Exhibit No. ___-T (TLW-9T)
Docket No. UT-061625
Witness: Tom Wilson

BEFORE THE WASHINGTON UTILITIES AND 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**

REPLY TESTIMONY OF

Thomas L. Wilson, Jr.

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

February 16, 2007

Q. Please state your name and business address.

A. I am Thomas L. Wilson, Jr. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504.

Q. Have you prepared testimony previously in this docket?

A. Yes, I submitted testimony and exhibits (Exhibit Nos. ___ TC (TLW-1TC) to ___ C (TLW-8C)) in this docket on January 29, 2007.

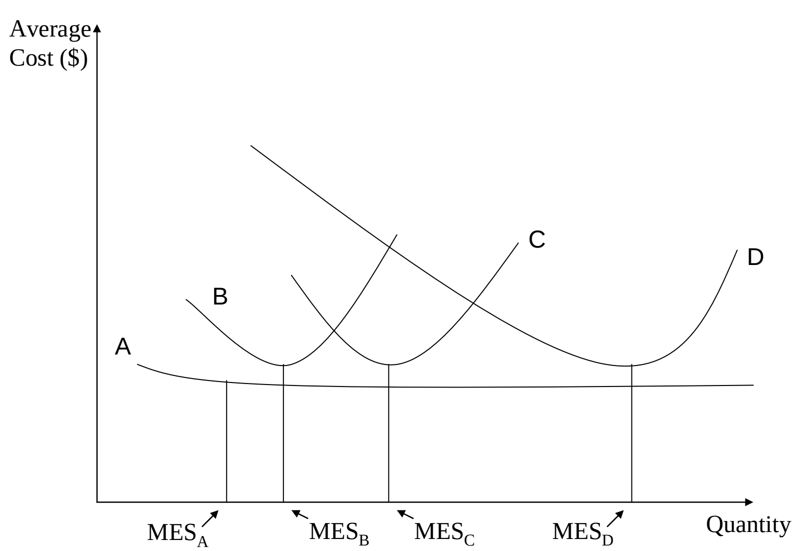
Q. Public Counsel's witness, Dr. Robert Loube, testifies that the Qwest proposal is anti-competitive because it increases rates in non-competitive markets. Would you expect a company facing "real competition" to need to raise rates to meet competition? Should customers expect to see lower prices as a benefit of competition, not rate increases?

A. I understand the concern, but I believe it is over-stated. Reference to microeconomic theory about the behavior of the firm, with specific attention to industrial organization theory provides a useful model for understanding the issue. Without dwelling upon all of the details of a full-blown academic discussion, I believe that the model and theory will provide an analytical construct when taken together with what I have already written in my direct testimony on related economic issues.

In economic theory, perfect competition is a condition that exists when price is equal to marginal cost, there are many buyers, many sellers, and there is perfect information about price. For purposes of this discussion, a simple set of analytical models may be useful for the discussion.

In a test-tube world, I would expect more competition to lead to lower prices and better service. However, in the actual world in which Qwest is operating, it is not necessarily surprising that the company seeks the flexibility for modest rate increases. First of all, it is important to note that while Qwest is seeking the flexibility to increase standalone residential local exchange rates, Qwest will only be able to raise prices and sustain market share subject to market conditions, and Qwest faces variable market conditions throughout its territory. In some areas of the state, Qwest may have more or less market power than in others. The following diagram from basic economics provides insight for discussion purposes:

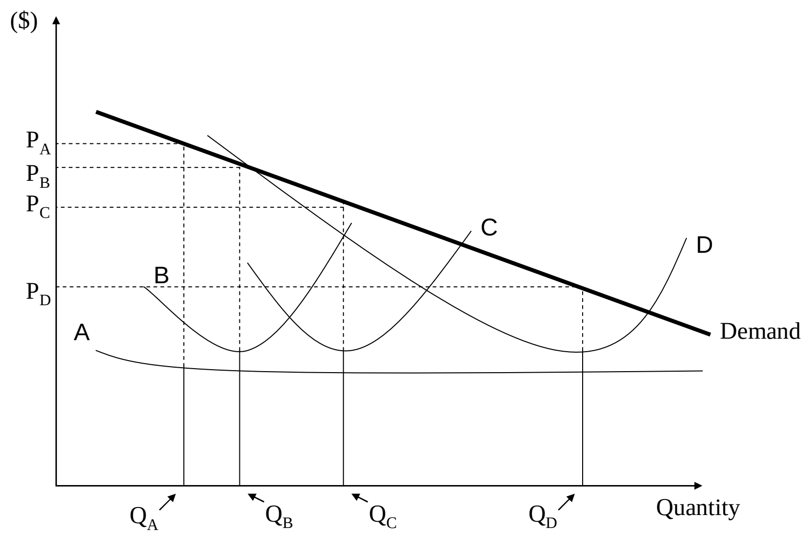
FIGURE 1



As I discussed in my direct testimony, the economics of the telecommunications industry are characterized by economies of scale. In Figure 1, the average cost curves for four companies, A, B, C and D, are shown. Each firm can be assumed to be attempting to operate where it can realize maximum economy of scale, illustrated by the point where the company's production function is on the lowest point of the average cost curve, or at minimum efficient scale (MES).

Assuming that the quantity output for each firm is equal to each firm's respective MES, and superimposing a hypothetical Demand curve upon the analysis, allows us to derive hypothetical prices for A, B, C, and D, as shown in Figure 2.

FIGURE 2



As illustrated in Figure 2, different firms with different economies of scale in their production function can yield different prices in our hypothetical market. Firm A would have price P_A, and Firm B would have price P_B, and so on. I am not asserting that the cost relationships in the hypothetical are real, and for purposes of the discussion, one could make different assumptions and still get to the same conclusion. If one assumed that Firm A is a CLEC, Firm B is a wireless company, Firm C is a cable provider, and Firm D is Qwest, then the diagram shows how it could be that, theoretically, Qwest might be able to raise prices even though there is competition for the service.

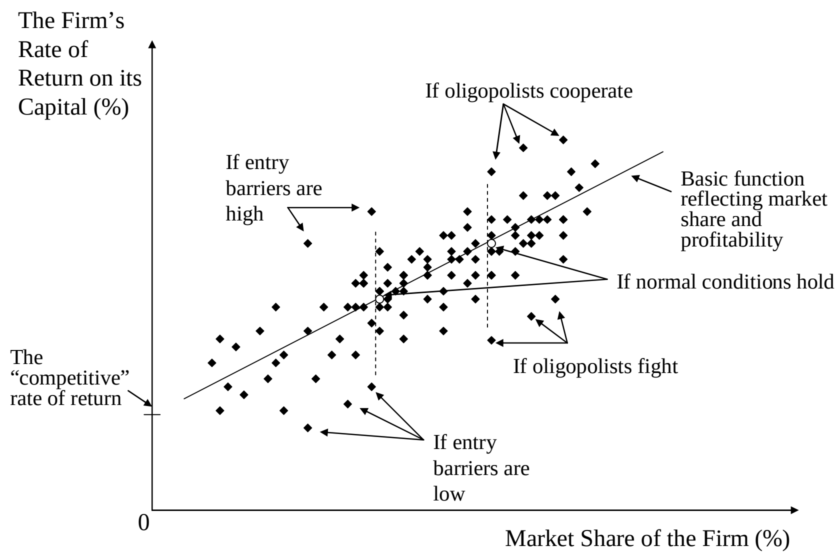
Q. Public Counsel also raises the concern that effective competition does not exist in the residential primary-line market and that the lack of effective competition would allow Qwest to exert monopoly power in that market. Please respond.

A. Given that I have shown in my direct testimony significant evidence of the extent of Qwest line losses in all rural and urban markets, including the market for residential local exchange services, I find it hard to believe that some level of competition does not exist in the residential primary line market. Be that as it may, the real question is whether Qwest can, in fact, exert monopoly power in that market.

The AFOR proposal specifically addresses the issue, at least in part, by imposing the condition that Qwest must maintain statewide average prices, terms and conditions for standalone residential service (as well as related universal service support programs) in the tariff, subject to a proposed pricing plan that is based on Staff's service quality incentive proposal. Furthermore, it is my opinion that Qwest will remain subject to substantial market-based discipline over its pricing behavior by intermodal and wireline competitors in many of its most important markets. The AFOR plan recommended by Staff helps maintain the effects of competitive discipline by requiring that Qwest not petition the FCC for additional relief from its unbundling obligations, thus ensuring that competitors will have access to monopoly bottleneck access network elements they need to be able to compete effectively.

Fundamental economic theory tells us that between pure competition and pure monopoly there are gradients, combining elements of market structure too many to count. Market power varies with market share, and so intermediate market shares cause gradients of intermediate monopoly effects.[1] Figure 3 is a diagram that shows the relationship between market share and profits, subject to the *caveat* that variations around this central tendency will occur.

FIGURE 3



Interactions between competitors may push the outcome up or down. There may or may not be collusion, and the effect of entry barriers can be significant. With this in mind, Dr. Loube may be overstating his case against Qwest market power and his concerns about possible pricing behavior somewhat.

[1] For this portion of the discussion, I am relying on the same text I used in my direct testimony, The Economics of Industrial Organization, Second Edition, by William G. Shepherd, 1979 by Prentice Hall. Please refer to the discussion on pages 40 to 43.

Q. Please discuss your concerns about Dr. Loube's analysis of market power.

A. Dr. Loube provides an estimate of the Herfindahl-Hirschman Index (HHI) in a static analysis of what it might be at a given point in time. My concern is that a static estimate of market concentration does not provide a definitive analysis of Qwest's market power or lack thereof. It is important to consider the effect of market share trends over time as well. As Dr. Loube refers to the HHI for his analysis, in the sense that estimates of market concentration are used by the U. S. Department of Justice, I first would like to make it clear that I have no concern about using HHI market concentration statistics for the purpose of analyzing market concentration. However, I think it should also be clear that reference to antitrust law in his analysis of Qwest's AFOR proposal is specifically to the U. S. Department of Justice Horizontal Merger Guidelines. Since Qwest's proposal is for AFOR, not horizontal merger, the use of the HHI has limitations.

The HHI analysis set forth by Dr. Loube should only be taken as one among many considerations in studying market power for regulated Qwest services in Washington. As I will explain, while estimates of market concentration are certainly part of a thorough analysis of market power, trends in market share, ease of entry and industrial organization generally should likewise be taken into account. Furthermore, inferences about market power are only one aspect of the statutory considerations the commission must take into account in reviewing Qwest's AFOR proposal.

According to the U.S. Department of Justice's Horizontal Merger Guidelines, market concentration is a function of the number of firms in a market and their respective market shares. The HHI is a measure of market concentration. The HHI is calculated by summing the squares of the individual market shares of all the participants. The HHI ranges from 10,000 (in the case of a pure monopoly) to a number approaching zero (in the case of an atomistic market). For example, a market consisting of four firms with market shares of 30 percent, 30 percent, 20 percent, and 20 percent has an HHI of 2600 (302 + 302 + 202 + 202 = 2600).

The Guidelines indicate at Footnote 17 that it is important to include all firms in the calculation, and also makes an aside that lack of information about small firms is not critical because such firms do not affect the HHI significantly.

According to the U.S. Department of Justice's Horizontal Merger Guidelines, Section 1.51, market concentration is a useful indicator of the likely potential competitive effect of a merger. Quoting almost directly from the Guidelines, the general standards for horizontal mergers are as follows:

a. Post-Merger HHI Below 1000. Markets in this region to be are regarded as 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. Markets in this region are seen as 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 can carry significant competitive concerns, depending upon additional factors such as potentially adverse competitive effects, market entry conditions, internal efficiencies, failing firm, and exiting assets conditions;

c. Post-Merger HHI Above 1800. Markets in this region are 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 upon additional factors such as potentially adverse competitive effects, market entry conditions, internal efficiencies, failing firm, and exiting assets conditions. 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 such as potentially adverse competitive effects, market entry conditions, internal efficiencies, failing firm, and exiting assets conditions make it unlikely that the merger will create or enhance market power or facilitate its exercise, in light of market concentration and market shares.

The U. S. Department of Justice and the Federal Trade Commission have documented that they have often allowed mergers involving market shares and concentration that fall outside the zones set forth in the Guidelines.[2]

As I have illustrated in several ways in my testimony, Qwest's position in the market, and the concentration of that market has been changing drastically since at least the beginning of this century. A static analysis of market concentration fails to take into account important dynamic changes in trends such as the steady decrease in market concentration that has been taking place.

Q. Does this conclude your testimony?

A. Yes.

[2] "This does not mean that the zones are not meaningful, but rather that market shares and concentration are but a "starting point" for the analysis, and that many mergers falling outside these three zones nevertheless, upon full consideration of the factual and economic evidence, are found unlikely substantially to lessen competition. Application of the Guidelines as an integrated whole to case-specific facts – not undue emphasis on market share and concentration statistics--determines whether the Agency will challenge a particular merger. As discussed in section 1.521 of the Guidelines, historical market shares may not reflect a firm's future competitive significance." (*See* U.S. Department of Justice and Federal Trade Commission's March 2006 Commentary on the Horizontal Merger Guidelines.)