COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Investigation by the Department on its own motion into the appropriate regulatory plan to succeed price cap regulation for Verizon New England, Inc. d/b/a Verizon Massachusetts' retail intrastate telecommunications services in the Commonwealth of Massachusetts	DTE 01-31- Phase II (Track B)

INITIAL BRIEF OF AT&T COMMUNICATIONS OF NEW ENGLAND, INC.

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Introduction

1.*Access Rates and Residential Pricing Flexibility*. In this phase of D.T.E. 01-31, the Department faces the dual challenge of establishing a method for determining switched access charges as well as rates for residential services. In the Department's Phase I Order in this docket issued on May 8, 2002 ("*Phase I Order*"), the Department determined that competitive pricing is the standard for judging whether regulated prices for specific services are just and reasonable. *Phase I Order*, at 101. As shown below, the best approach for ensuring that retail rates are consistent with competitive pricing is (1) to set the price of all wholesale inputs required by Verizon's competitors, including switched access, at TELRIC, and (2) to give Verizon the pricing flexibility it needs to recover an appropriate amount of joint and common costs from its retail customers, just as all its competitors must do (subject, however, to a cap of 10 percent per year increases). Such an approach has a number of desirable features:

It is competitively neutral in that it forces all competitors, including Verizon, to recover their joint and common costs from their own retail customers;

It gives Verizon the opportunity to recover its joint and common costs from its most inelastic service (dial-tone), thereby lessening the consumer welfare losses associated with price mark-ups on usage-based services, such as switched access and toll services;

It decouples access charges and residential rates, thereby avoiding a "make whole" approach that assumes Verizon is entitled to offset access charge reductions with residential rate increases, while at the same time giving Verizon the opportunity to recover in a more efficient way the joint and common costs it previously recovered from access charges.

2.*Conditions for Competitive Alternatives*. Full and fair competition is the best method for obtaining just and reasonable rates, as the Department has often noted. In this regard, even the limited residential pricing flexibility contemplated in Phase II of this docket is warranted only if there are true competitive alternatives to Verizon basic exchange service. Only then would the Department be assured that Verizon will not have the market power to increase rates for basic exchange service to economically

unjustified levels. Increased pricing flexibility for Verizon will not produce an economically sound result unless the Department creates and maintains the conditions necessary for new entrants to compete in the residential market.

a.*UNE Access*. An essential condition for competition in the residential market is CLEC access to unbundled network elements, including continued CLEC access to UNE-P and access to the full data and voice capability of fiber fed loops:

(i)*UNE-P*. It can fairly be said that competition in the residential market will not happen if CLECs lose access to unrestricted UNE-P at TELRIC pricing. In the absence of UNE-P, CLECs seeking to connect customers' loops to their switch inherently incur substantial costs and risks of service disruption (due to current hot cut processes and costs) that the ILEC does not. The increased cost and degraded service associated with the current manual hot cut process constitute an absolute economic barrier to the provision of mass-market services to small business and residential customers using unbundled loops and self-provisioned switches. Unless and until Verizon provides at a TELRIC-based rate an efficient process that allows CLECs to use unbundled loops with their own switches, UNE-P will remain an essential precondition to competition in the residential market. Indeed, even if Verizon were to provide such a process it would not provide the technological ease of customer acquisition that UNE-P does. UNE-P, therefore, will remain important as a means of acquiring customers even after it becomes possible to serve them on UNE-L.

(ii)*Fiber-Fed Loops*. CLEC access to (and the price of) fiber-fed loops is critical for competition in the residential market. *See*, Exh. ATT-1, Mayo Direct, at 5, n. 2. Verizon has refused, however, to provide the full capability of an unbundled loop for DLC-fed loops, in particular the capability to offer unified voice and data services. Indeed, Verizon will not even provide an unbundled DLC-fed loop capable of providing traditional voice telephony. At the same time, Verizon is deploying throughout its network this DLC-fed loop architecture. Verizon's deployment of the DLC-fed network architecture, therefore, threatens to truncate or preclude competitive choice in the residential market. The Department is presently considering CLEC access to unbundled DLC-fed loops in D.T.E. 98-57. Because CLEC access to such loops is critical for CLEC ability to contest the residential market, any

grant of Verizon pricing flexibility in this docket should be an important factor in the Department's decision in D.T.E. 98-57. If DLC-fed loops are not available to CLECs to serve the residential market, then Verizon could abuse any pricing flexibility that may be granted in this docket.

b.*Price Floors*. A second essential condition for competition in the residential market is the establishment of appropriate price floors. Because Verizon charges competitors more than the cost Verizon incurs to provide the service, it is critical that Verizon's minimum retail price be based, not on Verizon's costs, but on the prices it charges its competitors for the network elements necessary to provide a competing service (plus the incremental cost of the retail stage functions). In the absence of such a price floor, Verizon would be able to price its retail services at a level below the costs that equally efficient competitors incur to offer a competing service. Without price floor protection, therefore, there would be little incentive for new competitors to enter the market. In sum, price floors are essential to the development of competition.

I. THE DEPARTMENT SHOULD COMPLETE ITS STATED GOAL OF SETTING PRICES FOR WHOLESALE INPUTS AT ECONOMICALLY EFFICIENT LEVELS BY MOVING INTRASTATE SWITCHED ACCESS RATES TO TELRIC.

In its *Phase I Order*, the Department stated that it "will reduce switched access charges to their economically efficient levels in Phase II of this proceeding to promote economic efficiency and competition for intrastate toll[.]" *Phase I Order*, at 62-63. The testimony of Dr. Mayo demonstrates that the economically efficient level for switched access is best estimated by TELRIC. This is consistent with the Department's view that the price of ***all*** wholesale inputs, including inputs such as access that predate the Telecommunications Act of 1996, should move close to incremental cost. *Phase I Order*, at 63-64. Verizon opposed the position of the Department and AT&T, but based its opposition on the legally and factually erroneous assumption that the market for switched access is competitive. AT&T's position and the flaws underlying Verizon's response are set forth below.

In his testimony, Dr. Mayo proposed economic and policy guidelines "aimed at accomplishing the Department's goals of establishing just and reasonable rates that foster residential competition." Exh. ATT-1, Mayo Direct, at 5. He stated further that, if the Department allows Verizon upward pricing flexibility, "[i]t is critical . . . that input prices and access for new entrants be established and operational

in a manner fully consistent with permitting efficient new entrants the opportunity to compete for retail customers." *Id*., at 19. Conditions that permit new entrants to compete include the establishment of economic-cost based pricing for switched and special access. Dr. Mayo stated:

> Both switched and special access are vital inputs that are necessary for competitors to compete. A critical output of this proceeding should be the establishment of economic-cost based pricing of these vital inputs.

Exh. ATT-1, Mayo Direct, at 24. It is axiomatic that the most efficient price for a service is the marginal, or incremental, cost of that service. Exh. ATT-1, Mayo Direct, at 25, line 18. In order to provide consistency with UNE pricing, however, Dr. Mayo states that economic-cost based pricing for switched access requires that its rates be set at TELRIC, which includes a portion of joint and common costs. Exh. ATT-1, Mayo Direct, at 25.

Moreover, as Dr. Mayo explains, concern about where Verizon may recover the remainder of its joint and common costs is not a reason to deviate further from efficient, incremental cost-based pricing for switched access. Dr. Mayo states:

> [F]undamental economic principles require that retail, not wholesale (or input) prices be raised above economically efficient levels in order to recover joint and common costs. Increasing intermediate product prices above efficient levels creates distortions in downstream production processes that must ultimately be borne by consumers, no matter who they choose for their retail service. Thus, rather than applying through regulatory fiat a set of pricing principles that may be inconsistent with the underlying assumptions of the Ramsey model, I recommend that the Department focus its attention on ensuring as best it can that virtually all competition-enabling policies are in place – including efficient input pricing, which in this case means TELRIC pricing for access. By doing so, competition has the opportunity to take seed and grow, enabling the competitive marketplace, not regulators to figure out which [retail] services shall be responsible for the recovery of the firm's joint and common costs.

Id., at 26 (footnotes omitted).[1]

The response of Verizon's economist, Dr. Taylor, relies on an unsupported and patently false factual and legal predicate: that switched access is offered in a competitive market.[2] Dr. Taylor argues that economically efficient switched access rates should be determined by market conditions, the interplay of market demand and supply in the switched access and toll markets. Exh. VZ-6, Rebuttal Testimony

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[1] For further discussion and context regarding why the prices for access services should be reduced to economically efficient levels, please see pages 36-50 of Dr. Mayo's pre-filed testimony filed on August 24, 2001, in Phase I of this case.

[2] The testimony of Verizon's witness, Paula Brown, at the hearings on this issue was entirely devoid of any economic or policy rationale to support a policy of maintaining switched access charges above efficient levels. In effect, Ms. Brown asks the Department not to reduce access prices because it has already reduced them. Tr. 1, 10/22/02, at 91-95 (Brown).

of William E. Taylor, filed September 18, 2002 ("Taylor Rebuttal"), at 32, lines 18-20, 25-27. The obvious problem with Dr. Taylor's argument is that it assumes that switched access is offered in a competitive market. Switched access, however, has always been regulated as a monopoly service in Massachusetts (*see, e.g.*, D.P.U. 94-50, (May 12, 1995), at 105, 128-129, where access rates are subject to price cap regulation), and Verizon has never sought market-based pricing for it. Indeed, even Dr. Taylor in his oral testimony in Phase I of this proceeding conceded that switched access has monopoloy characteristics. Tr. 2 (12/19/01), at 240 (switched service requires a whole network to provide switched service). It is, therefore, a wholesale input that is offered by a monopolist (just like UNEs). Since it is not offered in a competitive market, there is no competitor to constrain Verizon's pricing of switched access services. As a result, in the "market" for switched access, the extent to which access rates exceed incremental cost reflects market power and monopoly profit; it does not represent in any way economically efficient rates.

The Department stated in its *Phase I Order*,

> Lowering all wholesale service rates closer to incremental cost improves efficiency, promotes competition, and creates a consistent economic framework for all wholesale services. Certain wholesale services (e.g., *switched access*, special access, PAL, and collocation) in Massachusetts pre-dated the Telecommunications Act, and there is no state or federal legal requirement for these wholesale services to be treated the same as wholesale services created as a result of the Telecommunications Act, such as UNEs. However, we judge that consistent regulatory policy for all wholesale services, whether they pre-dated the Telecommunications Act or were created as a result of it, will promote competition and administrative efficiency by pricing all wholesale inputs at more efficient levels.

Phase I Order, at 63-64 (emphasis added). The Department has already recognized that the most efficient pricing level for switched access is a price that is close to incremental cost. TELRIC is close to incremental cost and, by the Department's own reasoning, should be the basis for switched access pricing.

II. ECONOMICALLY EFFICIENT RETAIL RATES FOR DIAL-TONE SERVICE SHOULD RECOVER INCREMENTAL COST PLUS AND AN APPROPRIATE PORTION OF JOINT AND COMMON COSTS.

In its *Phase I Order*, the Department noted that Verizon had not sought market-based pricing flexibility for its residential retail services. *Id*. at 99. The Department established Phase II in part for the purpose of determining what form of regulation it should adopt for Verizon residential services. The Department

specified that such regulation should: (1) produce just and reasonable rates, (2) be consistent with Departmental precedent, (3) promote competition for residential services and (4) be compatible with its treatment of Verizon's business services. *Id*. The Department tentatively concluded that neither rate of return regulation nor price cap regulation is appropriate for Verizon's residential services. *Id*. at 99-101. Instead, the Department tentatively determined that a limited form of pricing flexibility would satisfy its four criteria. *Id*., at 102-103. The Department stated:

> Therefore, for basic residential services, we tentatively conclude that we should allow pricing flexibility within a range encompassing a floor of incremental cost and a ceiling of stand-alone cost. In order to promote our ratemaking goal of continuity however, we tentatively conclude that any price increases for residential services should be limited to five percent per year, which is less than the percentage price increases approved by the Department in the rate-rebalancing process started with D.P.U. 89-300, at 83 (1990), and is roughly comparable to the historic annual change in the Consumer Price Index.

Id. at 102-103. Pursuant to the Department's *Phase I Order*, the parties in Phase II have focused on whether the Department's tentative conclusions are likely to meet the Department's criteria. In particular, the issues that developed related to whether residential rates set within the Department's range would be efficient and promote the development of competition.

For the reasons discussed below, AT&T believes that, with minor adjustments, the Department's proposal will produce efficient rates and promote competition, provided that CLECs have access to UNE-P and fiber-fed loops on an unbundled basis, and a price floor is established to protect against anticompetitive pricing by Verizon.

All parties to this proceeding agree that residential retail rates should be set at economically efficient levels and that rates must recover at least the incremental cost of providing the service in order to be efficient. Tr. 2, 10/23/02, at 179-180 (Gabel); Exh. ATT-1, Mayo Direct, at 13, 16; Tr. 1, 10/22/02, at 24 (Taylor). Residential services will be subsidized by other services, if residential rates are set lower than incremental cost. Exh. ATT-1, Mayo Direct, at 13-14. No party contended that residential retail rates should be set above standalone costs. Exh. ATT-1, Mayo Direct, at 16; Exh. AG-1, Gabel Direct, at 16. The primary disputed issues are: (1) whether the range proposed by the Department is appropriate (*i.e*., whether any price above incremental cost and below standalone cost is "efficient" or equally "efficient"); and (2) whether a rule that permits Verizon to increase its prices by five, or ten,

percent annually will produce rates that fall within the appropriate range and more particularly approximate the price within that range that is the most efficient.

In order to resolve the two foregoing questions, two factual issues were presented: (1) what minimum level of residential rates will recover incremental costs, *i.e*., what is the lowest level of residential rates permissible, and (2) how much of Verizon's joint and common costs should residential rates recover, *i.e*., what is the highest level of residential rates permissible and is such a level likely to be exceeded if Verizon is permitted to increase its residential rates by five, or ten, percent annually. The evidence shows that Verizon's current retail rates are at or below incremental cost and that a right to increase prices of at least five percent annually is appropriate to allow rates to increase to a level that is compensatory. Without such an increase, it is virtually impossible for new competitors to enter the market and competition to develop. The evidence also shows that a right to increase prices of up to ten percent annually is necessary to allow rates to increase to a level that will recover an appropriate level of joint and common costs. As demonstrated below, it is most efficient for Verizon to recover its joint and common costs from dial-tone service. Any universal service concerns can be addressed more cost-effectively with targeted subsidies.

A. BECAUSE RESIDENTIAL RATES ARE CURRENTLY AT OR BELOW THE BEST AVAILABLE ESTIMATES OF INCREMENTAL COST, A RIGHT TO INCREASE RATES BY FIVE PERCENT PER YEAR IS APPROPRIATE TO ENSURE THAT RESIDENTIAL RATES CAN BE INCREASED TO A SUBSIDY FREE LEVEL.

1. When Dr. Gabel's Estimate of Retailing Costs Is Corrected, The Corrected Incremental Cost Of Residential Service Exceeds The Residential Rate Proposed By Verizon In This Proceeding.

As Dr. Gabel correctly noted in his testimony, the current residential rate is $23.34 per month for unlimited local service. This monthly rate is made up of $9.91 for dial-tone service, $6.94 for local usage, $0.49 for touch tone service, and $6.00 for the federally imposed subscriber line charge. After an anticipated increase in the subscriber line charge and an increase in the dial-tone rate to offset the elimination of the separate charge for touch tone service and a reduction in other charges, Verizon's residential rate for unlimited local service will be $25.63. Exh. AG-1, Direct Testimony of Professor David Gabel, filed September 4, 2002 ("Gabel Direct"), at 7. *See also*, Exh. VZ-1, *Compliance*

Filing, Tab A, p. 1, ¶ C , for the dial-tone component of the unlimited local service. As shown below, these rates do not recover the incremental cost (plus the minimal amount of joint and common costs included in TELRIC)[3] of providing residential retail service.

In his testimony, Dr. Gabel set forth a method for estimating the incremental cost of providing local exchange service based on the sum of (a) the TELRIC cost estimates of UNEs and (b) an estimate of the retailing phase of providing local service. Exh. AG-1, Gabel Direct, at 8. According to Dr. Gabel, the monthly cost of providing local service is comprised of the UNE loop ($14.98 statewide average), the switch port cost ($2.00), switch usage costs ($3.30-$4.63), and retailing costs ($1.73). Exh. AG-1, Gabel Direct, at 8. However, although Dr. Gabel has correctly identified the cost components of residential service, his estimate of the retailing phase is unsupported and grossly understated. Correcting his mistakes, it becomes apparent that even the increased residential rates currently proposed by Verizon will fall short of the (TELRIC estimated) incremental cost of providing residential local exchange service.

Dr. Gabel was unable to explain what costs he included in his estimate of $1.73 for the cost of the retailing function. While he made general claims that his estimate included "customer service and marketing expenses" (Exh. AG-1, Gabel Direct, at 8, lines 6-7), he was unable to specify which ARMIS accounts he used to estimate his costs. Tr. 2, 10/23/02, at 188-189 (Gabel). Although Dr. Gabel cavalierly brushed aside the specifics of estimating retail costs, it is important to determine all of the accounts that include costs relating to the retailing function. Not only must the direct costs of retailing, such as sales and marketing, be included; the indirect costs must be included as well. For example, in addition to the salary of sales representatives that Dr. Gabel *may* have included,[4] the indirect costs of retailing must also be included, for example, the costs for the building in which the sales force works, costs for the computer equipment that they use, costs for the furniture in their offices, costs

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[3] Although from a technical economic perspective residential rates need recover only incremental costs in order to be subsidy free, as a practical matter residential rates must at a minimum recover TELRIC costs (which slightly exceed incremental cost), because Verizon's competitors must purchase UNEs and thus must recover in their rates TELRIC costs in order to compete.

[4] Dr. Gabel's inability to describe with specificity what he included in his retailing costs leaves in doubt which items of even *direct* costs associated with sales that Dr. Gabel included.

of the salaries of the management personnel to whom the sales force reports (or, for that matter the furniture, office equipment and building costs necessary to support the management personnel), costs of the salaries of the Human Resources personnel required to support and monitor the sales force (and their associated office costs), and costs of the salaries of the accounting and finance personnel responsible for processing sales force expense requests and associated functions (as well as their associated office costs). Nor did Dr. Gabel say whether his estimate of the non-network, retail phase costs include any costs for operator and directory assistance services.

If, rather than using Dr. Gabel's unsupported estimate of retail phase costs, a well understood, Department-approved estimate of those costs were used instead, the corrected estimate of TELRIC-based incremental costs of providing residential service would exceed even the increased residential rates proposed by Verizon in its June 5, 2001 Compliance Filing ("*Compliance Filing*") (*i.e.*, $25.63). In the *Phase I Order*, the Department determined that an appropriate estimate of Verizon's retailing costs is reflected in the existing resale discount developed from the avoided cost calculation in the Consolidated Arbitrations. *See*, *Phase I Order*, at 91. In other words, the Department concluded that, based on its examination of the costs that would be avoided were Verizon to provide wholesale rather than retail service, retailing costs should be estimated using the resale discount of 29.47 percent.[5] This means that, rather than the retail cost of $1.73 provided by Dr. Gabel, the relevant cost is $5.11 [(9.91 + 6.94 + .49 = 17.34) x .2947]. *See*, Exh. ATT-2, Rebuttal Testimony of John W. Mayo, filed September 18, 2002 ("Mayo Rebuttal"), at 5-6. Thus, even accepting Dr. Gabel's unsupported switching costs,[6] the TELRIC based incremental cost of providing local exchange service, including the

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[5] Use of the 29.47 percent discount ensures that the costs of providing operator services are included in the retailing cost estimate.

[6] Dr. Gabel's cost estimate suffers additional problems beyond those infecting his estimate of retailing costs. Dr. Mayo points out Dr. Gabel's switch usage cost estimates are too imprecise for the Department to rely on. Dr. Mayo states:

> For example, as acknowledged by Dr. Gabel, the level of switch costs "varies depending on usage, the date of the approved rate, and whether transport is included" (p. 8). He cites an estimate of $3.30 from the National Regulatory Research Institute. Then, alternatively he produces a number fully 1/3 higher ($4.63). Given the range of variation Dr. Gabel freely acknowledges, the possibility exists that even higher cost may be realized in Massachusetts. If such variations in costs are present, the robustness of Dr. Gabel's conclusion regarding the retail rate/cost relationship becomes highly suspect.

(continued...)

cost of the retailing function, is $26.72 [14.98+2.00+4.63+5.11], a cost that exceeds even the higher residential rate proposed by Verizon of $25.63. *Id.*

Use of the Department's method of estimating retailing costs provides the Department with confidence that it knows how those costs have been estimated and what is included in those costs. Indeed, in Phase 2 of the *Consolidated Arbitrations*, the Department reviewed exhaustively the parties' Avoided Cost studies and investigated in detail the ARMIS accounts and subaccounts in which retailing costs were recorded. The Department considered and determined the appropriateness of including both direct (such as sales and marketing) and indirect costs (such as the costs of buildings, furniture, computers and support functions like Human Resources, used to support the marketing and sales forces).[7] The end result was a number representing the level of expenses associated with the retailing function, because it represented all those expenses that would not be incurred if Verizon were to exit the retail function and become a wholesale provider only.[8]

Dr. Gabel's criticism of the use of the resale discount for estimating retail phase costs has no relevance to the present case. Dr. Gabel warns that it would be inappropriate to apply a percent discount to a retail rate in order to estimate the portion of the rate that recovers retailing costs, *if the percent discount had been developed on the basis of another rate level*. The problem with Dr. Gabel's criticism is that it has no bearing on the present case. The $5.11 retailing cost estimate calculated by Dr. Mayo is based on the retail rates that were in effect at the time that the resale discount was developed. In other words, the retail rate against which Dr. Mayo applied the 29.47% discount is exactly the rate that produces the revenues in the Avoided Cost study from which the 29.47% was

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(...continued)
Exh. ATT-2, Mayo Rebuttal at 4. Indeed, even the method by which Dr. Gabel arrived at his $4.63 cost estimate for switch usage is unsupported. Dr. Gabel took switch usage patterns for Vermont from a document filed by AT&T at the FCC, and assumed that the same patterns would apply to Massachusetts. Tr. 2, 10/23/02, at 186-187 (Gabel). Nowhere in his testimony, however, does Dr. Gabel explain why Vermont usage patterns have any relevance to Massachusetts. *Id*. In fact, Dr. Gabel admitted in cross examination that he made no attempt to compare Massachusetts and Vermont usage patterns. *Id*. As a result, there is no way to know whether his estimate of switch usage costs is accurate for Massachusetts.

[7] Consolidated Petitions of New England Telephone and Telegraph Company d/b/a Bell Atlantic-Massachusetts, Teleport Communications Group, Inc., Brooks Fiber Communications of Massachusetts, Inc., AT&T Communications of New England, Inc., MCI Telecommunications Company, and Sprint Communications Company, L.P., pursuant to Section 252(b) of the Telecommunications Act of 1996, for arbitration of interconnection agreements between Bell Atlantic-Massachusetts and the aforementioned companies, D.P.U./D.T.E. 96-73/74, 96-75, 96-80/81, 96-83, 96-94 – Phase 2 Order (December 3 1996).

[8] *Id*., at 8-9, 33.

calculated. As Dr. Mayo stated at the hearings in this case, Dr. Gabel's criticism does not apply to the facts of this case. Tr. 3, 10/24/02, at 289-290 (Mayo).

2. The Lack Of Competitive Entry Is Further Evidence That Retail Rates Are Below Incremental Cost.

As Dr. Mayo states in his prefiled testimony, "the marketplace itself seems to offer some (albeit imperfect) information that residential service is under-priced in Massachusetts." Exh. ATT-2, Mayo Rebuttal, at 6-7. Firms are attracted to "surpluses" and repelled by "deficits" in competitive markets. *Id*. Because the level of competitive interest (entry, marketing, and growth of competitors) in residential markets has been anemic, the evidence of market activity suggests that residential prices are too low. *Id.*

Dr. Mayo, however, caveats his conclusion. He notes that the attractiveness of entry is driven not only by output prices but also by the ability of new entrants to secure inputs provided at efficient prices and under nondiscriminatory terms. *Id*. Thus, it is not possible to blame the lack of competitive entry into residential markets solely on the level of retail prices. Nonetheless, the market certainly has not been suggestive of retail prices that exceed incremental cost and the "surplus" that Dr. Gabel claims Verizon has been earning.

B. A Right To Increase Prices Of Up To Ten Percent Annually Is Necessary To Allow Rates To Increase To A Level That Will Recover An Appropriate Amount Of Joint And Common Costs.

While it is important to ensure that, at a minimum, residential retail rates recover the incremental cost of the service, economic efficiency requires that the rate for dial tone service recover an appropriate share of joint and common costs as well. Preventing Verizon from recovering an appropriate portion of its joint and common costs from dial-tone service would force Verizon to seek to recover such costs from other services, charged on a usage basis. If that were to occur, it would produce inefficient rates, distort consumer purchases of telecommunications services and undermine the development of competition. Indeed, for just these reasons, the Department determined in 1990 that economic efficiency – balanced against other considerations – required that residential rates should be set at a level high enough to recover an appropriate portion of joint and common costs, and established a

transition process to move residential rates for dial-tone to $15.00 per month. D.P.U. 89-300. However, in 1994, the Department truncated that process and froze rates for dial-tone service at $9.91, 34% below economically efficient levels. D.P.U. 94-50. With inflation in the years since 1994, the real price of dial tone service has fallen to a level that is 54 percent of economically efficient levels. As explained below, Verizon should be given the right to increase residential rates by as much as 10 percent per year in order to move closer to the levels determined by the Department in 1990 to be necessary for economic efficiency and the development of competition.

1. Verizon's Current Dial Tone Rate Is Below The Level Previously Determined By The Department To Be Sufficient For Economic Efficiency And The Development Of Competition.

Since 1985 the principles established by the Department in D.P.U. 1731 have guided its regulation of the telecommunications industry in Massachusetts. As a result of that decision, in 1986 the Department began a multi-phase investigation of Verizon's (then, NYNEX's) Massachusetts cost of service, rate base, required rate of return, cost allocations, marginal cost structure, rate structure and rate levels. The Department initially reviewed and approved a fully-distributed cost of service study methodology for NYNEX. *See* D.P.U. 86-33-C (1987). Subsequently, the Department determined NYNEX's Massachusetts intrastate revenue requirement and also reviewed and approved a marginal cost study methodology for the Company. *See* D.P.U. 86-33-G (1989). The Department thereafter opened a new docket for the purpose of investigating and determining appropriate rate levels and rate structure for NYNEX. D.P.U. 89-300.

The Department's 1990 decision in D.P.U. 89-300 approved new rates for NYNEX's Massachusetts services and also initiated a transitional rate restructure process designed ultimately to move NYNEX's rates to certain "target" rates, including the target rate of $15.00 for residential dial tone line rates. *See* D.P.U. 89-300, at 82-83. The target rates reflected the Department's determination of NYNEX's rate structure and rate levels best designed to achieve the goals of cost-based rates and the development of competition. *Id*. at 10-16, 22-24. In order to ensure consistency with the principle of rate continuity, the Department ordered NYNEX to make annual transition tariff filings designed to achieve the target rate levels over an unspecified period of years. *Id*. at 434-435.

NYNEX made three annual transitional tariff filings pursuant to the Department's directive in D.P.U. 89-300. In its decision, issued in January of 1994, approving NYNEX's third annual transition filing, the Department described its prior decisions, beginning with D.P.U. 1731, as follows:

> Traditionally, the pricing of telephone service was based on a method whereby residential monthly exchange rates were priced below cost in order to promote universal service; and long distance, toll, and business rates were priced above cost in order to subsidize residential exchange rates. While this system succeeded in serving a social purpose, it was a pricing scheme not conducive to the development of a fully competitive market, in which the benefits associated with competition would be realized by all customers. . . With the endorsement of competition as the best way to achieve its policy goals of efficiency and fairness, it became necessary for the Department to confront the problems associated with the traditional policy of pricing services without direct regard to cost. The Department addressed the pricing issue in IntraLATA Competition, when it determined that "properly defined incremental costs should be used as the primary basis for pricing all services, including local exchange service," and also found that "to the extent that current rates do not reflect an appropriate allocation of costs, the Department will, consistent with the need to avoid major discontinuities in rate levels, move toward that goal." *Id.* at 36-38.

D.P.U. 93-125 at 4-5. To the extent that pricing at incremental cost does not recover all of the costs of the firm, the Department recognized the need to recover remaining costs from the most inelastic services. *Phase I Order*, at 101.

In the D.P.U. 93-125 decision, the Department reaffirmed the timetable it had established one year earlier, in its order on NYNEX's second transitional tariff filing (D.P.U. 92-100 (1992)). In that earlier decision the Department had directed NYNEX to complete the transition to target rates in no more than three additional tariff filings. D.P.U. 93-125 at 8.

For reasons never linked to economic efficiency or consistency with the development of competition, the Department in 1995 capped the residential dial tone rate at $9.91 as part of an approval of a petition by NYNEX to replace traditional rate of return regulation with price cap regulation. *Petition of New England Telephone and Telegraph Company d/b/a NYNEX for an Alternative Regulation Plan for the Company's Massachusetts Intrastate Telecommunications Services*, D.P.U. 94-50 (1995). The residential dial tone rate, therefore, never reached the economically efficient levels the Department targeted as consistent with the development of competition. *See* Exh. ATT-2, Mayo Rebuttal, at 2-3.

2. Allowing Retail Prices To Increase To A Level Sufficient To Recover A Portion Of Joint And Common Costs Will Not Makes Rates Any Less Affordable Than The $9.91 Rate Was When It Was Established In 1994.

Since 1994, inflation has caused price levels to rise by 20.7%. *See*, Exh. ATT-6. Thus, the $15.00 rate that was the target as of 1994 is approximately $18.11 in today's dollars.[9] Verizon's current $9.91 dial-tone rate, therefore, is 54 percent of the economically efficient rate in today's dollars. If Verizon were to increase its dial tone rate of $9.91 by 10% per year for six years, the dial-tone rate would increase only to $17.57 [$(1.1)^6$ x 9.91], a rate that is below the target rate in today's dollars ($18.11), and with likely inflation even further below the same target rate denominated in dollars six years from now. Clearly, allowing Verizon ten percent per year pricing flexibility for six years will still produce rates that, at most, will be less than what would be required to achieve the level of economic efficiency the Department found appropriate in 1990.

A change in the price level is not the only factor affecting the affordability of residential rates. As Dr. Mayo described in his oral testimony, not only has the real price of residential service declined over the years as a result of inflation, but also Massachusetts incomes have increased in real terms. Tr. 3, 10/24/02, at 293-294. If one takes into account the rise in incomes as well as the decline in the real price of residential service, it becomes apparent that the cost of telephone service as a percentage of income has dropped precipitously (from 0.76% to 0.52%), leaving plenty of room for increases in Verizon residential rates without jeopardizing the affordability of basic telephone service. Tr. 3, 10/24/02, at 293-294. *See also*, Exh. ATT-6.

3. A Verizon Right To Recover Joint And Common Costs From Dial-Tone Service, Subject To A Cap Of Ten Percent Per Year, Allows Rates To Move In The Direction Of More Efficient and Competition Enabling Levels.

A central issue in this case relates to how much of Verizon's joint and common costs should the

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[9] In fact, price levels have risen 32.12% since 1990 when the $15.00 target rate was originally set. (Based on 155.1 index for 1994 and 177.3 index for 2001, from the Bureau of Labor Statistics' "CPI-U CONSUMER PRICE INDEX -- REVISED SEASONAL FACTORS AND SEASONALLY ADJUSTED INDEXES, JANUARY 1987-DECEMBER 2000." found on the web at ftp://ftp.bls.gov/pub/special.requests/cpi/revseas_2001cpi.txt. $15.00 in 1990 dollars is approximately $19.82 in today's dollars.)

Department permit Verizon to recover from rates for basic local exchange service. Resolution of that issue will determine how much above incremental costs the Department should permit Verizon to raise residential service rates. The Department has indicated that Ramsey pricing principles should guide the resolution of this issue, where the price mark-ups for different services to recover joint and common costs are determined by the relative price elasticities of the different services. In its *Phase I Order*, the Department stated the issue as follows:

> Thus, we can look to principles of competitive pricing for standards to judge whether regulated prices for specific services are just and reasonable. In competitive markets for telephone services, efficient market prices are based on incremental cost plus a mark-up for joint and common costs, based on Ramsey pricing principles. . . . . Pursuant to Ramsey pricing principles, joint and common costs are recovered from services in inverse proportion to the demand elasticity of particular services. In this way, demand for services is as close as possible to the level of demand under pure incremental cost-based prices. . . . We do know that the range of prices that could prevail in an efficient market starts at a floor of incremental cost (no recovery of joint and common costs) and ends with a ceiling of stand-alone cost (incremental cost plus all of the firm's joint and common costs).

Id., at 101 (citations and footnotes omitted). As explained in more detail below, the strict application of Ramsey pricing principles would require most of Verizon's joint and common costs to be recovered in rates for basic local exchange service and therefore would require basic rates to be far higher than those that would result from a 10% per year increase over three years. Accordingly, a plan under which Verizon could increase basic exchange rates by only 10% per year for three years is a conservative approach to the problem of joint and common cost recovery. *See*, Exh. ATT-1, Mayo Direct, at 19-20.

Dr. Gabel correctly stated the conditions for recovery of joint and common costs from dial-tone service:

> the own-price elasticity of demand for dial-tone (or dial-tone plus local services) is essentially zero (demand is completely unresponsive to price, but all other demand elasticities are distinguishable from zero[.]

Exh. AG-1, Gabel Direct, at 18. *See also*, Tr. 2, 10/23/02, at 199-200 (Gabel). Having stated the conditions, however, he ignores the evidence, leaving to Dr. Mayo the task of bringing to the Department's attention the vast quantity of data supporting the conclusion that the own price elasticity of demand for dial-tone is, in fact, very close to zero. *See*, Exh. ATT-2, Mayo Rebuttal, at 11. Indeed, in response to a Department information request, Dr. Mayo submitted several articles written

by respected scholars and researchers in the field reporting the results of econometric studies. DTE-ATT 4-1, Phase II. He also provided several articles on which Dr. Gabel commented during his cross examination. Tr. 2, 10/23/02, at 205-215. All of the articles produced results showing own price elasticities of basic exchange service very small and usually close to zero:

Location in Record	Author	Title	Elasticity Estimate (page)
DTE-ATT 4-1, Phase II, Tab 1; Tr. 2, 10/23/02, at 202	Kaserman, Mayo and Flynn	Cross-Subsidization in Telecommunications: Beyond the Universal Service Fairy Tale	-0.068 (p. 245)
DTE-ATT 4-1, Phase II, Tab 2	Cain and MacDonald	Telephone Pricing Structures: The Effects on Universal Service	-0.027 to -0.22 (p. 299)
DTE-ATT 4-1, Phase II, Tab 3	Garbacz and Thompson	Assessing the Impact of FCC Lifeline and Link-Up Programs on Telephone Penetration	-0.0021 (p. 74)
DTE-ATT 4-1, Phase II, Tab 4	Garbacz and Thompson	Universal Service Versus Universal Competition: A Review Article of Crandall and Waverman	Approx. Zero (pp. 93-94)
Exh. ATT-3; Tr. 2, 10/23/02, at 208-209	Lester Taylor	Chapter 4, Customer Demand Analysis, in Handbook of Telecommunications Economics	"small" elasticities of demand (p. 129)
Exh. ATT-4; Tr. 2, 10/23/02, at 210	Crandall and Waverman	Who Pays for Universal Service? When Telephone Subsidies Become Transparent	"The sensitivity of telephone penetration to the recurring monthly price is so small that it is increasingly difficult to detect." (pp. 103-104)
Exh. ATT-5; Tr. 2, 10/23/02, at 210	Eriksson, Kaserman, and Mayo	Targeted and Untargeted Subsidy Schemes: Evidence From Postdivestiture Efforts To Promote Universal Telephone Service	reducing price of local service using subsidies from long distance service lowers household penetration rates (p. 500)

By contrast, the evidence indicates that the demand elasticity for *usage*-based services (*e.g.*, minutes of toll service) is substantially higher. For example, Dr. Taylor presented evidence indicating that the demand elasticity for intraLATA toll minutes in Maryland was –1.9. AG-VZ 1-1. Indeed, the elasticity estimates for the demand of basic exchange access (dial-tone) are so small in comparison to the demand for other telecommunications services that the strict application of Ramsey pricing principles would compel that all joint and common costs be recovered in the rate for basic exchange service. Tr. 1, 10/22/02, at 24 (Taylor); Tr. 3, 10/24/02, at 278-281 (Mayo). Thus, if efficiency and the development of competition were the only considerations for setting rates for basic exchange service, virtually all joint and common costs would need to be recovered in the rate for basic exchange

service. This would produce a basic exchange rate far above anything that is being considered in this docket. *See*, Tr. 1, 10/22/02, at 27-28 (Taylor); Tr. 3, 10/24/02, at 280 (Mayo).

Indeed, in this docket, the proposal to allow Verizon to increase its rate for basic exchange service by up to 10% per year would permit the recovery of less joint and common costs in the basic exchange rate than the target rate of $15.00 established by the Department in 1990 and confirmed again in 1994. As noted above, a 10% per year rate increase over a six year period would increase the current $9.91 dial-tone rate to $17.57, while the target rate is $18.11 in today's dollars. A plan under which Verizon could increase basic exchange rates by only 10% per year for six years at least moves in the direction of efficiency, while at the same time limiting the rate-shock effect that would occur as a result of fully efficient rates.

Finally, to the extent that more efficient residential rates may have an adverse effect on universal service, that effect is confined to low income end-users. There is no need to maintain sub-optimal residential rates for all consumers in order to prevent declines in subscription to the network related to a subset of end-users. Instead, the Department should develop a universal service subsidy plan that targets the subsidy to the people most in danger of dropping off the network as a result of basic exchange rate increases. Exh. ATT-1, Mayo Direct, at 22. The subsidy should be "portable" in the sense that it flows to the carrier providing service to the customer. The subsidy should be transparent in the sense that its source and its ultimate use can be accounted for. The source of the subsidy should not be embedded in access charges, or other charges that Verizon can impose on its competitors.

In summary, AT&T's proposal for the recovery of an appropriate level of joint and common costs is both efficient and consistent with the maintenance of high levels of universal service.

4. The Attorney General's Objection To Moving Residential Rates In The Direction Of More Efficient Levels Is Based On Speculation And Flawed Reasoning.

The Attorney General objects even to the conservative approach local service pricing recommended above by AT&T. The Attorney General believes that the basic insights from Ramsey pricing can be used to efficiently set prices (Exh. AG-1, Gabel Direct, at 20), but he argues that Ramsey pricing does not require that joint and common costs be recovered in the basic exchange rate. The basis for his

claim, however, is mere speculation from his economist, Dr. Gabel. Dr. Gabel suggests that basic exchange rates should not necessarily recover a substantial portion of joint and common costs because the demand elasticity for basic local exchange service "***may***" no longer be close to zero. *See, e.g.*, Exh. AG-1, Gabel Direct, at 13 ("it is no longer clear that the dial tone line charge is the non-elastic price element"); *id*., at 14 ("the measure of elasticity could have changed significantly"); *id*., at 14 ("it is not clear that the dial-tone line service is the inelastic service"). Dr. Gabel, however, offers no data to support his conjecture. Indeed, he readily admits that he has none. Tr. 2, 10/23/02, at 194.

Moreover, when pressed, it turns out that Dr. Gabel's speculation regarding demand elasticity is misplaced. Dr. Gabel, in fact, appears to be speculating about the demand elasticity of Verizon *as a firm*; he is not even focusing on industry demand elasticity. Dr. Gabel argues that increases in the price of Verizon's basic exchange service may force consumers to obtain their dial-tone from other wireline carriers, cable companies or wireless companies. Exh. AG-1, Gabel Direct, at 14. In other words, Dr. Gabel is not positing a situation in which Verizon price increases lower subscription rates. To the extent that end-users are choosing other wireline carriers and cable companies for their dial-tone service, Verizon price increases have not forced them off the public switched network, and – as Dr. Gabel concedes – there is no decrease in welfare efficiency. Tr. 2, 10/23/02, at 197 (Gabel).

In summary, allowing Verizon the right to increase by 10% per year the price of basic exchange service will permit the recovery of a portion of joint and common costs from the most price ***in***elastic service. To the extent that Verizon recovers its joint and common costs from the most price inelastic service, and not from usage based services, such as toll and access, consumer welfare and efficiency will improve. The Department should reject the Attorney General's position because the limits it would place on price increases for basic exchange service would force Verizon to seek to recover its joint and common costs from usage-based services, with resulting decreases in consumer welfare and efficiency.

III. CLECS CANNOT CONTEST SERVICE TO THE RESIDENTIAL MARKET WITHOUT CONTINUED ACCESS TO UNE-P AND FIBER-FED LOOPS.

The best means of protecting consumers against economically unjustified price increases is to facilitate competitive alternatives to Verizon's basic exchange service. *See*, Exh. ATT-1 Direct Testimony of

John W. Mayo, filed September 4, 2002 ("Mayo Direct"), at 10-11. Thus, where the Department allows for *potential* price increases like those proposed by Verizon for its residential services, it is critical that "competitors and competition . . . provide a meaningful check on Verizon's upward pricing." *Id*., at 20. The best way for the Department to promote competitive alternatives is to ensure that competitors have access to unbundled network elements on terms and conditions that permit them to compete (Exh. ATT-1, Mayo Direct, at 19), including access to fiber-fed loops on an unbundled basis and – most critically, for the residential market – access to UNE-P. Thus, a predicate for even the limited residential pricing flexibility the Department is contemplating in this docket should be the continued availability of UNE-P and access to fiber-fed loops with voice and data capability. For the reasons discussed below, the Department should make clear that its grant of residential pricing flexibility is conditioned on the ability of CLECs to compete in the residential market, an ability that depends critically on UNE-P availability and access to fiber fed loops.

In his pre-filed testimony, Dr. Mayo was emphatic that, if Verizon is given sufficient pricing flexibility to increase prices to economically efficient levels, "[i]t is critical . . . that input prices and access for new entrants be established and operational in a manner fully consistent with permitting efficient new entrants the opportunity to compete for retail customers." Exh. ATT-1, Mayo Direct, at 19. As part of ensuring access to unbundled network elements necessary to compete, the Department must be vigilant in preventing Verizon from engaging in overt as well as subtle acts of discriminatory conduct in the provisioning of unbundled network elements. Dr. Mayo explained Verizon's underlying incentive to engage in such conduct:

> [*A]s input prices are transitioned to economically efficient levels the incentive by the ILEC to engage in non-price discriminatory conduct – **sabotage** – of its new retail stage rivals grows.* Thus, the Department must be especially mindful as it transitions to economically rationale pricing policies that its efforts to promote competition are not undermined by non-price exclusionary tactics by the incumbent.

This is particularly important in residential markets because residential customers' appetite for competitive alternatives and the ability of new entrants to secure and retain these customers is especially tenuous. Residential customers spend considerable less than business customers on local telephone services. Thus, while having some affinity for the prospect of competitive alternatives, the resistance to switch carriers is especially sensitive for residential customers. Bad experiences with competitors – whether due to the shortcomings of the new entrant or the incumbent underlying carrier of the wholesale input (here, Verizon) – will quickly quash the residential consumers' appetite for competitive

alternatives. That is, for the amount of money that residential consumers spend on local exchange telephone services, it is simply not worth the hassles for them to repeatedly test the competitive waters, especially should the customer not have a positive initial experience with competitors. Moreover, any sabotage that does occur in residential exchange services is likely to be long-lasting and widespread, because the "reputation" of the new entrants' larger portfolio of telecommunications services (e.g., long distance) may be damaged as well.

Exh. ATT-1, Mayo Direct, at 15.

The inability of CLECs to obtain UNE-P following passage of the Telecommunications Act of 1996 is itself a result of a strategy of sabotage by the ILECs, including Verizon, albeit a form of sabotage that was carried on through courts and regulatory agencies. The ILECs waged a campaign of massive resistance to their obligations to provide non-discriminatory access to their networks. For years, ILECs prevented CLECs from obtaining access to UNE-P, a form of access to local networks that can be implemented with the "flip of a switch," even as the ILECs gained "flip of a switch" access to the long distance networks of CLECs to serve their newly acquired long distance carriers following Section 271 approval.

Now that CLECs can use UNE-P for access to ILEC networks, it is essential that UNE-P remain available. Indeed, the critical need for UNE-P arises out of another form of Verizon sabotage: an unwillingness to provision unbundled loops in a high volume, cost-effective manner that would permit CLECs to compete in the residential and small business markets. Residential and small business customers have seen virtually no competitive alternatives emerge because CLECs have faced significant economic impairments in their attempts to address those markets using a facilities-based strategy. The presence of CLEC switches alone has not been sufficient to permit access to the mass volumes of small business and residential customers because access to those markets requires an efficient process for disconnecting large volumes of loops from Verizon's switches and reconnecting them to CLEC switches. Verizon instead provides only a one-at-a-time hot cut process, which is not economically viable for CLECs.[10] Because Verizon does not provide an efficient and cost effective process for

[10] The problems created by Verizon's refusal to provide a mass UNE-P to UNE-L conversion process is best illustrated in the small business market. In that market, AT&T has sought to reduce its dependence on UNE-P and to rely more on UNE-L as a means of using as much of its own network as possible. AT&T's original plans in that market called for the use of AT&T switching combined with a Verizon unbundled loop. However, after a significant effort, AT&T determined that UNE-L was not commercially viable in large part because of the expensive and inefficient, one-at-a time, hot-cut process required to obtain customers in the first place. The individualized, customer

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transferring a UNE-L customer from Verizon to a CLEC, CLECs that want to use their own switch to provide service in combination with a Verizon loop face substantial costs and risks of service disruption – costs and risks that Verizon does not face. UNE-P is the CLECs' only alternative. It is the one local entry mechanism that affords competitors the local equivalent to equal access necessary to compete for mass-market residential (and small business) customers.

It is no surprise that most of the competition that has occurred to date is in the market for high volume customers. It takes the revenues from high volume customers to justify the costs and problems of manual interconnection and hot cut processes. Certainly, those are the only customers that saw significant competitive alternatives before UNE-P became available. If the Department expects to rely on competition in the residential market to provide some discipline on Verizon after it is granted pricing flexibility, then it must maintain the availability of UNE-P. If it does not, then AT&T and other CLECs will be relegated primarily to serving large business customers, and the promise of lower rates and greater choices that competition provides will never reach the residential customer.

For the residential market, the only alternative to UNE-P competition is no competition. The economic reality is that – unless and until a CLEC obtains traffic volumes approaching the ILECs' – the economies of scale that characterize the ILECs' loop, switching, and transport facilities and their "first mover advantages" mean that Verizon will have substantially lower unit costs than any CLEC in virtually all circumstances and dramatically lower unit costs (suggestive of natural monopolies) in all but relatively unusual circumstances. Without a mass volume process for acquiring customers using Verizon's loops combined with CLEC switches, the only way for CLECs to obtain those volumes is through UNE-P. The Department cannot rely on cable telephony alone to provide an alternative to a substantial portion, and perhaps a majority of, Massachusetts residential customers. The Department need look only to the neighboring state of New York to see the competitive benefits that UNE-P provides. CLECs already

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by customer nature of the process made it both so cumbersome that AT&T's customers found it unacceptable and so expensive that it was not economically viable. AT&T's fall back plan was to acquire the customers on a UNE-P basis and then convert to UNE-L on a project basis. Even that process, however, has proven commercially infeasible, due to the unavailability of a forward-looking, high-volume UNE-P to UNE-L migration process at forward-looking TELRIC prices.

serve almost as many residential customers through UNE-P in New York alone as all cable telephony providers serve nationwide. And in the face of Verizon's plans to raise local service rates in New York, New York consumers now have meaningful alternatives, such as AT&T's offer of a service package that provides local service with no price increases for the next year. Such price competition, along with the new product and feature packages that AT&T and other CLECs have introduced in New York, prove that UNE-P allows competitors to provide residential consumers valuable competitive benefits that the Department should widely promote.

Finally, the Department should recognize that CLEC access to (and the price of) fiber-fed loops is also critical for competition in the residential market. *See*, Exh. ATT-1, Mayo Direct, at 5, n. 2. As the Department is aware, Verizon has refused to provide an unbundled loop when the end-user resides at the end of a fiber-fed loop, even when the only service requested by the end-user is voice telephony.[11] The adverse effect on competition caused by Verizon's refusal is magnified by its continued deployment of DLC-fed loop architecture throughout its network. By removing loops that Verizon will provide on an unbundled basis and replacing them with loops that it will not, Verizon is seeking to deny CLECs access to unbundled loops with which they can compete in the residential market. Such a strategy has the effect of rendering non-contestable a large and growing portion of the residential market. Although the Department is presently considering this issue in D.T.E. 98-57 Phase III, it should not grant Verizon's pricing flexibility until CLECs have the ability to compete in the residential market using the full capability of DLC-fed loops. At a minimum, any grant of Verizon pricing flexibility in this docket should be an important factor in the Department's decision in D.T.E. 98-57, because CLEC access to fiber-fed loops is critical for CLEC ability to contest the residential market. If DLC-fed loops are not available to CLECs to serve the residential market, then Verizon could abuse any pricing flexibility that may be granted in this docket.

Since 1985, the Massachusetts Department has been committed to a policy of promoting competition as an alternative to regulation. Since the passage of the Telecommunications Act of 1996, the

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[11] Verizon's policy prevents entirely the ability of CLECs to use Verizon fiber-fed loops to provide bundled voice and data services – services that an increasing portion of the residential market is now demanding.

Department – in furtherance of its pro-competition policy – has devoted substantial resources to determining the correct economic prices for unbundled network elements and to determining non-discriminatory terms and conditions for their availability.[12] Yet, none of this hard work will benefit residential customers if UNE-P does not remain available and if access to full voice and data capable loops at TELRIC prices is not required. While the Department is not being asked in this proceeding to rule on the availability of UNE-P or fiber-fed loops, the Department should not grant Verizon pricing flexibility unless it intends to ensure continued CLEC access to UNE-P and access to fiber-fed loops. Indeed, the Department's grant of limited residential pricing flexibility in this docket should be conditioned expressly on the availability of both. Competitive entry necessary to discipline Verizon's pricing flexibility in the residential market is not just impaired without UNE-P and voice and data capable fiber-fed loops; it is blocked altogether.

IV. PRICE FLOORS TO PROTECT AGAINST ANTICOMPETITIVE PRICING ARE ESSENTIAL FOR COMPETITORS TO CONTEST THE RESIDENTIAL MARKET.

As Dr. Mayo stated in his pre-filed testimony, the residential market will not be open to competition until "the proper relationship between TELRIC-based UNE rates and residential retail rates [is] finally established," Exh. ATT-1, Mayo Direct, at 5, n. 2.[13] Unless Verizon's residential retail rates exceed the sum of TELRIC based UNE rates and the incremental cost of the retail stage function, would-be entrants that require Verizon's monopoly inputs will not be able to compete. *See*, Exh. ATT-1, Mayo Direct, at 17 ("the minimum price should be based on the charges that Verizon imposes on its competitors for all of the monopoly inputs, plus Verizon's retailing costs."); Tr. 3, 10/24/02, at 274, 284 (Mayo).

Indeed, at the hearings, despite the extraordinary evasiveness of Verizon's witness, cross examination by the bench illustrated the importance of setting a minimum price for Verizon's retail services based on what competitors pay for the monopoly inputs necessary to provide the service. Tr. 2, 10/23/02, at

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[12] There is still much work to be done to remedy certain discriminatory practices. For example, Verizon's EEL use and commingling restrictions and its "no facilities-no build" policy impose costs and uneconomic network requirements on new entrants that Verizon does not incur to serve the same customer with the same traffic usage.

[13] Dr. Mayo also noted that "CLEC access to (and the price of) fiber-fed loops" is another essential predicate for fully open residential markets. Exh. ATT-1, Mayo Direct, at 5, n. 2.

234-238 (Brown). Because Verizon charges competitors substantially more than the marginal cost Verizon incurs to provide the service (Tr. 1, 10/22/02, at 85 (Brown)), it is critical that Verizon's minimum retail price be based, not on Verizon's marginal costs, but on the prices it charges its competitors for the network elements necessary to provide a competing service (plus the incremental cost of the retail stage functions). Tr. 2, 10/23/02, at 234-238. Otherwise Verizon would be able to underprice equally or more efficient competitors that purchase Verizon's network facilities. Tr. 2, 10/23/02, at 235, lines 10-14. If that possibility existed, there would be little incentive for new competitors to enter the market. *Id. See also*, Exh. ATT-1, Mayo Direct, at 13 ("prices that do not – at a minimum – recover the incremental cost of providing a service will simply fail to encourage any other parties to consider entry into the market").

In order to protect consumers against economically unjustified price increases, the Department should ensure the availability of competitive alternatives. Price floors are required in order to provide CLECs that are as efficient as, or more efficient than, Verizon the incentive to enter the market.

Conclusion

The Department should establish pricing methods for Verizon's switched access and residential services in accordance with the principles described above. Only if retail rates for the most inelastic services can be increased will it be possible to recover an appropriate level of joint and common costs without large consumer welfare losses. The evidence indicates that if joint and common costs are recovered from usage based services, such as switched access and toll services, the welfare losses will be much greater. Indeed, the empirical evidence indicates that attempts to recover joint and common costs from usage based services may even reduce penetration rates and universal service more than increases in basic dial-tone rates.

Further, any grant of pricing flexibility for Verizon should be predicated on the availability of unbundled network elements, including UNE-P and fiber-fed loops. The importance of CLEC access to UNE-P and fiber-fed loops for competition in the residential market cannot be overestimated. Insofar as the Department is relying on competition to discipline Verizon's pricing power after it is given the limited pricing flexibility under consideration in this docket, the Department should take the steps

necessary to ensure that competitive alternatives are available to consumers. Only if CLECs have access to UNE-P and fiber-fed loops on an unbundled basis can the Department have confidence that Verizon will not have the ability to abuse the pricing flexibility contemplated in this case

Finally, any grant of pricing flexibility for Verizon should also be accompanied by the establishment of a price floor based on the TELRIC charges that new entrants must pay Verizon in order to compete (plus Verizon's cost of the retail stage function). Such a price floor is necessary to protect competitors from an anticompetitive price squeeze by Verizon. Without such protection, competitors that rely on Verizon unbundled network elements will have little incentive to enter the market.

Respectfully submitted,

AT&T COMMUNICATIONS OF NEW ENGLAND, INC.

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