

Staff's Public Interest Analysis

Regarding the Settlement Agreement in Docket UT-081393

August 26, 2009

Staff recommends that the Commission accept and approve the settlement that Verizon and Embarq have filed in this case because it is in the public interest. The settlement provides for reductions to United's originating and terminating access charges that will reduce the anticompetitive and market-distorting effects of those rates. At the same time, because the access charge reductions are gradual, United is afforded an opportunity to correct its rate structure or prove its universal service support needs in a later proceeding without first suffering a drastic reduction in revenue. In that later proceeding, the company will have to undergo a full earnings review and account for any cost savings it may achieve as a result of its integration into the newly-formed CenturyLink organization.

Staff has not signed on to the settlement agreement because it does not believe it should bind itself to the course of advocacy that Verizon and United have agreed to in future proceedings.

Rates affected by the settlement

United's most significant current intrastate originating and terminating access rate elements are as follows:¹

Rate Element	Originating	Terminating
Carrier Common Line (CCL) charge	\$.010000	\$.000000
Local Switching	\$.020740	\$.004663
Interim Universal Service Fund Additive	N/A	\$.064851

These are the rates that United charges long distance carriers for calls that originate from and/or terminate to United local service customers.

Terminating Local Switching Rate

¹ Exhibit No. ____ HCT (JMF-THC) at 11.

The only rate in the above table that is not in controversy is United's terminating local switching rate, which is set at the same level as United's unbundled network element (UNE) rate for local switching. That UNE rate in turn is required by FCC rules to be determined using total service long-run incremental cost.² Similarly, WAC 480-120-540(3) provides that the cost of terminating access must be determined based on total service long run incremental cost, and that loop costs must not be included in the cost of terminating access.

Originating Local Switching Rate

The settlement provides for the reduction of United's originating local switching rate to Verizon's current level of \$0.0158172. Although originating and terminating switching have similar costs, WAC 480-120-540(3) allows a company to recover some of its loop costs through originating access charges. At the time the rule was adopted, the theory was that originating access charges would be constrained by competition.³ Subsequently, the Commission, in UT-020406, found it appropriate to reduce Verizon's originating access rates to the level of Qwest's originating access rate based on its authority to establish uniform rates to counter anticompetitive practices.⁴

Carrier Common Line Charge

The settlement provides for the elimination of United's Carrier Common Line (CCL) charge. The Commission eliminated the CCL charge for Qwest⁵ and Verizon,⁶ ruling that the

² 47 C.F.R. §§ 51.503, 505.

³ Exhibit No. ____ (GB-7) (General Order No. R-450 in Docket UT-970325).

⁴ Eleventh Supp. Order, Docket UT-020406, ¶¶ 103, 108, 110, 162, 169.

⁵ Fifteenth Supp. Order, Docket UT-950200 (1996).

⁶ Eleventh Supp. Order, Docket UT-020406, ¶¶ 104, 108, 110.

charge had outlived its usefulness and should be eliminated as a specific rate element of switched access.

Interim Terminating Access Charge

The main controversy in this case concerns the level of United's interim universal service fund additive, or ITAC (interim terminating access charge). The settlement provides for reduction of United's ITAC by half over two years. As discussed below, the ITAC is a special rate element that is not based on the local exchange carrier's cost of providing interexchange companies with access to the local exchange network. Rather, its purpose is to provide an explicit subsidy for companies that require it to keep their local service rates in high cost areas reasonably comparable to those charged in urban areas.⁷

The parties' advocacy regarding United's access rates

In this private complaint case, Verizon advocated for immediate reduction of United's access charges either to Verizon's level or alternatively to Qwest's level, including elimination of the CCL charge. Thus, the CCL on originating access would be eliminated, the originating local switching rate would either be \$0.0158172 (Verizon's rate) or \$0.014441 (Qwest's rate), and the ITAC would either be zero (Verizon's rate) or \$0.015891 (Qwest's rate).⁸ United calculates the annual revenue impact of this proposed rate reduction to Verizon's levels to be approximately [REDACTED].⁹

AT&T also advocated for immediate reduction of United's intrastate access charges to the level of the company's interstate access charges, but without any subscriber line charge or other revenue replacement mechanism. United calculates the annual revenue

⁷ WAC 480-120-540(1)(b).

⁸ Exhibit No. ____ THC (PBV-1THC) at 21-24.

⁹ Exhibit No. ____ THC (JMF-4HC).

impact of this proposed rate reduction to be approximately [REDACTED].¹⁰ Staff advocated for immediate elimination of the clearly anti-competitive intrastate originating CCL charge (consistent with Qwest and Verizon) and immediate reduction of the originating local switching rate to Verizon's level because that level covers United's incremental cost and contributes to United's joint and common costs¹¹ and the Commission has found that a higher rate would be unfair and anti-competitive.¹² While agreeing on the ultimate outcome, Staff parted company with Verizon and AT&T by advocating for a phased instead of immediate reduction of the ITAC over three years, starting on January 1, 2011.¹³ This transition period was meant to allow the company time to mount a rate case justifying either higher local exchange service rates, or a higher ITAC, or both, (though in Staff's view, the company's local rates are unreasonably low in at least some of its exchanges and should be made uniform at a level that alleviates at least some of the company's need for a subsidy from above-cost access charges).¹⁴ Additionally, Staff felt that the delayed start of this transition would allow United sufficient time to realize the synergies expected from its recent merger with CenturyTel (with the resulting parent entity to be known as CenturyLink).¹⁵

Legal framework for access charges

In a world without wireless carriers, cable voice operators, competitive local exchange companies, or Internet voice providers, companies such as United were able to sustain high access charges. The result was a pattern of high charges for long-distance services and low charges for local service.

¹⁰ *Id.*

¹¹ Exhibit No. ____ (GB-1HCT) at 19:3-12.

¹² *Id.* at 7:16-21, 18:3-14.

¹³ *Id.* at 35:22 – 36:6.

¹⁴ *Id.*; Exhibit No. ____ T (TWZ-1T) at 3:3-8.

¹⁵ Exhibit No. ____ T (TWZ-1T) at 3:17-20.

Wireline long distance providers' ability to compete with local exchange companies that offer both local and long distance services is diminished when the local exchange company imposes very high access charges on those competitors.¹⁶ The reason is that long distance providers are required by federal law to offer the same intrastate long distance rates to customers throughout the state,¹⁷ yet the per minute long distance rate that is competitive in Qwest territory may result in the company losing money through access charges on a call originating in United territory.¹⁸ The sustainability of high access charges is doubtful where consumers have alternatives to wireline "long distance" services via wireless carriers and cable voice over internet protocol (VoIP) providers, which generally do not incur intrastate access charges.¹⁹

Additionally, high terminating access charges are basically a means of exporting the costs of a rural local exchange company onto the customers of wireline long distance customers throughout the state. The Commission has recognized that circumstances may sometimes require this subsidy, but Staff believes its fairness and efficiency are suspect when the subsidy is so large as to allow the rural customers to pay less than the rates charged urban customers²⁰ and when the burden of subsidy is borne by a shrinking group of wireline long distance customers.²¹

A universal service fund that drew from all telecommunications providers and not just from wireline interexchange carriers would be preferable to above-cost access charges.²² The 1996 Telecom Act, at 47 U.S.C. Sec. 254(f), provides that "Every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable

¹⁶ Exhibit No. ____ HCT (GB-1HCT) at 4-7;

¹⁷ *Id.*; 47 U.S.C. § 47 C.F.R. § 64.1801.

¹⁸ Exhibit No. ____ HCT (GB-1HCT) at 4-7, 11-12.

¹⁹ *Id.* at 24, 25; Exhibit No. ____ HCT (JL-1HCT) at 6.

²⁰ Exhibit No. ____ HCT (GB-1HCT) at 29-31.

²¹ Exhibit No. ____ HCT (JL-HCT) at 4, 5; Exhibit No. ____ HCT (GB-1HCT) at 35.

²² Exhibit No. ____ HCT (JL-HCT) at 3-7.

and non-discriminatory basis, in a manner determined by the State to the preservation and advancement of universal service in that State.” Consistent with this, RCW 80.36.610, enacted in 1997, states that:

“The legislature intends that under the future universal service program established in this state:

- (a) Every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to the preservation and advancement of universal service in the state;
- (b) The contributions shall be competitively and technologically neutral; and
- (c) The universal service program to be established in accordance with RCW 80.36.600 shall not be inconsistent with the requirements of 47 U.S.C. Sec. 254.”

However, the Commission is prohibited from establishing a new state universal service program without legislative approval.²³ The Commission conducted a rulemaking and generic adjudicative proceeding in 1998 in response to the directive in RCW 80.36.600 and 610, but the Legislature did not adopt a state universal service fund at that time. Consequently, eleven years later, Washington, like many states, still relies on above-cost access charges as a universal service funding mechanism.²⁴ However, under WAC 480-120-540(1)(b), the Commission requires Washington local exchange companies to identify the above-cost portion of the access charges as a separate, explicit element on the terminating side:

If a local exchange company is authorized by the commission to recover any costs for support of universal access to basic telecommunications service through access charges, it shall recover such costs as an additional, explicit universal service rate element applied to terminating access service.

²³ RCW 80.36.610.

²⁴ Exhibit No. ____ HCT (JL-HCT) at 3-4.

Staff interprets the phrase “support of universal access to basic telecommunications service” to mean the subsidization that enables a company to provide local exchange service in high cost areas at rates that are “reasonably comparable to rates charged for similar services in urban areas.”²⁵ This is consistent with the universal service principle regarding access to telecommunications services in rural, insular, and high cost areas set out by Congress in the Federal Telecom Act. It is important to note that the rule does not *entitle* local exchange companies to an above-cost universal service element. Instead, it merely provides that *if the company is authorized* by the Commission to recover a subsidy for its local exchange rates through its access charges, it must do so through an explicit element on the terminating side.

Although WAC 480-120-540 discusses the methodology for determining the cost-based elements of originating and terminating access (e.g., switching and transport), it does not specify how a company’s universal service support “costs” (i.e., costs of local exchange services not recovered through rates charged for those services) are to be determined. In Docket UT-020406, *AT&T vs. Verizon Northwest*, the Commission characterized the reduced ITAC rate it required for Verizon as “the minimum that will meet the [universal service] goals of the ITAC and is not unduly or unreasonably preferential or harmful.”²⁶ At this time, it is plain that United’s ITAC is not the minimum necessary to meet the universal service goals of the ITAC because United’s local exchange rates are being supported at levels that are unreasonably low in comparison to rates charged in urban areas.²⁷ The persistence of United’s comparatively low local exchange rates demonstrates that the company’s ITAC is not set at a level that minimizes its unreasonably preferential and competition-harming effects.

²⁵ 47 U.S.C. Sec. 254(b)(3); Exhibit No. ____ HCT (GB-1HCT) at 29.

²⁶ Eleventh Supp. Order, Docket UT-020406, ¶ 138.

²⁷ Exhibit Nos. ____ T (TWZ-1T), (TWZ-2), (TWZ-3), (TWZ-4); (GB-6), (GB-1HCT) at 29.

Policy considerations regarding the universal service rate element

The amount of universal service support a company needs is fundamentally a question of revenue requirement and rate design. Once the Commission determines a company's revenue requirement, it can then design rates that cover the incremental cost of each service, and in combination, the investments and expenses of the company as a whole. Some elements can be determined based on forward-looking cost (i.e., what it would cost to re-construct the company's plant using newer and more current technology); however, ultimately, the company's total revenues from all services should do no more or less than allow the company the opportunity to meet its expenses including taxes, to recover its actual investment through depreciation, and to recover a reasonable return on net investment.

It is not necessarily wrong to use some type of forward-looking cost model to decide the amount of universal service support a local exchange company should receive. In fact in Dockets UT-980311(r) and UT-980311(a), the Commission did just that. The basic approach was to use benchmarks of total revenue that local exchange companies nationwide were able to achieve per line, per month. The amounts were \$31 for a residential line and \$51 for a business line. Next, the per-line forward-looking cost (on an unseparated basis) of providing single line residence and single line business services was determined for *each exchange* served by a particular carrier. Generally, the per-line cost was lower in urban areas and higher in rural areas. An exchange for which "high cost" support was determined to be necessary was one in which the "cost" exceeded the revenue benchmark, on an exchange by exchange basis. As such, the carrier serving that exchange would be entitled to support equal to the amount that the per-line unseparated cost of these services exceeded the per-line total revenue benchmark at that time. In this approach, the amount a company would have recovered for high cost support was determined independent of the company's actual

investment and that amount of support would have been taken as a given (subtracted from the revenue requirement) when designing rates for the company's various services, if a general rate case were ever filed near that time.

United's cost model in this case does not utilize any revenue benchmark for determining high cost exchanges. It simply computes a cost for reproducing its local exchange network - a significantly higher cost than the company's embedded investment - and then allocates that "cost" to only select services provided over that network, and in particular to exchange access service, assigning a portion of all of its loop costs to the cost of exchange access. Yet the model does nothing to allocate loop costs toward DSL service or other services which also use the loop. The model also does nothing to identify loops that are comparatively "higher cost" or that are in wire centers or exchanges that exceed a benchmark of reasonably obtainable revenues. Additionally, the model also deviates from the Commission's past practice of determining "unseparated" costs—that is, all costs prior to separation into interstate and intrastate categories. Although there may be numerous debates over what should or should not be included in a forward-looking cost model, what is important to remember is that universal service "costs" are nothing more than that portion the company's overall revenue requirement that cannot be met by retail rates that are reasonably comparable to rates charged for similar services in urban areas. A fairly simple calculation shows that the company could offset the need for almost all of the six-and-a-half cent universal service element by increasing its local rates to the same level it already charges for local exchange service in Poulsbo, its most urban exchange (e.g., \$16.40 for single-line residential service) and still be below Verizon's statewide rates (\$16.90 for single-line residential service).²⁸

²⁸ Exhibit No. ____ T (TWZ-1T) at 9:1-3, and Exhibit No. ____ (TWZ-5HC) at 3.

The reason Staff recommended a phased elimination of the ITAC was not because of clear evidence indicating that no universal service support is necessary for United, but due to (1) the market-distorting effects of above-cost access charges, (2) the failure of United to prove a genuine and current need for an ITAC, (3) the fact that the current ITAC is 12 years old, and (4) the simple calculation demonstrating that United could charge local exchange rates that are higher than its present rates but still within a range that is “reasonably comparable” to urban local phone service rates in Washington and across the country and thereby eliminate the need for the ITAC. This is not a new argument for Staff, as it has previously advocated for United to charge uniform local rates at the level it charges in its most urban exchange, Poulsbo.²⁹ Staff’s position has always been that, if at any time during the phased reduction of its ITAC United concluded that it needed to increase its local exchange rates it could propose to do so based on a full earnings review.³⁰ If the evidence of actual costs and embedded investment justified an ITAC to cover any residual revenue requirement not recovered through local exchange rates, that residual could be recovered through an ITAC. In such an earnings review, it would first be necessary to determine the company’s overall revenue requirement, then to design local rates that meet the standard of affordability and reasonable comparability to urban rates, and finally to provide for an explicit universal service additive to terminating access charges to meet any residual revenue requirement not met by local exchange rates, as provided by WAC 480-120-540.

²⁹ See Prefiled Testimony of Timothy Zawislak in Docket UT-051291.

³⁰ Exhibit No. ____ T (TWZ-1T), and Exhibit No. ____ (GB-7).

Public Interest considerations supporting the settlement

Reductions in Switched Access Rates

The rate design terms of the settlement resemble Staff's litigation approach almost to a tee – except that the ITAC is reduced by 50 percent³¹ over two years instead of on a path to be eliminated over three years. In either case, United still has the ability to file for a general rate case³² or an AFOR including a full earnings review after the applicable one year stay-out provision in the merger order. Therefore, the access charge complaint settlement in conjunction with the merger order's requirements³³ generally result in an outcome similar to what Staff's litigation position in this case was meant to accomplish.

Consistency with CenturyTel/Embarq Merger Conditions

Staff's position recognizes that the terms of the merger order should not be changed by this settlement agreement. The merger order adopts a one year "stay out" provision that nonetheless allows United to seek rate relief based on certain exogenous circumstances having a rate impact of more than \$1 million.³⁴ Staff's calculations indicate that the settlement, if adopted by the Commission, will not trigger the exogenous circumstances

³¹ Albeit, in Mr. Felz's surrebuttal testimony (pp. 15:21-16-4), United contends that it is constrained by competition from not raising its prices on bundled services. Staff was prepared to demonstrate through cross-examination that United's purported competitive analysis was deficient, because it compared its bundled rates to companies with which it did not compete and because it failed to offer a comparison to the higher bundled rates of cable operators that provided the only actual, though highly limited, competition faced by United. Staff also believes that, as a matter of policy, it is inappropriate to protect untariffed bundle prices from the effect of rate increases authorized for regulated services within the bundle.

³² Although this case is not a general rate case, United's Exhibit No. ____ (JMF-8HC) indicates a low rate of return to begin with. In Staff's opinion, United has understated the results of operations by omitting much of the actual State Operating Report (SOR) information that was filed with the Commission in Docket UT-091007. Therefore, Staff includes the entirety of the page from the report that United relies on in Attachment A to this narrative, in order to provide the Commission with context for this information, including the company's unadjusted interstate and unseparated rates of return.

³³ Order 05, Final Order Approving and Adopting Settlement Agreement; Authorizing Transaction Subject to Conditions, Docket UT-082119, ¶ 50: "[W]e will require the combined companies to file a report on the third anniversary of the closing date [7/1/2012] that includes a normalized, *pro forma* results of operations for regulated services in Washington that captures merger synergies realized through the relevant periods (test year and *pro forma* year)."

³⁴ *Id.*, Settlement Agreement, p. 6, terms 4.b. and c.

exception. That is because the revenue impact for 2010 will be less than the annual \$1 million threshold in the merger settlement under the treatment of exogenous events.³⁵

Flexibility to Address Issues in the Future

It is clear from United's statement of public interest (Section IV.B.) that it envisions a future in which there is no further challenge to its intrastate access rates and policy makers promptly provide it with a new universal service funding mechanism. The actual terms of the settlement do not preclude the unfolding of such a future, but those terms certainly do not require it. To the contrary, an important public interest element of the proposed settlement is that it preserves the ability of the Commission, its Staff, and other parties (with the exception of Verizon) to decide what, if any, actions should be taken to promote universal service, competition, and access charge reform.

The settlement preserves the ability of the Commission and its Staff to undertake further efforts to reform the access charges of United and other carriers. United has agreed to lower its originating and terminating access charges on a specified schedule, which United claims to place "a limitation on the reduction of the interim USF additive,"³⁶ but the settlement provides for no such limitation. It requires United to lower its access rates, but it does not otherwise limit the Commission's oversight of United's access charges. For example, the Commission remains free to consider further reductions upon complaint by another carrier or on its own motion.³⁷

The settlement also does not commit either the Commission or its Staff to undertake a generic proceeding on universal service funding or access charge reform. It is clear that United would like to see such a proceeding. Indeed, one could conclude from United's

³⁵ *Id.*, Settlement Agreement, p. 6, terms 4.b. and c.

³⁶ Para. 23.

³⁷ Verizon, as a party to the settlement, would be precluded under §2c from seeking further reductions in United's access charges. This restriction does not apply to Staff, the Commission, or parties that would otherwise have standing under state law to complain against United's rates.

statement that the Commission has for more than a decade neglected its duty to develop a universal service mechanism.³⁸ This assertion, which is not supported by United's own pre-filed testimony, is simply incorrect. United claims the Commission needs to "complete the process outlined in RCW 80.36.600 through RCW 80.36.620,"³⁹ but the Commission actually completed that process many years ago.⁴⁰ The Legislature in 1997 directed the Commission to develop a universal service program but prohibited it from implementing that program without further legislative authorization.⁴¹ The Commission fulfilled this mandate in Docket UT-980311 and submitted a recommended program to the Legislature in 1998. The Legislature considered these recommendations, heard little consensus among stakeholders, and did not provide the required authorization. The Commission has no more authority now to implement a universal service mechanism, and the terms of the settlement cannot and do not change that circumstance.

Finally, the settlement does not commit the Commission or its Staff to undertake a make-whole proceeding in which the lost access revenues would be restored through increases in other rates. Section 2b provides that Verizon will not object to a make-whole rate filing, but neither the Commission nor its Staff nor any party other than Verizon is

³⁸ "The time has come for the Commission to finish the work it did not complete, and has not revisited, following the proceedings of the late 1990s." Para. 31.

³⁹ Para. 30.

⁴⁰ United's statement at para. 25 mischaracterizes an excerpt from the Commission's September 23, 1998, order in Docket UT-970325 adopting the access charge rule. United suggests that the pending "resolution of universal service issues" means the enactment of some new universal service program, which it implies has now gone unattended for many years. In reality, it is clear from the next paragraph of this order that the Commission is actually referring to the completion of its cost analysis in Docket UT-980311:

Based on the decision and determinations made in UT-980311(a) the subsidy necessary to maintain universal service for each company involved should be known. Then, the interim (residual) temporary universal service increment will be eliminated and replaced with a Commission-authorized increment (consistent with subsection (3) of the rule). The Commission authorized increment may be more than or less than the temporary interim residual increment allowed prior to the Commission's decision regarding the cost of universal service. [General Order No. R-450, page 14].

The Commission issued its order establishing costs in Docket UT-9809311 on November 20, 1998, and submitted its report to the Legislature on a recommended universal service program on December 2, 1998.

⁴¹ RCW 80.36.600(1) states, in part: "The commission shall plan and prepare to implement a program for the preservation and advancement of universal telecommunications service *which shall not take effect until the legislature approves the program.*" [emphasis added]

required to accept or support such a filing. This is an important element of the settlement, particularly given the serious concerns raised by Staff to United's pre-filed testimony and evidence relating to cost. The settlement does not rely on or require the Commission to approve United's cost model or any other claims regarding its costs. Staff continues to believe that United has not presented an accurate statement of its costs of serving customers in rural areas.

As the above discussion illustrates, the non-rate components of the proposed settlement are strictly limited in their application. Staff is satisfied that the agreed rate reductions are a reasonable resolution of this specific case, particularly given its nature as a complaint brought by one carrier against another carrier. Staff could not, however, have supported the settlement if those non-rate terms were to have applied to it or other parties. Staff and non-party stakeholders remain free to address universal service and access charge reform issues on their merits as they arise. It is for this reason that Staff is not a party to the settlement despite its willingness to see the settlement approved by the Commission.

Conclusion

In summary, Staff believes that the settlement is in the public interest and should be approved because it provides for appropriate reductions in United's originating access charges and because it provides a gradual approach toward reducing and fine-tuning the interim terminating access charge. Along with these benefits, it is also apparent that the issue of local rates, including the question of reasonable comparability and affordability will be dealt with in United's next general rate case or AFOR with full earnings review, as it should be.

For these reasons, Staff recommends that the Commission accept and approve the settlement.