COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS & ENERGY

Investigation by the Department on its own Motion as to the Propriety of the Rates and Charges Set Forth in the Following Tariff: M.D.T.E. No. 14, Filed with the Department on June 16, 2006, to Become Effective July 16, 2006, by Verizon New England, Inc. d/b/a Verizon Massachusetts	} } } } } } }	Docket No. 06-61

VERIZON MASSACHUSETTS
REPLY BRIEF

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REPLY BRIEF OF VERIZON MASSACHUSETTS

Verizon Massachusetts ("Verizon MA") files this Reply to the Brief of the CLEC Coalition (the "CLEC Brief"). Time and again, the CLECs would have the Department skew the calculation of the avoided cost discount in ways that are inconsistent with governing law, fail to account for the actual real-world evidence before the Department in favor of speculation, and defy logic and common sense. While the CLECs insist that the *status quo* must be maintained, the substantial changes in both the appropriate standard and the industry as a whole since the Department's 1996 decision establishing the current avoided cost discount warrant a fresh look and significant adjustment of the discount.

I. The Department Should Use Jurisdictionally Separated Data for Calculation of the Avoided Cost Discount

The CLECs argue that the Department's determination in the *Phase 2 Order* in 1996 to use unseparated expenses in calculation of the avoided cost discount is "sound and consistent with applicable federal law," *CLEC Br.* at 7, that "should be viewed as binding on Verizon as a matter of collateral estoppel and *res judicata.*" *Id.* at 8. This argument is wrong on both counts; governing law has sufficiently changed that the *Phase 2 Order* is no longer a correct application of the prescribed rules.

In the first place, as the CLECs note, *Br*. at 7, the Department indicated in its *Phase 2* holding that it would defer to the FCC's "deep understanding of the separations process" respecting this issue – indeed, the Department found it significant that the *Local Competition Order*[1] had no "mention of [the] separations process at all in this portion . . . ." However, as Verizon noted in its Initial Brief, the FCC Wireline Competition Bureau has *since* accepted Verizon's use of separated data when the Virginia discount rate was before it.[2] The Bureau's action is a useful FCC indicator of the appropriateness of separated data on the process, and now provides better guidance to the Department than the mere failure of the FCC to reference the separations process in the earlier *Local Competition Order*.

The CLECs are also wrong to suggest that Verizon MA is collaterally estopped from advocating for the use of separated data. This case is not a repeat of a true adjudicatory proceeding between two parties for which *res judicata* would be appropriate. Moreover, the CLECs ignore the well-accepted administrative law exception to the doctrine of *res judicata*:

> Administrative decisions, even if adjudicatory in the sense that they determine rights and duties of specifically named persons, frequently have a regulatory component that may warrant reexamination in the light of changes in regulation, purpose, later decisional law, or applicable on-the-ground facts.

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[1] *First Report and Order in the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996,* FCC 96-325, CC Dkt No. 96-98 (*Local Competition Order*).

[2] Verizon Initial Br. at 10, *citing In the Matter of In the Matter of Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration In the Matter of Petition of AT&T Communications of Virginia Inc., Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia Corporation Commission Regarding Interconnection Disputes With Verizon Virginia Inc,* CC Dkt. No. 00-218, FCC DA 03-2378 (rel. Aug. 29, 2003). The WCB stood in the shoes of the Virginia State Corporation Commission, which, at the time, held itself without state-granted jurisdiction to hear § 252 arbitrations.

Stowe v. Bologna, 32 Mass. App. Ct. 612, 615 (1992) (citing *Ramponi v. Board of Selectman,* 26 Mass. App. Ct. 826 (1989)), *superseded on other grounds,* 415 Mass. 20 (1993). The Appellate Court succinctly explained that "regulatory component" in *Ramponi:*

> Ramponi apparently concedes, as in common sense he must, that the selectmen can make a decision under § 2(d) favorable to a person, and then, in the light of changed conditions, reverse the decision for the future. It should be equally clear that they may correct for the future a decision based on a mistaken view of the law -- an erroneous interpretation of the basic statute.

Ramponi, 26 Mass. App. at 829. This proceeding presents several of these "changed conditions" factors – a change in regulation; an initial decision (*the Phase 2 Order*) of first impression made without the benefit of later years' experience in the resale mode of entry; and a significant change in decisional law, in the holding of the Eighth Circuit in *Iowa Utilities Board v. FCC,* 219 F.3d 744, 754-56 (8th Cir. 2000), *aff'd in part and rev'd in part on other grounds, remanded on other grounds, sub nom. Verizon Communications Inc. v. FCC,* 535 U.S. 467 (2002). In the *Phase 2 Order,* the Department was applying the just-announced FCC standard pursuant to Rule 51.609, which was later overturned in its entirety, and which implemented an equally overturned regulatory standard – the assumption of a wholesale provider that solely resells its services.

Here, the CLECs attempt to brand the jurisdictional debate as a "policy argument," and thus bar it from consideration in this proceeding. There is nothing remotely policy-related about limiting consideration in this proceeding to the intrastate retail products and services whose avoided cost discount is being set. This is simply

consistent with the jurisdictional constraints of the Department, which extend to intrastate telecommunications, but not interstate. *E.g.,* 47 U.S.C. § 152. Nor is there an improper "policy" component to recognizing that in calculating a ratio, the numerator should be rationally related to the denominator. As noted above, the Wireline Competition Bureau expressly applied and reiterated the *Local Competition Order* bar to consideration of policy arguments in the *Virginia Arbitration Order*,[3] but nevertheless used jurisdictionally separated data in calculating the Verizon Virginia avoided cost discount.

Moreover, Dr. Calnon and Mr. Williams explained that "[t]he separations process does not create the wide distortion the CLEC Coalition would have one believe. The allocation of revenue and expense tracks much more closely when corresponding revenues are expenses are compared." *Rebut. Test.* at 5. They cite examples from Exhibit 2 to their testimony, including the CLECs' attribution of 93.6% of revenue to interstate services; the corrected figure is 62.2% when the total interstate revenues are used for comparison to their associated expenses; similarly, the CLECs' claim that 6.4% of interstate revenue subject to separations causes 29.6% of interstate expense is incorrect; the proper figure is approximately ***37.8%*** causing that 29.6%, when both separated, interstate numerator and denominator figures are used. *Id.* at 5. When the correct numbers are considered, it is clear that the separations process does *not* distort the allocation of revenues and expenses.

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[3] The WCB held:

> Finally, we agree with Verizon that our role is to apply the statute in determining the appropriate discount. Once the discount rate is set through the proper application of the statute, it is then up to the market place to determine how much competition will develop via resale. Nowhere in section 252(d)(3) are we required, or even permitted, to adjust the discount to manipulate the level or profitability of resale market entry.

Virginia Arbitration Order, ¶ 670 (footnotes omitted).

The problem with the CLECs' calculations is that they mismatch Verizon MA Product Management and Sales expenses with revenue solely from Basic Local Service, Long Distance Message Service and Miscellaneous Service. *Id.* The CLECs' error is that Product Management and Sales expense support *total* services, especially (for the Department's purposes) Network Access Service. By excluding Network Access Service Revenue, the CLECs have skewed the calculation by over $2.3 billion in the revenue side; that is, they are keeping the expense but ignoring the revenue. *Rebut. Test.* Exh. 2. Intrastate access services expenses, although not subject to resale, are not avoided in a resale scenario; therefore, it is inappropriate to exclude intrastate access as the CLECs purport to do.

Verizon MA's approach, which has been used by every post-*Iowa Utilities* state commission setting Verizon resale rates, applies the simple principle that when the "denominator of the discount calculation is limited to revenues associated with services subject to resale at wholesale discounted rates, the numerator should be limited to the retail costs that are actually avoided when those services are resold." *Id.* at 4. The Department should not depart from this routine practice.

II. If the Department Uses Unseparated Expenses, It Must Also Use Unseparated Revenues.

The CLECs argue that use of separated data understates avoided costs by excluding from the calculation those avoided expenses that are assigned to the interstate jurisdiction, and thus distorts the calculation. *See* CLECs' Br. at 10-11. The CLECs, however, fail to acknowledge that the same reasoning applies to revenues as well: use of unseparated expenses while using ***separated*** revenues improperly excludes those revenues (generated by services subject to resale) that are assigned to the interstate jurisdiction. Thus, even if the Department were to agree with the CLECs and use unseparated expenses in calculating the discount (which it should not), it must also use unseparated revenues as well. As Verizon MA's witnesses testified,

> If Verizon MA is required to include interstate expenses in the numerator of the avoided cost calculation as the CLEC Coalition suggests, then total revenue (including interstate revenue) should be included in the denominator.
>
> Either the entire combined state and interstate revenue subject to separations should be included in the denominator to be consistent with the inclusion of both interstate and intrastate expenses or conversely, expenses associated with the removed revenue should also be removed to calculate the avoided cost discount. Otherwise, Verizon MA's intrastate approach should be used to determine the avoided cost discount.

Rebut. Test. at 9-10; *see also* Verizon Initial Br. at 11-12.

An example serves to demonstrate the requirement to match the scope of the expenses and revenues used. Assume it costs $20 to provide a loop local loop, that $5 of that cost is assigned to customer-facing functions, that the loop generates revenue of $30 and that the loop is 20% allocated to interstate and 80% to intrastate. The CLECs would have the Department include the entire avoided cost of $5 in the numerator (including the

$1 in customer-facing costs that support interstate service) while using only the intrastate portion of the revenues, or $24, in the denominator.

This lopsided methodology would improperly exclude the $6 in loop-generated revenue that is assigned to interstate. Thus the Department would fail to capture a substantial portion (20%) of the revenue generated by the service that is subject to resale and unlawfully distort the calculated discount. If the DTE is going to use the full $5 in costs avoided when that loop is resold, it must also use the full $30 in revenue generated by that loop.

Just as the Department in the Phase 2 Order stressed the importance of including all costs regardless of jurisdictional separations, it should turn the same keen eye to including all associated revenues, again regardless of jurisdiction. Doing so is consistent with the practice in other states. As Verizon noted in its Initial Brief, at 12, each of the three jurisdictions (Florida, California and Indiana) that used unseparated expenses also used unseparated revenues. *Id.* (citing Verizon MA Resp. to DTE 3-5).

III. Verizon MA's Methodology Properly Accounts for Revenue in the Denominator when the Numerator Includes Intrastate Expense.

The CLECs argue that the denominator (revenue) should be markedly reduced by excising revenue associated with services not subject to resale, but they insist that no corresponding adjustment be made in the numerator (expense). This approach defies common sense and well-established practice.

First, the CLECs appear to misunderstand the nature of Verizon MA's methodology. Pointing to Verizon MA's Exh. DTE 3-22 example of application of the same ratio reflected in the numerator to the expenses in the denominator, they note, "None of the accounts listed in Verizon's response to DTE-VZ 3-22 contain revenues

from retail services." *CLEC Br.* at 15. While this may or may not be true, it is a non sequitur. The accounts reflected in that response are there because they are services ***not subject to resale at the avoided cost discount***, not because they are retail services.

This critical difference is reflected in Dr. Calnon's and Mr. Williams's testimony, which addressed the CLECs' contention that the denominator revenues should include only services subject to resale.

> [T]he revenue included in the denominator should be limited to those services subject to resale at a *wholesale discount.* Similarly, the avoided expenses included in the denominator should be derived in the same way. That is, the numerator should include only the avoided portion of the expenses that correspond with the revenues subject to resale at a wholesale discount. . . .

Rebut. Test. at 8. Verizon MA's methodology accounts for the services not subject to resale using a wholesale discount, on *both* sides of the equation, because inclusion of the revenue is balanced out by inclusion of the associated expense. The CLECs seek to tip this imbalance, by removing the intrastate revenue not subject to resale, but leaving *all* intrastate expense. But their contention that Verizon MA does not "specifically include[] expenses", associated with those services in the numerator, *Br.* at 15, is incorrect; their exclusion on the basis of the interstate/intrastate ratio is appropriate because Verizon MA has included *all* intrastate expenses on the other side of the ratio. Put another way, unless specifically *excluded,* Verizon MA has *included* all intrastate revenues and all expenses. Thus, it is necessary to exclude those expenses associated with services not subject to resale. The CLEC approach skews this by specifically including substantially more expenses than the revenues that would be associated with them.

Verizon MA's approach is consistent with that presented in every other state in which Verizon has presented cost studies (including the FCC Wireline Competition Bureau in the Virginia Arbitration, *id.)*; to the extent there is a customary practice in the industry regarding jurisdictional data in avoided cost proceedings, it is the CLECs, not Verizon MA, that ask that the Department materially depart from it.

The Verizon MA witnesses explained the effect of improperly weighting revenues against expenses in a manner proposed by the CLECs:

> If Verizon MA were required to include interstate expenses (without the corresponding interstate revenue), the effect would be to exclude not only the portion of the intrastate retail rate that recovers intrastate expenses that are actually avoided, but also the interstate expense recovered in rates and revenue for interstate services. This would not be appropriate, as it would exclude from the retail service rates more than the portion thereof (of that rate) attributable to recovering its associated avoided cost.

Rebut. Test. at 9. Such an exclusion would artificially raise the avoided cost discount beyond that "attributable to any marketing, billing, collection, and other costs that will be avoided by" Verizon MA, in violation of 47 U.S.C. § 252(d)(3).

In their Brief, the CLECs also argue that even if the Department accepts Verizon MA's methodology (and that of the numerous other states which have approved similar submissions), it should nonetheless reject Verizon MA's filing as "entirely unsupported." *Br. at* 15. As with large portions of their testimony, what the CLECs are really contending is that Verizon MA's position is unsupported to their satisfaction. This is not the standard. Rather, having made a prima facie showing, and having amply supported it with testimony and detailed responses to the both Department and CLEC discovery,

Verizon MA has provided more than sufficient bases for the Department to use Verizon MA's methodology.

Specifically, the CLECs object to Verizon MA's suggestion that the appropriate gauge for the ratio between intrastate revenues not subject to resale and total revenues requires applying the same percentage to expense. But, as discussed in Verizon MA's Initial Brief, this was illustrated in an attachment to DTE 3-22. Verizon MA has no objection to removal of revenue associated with services not subject to resale, so long as the associated expense is likewise removed. The only logical method for doing so is to take the amount removed divided by the total amount and use the derived revenue quotient as a proxy for percentage of expense to remove.

Because Verizon MA's methodology appropriately recognizes all revenues and all expenses, it is a superior, and well-tested approach, relative to the skewed method urged by the CLECs.

IV. Verizon MA's Methodology Properly Accounts for Sales Expenses Under USOA Account 6612.

The CLECs complain that Verizon MA has used a newer – and more accurate – approach in treating sales expenses than it utilized in cost studies several years ago. Again, the CLECs rely on an estoppel-type argument, contending that because several years ago while the industry was still awaiting a revised FCC rule, where Verizon conservatively assumed all sales expenses were avoided, Verizon may never revisit that assumption or correct or refine its approach. This flat-earth approach to administrative litigation finds little support in the evolutionary arenas of telecommunications rate setting and accounting.

Verizon MA's witnesses noted in testimony the ambiguity that surrounded the period following the Eighth Circuit's decision. *Reply Test.* at 16. Critically, the Department noted the same uncertainty, *while it was occurring,* in its April 2001 Interlocutory Order on the Part B Motions:

> Nevertheless, the Department agrees with Network Plus, AT&T and the Joint Commenters that, despite the Supreme Court's denial of certiorari on the resale pricing rules, uncertainty remains as to the FCC's forthcoming rules on remand. In previous orders setting out pricing rules, the FCC has been fairly detailed, and uncertainty about those details will impede our ability to efficiently review Verizon's proposed avoided cost study at this time.[4]

Thus, the Department appreciated that many questions concerning the avoided cost methodology were unsettled immediately following a remand decision from which further FCC advice was expected but never received.

Verizon MA's witnesses also expressly identified sales expenses, including account management functions necessary in maintaining a wholesale business, that are not avoided on resale. *See* Verizon Initial Br. at 15-16. Thus, the only hard evidence before the Department in this case is that 17.16% of Account 6612 expenses are wholesale in nature and are not avoided on resale. That this is so is not surprising. Indeed, one wonders, in the CLEC view of avoided costs, just who it is the Coalition members would contact for sales or assistance at a company with no wholesale account managers? Likewise, who would manage the accounts for wireless, for facilities based CLECs, and for interexchange carriers, both in terms of product offerings and account

[4] Interlocutory Order on Part B Motions, Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Pricing, based upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts' Resale Services in the Commonwealth of Massachusetts, D.T.E. 01-20 (rel. Apr. 4, 2001).

resolution? The costs Verizon MA incurs to provide these functions are not avoided in a resale environment. The Department should not ignore the hard evidence now before it in favor of an admittedly less-accurate methodology used years ago in other jurisdictions.

V. Verizon MA's Methodology Properly Accounts for Customer Service Expenses Under USOA Account 6623.

The CLECs insist that the FCC directed use of ARMIS 43-03 reporting of a wholesale/retail split under Account 6623, for the purpose of both UNE and resale rates. By extension, they argue, Verizon MA erred in using a special study for resale-related sales expenses, rather than the wholesale/retail split reported in its ARMIS. They further contend that Verizon MA's position – that while the Joint Conference suggested that the wholesale/retail split would be useful for UNE and resale ratesetting, the FCC directed its use solely for UNEs – is "flatly wrong."

In fact, the CLECs are flatly wrong. They cite the proper paragraphs of the FCC Order, but gloss over not only the absence of any relevant reference to *resale rates,* but the express reference to *UNE* rates as the stated purpose of the FCC's decision. Paragraph 9 is the FCC's summary of what it considered relevant from the Joint Conference's recommendations as follows:

> The Joint Conference recommends that the Commission reverse its decision in the *Phase II Report and Order* to consolidate Account 6621, Call completion services, Account 6622, Number services, and Account 6623, Customer services, into a single account—Account 6620, Services—and its decision to establish wholesale and retail subaccounts for Account 6620. **It recommends that the Commission consider other measures to achieve the Phase II goals of: (1) recognizing an increased importance of the wholesale versus retail distinction as competition develops in the local exchange market; and (2) assisting the states in developing unbundled network element (UNE) rates that properly reflect the costs of**

> **providing a wholesale service**. As an alternative, the Joint Conference suggests consolidation of Accounts 6621 and 6622 and retention of Account 6623 as a separate account with wholesale and retail subaccounts for Account 6623 only. It also suggests, as another alternative, modification of ARMIS reporting to provide wholesale/retail percentages for Account 6623 instead of requiring subaccounts.

Accounting Order, ¶ 9 (emphasis supplied; footnotes omitted). Clearly, the FCC found nothing relevant in the Conference's recommendation to use the wholesale/retail split to develop resale discount rates. Further, the FCC's decision on the question states that:

> . . . . We also decide not to require ILECs to create wholesale and retail subaccounts for Account 6623. We will instead require that ILECs report their wholesale and retail percentages for Account 6623, Customer services, in the ARMIS 43-03 report. This approach will be far less burdensome than the creation of subaccounts, and will provide wholesale and retail information for the Commission and the states for those costs that are most relevant. Reporting in ARMIS 43-03 will result in identification of the wholesale and retail percentages on a state-by-state basis. ***This is consistent with the Commission's determination in the Phase II Report and Order that wholesale/retail information is important for development of UNE rates, which are set by the states.***

Id. at ¶ 14 (emphasis added; footnotes omitted). Accordingly, no matter what the Conference had recommended, the FCC clearly directed ILECs to report the wholesale/retail data for use in developing UNE rates, as it stated, and did not state or even imply that such data were required or even preferred in setting the wholesale discount available to resellers. The CLECs rely on this paragraph in both their Brief and testimony but, tellingly, omit the critical last sentence which specifies the FCC's intent

and understanding of its own Order. *CLEC Brief* at 21 & n.77; *CLEC Reply Test.* at 35 & n.32.[5]

The CLECs' other contention with respect Account 6623 is even less tenable than their mischaracterization of the *Accounting Order*. They contend that, notwithstanding Verizon MA's extensive testimony in support of its special study,

> Verizon admitted that "[i]t would be practically and theoretically correct" to use the retail/wholesale percentage from the "USOA Account 6623 on the ARMIS 43-03 report."

Brief at 23 & n.85. But Verizon MA did not suggest it would be correct to use the percentage ***from*** the 43-03 Report; rather, it acknowledged, in response to the Department's inquiry, that

> [i]t would be practically and theoretically correct to use the same method and percent to report the retail percent of USOA Account 6623 on the ARMIS 43-03 report, but WP7 of Verizon MA's Cost Study (Exhibit 1) is actually a more accurate determination of the percent of Retail Customer Services in USOA Account 6623.

Verizon MA Resp. to DTE 3-11. The CLECs have reversed Verizon MA's response, which was intended to explain that it is theoretically sound to use the ***special study*** data to populate ARMIS 43-03; not that it is correct to use the "percentage from the 'USOA Account 6623'" in this proceeding. Verizon plans to review the methodology to report

[5] See also, ¶ 64 of the FCC's Report and Order, and Further Notice of Proposed Rulemaking, In the Matter of 2000 Biennial Regulatory Review -- Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2; Amendments to the Uniform System of Accounts for Interconnection; Jurisdictional Separations Reform and Referral to the Federal-State Joint Board; Local Competition and Broadband Reporting, CC Dkt. No. 00-199, FCC Rel. 01-305 (rel. Nov. 5, 2001) ("Phase II Report and Order"), which Accounting Order ¶ 14 cites in support. There, too, the FCC spoke solely to the use of wholesale/retail data for setting UNE rates, not resale rates. Paragraph 64 states that wholesale/retail data are "important for development of UNE rates" and that, "Adding these new subaccounts will assist the states in developing UNE rates that properly reflect the costs of providing a wholesale service." Had the FCC meant its requirement to report the wholesale/retail split on Account 6623 to control in state avoided cost proceedings, it certainly would have said so in at least one of these decisions.

the retail percent on future ARMIS 43-03 reports and may use the method in its current avoided cost study.[6]

As Verizon MA noted in response to DTE 3-11, its special study is "a more accurate determination of the percent of Retail Customer Services in USOA Account 6623." As the best and most accurate evidence available, the Department should not hesitate to rely on Verizon MA's special study results in this proceeding.

VI. Verizon MA Has Correctly Addressed Indirect Expenses in Its Cost Study.

The CLECs' insistence that indirect expenses must be avoided on resale is inconsistent with the holding of the Eighth Circuit in *Iowa Utilities Board.* They argue that:

> Verizon's assertion that the elimination of hundreds of millions of dollars of direct costs fails to result in the elimination of any indirect costs lacks credibility and defies common sense. … A reduction in retail related activities, such as a reduced labor force (as a result of avoided activities), will have ramifications for other portions of Verizon's organization, such as office supplies, office furniture, computers, real estate and human resources.

CLEC Br. at 25[7]. Their argument is fatally flawed. First and foremost, it mischaracterizes the nature of Verizon MA's avoided cost study. That study develops the amount of expenses Verizon MA avoids when a CLEC resells a service to a Verizon MA customer, represented as a portion (i.e. percentage) of the revenues generated by that service. By looking at those figures in the aggregate, i.e. across all such services that are

[6] The effect this action will have on future *UNE* rates is uncertain, but it will greatly lighten the administrative burdens recognized by the FCC in paragraph 13 of the *Accounting Order*.

[7] So that the factual record is clear, the total amount of avoided costs shown in Verizon MA's avoided cost study is one hundred-fifty five million dollars, not "hundreds of millions."

available for resale, the study results in a percentage that is appropriate to apply to any given resold service.

The study does not, however, depend on any assumption that resellers will capture all or any particular share of the market. And Verizon MA does not *actually* eliminate the costs shown in the study as avoided. Rather, it necessarily allocates a portion of those costs associated with the resale functions specified in § 251(c)(4) for purposes of making the avoided cost discount calculation. Because those costs are not actually eliminated, they do not result in "a reduced labor force," which in turn would result in reduction in indirect expenses.

The unstated premise of the CLECs' argument is that widespread success by resellers in winning Verizon MA customers across the market will eliminate significant Verizon MA revenue and cause a "reduction in retail related activities," necessitating a reduction in labor force and so on. But this is precisely the kind of forward-looking analysis the Eighth Circuit prohibited, instead requiring the Department to limit itself to consideration of costs actually avoided when a CLEC resells a service, not those costs that would be avoided if CLECs captured all or a given share of the market. Under the Eighth Circuit "avoided cost" standard, indirect expenses – executives, computers, tables and furniture – are not avoided on resale, because, unlike direct costs, no indirect costs are eliminated when "customer-facing activities" are performed by a CLEC rather than Verizon MA. The exercise would be a different one, and indeed ***was*** a different one, under overturned FCC Rule 51.609. This is because an *avoidable* cost scenario is a hypothetical construct in which "the avoided costs are those that an incumbent LEC

would no longer incur if it were to cease retail operations and instead provide all of its services through resellers." *Local Competition Order* at ¶ 911.

This judicially-rejected philosophy plainly colored the FCC's reasoning in paragraph 912 of the *Local Competition Order*, in which it directed that an avoided cost study must include shared as well as direct costs. The hypothetical "lower level of overall operations resulting from a reduction in retail activity" simply does not occur in a company that "itself remain[s] a retailer of telephone service with its own continuing costs of providing that retail telephone service." *Iowa Utilities Board*, 219 F.3d at 756. Indeed, this is precisely what the Eighth Circuit meant in stating that:

> Under the statute as it is written, it is only those continuing costs of providing retail telephone service which will be avoided by selling to the competitor the services it requests which are to be excluded. The FCC's rule is contrary to the statute.

Id. Put simply, executives, mail clerks, lawyers, human resources expenses, lobbying activities and the hundreds of other indirect costs are not avoided merely because a competitor resells a Verizon MA service.

This overriding flaw in the CLECs' appreciation of the relationship between indirect expenses and resale activities undermines each of the positions they articulate in their Brief. For example, they insist that eliminating direct expense, but failing to concomitantly reduce associate shared costs "is flatly inconsistent with Verizon's obligations to maximize shareholder wealth by minimizing expenses." *Brief* at 25. But of course, Verizon MA does not actually eliminate the direct costs allocated to 251(c)(4) activities; instead, it simply *allocates* them as required by law for purposes of calculating a resale discount. Indeed, as noted in its Initial Brief, Verizon MA does not even ***lose*** the

resold customer; it merely sheds the discrete functions associated with attracting and retaining it. But in "a retailer of telephone service with its own continuing costs of providing that retail telephone service, *Iowa Utilities Board*, 294 F.3d at 756, (as well as a wholesale provider) those functions are essentially dwarfed by the myriad obligations associated with provisioning a telecommunications network and serving as the carrier of last resort in most of the Commonwealth. Thus, the linear relationship between direct and indirect expense that the CLECs insist is common-sensical, simply does not exist.

VII. Agent Commissions Are Neither a Lawful Nor a Relevant Comparator for Avoided Cost Discounts.

The CLECs reiterate the novel and wholly unsupported notion that the commissions which Verizon MA pays outside agents to sell various packages of services should serve as a lower bound for the avoided cost discount prescribed by the Department. This argument has no merit.

In the first instance, it is precisely the sort of "policy" argument which the FCC deemed impermissible in the setting of avoided cost discounts. *Local Competition Order*, ¶ 914 ("An avoided cost study may not calculate avoided costs based on non-cost factors or policy arguments, nor may it make disallowances for reasons not provided for in section 252(d)(3). The language of section 252(d)(3) makes no provision for selecting a wholesale discount rate on policy grounds.").

Verizon MA's agent commission program does not provide even a remote analogue to the wholesale discount. Agent commissions are set by a different method, for a different purpose, with a different benefit, and for different services. First, the avoided cost methodology focuses solely on costs, while cost is only one of several factors associated with creating a retail sales commission program. *Rebut Test.* at 25-26. As

Verizon MA's witnesses testified, "the independent agent commission structure and levels are based on what the market [for such services] requires…." *Id.*. at 30. Second, commissions are earned – and thus set – based on sales of many services that are not available for resale, *see* Verizon Confidential Exhibit in Response to CLEC 1-24, Attach. II and Appx H., Section 4. Likewise, broad classes of services which Verizon MA must offer CLECs at the avoided cost discount would yield no commission if the same services or facilities were sold by an outside sales agent. *Id.* Put simply, there is insufficient similarity of purpose or of implementation to use sales agent commissions as a comparison to avoided costs discounts.

VIII. The "Trend" Analysis upon which the CLECs Rely Is Fundamentally Flawed.

The CLECs argue that the since Verizon MA's expenses have increased at a sharper rate than its revenues, the avoided discount rate "may" increase (rather than decrease as Verizon MA proposes), even though the absolute amount of expenses avoided upon resale is much small today than in the past as a result of the correction on the applicable standard. *See CLEC Br.* at 35. This is pure speculation, and the Department should ignore it. While the CLECs offer a nice graph showing expenses relative to revenue, they offer no evidence of any kind that such growth actually offsets the significant reduction in avoided expenses resulting from the new "avoided cost" standard.

Moreover, the CLECs' argument is based on an inaccurate presumption that "all else is equal." *Id.* at 34. It is, of course, empirically correct that when dealing with ratios, an increase in the numerator relative to the denominator will yield higher numbers. *E.g.*, 3/8 = .375; 5/8 = .625; 7/9 = .77777. But all else is not equal. The starting point

for a proper comparison is a rate properly comparable to the new, proposed rate, not, as here, a rate set under a markedly different standard struck down by a United States Court of Appeals.

Using data already in the record demonstrates the speciousness of the CLECs' argument. The calculations depicted in the following chart present the data from 1999 Expenses (earlier filed in the 2001 proceeding, and made a part of the record as a response to DTE 2-8), calculated using the same methodology as the Verizon MA submission in the current case.

AVOIDED COST / RESALE DISCOUNT STUDY - 2005 EXPENSES
Retail Avoided by Account Summary
MA State
($000's)

				USING VERIZON OPERATORS			NOT USING VERIZON OPERATORS		
Line	Account	Account Description	Regulated Intrastate Amount D=WP4, WP3	Avoided Amount E=WP3, WP8	% Avoided F=E/D	Discount Percentage G = E/D, Row 11	Avoided Amount H=WP3, WP8	% Avoided I=H/D	Discount Percentage G = H/D, Row 11
A	B	C							
Using 1999 Expenses (Tab 5, Attachment V DTE 2-8)									
11	5XXX	Revenue	$ 1,803,715						
13	6533	Customer Repair Center Testing	$ 41,266	$ 5,979	14.49%	0.33%	$ 5,979	14.49%	0.33%
14	6611	Product Line Management	$ 44,225	$ 9,299	21.03%	0.52%	$ 9,299	21.03%	0.52%
15	6612	Marketing Sales	$ 42,576	$ 35,271	82.84%	1.96%	$ 35,271	82.84%	1.96%
16	6220	Operator Systems	$ (29)	$ -	0.00%	0.00%	$ (29)	100.00%	0.00%
17	6621,6622	Call Completion/Number Svcs.	$ 38,522	$ -	0.00%	0.00%	$ 38,522	100.00%	2.14%
18	6623	Customer Services & Billing	$ 176,264	$ 146,842	83.31%	8.14%	$ 146,842	83.31%	8.14%
19	**Total (Sum of Lines 13 - 18)**		**$ 342,825**	**$ 197,391**	**57.58%**	**10.94%**	**$ 235,884**	**68.81%**	**13.08%**
Expense as pct of Revenue			19.01%						
Using 2005 Expenses (as filed by Verizon)									
11	5XXX	Revenue	$ 1,298,177						
13	6533	Customer Repair Center Testing	$ 25,010	$ 3,624	14.49%	0.28%	$ 3,624	14.49%	0.28%
14	6611	Product Line Management	$ 28,435	$ 5,979	21.03%	0.46%	$ 5,979	21.03%	0.46%
15	6612	Marketing Sales	$ 32,935	$ 27,284	82.84%	2.10%	$ 27,284	82.84%	2.10%
16	6220	Operator Systems	$ 132	$ -	0.00%	0.00%	$ 132	100.00%	0.01%
17	6621,6622	Call Completion/Number Svcs.	$ 35,805	$ -	0.00%	0.00%	$ 35,805	100.00%	2.76%
18	6623	Customer Services & Billing	$ 141,787	$ 118,119	83.31%	9.10%	$ 118,119	83.31%	9.10%
19	**Total (Sum of Lines 13 - 18)**		**$ 264,103**	**$ 155,006**	**58.69%**	**11.94%**	**$ 190,942**	**72.30%**	**14.71%**
Expense as pct of Revenue			20.34%						

While, just as the CLECs suggest, the analyses indicate that the avoided cost discount *increases*, rather than *decreases*, this is because the new rates (13.08% with operator services; 14.71% without) start from a base of *10.94%* and *13.08%*, respectively, rather than 24.99% and 29.47%. Once more, all else is not equal.

Moreover, the CLECs' trend analysis uses data that are irrelevant to avoided cost calculation. They base their trend on ***total*** *operating* costs from ARMIS 43-03, row 720. That information, as Dr. Calnon and Mr. Williams note, includes significant amounts for

plant specific, non-plant specific, depreciation/amortization, general and administrative expenses that have no bearing on expenses that are actually avoided when retail services are resold. *Rebut. Test.* at 22. Put another way, depreciation and amortization have no effect on avoided cost trends; they are affected by wholly different accounting principles and materially skew any studies seeking a relationship between revenue and expense. Thus, even if the CLECs' "trend analysis" were of any value in prescribing avoided cost discounts, there are no data in the record that would provide comparisons appropriate for the purposes argued by the CLECs.

IX. Resale of Verizon MA Products and Services Will Not Be Improperly Affected by Correcting Resale Rates in Massachusetts.

In their final argument, the CLECs abandon all pretense of eschewing policy concerns and contend that if the Department resets Verizon MA's avoided discount rate at the level Verizon MA calculates consistent with applicable law, "the resale mode of competitive entry under Section 251(c)(4) would be rendered virtually meaningless." *CLEC Br.* at 36. This argument asks that the Department not only suspend disbelief (given that many members of the Coalition actively resell Verizon services in other jurisdictions with much lower resale discounts), but that it disregard the factual evidence of record and, instead, "calculate avoided costs based on non-cost factors or policy arguments, [and] make disallowances for reasons not provided for in section 252(d)(3)." *Local Competition Order* ¶ 914. In other words, the CLECs ask the Department to do what the FCC expressly said it may not.

Further, the CLECs' end-of-the-world scenario overlooks a fundamental problem; the rates may currently be high because they are *not lawful*. Put another way, that the CLECs currently receive a massive, now unlawful, subsidy from Verizon MA is no

ground for continuing that subsidy in the face of changed facts and law. Any argument that seeks a level of discount above the costs that Verizon MA actually avoids because of the factors specified at § 251(c)(4), asks that the Department violate federal law and should be disregarded.

The CLECs' argument illustrates the difference between protection of competition, which this Department is charged with, and protection of *competitors*, which the CLECs wrongly demand from it. As Dr. Calnon and Mr. Williams explain,

> An attempt to preserve or promote one mode of competition through artificial incentives (in the form of discount rates above the level of avoided cost) frustrates, rather than promotes, a true market determined competitive process and produces benefits only for the class of competitor receiving the artificial incentive. The proper measure of the health of a competitive ***process*** should take into account all modes of competition and consider the degree to which market-opening initiatives promote the sort of efficient entry and rivalry that produces benefits for customers.

Rebut. Test. at 23 (emphasis original). Protecting competition does not entail artificial support for one mode of entry over another.

The Department should likewise give no weight to the CLECs' argument based on the forbearance sought by Verizon MA regarding § 251(c)(3) loop and transport unbundling in the Boston Metropolitan Statistical Area.[8] Such forbearances are granted because markets are *competitive*, not because one or more competitors require special supra-competitive subsidies in order to remain in the market. Indeed, the CLECs point to the FCC's reliance upon the availability of § 251(c)(4) resale in the *Omaha Forbearance* decision, *CLEC Br.* at 36. n142 (citation omitted), and indeed, Omaha provides an

[8] *In re: Petition of the Verizon Tel. Cos. for Forbearance Pursuant to 47 U.S.C. § 160 in the Boston MSA*, WC Dkt. No. 06-172 (filed Sep. 6, 2006).

excellent illustration that competition can thrive in the absence of a subsidy-level resale discount rate. The Qwest Nebraska resale discount is 16.00%, nearly 900 basis points below that of Massachusetts.[9] There is no reason to doubt the FCC's finding that carriers will still be able to rely upon the availability of § 251(c)(4) resale in Omaha, or that competition will continue to thrive there.

The CLECs deny that theirs is a policy argument that the Department is precluded from considering, *CLEC Br*. at 37, but that is mere wordplay. Almost in the same breath, they argue that "Verizon's proposed resale discount rates do not serve the pro-competitive purpose that requires Verizon to make them available (i.e. to spark competition and foster competitive entry). *Id.* at 37-38. Of course, seeking to satisfy a "pro-competitive purpose," sparking competition and fostering competitive entry are *policies*, which, no matter how beneficial in other circumstances, cannot be considered in setting the wholesale discount rate in this proceeding.

[9]http://www.uswest.com/about/policy/sgats/SGATSdocs/nebraska/NE_7th_Rev_5th_Amended_2_16_05_Exh_A_Clean.pdf

WHEREFORE, Verizon MA respectfully prays that the Department approve its proposed changes to Tariff M.D.T.E. No. 14.

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