] SIP stands for Session Initialization Protocol. Cisco SIP phones cost at least $200 and most cost much more. There is also the added expense and technical issues associated with routers, compatibility issues, the sunk cost of the existing system, etc.

> software at no charge, with free calls and rates of less than 5¢ a minute for many international calls. If you plan to use VOIP to replace your office phones, for instance, Voicenet Communications, in Philadelphia, starts with a $160 hardware fee plus a $19.95-per-line activation fee and a $9.95 basic monthly fee for each line.
>
> **Is it soup yet?** Not if you expect to dial 911 on your telephone and actually get someone. Most VOIPs have yet to link up with emergency call centers. Sound quality ranges from very good to barely audible. Billions of dollars are being spent on better infrastructure. Plan to keep a regular phone line as a backup in case your provider folds or the electricity goes out.
>
> **Should I care?** If not now, soon. VOIP cuts costs, and flexible features can make small companies sound bigger than they are. VOIP also promises to reduce the expense and bother of administering a traditional phone system -- unless you like waiting for the phone company to install new lines every time you reorganize your staff.
>
> **--Jane Salodof MacNeil** [34]

There are other obvious problems with VoIP that prevent its use as a substitute for Qwest's basic local exchange service in most situations. For instance, if the power goes out you have no phone service, unlike regular phones that are powered from the central office. As noted above, 911 services will not work with VoIP and the quality is poor. See for example the discussion of VoIP quality issues in the attached research report from Dr. Hall, a researcher with a non-regulatory federal agency.[35]

Mr. Wilson's discussion of other technologies such as Wi Fi and other digital access services suffer from the same flaw – no evidence in the record as to why these should be considered as substitutes. More importantly, there is no

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[34] See Link to Qwest.net -- Business Content -- VoIP

[35] It is not my intent to discuss VoIP in great detail in this proceeding. There are many different forms of VoIP and to discuss each variant would be time consuming and unnecessary for this proceeding. Nevertheless, it is clear that VoIP as a service delivery vehicle is still evolving and requires additional investment by the business customer.

evidence in the record as to whether or to what extent such services are being used in Qwest exchanges.

Q. DID YOU VISIT ANY OF THE WEBSITES THAT MR. WILSON INCLUDED IN HIS TESTIMONY?

A. Yes. A quick visit to those websites will show why these new offerings are not good substitutes for Qwest's basic local exchange service. Let me provide a few examples. Accima provides fixed wireless and other DSL services. For High Speed Symmetric DSL, Accima charges an $800 installation fee plus $35 per month in addition to the telco charges. The wireless DSL requires a $50 setup fee, $15 per month for rental of the equipment and $40 per month for Internet. The installation fee is waived if you purchase the equipment ($200 for antenna, 30 feet of LMR 400 coaxial cable, and a high speed wireless data radio) and install the antenna, cable and radio yourself. As with other wireless data services, the service is also probably distance limited and effectively unavailable to anyone without line-of-sight to the company's facilities. In addition, it is my understanding that often these wireless systems operate on unlicensed frequencies shared with other devices, such as garage door openers and cordless telephones. This makes them potentially subject to intermittent interference and interruption. Perhaps that is the reason that the following clause appears in the Accima contract which is on the company's website:

> Company reserves the right to establish and enforce usage limits limiting the speed of uploads and downloads of any kind and in all protocols, including without limitation, file downloads (FTP's), Web browsing, etc., from time to time, for all wireless, DSL or other system accounts.

In addition, there may be significant customer security concerns due to the danger of interception, which may make these services unattractive to businesses with needs or requirements for high data security. Perhaps significantly, there is no discussion of data security on Accima's website.

I called PocketiNet and discussed their service offerings. They do not provide any telephony services. High Speed.com is another Internet service provider identified by Mr. Wilson. In fact, Mr. Wilson states, "At least one of the providers listed above, High Speed.Com, is also registered as a telecommunications company, with lines reported and accounted for in the market share analyses I have referenced." When I called High Speed, I was told that they provided no telephone services, and had no plans to do so. Given this information it is curious that Staff has included High Speed lines in its market share analysis.

Q. WHAT DO YOU CONCLUDE FROM YOUR REVIEW OF STAFF'S DISCUSSION OF VOIP, WI FI, DIGITAL CABLE AND OTHER DIGITAL ACCESS OFFERINGS?

A. Mr. Wilson has provided an interesting review of these technologies. Unfortunately it is clear that the vast majority of these technologies do not yet provide readily available, functionally equivalent or substitute services at competitive rates, terms and conditions.

Q. WAS IT A USEFUL EXERCISE TO REVIEW THESE POTENTIAL TECHNOLOGIES?

A. I am sure that commissions and their staffs must stay abreast of new technologies and offerings. It is important to understand convergence in the industry and where the Commission may need to intervene in the future. For this case, however, the Staff's time would have been better spent investigating how Qwest might behave if it receives the competitive classification requested in this proceeding.

Q. PLEASE EXPLAIN.

A. No-where in Staff's testimony does it address how Qwest may behave once it receives a competitive classification. This seems to be a much more useful exercise than speculating on technological convergence. After all, Qwest is the dominant provider and the incumbent monopolist. The Merger Guidelines are used to estimate the impact of a merger by calculating a post-merger HHI. The Staff did not calculate a post-competitive classification HHI. As I showed above, even a one percent increase in Qwest's post-competitive classification market share will result in an unacceptable increase in market concentration. The Department of Justice finds such an increase will likely create or enhance market power or facilitate its exercise. The Commission should not abrogate its responsibility to protect and advance the public interest by ignoring the danger signs associated with Qwest's market dominance.

VIII. PROPOSED GUIDELINES FOR ANALYZING MARKET INFORMATION

Q. YOU HAVE STATED THAT EXISTING MARKET SHARES ARE INSUFFICIENT TO MEET THE REQUIREMENTS OF RCW 80.36.330. WHAT GUIDELINES DO YOU PROPOSE TO HELP THE COMMISSION DETERMINE THE EXISTENCE OF EFFECTIVE COMPETITION UNDER THOSE GUIDELINES?

A. Consistent with and in addition to the RCW 80.36.330 guidelines, I propose the following parameters to help the Commission determine when effective competition exists for a particular service:

- The presence of at least three CLECs providing services, one of which must be providing services from its own switch; (Standard to apply to each exchange, statewide)
- Facilities-based (owned loop and/or UNE-Loop) CLEC market share of at least 30 percent; (Standard to apply in at least 50% of exchanges statewide)
- At least one CLEC with a facilities-based market share of at least 10 percent; (Standard to apply in at least 50% of exchanges statewide)
- Total CLEC market share (resale and facilities-based) of at least 45 percent. (Statewide average)

These parameters should help the Commission in determining whether competition is sufficient to prevent Qwest from exercising its market power on a statewide basis.

Q. ARE YOU SUGGESTING THAT ANY ONE OF THE ABOVE PARAMETERS WOULD BE SUFFICIENT FOR A FINDING OF EFFECTIVE COMPETITION?

A. No. This is a four-prong test and all four of the requirements must be met. It should also be noted that this test assumes the continued availability of UNE-Loops.[36]

Q. WHY SHOULDN'T THE COMMISSION APPLY THESE STANDARDS ON AN EXCHANGE-BY-EXCHANGE BASIS?

A. RCW 80.36.330 refers to classification of "services" and does not discuss classification on an exchange-by-exchange basis. Nevertheless, in the previous case the Commission did grant competitive classification in four of the nine exchanges for which Qwest sought such classification.[37] To date, CLECs have entered in the most promising markets, where they can have access to the largest number of customers and hopefully gain some market share and profits that would allow them to expand and ultimately build out their own network. If Qwest is deregulated in those areas, where nascent competition is developing, its market dominance will crush the CLEC entry and the development of competition will end. Not only would this stop the development of competition in the urban parts of the state, but it would prevent expansion of competition to the more rural parts of the state. It is for this reason that most commissions have chosen to avoid piece-meal deregulation.

Q. HOW DO YOU PROPOSE THAT THE COMMISSION APPLY THESE PARAMETERS IN THE FUTURE?

A. I recommend that the Commission request this information – very similar to the information that Staff gathered for this case – on an annual basis. The Staff

[36] Any industry action that changes the availability or quality of UNEs will have negative consequences for CLECs. This proposal assumes that current and future standards will prevent backsliding on Qwest provisioning issues, e.g., performance of batch hot cuts, reasonable collocation rates.

[37] See *Commission's 2000 Order* at page 1.

would accumulate and distribute the data to the parties. If the data show that Qwest has met these standards, then Qwest should receive competitive classification on a statewide basis.

IX. TRIENNIAL REVIEW ORDER

Q. MR. WILSON SEEMS TO DOWNPLAY THE IMPORTANCE OF THE FCC'S TRIENNIAL REVIEW ORDER (TRO) BECAUSE "UNE-P BASED COMPETITION REPRESENTS ONLY ABOUT A QUARTER OF THE CLEC LOOPS IN THE RELEVANT MARKET."[38] PLEASE COMMENT.

A. First of all, any action that would impact 25 percent of the CLEC market is significant, especially when the CLEC market share is so minimal. Now that the TRO has been released, the significance of that Order is even more obvious.

The FCC has identified two markets – the enterprise market and the mass market – and is treating unbundled switching differently in each.[39] The difference between UNE-P and UNE-Loop is of course the switching UNE. For the enterprise market customers, the FCC has concluded that CLECs are not impaired without access to unbundled switching, however, the state commissions may petition the FCC within 90 days for a waiver of this finding.[40] For mass market customers, the FCC adopted a national finding that CLECs are impaired without access to unbundled switching, subject to state commission findings.[41] The FCC adopted a complicated multipart test that states must apply in determining

[38] Before the Federal Communications Commission; **REPORT AND ORDER AND ORDER ON REMAND AND FURTHER NOTICE OF PROPOSED RULEMAKING;** CC Docket Nos. 01-338, 96-98, and 98-147; Released August 21, 2003. Hereinafter referred to as the "TRO."
[39] Enterprise market customers are those that could be economically served by a DS1 loop, even if they presently are being served by DS0 loops. Mass market customers are those that could not be economically served by a DS1 loop.
[40] See TRO at paragraph 451.

whether to remove UNE switching for the mass market. The states are given some discretion to define the precise line between the enterprise and mass markets and to define the geographic market for application of the FCC's impairment tests.

Q. BASED ON YOUR BRIEF LAY REVIEW OF THE TRO, DO YOU STILL MAINTAIN THAT THE COMMISSION SHOULD NOT GRANT QWEST'S PETITION UNTIL THE COMMISSION UNDERSTANDS THE IMPACT OF THE TRO ON UNE-BASED SERVICES?

A. Yes. While we do not know the exact impact of the TRO, it is clear that it will dramatically impact the CLECs' use and perhaps cost of UNEs in the future. It would not be prudent to make decisions based on the current availability of UNEs.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

[41] See TRO at paragraph 459.