COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Pricing, based upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts' Resale Services in the Commonwealth of Massachusetts.	)	D.T.E. 01-20

INITIAL BRIEF OF WORLDCOM, INC. ON RECONSIDERATION ISSUES

*****PUBLIC VERSION*****

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INTRODUCTION

WorldCom, Inc. ("WorldCom") respectfully submits the following initial brief on the four issues on which the Department has sought additional evidence and briefing, in its September 24, 2002 *Order Granting Verizon and AT&T Motions for Reconsideration, in Part, and Requesting Additional Evidence* ("Reconsideration Order"). For the reasons set forth below, WorldCom urges the Department to:

- **Reject** Verizon's request to increase switching rates on account of claimed under-recovery of RTU fees, since these costs are already accounted for in its cost study;
- **Affirm** its finding that a TELRIC cost study should assume 90% new digital switches;
- **Reduce** the new switch discount consistent with the competitive bid data in the record; and
- **Reject** Verizon's attempt to increase its claimed costs for DC power cable.

ARGUMENT

I. VERIZON SHOULD NOT BE PERMITTED TO INCREASE ITS RTU FACTOR TO ACCOUNT FOR PURPORTED INITIAL RTU FEES ASSOCIATED WITH NEW SWITCH PURCHASES BECAUSE THESE COSTS ARE ALREADY RECOVERED THROUGH THE SWITCH MATERIAL PRICE

On reconsideration, Verizon alleges that the adoption by the Department of a network cost model that assumes 90 per cent new switches and 10 per cent growth equipment requires recovery through increased switching rates of an additional $225 million (or $1.88 million per switch) for initial "right-to-use" ("RTU") fees associated with the purchase of new digital switches. Verizon Motion, pp. 12-14. Although Verizon acknowledges that its Part G-9 cost study did not attempt to capture these costs[1], it argues nonetheless that the Department overlooked evidence from the *Consolidated Arbitrations* that shows a $1.88 million per switch investment associated with these initial RTU costs.[2] Verizon Motion at 13.

In its July 11, 2002 Order in this proceeding ("Order"), the Department found that Verizon had "failed to substantiate" its initial deployment RTU costs. Order, p. 308. Acting on Verizon's motion for reconsideration, the Department directed the parties to assess whether this new category of costs is appropriate, and further directed Verizon to provide updated cost information based on the purchase of software packages for Nortel and Lucent switches in 2000 and 2001. Reconsideration Order, p.4.

In response to the Reconsideration Order, Verizon, through the testimony of Mr. Gansert, presented "proposed prices" for initial RTU costs in 4 recent bids from Nortel, ranging from **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** for an average of **[BEGIN VERIZON PROPRIETARY]** **[END**

[1] Verizon Motion for Reconsideration and Clarification, p. 13. See also VZ-38 at 77.
[2] The work paper from the *Consolidated Arbitrations* was not made a part of the record of this proceeding.

VERIZON PROPRIETARY] per installation. Verizon Exhibit 60, p. 4. Mr. Gansert's testimony further estimated Lucent initial RTU costs, based on one recent bid for a Boston switch, at [**BEGIN VERIZON PROPRIETARY**] [**END VERIZON PROPRIETARY**] for a state-wide total estimate of [**BEGIN VERIZON PROPRIETARY**] **[END VERIZON PROPRIETARY**] for Lucent and Nortel switches. Verizon Exhibit 60, p.5. Based on this evidence, Verizon claims that its estimate of initial RTU costs of $1.88 million per switch is reasonable and should be adopted. Verizon Exhibit 60, p. 6.

Verizon's own documentation shows that initial RTU costs are already included in the per line switch material price

WorldCom respectfully submits that Verizon has again failed to substantiate that a proper TELRIC cost study requires inclusion of initial RTU costs in addition to its estimated switch material costs. The evidence provided by Verizon during discovery establishes that Verizon's per line switch material costs cover the costs of switching hardware **and** switch software costs (i.e. RTU fees) as well as vendor installation and engineering costs. AT&T Exhibit 33-P, p. 2. No additional costs should be assumed for initial RTU fees for purchase and installation of new digital switches because the costs are already fully recovered by the switch material cost estimate.

The discovery associated with the Nortel bid for the Frederick, MD switch purchase is illustrative of the point. The documentation provided by Verizon, attached as Attachment 5 to AT&T Exhibit 32-P, shows, as an initial matter, that Verizon did not actually pay the Nortel proposed price cited in Verizon's testimony because the Nortel bid was rejected by Verizon. Further, the Lucent bid for the same switch included initial RTU fees for the equivalent software that was several orders of magnitude lower that the Nortel proposal: [**BEGIN VERIZON**

PROPRIETARY] [**END VERIZON PROPRIETARY**]. Finally, and most importantly, the winning bid for the switch purchase was priced at a per line cost of [**BEGIN VERIZON PROPRIETARY**] [**END VERIZON PROPRIETARY**], ***which included the RTU fees for the base software***. AT&T Exhibit 33-P, p. 3.

Similar findings with respect to the Moorestown, NJ and Dulles Corner,VA switches are described in AT&T Exhibit 33-P. The Pearl Street, NY switch documentation is incomplete because it does not include any documentation on competing bids or bid analysis and thus cannot be relied upon by the Department to estimate costs. AT&T Exhibit 33-P, p. 4.

With respect to the estimate of Lucent initial RTU costs, Ms. Pitts' rebuttal testimony demonstrates that the [**BEGIN VERIZON PROPRIETARY**] [**END VERIZON PROPRIETARY**] estimate, based on a recent Lucent installation at the Franklin Street switch in Boston, cannot be used because in a subsequent discovery response, Verizon admitted that its complete buyout of the Lucent 5E14 base software cost only [**BEGIN VERIZON PROPRIETARY**] [**END VERIZON PROPRIETARY**]. AT&T Exhibit 33-P, p. 6. More importantly, the evidence on this recent Lucent installation shows that Verizon agreed to pay a [**BEGIN VERIZON PROPRIETARY**] [**END VERIZON PROPRIETARY**] per line cost for this switch, ***which per line cost included all hardware, software and vendor installation and engineering costs.*** AT&T Exhibit 33-P, p. 7.

Thus, Verizon's own documentation – for Lucent and Nortel switch purchases -- shows that the per line switch material price paid by Verizon for new digital switches already includes initial RTU costs. Accordingly, in estimating the TELRIC costs of switching, the Department should not add an additional cost category for these fees. To do so would be to sanction a substantial double recovery.

II. THE DEPARTMENT SHOULD REAFFIRM ITS FINDING ON THE APPROPRIATE RATIO OF "NEW" TO "EXISTING" SWIICHES IN THE SWITCHING COST STUDY

In the Order, the Department directed that the Verizon switching cost study assume switching costs are based on a network with 90% new switches and 10% existing switches. Order, p. 302. In doing so, the Department relied on the analysis contained in AT&T's response to RR-DTE-56. Specifically, the Department stated:

> By contrast, the analysis presented in RR-DTE-56 is based on a more appropriate foundation for a TELRIC analysis; namely, the assumption that in the first year, the model deploys all new switches and then, in subsequent years, growth is added to accommodate forecast demand. This assumption is more appropriate because it describes the "dropped in place" nature of a TELRIC-modeled network. (Order, pp. 301-302)

In its motion for reconsideration, Verizon alleges that the Department erred in assuming that all of Verizon's switches could be purchased at the steeply discounted price that it pays for recent switch purchases and argues that the "life cycle analysis" that it presented is superior to AT&T's analysis that was adopted by the Department. Verizon Motion, pp. 25-29. In response to Verizon's motion, the Department directed the parties to supplement and justify the analyses contained in RR-DTE-56 and RR-DTE-66, including additional analysis based on varying critical assumptions. Reconsideration Order, p. 8.

In its pre-filed direct testimony on reconsideration, Verizon alleges that the Department was mistaken in assuming 1) that all switching equipment in the network could be purchased at current market prices, and 2) that the entire switching investment needed to serve all access lines in the state could be purchased in one "massive transaction" with a supplier. Instead, Verizon argues, the Department should rely on a "life cycle analysis," which it claims would show that switch price discounts are much lower in the early years of the life cycle of the switching technology. Verizon Exhibit 60, pp. 7-8.

The Department Should Affirm Use of the AT&T Analysis

The thrust of Verizon's additional testimony on this issue is a continued attack on the notion that TELRIC requires that costs be based on a "dropped in place" network. In its motion, Verizon had argued that:

> The majority of equipment sold by switch vendors in the current marketplace is sold at the additional equipment "growth" discount levels. Thus, switch vendors' pricing strategies and revenue requirements for equipment sales are premised upon selling the majority of their equipment at the current mix of new and growth sales.

Verizon Motion, p. 25. Verizon's continued reliance on the "current mix" of new and growth sales is irrelevant. As the Department has very clearly found, the relevant question is what are the prices that would be paid for switching equipment in a "dropped in place" network.

Verizon's testimony adds nothing new to the debate. Mr.Gansert argues that Verizon's life cycle analysis is superior to the AT&T approach and that a 50/50 ratio more accurately captures long run costs. The testimony renews the argument in the reconsideration motion that AT&T assumes that purchase of the switches to satisfy total demand could be done through a single supply contract, at prices that Verizon pays for switches at the end of the life cycle of the switch technology. Verizon Exhibit 60, pp. 7-11.

On behalf of AT&T and WorldCom, Ms. Pitts offered a revised version of RR-DTE-56, which shows a 92.17/7.83 new-to-existing ratio, based on a 12 year study, 1.5% annual line growth, and a 11.45% cost of capital. AT&T Exhibit 32- P, pp. 5-7. In addition, Ms. Pitts demonstrated that varying the critical assumptions within a reasonable range did not significantly alter the results. AT&T Exhibit 32-P, p.7. Thus, even with the revisions needed to make the analysis consistent with the relevant input decisions made by the Department, RR-DTE-56 fully supports the Department's adoption of a 90/10 ratio, and shows that the Department's 90/10 ratio is, in fact, conservative.

Verizon's 50/50 ratio, on the other hand, is inconsistent with the "dropped in place" network that is assumed as part of a TELRIC study. Further, Verizon offers no evidence to support its argument that suppliers would not enter into large volume, aggressively priced supply contracts. Indeed, the record evidence is to the contrary. Documentation in the record shows that the market for digital switches is like any other: as volume increases, unit prices decline. See AT&T Exhibit 32, pp. 14-15. Further, Verizon itself has entered into large supply contracts with its vendors, as its witness Mr. Gansert conceded on cross-examination. Tr. 3740. Verizon offers no evidence as to why it would not or could not negotiate large volume contracts with one or more of its switch vendors. The Department should reaffirm the 90/10 ratio and again reject the "life cycle analysis" presented by Verizon.

III. THE RECORD EVIDENCE SUPPORTS REDUCTION OF THE NEW SWITCH DISCOUNT, BASED ON RECENT COMPETITIVE BIDS

In its Order, the Department directed Verizon to use, for new Lucent switches, the discount shown in Attachment 1, line 2 of RR-DTE-66. Order, p. 305. Verizon's proposed Nortel discount is based on its current contract with Nortel, resulting in a per line cost of approximately $82.62. The Department approved the Nortel discount included in the original study, rejecting AT&T's reliance on competitive bidding data provided by Verizon in the FCC's Virginia arbitration proceeding (RR-DTE-49-S). Order, pp. 305-306.

AT&T petitioned for reconsideration on this issue, arguing that the new switch discount for Nortel switches is too low. AT&T showed that the Department overlooked Verizon's concession in its post-hearing reply brief as to what it actually pays for new Nortel switches through competitive bids. AT&T Petition, pp. 17 et seq. In response to AT&T's argument on brief that the record evidence – based on the FCC Virginia arbitration record – supports a

material investment per line for new switches of $17.35, Verizon claimed that the actual achieved bid price per line was $36.00, thus conceding that its actual price per line on new Nortel switches is much lower than what Verizon filed in its original cost study.

In its Reconsideration Order, the Department stated that it "may have inadvertently misinterpreted late-filed cost data because it was not subject to full cross-examination…" Reconsideration Order, p. 11. The Department granted reconsideration and directed the parties to address the relevance of the discount data in RR-DTE-49S.

The Data in the Record Supports a Per Line Cost of $17.35 for New Nortel Switches

In her direct testimony, AT&T/WorldCom witness Pitts stated that the data in RR-DTE-49-S show that Verizon is able to purchase new switches from Nortel through competitive bidding for substantially less than the discount claimed in its study. AT&T Exhibit 32, pp. 9-10 (citing Verizon-VA response to FCC RR VZ-VA-32, in the proprietary attachment to RR-DTE-49S). The data show discounts that equate to an investment per line of $17.35. Pitts further testified that the $36 per line figure Verizon conceded in its reply brief is also too high because it appears from the competitive bidding data that this figure is not limited to switch material costs but also includes other costs, e.g. vendor installation, which is accounted for elsewhere. AT&T Exhibit 32, pp. 11-14.[3]

In its direct testimony, Verizon offered discount data on four recent Nortel bid proposals. Verizon Exhibit 60, pp. 13-14. However, Verizon does not support using this information because it claims that these discounts do not reasonably reflect the discounts that Verizon could receive in a forward looking environment.

[3] The record also establishes that the reply brief figure should have been lower—[**BEGIN VERIZON PROPRIETARY**] $31 [**END VERIZON PROPRIETARY**]—based on the vendor switch bid comparison for the Eastwick PA switch. AT&T Exhibit 33-P, p. 9.

Ms. Pitts' rebuttal testimony presented discount data on 16 different Nortel switch installations, showing an average per line material switch price of [**BEGIN VERIZON PROPRIETARY**] [**END VERIZON PROPRIETARY**]. AT&T Exhibit 33-P, pp. 9-10. The costs per line for these installations include RTU fees and vendor installation costs. This figure is almost identical to the figure Verizon admitted to in its post-hearing reply brief. Further, Exhibit 11 to AT&T Exhibit 33-P includes Verizon correspondence with its switch vendors in which it states: "[c]onsistent with Verizon's objective of continuous process improvement in cost, quality, and service, we have established a target of [**BEGIN VERIZON PROPRIETARY**] [**END VERIZON PROPRIETARY**] per line" for the purchase price for new switches. (Again, this target price is not limited to switch material price.) AT&T Exhibit 33-P, p. 11. Finally, Ms. Pitts explained that this data is usable to set the new switch discount only if certain adjustments are made on account of the inclusion of vendor installation costs in the per line bid data: either the material switch price must be reduced or, alternatively, the EF&I factor must be reduced on account of the inclusion of vendor installation costs in the per line price. AT&T Exhibit 33, pp. 12-13.

Ms. Pitts' analysis has not been effectively rebutted or challenged by Verizon on cross-examination. WorldCom respectfully urges the Department to rely on this analysis to set a new switch per line cost of $17.35 for Nortel switches.

IV. VERIZON HAS FAILED TO PROVIDE SUPPORT FOR ITS PROPOSAL THAT DC POWER CABLE COSTS BE DETERMINED ON THE BASIS OF AVERAGE CABLE LENGTH OF 121 FEET

In its Motion for Reconsideration, Verizon notes that it stated in this proceeding that its average collocation power cable length is 60.5 feet, and that this statement was in error. It now claims that the "actual" average cable length is 121 feet. Verizon Motion, pp.34-35. In its Reconsideration Order, the Department noted that its decision was "affected by Verizon's perhaps incorrect statements on the record….." and stated that the "Department and other parties must have the opportunity to examine the support for Verizon's original 121-feet proposal. Reconsideration Order, p. 13. Despite the Department's invitation to Verizon to supplement the record to repair the mistake that it admits it made in developing the record, Verizon offered no direct testimony on this issue to explain why 121 feet is the appropriate cable length to be used in developing DC power cable costs. Although the record would support -- based on the testimony of AT&T/WorldCom witness Steven Turner – a finding of average cable length of no more than 40 feet (AT&T Exhibit 30), there is no new evidence from Verizon to support the claim of 121 feet as the appropriate distance. At a minimum, the Department should affirm its prior decision on the basis of Verizon's failure to come forward with additional evidence or explanation.

CONCLUSION

For the reasons set forth above, WorldCom urges the Department to 1) reject Verizon's request to increase switching rates on account of claimed under-recovery of initial RTU fees, since these costs are already accounted for in its cost study; 2) affirm its finding that a TELRIC cost study should assume 90% new switches; 3) reduce the new switch discount consistent with

the competitive bid data in the record; and 4) reject Verizon's attempt to increase its claimed costs for DC power cable.

Respectfully submitted,

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