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)

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

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Introduction

In his initial brief, the Attorney General seeks a Department order requiring Verizon to submit costs studies in order to demonstrate that its rates are just and reasonable. The Attorney General's position, however, is inconsistent with the Department's tentative conclusions set forth in its Phase I Order in this docket issued on May 8, 2002 ("*Phase I Order*"). In the *Phase I Order*, the Department indicated a desire to move away from rate-of-return regulation requiring cost studies. *Phase I Order*, at 99. The Department also indicated a desire to move away from price cap regulation. *Id*., at 100. As AT&T explains below, the Department can ensure that Verizon's retail rates are just and reasonable without conducting cost studies and without reliance on price cap regulation, but only if competitive alternatives to Verizon are available and present in the market.

The Department has a long history of relying on competition, rather than cost studies, to ensure just and reasonable rates. The Department may do so again with respect to Verizon's residential retail rates, but only if new entrants to the local residential market can compete. In order to ensure that Verizon's rates are just and reasonable without cost studies or price cap regulation, the Department must ensure that new entrants can obtain at TELRIC prices and on non-discriminatory terms and conditions the unbundled network elements necessary to provide competing local service to residential customers. As AT&T explains below, and in its initial brief, non-discriminatory access to unbundled network elements means access to UNE-P and access to the full voice and data capability of fiber-fed loops. Without such access, it is not an exaggeration to say that competition in the residential market will not happen. If the Department ensures such access for as long as Verizon receives pricing flexibility, however, the Department can confidently approve the limited pricing flexibility requested without the need for cost studies or price cap regulation.

Reply Argument

I. THE DEPARTMENT CAN ADDRESS THE ATTORNEY GENERAL'S CONCERNS BY ENSURING COMPETITIVE ALTERNATIVES TO VERIZON RESIDENTIAL SERVICES.

A. DEPARTMENT PRECEDENT HAS LONG PROVIDED FOR THE USE OF COMPETITION AS A METHOD OF ENSURING JUST AND REASONABLE RATES WITHOUT THE NEED FOR COST STUDIES.

The AG argues that the Department must conduct a review of costs pursuant to c. 159, §§ 14 and 20, in order to determine whether Verizon's proposed rates, including rates that may result from Verizon's right to raise them further, are just and reasonable. AG Initial Brief, at 15. *See also*, *id*. at 18-19 ("Setting efficient prices for a regulated utility recovering a revenue requirement . . . requires knowledge of current incremental costs, embedded cost of serving classes, and Verizon's revenue requirement or at least earnings to avoid confiscatory or monopoly level pricing."). *See, e.g., id.* at 27: ("Verizon has the burden to show that increases falling entirely on the residential class would not be discriminatory," citing c. 159, §§ 14 and 20). The AG, however, ignores the substantial Department precedent developed over many years of ratemaking, which permits utilities to increase rates without cost reviews provided that there is a system in place that ensures that rate increases do not result in unjust or unreasonable prices. The two such systems the Department has approved in the past are price cap regulation and reliance on competitive markets. As the Department decides whether and how to move away from price cap regulation, it can and should rely on competitive markets, as it has done in the past, to ensure that Verizon's rates pursuant to the pricing flexibility proposal are just and reasonable.

In its landmark 1985 decision in D.P.U. 1731, the Department first set out the advantages of using competition, in lieu of regulation and cost studies, to satisfy the requirements of just and reasonable rates in accordance with c. 159, §§ 14 and 20. The Department stated:

> No party to this case seriously disputes the proposition that a competitive market will better promote our telecommunications goal of economic efficiency by requiring, in the long term, that prices be based upon marginal costs, and that incentives will be created to minimize those costs in order to maintain and expand market share. In addition, the evidence indicates that fairness may be furthered through competition, because a competitive marketplace will require that prices for services be driven toward their economic costs, thus helping to ensure that service classes are not paying more than the cost of providing service to that class.
>
> Additionally, it has not been disputed that competition will provide a market environment where the introduction and exploitation of technological innovations will be encouraged. In many market segments, competition will promote a greater sensitivity to specific customer demands and result in an increase in the diversity of service offerings and options available to telecommunications users.

D.P.U. 1731, at 25. Moreover, the Department noted that competition works as an alternative to regulation and cost studies by preventing the incumbent from raising prices above just and reasonable levels because there are alternative suppliers available. The Department stated:

> Market power may exist where consumers are unable to switch suppliers in response to price changes or where no supplier is willing or able to meet the demand for services if prices are increased. As the testimony in this proceeding reveals, under such conditions, carriers would be able to take advantage of the inability of consumers to obtain alternative suppliers and set prices higher than their incremental costs

Id. at 55. *See also*, *Phase I Order*, at 100 ("Since the issuance of the IntraLATA Competition Order in 1985, the Department has approved pricing flexibility for most carriers in Massachusetts and has allowed all non-dominant carriers to employ market-based pricing for business and residential services."), citing *Interlocutory Order*, D.T.E. 01-31 (June 21, 2002), at 15. Thus, as long as alternative suppliers are available (that is, are not hampered by uneconomic input prices and discriminatory provisioning practices by Verizon), Department precedent establishes that cost studies are not necessary to ensure just and reasonable rates.

In its February 2, 1995 interlocutory order in D.P.U. 94-50, the Department made it even more clear that it need not conduct cost studies and that it may rely on competitive forces in order to ensure just and reasonable rates:

> The Department's efforts in alternative ratemaking also extend to the telecommunications industry. Instead of requiring all common carriers under its jurisdiction to submit to cost-of-service, rate-of-return regulation, the Department has varied the type of regulation for these companies, based on competitive considerations and the carrier's market power. For example, the Department does not impose traditional cost-of-service, rate-of-return regulation on resellers of telecommunications services, mobile radio and cellular common carriers, and most interexchange carriers. See, e.g., First Phone Inc., D.P.U. 1581 (1984); Cellular Resellers, D.P.U. 84-250-1 (1984); GTE Sprint Communications Corporation, D.P.U. 84-157, at 4 (1985). In addition, in IntraLATA Competition, D.P.U. 1731, at 63 (1985), the Department decided not to apply rate-of-return regulation and revenue requirement determinations to nondominant carriers but continued the requirements for dominant carriers such as AT&T and NYNEX. The Department found in that proceeding that the alternative regulatory treatment for nondominant carriers would result in just and reasonable rates. Id. at 64. Finally, in D.P.U. 91-79, the Department changed the method of regulation for AT&T, by allowing market-based pricing for AT&T's sufficiently competitive services and adopting price cap regulation for its basic message telecommunications service. D.P.U. 91-79, at 34-35, 42.

D.P.U. 94-50 (February 2, 1995), at 47. Indeed, in this case, the Department has expressly rejected the notion that it must rely on cost studies in order to establish just and reasonable rates. *See*, *Interlocutory Order On Appeal By The Attorney General Of Hearing Officer's Ruling On The Procedural Schedule*, D.P.U. 01-31 (September 3, 2002), at 6 ("since 1985 the Department has relied on competitive market forces as suitable demonstration that rates of common carriers meet statutory requirements, with no cost-based demonstration required"), citing D.P.U. 1731 (1985).[1]

There are now more than 15 years of Department policy and precedent of relying on competition instead of cost studies to prevent unjust and unreasonable price increases, in markets where competition exists. The Attorney General's insistence on cost studies in this case is unfounded, so long as the Department takes the steps and maintains the conditions necessary for competition to exist and thrive.

B. IN ORDER FOR THE DEPARTMENT TO RELY ON COMPETITION TO AVOID THE NEED FOR CONDUCTING COST STUDIES, THE DEPARTMENT MUST ENSURE THAT COMPETITIVE ALTERNATIVES ARE AND REMAIN AVAILABLE.

In the absence of cost studies necessary for cost-of-service regulation and in the absence of price cap regulation, the only means for the Department to ensure just and reasonable rates is competition. The Department cannot, therefore, approve Verizon's proposed plan for pricing flexibility unless Verizon has established, and committed to maintaining, the conditions necessary for competitive alternatives to Verizon's residential service. Put another way, Verizon can meet its burden of showing that its rate proposal will result in just and reasonable retail rates by demonstrating that competitors have access to inputs at economic cost and on non-discriminatory terms and conditions. If those conditions exist, then the Department can appropriately rely on competition to ensure that Verizon's rates fall within a zone of reasonableness for just and reasonable rates.

The importance of establishing the conditions for competitive alternatives in the residential market cannot be overstated. In the long history of Department ratemaking, the

1 A cost study is required, of course, to set the *minimum* retail price that Verizon can charge, *i.e.*, price floors.

Department has departed from cost-of-service ratemaking only when it has determined that other mechanisms ensure just and reasonable rates. In the telecommunications industry, the other mechanisms on which the Department has relied are competition and price cap regulation. With respect to residential rates, the Department's tentative conclusions indicate that price cap regulation is inappropriate. *See*, *Phase I Order*, at 100-101. Thus, the Department must ensure that competitive alternatives for residential service are available if it is to address the AG's concern and meet its statutory mandate of ensuring just and reasonable rates.

1. In Order To Ensure Competitive Alternatives In the Residential Market, The Department Must Maintain The Availability of UNE-P.

The residential market presents challenges that are unique and different from those in the large business market. Because the potential revenues from residential customers are relatively small, competitors cannot afford high customer acquisition costs. The costs and service disruptions associated with acquisition of customers using UNE-L do not permit competition in the residential market, given Verizon's current individualized, one-at-a-time hot cut process. As Professor Mayo pointed out, the residential customer's willingness to experiment with competition may not be able to sustain the hassles and service disruptions.

> 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.

Exh. ATT-1, Direct Testimony of John W. Mayo, D.T.E. 01-31 (Phase II) (September 4, 2002) ("Mayo Direct"), at 15-16.

As a result, in order for there to be even the prospect of competition in the residential market, it is imperative that the Department maintain the availability of UNE-P. UNE-P is the one mechanism that permits CLECs to provide local service with the "flip-of-a-switch" to residential customers currently subscribed to Verizon. In this sense, it is the only mechanism that provides CLECs with access to ILEC local networks that is equivalent to the instantaneous, "flip-of-a-switch" access to long distance networks that ILECs have enjoyed to serve their newly acquired long distance customers following Section 271 approval.

2. Verizon's Reliance On The Department's D.T.E. 99-271 Decision In Support Of Its Claim That Its Hot Cut Process Is Adequate Is Misplaced.

In response to AT&T's evidence regarding the commercial unfeasibility of Verizon's hot cut process and its unsuitability for mass volumes, Verizon has in the past cited to the Department's evaluation of its Section 271 petition in D.T.E. 271 as proof that its hot-cut process is adequate. The Department's determination in that case, for Section 271 purposes, does not, however, foreclose forever a factual determination as to whether the current hot cut process is commercially feasible, even in the business market that was the subject of the hot-cut experience investigated in D.T.E. 99-271. *A fortiori*, it does not foreclose a factual determination of the commercial viability of the hot-cut process in the residential market. The Department, in any event, is not required to adhere forever to its prior decisions. To the contrary, the Department has substantial flexibility to reconsider existing regulatory policy in light of changed circumstances. *Boston Gas Co.* v. *Department of Public Utilities*, 367 Mass. 92, 104 (1975) (a decision of the Department in a particular proceeding does not become irreversible in the manner of judicial decision constituting *res judicata*). *See also, Massachusetts Automobile Rating and Accident Prevention Bureau* v. *Commissioner of Insurance*, 401 Mass. 282, 287-288 (1987).

At the time of D.T.E. 99-271, there was evidence regarding Verizon's performance with respect to the hot cut process and a Department determination in that regard. There was not, nor could there be, at that incipient stage of local competition, a determination as to whether the 95%

on-time performance standard that the Department used in its determination is commercially viable. At best, the Department could only guess as to whether the performance standards it used in its investigation would in fact be tolerated by the retail market.

The evidence is now in, and it conclusively demonstrates that the costs and service disruptions of a one-at-a-time, individualized hot cut process cannot be tolerated. The evidence is AT&T's decision not to acquire small business customers using UNE-L, even though it already has invested in and constructed the switches necessary to serve those customers using UNE-L. Clearly, the cost and service disruption of UNE-L are so great that AT&T prefers to pay Verizon for the switch element in UNE-P even though it has already incurred the cost of that element in its own network. In short, a business plan for competitive entry based on UNE-L failed in the retail business market. The prospects for a UNE-L based entry in the residential market is even more bleak given the sensitivity of residential customers to change that Dr. Mayo describes. Exh. ATT-1, Mayo Direct, at 15.

Based on the foregoing, it is no exaggeration to say that there will be no competitive alternative to Verizon in the residential market if the Department does not maintain the availability of UNE-P.[2] Accordingly, if the Department decides to grant the residential pricing flexibility contemplated in this docket, it must ensure continued UNE-P availability, or be willing to revisit any pricing flexibility rights granted in this docket were UNE-P to become unavailable to competitors.

[2] As AT&T stated in its initial brief in Phase II of this docket, the Department cannot rely on cable telephony alone to provide an alternative to a substantial portion, and perhaps a majority of, Massachusetts residential customers. Indeed, the lessons learned from New York demonstrate the advantages of competitive alternatives beyond cable telephony. CLECs there already serve almost as many residential customers through UNE-P in New York alone as all cable telephony providers serve nationwide.

3. CLEC Access To The Full Voice and Data Capability of Fiber-Fed Loops Is Also Necessary for Competitive Alternatives To Exist In The Residential Market.

Many residential customers are served by Verizon on fiber-fed loops. Under Verizon's existing policy, Verizon will not provision a loop to a CLEC seeking to offer to such customers voice service alone, or voice and data service together, if a spare cooper facility is unavailable. Moreover, the proportion of the residential market that is potentially foreclosed from competition by Verizon's policies is growing, as Verizon continues to deploy 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.

As AT&T noted in its initial brief in Phase II of this docket, the Department is presently considering this issue in D.T.E. 98-57 Phase III. Accordingly, it should not grant Verizon's pricing flexibility in this docket until it determines in D.T.E. 98-57 that 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 weigh heavily in favor of a Department decision in D.T.E. 98-57 requiring Verizon to provide the full voice and data capability of fiber-fed loops to CLECs. In the absence of such a decision in D.T.E. 98-57, any pricing flexibility granted in this case would be unwarranted. 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.

II. THE DEPARTMENT SHOULD SET VERIZON'S RETAIL RATES AND ACCESS CHARGES CONSISTENT WITH THE EFFICIENCY PRINCIPLES OF RAMSEY PRICING AND THE DEVELOPMENT OF COMPETITION WITHOUT TRYING TO MAKE VERIZON WHOLE.

AT&T agrees with the AG that Verizon should not be allowed to recover from residential customers anticipated losses from special access and other Department directives *solely because* those rates have been reduced. AG Initial Brief, at 11. That is a "make-whole" approach that assumes without proving that Verizon is entitled to those specific amounts. See Exh. ATT-1, Mayo Direct, at 26, n. 11 ("The Department should not be concerned with ordering Verizon to "make up" revenue losses in one area with price increases in another. . . . This 'must be made up' logic is…not relevant to the current regulatory context in which the Department is attempting to transition to a competitive residential marketplace.").

AT&T, however, differs from the Attorney General with respect to what the Department should do. Rather than conducting cost studies to determine a "revenue requirement" used in cost-of-service ratemaking, as the Attorney General advocates, AT&T believes that, instead, the Department should set prices and terms and conditions for inputs required by competitors, and then allow Verizon to seek to recover its legitimate costs through retail pricing flexibility. If the input prices are set at TELRIC and competitors have access to them on non-discriminatory terms and conditions, then competition will ensure that the resulting retail prices are just and reasonable. *See*, D.P.U. 1731, at 25 ("fairness may be furthered through competition, because a competitive marketplace will require that prices for services be driven toward their economic costs, thus helping to ensure that service classes are not paying more than the cost of providing service to that class").

III. CONTRARY TO THE AG'S ARGUMENT, LOOP COSTS SHOULD NOT BE ALLOCATED BY REGULATORY FIAT ACROSS DIFFERENT VOICE AND DATA SERVICES.

The Attorney General argues that "[i]n calculating the retail rate, the Department should divide loop costs among all services that depend on the loop, including local, interstate toll, high frequency data and vertical services." AG Initial Brief, at 26-27. The Attorney General's position is flawed, both as a theoretical and as a practical matter.

Professor Mayo addressed this argument head-on. He stated:

> The Department should dismiss this claim, for it is based on a mistaken economic perspective. In particular, it violates fundamental tenets of efficient costing and pricing. For instance, it is well established in both economic theory and regulatory parlance that costs should be determined consistent with principles of cost causation to the maximum – not minimal – extent possible. In the case of telecommunications, this requires examining the bona fide demands and bona fide supply characteristics of services provided. In the specific situation under consideration, consumers demand, and suppliers supply, access to the network, local usage, and long-distance usage. The fact that loops are used in the provision of a variety of telecommunications services does not alter the fact that these loops provide customer access to the network (*i.e.*, dial-tone) – the *sine qua non* of wireline telecommunication.

Exh. ATT-2, Rebuttal Testimony of John W. Mayo (September 18, 2002), ("Mayo Rebuttal"), at 7. Put another way, while it is possible to order and use access to the network without ever ordering or using any of the usage based services, such as local calling or long distance calling, or vertical services, it is not possible to order and use the usage based and vertical services without access to the network in the first place.

Indeed, the AG's economist, Dr. Gabel, articulates the characteristic of access (*i.e.*, dial-tone service) that defines it as a service with incremental costs based on the entire cost of the loop. Dr. Gable states that "[t]he defining characteristic of a service is that it is or would be demanded in its own right." Exh. AG-1, Direct Testimony of Professor David Gabel ("Gabel Direct"), at 9, n. 17. Based on this definition, it is readily apparent that dial-tone access is a service "demanded in its own right" and "the costs of providing that access, including the costs of the local loop, can readily be identified with the provision of such access." Exh. ATT-2, Mayo Rebuttal, at 8. As Professor Mayo stated, "this conclusion is widely recognized" and pointed to an issue of the Yale Journal on Regulation devoted to "Telecommunications in Transition" in which it was noted that

> subscriber access is a service in its own right. …A customer who demands subscriber access with no intention of ever placing a call…causes the same loop costs as other customers that use the network frequently." See Steve G. Parsons, "Seven Years After Kahn and Shew: Lingering Myths on Costs and Pricing Telephone Service," Yale Journal on Regulation, Winter 1994, p. 153. See also, Alfred E. Kahn and William B. Shew "Current Issues in Telecommunications Regulation: Pricing," Yale Journal on Regulation, Vol. 4, 1987.

Exh. ATT-2, Mayo Rebuttal, at 8, n. 5.

The practical problems that would result from adopting the AG's position here flow from its theoretical flaw. Competitors of Verizon in the basic voice telephony market must incur the entire cost of the loop in order to offer basic telephony service. If Verizon, however, prices its basic retail telephony service to include only a portion of that loop, then competitors will not be able to compete in that market. *See*, Exh. ATT-2, Mayo Rebuttal, at 9-10. The result will be that competitors will not want to serve the basic telephony market. At best the competitors will require customers to order other services if they want basic telephony from CLECs. This will leave those customers who desire only basic telephony with no choices. It will also leave the Department in the position of continuing to make decisions about how much of the loop cost to load on to basic telephony with no economic guideposts to go by. *See*, Baumol, Koehn, and Willig, "How Arbitrary is 'Arbitrary'? – or, Toward the Deserved Demise of Full Cost Allocation," *Public Utilities Fortnightly*, September 3, 1987, a copy of which is attached hereto.

See also, Exh. VZ-6, Rebuttal Testimony of William E. Taylor, D.T.E. 01-31 Phase II (September 18, 2002) at 13-15.

Pricing retail services to include only a portion of the loop also creates problems in establishing appropriate price floors. Because price floors are based on the cost that competitors must incur to offer a service, a retail price that includes only a portion of the loop would violate the price floor standard. As AT&T has consistently advocated, retail prices cannot be set below the sum of (a) the TELRIC cost of the wholesale inputs necessary to provide the retail service and (b) the cost to Verizon of the retailing functions.

Because of its flawed theoretical foundation and the obstacles it would present to the development of competition, the Department should reject the AG's argument that loop costs should somehow be allocated across different services. Rather, if loop costs are recovered as the incremental costs of providing access, competition will drive the other services such as vertical services down to their incremental costs. Exh. VZ-6, Rebuttal Testimony of William E. Taylor, D.T.E. 01-31 Phase II (September 18, 2002) at 14.

IV. THE AG'S SPECULATION THAT DIAL-TONE ACCESS MAY NO LONGER BE AS INELASTIC AS IT ONCE WAS IS NO BASIS FOR FORCING RECOVERY OF JOINT AND COMMON COSTS FROM USAGE BASED SERVICES.

The Attorney General does not dispute the concept that Ramsey pricing should be used to determine where joint and common costs are recovered. Exh. AG-1, Gabel Direct, at 20. The Ramsey pricing method endorsed by the AG calls for recovering joint and common costs from the most inelastic services. His sole objection to the position of Verizon and AT&T is that connection to the network may no longer be as inelastic as it once was. Exh. AG-1, Gabel Direct, at 13-14. He offers no proof of this, however. He offers only the speculation that the demand for connection to the network may be less inelastic now than in the past. *See*, AG Initial Brief, at 21-22.

Moreover, the changes that he cited do not, for the most part, reflect any change in demand elasticities for connection to the public switched network; rather, they reflect changes in demand elasticity for Verizon services. Tr. 2, 10/23/02, at 197 (Gabel); Tr. 1, 10/22/02, at 77-78 (Brown). In other words, Dr. Gabel's speculation regarding increases in elasticity are based on evidence that customers may be leaving *the incumbent* in response to incumbent price increases *in order to take local service from another local service provider.* Exh. AG-1, Gabel Direct, at 13-14. The Department need not worry that consumers no longer connect to the network through Verizon when they are connecting to the network instead through a Verizon competitor. 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).

Finally, it must be understood that, under Ramsey pricing, the mark-up above incremental cost is determined in inverse relation to the *relative* elasticities of the different services.[3] As both Professor Mayo and Dr. Taylor point out, the relative elasticity of demand for dial-tone service compared to usage based services leaves no doubt that dial-tone remains by far the most inelastic service (Tr. 3, 10/24/02, at 278-281 (Mayo); Tr. 1, 10/22/02, at 24 (Taylor)), even if there had been an increase in elasticity of demand for dial-tone service. The implications

[3] At page 7 of his pre-filed rebuttal testimony (line 32), Dr. Gabel states, "The basic principle of Ramsey pricing is that the price markups should be higher for those services that have lower demand elasticity since the distortionary effect of price markups on quantity demanded is smaller the lower the demand elasticity." Exh. AG-2, at 7. Later in oral testimony, when pressed about the implications of the definition of Ramsey pricing in his pre-filed testimony, Dr. Gabel attempted to confuse the issue by pointing out that Ramsey pricing should also take into account cross price elasticities of complementary services. Tr. 2, 10/23/02, at 198, 219, 251. Dr. Gabel, however, never made that point in his pre-filed testimony and – on cross examination – was forced to concede why: it is a point of academic interest with little real world relevance in the present situation. Tr. 2, 10/23/02, at 199. Indeed, the clear test he put forward for assigning joint and common costs to dial-tone service depends entirely on relative *own*-price elasticities and does not even mention *cross* price elasticities. Exh. AG-1, at 18; *see also*, Tr. 2, 10/23/02, at 199-200.

for this case of the relative own-price elasticities of demand for dial-tone and usage based services are significant. As a profit making enterprise, Verizon will, of course, seek to recover its joint and common costs. To the extent that the Department prevents it from recovering such costs from the inelastic dial-tone service, it will seek to recover it from usage-based services, such as switched access and toll. Because those services have relatively high elasticities of demand, consumption of them will fall and consumer welfare will decline. (Increases in access prices have precisely the same effect as increases in toll prices because Verizon must price its toll prices above switched exchange access prices in accordance with the price floor requirements in D.P.U 94-185-D (September 1, 1998), at 10.)[4] In short, preventing Verizon from recovering joint and common costs from dial-tone service unambiguously lowers consumer welfare.

V. UNIVERSAL SERVICE CONCERNS SHOULD BE ADDRESSED WITH TARGETED SUBSIDIES IN ACCORDANCE WITH THE COMPETITIVELY NEUTRAL POLICIES OUTLINED BY PROFESSOR MAYO.

The Attorney General objects to the potential for basic telephony rate increases on the grounds that it may undermine universal service. AG Initial Brief, at 27-29. The Attorney

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4 At many different points in this proceeding, Professor Mayo has addressed the problems caused by Verizon recovering its joint and common costs from an intermediate (wholesale) service such as switched or special access. *See, e.g.*:

- ?? Exh. ATT-1 in Phase I, August 24, 2001 Mayo Testimony ("Phase I, 8/24/01 Mayo Testimony"), at 44, lines 6-13;
- ?? *id*., at 48, lines 5-7 ("pricing access services above their economic costs in order to reduce local exchange rates is a particularly poor and arguably counterproductive way of achieving the goal of universal service");
- ?? *id*., at 50, lines 3-6 ("Increasing intermediate product prices above efficient levels creates distortions in downstream production processes that ultimately must be borne by consumers, no matter which carrier they choose for their retail service.");
- ?? *id*., at 50, n. 57 ("price mark-ups on access have precisely the same economic consequence as the imposition of taxes on intermediate inputs. But the distortionary effects associated with taxation of inputs are well known.").

General, however, ignores the overwhelming evidence submitted in this proceeding demonstrating that increases in basic exchange rates have virtually no effect on telephone subscription rates. For example, Robert Crandall and Leonard Waverman, two economists whom Dr. Gabel concedes are "highly regarded" (Tr. 2, 10/23/02, at 209), found that "[t]he sensitivity of telephone penetration to the recurring monthly price is so small that it is increasingly difficult to detect in modern studies." Exh. ATT-2 (Crandall and Waverman, "Who Pays For Universal Service? When Telephone Subsidies Become Transparent"), pp. 103-104. Indeed, Professor Mayo found that the evidence indicates that the effort to keep basic exchange rates low by inflating usage charges actually has a counterproductive effect on household penetration rates for basic exchange service. *See*, Exh. ATT-5 (Eriksson, Kaserman, and Mayo, "Targeted and Untargeted Subsidy Schemes: Evidence From Postdivestiture Efforts To Promote Universal Telephone Service"), p. 500.

In response, the Attorney General selects data out of an undisclosed document which he claims shows that subscription rates declined by 0.2 percent from 1984 to 2001. AG Initial Brief, at 28. The AG, however, fails to mention that the supposed 0.2 percent decline was represented on the undisclosed document as a statistically ***in***significant change.[5] That is, the observed difference is so small that it is due to random variation in measurement error. Thus, rather than supporting the AG, the information that the AG seeks to present by way of brief actually supports the testimony of Professor Mayo: despite significant increases in the price of dial-tone service in Massachusetts, subscription rates in Massachusetts held steady. Thus, on the

[5] A copy of the table upon which AT&T believes the AG relied, together with the FCC press release and report cover page and table of contents, is attached to this brief. The report was obtained from http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/Monitor/mrs02-0.pdf.

basis of the best Massachusetts-specific evidence available, the Department need not prevent Verizon from raising residential rates to more economically efficient levels out of a concern that it will reduce subscribership to the public switched network.

The AG goes on to argue that the proposed LifeLine credit is somehow inadequate based on a calculation that he did in his brief. *See*, AG Initial Brief, at 29. The calculation in the AG's brief, however, contains a fundamental flaw, which renders it useless for the AG's purposes. Based on a second undisclosed document, the Attorney General asserts that the Massachusetts population is 6,379,304. *See*, AG Initial Brief, at 29. He then applies the percentage of households without telephone service (100 less 95.6 = 4.4) to the ***population*** (6,379,304) and claims that there are 208,689 ***households*** in the Commonwealth without telephone service.[6] While it is difficult to understand what the AG's point was in the first place, it is certainly undercut by a calculation that overstates by a factor of several times the number he is claiming to estimate.

In any event, the Attorney General's argument misses the forest for the trees. The legitimate issue that the Department faces relates to how best to achieve universal service objectives without undermining the development of competition. In that regard, Professor Mayo offered a suggestion with which Dr. Gabel agreed. Exh. AG-2, at 15-16. Professor Mayo suggested that the Department "follow this Phase II proceeding with an investigation of how the Department might efficiently pursue the goal of maintaining universal service as the Commonwealth transitions to a competition-enabling regulatory framework." Exh. ATT-1,

[6] A percentage of the number of people in Massachusetts is a smaller number of *people*, not *households*. The AG apparently also made a transposition error as well. (.044 x 6,379,304 = 280,689.)

Mayo Direct, at 23. Professor Mayo offered sound guiding principles in Attachment C to his Phase II testimony filed on September 4, 2002. Exh. ATT-1, Mayo Direct, Attachment C.

Professor Mayo's principles will address the ultimate concern of the Attorney General, the promotion of universal service, and they will do so in a manner that is consistent with the development of competition. In his article with Professor Kaserman, Professor Mayo states:

> To be more effective in promoting universal service and to be compatible with emerging competition, this new system will need to exhibit the following four characteristics:
>
> 1. Subsidization of telephone subscribership should be made explicit.
> 2. Collection of the necessary funds should be broadly based.
> 3. Distribution of the subsidy should be narrowly targeted to those households that are most likely to drop off the network in the absence of the subsidy.
> 4. Both collection and distribution of the subsidy should be competitively neutral.

Exh. ATT-1, Mayo Direct, Attachment C, p. 140.

As Professor Mayo explains, the first characteristic mentioned addresses the first major problem of the current system: cross-subsidies involved in the internal flows within the regulated firm (Verizon). The subsidy should be made explicit so that it can be determined who is paying and who is receiving the subsidy. To the extent that there is no subsidy in Massachusetts (where service revenues cover the incremental cost of providing the service), one can still make an explicit determination of where recovery of joint and common costs should come from.

The second characteristic addresses the tax-like characteristics of the subsidy, or of the funds need to recover joint and common costs. The funds should be raised by a charge, which is in effect a tax. Rather than concentrating it on a limited service, such as switched access, such funds should be recovered broadly across all services of the firm.

The third characteristic of Professor Mayo's universal service proposal calls for the targeting of the subsidy to those individuals most likely to drop off the public switched network without it. Again, this principle is equally applicable to a situation where there is no subsidy *per se* (in the sense that revenues recover incremental cost). The principle can be used to provide a discount off of a generally applicable residential rate that is high enough to recover an appropriate amount of joint and common costs. The discounted residential rate for the targeted group may, or may not, be below incremental costs, depending upon the determination by the Department of what is necessary to achieve universal service. The important point, however, is that the amount by which the generally applicable residential rate is reduced becomes the "subsidy" available to the targeted group, and the amount of such "subsidy" is recovered broadly from all other consumers.

The fourth characteristic requires that the collection and the distribution of the subsidy be competitively neutral. As long as the "subsidy" amount as determined above (difference between Verizon's residential rate and its discounted rate for the target group) is available to any competitive carrier seeking to serve the targeted group, all carriers will have the same incentive to serve that group.

The Department has recognized for a number of years the need to establish a competitively neutral universal service mechanism at the time it permits generally applicable residential rate increases. Indeed, the Department has recognized the need for residential price increases, combined with a competitively neutral universal service mechanism, in order to provide incentives for carriers to invest in facilities to serve the residential local exchange market. D.P.U./D.T.E. 94-185-D (September 1, 1998) at 8-9. Consistent with the Department's precedent on the issue, the Department should initiate a separate universal service proceeding rather than prevent retail prices from moving to economically efficient levels.

In summary, the Department does not need to maintain economically inefficient residential rates in order to achieve universal service. The best approach – the approach most consistent with the development of competition – is to permit Verizon sufficient pricing flexibility to recover an appropriate level of joint and common costs from its residential retail rates, while at the same time, provide a targeted subsidy to those most in danger of dropping off of the network.

Conclusion

The Department can implement a system that produces just and reasonable retail rates for residential consumers by permitting Verizon the pricing flexibility contemplated in this docket, provided however that the Department ensures that Verizon's competitors have access to unbundled network elements at TELRIC prices and on non-discriminatory terms and conditions. Competition in the residential market – the condition precedent to just and reasonable rates under Verizon's proposal – requires that competitors have access to UNE-P and the full voice and data capability of fiber-fed loops. Competition also requires that a price floor be established 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,

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