BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of, QWEST CORPORATION For Competitive Classification of Basic Business Exchange Telecommunications Services	DOCKET NO. UT-030614

COMMISSION STAFF'S OPENING BRIEF

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I. INTRODUCTION

1 This case will determine the rules by which Qwest competes in the *retail* market for basic business telecommunications services. The case requires, however, that the Commission consider not only the condition of that retail market but also the state of the *wholesale* market for the inputs that competitors use to provide those services. At present, both markets are intensively regulated. The wholesale market will continue to be regulated regardless of the outcome of this case.

2 The wholesale market[1] was created by Section 251 of the Federal Telecommunications Act, 47 U.S.C. § 251. It is the market in which competitive local exchange carriers (CLECs) have the right to obtain, at wholesale, finished telecommunications services or to lease unbundled elements of the existing phone network from incumbent local exchange carriers, like Qwest. The CLECs then use these inputs to compete with Qwest in the retail market for local exchange telecommunications services.

3 Every aspect of the wholesale market—including what must be offered, at what price, on what terms, and according to what performance metrics—is closely regulated at both the state and federal level.[2] The FCC, in partnership with state commissions, determines which services and network elements an incumbent must provide to its competitors and at what price. *See, e.g.*, 47 U.S.C. § 251(d)(2); 47 CFR § 51.319. These regulators also closely oversee the processes by which the incumbents provide

[1] The parties in this proceeding have used the word "wholesale" in reference to both "total service resale" under 47 U.S.C. § 251(c)(4) as well as to the provision of unbundled access to network elements under § 251(c)(3). This may potentially confuse an important distinction.

[2] *See* Sec. IV(C)(1)(b), *infra*.

wholesale services and network elements to competitors to ensure that there is no discrimination.

4 The opponents of this petition are correct about one thing—the retail market is closely connected to the wholesale market. Whether Qwest is able to profitably maintain prices above cost in the retail market has a great deal to do with how easily competitors can take customers away from Qwest if Qwest tries to price above cost. How easily those competitors can win Qwest customers depends in large part on the structure of the wholesale market. The opponents of the petition are wrong, however, about the implications of this close connection. They are wrong when they assert that, because the CLECs often rely on Qwest for inputs, their ability to compete is too tenuous to be considered "effective competition." This is an argument that the regulatory structure of the wholesale market and the price floor protections of RCW 80.36.300 will fail to prevent the very kinds of anti-competitive conduct by Qwest that they are designed to prevent.

5 The petition opponents are also wrong to assert that, to the extent CLECs are simply "reselling" Qwest services, they are not able to able distinguish their offerings and therefore are not really offering "alternatives" to Qwest service within the meaning of RCW 80.36.330. But this argument denigrates the importance of competition on the basis of *price*, and price competition is what RCW 80.36.300 is about.

6 Data presented by Qwest shows that competitors are offering competitive alternatives to Qwest's basic business services throughout virtually the entire Qwest service territory.[3] The data gathered from Qwest's competitors shows that those

[3] *See* Sec. III(B), *infra.*

companies are serving not only the large and medium sized businesses that typically purchase private branch exchange (PBX) trunks or centrex service, but also the small and medium business segment whose needs do not justify a PBX or centrex service and who therefore purchase flat or measured rate basic business lines. Wilson, Ex. 225 (Qwest's competitors serve about one-third of basic business lines); Wilson, Tr. at 1507:13 to 1508:4.

7 While Qwest still holds some 72 percent of the market, its market share is declining.[4] It is also increasingly confronting "intermodal" forms of competition (wireless and VoIP). And most significantly, market-opening mechanisms have recently come in place that are more favorable to competition based on unbundled network elements than ever before. It cannot be emphasized enough how significantly the structure of the wholesale market has changed since this Commission issued its order in Qwest's last contested competitive classification proceeding, UT 000883. *In the Matter of the Petition of Qwest Corporation for Competitive Classification of Business service in Specified Wire Centers*, Seventh Supp. Order Denying Petition and Accepting Staff's Proposal, Docket UT-000883, ¶ 32 (Dec. 2000)("Staff points out that pending changes in the structure of the market likely will make it easier for firms to enter the market for small business customers."). Among the most significant changes are as follows:

> 1) The unbundled network element platform has become available and has been proven in the market place. Reynolds, Tr. at 307:8 to 308:5.
>
> 2) The nonrecurring charges that a CLEC must pay to switch a customer from Qwest retail service to service from the from CLEC using unbundled network elements has been reduced from as much as $200.00 to a mere $0.27. Ex. 231 at 17:9-12 (testimony of Dr. Blackmon in UT-000883); Ex. 6.

[4] *See* Sec. III(D)(1), *infra.*

> 3) As a result of the process by which Qwest obtained approval to offer intraLATA long-distance services it has demonstrated that it provides nondiscriminatory access to network elements and is under a performance assurance plan that is subject to FCC enforcement. *See* Sec. IV(C)(1)(b), *infra.*

These market structure changes all translate to greater ease for competitors to win customers from Qwest, particularly smaller customers who are served over individual lines.

8 While the petition opponents argue for maintenance of the status quo—namely, continued tariff regulation of Qwest's retail rates for the petition services—this case highlights a shortcoming of that status quo. There is a mismatch in the way rates in the wholesale market are regulated today and the way Qwest's wholesale rates were fixed in US WEST's (Qwest's predecessor's) last general rate case. *WUTC v. US WEST Communications, Inc., 15th Supp. Order,* at 97-101, Docket No. UT-950200 (1996). The rates that this Commission has set for unbundled network elements varies substantially from the urban to the rural parts of the state. *In the Matter of the Pricing Proceeding for Interconnection, Unbundled Element, Transport and Termination, and Resale, 24th Supp. Order*, Docket Nos. UT-960369, 960370, 960371, at ¶ 81 (May 2000). This is a function of the length of the loops that are required to serve customers in rural locations as compared with customers in areas that are more densely developed. *Id.* at ¶¶ 14, 28. The rates that the Commission has long had in place for the retail services that are provided over those loops, however, are uniform throughout Qwest's service territory. In other words, UNE-loop rates have been deaveraged, while retail rates have not.

9 The practical consequence of this is that Qwest's tariffed rates for the business basic exchange services at issue may be significantly higher than the costs competitors incur in the lower cost zones. Qwest indicates that its objective for seeking competitive classification is geographic deaveraging of retail prices. "Competitors are not limited to statewide average pricing restrictions. To the extent that Qwest's competitors are able to price their basic business exchange services in accordance with specific market conditions, Qwest seek the same capability in an effectively competitive market." Reynolds Ex. 7RT at 11:12-15; Reynolds, Tr. at 149, 302.

10 Staff believes the evidence in this case shows the existence of effective competition and the incentive for Qwest to reduce its retail prices to meet that competition. The law requires that Qwest not price below cost—or below the imputed costs its competitors incur when they purchase inputs from Qwest in order to compete in the local exchange services market. *See* Sec. IV(B), *infra.* This imputation test can, and should, be applied in each pricing zone—thus, potentially resulting in retail rates that vary geographically. Qwest's opponents in this case concede that, so long as Qwest does not price below cost, if Qwest were to lower it prices in the lower cost areas of the state this would be good for consumers and good for competition. Baldwin, Tr. at 751:9 to 752:14; Stacy, Tr. at 1082:24 to 1084:6.

II. APPLICABLE LAW

11 RCW 80.36.330 authorizes the Commission to classify a telecommunications service provided by a telecommunications company as competitive 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.

RCW 80.36.330(1). "These four factors are not exclusive, and there may be other factors that bear on the Commission's determination in individual cases." *In the Matter of the Petition of U S West Communications, Inc. for Competitive Classification of its High Capacity Circuits in Selected Geographical Locations*, Eighth Supplemental Order Granting Amended Petition for Competitive Classification, at 4, Docket No. UT-990022 (Dec. 1999).

12 The consequence of competitive classification is that the company is free to offer and price the services at issue subject only to the pressures of competition and the statutory requirement that such services must recover the costs of providing them. RCW 80.36.330(3). With competitive classification, the company is no longer bound by the rates set out in its tariffs but is free to charge customers less or more than the tariff would allow.[5]

[5] However, Qwest would still be required to comply with all statutes and rules other than those related to pricing authority.

13 Whether, and to what degree, the company is permitted to engage in price discrimination under competitive classification is not as simple. Statutory prohibitions against undue preference and rate discrimination do not apply to *contracts* for services classified as competitive under RCW 80.36.330. *See* RCW 80.36.170 and 180. With respect to competitive services offered *under a price list*, on the other hand, the Commission has the discretion to waive the statutory prohibitions against undue preference and discrimination to whatever extent it finds that competition will serve the same purpose and protect the public interest. RCW 80.36.330(8). Qwest has indicated that it does not seek a waiver of the preference and discrimination statutes. Reynolds, Tr. at 274:24 to 275:7.

14 When deciding whether the record supports a finding of effective competition, it is essential that the Commission not focus solely on market share analysis to the exclusion of market structure analysis which suggests that Qwest's pricing is likely to be constrained by competitors. In fact, market share is listed as merely one of the "other indicators" of effective competition that the Commission may consider under the statute. Significantly, the "other indicators" are fourth in order following consideration of the number and size of alternative providers, the extent to which services are available from alternative providers, and the ability of alternative providers to make substitute services available.

15 In applying RCW 80.36.330, the Commission has consistently held that when structures that support market entry are favorable, market share is less important. Market structure looks at the means that are available to competitors to enter the market, or having entered the market, to win customers from the incumbent. In 1987, in

the first contested case under RCW 80.36.320-330, the Commission granted "competitive classification" to the major providers of long distance service, including the incumbent monopoly, AT&T. The Commission found that although AT&T held approximately 75% of the market for intrastate long distance services, it was nevertheless subject to effective competition. This was largely due to evidence concerning the ease with which competitors could enter the long distance market to compete with the incumbent if AT&T tried to raise its prices significantly above cost, though, to be sure, the Commission confronted arguments similar to those made in this appeal when it made its decision then.[6]

16 But market share analysis does provide the important "proof in the pudding" that can validate or refute a parties' market structure analysis. In the most recent contested proceeding under RCW 80.36.330, the Commission rejected an argument that the statute should be interpreted as only requiring a finding the competitors exist in the market who are capable of providing alternative service. Instead, the Commission held "we must also have confidence the 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." *In the Matter of the Petition of Qwest Corporation for Competitive Classification of Business*

[6] Similarly, Qwest's local (intraLATA) toll classification proceeding, *In the Matter of the Petition of US WEST Communications, Inc. for competitive Classification of its IntraLATA Toll Service*, Order Granting Petition, Docket UT-990021 (Jan. 1999), the Commission gave no weight to market share, but focused instead on an analysis of market structure – that is, whether there were any significant barriers to entry that would prevent firms from competing against the incumbent in a relatively short period of time (particularly if the incumbent were to raise its prices, thereby inviting such market entry by a competitor).

service in Specified Wire Centers, Seventh Supp. Order Denying Petition and Accepting Staff's Proposal, Docket UT-000883, ¶ 66 (Dec. 2000).

III. DEFINITION OF RELEVANT MARKET

A. DEFINITION OF PRODUCT MARKET

17 Qwest has petitioned for competitive classification of its flat and measured rate business exchange service, private branch exchange (PBX) trunks, Centrex services, and the vertical business features that are packaged with those services.[7] Reynolds, Ex. 1T at 4:16-19. A complete list of the services is set out in Exhibit 2. The relevant product market, therefore, is the market for services that provide business customers with basic connectivity to the public network for switched, voice-grade communications. Wilson, Ex. 201T at 14:14 to 15:3.

18 All three services (business lines, Centrex services, and Private Branch Exchange) can provide functionally equivalent exchange access and thus are appropriately considered in concert. That is, a CLEC may convince a Qwest multi-line or PBX business customer to buy the CLEC's centrex service and vice versa. Reynolds Ex. 7RT at 13:15-18.

19 When consumers consider one service a substitute for the other, those services are in the same relevant market. Wilson Ex. 201T at 15:7-8. Both Qwest and Staff's empirical data in this case is based on a more conservative premise, however. Both parties' market share numbers present a picture that only includes the competitive local

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[7]In *WUTC v. US WEST Communications, Inc., Fourth Supp. Order Denying Complaint; Accepting Tariffs Conditionally; Requiring Tariff/Price List Refiling,* Docket Nos. UT-911488 and UT-911490 (Nov. 1993), the Commission found that (1) PBX and Centrex, together with the package of features available with each, are functionally equivalent, and (2) vertical features that are available with PBX and Centrex are "incidental" to the service and are not "bottleneck" or "gateway" monopoly features.

exchange carriers providing wireline, price-listed services using the public switched telephone network.

1. It was not inappropriate for Qwest to limit the services in its petition to analog services.

20 Qwest has limited its petition to analog services. That is, services that function over analog, as opposed to digital, customer premises equipment. Reynolds, Tr. at 179:21 to 180:5. The analog/digital distinction is not new to this case. Qwest previously petitioned for and partially received competitive classification of this same list of services provided over DS-1 or higher circuits in Docket No. UT-000883. Qwest subsequently obtained competitive classification of digital services within the same wire centers and over the same capacity circuits in UT-021257.

21 Qwest has not included its digital switched business services because the primary focus of Qwest's petition is competition based on the use of specific Qwest wholesale services, such unbundled loops (excluding those associated with provisioning digital services), and UNE-P. Reynolds Ex. 1T at 5:18-20. Qwest's competitors are not generally using these wholesale products—which they obtain from Qwest—to provision their digital services. Id. at 5:20-21.

22 Digital services, such as ISDN BRI and trunks for digital PBXs, can represent substitutes for Qwest's analog services. They are not as close a substitute as analog services however, because a customer who wishes to switch from Qwest analog services to a comparable digital service would have to replace analog customer premises equipment with digital customer premises equipment. Reynolds, Tr. at 299:7-16.

23 For purposes of conducting an "apples-to-apples" market share analysis, it is proper to look at line share numbers for analog services provided by CLECs. The only way this might be problematic is if it were clear that Qwest had a proportionally higher market share in the market for comparable digital services in comparison to its competitors. The evidence in the record is to the contrary. Reynolds, Tr. at 294:18 to 298:16 (estimating market share for digital services, based on Qwest wholesale information, in DS0 equivalents, at 175,000 for Qwest and 84,000 for CLECs).

2. The relevant market is the retail market for business basic exchange services, whether served by competitors over their own facilities or over facilities obtained from the Qwest.

24 Ms. Baldwin, on behalf of Public Counsel, suggests a means of measuring market share that is based on Qwest's share of the market at the wholesale level. Baldwin, Ex. 401T at 28:19-20. This is clearly improper. As Mr. Shooshan testified, "the question is not where the money ultimately goes in the chain of production (one should calculate [switching equipment manufacturers] Nortel and Lucent's local exchange "market share" if that were the case) but where the revenues go at the level of the market being analyzed (i.e., the retail level). Shooshan Ex. 103T at 8:17 to 9:2.

25 Similarly, Mr. Gates and Mr. Stacy, on behalf of MCI, completely disregard—and eliminate from their market share calculations—any service that a competitor is providing over Qwest facilities as a competitive alternative to Qwest retail service. Stacy, Ex. 603T at 3:56-70. Mr. Gates and Mr. Stacy essentially argue that UNE-based competition is not "real" competition because it does not allow competitors to offer services that are any different than those provided by the incumbent—that is, to compete with innovative offerings. Gates, Ex. 504T at 8:211 to 9:229. When one

considers that Qwest's competitors commonly bundle that "resold" local exchange service with other services such as their own long distance service, MCI's claim becomes less compelling. Exs. 430, 432 at 2, 433. But even if true, MCI cannot deny a more important point. Qwest's competitors that rely on UNE-P *are fully capable of restraining Qwest's pricing* by offering services that, by definition, are perfect substitutes for those offered by Qwest.

26 RCW 80.36.330 is primarily concerned with the efficiency that comes with *price* competition. The statutory policy behind competitive classification is to "advance the *efficiency* and availability of telecommunications service" and "[p]ermit flexible regulation of competitive telecommunications companies and services." RCW 80.36.300. MCI's witnesses dismiss UNE-P based competitors for failing to offer consumers anything other than precisely the same wireline, public switched telephone network service offered by Qwest. Ironically, they dismiss the most truly innovative alternatives to the listed services—namely, wireless and VoIP because these services allegedly fall short as complete substitutes. Gates, Ex. 501T at 18 to 38.

27 Nothing in RCW 80.36.330 requires the mode of competitive entry to be competitor-owned. The important thing is that the mode of competition be capable of restraining the incumbent's pricing. And as Mr. Shooshan testified, "Once the CLEC obtains the customer, the CLEC has the opportunity to capture all the retail revenue associated with that customer (local, toll, vertical features, etc.)." Shooshan, Ex. 103T at 8:13-15.

3. There is no evidence from which to conclude that there is an uncontested market segment of businesses that purchase three or fewer lines.

28 In market power analysis, markets are typically defined by a product, or group or products, and a geographic area. Ex. 225 (Horizontal Merger Guidelines) at 4. Customer characteristics do not become a part of the market definition unless it can be demonstrated that there is discrimination against a particular type of customer. *Id.* ("Absent price discrimination, a relevant market is described by a product or group of products and a geographic area.") Despite this orthodoxy, Ms. Baldwin assumes, despite a lack of evidence of present or possible future discrimination, that there is a separate market for small business customers who purchase three lines or fewer. Ms. Baldwin asserts that this group of customers is under served by CLECs.

29 CLECs price offerings, Ex. 4, by Ms. Baldwin's admission, do not discriminate against this group as opposed to customers who purchase a greater number of lines. Tr. at 768:9 to 770:7. The only significant pricing distinction is between individual lines, on the one hand, and PBX or Centrex on the other. Ex. 4. The record shows that CLEC market share is a strong one-third of the market in basic business lines. Wilson, Ex. 225. There is no basis to conclude that small businesses that purchase three lines or fewer constitutes a separate market for purposes of this case.

4. Intermodal (Wireless, VoIP) competition is becoming increasingly important and the Commission should give it some weight as a source of effective competition for Qwest's services.

30 While Qwest and Staff's empirical data in this proceeding is based on Qwest and CLEC data, both parties discuss the availability of service alternatives from non-CLEC providers in order to provide the Commission a more complete picture of the competitive landscape. An analysis that focuses solely on CLEC-based competition would understate the actual level of competition for Qwest's business local exchange services. Teitzel, Ex. 51T at 3:13-15.

31 To the extent that wireless and voice over internet protocol (VOIP) services are seen as functional equivalents to a basic business exchange, PBX or centrex service from Qwest, they are in the same relevant market. Wilson Ex. 201T at 15:8-11.

32 While wireless service can be a total replacement for wireline service for some smaller businesses, it is probably best viewed as reducing demand for wireline service to larger businesses, rather than replacing the need for wireline service. Teitzel, Ex. 51T at 16:11 to 17:7, 19:15 to 20:8. Wireless services are widely available throughout Washington, Teitzel, Ex. 51T at 17:10-13, and is priced at rates that are competitive with Qwest's flat-rated local exchange business line service. Teitzel, Ex. 51T at 18:9 to 19:11.

33 VoIP is maturing in quality and providers are offering features that are very similar, and in addition to, those in the petition. VoIP service is now available from at least two providers wherever broadband connections (i.e., cable, satellite or DSL) are available. Vonage and Packet8 offer plans for small businesses that have calling features similar to Qwest's local service vertical features and allow either unlimited or substantial local and long distance calling at $49.99 and $59.99, respectively. The evidence also shows that VoIP service providers are marketing services as replacements or complements to PBX systems used by large and medium size business. Teitzel, Ex. 51T at 23:10 to 24:15.

34 Only two things are required to make a VoIP call from a home or business: a broadband connection and an Analog Telephone Adapter—which is often given away

by VOIP providers—to allow the user to plug in his or her existing analog phone. Williamson, 301T at 8:1-4. Voice quality over VoIP is now as good as over the public network. Teitzel, Ex. 51T at 25:3-6.

35 By using VoIP technology on a corporate local or wide area network, companies can avoid the need to purchase additional business lines for employees as remote locations (such work at home employees) because those employees can make phone calls over a broadband internet connection as if they were at the corporate headquarters. Williamson, Ex. 301T at 8:9-13.

36 Smaller businesses that have older, analog systems can move to VOIP to integrate voice and data, improve efficiency, reduce costs, bypass toll, and to enjoy physical portability of the VOIP lines. Wilson, 201T at 29:7-16.

37 Neither Staff nor Qwest have put wireless or VoIP into their empirical market share calculations. But an analysis of the market would be incomplete without it. At a minimum, these intramodal competitors are a reality that Qwest will have to consider in deciding how to price services after a grant of pricing flexibility. This is because business customers simply choose the functionality that they need, often with little regard to how the service is provided. Wilson, Ex. 201T at 17:10-13.

B. DEFINITION OF GEOGRAPHIC MARKET

38 To analyze market power, it is necessary to consider a geographic area. The only reason the Commission might choose to focus on less than Qwest's entire service territory is if there were a reason to conclude that competitive entry by CLECs was unproven in some part of Qwests' service territory.

39 Until Docket No. UT-990022 (Qwest petition for competitive classification of DS3 service), the Commission had not received petitions for competitive classification of a service for less than the entire operating territory of a company in Washington. In UT-990022, the Commission relied on the phrase "relevant market" and approved competitive classification of US WEST DS3 services in certain wire centers. *In the Matter of the Petition of US WEST Communications, Inc., for Competitive Classification of its High Capacity Circuits in Selected Geographical Locations*, Docket No. UT-990022, Eight Supplemental Order at 14 (December 21, 1999).

40 In this case, the relevant geographic market is Qwest's statewide service territory.[8] Wilson, 201T at 14:13-14. It is appropriate to define the market as such because the Staff data shows that CLECs are providing services in competition with Qwest ubiquitously throughout Qwest's wire centers. Wilson, Ex. 201T at 21:5-9; Ex. 204C; Ex. 205C. While this is not necessarily true of competitors utilizing their own switches, it is true of competitors utilizing the unbundled network element platform. Ex. 232 (compare column I and J figures for lines 16, 17 and 39, 40, 41). And it is true even where UNE-Loop (and therefore UNE-P) costs are highest. Wilson, Ex. 201T at 25:13-16 and Ex. 8 at 4 to 10.

IV. REVIEW OF STATUTORY FACTORS FOR EVALUATING EFFECTIVE COMPETITION

A. NUMBER AND SIZE OF ALTERNATIVE PROVIDERS

41 Under RCW 80.36.330(1)(a), one factor the Commission must consider in evaluating a petition for competitive classification is the number and size of alternative

[8] Outside of current Qwest exchanges, Qwest is a new entrant with zero customer base. Therefore, Qwest is subject to effective competition everywhere in the state. Wilson, 210TC at 5:6-8.

providers of service. There is no magic number of CLECs that creates effective competition. Wilson, Ex. 210 TC at 5:12-14. In this case, a number of different estimates of how many competitors provide basic business, PBX, and Centrex service in Washington have been offered. The estimates are primarily based on two sets of data: wholesale data and CLEC-owned facilities data. Qwest provided evidence on wholesale providers, i.e., companies providing service through the use of resale or UNEs, such as UNE-P or UNE loop. Commission Staff provided evidence based on CLEC responses that verify Qwest's wholesale data and demonstrates the number of companies providing service through CLEC-owned facilities.

1. The wholesale information provided by Qwest demonstrates that the number and size of CLECs is sufficient for approval of the petition.

42 The analysis often begins by stating 161 CLECs were registered with the Commission as of March 2003. *See* Teitzel, Ex. 51T at 6:1; Gates, Ex. 501T at 9:218 to 10:235. All parties acknowledge that the total number of CLECs registered to provide telecommunications service in Washington is not the number of alternative providers relevant to this proceeding. In considering alternative providers, the Commission should consider only those providers that offer services functionally equivalent to those for which competitive classification, and not all of the registered CLECs do so.

43 Qwest lists 37 CLECs purchasing resale, UNE-P, and UNE loops in Exhibit 3. In Exhibit 55C, Qwest provides detail regarding CLECs providing basic business exchange access lines through wholesale inputs. The information in Exhibit 55C informs the Commission about the size, as well as the number, of competitors using wholesale inputs because the information shows the number of lines provided by each company by exchange. The data also indicates CLECs are purchasing wholesale inputs to provide service in rural areas as well as urban areas. Teitzel, Ex. 55C; Wilson, Tr. at 1508:16-22; Wilson, Tr. at 1523:24-25.

2. The CLEC data received in response to the Commission's request for information further demonstrates that CLECs exist in sufficient numbers and sizes.

44 The Commission requested information from CLECs regarding the basic business, PBX, and Centrex services in the Commission's Order No. 06 in this docket. The request was sent to over 200 CLECs, presumably representing all CLECs registered with the Commission. Wilson, Ex. 201T at 10:14-15; Wilson, Tr. at 1280:1-15. The CLECs were instructed to send responses to Commission Staff, who was to aggregate the data preserving the confidentiality of the respondents. A total of 27 CLECs responded to the Commission's request for data. Wilson, Ex. 210TC at 6:13.

45 The CLEC data offers the Commission a snapshot of the local business market as of December 31, 2002. The data likely does not provide a complete picture of the market because evidence indicates that not all CLECs providing basic business, PBX, or Centrex services responded to the request for information. Wilson, Ex. 210TC at 6:13-19. Staff estimates that there could be as many as 40 CLECs providing local business service. Wilson, Tr. at 1431:17-19. However, the data collected offers a representative sample of the market and supports approval of Qwest's petition.

46 The CLEC data describes services provisioned over CLEC-owned facilities as well as services provisioned using wholesale inputs purchased by the CLECs from Qwest. The data indicates that CLECs are providing services in both the urban areas of the state (as expected) and also in the more rural and insular parts of the state. Wilson,

Ex. 201T at 4:12-16; Wilson, Ex. 323; Wilson, Tr. at 1523:24-25. For example, there are at least eight to 11 CLECs serving smaller wire centers such as Graham, Sequim, Longview, Moses Lake and Shelton. Three to six CLECs are serving the combined exchanges of Easton and Ephrata. Wilson, Ex. 232. CLEC presence in rural Washington strongly supports granting Qwest's petition for competitive classification.

3. The financial condition of CLECs is vastly improving, indicating that the number and size of CLECs will remain healthy.

47 The decline in market capitalization experienced by CLECs between December 31, 1999, and January 17, 2003, was part of an overall shrinking of the economy, beginning with the burst of the high technology bubble and worsened by the impact of September 11, 2001. Gates, Ex. 501T at 46:1092 to 50:1185; Shooshan, Ex. 103T at 6:9 to 8:3. During this same time period, the Down Jones Industrial Index loss 25% of its volume, and Qwest lost 89% of its market capitalization. Shooshan, Ex. 103T at 7:4-12.

48 MCI offers a study on the decline of the CLEC market spanning the period of December 31, 1999 to January 17, 2003. Gates, Ex. 503. A more recent study was conduced by the Association for Local Telecommunications Service, a CLEC industry association, that was released on July 2, 2003. Wilson, Ex. 210TC at 10:20-22. That report indicates that CLECs are emerging from bankruptcy and that the market capitalization for publicly traded CLECs has more than doubled since the end of 2002. Wilson, Ex. 211. The CLECs remaining in the market today should be the stronger firms with more likelihood of long-term survival. Shooshan, Ex. 103T at 8:1-3.

B. EXTENT TO WHICH SERVICES ARE AVAILABLE FROM ALTERNATIVE PROVIDERS IN THE RELEVANT MARKET

49 The Commission must consider the extent to which services are available from alternative providers in the relevant market under RCW 80.36.330(1)(b). The purpose of this factor is to determine whether customers have a choice of providers from whom to purchase service at a reasonable price.

50 CLECs offer service throughout Qwest territory. CLECs are offering services in every Qwest exchange except Elk. Wilson, Ex. 201T at 4:12-14; Baldwin, Tr. at 709:12-17. However, even in Elk, according to information from the Spokane telephone book, customers may request service from either Qwest or a number of CLECs. *See* Reynolds, Ex. 8; *See also* Baldwin, Ex. 469; Baldwin, Tr. at 678:14 to 680:17. Not only are carriers serving the urban areas, the data shows a rich level of facilities-based competition in surprisingly remote, insular, sparsely populated areas of the state. Wilson, Tr. at 651:16-20. Thus, business customers throughout Qwest's service territory have choices regarding their telephone service providers.

51 Moreover, both large and small businesses have choices with regard to their telecommunications needs. Business customers in rural areas tend to be smaller than those in urban areas. In addition, CLECs such as Integra do compete for customers with one to two access lines. Slater, Tr. at 842:13-17. Integra's target market is the small to medium sized business customer, Slater, Tr. at 874:23-24, and the average Integra customer has approximately six lines. Slater, Tr. at 876:15-16. Customers with three or fewer lines account for approximately 10 – 20% of Integra's business. Slater, Tr. at 876:5-10.

52 Although CLECs must reconcile the higher cost of providing service in certain areas of the state before entering, compelling reasons to enter the more rural markets exist today. Slater, Tr. at 881:11 to 882:2. In fact, Integra is actively considering initiating service in Easter Washington markets.[9] Slater, Tr. at 881:11-15. Thus, business customers in Qwest's service territory currently have choices and will likely continue to have choices if Qwest's petition is granted.

C. ABILITY OF ALTERNATIVE PROVIDERS TO MAKE FUNCTIONALLY EQUIVALENT OR SUBSTITUTE SERVICES AVAILABLE

53 The fact that the structural framework for the local exchange market is open to entry and fosters competition is also extremely important. Wilson, 210TC at 7:14. Alternative providers have a variety of methods available to offer services to business customers. They can build their own facilities, purchase unbundled network elements from Qwest and resell Qwest's retail business services. Reynolds, Ex. 1T at 19:18-21.

1. Wholesale-based services (resale; UNE-P; UNE-L)

54 For a small fee, a CLEC can switch a customer from Qwest to its service almost automatically. Wilson, Ex. 201T at 23:8-9. Through the structural framework of OSS and interconnection, competitors have the ability to make alternative services available. For a small incremental charge and in a very short time, competitors can compete head-to-head with Qwest. Wilson, Ex. 201T at 26:6-9.

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[9] Although Integra indicates that it would "pull back" its efforts in Washington, it is unclear what effect that would have. Slater, Tr. at 858:12 to 859:12; Slater, Tr. at 863:8-10. Integra also states that it has a large investment it would be reluctant to "walk away from." Slater, Tr. at 879:15-18. In addition, there is no evidence in the record that other CLECs would react in the same manner to a grant of competitive classification.

a. Total service resale

55 Qwest's basic business exchange services are available to resellers at a wholesale discount of 14.74 percent below the (monthly) recurring retail rate and a discount of 50 percent from the nonrecurring (set-up) retail rate. Reynolds, Ex. 1 at 10:3-5; *In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale,* Dockets No. UT-960369, et al., Eighth Supplemental Order, April 16, 1998, at pages 98-99.

56 Those non-recurring charges are as follows for circumstance in which a Qwest retail business customer converts to a CLEC resold service:

POTs Customer Transfer Charge (nonrecurring)	
First Line:	$5.73*
Additional Line:	$5.61*
Conversion Completed:	Same business day

*Rates filed in Advice No. 3397T[10]

Reynolds, Ex. 1T at 15:1-18. In Docket UT-000883, the Commission discounted the competitive importance of total service resale on the theory that a CLEC utilizing resale does not have the ability to constrain the incumbents pricing. *In re Qwest Corporation*, Docket No. UT-000883, Seventh Supplemental Order Denying Petition and Accepting Staff's Proposal at ¶ 75 (December 2000). The basis of this theory is that the wholesale price for total service resale is based on a fixed percentage discount off of the incumbent's retail rate. Therefore, if the incumbent raises its retail rate, the wholesale rate rises with it in lock step.

57 At present, the unbundled network element platform (UNE-P) is more attractive to CLECs than total service resale. Reynolds, Tr. at 307:8 to 308:5. Consequently, the

[10] Advice No. 3397T filed April 18, 2003 (Compliance filing in Docket No. UT-003013, Part B).

degree to which CLECs are providing resold service has become relatively small while the degree to which they are utilizing UNE-P has rapidly increased. *Id.*

b. Unbundled network element loops (UNE-L) and the unbundled network element platform (UNE-P)

58 CLECs may sell retail business services utilizing the unbundled network element platform, which provides a complete retail service using Qwest's unbundled network elements (a loop, a switch line port, shared transport and local switching usage components, and features). Reynolds, Ex. 1T at 10:10-12, n. 9. As with resale, UNE-P allows the alternative provider to reach every location to which Qwest has facilities. Reynolds, Ex. 1T at 10:12-14.

59 Those incremental charges a CLEC incurs and the time frames involved are as follows when a Qwest business customer converts to the CLECs UNE-P service:

UNE-P POTs Conversion Charge (nonrecurring)	
First Line:	$0.27*
Additional Line:	$0.14*
Conversion Completed:	Same business day

*Rates filed in Advice No. 3397T[11]

Reynolds, Ex. 1T at 15:1-18. The recurring charge varies according to the geographic pricing zone within which the customer is located. Those charges vary from $8.83 a month in Zone 1 to $21.48 in Zone 5. To provide a point of reference, Qwest's current statewide average retail rate for a flat rate business line is $26.70. Reynolds, Ex. 6C.

60 Alternative providers can and do provision business services in competition with Qwest by combining Qwest's unbundled network elements, such as unbundled loops, with their own elements or those of a third party. Reynolds, Ex. 1T at 10:8-10. The non-

[11] *Id*.

recurring charges and time interval for a CLEC converting a customer to service over its own switch, using and unbundled loop obtained from Qwest are as follows.

> Basic installation without testing (nonrecurring)
> First Loop $37.53
> Additional Loops $34.78
> Installation: Quick Loop, (1-24 lines) - 3 business days
>
> Reynolds, Ex. 1T at 15:1-18.

61 Qwest's rates for UNEs have been established by the Commission in various cost dockets. These rates are based on forward-looking costs and are independent of Qwest's retail rates. Reynolds Ex. 1T at 10:14-16. In other words, the rates that CLECs pay for UNEs does not go up when Qwest raises its retail prices.

62 One measure of competitor's ability to compete effectively using UNEs and UNE combinations such as UNE-P, is whether Qwest provides those wholesale services to its competitors at parity with the service quality level Qwest provides its own retail customers. Qwest was recently required to demonstrate that it provides competitors with nondiscriminatory access to unbundled elements in connection with its application to obtain authority to provide interLATA long distance services pursuant to 47 U.S.C. Sec. 271. See Order FCC 02-332, ¶ 33, released December 23, 2002.

63 Qwest's Statement of Generally Available Terms for interconnection, access to interconnection, access to unbundled network elements, and resale (SGAT) and the interconnection agreements entered into with every CLEC in Washington all contain provisions for a performance assurance plan. Wilson, 210TC at 7:17 to 8:3. The FCC said that the performance assurance plans that are in place as a result of the Sec. 271 process "provide assurance that the local market will remain open after Qwest receives section 271 authorization in the nine application states." *Id*. at ¶ 420. 47 U.S.C. Sec.

271(d)(6) requires Qwest to continue to satisfy the conditions required for approval of its section 271 application after the FCC approves the application. In this regard, the FCC said "We stand ready to exercise our various statutory enforcement powers quickly and decisively in appropriate circumstances to ensure that the local market remains open in these states. We are prepared to use our authority under section 271(d)(6) if evidence shows market opening conditions have not been maintained." *Id*. at ¶ 510.

64 Qwest operations support systems (OSS) are monitored and reported to the Commission. On May 1, 2003, Qwest reported aggregate OSS performance results for the period April 2002 – March 2003. In general, Qwest has been meeting, and often exceeding, the UNE-P (POTS) parity requirement within metropolitan service areas (MSAs) with dispatches, outside of MSAs with dispatches, and without dispatches. This is also true for UNE-P centrex. Wilson, Ex. 201T at 20:9 to 21:3; Reynolds, Ex. 1T at 11:6-9.

2. CLEC-owned loops

65 CLECs can, of course, provide services in competition with Qwest over facilities that they have built to the customer premises instead of leasing those loop facilities from Qwest. In many cases, they do so. Ex. 232, column L. In those places where competitors have built their own loop facilities and are actively providing service, all parties would likely agree that these competitors represent effective competition for Qwest in the market for business basic exchange services.

66 Those CLECs that reported on the manner in which they provide customers with PBX trunks indicated that they do so by an overwhelming percentage over their own

loops. The data indicates that PBX is one of the most competitive segments of the relevant market. Wilson, Ex. 210TC at 9:14-16.

3. Intermodal (wireless, VoIP, Wi Fi, cable, etc.)

67 Please see Staff's discussion of intermodal services in the section II.A., above.

D. OTHER INDICATORS OF MARKET POWER

68 The Commission must consider other indicators of market power under RCW 80.36.330(1)(d). Other indicators of market power include market share, growth in market share, ease of entry, and the affiliation of providers of service. The Commission may consider other factors as well, such as market concentration. Market power is the ability of a firm to profitably raise price above cost without losing market share. Wilson, Ex. 201T at 22:18-19; Wilson, Ex. 225 at 2.

1. Market share analysis

69 A firm's market share may provide information about its ability to exercise market power. Because market share can be an imperfect indicator of market power, Staff advocates that the Commission look beyond the market share numbers and consider the structure of the market itself. Wilson, Ex. 210 at 8:9-12. A company seeking competitive classification may satisfy the statutory requirement of effective competition by showing declining market share or by explaining why a stable market share lends itself to effective competition. *In the Matter of the Petition of Pacific Northwest Bell for Classification of Services as Competitive*, Docket No. U-88-2052-P, Third Supplemental Order Granting Petition in Part at 14 (May 8, 1990).

70 Qwest estimates its market share in the relevant market, using only wholesale data, to be 83%. Teitzel, Ex. 51T at 4:1-4 and at 8, Table B. After incorporating all

revisions to CLEC data, Staff estimates Qwest's market share to be 71.88%. Each of the market share calculations includes only analog loops. *See* Wilson, Ex. 201T at 12:15 to 13:1.

71 Since 2000, Qwest's market share has decreased in all exchanges in its service territory even after receiving competitive classification for services provided over a DS1 or larger circuit. Reynolds, Tr. at 311:18 to 312:3. Qwest argues that its market share is declining in response to CLECs successfully forging inroads into the local business market. Qwest testifies that the number of lines provisioned by CLECs in Washington increased by 32% from December 2001 to December 2002. Reynolds, Ex. 1T at 13:8-15, fn. 13 and at 17:9-10. This increase in lines translates to a 33% increase in CLEC market share. *Id.* During this same time period, Qwest contends that the number of business local exchange retail access lines decreased by 13%. Teitzel, Ex. 51T at 4:10-12.

72 Another indicator of CLEC growth in Washington is in the growth of UNE-P and UNE loop. Reynolds, Ex. 1T at 13:10 to 14:11; Stacy, Ex. 603T at 5(chart UNE-L vs. UNE-P Growth). Although Mr. Stacy's chart indicates that the increase in UNE loop is not as dramatic as the increase in UNE-P, the increase in UNE loop indicates an increase in facilities owned by CLECs. Reynolds, Ex. 1T at 14:2-5. Mr. Stacy's chart is based on national data and does not necessarily reflect the Washington market. In fact, the increase in CLEC use of UNE loop in Washington has increased by 46% from December 2001 to December 2002. Reynolds, Ex. 1T at 13:14.

73 Market share by itself does not equate to market power. *See In the Matter of the Investigation on the Commission's Own Motion Whether the IntraLATA Toll Services of GTE Northwest, Inc. Should be Classified as a Competitive Telecommunications Service*, Docket No.

UT-970767, First Supplemental Order Granting Competitive Service Classification with Conditions (September 29, 1997); Shooshan, Tr. at 530:23 to 531:3. In that case, GTE held a market share no larger than 78%. at 2. Both Staff and GTE argued that market share was not indicative of market power in that case, but rather that the Commission should use the number of firms in the market, ease of entry into the market, and whether customers are captive as better indicators of market power. *In the Matter of the Investigation on the Commission's Own Motion Whether the IntraLATA Toll Services of GTE Northwest, Inc. Should be Classified as a Competitive Telecommunications Service*, Docket No. UT-970767, First Supplemental Order Granting Competitive Service Classification with Conditions at 3 (September 29, 1997). The Commission granted GTE's request for competitive classification even though it had a high market share because the number of competitors and the availability of alternative service were satisfactory. *Id*. at 10.

74 In addition, the Commission in 1987, classified AT&T as a competitive telecommunications company in a case involving a historically dominant carrier. At that time, AT&T retained a 75 percent market share. *In theMatter of the Petition of AT&T Communications of the Pacific Northwest, Inc., for Classification as a Competitive Telecommunications Company,* Docket No. U-86-113, Fourth Supplemental Order at 11 (June 5, 1987).

75 In this case, Qwest has a market share of 71.88%. Although 71.88% may be a relatively high market share, the market structure, i.e., the ease of entry, number of firms, etc., indicates that Qwest is not able to exercise market power.

2. Market concentration analysis

76 One measure of market concentration is the Herfindahl-Hirschman Index (HHI), described in the Department of Justice and Federal Trade Commission's Merger guidelines and used primarily to evaluate mergers in antitrust proceedings. Qwest offered a three-pronged approach to using HHI in evaluating a petition for competitive classification. Shooshan, Tr. at 528:19 to Tr. 532:17. First, the relevant market must be defined. Shooshan, Tr. at 529:1-2. Second, market concentration is measured as a method of gauging market power. Shooshan, Tr. at 530:3-6. Third, the significance of the market concentration must be determined. Shooshan, Tr. at 530:9-15.

77 Under a traditional HHI analysis, HHI is calculated by summing the squares of the individual market shares of all the participating firms in the relevant market. Wilson, Ex. 225 at 15. An HHI under 1000 indicates an unconcentrated market. *Id.* An HHI between 1000 and 1800 indicates a moderately concentrated market. *Id.* An HHI over 1800 indicates a highly concentrated market. *Id.* Mechanical application of HHI is discouraged. Wilson, Ex. 225 at 1; Gates, Tr. at 1185:11-14. Rather, the agency applying HHI is to exercise judgment in evaluating the specific facts before it. Wilson, Ex. 225 at 1.

78 When using HHI to evaluate a competitive classification petition, the Commission has found effective competition in markets that are much more highly concentrated than is acceptable under a merger analysis. *In re Qwest Corporation*, Docket No. UT-000883, Seventh Supplemental Order Denying Petition and Accepting Staff's Proposal at ¶ 73 (December 2000). Evaluating a merger involves different issues than evaluating a request for competitive classification. Gates, Tr. at 1191:18 to 1192:12.

A high concentration ratio by itself does not demonstrate market power. Shooshan, Ex. 103T at 17:9; Baldwin, Tr. at 828:17-20. A market may be highly concentrated, but may also be workably competitive if the market structure effectively supports competition. Shooshan, Ex. 103T at 17:9-12. Indeed, the Commission has stated that a very high concentration index does not disqualify services from being competitively classified if the market structure is sufficiently pro-competitive. *In re Qwest Corporation*, Docket No. UT-000883, Seventh Supplemental Order Denying Petition and Accepting Staff's Proposal at ¶ 73 (December 2000).

79 Staff, Public Counsel, and MCI offer HHI analyses. *See*, Wilson, Ex. 208C; Wilson, Ex. 209C; Baldwin, Ex. 403C; Ex. 404C; Ex. 405C; Stacy, Ex. 604C. Public Counsel concludes that the market is highly concentrated. Baldwin, Ex. 401T at 22:13-14 and at 25:7-8. As a result, Public Counsel recommends the Commission deny Qwest's petition. Baldwin, Tr. at 401 at 25:16-20 and at 62:1-7. MCI performs an HHI analysis using only CLEC-owned line data and UNE loop data, thus discounting lines provided using resale and UNE-P. Stacy, Ex. 604C.

80 Staff agrees that a traditional HHI analysis yields numbers consistent with a highly concentrated market.[12] Wilson, Ex. 201T at 24:12. Staff concludes, however, that an HHI analysis does not provide the best representation of the market because the data easily becomes stale. *Id.* at 24:13 and at 25:2-3. In addition, the market structure is sufficiently pro-competitive to support classifying Qwest's business services as competitive. Therefore, Staff recommends that the Commission place less weight on HHI and more weight on the market structure analysis, i.e., ease of entry, number and

[12] Interestingly, the minimum HHI in Zone 5 (5594) is less than the HHI in Zone 1 (6673). Wilson, Ex. 201 at 25:13-16.

size of firms, etc. Market share and HHI are minor parts of the overall analysis required to evaluate a petition for competitive classification. Stacy, Tr. at 1096:9-11; Baldwin, Tr. at 828:17-20.

3. Ease of entry

81 A firm is less likely to exercise market power if entry is so easy that competitors may react swiftly to a firm increasing its price above the competitive level. Wilson, Ex. 225 at 25. Entry that is timely, likely, and sufficient will curb the exercise of market power, *Id.*, and is one characteristic of an open market. Ease of entry is important to analyze because easy entry (1) indicates that the wholesale provisioning process is healthy, and (2) constrains Qwest's pricing decisions to the competitive level. Shooshan, Ex. 101T at 10:15 to 11:2.

82 In this case, entry is easy, illustrated by both the number of CLECs participating in the market currently, as discussed above, and the methods of entry. There is ample data of firms that have already entered the market and are actively providing service to business customers. Shooshan, Ex. 103T at 6:3-6.

83 Four modes of entry have been described in this case: resale, UNE-P, UNE loops, and facility-based competition. Of the lines reported using each entry method, resale consists of 10.12%, UNE-P consists of 26.9%, UNE loop consists of 42.64%, and facilities-based competition consists of 20.34%. Wilson, Ex. 201T at 21:18-20.

84 While resale is viewed as the least robust form of competition, it allows competitors to quickly enter the market and develop relationships with customers. Although businesses will have costs in addition to the wholesale inputs purchased from

Qwest, Reynolds, Tr. at 160:15-17, the non-recurring costs[13] to switch a customer from Qwest service to a CLEC providing service via resale is $5.73 for the first line and $5.61 for each additional lines. Reynolds, Ex. 1T at 15:1-6. The conversion can be completed on the same business day, provided that the service remains the same and a mechanized local service request is submitted before noon Mountain Time. Reynolds, Ex. 1T at 14, n. 15 and at 15:1-6.

85 CLEC reliance on resale is diminishing, and CLECs are relying more on UNE-P as an entrance strategy. Reynolds, Tr. at 308:13 to 309:5. UNE-P is one of the most effective means of entering the local market and has enhanced competition over the last few years. Gates, Ex. 501T at 16:373-374; Gates, Tr. at 1154:25 to 1155:2. The economics of UNE-P is more advantageous for CLECs than the economics of resale. Gates, Ex. 501T at 17:400-402. The non-recurring costs to switch a customer from Qwest service to a CLEC providing service using UNE-P is $0.27 for the first line and $0.14 for each additional line, and the conversion may be competed on the same business day. Reynolds, Ex. 1T at 15:7-12.

86 CLECs purchasing UNE loops pay $37.53 for the first loop and $34.78 for each additional loop. Installation of a "quick loop," a loop consisting of one to 24 lines, can be done in three business days. Reynolds, Ex. 1T at 15:13-18. A CLEC purchasing UNE loops from Qwest owns its own switch and can differentiate its service from Qwest's service. Gates, Ex. 504T at 13:318-322. There is evidence of CLECs purchasing UNE loops in most exchanges in Qwest's service territory.[14] Wilson, Tr. at 622:14-16.

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[13] Qwest argues that non-recurring rates are the only rates that effect entry. Reynolds, Tr. at 132:4-6.

[14] The total number of lines served by exchanges identified as having no UNE loops is 15% of the statewide access line total. Baldwin, Tr. 709:12-17.

87 There is little evidence in the record regarding the costs of entering the market using CLEC-owned facilities. However, CLECs weigh different entry modes and determine what would work best with their individual business plans. Companies such as Integra may seek to differentiate itself more from the incumbent (Qwest) by focusing on building facilities, rather than using wholesale inputs, to provision services. *See* Slater, Tr. at 847:11-20. Facilities-based competition represents 20.34% of the CLECs' entry method in Washington. Wilson, Ex. 201T at 21:18-20

88 Although Qwest is the dominant wholesale provider, it loses the retail customer relationship when a customer decides to switch from Qwest service to a CLEC, even when that CLEC is purchasing wholesale inputs from Qwest. Reynolds, Tr. at 306:21 to 307:7; Gates, Tr. at 1151:7-19; Gates, Tr. at 1152:5-13. Thus, entry based on wholesale inputs is relevant to evaluating whether Qwest's petition should be granted.

4. Affiliation of providers of service

89 The affiliation of providers of service may affect the amount of competition a firm faces in the market. Including affiliated firms as independent firms may overstate the amount of competition a firm faces in the relevant market. Affiliated firms are generally counted as one firm to recognize the fact that they are not truly independent entities.

90 In this case, although Staff counted each reporting CLEC as a separate company in the analysis of CLEC data regardless of the company's affiliation, Wilson, Tr. at 1465:6-8, the number of affiliated carriers does not alter the analysis. There are no more than five affiliated companies included in Staff's analysis. Wilson, Tr. at 1465:9-11.

Also, the number of lines reported would not change, only the number of carriers. Thus, the analysis remains valid.

5. Other – Analysis of the reasons customers disconnect from Qwest's service

91 A number of parties have address the reasons customers disconnect from Qwest service to support a contention that Qwest is losing market share due to problems in the economy. *See* Cowan, Ex. 701TC at 13:17 to 15:16; Baldwin, Ex. 401T at 31:5-9; Baldwin, Ex. 408C; Teizel, Ex. 82. However, disconnects due to a sagging economy would also affect CLECs, and CLECs would likely experience disconnects for similar reasons. Disconnects due to a downturn in the economy, such as bankruptcy, closing business, and downsizing, would likely result the decrease of number of total lines being served by all companies in the market. In other words, the market itself would shrink. The important measure is not the shrinking market, but rather is the share of the total lines possessed by the CLECs *vis a vis* the share of total lines possessed by Qwest.

E. SIGNIFICANT CAPTIVE CUSTOMER BASE

92 The Commission may grant Qwest's petition for competitive classification only if the services for which classification is sought are not provided to a significant captive customer base. RCW 80.36.330(1). A captive customer is one that has no choice for service other than the incumbent.[15] Reynolds, Tr. at 546:8-13; Shooshan, Ex. 103T at 15, n. 18. The definition of effective competition seems to anticipate that there may be a small level of captive customers by stating that there must not be a *significant* amount of captive customers.

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[15] Public Counsel offered a different definition of a captive customer. According to Public Counsel, a captive customer is one who has not chosen to switch to a CLEC, but has remained with Qwest. Baldwin, Tr. at 818:9-19. This definition does not seem to be consistent with the intent of RCW 80.36.330.

93 In this case, the data demonstrates that CLECs are providing and offering service in all parts of Qwest's service territory, with perhaps the exception of Elk, as of December 2002. Qwest indicated that five wire centers lacked CLEC presence, including Elk. Teizel, Ex. 51T at 9:14-15. The lines contained in those wire centers consists of approximately 0.11% of the total Qwest business lines in the state. Teitzel, Ex. 51T at 9:16-18. The data collected from CLECs indicate that only Elk remained without a CLEC presence as of December 2002. Wilson, Ex. 201T at 4:12-14.

94 Elk consists of a very small portion of the market; the 500 lines in Elk consist of approximately 0.03% of the total access lines statewide. Shooshan, Tr. at 545:3-7; Baldwin, Tr. at 710:17-20; Gates, Tr. at 1135:8-24. Evidence in the record also indicates that customers in Elk may be able to subscribe to service offered by CLECs. Reynolds, Ex. 8; Wilson, Tr. at 1277:7-21. Even if the customers in Elk are captive, the small percent of the market they represent is not likely to be significant under RCW 80.36.330.

95 Customers in Elk are protected from unreasonable rates because Qwest is not seeking waiver of the discrimination requirements. Reynolds, Tr. at 276:17 to 277:13. Also, ease of entry will affect Qwest's pricing decisions. Thus, Qwest will not be able to raise rates significantly in Elk compared to other segments of its service territory.

96 In addition, both Qwest and CLECs are targeting large as well as small customers. Thus, business customers in the vast majority of Qwest's service territory have the ability to choose either Qwest service or service from a CLEC.

97 The Commission may consider the evidence as a whole to determine whether customers have a range of alternatives significant enough for a finding of effective competition and also whether customers have the economic incentive and

sophistication to exercise those options. *In the Matter of the Petition of Pacific Northwest Bell for Classification of Services as Competitive*, Docket No. U-88-2052-P, Third Supplemental Order Granting Petition in Part at 15 (May 8, 1990). In this case, the customers are business customers, who tend to be a fairly savvy subset of customers. They have an economic incentive to choose a service provider that best fits into their business plans. In addition, they have a wide range of service alternatives from CLECs. Thus, the evidence supports a finding of no significant captive customers.

V. OTHER ISSUES

A. IMPACT OF OTHER DOCKETS (TRO, COST DOCKETS, ETC.)

98 Several parties argue that Qwest's petition for competitive classification is premature because other proceedings may affect the market. *See* Gates, Ex. 501T at 58:1388 to 60:1428; Gates, Ex. 504T at 31-32; Cowan, Ex. 701TC at 4:10-12 and at 16:8 to 17:18; Baldwin, Ex. 401T at 3:6-12. The proceedings in question are the Commission's review of UNE costs and the Triennial Review Order proceeding. It is important to note that RCW 80.36.330 and other statutory provisions give the Commission authority to address future changes in circumstances. For example, the Commission may reclassify Qwest's services if reclassification would be in the public interest. RCW 80.36.330(7).

1. Cost Dockets

99 The Commission has had one or more cost proceedings open since 1997. Slater, Tr. at 872:10-15. During this time, the Commission has also evaluated petitions for competitive classification. *See* Docket No. UT-990022; Docket No. UT-000883. A shift in UNE pricing, while it may cause some uncertainty for CLECs with regard to what their

input prices may be, will affect the price floor that may be charged. For example, if the UNE prices rise, the price floor will also rise. Wilson, Tr. at 1518:15-21. Thus, the Commission may continue to evaluate petitions for competitive classification, such as Qwest's petition, while cost dockets are pending.

2. Triennial Review Order

100 The FCC released its Triennial Review Order (TRO) on August 21, 2003, shortly after Qwest filed its petition, but before the evidentiary hearings were held in this case. The on-going availability of mass market switching, and thus UNE-P,[16] will be the subject of a Commission review process to determine whether economic or operational impairment would occur if CLECs were unable to obtain the switching element when serving customers in the mass market. Customers in the mass market are those customers served using DS0 lines, rather than DS1 or larger circuits. *TRO* at 12. To conduct the analysis, the Commission must evaluate certain triggers set forth in the TRO. *Id.* at 12 and at 313, ¶ 493 to 333, ¶ 520. The analysis is conducted on a granular level rather than on a statewide level. *Id.* at 314, ¶ 495.

101 Before the TRO was released, CLECs stated that the uncertainty surrounding UNE-P created uncertainty in CLEC business plans. Cowan, Ex. 701TC at 16:16-18. Once the TRO was released, CLECs gained some degree of certainty, and there was favorable reaction in the CLEC community to the TRO due to the continuation of UNE-P. Cowan, Tr. at 1015:22-25; Cowan, Ex. 703; Baldwin, Ex. 430. Both AT&T and Sprint announced plans to expand service to local markets across the nation in response to the TRO. Wilson, Ex. 210TC at 11:7-11; Wilson, Ex. 212; Cowan, Ex. 703.

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[16] UNE loops, the element purchased by CLECs that own their own switches, and resale are not affected by the TRO.

102 The outcome of the TRO proceeding should not affect the Commission's evaluation of Qwest's petition in this docket. The data indicates that substantial competition exists even without UNE-P. Wilson, Ex. 210TC at 10:8-13. Due to the safeguards created by the triggers in the TRO, CLECs will have access to UNE-P as long as is necessary[17] in those parts of the state where it would be uneconomic for CLECs to compete without it. In any event, CLECs will continue to have access to resale and UNE loops. Shooshan, Ex. 103T at 19:7 to 20:7.

B. COST FLOOR

103 Qwest is not seeking any rate changes for its services in this proceeding, and thus has not filed any cost analysis. Qwest's business service rates were last established by Commission order and are presumed to be lawful.

104 It is Staff's understanding that the current rates for Qwest's listed services are, on average, above cost. This is because they were supported by cost studies demonstrating that the rates were above cost at the time they were originally filed. Since then, generic cost study dockets have established TELRIC estimates for unbundled network elements for Qwest. Qwest revenue-per-line data provided to Staff via discovery reveals that Qwest is able to achieve sufficient revenue in every wire center to pass an imputation test. Wilson, Ex. 201T at 22:9-12. Neither Mr. Stacy nor any other witness asserts that Qwest's current rates are creating a price squeeze. Stacy, Tr. at 1082:11, 12. Indeed, Qwest's analysis shows that, even in the highest cost UNE pricing zone, Qwest's current retail rates do not create a price squeeze, even if one applies the additional increment that Mr. Stacy suggests for retail related costs. This is borne out by the fact

[17] The outer limits of the time period during which UNE-P may be available is determined by the FCC.

that competitor's market share in zone 5 wire centers is in many cases as robust as in the lower cost zones. Wilson, Ex. 201T at 25:13-16.

105 In Qwest's most recent contested competitive classification proceeding, the Commission was confronted with arguments that it should determine the cost standard to be used to establish the price floor for competitive services. The Commission declined to do so. It said: "As with the competitive classification of toll services, 'the initial price lists filed pursuant to competitive classification of these services should mirror the current tariff rates. Thereafter, any rate change must continue to cover its related costs and pass the imputation test.'" *In the Matter of the Petition of Qwest Corporation for Competitive Classification of Business service in Specified Wire Centers*, Seventh Supp. Order Denying Petition and Accepting Staff's Proposal, Docket UT-000883 (Dec. 2000), citing *In the Matter of the Petition of US WEST Communications, Inc. for competitive Classification of its IntraLATA Toll Service,* Order Granting Petition, Docket UT-990021 (Jan. 1999). The Commission should follow these precedents in this case.

106 Imputation tests are designed to prevent the problem of price squeeze. As Mr. Stacy says: "A price squeeze is created when a vertically integrated firm (such as Qwest) has unrestrained retail pricing freedom to compete against companies (such as CLECs) in retail markets while controlling critical inputs that its competitors are dependent upon. In this situation, the vertically integrated firm can use the price squeeze as an anticompetitive device by lowering the price for retail service to or below the price which it charges for the wholesale elements necessary for competitors to compete, thus squeezing the dependent competitors' margins between retail rates and wholesale rates, and reducing or eliminating their ability to recover their costs." Stacy, Ex. 601T at 19:467-474.

107 Denying below-cost pricing is a key provision of the competitive classification statute. As stated above, the Commission has held that it is appropriate to determine the cost floor for price listed services by applying an imputation test. It has also done so by rule. WAC 480-80-204(6) specifically provides that:

> The rates, charges, and prices of services classified as competitive under RCW 80.36.330 must cover the cost of providing the service. Costs must be determined using a long-run incremental cost analysis, including as part of the incremental cost, the price charged by the offering company to other telecommunications companies for any essential function used to provide the service, or any other commission-approved cost method.

TELRIC estimates—together with some increment to represent the CLEC's retail related costs as suggested by Mr. Stacy—would suffice as a price floor for future pricing of listed services if the Petition is approved.

C. ACCESS CHARGES

108 MCI witness Timothy Gates argues that Qwest "will be able to use the subsidies inherent in access charges to subsidize its competitive offerings to the detriment of its competitors" and that "[i]n effect, Qwest can subsidize its competitive offerings with profits from its competitors." Gates, Ex. 501T at 53.

109 RCW 80.36.330(6) prohibits, and provides a remedy for the kind of cross-subsidy that Mr. Gates suggests Qwest could make from its regulated switched access charges to its retail business services business. The rate levels for Qwest's switched access service elements should have no bearing on this docket. Even Public Counsel witness Susan Baldwin states that "the issue of access charge pricing is well beyond the scope of

this proceeding" and that MCI's concerns "seem to be a distinct issue that should be addressed in a separate proceeding." Baldwin, Ex. 422RT at 22:4-9.

110 MCI's argument also fails because CLECs have the same ability as Qwest to recover their filed switched access charges from interexchange carriers at the rate levels they have price listed with the Commission. In fact, a number of CLEC's intrastate switched access rates, including MCI's and AT&T's, are equal to, or greater than, Qwest's intrastate switched access rates. Reynolds Ex. 7RT at 13:1-6.

D. PROPOSED CONDITIONS ON APPROVAL

111 Staff recommends that the Commission approve Qwest's petition without imposing conditions. Wilson, Tr. at 1343:21; Wilson, Tr. at 1355:3-4. Conditions are not necessary if the market is effectively competitive. Some parties, however, have proposed conditions for the Commission to consider.

112 Qwest has committed that, should the Commission grant Qwest's petition, Qwest will not abandon service in the exchange areas it currently serves for the services listed in the petition. Qwest states that the commitment is effective until November 7, 2009. The commitment will not affect Qwest's ability to grandfather the services listed in the petition or to sell any or all of its business in the service areas where it currently offers such services. Qwest acknowledges that its obligation to serve under other statutes and rules would not be altered by this condition. Reynolds Ex. 7RT at 8:5-8, n. 11. Staff does not disapprove of this commitment. Wilson, Ex. 201T at 2:3-10.

113 AT&T proposes a number of conditions. Cowan, Ex. 701TC at 18:1 to 19:13. The first condition AT&T proposes is that the Commission grant Qwest's petition only in the geographic locations where it has actually proven it faces effective competition.

Cower, Ex. 701TC at 19:3-4. In order for the Commission to grant Qwest's petition, it must find that effective competition exists. Qwest's petition requests competitive classification on a statewide basis, which requires the Commission to find that effective competition exists statewide. Thus, the first condition AT&T proposes is unnecessary.

114 The second condition is that Qwest be required to provide UNE loop, UNE-P, and resale for a period of ten years and that the requirement be removed only upon a showing of effective competition without the provision of wholesale services. Cowan, Ex. 701TC at 19:5-8. UNE loop and resale requirements are not being reviewed in proceedings addressing the TRO. Thus, they will remain available to CLECs until the FCC and state commissions decide they are unnecessary. UNE-P may be discontinued, but only in specific geographic areas if the Commission finds that CLECs are not impaired without it. In addition, a period of ten years is excessively long given the dynamic nature of the telecommunications industry. The Commission should not adopt the second proposed condition.

115 The third condition is that Qwest meet its PAP requirements in any consecutive three month period or lose its competitive classification in those areas wherein it fails. Cowan, Ex. 701TC at 19:9-11. This condition is partially redundant – Qwest is already required to meet its PAP requirements and is subject to penalties if it does not. Furthermore, the Commission may reclassify Qwest's services if reclassification is in the public interest, such as if the company engages in anticompetitive acts. Cowan, Tr. at 1019:5-13. The third condition is unnecessary.

116 The fourth, and last, condition proposed by AT&T is to require that Qwest establish price floors for each service classified as competitive. Cowan, Ex. 701TC at

19:12-13. Presumably, the reason for a price floor is to prevent below-cost pricing. However, Qwest is prohibited from pricing below cost by RCW 80.36.330(3). Thus, the fourth condition is also unnecessary.

117 The evidence in the record indicates that effective competition exists in the relevant market. Thus, the Commission may grant Qwest's petition without imposing conditions on Qwest. Staff recommends that the Commission do so.

E. OTHER

118 N/A

VI. CONCLUSION

119 Effective competition exists in the relevant market. CLECs are providing service to business customers throughout Qwest's service territory, and both large and small businesses have access to alternatives to Qwest service. Although Qwest has a 71.88% market share, it does not possess market power in its service territory due to the pro-competitive nature of the market. Therefore, Staff recommends that the Commission grant Qwest's petition for competitive classification.

DATED this 28th day of October, 2003.

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