Exhibit No. _____ (CRD-1T)
Docket No. UT-040788

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	
Complainant,	)	
v.	)	**DOCKET NO. UT-040788**
VERIZON NORTHWEST INC.,	)	
Respondent.	)	
. . . .	)	

REBUTTAL TESTIMONY OF

CARL R. DANNER

ON BEHALF OF
VERIZON NORTHWEST INC.

FEBRUARY 2, 2005

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I. INTRODUCTION

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

A. My name is Carl R. Danner. I am a Director with Wilk & Associates/LECG LLC, 201 Mission Street, Suite 700, San Francisco, CA 94105.

Q. PLEASE SUMMARIZE YOUR EXPERIENCE AND QUALIFICATIONS.

A. I was Advisor and Chief of Staff to Commissioner (and Commission President) G. Mitchell Wilk during his tenure at the California Public Utilities Commission (CPUC). Since leaving the CPUC, I have provided consulting services to various clients on regulation and policy, with emphases on the telecommunications and energy industries. I hold a Masters and Ph.D. in Public Policy from Harvard University, where my dissertation addressed the strategic management of telecommunications regulatory reform. At Harvard I served as Head Teaching Assistant for graduate courses in microeconomics, econometrics, and managerial economics. I hold an AB degree from Stanford University, where I graduated with distinction in both economics and political science. My experience includes researching and teaching regulation, advising regulators, testifying in regulatory proceedings, and advising clients on regulatory issues. My complete resume is attached as Exhibit No. CRD-2.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. My testimony principally responds to the direct testimony of Commission Staff witnesses Dr. Glenn Blackmon and Dr. Lee Selwyn. In particular, I respond to a variety of assertions Dr. Blackmon offered about the circumstances of this case and the effect of competition on Verizon Northwest Inc. ("Verizon NW" or the "Company"). I also rebut Dr. Selwyn's assertion that $75 is an appropriate market value for a new customer for long distance service. Additionally, I respond to Staff witness Jing Roth with regard to the role of cost-based retail pricing in a competitive environment, and to Dr. Loube's claim, on behalf of Public Counsel and AARP, that the loop is not an incremental cost of basic local exchange service.

II. RESPONSE TO DR. BLACKMON'S THEORY OF THE CASE

Q. IS THERE A FUNDAMENTAL PROBLEM WITH DR. BLACKMON'S TESTIMONY AND OPINIONS?

A. Yes, there is. This is a rate case proceeding in which the Commission is charged with determining just, reasonable and sufficient rates for Verizon NW based on test year expenses, revenues, and investment-related costs (depreciation and rate of return). For that reason, the focus of this case is necessarily on the dollars and cents of expenses, investment levels, depreciation, and the like. Most of the testimony in the case addresses such figures either directly or indirectly, as it should to assist the Commission in preparing the numerical outcome to which the case must lead.

In contrast to this focus, Dr. Blackmon's testimony consists mainly of comments and assertions. He proposes no adjustments to test year expenses, revenues, investment levels, depreciation or rate of return. He talks about what he sees as a lack of suitability of the rate case process to the current circumstances facing Verizon NW, without offering any useful information to inform that process. He offers a fundamentally mistaken view of the impacts of competition on Verizon NW and its customers, without demonstrating how his assertions (even if true or reasonable) should translate into a single adjustment to any figure contained in the Company's results of operations. In other words, his testimony is irrelevant to this proceeding; it does not offer information that will be helpful to the Commission in deciding the issues at hand.

Q. HOW DOES DR. BLACKMON CHARACTERIZE COMPETITION AND ITS IMPACTS ON VERIZON NW?

A. Dr. Blackmon expresses a variety of concerns and regrets about competition and Verizon NW's responses to it, and the rate case process that this Commission is following for Verizon NW. In general, he feels that intrastate regulated services are diminishing and that services not subject to this Commission's jurisdiction are the replacement. He believes that customers are being shifted away from intrastate regulated services by deliberate actions of Verizon NW business units. He also takes exception to the results produced by the federally mandated separations process. (Blackmon pages 24, 9, 10, 11). Dr. Blackmon is further concerned that Verizon NW is "attempting in this proceeding to shift its losses from competitive activities to its remaining captive customers." (Blackmon pages 11, 24)

Q. IS DR. BLACKMON'S PERSPECTIVE ON COMPETITION AND REGULATION VALID?

A. No, it is not. I agree with Dr. Blackmon that Verizon NW faces substantial competition that is affecting its intrastate operations, including from technologies he identifies such as broadband Internet access and wireless. But beyond that point, Dr. Blackmon's perspective on competition and regulation is incorrect in fundamental ways.

Q. IS VERIZON NW IN A POSITION TO DICTATE THE COURSE OF COMPETITION, CONSISTENT WITH DR. BLACKMON'S ASSERTIONS?

A. Verizon NW is in no such position, and could not pursue Dr. Blackmon's claimed strategy of allocating customers at will among its business units in some attempt to make its regulated books look bad. Rather, Verizon NW must do its best to respond to competitive pressures and marketplace decisions that are ultimately driven by choices customers make. Customers desire new or improved technologies and will move to providers that can satisfy those needs. It happens that most such needs are currently being met through competitive offerings that are less regulated or unregulated – such as wireless providers and high-speed Internet access using DSL, cable modem, satellite and, increasingly, other wireless alternatives. While various Verizon business units provide some of these offerings and are presumably doing their best to promote them to customers, these are also highly competitive services in which no provider has the ability to allocate a customer anywhere he or she doesn't want to go. Indeed, the FCC has generally followed a pro-competitive policy over the years that has led to a highly desirable public policy result of little or no public utility-style regulation of such alternatives. Therefore, when customers shift from ILEC-type services, they tend to go in a less-regulated direction. There is nothing wrong with that; rather, it is the best outcome for the benefit of the public.

Dr. Blackmon does not accurately acknowledge these competitive dynamics and customer choices when he adversely characterizes, for example, a customer's decision to upgrade Internet access to DSL in place of an existing second line used for dial-up access (Blackmon, page 24). To describe that customer as having been "shifted" by Verizon NW for some larger corporate purpose is to turn the reality of the market on its head. Neither is there any improper motive when Verizon Long Distance ("Verizon LD") offers a customer a more capable long distance service, perhaps in combination with a package discount of some kind, in hopes of retaining that customer in the face of other competitive alternatives. Likewise, customers enjoy the very low (effectively "free") long distance prices that wireless bucket plans provide, and an increasing number of customers like wireless service enough that they abandon their wired service for one of the several alternatives (including Verizon Wireless) they have available. These developments are part and parcel of a tremendous public policy success in promoting new technology and competition in a once-monopoly industry. By contrast, the essence of Dr. Blackmon's response is that too many intrastate regulated service customers are leaving Verizon NW and the Company should do more to stop them.

Q. DO YOU AGREE WITH DR. BLACKMON'S POSITION ON THE GENERAL RATE CASE PROCESS IN THE PRESENT COMPETITIVE ENVIRONMENT?

A. No. The reality is that a rate case is the only avenue Verizon NW has in Washington to attempt to set some of its prices at more reasonable levels so it can achieve a measure of financial health in this jurisdiction. The Commission must follow this statutory process and make a decision according to rate case principles.

III. RESPONSE TO DR. BLACKMON'S SPECIFIC CLAIMS

Q. PLEASE COMMENT ON DR. BLACKMON'S CLAIM THAT VERIZON NW'S ACCESS REVENUES WOULD HAVE DECREASED AS A RESULT OF COMPETITION EVEN IF THE COMMISSION HAD NOT ORDERED A REDUCTION IN ACCESS RATES. (BLACKMON, PAGE 23)

A. In the first instance, this claim contradicts the claim Dr. Blackmon made in the AT&T Access Complaint Case, Docket No. UT-020406, that Verizon NW's access charges are *not* competitive and could *not* be reduced by competition. He said, "I believe that originating access charges have not proven to be as effective a catalyst to competition as we hoped in 1997. Competitors appear to charge the incumbents prevailing access rates and do not compete based on the price of switched access services." (Exhibit T-(GB-RT), Page 4, L 9-12) Dr. Blackmon stated further in that case, "[A]chieving lower access charges, which has clearly been the Commission's objective all along, will require more overt pressure in the form of proceedings such as this one." (Exhibit T-(GB-RT), Page 4, L 14-16) The Commission apparently accepted Dr. Blackmon's argument, because it held in its Eleventh Supplemental Order (¶ 45, n. 17) that Verizon NW's access service is "noncompetitive."

In any event, the more important point is that Verizon NW needs to recover its costs of regulated service in Washington, and the Commission must set rates that permit the Company to do so. The fact that the access charge order deprived Verizon NW of a substantial stream of revenues means that the Company is even further removed from rate levels that will permit that fundamental obligation to be met. With regard to that necessary level of revenues, it really does not matter what customers might have done in the absence of the access charge order. Even if customers would have abandoned wired long distance service altogether (making access charge revenues entirely disappear), Verizon NW's expenses would still have to be recovered in rates through this case. So Dr. Blackmon's statement is beside the point if he means to suggest that the access charge revenues are somehow illegitimate or unnecessary in light of any particular characterization of competition. The only actual ratemaking issue is the appropriate level of access charge usage to use going forward (for rate design purposes) in order to make the authorized rates add up to the authorized revenues the Commission will order. In that regard, Verizon NW has provided the information on access service volumes needed for rate-setting, and Dr. Blackmon has offered nothing to suggest those numbers are not accurate.

Q. DR. BLACKMON STATES "THERE IS ABSOLUTELY NO EVIDENCE TO SUGGEST THAT THE DEPRECIATION OR 'CAPITAL RECOVERY' PRACTICES OF THE WASHINGTON COMMISSION FAIL TO RESULT IN FULL RECOVERY BY VERIZON NW, WITH A FAIR RETURN TO

INVESTORS, OF THE INVESTMENTS THAT THE COMPANY MAKES IN THIS STATE." (BLACKMON, PAGE 17). DO YOU AGREE?

A. No. Dr. Blackmon is wrong. As shown in the testimony of Tony Flesch in Docket UT-040520, Verizon NW's accumulated depreciation reserve is not adequate, which means that the Commission's capital recovery practices are inadequate. The depreciation reserve lags the Verizon NW Washington GAAP depreciation reserve by $471 million and the Verizon NW Washington FCC depreciation reserve by $242 million. (*See* Depreciation Study, Exhibit AJF-7, Introduction Section Docket UT-040520.) In that docket I also discuss public policy concerns and core principles of ratemaking that require Verizon NW be permitted a reasonable opportunity to recover its investments. Unless the Commission changes it depreciation practices and approves the depreciation rates recommended, Verizon NW will be denied the opportunity for full recovery of its capital investment in Washington that it must be permitted under core principles of regulation and economics.[1] In addition, the Commission needs to bear in mind that in the current economic environment and the competitive telecommunications market, Verizon NW's Washington operation is competing for capital. Its investors have many other demands on their capital and many other opportunities for investment. A poor investor perception of the capital recovery practices of the Commission has a negative impact on the willingness of investors to deploy more dollars to the state.

[1] This leaves aside the nearly $100 million that the Company will not be able to recover in any event under the Commission's ratemaking, as my testimony also discussed.

While the depreciation docket is proceeding on a parallel schedule to this rate case and will presumably be decided in the near term, it is important to set the record straight here about Dr. Blackmon's erroneous claim.

Q. DR. BLACKMON STATES "THE COMMISSION SHOULD SET RATES FOR THE LONG RUN, ESPECIALLY SINCE VERIZON NW HAS DEMONSTRATED THAT IT CAN GO MANY YEARS WITHOUT SUBMITTING A GENERAL RATE CASE . . . ." (BLACKMON, PAGE 25, LINES 8-11). DO YOU AGREE?

A. No. This is just a vague way of asking the Commission to ignore the test year ratemaking process and deny Verizon NW needed revenues because of Dr. Blackmon's assertion about problems in the Washington economy. This suggestion violates ratemaking practices under rate of return regulation, which contemplate neither waiting to see if a hazy futuristic event ever materializes nor adjusting a test-year showing based on the current state of the economic cycle. Rates are set based on revenues, expenses, and investment framed within a test year. The rate case rules do allow for adjustments within twelve months of the test year, but they must be "known" and measurable."[2] With regard to making the numbers add up, there is no "long run;" there is only the test year. Once again, Dr. Blackmon has done nothing to inform the Commission as to what specific revenue or expense levels should be considered to develop appropriate test year rates.

[2] See WAC 480-07-510 3(b)(ii) "Pro forma adjustments" give effect for the test period to all known and measurable changes that are not offset by other factors. The filing must identify dollar values and underlying reasons for each proposed pro forma adjustment.

Q. DR. BLACKMON ALSO SUGGESTS THAT VERIZON NW SHOULD BE PRECLUDED FROM TRYING TO RECOVER ANY REVENUES "LOST DUE TO COMPETITION." (BLACKMON, PAGE 25). PLEASE COMMENT.

A. This is an exceedingly untenable regulatory suggestion in an environment in which every Verizon NW service is open to competition. Phrasing it in terms of "captive customers" (as Dr. Blackmon does) is of no help because precious few (if any) of Verizon NW's customers are literally captive to anything the Company offers. To take such a suggestion seriously would require an attempt to break regulated companies into pieces based on what alternatives customers saw to particular services. If somehow accomplished, Dr. Blackmon's suggestion would likely have the opposite result to what he seems to imagine, as excluding the more competitive services from ratemaking is also likely to exclude precisely those services whose margins have helped sustain other Verizon NW offerings (like basic residential service) whose prices are low. In any event, this is another of Dr. Blackmon's suggestions that has no relevance to determining just, reasonable and sufficient rates through a rate case process.

By contrast, the way to deal with increasing competition (as I state in the depreciation docket) is not to contort the traditional regulatory process to fit someone's personal vision of how competition ought to take place. The appropriate public policy response to competition is deregulation. But since that has not happened in Washington, the Commission must respect the principles of the rate case process, which are contrary to the inaccurate (and vague) suggestions and arguments Dr. Blackmon offers repeatedly in his testimony.

IV. RESPONSE TO DR. SELWYN'S ERRONEOUS LONG DISTANCECUSTOMER ACQUISITION COST CLAIM

Q. WHAT DOES DR. SELWYN CLAIM ABOUT THE AFFILIATE RELATIONSHIP BETWEEN VERIZON NW AND VERIZON LONG DISTANCE (VERIZON LD)?

A. Dr. Selwyn claims that Verizon LD is not properly compensating Verizon NW for services Verizon NW provides to Verizon LD in connection with the selling of Verizon LD services. In particular, Dr. Selwyn asserts that information I previously provided about AT&T in the access charge complaint case supports a market value of $75 for the acquisition of a long distance customer, which figure Staff witness Timothy Zawislak proposes to use in calculating adjustments to Verizon NW's results of operations.[3] In other words, Dr. Selwyn states that since AT&T was willing to spend $75 to acquire a long-distance only customer, that customer must have been worth at least $75 to AT&T. Dr. Selwyn also notes that this $75 is consistent with earlier information about interexchange carrier spending on long distance customer marketing provided by two economists testifying on behalf of several RBOCs in February 2002.

Q. AS A THRESHOLD MATTER, IS STAFF'S USE OF THE AT&T CUSTOMER ACQUISITION COST APPROPRIATE IN EVALUATING VLD'S PAYMENT TO VERIZON NW FOR ITS SERVICES?

A. No; it is apples and oranges. As Mr. Fulp explains in his testimony, the services that Verizon NW provides to Verizon LD equate to only a portion of what is involved in the

[3] Selwyn, page 41, referring to my surrebuttal testimony of February 23, 2003 in UT-020406. My analysis responded to a highly questionable figure of $300-600 that Dr. Selwyn had claimed in that case.

customer acquisition effort represented by the AT&T figure. Therefore, it is not appropriate to compare these limited services to the entirety of customer marketing and acquisition spending that a carrier might undertake. Accordingly, there is no proper role for the $75 figure, or another number like it, in setting rates for Verizon NW.

Q. AS A FURTHER CONCERN BEYOND THE LACK OF ANY ROLE FOR SUCH A NUMBER, IS $75 STILL AN ACCURATE FIGURE FOR WHAT AT&T IS SPENDING TO ACQUIRE STAND-ALONE LONG DISTANCE CUSTOMERS?

A. No, it is not. The long distance market has changed since early 2003, as a recent Morgan Stanley assessment of AT&T, MCI, and Sprint discussed:

> "The companies have shifted their focus away from traditional consumer services, and AT&T and MCI are not spending to acquire new residential local and stand-alone long distance customers."[4]

An AT&T news release made the same point in July of 2004:

> "As a result of recent changes in regulatory policy governing local telephone service, AT&T will no longer be competing for residential local and standalone long distance (LD) customers. The company stressed that existing residential customers will continue to receive the quality service they expect from AT&T; however, the company will no longer be investing to acquire new customers in this segment."[5]

Subsequently, AT&T confirmed that discontinuing these customer marketing and acquisition costs is creating genuine cost savings:

[4] Morgan Stanley Equity Research, Telecom Services. "3Q04 Trend Tracker: Let the Good Times Roll?" December 3, 2004, page 39.
[5] AT&T Corporation News Release. "AT&T Announces Second-Quarter 2004 Earnings, Company to Stop Investing in Traditional Consumer Services; Concentrate Efforts on Business Markets," July 22, 2004.

> "AT&T also said that as a result of its decision to stop marketing traditional residential services, as well as corporate transformation initiatives, it will significantly exceed its previously estimated workforce-reduction target of 8 percent in 2004…[A]T&T's acceleration of workforce reductions and other cost-cutting initiatives are having a positive impact on profitability across the business. The company is also beginning to benefit from lower marketing expense as it scales back its traditional consumer operation."[6]

Indeed, the potential for reductions in AT&T's customer marketing and acquisition costs was already recognized by the time of the February, 2003 report I provided:

> "To the extent that AT&T decides to run the Consumer business under more of a harvest strategy vs. acquisition strategy the acquisition and sales budget could be a greater source of cost savings going forward."[7]

Therefore, the prior information I provided about AT&T's costs of marketing and customer acquisition is now obsolete, as is the earlier analysis of the two economists to whom Dr. Selwyn referred. His failure to acknowledge these subsequent developments leaves a rather large hole in Dr. Selwyn's testimony.

Q. DOES DR. SELWYN PROVIDE ANY CURRENT OR ADDITIONAL INFORMATION ABOUT THE SUBJECT?

A. No, he only refers to the prior analysis of others, as I have described.

Q. FROM THIS INFORMATION, WHAT SHOULD THE COMMISSION CONCLUDE ABOUT RATEMAKING FOR VERIZON NW?

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[6] AT&T Corporation News Release. "AT&T Continues Restructuring and Cost Reduction Efforts," October 7, 2004.
[7] Credit Suisse First Boston. "AT&T Consumer: A Base Case Ahead of The Triennial Review," February 5, 2003 (page 8).

A. First, as noted above, Verizon NW is not actually performing the full range of activities related to acquiring long distance customers for Verizon LD. Therefore, the $75 – or any figure like it – is not relevant to setting rates for Verizon NW. Separately and additionally, Dr. Selwyn has presented only obsolete information to support the use of a $75 figure to estimate the market value of a long distance customer delivered to a provider. By contrast, the actions of major long distance carriers now support a figure of zero for such a market value, if such a number was appropriate for use in ratemaking (which it is not for Verizon NW).

V. THE ROLE OF COST-BASED PRICING IN A COMPETITIVE ENVIRONMENT

Q. IN HIS REBUTTAL TESTIMONY, MR. FULP OPPOSES STAFF'S PROPOSAL FOR DEAVERAGED BASIC LOCAL RATES. WITH REGARD TO STAFF'S PROPOSAL, CAN YOU PLEASE PROVIDE AN OVERALL ECONOMIC PERSPECTIVE ON RELATED PRICING ISSUES IN A COMPETITIVE ENVIRONMENT?

A. Yes. In the non-competitive environment in which local telephone companies historically operated, service prices could be set by regulators at a variety of levels without fear that competition would undermine the results. In other words, there was a wide range of prices that could be sustained – and which might, or might not, comport with the way in which economic principles would suggest setting those prices. There were, of course, economic consequences that flowed from those pricing decisions. For example, the historical overpricing of long distance service relative to its incremental cost (and corresponding under pricing of basic local exchange service relative to its incremental cost) caused substantial economic losses for the economy and consumers and harmed universal service. For regulatory purposes in this single-provider environment, analysis of underlying costs was important as an aid to trying to set prices in as economically efficient a manner as possible under regulation.

In today's competitive environment, principles of economics call for a different analysis than was appropriate in a monopoly setting. The market is now setting competitive limits on basic service prices (and determining how underlying costs will be factored into those prices) based on the interplay of competitors and the various technologies they employ, along with consumers and their various and changing preferences. For example, providers compete using technologies that have differing cost characteristics (e.g., as between fixed wireline networks, wireless networks, and voice over Internet protocol or VoIP). While Verizon NW's calculated costs are still potentially significant to these competitive pricing decisions, neither the level nor the structure of Verizon NW's costs will necessarily determine the market prices that the Company is able to charge for its services, including basic local exchange service. Indeed, the model is changing from one in which Verizon NW's costs could determine prices (e.g., where the Commission might set prices based on such cost calculations) to one where Verizon NW finds the prices as they are given by the market regardless of what its own costs might be.

Q. IS THE MARKET MODEL A PREFERRED APPROACH FOR PRICE-SETTING BASED ON ECONOMIC PRINCIPLES?

A. Yes, it is. Market prices can factor in the full variety of dynamic influences (such as changing costs, customer demands, new technologies and uses for services, etc.) in a way that no regulatory or administrative process ever could. While setting prices based on underlying costs is an apt goal for a regulatory process in a non-market environment, in a market environment such an effort will inevitably fall short of the more economically appropriate prices that market forces will set, and modify over time.

Q. WHICH PRICING APPROACH IS REPRESENTED BY THE STAFF'S DEAVERAGING PROPOSAL?

A. The Staff's deaveraging proposal is based on the administrative approach to price-setting under which regulators seek to match prices to underlying costs as an administrative matter. The problem with this proposal in today's environment is that it does not take account of the market pressures that Mr. Fulp identifies, by which the competition (including the preferences of consumers) is pushing Verizon NW to offer uniform statewide prices for basic service, even in locations where the incremental cost of that service may vary. In the current competitive environment, Verizon NW's proposal is based on its own market experience and should be adopted.

Q. DR. LOUBE OPINES THAT THE LOOP IS NOT APPROPRIATELY CONSIDERED AN INCREMENTAL COST OF LOCAL EXCHANGE SERVICE, A POSITION HE NOTES THE COMMISSION HAS ALSO ENDORSED (LOUBE, PAGES 11-13). PLEASE COMMENT.

A. I would offer two responses. First, I do not believe that this question needs to be resolved in order for the Commission to authorize a reasonable rate design for Verizon NW. As I have noted above, marketplace pressures have now replaced administrative cost calculations as the best way to determine economically appropriate prices for Verizon NW's basic services. As well, even Dr. Loube's argument still leaves the need to recover loop costs from some set of service prices, and the market is the obvious and reasonable guide as to where those costs should be recovered.

The second response is that Dr. Loube and the Commission's prior finding are simply in error. To the extent it may make a difference to the Commission's deliberations on rate design, the Commission should acknowledge the economic reality that the cost of the loop is an incremental cost of network access, which is provided to customers through basic local service.

Q. PLEASE SUMMARIZE WHY THE COST OF THE LOCAL LOOP IS AN INCREMENTAL COST OF BASIC EXCHANGE SERVICE.

A. Fundamental principles of economics lead to this conclusion. Briefly, the cost of the loop is incurred – in its entirety – by providing basic service (i.e., network access) to a customer. The decision to have basic service is what causes the cost to be incurred. The essence of the economic definition of "cost" is causation; and a customer's decision to use a loop to buy other services (such as speed dialing or Caller ID) no more "causes" the cost of that loop than does a mail carrier "cause" the cost of one's driveway by walking down it to deliver a package. This is the correct analysis, as eminent economist Dr. Alfred Kahn noted in a discussion of this fallacy:

> *"1. The concept of "cost" has no meaning in either economics or logic except in terms of <u>causation</u>. When we say that drunk driving "costs" us so many lives per year or so many dollars in property damage, we can mean only that the practice <u>causes</u> us, individually and/or collectively, to suffer those consequences. Similarly, when we say that the "cost" of a subscriber loop is some amount, it can mean nothing except that some act of purchase by a consumer <u>causes</u> a telephone company and society to incur that cost. In order to set efficient telephone prices we must then determine <u>which</u> act of purchase has that effect.*
>
> *2. Consumers impose the cost of the loop on a telephone company and on society by the act of subscribing to telephone service. The causation principle therefore requires that the cost of providing the loop be fully incorporated in the cost of that basic service, that is, in a flat one-time or periodic charge. Conversely, if, as I understand to be essentially the case, actual use of the loop imposes <u>no</u> loop costs on the supplier and if subscribers were to refrain from placing those calls or using any of those other services it would not <u>save</u> any of those costs, there is no sense in which usage or other services can be held causally responsible for them."*[8]

Q. HAS THIS ISSUE BEEN ADDRESSED IN THE FEDERAL CONTEXT?

A. Yes, the treatment of the loop has been relevant to the FCC's access charge reform efforts, which now span decades. In its 1984 opinion reviewing the FCC's decision to impose per-line subscriber line charges (NARUC v. FCC, 737 F.2nd 1095 (1984)), the District of Columbia Circuit Court of Appeals made the following statement about the cost characteristics of local loops, and how those relate to appropriate recovery of those costs:

[8] Kahn, Alfred E. <u>Letting Go: Deregulating the Process of Deregulation</u> (The Institute of Public Utilities and Network Industries, Michigan State University, 1998), pages 71-72; emphases in original, footnote omitted.

> *"Plant costs are nontraffic sensitive when they do not vary with the extent to which the facilities are used. The basic cost of installing and maintaining a local loop, for example, remains the same whether the subscriber, or 'end user,' uses the loop to make one call or a hundred, and whether those calls are local or long-distance." (Opinion, Page 1104).*

> *"The end user charge reflects costs caused not by a subscriber's actually making interstate calls, but by the subscriber's connection into the interstate network, which enables the subscriber to make interstate calls. The same loop that connects a telephone subscriber to the local exchange necessarily connects the subscriber into the interstate network as well. Under Smith, a portion of the costs of that loop are assigned to the interstate jurisdiction, for recovery under the regulatory authority of the FCC, on the basis of a complex division taking into account statistical calling patterns. That separations decision, however, does not affect the cost of the loop. Local telephone plant costs are real; they are necessarily incurred for each subscriber by virtue of that subscriber's interconnection into the local network, and they must be recovered regardless of how many or how few interstate calls (or local calls for that matter) a subscriber makes." (Opinion, Pages 1113-14).*

> *"Every telephone subscriber is automatically connected through the same subscriber plant into both the local exchange and the interstate network. No subscriber can avoid 'causing' those costs of its telephone line allocated to the interstate jurisdiction." (Opinion, Page 1115).*

In defending the FCC's CALLS order on appeal, the Department of Justice made these same points in March, 2002. See Brief for the Federal Respondents in Opposition (to a petition for writ of certiorari), National Association of State Utility Consumer Advocates v. Federal Communications Commission and United States of America, (U.S. Supreme Court No. 01-968), March, 2002, Pages 14-15 ("…It has long been accepted that the customer 'causes' the costs of the loop…[b]ecause the costs of the loop are not traffic-sensitive, the costs caused by a particular customer do not vary depending on how many calls he or she makes…[T]he SLC requires consumers to pay only for the loop costs that they cause…[I]t is end-users of the telecommunications network, not their long-distance carriers, that ultimately cause the costs associated with interstate access.”).

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.