CLEC Coalition

Mass. Dept. of Telecommunications and Energy

D.T.E. 06-61

Respondent: August H. Ankum and Warren R. Fischer,
QSI Consulting Inc. on behalf of the CLEC Coalition

REQUEST:	Dept. of Telecommunications and Energy, First Set to CLEC Coalition
DATED:	September 29, 2006
ITEM: **DTE-CC 1-1**	Please provide a copy of the FCC's Accounting Order cited on page 6, footnote 4 of the Rebuttal testimony.
CLEC COALITION RESPONSE:	The FCC's Accounting Order is attached hereto as Attachment DTE-CC 1-1A.

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ITEM: **DTE-CC 1-2**: Please provide a copy of the ARMIS Report 43-03 cited on page 3, line 12 of the Rebuttal testimony.

CLEC COALITION RESPONSE: The CLEC Coalition assumes the Department is referring to page 6, line 12 instead of page 3. Assuming this is correct, the 2005 ARMIS 43-03 report cited in the testimony is included in Exhibit AA/WF-3, pages 41-44 in the printed version and Tab ARMIS 43-03 in the Excel version. The percentage split between wholesale and retail costs for Verizon's Customer service account is listed in the following rows within the ARMIS 43-03 report:

6623.1	*% Customer service - Wholesale*	*7*
6623.2	*% Customer service - Retail*	*93*

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ITEM: **DTE-CC 1-3**	Please see page 10, lines 2-3 of the Rebuttal testimony. The testimony states that the panel "generally employ VZ-MA's approach to calculating the resale discounts." Does the panel agree that VZ-MA's methodology for calculating the resale discounts is generally correct?

CLEC COALITION RESPONSE:

In the absence of specific FCC guidance on how to perform avoided cost calculations following the Eighth Circuit's opinion in *Iowa Utilities Bd. II*, 213 F.3d 744 (8th Cir. 2000) (subsequent history omitted), it is difficult to positively affirm or deny whether a particular methodology is correct in a formal sense. In view of this and in order to avoid difficult policy and economic deliberations over what methodology to use, QSI has opted to follow the general methodology as presented and employed by VZ-MA itself with the exceptions noted in our Rebuttal testimony.

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ITEM:
DTE-CC 1-4

What guidance generally or specifically exists at the state or federal level for state commissions to rely upon in determining the correct methodology to use in setting resale discounts, given that the 8th Circuit Decision vacated the FCC's avoidable cost rules and the FCC has not issued new rules? Is a state commission legally bound to consider an ILEC petition to change the resale discount where the FCC has not completed its rulemaking to develop new rules for the avoided cost discount? If your answer is no, do states have the discretion to do so nonetheless.

CLEC COALITION RESPONSE:

In response to the first question, and although we are not lawyers and do not purport to give a legal argument or opinion, it is our understanding that state commissions must adhere to the specific language found in 47 U.S.C. § 252(d)(3), along with the Eighth Circuit's opinion in *Iowa Utilities Bd. II* interpreting this section of the Act and invalidating FCC rule 51.609, in determining the correct methodology to use setting the resale discount rate that applies to Section 251(c)(4) services. Other state commission decisions, including the FCC Wireline Competition Bureau's Virginia Arbitration order, are only persuasive authority and are not binding on the Department. *See, e.g., Mpower Comm. Corp. v. Ill. Bell Tel. Co.*, 457 F.3d 625, 631 (7th Cir. 2006). Aspects of the *Local Competition Order* that address the resale discount not disturbed by the Eighth Circuit's decision remain applicable. For instance, the FCC explained that "an avoided cost study may not calculate avoided costs based on non-cost factors or policy arguments, nor make disallowances for reasons not provided in Section 252(d)(3)." *Local Competition Order*, 11 FCC Rcd 15499, ¶ 914 (1996) (subsequent history omitted). Furthermore, Massachusetts law requires that rates be just, reasonable and not unjustly discriminatory, *see* G.L. c. 159, §§ 14 & 17, and 47

U.S.C. §§ 251(d)(3), 252(e) & 261 explicitly preserve the Department's authority to apply state law and render decisions that are consistent with the Act and the FCC's interpretations of it. However, the Department has recognized that the plain meaning interpretation of the Act or a regulation controls. *See* DTE 04-33, Arbitration Order, at 77 (July 14, 2005). There the Department quoted from various court decisions and stated:

> "The Supreme Court has repeatedly emphasized the importance of the plain meaning rule, stating that if the language of a statute or regulation has a plain and ordinary meaning, courts need look no further and should apply the regulation as it is written." United States v. Lachman, 387 F.3d 42, 50 (1st Cir. 2004). "Agencies have an important role to play in the interpretation of statutes and regulations under [Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984)] and related doctrines . . . [b]ut we look to agency interpretations only when the statute or regulation remains ambiguous after we have employed the traditional tools of construction." *Lachman*, 387 F.3d at 54 (internal citations omitted).

With respect to the second and third questions, state commissions are required to resolve issues that an ILEC raises in an Section 252 arbitration petition, including the appropriate § 252(d)(3) avoided cost discount that should apply. *See* 47 U.S.C. § 252(b)(4)(C). In stark contrast, this proceeding is not a Section 252 arbitration and the Act does not compel the Department to consider prematurely an ILEC request to change the resale discount, especially when the FCC has not completed its rulemaking and established a standard upon which to develop new rules that apply when establishing it. Indeed, in its 2003 Notice of Proposed Rulemaking, the FCC solicited comments from parties regarding the standard that should apply in determining the resale discount. *See In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Doc. No. 03-173, Notice of Proposed Rulemaking, FCC 03-224, ¶¶ 141-146 (rel. Sept. 15, 2003). However, the Department acting under its state law authority retains the discretion in determining that such a request is inappropriately premature until the FCC articulates the standard upon which the Department can establish the avoided cost discount. Any Department decision before the FCC establishes the standard is speculative at best and, conceivably, could be inconsistent with the FCC's mandated approach. If that were the case, the Department would have to open an entire new

investigation and establish rates that are consistent with that approach. At this time, Massachusetts law does not compel the Department to proceed with an investigation. *See* G.L. c. 159, § 13 ("The department ***may*** inquire into the rates, charges, regulations, practices, equipment and services of common carriers in this commonwealth, and elsewhere, rendering any service of a kind subject to its jurisdiction.") (emphasis supplied).

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ITEM: **DTE-CC 1-5**	Please see footnote 13, second sentence of the Rebuttal testimony. What would be the general effect on the trend analysis of removing revenues from miscellaneous services that are not subject to resale?

CLEC COALITION RESPONSE:

Footnote 13 within the Rebuttal testimony was inadvertently not worded correctly. The trend analysis reflected on page 11 of the Rebuttal testimony includes only revenue from local and long distance services. No miscellaneous service revenue was included because it is not broken out by individual service or U.S.O.A. in the ARMIS 43-03 report as it is on VZ-MA's general ledger. Account and sub-account level detail is required to accurately identify miscellaneous service revenue that is subject to resale. Footnote 13 should read as follows:

> "Retail revenue is comprised of basic local service revenue and long distance revenue for this analysis and is assumed to represent a reasonable proxy of VZ-MA's revenue subject to resale. *It does not include revenue from miscellaneous services because sufficient detail is not available to ascertain revenue that is subject to resale*."

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ITEM:
DTE-CC 1-6

To what does the panel attribute the increase in the ratio of total operating expenses to retail revenue from 1996 through 2005? Do total operating expenses include only total retail expenses?

CLEC COALITION RESPONSE:

With respect to the first question, QSI has not specifically investigated the causes of this manifest trend. However, one of the causes might be that VZ-MA's efforts to control expenses have not kept pace with its decline in revenue. The chart attached hereto as Attachment DTE-CC 1-6A compares VZ-MA's total regulated operating revenue, total regulated operating expenses and resulting total regulated operating income for the years 1996-2005.

With respect to the second question, total operating expenses include all expenses, not just retail expenses.

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ITEM:
DTE-CC 1-7

Is there evidence that CLECs can not compete profitably with a resale discount below 15 percent?

CLEC COALITION RESPONSE:

In a sense, yes. CLEC sales activity, like business activity in general, is input price sensitive, particularly in a market in which the CLECs are mostly "price takers" (*i.e.*, they lack significant market power and set their prices relative to the prevailing market price). That is, the higher are CLEC input prices (*i.e.*, resale discounts), the less CLECs are able to compete. As discussed in our Rebuttal Testimony, resale activity using the current discount rates has declined dramatically over the period from 2000 to 2005. Therefore, it is reasonable (and consistent with economic theory) to assume that a significant reduction in the resale discount, below 15 percent, would adversely impact CLEC resale activity, quite possibly to the point at which resale is an incidental activity rather than an economically viable market entry strategy as provided for under the Act of 1996.

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ITEM: DTE-CC 1-8: Please see footnote 20 of the Rebuttal testimony. What is the point being made from the text contained in the parentheses?

CLEC COALITION RESPONSE:

The language contained in the parentheses is a direct quote from the referenced FCC *Access Reform Order*. This language reflects the FCC's reasoning for not eliminating from the separations process and the access charge regime all implicit support mechanisms. Again, as the FCC notes: "Moreover, in the Act's legislative history, Congress qualified its intention that 'support mechanisms should be explicit, rather than implicit,' with the phrase '[t]o the extent possible.'" *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, and End User Common Line Charges*, CC Docket Nos. 96-262, 94-1, 91-213, and 95-72, First Report and Order,12 FCC Rcd 15982, 15987 ¶ 9 (rel. May 16, 1997).

We presented this language to support our contention that VZ-MA's use of jurisdictionally separated data is inappropriate because the separated data do not follow cost causation and as such are not capable of accurately reflecting all "avoided costs." As we noted: "While clearly the separations process does not entirely fail to reflect cost causation (in fact, the FCC increasingly pursues policies that seek to align prices and costs), it is fair to say that the jurisdictional separations process continues to assign costs to the state and interstate jurisdictions based on negotiations and on public policy objectives other than those embodied in the sections of the 1996 Act regarding resale." That is, as we demonstrate in our testimony, VZ-MA's use of separated data means that certain "avoided costs" will be assigned away to the interstate jurisdiction and, as a consequence, these "avoided costs" will not be reflected in the

resale discounts. This is unjust to the CLECs and inappropriately benefits VZ-MA because it avoids costs that VZ-MA will not be required to reflect in the resale discount.

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ITEM:
DTE-CC 1-9

What explanation does Verizon give for using separated revenues and expenses in its avoided cost study, where the Department's precedent is to use unseparated data? Are the reasons that the Department articulated for requiring the use of unseparated data in its Consolidated Arbitrations, Phase 2 Orders still relevant for use in Verizon's current filing?

CLEC COALITION RESPONSE:

With respect to the first question, the explanation appears to be as expressed by Mr. Williams on page 8 of his testimony:

> Interstate services and non-regulated services are *not subject to resale* at a discounted rate. […] The resale discount that will apply to intrastate regulated services should be calculated using the expenses that are recovered in Verizon MA's intrastate regulated rates. (Emphasis in original.)

This reasoning is reiterated by Mr. Williams on page 13 of his testimony: "Interstate revenues – These have been removed since the resale discount only applies to Intrastate services."

When probed on this opinion in discovery (CLEC 1-23), VZ-MA provided a supplemental response as follows:

> Irrespective of the extent to which interstate services are available for resale, only the intrastate avoided cost discount is subject to the regulation of the Department, and as such only intrastate services are at issue in this proceeding.

We have addressed this supplemental response in our Rebuttal testimony. On page 15 we note: "First, there is nothing in

Sections 251(c)(4) and 252(d)(3) that limits VZ-MA's obligations to offer services for resale to intrastate services only." We then proceed to explain on page 17 that "[t]he issue of whether the DTE has jurisdiction to set resale discounts only for intrastate services should not affect how the calculation of resale discounts are to be calculated." As discussed, "Section 253(d)(3) prescribes that wholesale prices are to reflect the costs avoided by ILECs. The statute does not speak of avoided "separated" costs, nor does the FCC speak of avoided separated costs in its *Local Competition Order*." In short, we believe that the resale discounts should reflect *all costs* that are avoided by VZ-MA and not just a separated portion. We also note that in the more than 10 years since the Act was passed, the FCC has not set a resale discount for interstate service for any ILEC. Thus, the Department should not assume that the FCC intends to set a resale discount rate for interstate services sold by VZ-MA.

With respect to the second question, the reasons articulated by the Department on the use of unseparated data in its Consolidated Arbitrations, Phase 2 Order, are just as relevant in the current Verizon filing as they were in the previous filing made by NYNEX. *See* D.P.U. 96-73/74, 96-75, 96-80/81, 96-83, 96-94-Phase 2, at 31-32 (Dec. 3, 1996) ("Phase 2 Order"). According to the summary of the NYNEX position in Section No. 7, Separated vs. Unseparated Costs, on pages 29-30 of the Phase 2 Order, NYNEX articulated a similar position to that put forth by VZ-MA as noted in (a) above.

> NYNEX asserts that these separated costs should be used as the basis for developing an avoided cost study because the company's intrastate retail rates and revenue requirements were set by the Department on the basis of separated costs.

The Department's decision on page 32 of the Phase 2 Order was as follows:

> Sprint has succinctly stated the appropriate basis for resolving this issue: Costs will not be avoided based on jurisdiction, but in total. In addition, we agree that to base the avoided cost determination on the separations process would be to impute a policy of shifting avoided costs between jurisdictions, in the manner historically used to shift local costs to the long distance jurisdiction. The FCC has explicitly forbidden such a policy-based action.

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ITEM: **DTE-CC 1-10**	Please see page 31, lines 4-14 of the Rebuttal testimony. Is the panel aware of Verizon having treated 100% of its sales expenses as avoided in any other state commission avoided cost proceedings since 2001?

CLEC COALITION RESPONSE:

The panel is not aware of Verizon treating 100% of sales expenses as avoided in state commission avoided cost proceedings other than Virginia and the District of Columbia since 2001. The avoided cost studies provided by Verizon in response to the CLEC Coalition's First Set of Data Requests, CLEC 1-16, for the states of Illinois and Pennsylvania both reflect less than 100% of sales expenses as avoided. Per Verizon's response to the CLEC Coalition's First Set of Data Requests, CLEC 1-2, Verizon has only filed avoided cost studies in the District of Columbia, Illinois, Pennsylvania, and Virginia since the 8th Circuit Decision in 2000 in *Iowa Utilities Bd. II.*

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ITEM: **DTE-CC 1-11**	Please see footnote 34 of the Rebuttal testimony. Please provide a copy of the FCC's Joint Conference Order. Please see page 37, line 6 of the Rebuttal testimony. Please provide a copy of the Joint Conference recommendation.

CLEC COALITION RESPONSE: The Federal-State Joint Conference Recommendation document referenced in footnote 34 is the same as that referenced on page 37, line 6 of the panel's Rebuttal testimony. *See* Attachment DTE-CC 1-11A. The FCC's Report and Order in this same docket has been provided in response to Request DTE-CC 1-1. *See* Attachment DTE-CC 1-1A.

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ITEM:
DTE-CC 1-12

Please see page 39, lines 4-10 of the Rebuttal testimony. Notwithstanding the panel's statements concerning ILEC obligations to use retail related expenses for Acct. 6623 in ARMIS report 43-03, is there any evidence that Verizon's special study is a less reliable indicator of its retail related expenses for Massachusetts than the ARMIS data?

CLEC COALITION RESPONSE:

Yes. First, the FCC ordered that retail expenses be reported as part of ARMIS Report 43-03 for the express purpose of aiding state commissions in these types of proceedings. As such, to the extent that there are discrepancies between a "special study" and the FCC-required calculations, the rebuttable presumption should be that the FCC-mandated ARMIS Report data are correct and the "special study" results are not.

Second, the data in VZ-MA's ARMIS Report 43-03 are supposed to be *state (i.e., Massachusetts) specific* – the data in the "special study" are not. The special study is based upon the entire Verizon operation. Given the greater degree of specificity (with respect to Verizon's operations in Massachusetts) of the ARMIS Report 43-03 data, it is clear that deviations of the results in the "special study" from the ARMIS data are due, in part, to some averaging, which, by definition, makes the "special study" less appropriate for purposes of determining *resale discounts specific to Verizon's Massachusetts* operations.

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ITEM:
DTE-CC 1-13: Please see page 42, lines 9-15 of the Rebuttal testimony. Please provide copies of the pages of the Virginia and District of Columbia decisions that discuss indirect expenses. Also, please provide copies of relevant pages from any other post 2001 state decision that support your position.

CLEC COALITION RESPONSE: Attached are pages from the Virginia (*see* Attachment DTE-CC 1-13A) and District of Columbia (*see* Attachment DTE-CC 1-13B) decisions discussing indirect expenses. Also attached are pages from the Illinois Commerce Commission's ("ICC") decision (*see* Attachment DTE-CC 1-13C) discussing Verizon's agreement to include a pro rata share of contribution in the avoided discount rate. This latter agreement is stipulated in the ICC's resale guidelines. The ICC guidelines are discussed succinctly in the attached pages from its comments filed in the FCC's Notice of Proposed Rulemaking on UNE and resale pricing rules. *See* Attachment DTE-CC 1-13D. Additionally, on page 91 of these comments, the ICC addressed identification of avoided direct and indirect costs and stated:

> The Commission also asks if it should establish evidentiary guidelines for determination of the resale discount, such as having carriers specifically identify direct and indirect avoided costs. [footnote omitted] *The ICC notes that any identification of avoided costs, or direction by the FCC on how to determine the specific avoided costs of a carrier, would be a great help in determining the resale discount, because our experience in Illinois is that carriers do not identify avoided costs in a consistent manner.* [emphasis added].

See Attachment DTE-CC 1-13D.

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ITEM: DTE-CC 1-14: Please see page 51, lines 4-7 of the Rebuttal testimony. State the basis of support for the statements in this testimony.

CLEC COALITION RESPONSE: The referenced statement provides as follows:

> In general, companies use sales agents because it helps them to curtail the size of their own sales force and limit retail related activities. As such, the sales commissions that companies pay are in large part reflective of the retail related expenses that they avoid by not having to hire (or expand) their own sales force.

This statement is based on a general theory of when and under which conditions large manufacturing firms opt to vertically integrate into downstream markets. Discussions of vertical integration and the use of sales agents (to absorb the retailing functions of the manufacturer) are part and parcel of many standard industrial organization texts. *See, e.g.*, Jean Tirole, *The Theory of Industrial Organization* ch. 4 (1988) (a widely used economics text).

Sales agents perform a retail function for the manufacturer. As Tirole points out: "[s]ince a retailer is an agent for the manufacturer (in an economic sense, not necessarily in a legal sense), he must be given incentives to choose the adequate level of promotional services, retail price, etc." (*See* Sec. 4.3.4., page 184). Tirole discusses the wholesale price/retail price relationship as well as the manner in which the wholesale price is an "instrument" to be used by the manufacturer in order to control the agent's activities and success in the market (*e.g.*, the higher the wholesale price set by the manufacturer, the more difficult it is for the sales agent to set a competitive price in the

retail markets and vice versa). The ultimate objective for the manufacturer, however, it to achieve the highest level of profit (as it is in the long run for all firms). In seeking this objective, the manufacturer's desire to select a high wholesale price in order to claim as much of the overall profit as possible is tempered by the realization that a higher wholesale price may hamper the sales agent's ability to compete in the retail market. Generally, the range in which the manufacturer will set the wholesale price is between an upper level at which a wholesale price is so high that the sales agent makes no profit and a lower level at which the wholesale price is set at the manufacturer's wholesale cost. All of this is discussed (with variations depending on assumptions about market structure, etc.) in Chapter 4. Critical in determining the upper level and lower level are, among other factors, the following: (1) the wholesale costs, (2) the retail related expenses, (3) retail profits (associated with a given retail market price). This brings us back to the statement in my testimony: "the sales commissions that companies pay are in large part reflective of the retail related expenses that they avoid by not having to hire (or expand) their own sales force." That is, the sales agents' commissions are equal to or less than the avoided retail expenses. If they are less than the avoided retail expenses, the manufacturer—in the current proceeding, Verizon—is able to capture some of the retail markets profits. As such, the sales agents' commissions are a conservative proxy for the lower limit at which the resale discounts should be set, which is the point asserted in the section of our rebuttal testimony referenced in this request.

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ITEM: **DTE-CC 1-15**	Is the panel aware of any federal or state decision since 1996 in which the resale discount was determined by taking into account the level of ILEC sales agent commissions?
CLEC COALITION RESPONSE:	No; however, at the same time, we are not aware of any other instance in which an ILEC has proposed a resale discount that is substantially less than what it pays its sales agents.

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ITEM:
DTE-CC 1-16

See page 53, lines 13-18 of the Rebuttal testimony. Is the panel using the term "anticompetitive" in the sense of describing unlawful conduct? Assuming so, if the resale discount is calculated correctly pursuant to relevant legal and precedential standards, and the result is a discount percentage that is lower than the ILEC's sales agents' commissions, would that discount still be anticompetitive?

CLEC COALITION RESPONSE:

We are not expressing a legal opinion in this testimony. However, as a matter of economics, the conduct may be classified as "anticompetitive." As for the hypothetical posited by the DTE, our response is that the resulting situation would be "anticompetitive" (though not necessarily the discounts).

In any event, the point of this part of our Rebuttal testimony is to explain that (1) the resale discounts are in a sense a "revealed truth" about what Verizon perceives to be a minimum level of "avoided costs" when it need not engage in certain retailing activities, and (2) resale discounts below sales agents' commissions are irrational and lead to a playing field that is not level.