BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

AT&T COMMUNICATIONS OF THE VERIZON NORTHWEST, INC.,	)	**DOCKET NO. UT-020406**
Complainant,	)	**WorldCom's Initial Post Hearing Brief**
v.	)	
NORTHWEST, INC.,	)	
Respondent.	)	

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I. INTRODUCTION

While this action was brought against Verizon Northwest, Inc. ("Verizon") by AT&T Communications of the Northwest, Inc. ("AT&T"), Verizon's above cost intrastate access rates are of concern to all competitive toll providers that provide services in Verizon territory in Washington, including WorldCom, Inc. and its regulated subsidiaries (collectively "WorldCom").

Switched access is an essential input into the provision of toll services. Switched access provides the crucial connection between long distance providers and their end user customers. Verizon (like other incumbent local exchange carriers ("ILECs")) has monopoly control over switched access given its ubiquitous local exchange network with links to virtually all end users in its service territory. To date, no meaningful competition for switched access services has emerged. Accordingly, toll providers, including WorldCom, are completely dependent on Verizon for the provision of this necessary service in order to furnish long distance service to their retail customers.

As the monopoly provider of switched access service, Verizon has both the incentive and ability to substantially affect competition in that market. Maintaining Verizon's access

charges at the current high levels allows Verizon and its affiliates to engage in anticompetitive price squeezes and accrue unreasonable, excessive monopoly profits. Regulatory safeguards, such as imputation, intended to prevent pricing abuses, do little to restrain Verizon from exploiting the significant, anticompetitive advantage it achieves by selling access service at prices set significantly above cost.

To overcome these potential problems, it is essential that Verizon be compelled to reduce its access charges to economic cost. Lowering intrastate switched access charges to economic cost will provide several important competitive and pro-consumer benefits. First, competition in the interexchange market will be enhanced. Second, consumers will experience lower long distance rates as competition drives rates toward cost. Third, once interexchange carriers are no longer forced to subsidize Verizon by paying inflated access charges, they can better channel their resources. Thus, reducing access charges will encourage efficient investment and innovation. Fourth, the efficient development of local competition will be enhanced since Verizon may be using the subsidies generated by inflated access charges to engage in strategic pricing to deter local facilities-based competition.

WorldCom joins in AT&T's Complaint and requests that the Commission order Verizon to reduce its intrastate access rates to forward looking economic cost for the reasons set forth in the testimony of AT&T witness, Lee Selwyn.

II. DISCUSSION

A. What Should Verizon's Access Charges Be, and Why?

1. Access Should Be Set at Economic Cost

WorldCom agrees with AT&T's argument that Verizon's access rates should be set at forward looking economic cost, including a reasonable allocation of forward-looking joint and

common costs and a competitive return on investment.[1] It has long been recognized that access charges were set at rates in excess of their cost to keep other rates low. In the Federal Communications Commission's ("FCC's") First Report and Order in CC Docket 96-45, the FCC states:

> States have maintained low residential basic service rates through, among other things, a combination of geographic rate averaging, high rates for business customers, high intrastate access rates, high rates for intrastate toll service and high rates for vertical features and services such as call waiting and call forwarding.[2]

Dr. Selwyn calculated Verizon's tariffed intrastate access rates to be $.0614 per originating minute and $.0315 per terminating minute. These prices include all common line, local switching, tandem switched transport, information surcharge, universal service and residual charges as they apply to interexchange carriers.[3] While the Commission has somewhat reduced the rates of incumbent local exchange carriers in the last few years, intrastate access rates, particularly Verizon's, are still far in excess of cost. Dr. Selwyn estimated Verizon's cost to provide switched access to be $.0030263 per minute at each end of the call.[4] Thus, Verizon's originating rate is more than 20 times its cost and the terminating rate is more than 10 times its cost.

The need to reduce access to cost and to remove implicit subsidies is required by the Telecommunications Act and in the FCC orders implementing the Act.[5] The Commission last lowered Verizon's intrastate access charges in the Bell Atlantic/GTE Merger docket. Since then, developments in the telecommunications marketplace, regulation and technology have

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[1] Exhibit T-1 at p. 9.

[2] Report And Order, *In the Matter of Federal State Joint Board on Universal Service,* CC Docket No. 96-45 (May 8, 1997) at ¶ 14.

[3] Exhibit T-1 at p. 7. Dr. Blackmon testified that Verizon charges 5.7 cents per minute for originating access service. Exhibit T-130 at p.4.

[4] Exhibit T-1 at pp. 11-12.

[5] 47 U. S. C. Section 254(e); *Comsat Corp. v. FCC*, 250 F.3d 931 (5th Cir. 2001).

caused the costs of providing switched access to drop substantially.[6] During the past several years, the FCC has taken steps in recognition of these cost changes and ordered substantial reductions in access charges within its jurisdiction.

For example, the national average of per-minute interstate access charges dropped 72 percent (from 6.9 cents per minute to 1.9 cents per minute) between January 1995 and July 2000.[7] The aggregate dollar amount of access charge reductions ordered by the FCC has also been impressive. The FCC's 1997 access reform order produced a $1.7 billion reduction in interstate access charges on July 1, 1997.[8] These were followed by additional reductions in interstate access charges of approximately one billion dollars per year over the next two years. Then in 2000, the FCC ordered the largest decrease ever -- $3.8 billion -- in interstate access charges.[9]

It is important to recognize that switched access is essentially a combination of three basic unbundled network elements -- local switching, transport and tandem switching. There are no significant differences in the costs of a local phone carrier's end user switching and connectivity functions whether they are undertaken for purposes of providing switched access services to interstate long distance providers, intrastate long distance providers or local call originations and terminations for local intercarrier hand-offs.[10]

All parties to this proceeding agree on the need to restructure access charges, but differ significantly on how to accomplish that important task.[11] Taking the necessary steps to eliminate

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[6] Exhibit T-105 at 2; Exhibit T-3R at 1-2 and 7.

[7] Statistics of the Long Distance Telecommunications Industry, Industry Analysis Division, Common Carrier Bureau, FCC, January 2001, Table 12.

[8] First Report and Order, FCC 97-158, CC Docket Nos. 96-262, 94-1, 91-213, and 95-72 (May 7, 1997).

[9] Report and Order, CC Docket Nos. 96-262, 94-1, 99-249 and 96-45 ("CALLS" decision) (May 31, 2000).

[10] Exhibit T-1 at pp. 10-12; First Report and Order at para. 1033.

[11] *See* Exhibit T-1 at p. 9; Exhibit T-130 at p. 3 and Exhibit T-262 at p. 31.

or restructure subsidies is a complex undertaking, but must be commenced. The FCC faced the same dilemma in its access reform effort. The FCC stated:

> As we devise a transition to a more economically rational approach to access charges and universal service, we need to balance various and sometimes conflicting interests – including promotion of competition, deregulation, maintaining affordability for all, and avoiding rate shock to consumers. It is important, however, that the Commission not permit itself to be grid locked into inactivity by endeavoring to find precise solutions to each component of this complex set of problems. It is preferable and more reasonable to take several steps in the right direction, even if incomplete, than to remain frozen with indecision because a perfect, ultimate solution remains outside our grasp.[12]

The FCC's reasoning supports its layered or step-down approach to reducing access charges to cost.

The Washington Commission has also taken a measured approach to access charge reduction.[13] The time is now, however, to take the final step. The benefits of cost-based access charges far outweigh the cost of making this adjustment now. The FCC recognized the benefits of reducing access charges. Those benefits include reducing competitive advantages currently enjoyed by the ILECs by virtue of the implicit subsidies. Specifically, the FCC stated:

> … the reduction in switched access usage charges will promote competition in the long-distance market between BOC affiliates entering this market and IXCs. To the extent switched access usage charges paid by IXCs are significantly above cost, BOC affiliates would have a competitive advantage because they would obtain switching services from the BOCs at cost. By driving switched access usage charges closer to their actual costs more quickly than would occur under the existing price cap regime, the CALLS Proposal will minimize the competitive advantages BOC

[12] *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Users, Federal-State Joint Board on Universal Service*, CC Docket No. 96-262, *Sixth Report and Order* in CC Docket No. 96-262 and 94-1, *Report and Order* in CC Docket No. 99-249, *Eleventh Report and Order* in CC Docket No. 96-45, FCC 00-193 (rel. May 31, 2000) at ¶ 27. ("CALLS Order")

[13] *In the Matter of the Application of GTE Corp. and Bell Atlantic Corp.*, WUTC Docket Nos. 981367, 990672 and 991164, Fourth Supplemental Order (December 16, 1999); General Order No. R-450, WUTC Docket No. 970325 (Sept. 23, 1998)

> affiliates would have over IXCs in offering long-distance services while switched access rates were significantly above cost.[14]

Likewise, reducing intrastate access rates to their economic cost will promote competition in Washington's intrastate long distance market as it will eliminate the competitive advantages Verizon and its long distance affiliate maintain over IXCs in offering long distance services while access rates are significantly above cost.

2. Failing to Reduce Access to Cost Permits a Price Squeeze

Allowing access prices to be set above cost permits Verizon to engage in a price squeeze. A price squeeze is a situation where a vertically integrated firm competes against companies in retail markets while controlling prices in wholesale markets for critical inputs or other essential functions that its competitors are dependent upon. In this situation, the vertically integrated firm can use the price squeeze as an anticompetitive device by raising the prices for the wholesale inputs or essential functions thus squeezing the dependent competitors' margins between retail rates and wholesale rates, reducing their ability to recover their costs.[15] Dr. Selwyn presents an example of a price squeeze in his testimony.[16]

By choosing to minimize its margin on the non-access portion of its retail interexchange services, Verizon can set its interexchange rates at or near its access rates, and indeed has an economic incentive to do so. In doing so, Verizon is able to impose a price squeeze on competitive providers of intrastate interexchange service. Verizon retains this unfair financial advantage even if it provides long distance service through an affiliate. Verizon may be required to "charge" its affiliate the same access rates paid by its nonaffiliated competitors, but this is nothing more than moving the money from one corporate pocket to the other. Verizon's economic cost of providing access remains low; the inter-corporate transfer of funds from the

[14] *Id* at ¶ 158.
[15] See Exhibit T-1 at p. 26.
[16] Exhibit T-1 at pp. 25-26.

affiliate to Verizon involves no real expenditure of cash, so the actual "cost" to the overall corporation continues to be only the economic cost of furnishing access.[17]

To the extent that access charges are priced above cost, Verizon can literally squeeze competitors out of the intrastate interexchange market by lowering its retail interexchange rates towards its access charge rates. The closer the retail interexchange rate is to the access rate, the harder it becomes for other carriers to provide a competitive alternative to Verizon's interexchange service. The proximity of retail interexchange and wholesale access rates does not negatively impact Verizon (or its affiliate), because its own economic cost of using its own access service is much lower than the rate it charges others for that same service.[18]

Moreover, by setting access charges well in excess of cost, Verizon obtains the ability to earn a sizable profit on its retail interexchange services even when its IXC rivals, which may be charging exactly the same retail price, could be forced to operate at a loss or at no profit.

Verizon argues that it has no incentive to discriminate against interexchange carriers when access is priced above cost because it would lose access profits as a result. This "opportunity cost" argument fails to recognize many situations in which taking interexchange business from long distance companies would be profitable. For example, Verizon could offer volume discounts that competing IXCs could not profitably match. Since Verizon's private marginal cost of access is less than its competitor IXCs' marginal cost of access, Verizon could afford to stimulate minutes through pricing plans with deep discounts. Verizon would make a profit on the stimulated minutes while competing interexchange carriers would lose money because of the much higher access charges they pay. In this case, Verizon could succeed in the long distance business even if it were less efficient than competing carriers. Lowering access

[17] Exhibit T-1 at pp. 18-25. Dr. Selwyn addresses this issue in his "double marginalization" discussion.
[18] Id. And Exhibit T-1 at pp. 25-28.

charges will ensure that all competitors can offer consumers pricing plans that reflect the low economic cost of access.

If Verizon were required to lower access charges to cost, this would eliminate the incentives and the ability of Verizon to impose a price squeeze. With access charges reduced to economic cost, a price squeeze would become a money-losing strategy for Verizon. And with access charges reduced to economic cost, competitors will experience the same costs of access as Verizon, and consumers will enjoy significant savings.

Even if Verizon decided not to use a price squeeze to force competitors out of the market, above-cost access charges still harm competition. When Verizon charges access rates are set above their economic cost, Verizon reaps all the above-cost gains in the business; both from its own sale of long distance service, and from the monopoly profit that is included in the access charges that interexchange carriers have to pay. Consumers, of course, pay a higher price than they should, competing IXCs make only a normal profit, and the LEC makes the monopoly profits described above.

In sum, the Commission should reduce Verizon's access rates to their economic cost. To maintain access rates at levels above their economic cost would harm the competitive toll market and maintain artificially inflated intrastate toll rates for consumers here in Washington.

B. Imputation Issues

Imputation is often touted as a mechanism to avoid the price squeeze issue. However, imputation does not result in lower prices to consumers, the primary intended beneficiary of competition. An imputation requirement does not cause a reduction of high access charges, nor does it prevent Verizon from earning excessive returns and inflicting economic losses on the consumers of Washington. Moreover, imputation does not eliminate the ability of Verizon to use

its continuing market power in an anticompetitive fashion if access rates remain priced significantly above economic cost.[19]

Imputation is merely a pricing requirement. Theoretically, imputation generally requires a LEC to include in its own retail rate the price it charges other carriers for the same service or capability.[20] But the imputation rule does not change the fact that the real costs of access for Verizon-provided interexchange services remain much lower than the real cost incurred by competing interexchange carriers for the same access services. It is this fact that creates a discriminatory situation. Competing interexchange carriers have no market from which they can recover efficient mark-ups for shared and common costs. Moreover, given the complexity of toll tariffs and the minimal amount of regulatory scrutiny afforded them, imputation requirements are difficult to enforce.

The high profit margin contained in switched access also would allow Verizon to engage in strategic pricing against rivals in both the local and interexchange markets. Bundled service plans or quantity discounts can be used to discriminate against equally or even more efficient potential competitors in either market.[21]

C. Do Verizon's Access Charges Violate State Or Federal Law As Alleged In AT&T's Complaint?

Verizon's access charges violate state and federal law. For the reasons stated above, Verizon's access charges are not fair, just or reasonable as required by RCW 80.36.140. Verizon maintains an inappropriate competitive advantage by charging above cost rates. It maintains the ability to impose a price squeeze on its competitors and produce a revenue stream not available

[19] Exhibit T-1 at pp.49-52.
[20] Exhibit T-1 at p. 28.
[21] Exhibit T-1 at 48.

to competing toll providers. In addition, because Verizon's current access charges contain implicit subsidies, they violate Section 254(e) of the Act.[22]

D. Earnings Issues

Access charges above economic cost could not be sustained in the competitive environment that the Congress and this Commission are endeavoring to create. Any revenues that will be "lost" as a result of moving prices to economic cost simply represent the difference in revenues recoverable in a competitive versus a monopoly market. Access priced at economic cost still will be sufficient to recover all economic costs, including a competitive level of profit and a reasonable portion of shared and common costs. Moreover, "lost" revenues will be countered by market growth fostered by competitive markets. Immediate access charge reform provides immediate consumer benefits by accelerating price reductions. Consumers should not be required to suffer because Verizon is not prepared for access reform. At the same time, Verizon should not continue to be rewarded with undeserved, windfall excess profits generated through its excessive access charge revenues.

F. How Should an Access Charge Reduction Be Implemented, if the Commission Decides that Such a Reduction is Appropriate?

WorldCom agrees with Dr. Selwyn's recommendation that the Commission lower Verizon's switched access rates to cost-based levels or, as an interim measure, to interstate levels, so that Verizon unequivocally satisfies imputation and the price squeeze on competitive toll providers is eliminated.[23]

If Verizon deems it necessary to raise other rates as a result of the reduction in switched access rates, Verizon may file a petition with the Commission, asking that it be permitted to raise its rates. That inquiry should take place in a separate proceeding. As suggested by Commission

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[22] *Comsat v. FCC, supra.*
[23] Exhibit T-3R at p. 58.

Staff, Verizon may also move the Commission to offset an access charge reduction with a retail switched access charge imposed on Verizon's local exchange customers.[24]

III. CONCLUSION

For all the reasons stated herein and in the testimony of AT&T witness, Dr. Lee Selwyn, WorldCom respectfully asks this Commission to order Verizon to reduce its intrastate switched access rates to forward looking economic cost. In the alternative, as an interim measure, WorldCom asks the Commission to order Verizon to lower its access rates to its interstate switched access rate levels.

Dated this 6th day of June 2003.

Respectfully Submitted,

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[24] Exhibit T-130 at pp. 8-9.