April 11, 2003

D.T.E. 01-31-Phase II

Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Regulatory Plan to succeed Price Cap Regulation for Verizon New England, Inc. d/b/a Verizon Massachusetts' intrastate retail telecommunications services in the Commonwealth of Massachusetts

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I. INTRODUCTION AND PROCEDURAL HISTORY

In 1995, the Department of Telecommunications and Energy (“Department”) approved a petition by NYNEX (now Verizon New England, Inc. d/b/a Verizon Massachusetts (“Verizon” or “VZ”)) to replace traditional rate of return regulation of its retail rates and profits with an alternative form of regulation called a price cap. 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) (“Price Cap Order”). The term of the price cap approved in the Price Cap Order was six years. Therefore, after Verizon made its sixth annual price cap filing, the Department directed Verizon to file a proposal for further Department regulation of Verizon’s retail telecommunications services.

Investigation by the Department of Telecommunications and Energy on its own Motioninto the Appropriate Regulatory Plan to Succeed Price Cap Regulation for Verizon NewEngland, Inc. d/b/a Verizon Massachusetts' Intrastate Retail Telecommunications Services in the Commonwealth of Massachusetts, D.T.E. 01-31, at 2, Vote and Orderto Open Investigation (February 27, 2001). The Department directed Verizon to file aproposal that included, at a minimum, a component for regulating or deregulating retailprices, regulating service quality, and intrastate access charge reform. Id.

Close On April 12, 2001, Verizon filed its proposed Alternative Regulation Plan with the Department. The Department docketed its investigation of Verizon's proposal as D.T.E. 01-31.

After receiving comments on the appropriate scope of the proceeding, the Department bifurcated its investigation, determining that the first phase of the proceeding would investigate whether there was sufficient competition for the services for which Verizon sought pricing flexibility in its proposed Alternative Regulation Plan (i.e., Verizon's retail business services).
Verizon, D.T.E. 01-31, at 17, Interlocutory Order on Scope (June 21, 2001).

Close Following an investigation into the state of competition in Massachusetts, on May 8, 2002, the Department issued its Order in Phase I of this proceeding ("Phase I Order").

A. Phase I Order

In the Phase I Order, the Department employed a three-pronged market power analysis of supply elasticity, market share, and demand elasticity, to find that Verizon had successfully demonstrated the existence of sufficient competition to warrant pricing flexibility for most of Verizon's retail business services. Phase I Order at 91. Consistent with Department precedent, a finding of sufficient competition for atelecommunications service permits the Department to allow pricing flexibility for thatservice. See, e.g., AT&T Alternative Regulation, D.P.U. 91-79 (1992);NET–Intellidial, D.P.U. 88-18-A (1988); NET–Centrex, D.P.U. 85-275/276/277(1985).

Close Therefore, the Department granted Verizon's request for pricing flexibility for those retail business services whose components are available on a wholesale basis as unbundled network elements ("UNEs"). Id. at 92. The Department concluded, however, that unlimited downward pricing flexibility for Verizon's retail business services could enable Verizon to engage in a "price squeeze" with respect to UNE-based competitors. Id. at 90. Consequently, the Department implemented an enhanced price floor for Verizon's retail business services, equal to the density zone-specific UNE rates for the elements that make up the service, plus a mark-up for Verizon's retailing costs as reflected in the wholesale discount. Id. at 91.

With respect to Verizon's basic residential services, which would remain a regulated, dominant carrier offering, the Department offered tentative guidance that prices would be judged to be just and reasonable as long as they were between a range of incremental cost as a floor and stand-alone cost as a ceiling. Id. at 101-102.
In the Phase I Order at 96 and n.60, the Department indicated that it was providingtentative conclusions on Verizon's residential services to guide the parties in futurepresentation of evidence and proof regarding the issues to be addressed in Phase II.

Close Wholesale services, such as UNEs, interconnection, and resale, would continue to be regulated as monopoly services, pursuant to the requirements of the Telecommunications Act of 1996. Pub. L. No. 104-104, 110 Stat. 56 (1996), codified at 47 U.S.C. §§ 151 et seq.("Telecommunications Act" or "Act").

Close The Department directed Verizon to submit to the Department a plan for regulatory treatment of its retail services consistent with the requirements set forth in the Phase I Order.

On June 5, 2002, Verizon submitted its Phase I Compliance Filing incorporating both the Department's directives regarding Verizon's retail business services and the Department's tentative guidance regarding Verizon's retail residential services. The Department determined that Phase II of D.T.E. 01-31 would consist of an evaluation of Verizon's compliance with the Phase I Order, as well as an investigation into proposals for regulatory treatment of Verizon's retail residential services and Service Quality Plan. Verizon, D.T.E. 01-31-Phase II, Interlocutory Order on Appeal of the AttorneyGeneral of Hearing Officer's Ruling on the Procedural Schedule (September 3, 2002).

Close

B. Phase II Proceedings

Pursuant to notice duly issued, the Department held four public hearings in Phase II of this proceeding on August 27, August 29, September 3, and September 5, 2002, in Pittsfield, Worcester, Boston, and New Bedford, respectively, in order to provide interested persons an opportunity to comment on Verizon's Phase I Compliance Filing. All of the parties to Phase I of this proceeding were deemed to be parties to Phase II, with the addition of XO Massachusetts, Inc. ("XO").
The following parties have intervened in the Department's D.T.E. 01-31 investigation: AT&T Communications of New England, Inc. ("AT&T"); Network Plus, Inc.("Network Plus"); Global NAPs, Inc. ("GNAPs"); New England PublicCommunications Council ("NEPCC"); WorldCom, Inc. ("WorldCom"); New EnglandCable Television Association ("NECTA"); Sprint Communications Company, L.P.("Sprint"); Association of Communications Enterprises ("ASCENT"); and QwestCommunications Corporation

("Qwest"). Boston Gas Company d/b/a KeySpan EnergyDelivery New England ("KeySpan") was granted limited participant status. TheAttorney General of the Commonwealth of Massachusetts ("Attorney General" or"AG") filed a notice of intervention in the proceeding pursuant to G.L. c. 12, § 11E. XO's petition to intervene in the second phase of D.T.E. 01-31 was granted by HearingOfficer Ruling on July 2, 2002.

Close

At a procedural conference held on August 22, 2002, after discussion of the various procedural schedules for Phase II proposed by the parties and the Department, the hearing officer established a two-track procedural schedule for Phase II: Track A to evaluate Verizon's compliance with the Department's directives in the Phase I Order regarding Verizon's retail business services (including the parties' filing of comments, reply comments, and discovery); and Track B to investigate the appropriate regulatory framework for Verizon's retail residential services and Verizon's proposed Service Quality Plan (including pre-filed testimony, discovery, evidentiary hearings, and briefs).

The Department received comments on Verizon's compliance with the Phase I Order in June and July 2002 from AT&T, the NEPCC, WorldCom, and the Attorney General. Reply comments were received from Verizon and the NEPCC. Three days of evidentiary hearings in Track B of D.T.E. 01-31-Phase II were held at the Department's offices between October 22 and October 24, 2002. At the hearings, Verizon presented the testimony of Dr. William E. Taylor, Senior Vice President, National Economic Research Associates, Inc.; Paula L. Brown, Vice President–Regulatory Planning and Policy, Verizon; and John L. Conroy, Vice President–Regulatory, Verizon Massachusetts. The Attorney General sponsored the testimony of Dr. David Gabel, Professor of Economics at Queens College in New York City, and Visiting Scholar in the Massachusetts Institute of Technology Internet and Telecommunications Convergence Consortium. AT&T sponsored the testimony of Dr. John W. Mayo, Professor of Economics, Business, and Public Policy at Georgetown University.

The Phase II (Track B) evidentiary record consists of 117 exhibits. Verizon entered seven exhibits, the Attorney General entered six exhibits, and AT&T entered six exhibits. Verizon also sponsored as individual exhibits 94 Track B information request responses; the Attorney General sponsored as exhibits four information request responses. The record also includes responses by Verizon to one record request by the Attorney General and two supplemental record requests by the Department. Track B briefs were filed by Verizon, the Attorney General, WorldCom, and AT&T. Reply briefs were filed by Verizon, the Attorney General, AT&T, and the NEPCC.
The Department also permitted limited discovery as part of our Track A complianceevaluation and we hereby move the Track A information request responses into therecord of our Track A evaluation.

Close

II. STANDARD OF REVIEW AND REGULATORY HISTORY

A. Statutory Requirements

The Department's jurisdiction for regulation of intrastate telecommunications common carriers within the Commonwealth is provided under G.L. c. 159. The Department has broad general supervisory power over the provision of telecommunications services. G.L. c. 159,

§ 12; see also G.L. c. 166. Sections 14 and 20 of G.L. c. 159 give the Department authority over the rates of common carriers subject to the Department's jurisdiction. G.L. c. 159, § 14 states in part:

Whenever the department shall be of the opinion, after a hearing had upon its ownmotion or upon complaint, that any of the rates, fares or charges of any commoncarrier for any service to be performed within the commonwealth, or theregulations or practices of such common carrier affecting such rates, are unjust,unreasonable, unjustly discriminatory, unduly preferential, in any wise in violationof any provision of law, or insufficient to yield reasonable compensation for theservice rendered, the department shall determine the just and reasonable rates, faresand charges to be charged for the service to be performed . . . [emphasis added].

G.L. c. 159, § 20 states in part:

If [as regards] . . . any proposed decrease in any rate . . . it shall appear to thedepartment that the said rate, joint rate, fare, telephone rental, toll or charge isinsufficient to yield reasonable compensation for the service rendered, thedepartment may determine what will be a just and reasonable minimum to becharged . . . [emphasis added].

Close See also G.L. c. 159, § 17 ("All charges made . . . by any common carrier for any service rendered . . . shall be just and reasonable . . . and every unjust or unreasonable charge is hereby prohibited and declared unlawful").

Thus, under G.L. c. 159, the Department is responsible for enforcing a "just and reasonable" standard for all common carrier rates. Section 14 also requires that rates not be unjustly discriminatory or unduly preferential. See Attorney General v. Department of

Pub. Utils., 390 Mass. 208, 234 (1983), citing American Hoechest Corp. v. Department of Pub. Utils., 379 Mass. 408, 411 (1980).

While the General Court specifies that rates are to be "just and reasonable" and that rates should provide a utility with "reasonable compensation" with reference to the service provided, neither of these two statutes prescribe a particular method by which the Department must fulfill its statutory mandate of ensuring just and reasonable rates or limit the Department to a specific regulatory scheme, such as cost-of-service, rate of return ratemaking, or regulation through a price cap. See NYNEX Price Cap, D.P.U. 94-50, at 37-38, Interlocutory Order on Motion to Dismiss of NECTA (February 2, 1995) (containing a comprehensive evaluation of Department authority to permit alternatives to the rate of return regulation model).

B. IntraLATA Competition Order, D.P.U. 1731 (1985)

In D.P.U. 1731, subsequent to the 1984 divestiture of the Bell Operating Companies from AT&T, the Department developed a new framework of regulation for all common carriers in Massachusetts. IntraLATA Competition Order, D.P.U. 1731 (1985). In that Order, the Department established telecommunications policy goals and adopted an overall regulatory framework and pricing approach flexible enough to react to marketplace changes.
The three public policy goals adopted by the Department in D.P.U. 1731 wereeconomic efficiency, fairness, and universal service. D.P.U. 1731, at 19-24. TheDepartment later adopted the additional policy goals of simplicity, earnings stability,and continuity. New England Telephone and Telegraph Co., D.P.U. 86-33-C at 22(1987).

Close Id. The Department determined that while simulation of the results of a competitive market is a principal goal of regulation, actual competitive telecommunications markets are preferable to regulation as a surrogate for competition. Id. at 25. The Department endorsed competitive markets over regulation as the best way to achieve its policy goals for telecommunications, because competitive markets promote economic efficiency, technological innovations, and a greater sensitivity to customer demands. Id.

In that Order, the Department created a regulatory classification of carriers as "dominant" or "non-dominant," in order to determine the level of price regulation that would be applied to all common carriers. Id. at 61-62, 67-69. Under this classification, dominant carriers were subject to traditional regulatory requirements, and non-dominant carriers were presumed to be disciplined by market forces and to have no ability to exercise market power. Id. at 64. Dominant carriers were allowed to petition for a change in classification in response to marketplace changes. Id. at 65. While retaining traditional rate of return regulation for New England Telephone and Telegraph ("NET," now Verizon) and for AT&T as dominant carriers, the Department stated, "[I]f an entire service class is determined to be fully competitive by the Department, we may find that the prices set by the market are fair and reasonable, and we will regulate such service class in accordance with the minimum statutory requirements. Such a determination may be made only upon a showing by [the carrier] that such a service is fully competitive." Id. at 39-40. Thus, the Department anticipated that Massachusetts markets could reach a point where competition, rather than regulation, would govern the prices for some of a dominant carrier's retail telecommunications services.

C. New England Telephone and Telegraph Co., D.P.U. 89-300 (1990)

Beginning in 1986, the Department conducted a multi-phase investigation into the costs and rates of NET, including approval of a marginal cost study. New England Telephone and Telegraph Co., D.P.U. 86-33-0 (1990). The Department then began a series of annual, revenue-neutral "rate re-balancings" to bring NET's retail rates more in line with the underlying cost structure. New England Telephone and Telegraph Co., D.P.U. 89-300 (1990); New England Telephone and Telegraph Co., D.P.U. 91-30 (1991); New England Telephone and Telegraph Co., D.P.U. 92-100 (1992); New England Telephone and Telegraph Co., D.P.U. 93-125 (1994). In that process, the Department significantly reduced the rates for business customers and toll, local usage, and switched access services, as well as eliminated message units and different rate groups for local unlimited services. The Department also increased rates for some basic residential services, including the fixed rate for the dial-tone line and for analog private line services.

D. AT&T Alternative Regulation, D.P.U. 91-79 (1992)

In D.P.U. 91-79, AT&T filed a petition requesting that the Department adopt an alternative form of regulation for AT&T's Massachusetts intrastate services. AT&T proposed that certain of its services be classified as "Category M" (i.e., sufficiently competitive) services, with prices set by competitive market forces, and its remaining services classified as "Category D" services, with prices regulated according to a price cap. AT&T Alternative Regulation, D.P.U. 91-79 (1992). In classifying the majority of AT&T's services as Category M, and thus subjecting those services to reduced regulatory scrutiny, the Department stated that "sufficient market forces are in place to ensure that rates charged by AT&T for its proposed Category M services are just and reasonable." Id. at 34. The Department based its decision on an analysis of market share, supply elasticity, and demand characteristics, and concluded that AT&T did not have market power in Massachusetts with regard to Category M services. Id.

Regarding AT&T's Category D services, the Department found that, although there was not as much competition as with Category M services, there was some competition since Basic (low volume) MTS customers had alternatives to AT&T for long distance service. Id. at 43. The Department determined that any market power that AT&T had was the result of demand inertia and not bottleneck control of the market. Id. at 44. Thus, the Department found that rate of return regulation would not be necessary. Id. The Department determined that the weighted-average price cap mechanism it approved for AT&T contained sufficient regulatory safeguards which, coupled with market forces, would result in just and reasonable rates for AT&T's Basic MTS customers. Id. at 34. Except for Basic MTS and operator services, prices for AT&T's services were regulated according to market-based pricing principles, in the same way that the Department regulated prices of services offered by non-dominant carriers.

E. Entry Deregulation, D.P.U. 93-98 (1994)

In D.P.U. 93-98 (1994), the Department eliminated the certification requirement for telecommunications providers that seek to do business in Massachusetts, and required instead

that carriers register with the Department. The Department found that "current market forces, statutory requirements, and the Department's tariff regulations, notice requirements, and consumer complaint resolution process, are sufficient to ensure not only that rates are just and reasonable but that there is adequate consumer protection for interexchange, competitive access, and [alternative operator services], absent the regulation of entry into these markets." Entry Deregulation, D.P.U. 93-98, at 12 (1994).

F. Price Cap Order, D.P.U. 94-50 (1995)

In D.P.U. 94-50, the Department concluded that adoption of a price cap as an alternative form of regulation for NYNEX (now Verizon), did not require a specified level of competition or market structure; however, "[i]f NYNEX were requesting market-based pricing in the instant petition, it would certainly be required to make a showing of effective competition in order for the Department to consider granting such relief." D.P.U. 94-50, at 112-115 (1995). The Department also concluded that price cap regulation was not appropriate for a fully competitive market and "if effective competition exists, no rate regulation whatsoever (ROR regulation, price caps, etc.) would be needed . . . [because] [i]n a competitive market, competition itself will lead to an efficient outcome." Id. at 113.

III. TRACK A: COMPLIANCE WITH THE PHASE I ORDER

A. Introduction

As noted above, Verizon's Phase I Compliance Filing consists of two separate components: (1) Verizon's compliance with the Department's directives in the Phase I Order regarding regulation of Verizon's retail business services (i.e., the Department's "Track A" compliance evaluation); and (2) Verizon's proposed regulatory treatment of its retail residential services and Service Quality Plan (i.e., the Department's "Track B" evidentiary proceeding). This section contains our Track A evaluation of Verizon's compliance with the Phase I Order directives on retail business services.

B. AT&T's Motion for Summary Judgment

1. Introduction

On December 13, 2002, AT&T filed in Track A of this proceeding, a Motion for Summary Judgment, or, in the Alternative, Motion for Leave to Present Evidence and

File Briefs Regarding Verizon's Failure to Comply with the Department's Phase I Order ("AT&T Motion for Summary Judgment"). Pursuant to the schedule established by the hearing officer, responses to AT&T's Motion for Summary Judgment were filed by WorldCom, the Attorney General, and Verizon; AT&T and Verizon filed replies.

2. Standard of Review

The Department's procedural rules authorize the use of full or partial summary judgment in Department decisions. 220 C.M.R. § 1.06(6)(e). The rule specifically provides that "[a] party may move at any time after the submission of an initial filing for dismissal or summary judgment as to all issues or any issue in the case." Id. Summary judgment may be granted by an administrative agency where the pleadings and filings conclusively show that the absence of a hearing could not affect the decision. Massachusetts Outdoor Advertising Council v. Outdoor Advertising Board, 9 Mass. App. Ct. 775, 783-86 (1980); see also Hess & Clark, Div. of Rhodia, Inc. v. Food and Drug Administration, 495 F.2d 975, 985 (D.C. Cir. 1974). The standard of review on motions for summary judgment in judicial proceedings is instructive and satisfies the requirements of procedural due process in administrative proceedings. 9 Mass. App. Ct. at 789; see also Mass. R. Civ. P. 56.

In determining whether to grant a motion for summary judgment, the Department will review the initial pleadings, pre-filed testimony, responses to discovery, and the memoranda of the parties. IMR Telecom, D.P.U. 89-212, at 12 (1990). Summary judgment is appropriate if a review of the materials on file shows that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. Cambridge Electric Light Company/MIT, D.P.U. 94-101/95-36 (1995), citing Re Altresco Lynn Inc./Commonwealth Electric Company, D.P.U. 91-142/91-153, at 10 (1991). An opposing party may not rest on mere allegations or pleadings, but must support that opposition by affidavit and supporting papers. See Mass. R. Civ. P. 56(e). If an opposing party demonstrates "an authentic need for, and an entitlement to, an additional interval in which to marshal facts essential to mount an opposition," the Department may deny the motion for summary judgment or order a continuance to permit the opposing party to obtain further discovery. See Resolution Trust Corp. v. North Bridge Assoc., 22 F.3d 1198, 1203 (1st Cir. 1994); Mass. R. Civ. P. 56(f).

3. Positions of the Parties

a. AT&T

In its Motion for Summary Judgment, AT&T argues that summary judgment is warranted on the following two independent grounds: (1) Verizon has failed to show that its retail business services are contestable using UNEs; and (2) Verizon has failed to reduce special access charges to Total Element Long Run Incremental Cost ("TELRIC") (AT&T Motion for Summary Judgment at 5, 32). Because Verizon has failed to present evidence on these two essential elements of the Department's Track A evaluation, AT&T argues that the Department should grant summary judgment in AT&T's favor and dismiss

Verizon’s Phase I Compliance Filing (id. at 5, 32).

AT&T argues that in the Phase I Order, the Department required Verizon to identify its retail business services that are not contestable on a UNE basis, and Verizon has failed to identify such services (id. at 5). AT&T argues that, in Verizon’s Phase I Compliance Filing, Verizon has asserted that all of its business services are contestable using UNEs, but has not provided any factual support for this assertion and has not addressed AT&T’s arguments that competitive local exchange carriers (“CLECs”) cannot use UNEs to provide competing services in the face of the restrictions that Verizon places on them (id.).
In its Motion for Summary Judgment, AT&T provides a comprehensive discussion ofVerizon’s restrictions on CLECs’ use of enhanced extended links (“EELs”), theprohibition against commingling of CLECs’ UNE and access traffic, Verizon’s “nofacilities, no build” policy, and the lack of cost-effective mass migration from UNE-Platform (“UNE-P”) to UNE-Loop (“UNE-L”) (AT&T Motion for Summary Judgmentat 7-30).

Close AT&T further argues that if the Department believes that there are disputed issues of material fact as to whether CLECs can compete for Verizon’s retail business services on a UNE basis, the Department should hold hearings to resolve the disputed facts (id. at 30-31).

AT&T argues that Verizon is incorrect to assume that the Department’s Phase I Order included a blanket grant of pricing flexibility for Verizon’s retail business services (AT&T Reply at 2). Rather, AT&T argues that the pricing flexibility discussed in the Phase I Order will apply only after Verizon has shown that every business service is contestable on a UNE basis (id.). Moreover, AT&T argues that Verizon’s response to AT&T’s Motion for Summary Judgment contains bald assertions only, and fails to address, let alone explain, how Verizon has met its burden to demonstrate contestability (id. at 5).

In addition, AT&T argues that Verizon has failed to reduce special access charges to TELRIC as required by the Phase I Order, and, therefore, AT&T argues that the Department should grant summary judgment in AT&T’s favor and dismiss Verizon’s Phase I Compliance Filing on this separate ground (AT&T Motion for Summary Judgment at 33-34). Finally, AT&T argues that, whether or not the Department grants AT&T’s Motion for Summary Judgment, the Department could expedite its long-term goal of using markets to discipline Verizon’s pricing power by addressing the restrictions Verizon imposes on CLECs’ use of UNEs (id. at 34). AT&T argues that such discipline could include, for example, the Department’s establishing a set of “safe harbors”
“Safe harbors” are the standards set by the FCC that CLECs must meet in order toavoid UNE use restrictions. See Implementation of the Local Competition Provisionsof the Telecommunications Act of 1996, CC Docket No. 96-98, Supplemental OrderClarification, FCC 00-183, at ¶ 22 (rel. June 2, 2000) (“Supplemental OrderClarification”).

Close that are different from those established by the FCC (id. at 35-42).

b. WorldCom

WorldCom supports AT&T's Motion for Summary Judgment in all respects (WorldCom Response at 1).

c. Attorney General

The Attorney General argues that the record in the Track A compliance evaluation is not sufficient for the Department to make a finding as to whether Verizon has complied with the Department's directives in the Phase I Order (AG Response at 2). Specifically, the Attorney General argues that the record on the contestability of Verizon's business services is incomplete because Verizon has produced some, but not a complete, factual response to AT&T's charges of non-contestability (id. at 6).
The Attorney General asserts that the Track A record on contestability consists only ofExh. DTE-ATT 1-1 and Verizon's October 15, 2002 Supplemental Response (AGResponse at 6).

Close The Attorney General further argues that the parties were unable to subject Verizon's limited response to cross-examination or briefing under the Track A procedural schedule as set in the August 22, 2002 procedural conference (id.). The Attorney General argues that summary judgment is therefore inappropriate, and that further hearings are necessary (id. at 6-7). The Attorney General argues that Verizon must present a full factual case (including additional discovery, testimony, cross-examination, and briefs) regarding the contestability of Verizon's business services (id. at 8). The Attorney General suggests that the Department should examine issues regarding contestability as part of an examination of residential price squeeze and universal service issues in the next phase of this proceeding (id.).

d. Verizon

Verizon argues that AT&T's Motion for Summary Judgment should be denied as an abuse of process (VZ Response at 1, 4). Verizon argues that AT&T has repeatedly introduced the issues of UNE use restrictions and commingling prohibitions, and that the Department has rejected those arguments each time (id. at 2-6). Verizon further argues that AT&T's request for additional hearings if the Department denies AT&T's Motion for Summary Judgment should be rejected (id. at 6). Verizon argues that AT&T did not appeal the procedural schedule established at the outset of Phase II, and, thus, AT&T has waived any objection to the process established to evaluate Verizon's compliance with the Phase I Order (id. at 7).

In addition, Verizon argues that it has rebutted every argument raised by AT&T in Phase

II regarding the ability of CLECs to compete using UNEs (id.). Verizon argues that it has provided detailed discussions on its “no facilities, no build” policy, as well as its alleged UNE provisioning problems (id. at 8-9). Verizon further argues that the Attorney General’s proposal to hold additional hearings on contestability renders the Department’s conclusions on the sufficiency of competition for Verizon’s business services in the Phase I Order meaningless, and, thus, the Attorney General’s proposal should also be rejected (VZ Reply at 2). Lastly, Verizon argues that although the Department did not require that Verizon reduce intrastate special access charges in the Phase I Order, the parties have already discussed this issue at length in the Track A record, and no further record is required in order for the Department to determine the matter (VZ Response at 9).

4. Analysis and Findings

For the following reasons, we dismiss AT&T’s Motion for Summary Judgment. The Track A procedural schedule (established to evaluate Verizon’s compliance with the Phase I Order) did not include evidentiary hearings on the issue of compliance.
See Transcript of Procedural Conference, D.T.E. 01-31-Phase II at 23-24 (August 22,2002); Hearing Officer Email to Parties Attaching Procedural Schedule, D.T.E. 01-31-Phase II (August 22, 2002).

Close Instead, we determined that Verizon’s compliance with the Department’s requirements set forth in the Phase I Order – as demonstrated by Verizon’s June 5, 2002 Phase I Compliance Filing – could be adequately evaluated through the written comments filed by the parties, followed by a short period of discovery. Written comments on Verizon’s compliance filing were due June 25, 2002, and replycomments were due July 16, 2002. AT&T, WorldCom, NEPCC, and the AttorneyGeneral filed written comments; Verizon and NEPCC filed reply comments. The opendiscovery period for Track A ran from August 22, 2002, to September 20, 2002.

Close No party appealed the Track A procedural schedule established by the hearing officer at the August 22, 2002 procedural conference. The Department addressed the Attorney General’s appeal of the Track B proceduralschedule in Verizon, D.T.E. 01-31-Phase II, Interlocutory Order on Appeal by theAttorney General of Hearing Officer’s Ruling on the Procedural Schedule (September3, 2002). At that time we emphasized that “[t]he Track A procedural schedule remainsas established in the August 22, 2002 procedural conference.” Id. at 2 n.2.

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Summary judgment is customarily used as a device to obviate the need for evidentiary hearings, as evidenced by Department Orders issued in the past addressing partial and full summary judgment. See, e.g., AT&T/National Interactive Systems/CommNetics, Inc., D.P.U. 91-140, at 25 (1991); Altresco Lynn, Inc./Commonwealth Electric Company and Cambridge Electric Company, D.P.U. 91-142/91-153, at 15 (1991). By determining that evidentiary hearings were not required in Track A, the Department was, in effect, reaching the same conclusion that results from granting a motion for summary judgment; that is, that the absence of a hearing will not affect the Department's decision, and that our decision may be made on the basis of pleadings, material obtained from discovery, and other filings. See 9 Mass. App. Ct. at 785-86; see also Mass. R. Civ. P. 56.

In addition, in the instant proceeding, the Track A discovery period has been long-closed, and it is unclear what procedure AT&T seeks to dispose of by moving for summary judgment at this time. See Price Cap Order at 33-37 (discussing post-hearing motion for summary judgment filed for the purpose of disposing of the need for parties to review and brief certain issues). Nevertheless, our procedural rules allow parties to move for full or partial summary judgment "at any time" after the submission of an initial filing; 220 C.M.R. § 1.06(6)(e).

Close therefore, we do not agree with Verizon that AT&T's submission of a motion for summary judgment at this stage of the proceeding is per se an abuse of process. But we determine that AT&T's arguments regarding Verizon's lack of compliance as set forth in AT&T's Motion for Summary Judgment concerning special access pricing and contestability of business services, were also included in AT&T's written comments on Verizon's compliance filing and AT&T's responses to discovery (which are part of the Track A record and which we discuss at length in Sections III.C, and III.D, below). We determine, therefore, that ruling on AT&T's motion is unnecessary because the motion argues in favor of the procedural approach we have already established and includes arguments already provided and responded to in the Track A record. Moreover, no party is harmed by our declination to address AT&T's arguments in a ruling on a motion we deem to be procedurally redundant and unnecessary, and, thus, we dismiss the motion.

In response to AT&T's alternative Motion for Leave to Present Evidence and File Briefs Regarding Verizon's Failure to Comply with the Department's Phase I Order, we determine that this motion, in substance, constitutes an untimely appeal of the hearing officer's ruling establishing the Track A procedural schedule, and that AT&T has not shown good cause for such an extended delay in filing its appeal.
As noted above, the Track A procedural schedule was established on August 22, 2002,and AT&T's Motion for Leave to Present Evidence and File Briefs was filed onDecember 13, 2002 – nearly four months later.

Close Therefore, we also dismiss this portion of AT&T's motion. We also conclude that the Attorney General has misconstrued the Department's Phase Ideterminations. Our evaluation of the sufficiency of competition for Verizon's retailbusiness services was completed in Phase I with the issuance of the Phase I Order. Weaffirmed our conclusions on the sufficiency of competition in Verizon, D.T.E. 01-31-Phase I-A at 2-9, 14, Order on Attorney General's Motions for Reconsideration andExtension of Judicial Appeal Period, and AT&T’s Motion for Clarification (August 5,2002). Therefore, we do not agree that it is warranted to undertake an additionalinvestigation into competition for Verizon’s retail business services as part of a thirdphase of this proceeding.

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In sum, because we have already determined that evidentiary hearings are not required as part of our Track A compliance evaluation, it is not necessary to rule on AT&T’s motion seeking to obtain a judgment on the filings, and, thus, we dismiss the motion. However, we fully address the arguments raised by AT&T in its written comments and responses to discovery regarding Verizon’s compliance with our directives in the Phase I Order (specifically, our requirements concerning special access pricing and identifying business services that are not contestable using UNEs) in the following sections.

C. Special Access Pricing

1. Introduction

In our Phase I investigation, we found that CLEC supply elasticity is lower for private line services,
Verizon’s analog and digital private line services are the retail equivalent to wholesalespecial access service. Phase I Order at 61. Special access is a dedicated line from anend-user to a long distance company. Id. at viii n.2.

Close compared to other Verizon retail business services, such that “CLECs could not be expected to have the same controlling effect on prices for these services.” Phase I Order at 58. In Phase I, we agreed with the CLECs’ argument that current special access pricing constitutes a barrier to entry because it levies higher costs on CLECs than those levied on Verizon. Id. at 61. Therefore, the Department determined that Verizon would be granted upward pricing flexibility with regard to private line services only after special access services are moved to UNE-based pricing. Id. at 91.

2. Positions of the Parties

a. Verizon

Verizon argues that the Phase I Order offers Verizon the choice of whether to reduce intrastate special access rates to UNE levels and obtain pricing flexibility, or alternatively, to maintain current intrastate special access rates and have private line services remain subject to price regulation (Phase I Compliance Filing at 3). Verizon asserts that “the Department stated that Verizon MA could obtain pricing flexibility if it chose to reduce Intrastate Special Access rates to UNE levels” because the Department concluded that other carriers were unable to provide competing private line services through UNEs and had to use special access services in order to do so (id.).

Notwithstanding the Department's conclusion, Verizon argues that private line services "are competitive today and can be provided via UNEs" (id.). Verizon also argues that Tab C of its Phase I Compliance Filing identifies Verizon private line offerings and lists the UNEs that can be used by carriers to provide competing services (id.).

Moreover, Verizon argues that lowering intrastate special access rates to UNE levels raises a significant potential for arbitrage between state and Federal special access services (id.). Verizon asserts that the FCC does not permit carriers to purchase interstate special access at UNE rates, and that a decrease in intrastate special access rates presents an opportunity for "tariff shopping," which would conflict with Federal policies and seriously erode Verizon's interstate revenues (id.).

For these reasons, Verizon states that it is opting not to obtain pricing flexibility for private line services, but chooses instead to continue to have these services subject to price regulation (id. at 4). Verizon proposes that its Alternative Regulation Plan limit overall increases in price for private line services to 15 percent per annum (id.). In addition, Verizon argues that it should be permitted to raise, lower, or restructure prices for private line services as long as they do not exceed the 15 percent annual limit and continue to remain above the relevant price floor as determined by the Department (id.).

b. CLECs

AT&T asserts that the Department required Verizon to price intrastate special access at UNE rates because Verizon's current prices are a barrier to entry, leading to Verizon retail prices above economically efficient levels (AT&T Comments at 2). AT&T argues that Verizon has misinterpreted the Department's Phase I Order to conclude that the Department did not really require Verizon to price its intrastate access circuits at UNE levels (id. at 3). AT&T also argues that the Department never stated that Verizon had the right to choose whether to reduce its intrastate special access rates or not, nor did the Department indicate that Verizon could obtain pricing flexibility if it exercised such a right to choose (id.). Therefore, AT&T argues that the Department should "reject Verizon's self-serving interpretation of the Phase I Order" and require Verizon to comply with the Department's intrastate special access pricing requirements (id. at 4).

Moreover, AT&T argues that Verizon's stated preference to remain price regulated in retail markets that rely on special access circuits as inputs, rather than compete at retail with carriers that face the same costs for special access that Verizon does, is a "dramatic illustration of the advantages [Verizon] enjoys in downstream retail markets as a result of its control of special access circuits at the wholesale level" (id.). More specifically, AT&T contends that the only way a grant of pricing flexibility will allow Verizon to increase its retail rates is if its competitors have to pay more than Verizon for the necessary inputs (id.). AT&T argues that Verizon's proposed regulation of private line services is intended to achieve that same result; that is, Verizon will have the ability to raise retail rates while its competitors must pay more than the cost that Verizon incurs for the network facilities necessary to compete (id.). AT&T supports the Department's decision to price special access circuits at the same cost as Verizon incurs so that AT&T

can compete for end users in the private line market on a level playing field with Verizon (id. at 5). Indeed, AT&T argues that retail prices for private line services are likely to be driven down by the availability of special access circuits to CLECs at parity with Verizon, and urges the Department to require Verizon to do so, as the resulting decline in retail rates will benefit consumers, rather than allowing Verizon to further inflate prices for private line services (id.).

AT&T also argues that the Department should reject any attempt by Verizon to re-litigate the issue of whether AT&T and other CLECs must use special access circuits to offer private line and other business services (id. at 6). AT&T argues that it devoted substantial resources to submit evidence on this issue, and that the Phase I rebuttal testimony of AT&T's witness Deborah Waldbaum was devoted to this point (id.). AT&T therefore argues that, now, after the Department has "rendered its decision on the basis of uncontested evidence adduced by AT&T," it is too late for Verizon to offer evidence to the contrary (id.).

Likewise, WorldCom argues that Verizon disingenuously asserts that the Department conferred the option of reducing special access rates upon Verizon when, in fact, no choice was given (WorldCom Comments at 1). WorldCom argues that Verizon should not be permitted to circumvent the import of the Phase I Order through the exercise of a nonexistent choice (id. at 2).

3. Analysis and Findings

For the reasons discussed more fully below, we reject AT&T's and WorldCom's arguments that our Phase I Order obligates Verizon to reduce its special access rates and pursue a finding of sufficient competition for private line services, and we reject Verizon's proposal to restructure its retail private line services subject to a 15 percent annual cap.

In our Phase I Order, we denied Verizon pricing flexibility for retail private line services, and said that we would re-price special access "before allowing Verizon upward pricing flexibility for analog and digital private line services." Phase I Order at 62 (emphasis added). In response, Verizon indicated that it would not pursue a finding of sufficient competition for private line services, and would instead have private line services remain subject to price regulation (Phase I Compliance Filing at 3-4).

Although the Department found in its Phase I Order at 61, that Verizon's special access rates constitute a barrier to entry, the sole consequence of that finding was the rejection of pricing flexibility for private line services, not the mandatory re-pricing of special access. The Department's Phase I Order did not require the immediate reduction of special access rates to UNE levels, but rather contemplated a separate showing in order to obtain a finding of sufficient competition for private line services. See Phase I Order at 62. Therefore, Verizon's election to have private line services remain subject to price regulation is fully compliant with our Phase I Order, and unless and until Verizon seeks pricing flexibility for retail private line services, the Department's basis for re-pricing special access circuits will not ripen.

Although Verizon stated in its Phase I Compliance Filing at 4, that private line services would remain subject to price regulation, we determine that Verizon's proposal to raise, lower, or restructure private line services subject to 15 percent annual cap is, in effect, a second request for pricing flexibility and therefore is not compliant with our conclusions in Phase I. Our Phase I Order contemplated that unless special access rates were reduced to UNE levels, there would be no pricing flexibility for private line services, and having denied pricing flexibility for Verizon's private line services, Verizon's rates for private line services will remain frozen until Verizon makes a showing of sufficient competition.

In sum, we determine that Verizon's proposal for regulatory treatment of its private line services in its Phase I Compliance Filing is not in compliance with our Phase I Order, and Verizon is instructed to submit a revised filing consistent with these conclusions.

D. Contestability Using UNEs

1. Introduction

In Phase I of this proceeding, the Department found that for the vast majority of Verizon's retail business services, the supply elasticity is high, and, therefore, the market for those services is contestable. Phase I Order at 67. Therefore, the Department granted Verizon pricing flexibility for those retail business services we found were contestable. Id. at 91. In addition, we directed Verizon to identify other retail business services – other than private line services discussed in the above section – if any, that are not contestable on a UNE-basis. Id. at 61 n.39.

2. Positions of the Parties

a. Verizon

In its Phase I Compliance Filing, Verizon argues that, with the exception of administrative charges (e.g., dishonored check charges, late payment charges, etc., which are charges that a CLEC can apply to their own customers), all of Verizon retail business services can be replicated by competitors via UNEs (Phase I Compliance Filing at 8). Verizon lists its retail business services and the corresponding UNEs that are necessary to provide competing services (id. at Tab C).

Verizon argues that AT&T's assertion that not all of Verizon's retail business services are contestable stems from AT&T's inability to convert existing special access arrangements to UNEs because of the FCC's restrictions on CLECs' use of UNEs (VZ Reply Comments at 16).
The FCC's UNE use restrictions do not require the incumbent local exchange carrier("ILEC") to convert special access circuits to UNE loops or UNE loop-transportcombinations unless the following three criteria are met: (1) the CLEC is the soleprovider of local exchange service to the customer; (2) the CLEC certifies that

itprovides local exchange access and handles at least a third of the local exchange traffic;and (3) the CLEC certifies that at least 50 percent of the activated channels on a circuitare used to provide originating and terminating local dial-tone service, at least 50percent of the traffic on each of these channels is local voice traffic, and at least 33percent of the entire loop facility carries local voice traffic. See Supplemental OrderClarification at ¶ 22. These three criteria are known as the FCC's "safe harbors"necessary to avoid UNE use restrictions. See also CompTel v. FCC, 309 F.3d 8 (D.C.Cir. 2002) (upholding FCC safe harbor rules).

Close Verizon further argues that AT&T fails to meet the FCC's requirements for converting special access to UNEs because AT&T has a significant amount of interstate traffic going over those facilities (id.). However, Verizon asserts that CLECs seeking to provide truly intrastate retail business services do have access to UNE facilities (id.). In addition, Verizon disagrees with AT&T's argument that Verizon's "no facilities, no build" policy Under the Telecommunications Act, Verizon is required to unbundle only its existingnetwork. See 47 U.S.C. § 251(c)(3); Iowa Utils. Board v. FCC, 120 F.3d 753, 812-813 (8th Cir. 1997), appealed on other grounds, AT&T Corp. v. Iowa Utils. Board, 525U.S. 366 (1999). When a CLEC requests UNEs where no network facilities exist,Verizon responds with a "no facilities" classification.

Close inhibits AT&T's ability to compete because "if a facility does not exist, it does not exist for all market participants," including for Verizon (id. at 16-17).

b. AT&T

AT&T argues that Verizon has not shown that its retail business services are contestable, and asserts that none of Verizon's retail business services, except certain services for small businesses, are contestable using UNEs (AT&T Comments at 7; see DTE-ATT 1-1, DTE-ATT 2-1, DTE-ATT 2-2).
AT&T asserts that CLECs can contest Verizon's retail services that are offered onVG/DS0/POTS circuits, but only if the Department maintains the necessary switchingand UNE-P conditions (DTE-ATT 2-2, at 3). AT&T argues that CLECs cannot contestVerizon's retail services on DS1 or above circuits because CLECs must use specialaccess instead, and, thus incur substantially higher costs for the connectivity to thecustomer premises (through inflated interstate access charges) than does Verizon (DTE-ATT 1-1; DTE-ATT 2-2, at 1).

Close AT&T argues that, because of UNE use restrictions, most of AT&T's business services must be provided over special access circuits (AT&T Comments at 7). Further, AT&T argues that the use of special access circuits is not limited to competing with Verizon's private line services, but rather to provide any bundle of business services that has commercial viability (id.).

AT&T argues that the existing record in Phase I demonstrates the inability of CLECs to obtain UNEs in order to provide services to medium and large business customers (id.). AT&T asserts that just because a CLEC can offer a vertical service using Verizon's switch UNE does not mean that service is contestable; rather, if a CLEC cannot obtain access to an unbundled loop, then that service is not contestable using UNEs (id. at 8). Further, AT&T argues that, although Verizon lists services that require UNE loops in Tab C of its Phase I Compliance Filing, Verizon does not identify under what circumstances those loops are precluded by the UNE use restrictions (id.). For example, AT&T argues that all Verizon loop-transport combinations in an EEL configuration

An Enhanced Extended Link ("EEL") configuration consists of a combination ofunbundled loop, multiplexing/concentrating equipment, and dedicated transport. AT&T argues that EEL configurations are considered more efficient network designs,where "intervening electronics are inserted to connect the time slot on the EEL facilityto the switch only when that time slot is active" and that "this is clearly the mostefficient and appropriate network design to handle traffic from multiple customers,[however,] use of this configuration dramatically complicates a CLEC's ability tomonitor traffic to collect data needed to take advantage of the second and third safeharbors described in the Supplemental Order Clarification" (DTE-ATT 1-1, Att. Aat 14 n.9).

Close are precluded by Verizon's UNE use restrictions (id.). AT&T argues that if the business services listed in Tab C of Verizon's Phase I Compliance Filing can indeed be provided over UNE loops and transport without violating UNE use restrictions, then Verizon must be required to make those loops available to competing CLECs (id. at 9).

In addition, AT&T states that Verizon's retail business services cannot be considered contestable as long as Verizon maintains a unilateral "no facilities available" classification, thus invoking the "no build" policy for UNEs (id.). AT&T asserts that CLECs are forced to purchase special access circuits for business services that require interoffice facilities ("IOF"), dedicated transport, or multiplexers because of Verizon's wide latitude in determining the availability of facilities (id.). AT&T argues that because Verizon has not shown that CLECs can obtain all the UNEs necessary to provide competing services without Verizon invoking the UNE use restrictions or "no facilities" classification, the Department must reject Verizon's claim that all of its retail business services are contestable using UNEs (id. at 9, 17).

AT&T argues that CLECs are forced to purchase special access circuits rather than UNEs, and that they must purchase from the higher-priced Federal special access tariff, rather than the intrastate special access tariff (DTE-ATT 2-1, at 5 n.6). AT&T argues that even when Verizon's intrastate special access offering is reduced to UNE levels in conformance with the Department's directives in the Phase I Order (see Section III.C, above), Verizon's retail business services will still not be contestable because CLECs will continue to be forced to buy out of the Federal special access tariff at higher prices than Verizon will incur for providing the same services to its retail customers (DTE-ATT 2-1, at 7). AT&T argues that if Verizon were required to apply to CLECs the same policies it applies to its own end-users for determining the jurisdiction of special circuits,

then CLECs would be able to purchase the vast majority of special circuits under the state tariff and thus obtain the wholesale input charges that the Department intended in its Phase I Order (id. at 2).
AT&T argues that this alone would not be sufficient to ensure contestability, but rathera performance assurance plan for special access would also be required, and thatVerizon must be prohibited from applying use restrictions on CLEC special circuits andfacilities that it does not apply to itself (DTE-ATT 2-1, at 9).

Close Alternatively, AT&T argues that the Department should require Verizon to allow CLECs to purchase the underlying facilities as UNEs, rather than as special access, Defining the connectivity as “special access” under a regulatory regime that pre-datesthe Telecommunications Act of 1996, AT&T argues, raises a host of jurisdictional andregulatory problems, and that defining the connectivity as “UNEs” instead is the mostdirect way for the Department to exercise jurisdiction over the wholesale inputs (DTE-ATT 2-1, at 3).

Close when CLECs are seeking to contest Verizon’s retail services (id. at 10). AT&T suggests that the Department adopt its own “safe harbor” test (similar to thelocal usage definition recently adopted by the New York Public Service Commission),which would permit CLECs to purchase UNEs to offer business services that competewith Verizon’s business services (DTE-ATT 2-1, at 12). AT&T also argues that theDepartment must then establish transition mechanisms to convert special access toUNEs, provide relief from term and volume penalties in existing payment plans, andprevent Verizon from using its “no facilities, no build” policy to bar further use ofUNEs (id. at 10, 12).

Close If either of these two options obtain, AT&T concedes that some of Verizon’s retail business services would be contestable (id. at 8).

3. Analysis and Findings

In Phase I of this proceeding, we investigated the contestability of Verizon’s retail business services. As a result of our investigation, the Department concluded that most of Verizon’s retail business services, with the exception of private line services, are contestable. Phase I Order at 67. Our inquiry in this phase is to determine whether Verizon has complied with the Department’s directive in the Phase I Order to identify whether there are other retail business services, in addition to Verizon’s private line services, that are not contestable using UNEs. Verizon argues in its Phase I Compliance Filing that all of Verizon’s retail business services are contestable using UNEs, and AT&T argues that, due to the FCC’s UNE use and commingling restrictions, Verizon’s broad “no facilities” classification, and policies on determining jurisdiction of special access circuits, none of Verizon’s business services provisioned on DS1 or above circuits are contestable.

As an initial matter, if we were to accept AT&T's argument that none of Verizon's retail business services are contestable using UNEs, we would, in fact, be adopting a conclusion contrary to the one we reached in Phase I. If AT&T wished to have the Department revisit its conclusion on the contestability of Verizon's retail business services, the proper avenue would have been through a timely-filed petition for reconsideration. Moreover, in responding to AT&T's Motion for Clarification of the Phase I Order, we stated:

It is Verizon's compliance with the safeguards and conclusions reached in the Phase I Order, as shown in Verizon's [compliance] filing of June 5, 2002, that will be the subject of Phase II, not the taking of further evidence and argument on how additional issues affect competition for Verizon's retail business services. As a result, both AT&T's UNE use restriction argument and commingling argument, which both concern competition for Verizon's retail business services, will not be part of Phase II.

Verizon, D.T.E. 01-31-Phase 1-A at 15, Order on Attorney General's Motion for Reconsideration and Motion for Extension of the Judicial Appeal Period, and AT&T's Motion for Clarification (August 5, 2002) (emphasis added, footnote omitted).

We acknowledge that AT&T's continued interjection of special access provisioning has raised a number of very important issues related to Verizon's special access services, as well as having drawn attention to the fundamental, and sometimes problematic, distinctions between pre- and post-Telecommunications Act regulation. However, we note that most of the arguments raised by AT&T have also been raised in the Department's separate investigation into Verizon's provisioning of intrastate special access services,
Investigation by the Department of Telecommunications and Energy on its own motionpursuant to G.L. c. 159, §§ 12 and 16, into Verizon New England Inc. d/b/a VerizonMassachusetts' Provision of Special Access Services, D.T.E. 01-34.

Close and we agree with Verizon that that forum, as well as the FCC's ongoing investigation into interstate special access See Performance Measurement and Standards for Interstate Special Access Services,CC Docket No. 01-321, Notice of Proposed Rulemaking, FCC 01-339 (rel. Nov. 19,2001) ("Special Access NPRM"). In the Special Access NPRM at ¶¶ 13-20, the FCCrequested comment on what, if any, measurements, standards, and reporting proceduresshould apply to ILECs' provisioning of special access services.

Close and the FCC's Triennial Review of UNE requirements, Review of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers,CC Docket No. 01-338; Implementation of the Local Competition Provisions of theTelecommunications Act of 1996, CC Docket 96-98; Deployment of Wireline ServicesOffering Advanced Telecommunications Capability, CC Docket 98-147; Notice ofProposed Rulemaking, FCC 01-361 (rel. Dec. 20, 2001) ("Triennial Review"). OnFebruary 20, 2003, as part of its Triennial Review proceeding, the FCC adopted newrules governing ILECs' unbundling obligations. Although the FCC's final Order hasnot yet been released, the FCC is expected to address several issues raised by AT&T inthis proceeding.

Close provide the proper avenues to seek the remedies for which AT&T argues.

We determine that Verizon has complied with our directives in the Phase I Order to identify whether there are retail business services, other than private line services, that are not contestable. The services listed in Verizon's compliance filing can be purchased in their component parts as UNEs in a manner that allows CLECs to use those UNEs to compete for the final retail product (see Phase I Compliance Filing at Tab C). For these reasons, we agree with Verizon that its retail business services subject to the Phase I Order are contestable.
With regard to AT&T's concerns about the continuation of UNE-P, that issue is alsogoverned by the FCC's Triennial Review.

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E. Operation of Price Floors

1. Introduction

In our investigation in Phase I of this proceeding, the Department determined that Verizon may be granted upward pricing flexibility for its retail business services that are contestable on a UNE basis, "but that such a grant must be subject to a price floor equal to the density zone-specific UNE rates underlying the service plus a mark-up equal to the resale discount percentage." Phase I Order at 92. We found that "both the FCC's goal of a transition to facilities-based competition and the Department's goal of economic efficiency will be best served by allowing Verizon upward pricing flexibility for those retail business services that CLECs can compete against with their own UNE-based retail service." Id. at 89.

We determined that allowing Verizon upward pricing flexibility will not harm competitors, and, due to the high supply elasticity of resale and UNEs, competitors could easily respond to an increase in price by Verizon. Id. However, granting Verizon unlimited downward pricing flexibility raised the possibility of Verizon applying a "price squeeze" by reducing its retail price until the margin between Verizon's retail price for a service and the cost of the underlying UNE is diminished to the point where Verizon is not covering the costs it charges to its competitors and its own retailing costs so that CLECs cannot efficiently compete with Verizon. Id. at 90. As a result, the Department determined that we will require a UNE-based price floor for Verizon's business services that are contestable on a UNE basis, and will also require Verizon to "file a cost analysis calculating the price floor" when it seeks an initial decrease in price for any retail business service. Id. at 91.

2. Positions of the Parties

a. Verizon

Verizon asserts that the Phase I Order places the burden on Verizon to file sufficient supporting documentation when seeking an initial price decrease for a business service to establish that the applicable price floor is met (Phase I Compliance Filing at 5). Accordingly, Verizon states that, when making an initial filing to reduce rates for a business service, it will include an analysis of the relevant UNE charges for a competitor providing a comparable service plus a retail overhead (id.). Verizon asserts, however, that subsequent filings that rely on the initial price floor analysis should require no additional demonstration if there has been no increase to the price floor inputs (id.). Verizon also asserts that the Department should permit Verizon to demonstrate a “new lower price floor” in subsequent filings when there are “unique circumstances, price decreases of relevant inputs, or other changes that impact the price floor calculation” (id.). If the initial price floor is decreased, Verizon states that it would provide the calculation of the new lower price floor with any filing to reduce rates (id. at 6).

Verizon argues that the price floors required by the Phase I Order are intended to avoid a price squeeze between Verizon retail rates and the wholesale elements used by CLECs to compete with the relevant business retail service (VZ Reply Comments at 17). Verizon also argues that it will include all UNEs needed by a UNE-based CLEC to provide a comparable service plus a retail overhead in its calculation of a price floor, and that the costs Verizon itself incurs in providing the same service are not relevant to the calculation of a proper price floor (id. at 18).

Verizon argues that the Department determined that certain business services are contestable on a UNE basis and that these services are permitted pricing flexibility on a UNE basis and are subject to the enhanced price floor rules (DTE-VZ 2-2). Verizon argues that the enhanced price floor rules do not eliminate the D.P.U. 94-185 rules, but are in addition to the previous requirements (id.).
The price floor rules established in Investigation by the Department of Public Utilitieson its own Motion into IntraLATA and Local Exchange Competition, D.P.U. 94-185,at 31 (1996) have two sets of requirements, depending on whether or not the incumbentprovider controls “an essential input for a competitor’s offering of a competingservice.” For services where Verizon controls an essential input, the price floorconsists of “the relevant wholesale rate that at least one competitor pays to [Verizon] inorder to offer the service” plus Verizon’s “marginal cost of related overhead.” Id.(citing Price Cap Order, D.P.U. 94-50, at 205-206 (1995)). For all other services, theDepartment determined that proper price floor was to be the marginal cost. See PriceCap Order at 206. In a later Order, the Department found that for all of Verizon’sretail services (except measured toll services), Verizon could satisfy the price floorrequirement by offering these services for resale at the avoided cost discount. D.P.U./D.T.E. 94-185-C at 10 (1997). For measured toll services, Verizon wouldhave to satisfy a marginal cost-based price floor. See D.T.E. 94-185-E (2000).

Close Moreover, Verizon asserts that the establishment of different price floor methodologies for different competitive circumstances conforms to Department precedent (VZ Reply Comments at 19). Verizon further argues that the Department has developed relevant price floors on a case-by-case basis, and that there is no "one-size-fits-all" approach (id.). Verizon argues that all of the retail services listed in Tab A of its Phase I Compliance Filing and its response to ATT-VZ 2-3 remain subject to the price floor rules established in D.P.U. 94-185, while other retail business services, listed in the attachment to Verizon's response to DTE-VZ 2-2, are subject to the enhanced price floor rules established in the Phase I Order (DTE-VZ 2-2; ATT-VZ 2-3).

b. AT&T

AT&T argues that the language that Verizon uses in its Phase I Compliance Filing regarding its price floor obligations differs materially from that used by the Department in the Phase I Order; therefore, Verizon has failed to meet the requirements of the Phase I Order (AT&T Comments at 10). Specifically, AT&T asserts that the Department's price floor requirement can be divided into two parts: one pertaining to the cost of UNEs; and the other to the remaining costs of the retail service (id.).

With respect to the cost of UNEs, AT&T argues that in Verizon's Phase I Compliance Filing, Verizon does not specify that its price floor will include the UNE rates for the elements that make up the retail service as specified in the Phase I Order (id.). Instead, AT&T argues that Verizon only states that its price floor filing will include an analysis of the relevant UNE charges for a competitor providing a comparable service (id.). AT&T submits that Verizon should not be able to limit the UNE costs only to those UNEs that a particular competitor uses, but rather, ought to be required to ensure that its retail price covers the economic costs that Verizon incurs at both the upstream and retail stages of providing the service (id.). In order to accomplish this, AT&T argues that Verizon must ensure that the UNE component of the price floor covers the cost of all the elements it uses in the provision of the service regardless of the number of elements used by a competitor (id. at 11).

With regard to non-UNE costs, AT&T argues that Verizon's use of the term "retail overhead" in its Phase I Compliance Filing does not clearly reveal the fact that the Department required Verizon to use the wholesale discount to reflect the non-UNE costs that Verizon incurs in offering the retail service (id.). AT&T argues that Verizon's filing should be amended to use the same language as the Department and to specify that the retail overhead must be calculated by using the wholesale discount (id. at 12).

AT&T also claims that the issue of price floors in general remains an issue that should be further addressed in Phase II of this proceeding (id.). AT&T argues that while the Department stated in its June 21 Interlocutory Order
Verizon, D.T.E. 01-31, Interlocutory Order on Scope (June 21, 2001).

Close that it would consider the price floor issue during Phase II of this proceeding, it has not addressed whether price floor rules in D.P.U. 94-185 should continue, except as modified in Phase I, or whether other modifications are warranted (id.). AT&T asserts that although Verizon considers the price floor rules from D.P.U. 94-185 to remain in effect, notwithstanding modifications from the Phase I Order, there was no explicit confirmation of this position by the Department in the Phase I Order (id.). AT&T argues that, at the very least, Verizon should be required to specify which services are subject to the price floor rules in D.P.U. 94-185, and which services are subject to the price floor rules in Phase I of this docket, and that AT&T should be given a further opportunity to contest Verizon's position (id.).

3. Analysis and Findings

The Department agrees with Verizon that the purpose of the price floors required by the Phase I Order is to avoid a "price squeeze." As such, the intent of the price floor is to preserve a margin between Verizon's price of a service and the cost of the inputs required by competitors to profitably provide competing services that is equal at least to Verizon's retailing costs. In this instance, the margin is between Verizon's retail rate for a service and the density zone-specific UNE rates underlying the service (plus a mark-up equal to the resale discount percentage) that CLECs need to compete with Verizon. Therefore, we find that Verizon has complied with the Phase I Order with respect to the calculation of price floors by proposing to impute all UNEs required by CLECs to provide a competing service – rather than the direct costs incurred by Verizon in providing the same service – in its price floor calculations. However, we agree with AT&T that Verizon's use of the term "retail overhead" to designate the mark-up component of a price floor is ambiguous, and so require Verizon to plainly and specifically state that the mark-up included in price floor calculations is equivalent to the approved wholesale discount.

Further, the Department agrees with Verizon that the enhanced price floor rules established in the Phase I Order do not entirely eliminate the need for the D.P.U. 94-185 price floor rules. The pricing flexibility we approved in the Phase I Order is limited to "those retail business services that CLECs can compete against with their own UNE-based retail service." Phase I Order at 89. Indeed, the Department explicitly stated that it will require a UNE-based price floor for "Verizon's business services that are contestable on a UNE basis." Id. at 91. The services identified by Verizon as remaining under the D.P.U./D.T.E. 94-185 requirements (such as toll services, administrative and non-recurring charges, operator services, apartment door answering, and Centrex (see ATT-VZ 2-3)), do not fall into the category of business services discussed in the Phase I Order, and, thus, remain governed by the price floor rules established in our D.P.U./D.T.E. 94-185 proceeding.

F. PAL/PASL, and Other Wholesale-Like Services

1. Introduction

When the Department undertook its investigation into the sufficiency of competition for Verizon's retail business services in Phase I of this proceeding, we identified certain business services that "have historically been treated as retail services . . . but are primarily [ ] or . . . exclusively intended for purchase by other carriers as wholesale services rather than by end-users as retail services." Phase I Order at 36 (footnote omitted). The Department specifically identified Public Access Lines ("PAL"), Public Access Smart Lines ("PASL"), collocation, and special construction
Verizon provides PAL and PASL to competing providers of payphone service. Collocation occurs when a CLEC locates its equipment within a Verizon central office. Special construction applies when a telecommunications carrier requests a special orunique access arrangement from Verizon that is not available under Verizon's existingtariff.

Close as such services, and concluded that Verizon's "evidence of competition for retail services does not provide any guidance as to the level of competition for wholesale services." Id. at 94-95. The Department excluded such services from the pricing flexibility granted to Verizon's retail business services, and required Verizon to identify in its Phase I Compliance Filing any other retail services that are primarily provided to competitive carriers, rather than to end-users, and are thus wholesale in nature. Id. at 95. The Department further required Verizon to include in its filing a proposal to price such wholesale services on a UNE basis. Id.

2. Positions of the Parties

a. Verizon

In its Phase I Compliance Filing, Verizon argues that it has calculated rates for PAL and PASL based upon current UNE rates, and estimates that the additional revenue generated from this re-calculation is approximately $345,000 per annum (see Phase I Compliance Filing, Tab B, Att. 1, Workpaper 1). Verizon proposes to use this revenue to reduce the offsets to the residential dial-tone rate created by the Department-ordered re-pricing of access services and collocation (id.). This proposal, argues Verizon, is fully compliant with the Department's Phase I Order, and Verizon references the existing record in the Department's Payphone Docket
Investigation by the Department of Telecommunications and Energy on its own MotionRegarding (1) Implementation of Section 276 of the Telecommunications Act of 1996Relative to Public Interest Payphones, (2) Entry and Exit Barriers for the PayphoneMarketplace, (3) New England Telephone and Telegraph Company d/b/a NYNEX'sPublic Access Smart-Pay Line Service, and (4) the Rate Policy for Operator ServicesProviders, D.P.U./D.T.E. 97-88/97-18 (Phase II) ("Payphone Docket"). ThePayphone Docket is an ongoing investigation by the Department into Verizon's ratesfor PAL and PASL.

Close to assert that it has also complied with applicable FCC requirements regarding its rates for PAL and PASL services (VZ Reply Comments at 22). Verizon argues that the Department should address the PAL and PASL rate issues in the Payphone Docket, rather than in the Department's Phase II investigation in this proceeding, because the record in the Payphone Docket has been extensively litigated and is fully developed (id.). Verizon suggests that when the Department issues its rate determinations in the Payphone Docket, Verizon will incorporate those findings into its alternative regulatory plan (id. at 23).

In addition, in order to comply with our directive to set collocation rates at UNE levels, Verizon seeks to offset the reduction in collocation revenue resulting from the conversion of charges for existing circuits from Tariff M.D.T.E. No. 10 to Tariff M.D.T.E. No. 17 by increasing the residential dial-tone rate "consistent with the revenue-neutral approach adopted by the Department for other reductions in wholesale rates" (Phase I Compliance Filing at 7; see DTE-VZ 2-1). With regard to special construction, Verizon proposes that the pricing of special construction for access services will continue on an individual case basis, as defined in Tariff M.D.T.E. No. 16 (id.). Finally, Verizon states that there are no additional retail business services (other than PAL, PASL, collocation, and special construction) that are provided to carriers and are wholesale in nature (id. at 8).

b. Attorney General

The Attorney General argues that the Department must conduct a thorough investigation to determine if Verizon's estimate of lost revenue for the proposed regulatory treatment of access charges, PAL, and PASL is accurate (AG Comments at 9). The Attorney General argues that Verizon has not adequately explained its re-pricing of collocation or the effect on Verizon's revenue (id. at 11).

c. NEPCC

The NEPCC argues that, while Verizon's rate adjustment for PAL evidences the wholesale nature of this service – rather than its previous retail status – the rate adjustment results in a projected annual increase of $396,128 in Verizon revenue for PAL and a projected decrease of $51,067 in Verizon revenue for PASL (NEPCC Comments at 3). The NEPCC alleges that PASLs are the lines used by Verizon's payphone services, whereas PALs are those used by competitive payphone service providers (id. at 3). According to the NEPCC, the "efficiency" benefits of shifting PAL service to a wholesale-oriented rate are increased overall costs for Verizon's competitors; but for Verizon's own payphone services, the shift means reduced overall costs (id. at 3-4).

The NEPCC argues that Verizon is proposing a local loop rate component for PAL and PASL that is based on a statewide average, weighted according to the four density zones in Massachusetts, for a basic analog two-wire loop (id. at 5). However, the NEPCC contends that this rate does not comply with the FCC's Payphone Orders Implementation of the Pay Telephone Reclassification and Compensation Provisions ofthe Telecommunications Act of 1996, et al., CC Docket No. 96-128, Report and Order,FCC 96-388 (rel. Sept. 20, 1996), Order on Reconsideration, FCC 96-439 (rel. Nov.8, 1996); aff'd in part and remanded in part sub nom., Illinois Public Telecom.

Ass’nv. FCC, 117 F.3d 555 (D.C. Cir. 1997), First Clarification Order, 12 FCC Rcd. 20997(Com. Car. Bur. 1997), Second Clarification Order, 12 FCC Rcd. 21370 (Com. Car.Bur. 1997), Second Report and Order, FCC 97-371 (rel. Oct. 9, 1997), aff’d in partand remanded in part sub nom., MCI v. FCC, 143 F.3d 606 (D.C. Cir. 1998), ThirdReport and Order and Order on Reconsideration of the Second Report and Order, FCC99-7 (rel. Feb. 4, 1999), aff’d, American Public Communications Council, Inc. v.FCC, 215 F.3d 51 (D.C. Cir. 2000); In the Matter of Wisconsin Public ServiceCommission Order Directing Filings, CPD No. 00-01, Memorandum Opinion andOrder, FCC 02-25 (rel. Jan. 31, 2002) (collectively, the FCC’s “Payphone Orders”).

Close or the Department’s Payphone Docket because this rate is not based on the costs incurred by Verizon that are actually caused by that particular service (id.). Therefore, the NEPCC recommends that the loop component of Verizon’s proposed PAL and PASL rates be denied by the Department (id. at 8).

In addition, the NEPCC argues that Verizon’s proposed “UNE-like” unloaded port rate for PAL is higher than the UNE rate for a fully loaded analog port (id.). According to the NEPCC, the Department’s Payphone Docket established that the fully loaded analog port is functionally equivalent to the port required for PAL (id.). If the Department is to approve a new PAL port charge, the NEPCC argues that the Department adopt the UNE rate for a fully loaded analog port (id.).

Finally, the NEPCC argues that Verizon is proposing a dramatic increase in the rate it charges for Directory Assistance on both “Unlimited” and “Measured” PAL service (id. at 8-9). The NEPCC alleges that part of this increase results from the costs for “Telco branding,”

“Telco branding” is an optional service provided by Verizon that identifies acompetitive carrier’s name with the directory assistance or operator services that areannounced to that carrier’s end-user.

Close which “clearly was meant for [CLECs] who may desire the branding” (id. at 9). Payphone providers, argues the NEPCC, have no need for this branding, and, therefore, should not be charged for this service (id.).

3. Analysis and Findings

Our directives in the Phase I Order regarding PAL, PASL, and other wholesale-like services sought to establish regulatory pricing consistency for Verizon’s wholesale services on the basis that “lowering all wholesale service rates closer to incremental cost improves efficiency, promotes competition, and creates a consistent economic framework for all wholesale services.” Phase I Order at 63. The Department determines that Verizon has complied with our Phase I Order by submitting wholesale pricing plans for PAL and PASL (see Phase I Compliance Filing, Tab B, Att. IV). However, the Department also has an open proceeding – the Payphone Docket – addressing rates for Verizon’s PAL and

PASL services. Because the Payphone Docket is specifically addressing, inter alia, the pricing of payphone services, and has a fully developed record already established, the Department will defer to that proceeding the responsibility for establishing whether Verizon's proposed rates for PAL and PASL comply with the FCC's Payphone Orders. When that investigation is completed, the Department will require Verizon to incorporate the conclusions of that proceeding into its alternative regulation plan.

In addition, Verizon has complied with our directive in the Phase I Order regarding the re-pricing of collocation circuits and special construction charges for access services; thus, we approve that re-pricing.
We likewise determine that Verizon's proposed re-pricing of its switched accessservices to interstate levels complies with our directives in the Phase I Order, and, thus,we approve the re-pricing. We discuss the effect of the re-pricing of access services onVerizon's residential services in Section IV.D, below.

Close Verizon proposes that carriers purchasing collocation circuits out of Tariff M.D.T.E. No. 10 have their charges transitioned to the lower rates in Tariff M.D.T.E. No. 17, and that special construction charges for access services remain priced out of Tariff M.D.T.E. No. 16 on an individual case basis (see Phase I Compliance Filing, at 7, and Tab B, Att. V; AG-VZ 2-10). Because Verizon will be pricing collocation from Verizon's UNE rates tariff, we find that Verizon's proposal for collocation is consistent with our finding in the Phase I Order that this service should be priced in a UNE-like manner. Moreover, because special construction charges are unique for each request, the Department finds it inappropriate for Verizon to calculate a uniform tariffed rate for this service. Therefore, Verizon will be assessing special construction costs based on the actual costs Verizon incurs.

Further, Verizon has stated that there are no other retail services that are wholesale in nature (Phase I Compliance Filing at 8). Moreover, no other party to this proceeding asserted that any other Verizon retail services are more properly classified as wholesale services. In reviewing the list of Verizon's retail business services submitted in its Phase I Compliance Filing, Tab A, Att. B, the Department does not consider any other retail business services to be comparable to wholesale services, such as PAL, PASL, collocation, and special construction discussed above. Therefore, we find that Verizon has complied with this requirement of the Phase I Order.

Finally, Verizon proposes to recapture its lost revenue as a result of the re-pricing of collocation circuits through a revenue-neutral adjustment in basic residential services, and to offset this lost revenue by the excess revenue recovered from the re-pricing of PAL and PASL. Because Verizon's proposal affects basic residential service rates, the Department's consideration of this aspect of its proposal is contained in the Track B section of this Order.

IV. TRACK B: RESIDENTIAL SERVICES AND SERVICE QUALITY PLAN

A. Introduction

In our Phase I Order, we characterized our inquiry into the appropriate framework for regulation of Verizon's residential services in the following way: "[W]hat form of Department regulation would (1) ensure just and reasonable rates for residential services, (2) be consistent with our precedent, (3) promote more competition for residential services, and (4) be compatible with our treatment of Verizon's [retail] business services?" Phase I Order at 99. Guided by the series of tentative conclusions the Department outlined in the Phase I Order, Verizon filed its proposal for residential services in its Phase I Compliance Filing. In the evidentiary proceeding examining Verizon's proposal for regulatory treatment of its residential services, the Attorney General, AT&T, and WorldCom suggested modifications to Verizon's proposal.

B. Basic Residential Services

Verizon's basic residential services include the residential dial-tone line, measured andunlimited usage, and Suburban, Metropolitan, Circle and Expanded Community Callingservices (Exh. VZ-1, at Tab A, Att. A). Verizon's non-basic residential servicesinclude all other residential services (id. at Tab B, Att. B).

Close

1. Introduction

In the Phase I Order, the Department tentatively concluded that, while some form of alternative regulation would be appropriate for Verizon's residential services, an "inflation minus productivity" price cap may not be the best regulatory mechanism because historic evidence shows that residential rates are likely below their efficient levels. Phase I Order at 100. The Department further suggested that, in order to replicate the range of prices that could prevail in an efficient market, we should allow pricing flexibility for basic residential services within a range encompassing a floor of incremental cost and a ceiling of stand-alone cost. Id. at 102. In addition, in order to promote our ratemaking goal of continuity, we suggested that any price increases for basic residential services should be limited to five percent per year. Id. at 102-103.

2. Positions of the Parties

a. Verizon

Verizon argues that its proposed plan for regulatory treatment of its residential basic services implements the Department's tentative conclusions in the Phase I Order and constitutes an appropriate move toward market-based price regulation that still provides adequate safeguards to ensure that the Department's telecommunications policy objectives will be met (Exh. VZ-3, at 2-3). Verizon states that its proposal for regulatory treatment of residential services permits up to a five percent annual price increase for basic residential services, which is far less than the price increases prescribed by the

Department in D.P.U. 89-300 (1990), and is therefore in accordance with the Department's goal of protecting consumers from unwarranted rate shock (id. at 3; VZ Brief at 3). Verizon argues that allowing it to raise rates for basic residential services up to five percent per year prevents real prices from declining (Exh. VZ-3, at 3). Verizon also argues that basic residential prices are "most assuredly below efficient competitive levels" and that maintaining real prices below competitive market levels will impede competitive entry to the detriment of all consumers in Massachusetts (Exh. VZ-3, at 3; see VZ Brief at 2). Verizon asserts that its proposal extends the movement of residential prices toward more economically efficient levels that the Department began with the rate re-balancing process in D.P.U. 89-300 (1990), and that Verizon's proposal facilitates the transition to full market-based pricing (Exh. VZ-2, at 13; VZ Brief at 7).

Verizon argues that cost is not the only basis for pricing retail residential telecommunications services, and states that the Telecommunications Act of 1996 and subsequent federal and state regulations have opened local exchange markets to competition so that market forces must also be an important determinant of price (Exh. VZ-6, at 1; see VZ Brief at 22). While acknowledging that the reasonableness of rates for natural monopolies could be judged with reference to cost, Verizon disputes that natural monopoly conditions prevail in the market for basic residential services in Massachusetts due to the implementation of the Telecommunications Act of 1996 (Exh. VZ-6, at 3; VZ Brief at 22-23). Verizon also explains that because price regulation breaks the link between prices and accounting costs – thus encouraging a regulated firm to behave more like a firm in a competitive market – price regulation is preferable to rate of return ("ROR") regulation (Exh. VZ-6, at 3).

Moreover, Verizon argues that instituting cost-of-service regulation after the Department has established a price cap regime removes the incentives that the Department was trying to create for Verizon in the initial price cap plan, and punishes Verizon for the efficiencies it was able to achieve under price cap regulation by prohibiting it from profiting from those efficiencies; or alternatively, rewards Verizon for inefficiency (Exh. VZ-2, at 14). Verizon also contends that in the Phase I Order, the Department recognized the difficulty of undertaking a cost-of-service investigation for only one set of Verizon customers (i.e., residential service customers), noting that the allocation of joint and common costs shared between business and residential customers "might be unacceptably arbitrary," and argues that cost-of-service regulation might even facilitate the ability of a regulated company to cross-subsidize competitive services with revenues from regulated services (Exh. VZ-2, at 15).

In addition, Verizon argues that the embedded cost analysis offered by the Attorney General "has no relevance whatsoever to the issues in this proceeding" because it is a historical cost analysis that focuses on accounting costs rather than the costs that an efficient firm would face going forward (Exh. VZ-6, at 24; Tr. 1, at 14; VZ Brief at 21). Moreover, Verizon argues that embedded cost analyses of individual services depend on allocations of costs which are not on a cost-causative basis (Tr. 1, at 14). Thus, Verizon argues that historical cost measures "have no relevance to the concept of 'just and reasonable' as it pertains to the price of telephone services provided under regulatory and current market conditions in Massachusetts" and are inconsistent with the principles of competitive pricing on which the Department has stated it could rely to evaluate just and reasonable prices (Exh. VZ-6, at 24; see VZ Brief at 21-22).

Verizon also disputes the Attorney General's claim that the loop is a shared facility whose cost should be allocated to different services because the Attorney General's claim conflicts with the fundamental principles of cost causation (Exh. VZ-6, at 9; see VZ Brief at 26-29). Verizon argues that the local loop is a facility that provides dial tone that enables an end-user to gain connectivity to the public switched telephone network, and that the connectivity provided by the local loop is a pre-condition for access to many usage services (Exh. VZ-6, at 6). Verizon contends that, while the fact that various providers of usage services rely on the local loop to deliver their services to the end-user may lead some observers to arrive at the conclusion that the loop is a shared facility, the local loop is actually an output service that is "demanded in its own right" and must be identified with the full cost that is added to the network when a local loop is placed in service (Exh. VZ-6, at 7). Verizon argues that once a customer acquires a loop, other services can only be made available to that customer at additional cost, and that the cost incurred to provide toll service, for example, to the customer is separate from the cost incurred to provide the loop itself; therefore, the loop cannot be a joint or shared cost (id. at 11; see VZ Brief at 28). Verizon asserts that the manner in which the loop is subsequently used has no bearing on the pricing of the service as cost causation requires the price of a service to reflect the cost incurred to fulfill the demand for the service (Exh. VZ-6, at 8; VZ Brief at 26-27).

With regard to Verizon's basic residential service,
Verizon's basic residential service bundles the loop with local usage (Exh. VZ-6, at 9).

Close Verizon contends that the cost of the loop is incurred when the loop is provisioned, regardless of the actual usage of the loop (Exh. VZ-6, at 9; VZ Brief at 27). Verizon argues that pricing based on cost causation principles will yield prices that are economically efficient; will "result in buying and selling transactions that maximize social welfare;" and that the only measure of cost that reflects the underlying cost caused by a given activity is incremental cost, which is, by definition, prospective and forward-looking (Exh. VZ-6, at 8; see VZ Brief at 28).

Verizon agrees with the Department's assertion in the Phase I Order that any price within the range of incremental cost and stand-alone cost could prevail in an efficient market, but notes that "it is certainly not the case that every price in that range is necessarily Ramsey-efficient"
The concept of "Ramsey-efficient" prices refers to the principles of taxation firstarticulated by Professor Frank Ramsey and later brought into the regulatory pricingarena (see Exh. ATT-1, at 2). The Department stated in the Phase I Order at 101, "[i]ncompetitive markets for telephone services, efficient market prices are based onincremental cost plus a mark-up for joint and common costs, based on Ramsey pricingprinciples . . . [and] pursuant to Ramsey pricing principles, joint and common

costs arerecovered from services in inverse proportion to the demand elasticity of particularservices."

Close (Exh. VZ-6, at 25, emphasis in original; see VZ Brief at 25). Verizon argues that prices in competitive markets tend to be subsidy-free, i.e., they neither receive nor provide a subsidy and cannot be considered predatory, and also tend to be efficient by being driven by market conditions to being as close to underlying incremental costs as possible (Exh. VZ-6, at 25-26). However, Verizon contends that, due to the presence of large shared and common costs in telecommunications, a firm that priced all of its services exactly at their respective incremental costs would never recover the shared and common costs and would not break even or remain viable in the long run (id. at 26). Verizon contends that service prices must therefore be marked up above incremental cost to contribute to the full recovery of shared and common costs (Exh. VZ-6, at 26).

Verizon further argues that the residence dial-tone line charge historically has been priced beneath the economically efficient level, and that pursuant to Ramsey pricing principles – where joint and common costs are recovered from services in inverse proportion to the demand elasticity of particular services – Verizon's residence dial-tone line charge would have increased [were it not for the freeze imposed by the price cap plan], and other basic residential service prices would have also moved toward efficient levels in the presence of increasing competition (Exh. VZ-2, at 8-9). Moreover, Verizon argues that the residence dial-tone line rate increases from 1990 to 1994 exceeded 5 percent per year and that these increases shifted the residence dial-tone line rate towards more economically efficient levels without negatively impacting residential subscriber penetration and created an environment to encourage competitive entry (id. at 10; see VZ Brief at 16-17).

Verizon contends that the Department found existing and growing competition for Verizon's residential services in Massachusetts in the Phase I Order and maintains that this competition constrains its ability to increase prices without limit (Exh. VZ-2, at 11; see VZ Brief at 14). Verizon asserts that consumers will see a benefit from its proposal because competition will drive prices for non-basic residential services down towards economically efficient levels (Exh. VZ-2, at 11). Verizon contends that residential services are not subsidized because each service is priced above the forward-looking direct cost of providing that service (Exh. VZ-6, at 5; VZ Brief at 24). Verizon argues that the rates for basic residential services were determined to be just and reasonable in the Price Cap Order, and that those rates exceeded the marginal cost of each service and provided various levels of contribution (Exh. VZ-5, at 2). Verizon asserts that current rates exceed the marginal cost of each service compared to cost data from Marginal Cost Study VI ("MCS VI") and that comparison with the 1997 TELRIC costs from the Consolidated Arbitrations

See Consolidated Arbitrations, D.P.U. 96-73/74, 96-75, 96-80/81, 96-83, 96-94. TheConsolidated Arbitrations were the series of Department orders beginning in late 1996,that addressed the consolidated arbitration petitions of NYNEX, AT&T, MCICommunications Company, Sprint Communications Company, L.P., TeleportCommunications Group, Inc., and Brooks Fiber Communications.

Close also yields results that are directionally the same (Exh. VZ-5, at 3; see VZ Brief at 9-10). Moreover, Verizon argues that its analyses of current and proposed rates, and MCS VI and TELRIC costs, illustrate that the residence dial-tone line charge contains less contribution in relation to other services and will still contain lower levels of contribution than usage and vertical services even with the rate changes provided for in the proposed plan (Exh. VZ-5, at 5; see VZ Brief at 24). Nonetheless, Verizon submits that the residence dial-tone line charge covers its incremental cost and is not subsidized in an economic sense (Exh. VZ-5, at 4). Verizon also insists that there is no merit to the claim that competitive services are subsidized by residential services as this contention is based on the Attorney General's erroneous assumption that the local loop is a joint and common facility (Exh. VZ-6, at 24). In addition, Verizon argues that there has been no demonstration that any competitive service is priced below its forward-looking direct cost and is therefore subsidized (id. at 25).

Verizon argues that while it recognizes that its prices should be required to equal or exceed their corresponding incremental cost price floors, stand-alone cost is "a useful concept in theory, but extremely difficult – perhaps even impossible to implement in practice" because the calculation of the stand-alone cost of any single service out of the range of services derived from networks that depend considerably on shared and common assets is "entirely a matter of conjecture" (Exh. VZ-6, at 26). Verizon also claims that Total Service Long Run Incremental Cost ("TSLRIC")

TSLRIC can be roughly approximated as TELRIC minus joint and common costs(Tr. 1, at 36-37; see Exh. VZ-5, at 3).

Close (or, in the absence of TSLRIC data, marginal cost) is the appropriate incremental cost price floor for its basic residential services in order to avoid cross-subsidy (Tr. 1, at 23). Verizon argues that Ramsey pricing principles offer some insight into the pricing of its services in the presence of substantial shared and common costs in competitive markets, and agrees that precise knowledge of individual own-price and cross-price elasticities for all of Verizon services is not essential to ensure that prices move in directions "generally warranted by the Ramsey pricing principle" (Exh. VZ-6, at 28). Verizon argues that the residence dial-tone line is not as inelastic as it may have been before, but it remains the most inelastic element (Exh. VZ-5, at 4; see VZ Brief at 11). Verizon asserts that the margins of contributions from residential services to shared and common costs are the opposite of what one could expect in an efficient market; that is, instead of a relatively low percentage markup for residence dial-tone line and a relatively high markup for usage services, the reverse would be expected (Tr. 1, at 25-26; VZ Brief at 9).

Verizon therefore argues that the Department can rely on "rough elasticities" such as order-of-magnitude elasticity estimates and the contribution margins for directional guidance on the movement of residential prices towards efficient levels (Tr. 1, at 26-27). Moreover, Verizon insists that any increase in basic exchange rates is going to increase efficiency for a while given that these ratios of margins are in the opposite direction of what they should be and that "a ceiling for residential basic exchange rate increases of five percent in nominal terms every year isn't going to get you beyond the point of efficiency any time in our lifetimes" (Tr. 1, at 27-28; see VZ Brief at 26). Verizon maintains that the "real virtue" of competition is that efficient or just and reasonable prices need not be arbitrarily selected from the wide range between incremental and stand-alone cost and notes that the presence of viable competitors acts as a policing mechanism that keeps the incumbent's prices in check (Exh. VZ-6, at 26-27).

Verizon acknowledges that even if the relevant elasticities are known and available, implementation of Ramsey pricing principles is still far easier under the "old regulatory break-even constraint" because the firm's revenue requirements are known and the markup in service prices can be carefully calibrated according to the known price elasticities (Exh. VZ-6, at 28). However, Verizon argues that Ramsey-like results can be approximated in a market where the break-even constraint does not apply, and price elasticities are not known exactly, by permitting the market to reveal the sustainable level of markup in each service price (id.; see VZ Brief at 25). Verizon asserts that sustainable prices that simulate the outcomes from a pure Ramsey pricing exercise can be determined by offering customers various combinations of price, volume, and service quality, and letting their preferences reveal the relative strength of demand for each service (Exh. VZ-6, at 28-29; see VZ Brief at 25).

b. Attorney General

The Attorney General argues that Verizon's proposed alternative regulation plan does not achieve the Department's goals of promoting competition, ensuring just and reasonable rates, and maintaining a high level of service quality (Exh. AG-1, at 4). The Attorney General argues that "the reasonableness of rates for regulated public utilities has always been judged with reference to cost" and that Verizon has not provided any recent cost estimates (id.). The Attorney General argues that the Department should not rely on retail cost data from the 1980s as a basis for the pricing of residential services because relying on outdated costs for residential customers would deny these customers the scale and scope economies, as well as the technological changes and merger savings, which have occurred over the past fifteen years and which have been factored into wholesale rates (id. at 4-5, and n.8). The Attorney General further argues that raising residential rates without any cost justification would not ensure that the rates reasonably approximate what would be found in a competitive market (id. at 5). The Attorney General argues that without knowing total costs, efficient prices cannot be determined because it is unknown whether the proposed prices exceed costs (Exh. AG-2, at 6).

In order to ensure that the rates for residential dial-tone services represent "true costs" and are just and reasonable, the Attorney General recommends that the Department freeze the residential rates at their current levels and open a new docket to conduct a cost-of-service study to determine if Verizon's rate of return is adequate or exorbitantly high (Exh. AG-1, at 33). The Attorney General argues that the Department cannot "talk about Ramsey efficient pricing without identifying what is the revenue goal of that pricing exercise" (Tr. 2, at 182). Further, the Attorney General argues that "until the Department renounces that goal [of adopting Ramsey-efficient prices], they need to undertake this embedded cost study" (id. at 183).

According to the Attorney General, in the cost-of-service study submitted in D.P.U. 89-300 (1990), Verizon demonstrated that an increase in residential rates would be necessary if revenue from other service areas were decreased in order "to equalize the class rate of returns" (Exh. AG-1, at 6). The Attorney General argues that because rates and costs have changed since then, it is no longer valid to assume residential rates continue to be subsidized, and that new cost information must be analyzed to determine if any subsidies exist in the residential rate (id.). However, the Attorney General concludes that Verizon's basic residential rates are not subsidized because Verizon's current residential rate for basic unlimited local service exceeds the sum of Verizon's current UNE rates and marginal cost (id. at 8; Tr. 2, at 180-181, 211).

In addition, the Attorney General states that Verizon has not submitted any cost or demand data to determine if its proposed price increases would be efficient, and argues that Verizon's alternative regulation proposal is inconsistent with economic efficiency (Exhs. AG-2, at 4; AG-1, at 16). The Attorney General states that while competitively efficient prices can be expected to lie between stand alone and incremental costs, it is not true that any price between stand alone and incremental cost will therefore be efficient (Exh. AG-1, at 16-17). The Attorney General claims that defining "efficiency" broadly as the range between stand alone and incremental cost could result in the discriminatory treatment of different classes of customers and "violate the DTE's definition of fairness" by charging one class of customers the stand alone cost and another the incremental cost (id. at 17). According to the Attorney General, firms in a competitive market often take into consideration a strategy of segmented pricing, such as peak-load and service bundles, which implies the existence of a much more dynamic and fluid pricing environment than one in which prices are merely driven to incremental cost (id. at 23-24). As an example, the Attorney General states that this pricing environment exists in the cable and wireless markets (id. at 24-27).

The Attorney General argues that, contrary to Verizon's assertions, increasing the price of residential service may slow market penetration (Exh. AG-2, at 10). The Attorney General argues that Verizon's reliance on the FCC data measuring the impact of prices on residential subscriber penetration levels in Massachusetts from 1990-1994 is overstated because consumers respond to price changes gradually, over a longer period of time than is represented by Verizon (id. at 11). The Attorney General contends that Verizon fails to take into account the overall decline in Massachusetts market penetration which occurred from 1993 to 2000 (id. at 12).
The Attorney General asserts that, according to FCC data, the penetration rate for localservice in Massachusetts gradually declined from a high of 97.4 percent in 1993 to alow of 94.0 percent in 2000, before rebounding to 95.9 percent in 2001 (Exh. AG-2,at 12).

Close In addition, the Attorney General states that elasticities can only be estimated by holding all other things constant, but Verizon's penetration data did not account for the changes that occurred within the study period, such as rate decreases in other telecommunications services and demand shifts resulting from the expansion of internet services (id. at 13-14).

The Attorney General argues that in some competitive markets, efficient prices are based on incremental cost plus a mark-up, which is derived from Ramsey pricing principles, to recover joint and common costs (Exh. AG-1, at 19). The Attorney General argues that while it is possible to determine demand elasticities, it would be unrealistic for regulators to estimate all the own-price demand and cross-price demand elasticities necessary to implement Ramsey prices (id. at 20). According to the Attorney General, this is because the demand elasticities for services are interrelated, such that if prices are changed, complementary services are affected (Tr. 2, at 219). The Attorney General argues that while the basic insights of Ramsey pricing can be applied to set efficient prices, Ramsey pricing principles hold true only under special circumstances, such as when service demands are independent (Exh. AG-1, at 19, 20; Tr. 2, at 198). The Attorney General argues that access to the telecommunications network is not an independent demand, but rather a derived demand, meaning that consumers seek access for placing and receiving calls, not for access independent of those services (Tr. 2, at 214).

In addition, the Attorney General argues that loop costs should not be recovered solely from residential dial-tone because the loop is a shared facility (Exh. AG-1, at 9). The Attorney General claims that Verizon's proposal to recover 100 percent of the loop cost from the end-user rests on two propositions: (1) the loop is a separate service; and (2) the loop is a dedicated non-traffic sensitive cost (id.). According to the Attorney General, the FCC supports the Attorney General's contention that the loop is an input into the production of almost all other telecommunications services, not a separate service (id.). The Attorney General argues, therefore, that loop costs should be shared among all of the services utilizing the loop facility (id. at 10). Furthermore, the Attorney General argues that the addition of electronics such as digital loop carriers
A digital loop carrier ("DLC") commingles traffic from multiple copper loops onto afiber loop at a terminal between the end-user and the serving central office. Theamount of traffic concentrated at the DLC is determined by a concentration ratio, whichis a "function of the traffic load to be carried" (Exh. AG-1, at 11). According to theAttorney General, because the fiber portion of the loop is not a dedicated path betweenan end-user and central office, but carries commingled traffic from multiple end-usersto the central office, the fiber portion of the loop is traffic sensitive (id.).

Close converts the loop into a traffic sensitive facility, contrary to Verizon's position (id. at 11).

Additionally, the Attorney General points out that new technology and network configurations enable the loop to carry more advanced non-voice services, such as digital subscriber line ("xDSL") (id. at 28). The Attorney General argues that because the loop

allows carriers to have multiple revenue streams,
The Attorney General argues that multiple revenue streams over a single loop canoccur, for example, from vertical services and line sharing or line splittingarrangements, where voice services are provisioned over the low-frequency portion ofthe loop and non-voice data services are provisioned over the high-frequency portion ofthe loop (Exh. AG-1, at 28).

Close the entire revenue stream should be taken into account in the recovery of the cost of the loop facility (id.). The Attorney General argues that for these reasons, allowing Verizon to recover the full cost of the loop from flat end-user dial-tone rates is no longer providing the correct signal to end-users and investors (id. at 11). Moreover, the Attorney General argues that Verizon's own witness, Dr. Taylor, agreed in a case before the New Mexico Public Regulatory Commission, that in a line sharing or line splitting arrangement, the costs of the loop are fixed costs between the two arrangements and should be shared, contrary to the position that Verizon has taken in this case (Tr. 2, at 254; see Exh. AG-6).

Further, the Attorney General argues that section 254(k) of the Telecommunications Act requires states to allocate the cost of the loop to all the services that use the loop in order to ensure that services defined under universal service do not bear an unreasonable portion of the joint and common costs of that shared facility (Exh. AG-1, at 31-32). The Attorney General argues that recovering 100 percent of shared costs from the dial-tone rate is neither pro-competitive nor pro-consumer for two reasons (id. at 21). First, the Attorney General argues that "competition is not good for its own sake" because artificially high prices will result in inefficient firms profitably entering the market (id. at 22). Second, the Attorney General claims that artificially high prices for dial-tone will result in lower prices for other services, thus thwarting competition in those markets (id.).

c. WorldCom

WorldCom states that it does not oppose Verizon's proposal for regulation of Verizon's residential services, provided that the Department adopts two modifications to the proposal (WorldCom Brief at 1). First, WorldCom argues that the Department should require Verizon to further reduce its intrastate switched access charges from the current level of interstate rates (as mandated in the Phase I Order) to TELRIC over a three year period (id. at 2-3). Second, WorldCom argues that the Department should suspend Verizon's rate flexibility for basic residential service if the level of residential competition is "frozen" or reduced as a result of changes in regulations concerning the availability of UNE-P now being considered by the FCC (id. at 3-4). The Department should retain the authority, argues WorldCom, to terminate all or part of the alternative regulation plan if market conditions warrant a suspension of the flexibility contained within the plan (id.).

d. AT&T

AT&T asserts that local exchange telephone companies were traditionally subject to ROR regulation, under which the regulator first determined the size of the company's capital base and then calculated rates for the company's various services in order to achieve the "fair" rate of return on those assets (Exh. ATT-1, at 7). AT&T asserts that regulators set rates for basic residential local exchange telephone service residually under ROR regulation; in other words, regulators set rates for other services at well above cost, and then set rates for residential local exchange service as low as possible to attain the target return (id. at 8). This pricing methodology, argues AT&T, led to largely inefficient prices for the portfolio of telephone services offered by the local exchange company (id.). Moreover, AT&T argues that the adoption of price cap regulation did not halt the inefficient pricing of local exchange and access services because, for the most part, the initial prices established for the firm's regulated services were those that prevailed under ROR regulation (id. at 9). AT&T maintains that subsequent adjustments for inflation and productivity gains did not address the fundamental pricing distortions brought about by residual pricing, and that residential local exchange rates continued to be priced at levels below those warranted by economic efficiency (id.).

However, AT&T argues that conducting a traditional cost-of-service study would have limited and questionable value for setting local residential rates because the allocation methodologies of such an approach produce costs and rates that are inconsistent with cost-causation principles (Exh. ATT-2, at 2). AT&T argues that earlier cost-of-service studies are outdated, and that the Attorney General's calculations are based on several assumptions, and are far too imprecise for the Department to base findings on whether the price of residential service exceeds its costs (id. at 3-4; see AT&T Brief at 9-13). As a result, AT&T suggests that it is not clear whether Verizon's basic residential service is no longer subsidized (Exh. ATT-2, at 6). Moreover, AT&T alleges that the "anemic" competitive interest in residential markets in Massachusetts provides some amount of prima facie evidence that residential prices are too low, but also notes that "the attractiveness of entry is driven not only by output prices but also by the ability of new entrants to secure inputs at efficient prices and under nondiscriminatory terms" (id. at 6-7; see AT&T Brief at 13-14).

Furthermore, AT&T asserts that the Attorney General's argument that the relevant cost against which residential rates should be benchmarked should not include the entire cost of the loop is without merit since it is based on "a mistaken economic perspective" (Exh. ATT-2, at 3, 7). AT&T argues that the Attorney General's argument violates the "fundamental tenets of efficient costing and pricing," and is inconsistent with principles of cost causation (id. at 7). In particular, AT&T argues that dial-tone access is "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; thus, AT&T argues that the incremental cost of providing that access should be recovered in the monthly fixed charge (id. at 7-8). AT&T also asserts that, contrary to the Attorney General's claims, the incremental cost of dial-tone is neither zero nor very close to zero (id. at 9). AT&T explains that in a network industry, where access to the network is the primary service, the incremental cost of access should be computed before that of other services that rely on access to the network (id.). AT&T argues that, when properly calculated in this manner, the incremental cost of access is identified on a cost-causative basis and is not shared among other services (id.).

AT&T asserts that the Telecommunications Act of 1996 transformed the fundamental role of regulatory commissions to one of developing “a set of competition-enabling policies that will allow for the introduction and development of competition” so that, as competition grows and becomes effective, markets can replace regulation as the primary source of protection of consumers (Exh. ATT-1, at 11). AT&T argues that residual pricing of residential local exchange services must cease because the imposition of residually determined, artificially low rates is inefficient and discourages the establishment of competition in telecommunications (id. at 12). AT&T argues that prices that do not, at a minimum, recover the incremental cost of providing the service constitute a regulatory barrier to entry that deters the introduction and growth of competition (id. at 13; AT&T Brief at 29-30).

While AT&T considers the range between incremental cost and stand-alone cost for pricing flexibility proposed in the Department’s tentative conclusions to be “appealing” to the extent that prices outside the range would be inefficient and “arguably unfair,” AT&T contends that there are important reasons to narrow this range further (Exh. ATT-1, at 16). At the top of the range, AT&T asserts that the stand-alone cost of providing residential local exchange is likely to be quite high and would “certainly allow for the extraction of considerable amounts of consumer surplus” (id. at 17). On the other hand, AT&T argues that where the prices Verizon charges to competitors for necessary inputs remain above the incremental cost of the input to Verizon, denoting a price floor at Verizon’s incremental cost “creates the very real prospect that efficient competitors will be artificially excluded from [the] market” (id.; see AT&T Brief at 9). Therefore, AT&T recommends that the low end of the range should reflect the cost Verizon imposes on its competitors for all of the monopoly inputs, plus Verizon’s retailing costs (Exh. ATT-1, at 17).

AT&T argues that the Ramsey pricing principles suggested by the Department as the basis upon which recovery of joint and common costs might be recovered in its Phase I Order, “are sound and may guide decisionmaking,” but contends that caution should be exercised before applying them as they are meant to be applied specifically to a declining-cost, regulated natural monopoly (id. at 25). AT&T argues that in such an industry, “the first-best efficient price” is marginal cost, but that the revenues resulting from pricing at marginal cost are insufficient for the firm to recover all its costs (id.). Therefore, AT&T argues that prices must be marked up from the economically efficient level for the firm to recover joint and common costs as well as its marginal costs (id.). AT&T argues that Ramsey pricing principles advise that the efficient set of mark-ups should vary inversely with the price elasticity of demand for the firm’s various service offerings in order to minimize distortions to economic efficiency (Exh. ATT-2, at 10; see Exh. ATT-1, at 25).

Nevertheless, AT&T disagrees with the Attorney General’s fundamental challenge to the implication of applying Ramsey-based inverse elasticity guideposts to pricing for residential exchange service (Exh. ATT-2, at 10). More specifically, AT&T objects to the Attorney General's speculation regarding whether the residential dial-tone line charge is still the most inelastic price element or not, and the Attorney General's consequent assertion that the mark-up over marginal cost for the dial-tone line charge should be somewhat similar to the mark-up for other telecommunications services (id. at 11). AT&T contends that a "large and robust econometric literature" suggests that the demand elasticity for residential dial-tone access is highly inelastic in both an absolute sense and relative to other telecommunications services (id.; see Exhs. ATT-3; ATT-4; ATT-5). AT&T therefore argues that there will likely be minimal efficiency losses from raising basic residential rates and that universal service concerns can be addressed effectively through a complementary policy of targeting assistance to those households in need of assistance (Exh. ATT-2, at 12; see also Exh. ATT-6 (showing the decline of the dial-tone line charge in real terms and as a percentage of income)).

AT&T also argues that fundamental economic principles require that retail, not wholesale (or input) prices be raised above economically efficient levels in order to recover joint and common costs (Exh. ATT-1, at 26). AT&T therefore recommends that the Department devote its attention to pricing inputs at economically efficient levels (i.e., TELRIC pricing for switched access (see AT&T Brief at 4-7)) and establishing a price-escalator cap for Verizon's residential retail services, rather than applying through regulatory fiat a set of pricing principles that may be inconsistent with the underlying assumptions of the Ramsey model (Exh. ATT-1, at 26). AT&T argues that this approach will foster competition and let the market, not regulators, determine the appropriate contribution from each service to the recovery of the firm's joint and common costs (id. at 27). However, AT&T argues that the economic rationale for the economically efficient pricing of inputs and the establishment of "generally subsidy-free" retail residential rates are independent and have "no logical connection" to each other in a regulatory framework of enabling competition (id.). AT&T recommends that the Department should not concern itself with how Verizon may recoup revenue losses in one area with price increases in another because, while that logic may have been pertinent to residual ratemaking, it "sacrifices both economic efficiency and competition" in the current transition to a competitive residential marketplace in Massachusetts (id. at 25-26).

AT&T does not consider the Department's tentative conclusion in the Phase I Order to limit residential price increases to no more than five percent per year to be unreasonable, as this price-escalator cap ensures minimal disruptions to consumers (Exh. ATT-1, at 18). However, AT&T expresses concern that the five percent limit might be an impediment to competition in Massachusetts because it may restrict Verizon from setting retail residential rates that reflect the economic cost of providing basic residential service (id.). AT&T therefore suggests that the Department consider a ten percent per year limit on rate increases for basic residential service for the next three years as this would allow Verizon to set rates more likely to reflect the economic cost of providing the service (id. at 19; see AT&T Brief at 14-15, 21).

AT&T argues that if the Department agrees with AT&T's suggestion, it is critical for the

Department to ensure that inputs essential for new entrants to compete are correctly priced at their economic cost so that competitors may provide a meaningful check on Verizon's upward pricing (Exh. ATT-1, at 19-20). Therefore, AT&T urges the Department to examine retail residential rates and the rates for the UNE inputs required to provide the retail service, and remedy the situation if retail rates are found to be below UNE rates, as the Department stated it would do in the Phase I Order (id. at 21). AT&T emphasizes the necessity of requiring Verizon to set its retail prices at or above the TELRIC-based UNE costs of providing the service plus its retail overhead, regardless of the pricing flexibility afforded Verizon (id. at 21-22). Finally, AT&T concludes that permitting moderate rate increases for retail residential rates as part of a larger strategy of enabling competition is likely to yield lower rates in the long run, as robust competition will drive costs down, and produce rates lower than can be expected under "a regime of monopoly regulation or anemic competition" (Exh. ATT-2, at 13).

Finally, AT&T argues that the best means of protecting consumers from economically unjustified basic residential price increases is to facilitate competitive alternatives to Verizon's basic residential service (AT&T Brief at 23). Therefore, argues AT&T, the Department should make clear that a grant of residential pricing flexibility to Verizon will be conditioned on the ability of CLECs to compete in the residential market, which is in turn dependent on CLECs' continued access to UNE-P and the full voice and data capability of fiber fed loops (id. at 23-24).

3. Analysis and Findings

a. Introduction

Our statutory responsibility requires us to ensure that rates for common carrier telecommunications services in Massachusetts are just and reasonable. G.L. c. 159, §§ 14, 17, 20. Over time, the Department has satisfied this statutory mandate in different ways as the relevant statutes do not prescribe any single method. See Phase I Order at 17-19. Most recently, in our Phase I Order in this proceeding, we determined that market forces could be relied upon to produce just and reasonable rates for Verizon's retail business services, as those services are subject to competition sufficient to keep prices at a reasonable level. Id. at 93. Verizon has not sought a similar determination with regard to its basic retail residential services; therefore, we have not investigated Verizon's proposal with an eye towards whether there is sufficient competition for Verizon's basic residential services to rely on market forces to ensure that rates for these services are just and reasonable. Rather, the question that the Department investigated in this phase of the proceeding is what form of regulation would be appropriate for Verizon's basic residential services going forward.

As discussed above, the Attorney General argues that the Department should continue the rate freeze and open a new proceeding to examine the costs that Verizon incurs in provisioning residential services, based on a traditional, rate case review of Verizon's historic costs (Exh. AG-1, at 2).
In his Brief, the Attorney General also suggested that the Department order

anindependent audit of Verizon's regulatory accounting (AG Brief at 29-30). Thissuggestion was a repeat of an earlier request made by the Attorney General in hisappeal of the Track B procedural schedule. When the request was first made, theDepartment stated that the Attorney General must prove the need for such an audit aspart of an evidentiary showing in Track B. See Verizon, D.T.E. 01-31-Phase II, at 6,Interlocutory Order on Appeal by the Attorney General of Hearing Officer's Ruling onthe Procedural Schedule (September 3, 2002). Although the Attorney General did puton a direct case and sponsor an expert witness in Track B, nowhere in his direct case isthere any mention of the need for an independent audit of Verizon's regulatoryaccounting or evidence to support such a request. Therefore, the Department does notgrant the Attorney General's request.

Close Verizon, guided by the Department's tentative conclusions in the Phase I Order, proposes that basic residential prices fall within the range between incremental cost and stand-alone cost, subject to a five percent annual cap on rate increases (Exh. VZ-6, at 25). AT&T argues that Verizon's basic residential rates should be subject to a price floor that reflects the costs Verizon imposes on competitors for inputs necessary to provide a competing service plus Verizon's retailing costs, rather than the incremental cost Verizon incurs to provide the service itself, and suggests that a ten percent annual cap on rate increases might be necessary to enable Verizon to set retail rates that recover the economic cost of providing basic dial-tone line service and attract competitive entry (Exh. ATT-1, at 17, 26).

For the reasons discussed in detail below, we determine that it would not be consistent with the Department's goal of rate continuity to establish a floor of imputed incremental costs plus retailing costs for basic residential services. Establishing such a price floor could require over a $6.00 per month increase in the residential dial-tone line rate.
As discussed further below, this estimate is derived using the new UNE rates proposedby Verizon in its February 13, 2003 compliance filing in the Department's UNE RatesProceeding, D.T.E. 01-20. Pursuant to 220 C.M.R. § 1.10(3), the Departmentincorporates this material from the D.T.E. 01-20 record for illustrative purposes insupporting its conclusions regarding the interplay between UNE rates and Verizon'sbasic residential service rates.

Close However, in order to move basic exchange rates closer to economically efficient levels and improve conditions for local exchange competition, while meeting our statutory obligation to ensure just and reasonable rates, we determine that a one-time increase of $2.44 in Verizon's dial-tone line charge is warranted at this time, with no further pricing flexibility absent a Verizon demonstration of sufficient competition.

b. Cost-of-Service

As an initial matter, we disagree with the Attorney General's proposal to continue the rate freeze for basic residential services and conduct a cost-of-service study. The

Attorney General’s recommendation is based on his assertion that “there is no cost data that justifies an increase in the price of residential service,” and his position that Verizon’s proposal violates two fundamental regulatory principles: (1) the prohibition against raising rates without current supporting cost data; and (2) the requirement that rates reasonably approximate what would obtain in a competitive market (Exh. AG-1, at 5). As discussed below, we disagree with the Attorney General’s choice of historic costs as the appropriate standard. Further, we do not share the Attorney General’s position that any increase in basic residential rates without a traditional cost-of-service study violates our regulatory goals or Massachusetts statutory requirements.

Prior to 1995, the Department regulated Verizon using a rate of return model, under which Verizon’s aggregate revenue requirements were calculated based on its recorded costs in an historic test year, including a fair rate of return on its capital base. This method has been commonly referred to as “cost plus,” (i.e., revenues equal historic costs plus a return on investment). Once the revenue requirement was established, prices for individual services were then determined on the basis of historic billing determinants in order to equal the approved revenue requirement. It is important to note, though, that prices for individual services calculated in this manner were not required to have any connection to either cost causation or equalization of rates of return from specific services or customer classes. See D.P.U. 89-300, at 10-16 (1990). Long-distance, toll, and business rates were priced above cost in order to subsidize basic residential services, which were priced below cost to promote universal service.
Universal service means that the rate structure for telecommunications companiesensures rates that allow basic telecommunications services to be obtained by the vastmajority of the state’s population. D.P.U. 89-300, at 12 (1990).

Close See D.P.U. 93-125, at 4 (1994).

As noted, the rate structure used to recover the revenue requirement often had little or no relation to marginal or incremental costs. In other words, the statutory mandates that rates be just and reasonable and result in reasonable compensation for the service provider (see G.L. c. 159, §§ 14, 17, 20) were satisfied only in terms of the overall revenue requirement. Similarly, a “general increase in rates” has been interpreted to mean an increase in the regulated company’s overall revenues – rather than an increase in a particular rate element – which triggers the notice, hearing, and other obligations contained in G.L. c. 159, § 20, pertaining to general rate increases.
For example, non-dominant carriers have raised rates for particular services numeroustimes since 1985 without triggering the G.L. c. 159, § 20 requirements for notice and ahearing.

Close See Price Cap Order at 219-220.

Further, given that business services have already been granted upward pricing flexibility in our Phase I Order, and non-basic residential services have been subject to market-based pricing since the Department's first rate re-balancing order (D.P.U. 89-300 (1990)), the Department recognizes that conducting an embedded cost-of-service study today for only one set of Verizon customers would be difficult and, more importantly, would not produce an economically rational result. This is because the allocation of joint and common costs shared between business and residential services, as well as basic and non-basic residential services, would be unacceptably arbitrary (see Exh. VZ-2, at 15). Moreover, we agree with AT&T that the allocation methodologies of a cost-of-service study often result in rates and costs that are inconsistent with cost-causation principles (Exh. ATT-2, at 2). In addition, unlike forward-looking economic costs, embedded costs focus on historic accounting costs instead of the costs that an efficient firm would face going forward (Exh. VZ-6, at 8 and n.4, 24). We also remain concerned that cost-of-service regulation may facilitate a regulated company's ability to cross-subsidize competitive services with revenues from regulated services (see Exh. VZ-2, at 15). Phase I Order at 99.

The Department has previously noted that the "simulation of the results of a competitive market is a principal goal of regulation" (Price Cap Order at 105), and found that we could "look to principles of competitive pricing to judge whether regulated prices for specific services are just and reasonable." Phase I Order at 101. We agree with Verizon that prices in competitive markets tend to be subsidy-free and efficient in that they are driven as close to their underlying costs as possible (Exh. VZ-6, at 25-26). We also agree that incremental cost is the only measure of cost that is forward-looking and reflects the underlying cost caused by a certain activity (id. at 8). Embedded cost analysis, on the other hand, is a historical cost analysis that is not compatible with principles of market-based, forward-looking pricing (id. at 24). See D.P.U. 89-300, at 13, quoting IntraLATA Competition Order at 38 ("[P]roperly defined marginal costs 'represent the most efficient costs to be considered for pricing services as competition enters a marketplace,' and, therefore, are consistent with the Department's goals of economic efficiency and fairness"); Price Cap Order at 108-112, 128 ("The Department is not abandoning its long-standing commitment to competition in telecommunications, so the promotion of allocative efficiency must and should [continue to] be important . . ."). See also Verizon Communications, Inc. v. Federal Communications Comm'n, 535 U.S. 467, 122 S. Ct. 1646, 1665-1667 (holding that 1996 Telecom Act does not require that TELRIC rely on historical costs for developing forward-looking rates).

Moreover, we determine that our statutory mandate does not require us to conduct a cost-of service study of Verizon's basic residential services. G.L. c. 159 does not differentiate between dominant and non-dominant carriers, CLECs and ILECs, LECs and interexchange carriers, etc. Our obligations under chapter 159 apply equally to every common carrier. Therefore, any argument to the effect that we are legally required to take certain measures in regulating Verizon, but not in regulating all other common carriers, is incorrect. For example, if we are legally required to conduct a cost-of-service evaluation to determine that Verizon's rates are just and reasonable, as argued by the Attorney General, then we must conduct the same evaluation for every common carrier. In fact, it is the opposite of this argument that is correct – if it is legally permissible to rely on market forces or non-revenue-requirement-based cost measures to determine that other common carriers' rates are just and reasonable, as we have done for all non-dominant carriers since 1986 pursuant to the IntraLATA Competition Order, then it is legally permissible to do so for Verizon's residential services as well. And, where we do decide to use a cost standard for judging whether rates are just and reasonable, we are free to choose the appropriate cost standard, whether it be fully-allocated, historic cost, marginal cost, TELRIC, or TSLRIC. See American Hoechest Corp. v. Department of Pub. Utils., 379 Mass. 408, 413 (1980) ("[W]hen alternative methods are available, the department is free to select or reject a particular method as long as its choice does not have a confiscatory effect or is not otherwise illegal"); New England Tel. & Tel. Co. v. Department of Pub. Utils., 371 Mass. 67, 71 (1976) (holding that although the Department is not required to use a method based on an adjusted historic test year in rate proceeding, it is permitted to do so).

c. Continuation of Price Cap

In addition, we determine that a price cap methodology for regulating Verizon's basic residential services is unwarranted. In 1995, the Department determined that price cap regulation would be superior to ROR regulation in terms of benefits to both ratepayers and Verizon (then, NYNEX) because price cap regulation promotes technical efficiency "Technical efficiency" is the measurement of the value of resources expended toproduce goods and services. Price Cap Order at 108.

Close by providing the regulated firm with the types of incentives found in a competitive marketplace. Price Cap Order at 110-111. The Department also decided to terminate the transitional rate re-balancing process before the target rates discussed in D.P.U. 89-300 (1990) were achieved and initiated a freeze on basic residential service rates for the duration of the price cap plan. However, because an "inflation minus productivity" price cap is designed to control the aggregate prices and earnings of a regulated company, and not to determine just and reasonable rates for any particular rate element, An "inflation minus productivity" price cap is not a tool of rate design; rather, it is akinto the establishment of a revenue requirement.

Close we determine that continuation of "inflation minus productivity" price cap regulation is unlikely to yield efficient prices for Verizon's basic residential service going forward. See Phase I Order at 101.

d. The Appropriate Cost Standard

As stated above, we can look to principles of competitive pricing to assess whether rates for individual services are just and reasonable. Due to the presence of large shared and common costs, efficient market prices in competitive markets for telephone services are based on incremental costs plus a mark-up for joint and common costs pursuant to Ramsey pricing principles, where joint and common costs are recovered in inverse proportion to the demand elasticity of particular services. See Price Cap Order at 249 n.144.

The Department agrees with the Attorney General that it would be unrealistic for "regulators to estimate all the own-price demand and cross-price demand elasticities necessary to implement Ramsey prices" (Exh. AG-1, at 20). Verizon also asserts that "it is practically impossible to obtain precise measurements of price elasticity in a dynamic competitive market" (VZ Brief at 12). We have also previously noted that it is "impractical for regulators to determine demand elasticity (and, thus, efficient mark-ups) for any specific service." Phase I Order at 101.

However, we agree with Verizon that precise knowledge of individual own-price and cross-price elasticities for all of Verizon's services is not necessary to move prices toward efficient levels (Exh. VZ-6, at 28). There was no disagreement among the economists testifying in this proceeding that Ramsey pricing principles require rates that "place greater responsibility for the recovery of joint and common costs on services having the lowest elasticities of demand" (VZ Brief at 10). Persuasive expert testimony in this case, and the econometric literature submitted by the parties in this proceeding, show that the demand for basic residential service is very inelastic, and likely very close to zero (see Exh. DTE-ATT 4-1; AT&T Brief at 20). And the evidence presented by both AT&T and Verizon suggests that the demand elasticity for usage-based services is considerably higher, perhaps even several orders of magnitude higher (see Exhs. AG-VZ 1-1; DTE-ATT 4-1).

The Attorney General concurs that basic residential services historically has been the least elastic service offered by a telephone company, and we are persuaded that the alternative services that have emerged as substitutes for Verizon's basic residential service (e.g., wireless and cable telephony) also serve as substitutes for Verizon's usage and other services, and have not significantly altered the price elasticity for basic residential service relative to these other services. Thus, we can reasonably conclude that, in comparison to usage-based services, basic residential service remains the most inelastic service. Indeed, using a strict application of Ramsey pricing principles (with efficiency as the only consideration), the order of magnitude difference between the elasticity estimates for basic residential service and usage-based services would require the assignment of almost all joint and common costs to basic residential services. In fact, assignment of all joint and common costs to the most inelastic rate element was the basis for the illustrative tariffs that guided the Department's decisions on rate re-balancing in the series of cases that began with D.P.U. 89-300. See D.P.U. 86-33-G at 477-478 (1989).

A review of Verizon's detailed contribution margin analyses indicates that basic residential services contribute far less to the recovery of joint and common costs than virtually all other services (see Exh. VZ-5, Atts. A, B). Specifically, the analyses demonstrate that the relative contribution from the residential dial-tone line rate is significantly below that of almost all other Verizon residential services, even compared to different measures of incremental costs from Verizon's Marginal Cost Study VI (1994) and the 1997 TELRIC study developed in the Consolidated Arbitrations (see id.). Verizon demonstrates that the present dial-tone line rate contains a 21.82 percentmargin above marginal costs. The -18.85 margin relative to TELRIC cost is due to theloading of 25 percent for joint and common costs already included in the TELRICrates. If joint and common costs are removed from TELRIC, the present dial-tone linerate has an 8.76 percent margin above TELRIC (see Exh. VZ-5, Att. B).

Close We agree with Verizon that this level of contribution is “neither fair nor economically efficient and is not a result that would prevail in an unregulated competitive market” (VZ Brief at 23).

The Attorney General’s assertion that Verizon’s measures of incremental cost are inaccurate and overstate the true incremental cost of providing basic residential service is based on the Attorney General’s position that the local loop is a shared facility, the cost of which should be allocated to the various services that use the loop (Tr. 2, at 223). The Attorney General’s assertion that the contribution margin for the residential dial-tone line rate may be higher than shown in Verizon’s contribution margin analyses is premised on this “shared cost” assumption, which results in a lower underlying marginal cost for providing residential service. However, the Attorney General’s assertion is inconsistent with the principles of cost causation, under which responsibility for the costs incurred to provide the loop is assigned to the customer who caused that cost to be incurred.

We agree with Verizon and AT&T that the local loop is demanded in its own right, and that the cost of the loop is incurred and easily identified when it is provisioned – irrespective of subsequent usage (Exhs. VZ-6, at 6-21; ATT-2, at 7-8).
The assertion of Verizon’s witness, Dr. Taylor, in an October 4, 2000 proceedingbefore the New Mexico Public Regulatory Commission that the loop is a shared cost –which the Attorney General asserts contradicts Verizon’s position in the instantproceeding – specifically addresses the recovery of shared costs between voice access tothe network and the high-frequency data UNE, which are truly joint products in thesense that they are only available in a fixed proportion where the individual incrementalcosts of voice access and data access are not defined (see Exhs. VZ-7, at 19-20; AG-6). In the same proceeding before the New Mexico Commission, Dr. Taylor clearly statedthat, with respect to basic exchange service and other telephone services, cost causationdictates that the loop cost should be borne entirely by basic exchange service (Exh. VZ-7, at 75-78). Therefore, we determine that Dr. Taylor’s assertions in the New Mexicoproceeding do not contradict Verizon’s position in this proceeding.

Close This is the same conclusion the Department reached in the late 1980's when it reviewed Verizon’s marginal cost study (see D.P.U. 86-33-G at 455 (“Access is customer-related because it is the demand for lines connecting the customer’s premises with the central office that causes these costs to be incurred”)), and the record in this case does not cause us to revise that finding in this context. Therefore, we determine that the entire cost of the loop is properly identified on a cost-causative basis with the provision of access, whether as an unbundled loop or bundled with local usage as basic residential service. We further determine that this incremental cost is not an insignificant amount because, in a network industry, the cost of access should be calculated prior to the services that rely on that access. When the cost of the loop is identified entirely with the dial-tone line rate (as in Exh. VZ-5, Att. B), the dial-tone line rate contains significantly less contribution to joint and common costs than usage-based services.

The question then is what measure of incremental cost is appropriate for ensuring that rates are just and reasonable and promote efficient competitive entry? For the reasons discussed below, we conclude that TELRIC is the appropriate cost standard to meet these goals. AT&T argues that, because Verizon charges competitors more for the network elements necessary to provide a competing service than the marginal cost it incurs to provide the service itself, UNE-based competitors that require inputs from Verizon will not be able to compete unless Verizon's basic residential rates equal or exceed the sum of the TELRIC-based UNE rates of the UNEs that comprise basic residential service plus Verizon's retailing costs. Whereas Verizon may argue that its prices should be based on marginal cost or TSLRIC data, approval of such prices might enable Verizon to engage in an anticompetitive "price squeeze" by decreasing its retail rates until the margin between its price for basic residential service and the cost of the underlying UNEs is reduced to the point where UNE-based residential service competitors cannot efficiently compete with Verizon.
While the Department's grant of upward pricing flexibility for Verizon's retail businessservices that are contestable on a UNE basis required a showing of sufficientcompetition, that pricing flexibility was also predicated on the establishment of a pricefloor "equal to the density zone-specific UNE rates underlying the service plus a mark-up equal to the resale discount percentage." Phase I Order at 92.

Close

Another factor weighing in favor of using TELRIC as the appropriate cost standard is that TELRIC already includes an allocation of joint and common costs. The allocation of joint and common costs in the TELRIC model is a fixed percentage, and thus is not consistent with Ramsey pricing principles. But, with the difficulties associated with setting Ramsey-based prices discussed above, it is an acceptable alternative to rely on a fixed percentage allocation, which at least moves in the direction of a more efficient allocation of joint and common costs. In effect, the Department concludes that our standard for judging the reasonableness of regulated rates for telecommunications services – whether wholesale or retail – should be harmonized by using the same cost standards (see Section IV.D, below, for a discussion of re-pricing of certain wholesale services), and that this "bottom-up" approach is more compatible with determining individual rate elements, rather than the "top-down" cost analyses used in cost-of-service or price cap regulation, which are relevant only to aggregate determinations of revenue requirements.

While the Department concurs with AT&T that ideally, Verizon's basic residential rates should be set at least equal to the cost it imposes on its competitors to provide a competing service, that is, the UNE rates underlying the competing services (averaged across the state for UNE prices that differentiate by zone), plus a mark-up equal to the

resale discount percentage, requiring this change would necessitate such a large increase in the price of basic residential service that it would be incompatible with the important Department goal of rate continuity. For example, using the new UNE rates under review in the Department's D.T.E. 01-20 proceeding, this approach would require an increase of $6.58 over Verizon's current dial-tone line charge of $9.91 (an increase of over 66 percent), which, as noted above, is the least elastic rate element for basic residential services.
This estimated increase is calculated using a 24.99 percent retail markup and $15.26loop and $2.73 port UNE rates. ($15.26 + $2.73) (1.2499) = $22.49. The currentrate for Verizon's One Party Measured Residential Service ("1MR") is $15.91 ($9.91dial-tone line charge + $6.00 Federal subscriber line charge). $22.49 - $15.91 =$6.58. See UNE Rates Proceeding, D.T.E. 01-20 Part A-A, Verizon ComplianceFiling, Tab 2A (February 13, 2003); Tariff M.D.T.E. No. 10, Part M, Section 1, Page14. We use 1MR in this analysis because it is the most basic and inexpensive ofVerizon's basic residential services, and this service will show the largest change withan increase in the dial-tone line charge.

Close The Department therefore faces the challenge of balancing its interest in encouraging efficient competitive entry with its commitments to rate continuity and continuation of universal service. While in the past, the Department has embarked upon a multi-year, transitional process to achieve large increases in basic residential service rates, From 1990 to 1994, the Department gradually increased residential dial-tone line ratesfrom $1.19 to $9.91 before instituting the rate freeze in 1994 (see VZ Brief at 16).

Close by adopting the significantly smaller, one-time increase discussed below, we conclude that a multi-year approach is unnecessary.

In balancing our competing goals, we conclude that a one-time increase of $2.44 in Verizon's dial-tone line charge represents a substantial movement in the direction of aligning local telephone rates with their underlying costs without burdening consumers with rate shock or potentially affecting the overall rate of telephone subscription in Massachusetts.
As discussed fully below in Section IV.D.3, an elimination of the separate charge forVerizon's Touch Tone service will bring the increase in the dial-tone line charge to lessthat $2.00 for the vast majority of Verizon's residential customers.

Close

This increase is close to the average increase of $2.18 per year implemented during the four years of Department rate re-balancing in the early 1990's,
In the last rate re-balancing effort undertaken in the early 1990's, the Departmentordered the following increases in Verizon's dial-tone line charge: $3.31 in 1990,$1.12 in 1991, $1.80 in 1993, and $2.49 in 1994. D.P.U. 89-300 (1990); D.P.U. 91-30 (1991); D.P.U.

92-100 (1992); D.P.U. 93-125 (1994).

Close which record evidence shows to have had virtually no impact on the residential telephone subscriber penetration rate. Despite a total increase in the dial-tone line rate of over 730 percent between 1990 and1994 in Massachusetts, the residential subscriber penetration rate barely declined, from96.6 percent in 1990 to 96.5 percent in 1994, and, as of November 2001, theresidential penetration rate in Massachusetts stood at 95.9 percent (Exhs. VZ-2, at 10;AG-2, at 12).

Close Therefore, we conclude that this one-time $2.44 increase in basic residential rates will not harm the Department's universal service goals. Moreover, the very low elasticity of demand for dial-tone service confirms that small increases in that charge will have a negligible effect on residential subscriber penetration, if any. In addition, this increase is also roughly comparable to recent increases in basic residential rates in several other states, The Maine Public Utilities Commission approved a $1.78 increase in Verizon's basicmonthly per line rate in May 2001. Investigation into Verizon-Maine's AlternativeForm of Regulation, MPUC Case No. 99-851, Part 2 (May 9, 2001). The New YorkPublic Service Commission authorized a two-year Verizon Incentive Plan (with a thirdyear for the Service Quality Plan) which permits increases in the Basic Service chargesup to $1.85 in the first year and $0.65 in the second year for the customer's first line. Proceeding on Motion of the Commission to Consider Cost Recovery by Verizon and toInvestigate the Future Regulatory Framework, NYPSC Case No. 00-C-1945 (February27, 2002). According to the NYPSC, these increases would count against a 3 percentcap on overall revenue growth for Verizon. Id.

Close and to the overall increase in the Federal subscriber line charge since 2000. The Federal subscriber line charge has increased from $4.35 in July 2000 to $6.00 inJuly 2002. See 47 C.F.R. § 69.152(d).

Close We have chosen $2.44 per line for this increase in order to make it proportionate to changes we are making to rates for services that are currently priced at inefficiently high levels (see Section IV.D.3, below). Ideally, all wholesale services would be priced at UNE levels, and all retail services would be priced to cover the imputed UNE costs plus retailing costs. But, as discussed above, such a move would violate our goal of rate continuity. Therefore, we have concluded that a partial movement toward a more efficient rate structure is appropriate, and it is fair to keep the increases in proportion to the decreases.

While an increase of $2.44 to Verizon's dial-tone line charge falls short of moving the price of 1MR

The current rate for Verizon's 1MR service is $15.91 ($9.91 dial-tone line charge +$6.00 Federal subscriber line charge). See Tariff M.D.T.E. No. 10, Part M, Section1, Page 14.

Close to its ideal level (i.e., at least equal to the sum of the underlying UNE rates plus a retail markup), it is important to note that 1MR lines constitute a very small subset of total Verizon residential lines. Verizon's 1MR lines constitute approximately 4.3 percent of total Verizon residentiallines. See Verizon Massachusetts Sixth Annual Massachusetts Price Cap ComplianceFiling, Section C at 27-28 (filed October 2, 2000).

Close The vast majority of Verizon basic residential services customers subscribe to various bundled packages that combine usage with basic dial-tone service. Bundled services that include usage with dial-tone access account for approximately95.7 percent of total Verizon residential lines. Id.

Close An increase of $2.44 in Verizon's dial-tone line charge ensures that the retail price of these bundled basic service packages would be priced above the sum of the underlying UNE rates plus a retail markup, thereby encouraging further competitive entry for these services. For example, One Party Unlimited Local Residential Service ("1FR"), Verizon's most popular bundled basic residential package is currently priced at $22.85. This current rate for Verizon's 1FR service is calculated as follows: $9.91 (dial-toneline charge) + $6.00 (Federal subscriber line charge) + $6.94 (unlimited local usage). See Tariff M.D.T.E. No. 10, Part M, Section 1, Page 14.

Close An increase of $2.44 in the dial-tone line charge would raise the price of 1FR to $25.29, which is above the cost that Verizon's competitors must incur to provide a competing service. This cost is calculated using a 24.99 percent retail markup and the following UNErates: $15.26 (loop) + $2.73 (port) + $0.9864 (switching [assuming a typical 600minutes of use per month]) (1.2499) = $23.72. See UNE Rates Proceeding, D.T.E.01-20 Part A-A, Verizon Compliance Filing, Tab 2A (February 13, 2003).

Close

Although the possibility of a "price squeeze" would continue to exist for CLECs that wish to serve the small class of customers who subscribe to 1MR, several reasons mitigate this concern. First, 1MR subscribers who demand vertical services, such as Call Waiting and Caller ID, can be excluded from the class of customers for whom competitors encounter a "price squeeze" because the relatively high margin built into vertical services ensures that the total rate paid by the customer at least meets the cost of serving that customer. Moreover, the emergence of residential service packages that bundle local and toll calling with long-distance calling (such as MCI's Neighborhood Plan, Sprint's Common Sense, and Verizon's own Veriations Plan) reduce the importance of the profitability of dial-tone access alone in encouraging and sustaining competition. We concur with Verizon's witness, Dr. Taylor, on the following:

[S]ometimes we ask the question, can a CLEC make money in residential service, for example? And for that, what matters is the full panoply of services that a CLEC or ILEC can expect to provide when it attracts a customer. So for that it makes sense to include the revenues and the costs from vertical services in the calculation.

(Tr. 1, at 16). Therefore, with the $2.44 one-time increase in Verizon’s dial-tone line charge, we determine that competitors can profitably enter and serve the residential telephone market in Massachusetts, without burdening consumers with a large increase, or multiple, multi-year increases in service rates. Because we conclude that a $2.44 increase in Verizon’s dial-tone line charge reasonably balances our goals in promoting competition and in ensuring rate continuity and universal service, we do not find that any further upward pricing flexibility for Verizon is warranted at this time. Verizon may seek further upward pricing flexibility for its basic residential services when it can demonstrate the presence of sufficient competition for these services, as it has with its retail business services.

We note that the economic conditions that the Department relied upon in grantingpricing flexibility for Verizon’s business services may be present for residentialservices. If that is the case, it may be appropriate for Verizon to seek classification ofresidential services as sufficiently competitive in order to better match regulatoryoversight to market conditions.

Close

In addition, Verizon sought and was granted in Phase I the ability to deaverage business prices by density zone, but Verizon did not seek that flexibility for residential prices. While retail prices that reflect geographic cost differences would enhance efficiency, particularly because UNE loop rates are geographically deaveraged, we do not believe deaveraging of basic residential rates would be appropriate at this time, nor does the record support such a change. The Department may, in a future docket, consider adoption of a universal service funding mechanism to reduce the arbitrage opportunities and the price squeeze problems presented by the interaction of deaveraged wholesale prices and averaged retail prices.

e. Affordability

We determine that pricing basic residential services in this manner continues the long-standing Department objective of a transition to more competitive, economically efficient prices for basic residential services, while also minimizing rate shock to consumers. Indeed, the increase of $2.44 (under $2.00 to Verizon’s Touch Tone customers) still constitutes about one third of the increase necessary to fully resolve the disparity between basic residential retail rates and the underlying UNE costs. Moreover, while the prices of Verizon’s basic residential services have fallen in real terms since 1994, Massachusetts incomes have increased in real terms, and the cost of basic residential service as a percentage of income has declined considerably from 0.76 percent in 1994 to 0.52 percent in 2002 (Exhs. ATT-6; VZ-3, at 15). Thus, we conclude that Verizon's basic residential service rates can be increased somewhat without compromising the affordability of basic residential service. Finally, as discussed further in Section IV.D.3, below, an increase in the LifeLine credit offers targeted assistance to those least able to afford telephone service, ensuring that the cost of basic telephone service remains unchanged for those customers who receive assistance for this service.

C. Non-Basic Residential Services
Verizon's non-basic retail residential services include such offerings as DirectoryListing Service, Busy Line Verification and Busy Line Interrupt, Ringmate Ring IDService, and Integrated Services Digital Network ("ISDN") (Exh. VZ-1, at Tab A,Att. B).

Close

1. Introduction

As part of our Phase I investigation, the Department tentatively concluded that Verizon's non-basic residential services should continue to be regulated differently from basic services. Phase I Order at 104. The Department noted that since the Department's first rate re-balancing order – D.P.U. 89-300 (1990) – non-basic services have been considered to be premium services, and the Department has allowed Verizon to price its non-basic services based on market conditions and revenue-maximization. Id. Consequently, in the Phase I Order, the Department tentatively concluded that, going forward, Verizon should be accorded at least the same level of flexibility as it currently has for its non-basic residential services. Id.

2. Positions of the Parties

a. Verizon

Verizon argues that the Department should grant pricing flexibility for Verizon's non-basic residential services consistent with the Department's findings in D.P.U. 89-300, at 146 (1990) and D.P.U. 92-100, at 62 (1992) regarding pricing flexibility for auxiliary and discretionary services (Exh. VZ-2, at 7; Tr. 1, at 18-19). Verizon further argues that because the Department granted pricing flexibility for Verizon's business services in Phase I of this proceeding, pricing flexibility for non-basic residential services is necessary in order to have symmetric competition among all carriers (Tr. 1, at 18-19). In addition, Verizon asserts that new services (which could include bundles of existing services) should be subject to the same pricing flexibility (id. at 20). With new services, argues Verizon, there is no "incumbent" provider per se, and no competitive harm (such as driving a competitor from the market) could result from allowing pricing flexibility for those services (id. at 19).

No other party addressed Verizon's non-basic residential services or new services.

3. Analysis and Findings

We agree with Verizon that a continuation of pricing flexibility for Verizon’s non-basic residential services is warranted. No party has provided any record evidence to support a departure from our current regulatory treatment of non-basic residential services, which has resulted in just and reasonable rates for these services, and we find that our telecommunications policy goals of continuity and simplicity would be best served by this approach. This pricing flexibility is consistent with our treatment of retail business services, in that these rates will continue to be set based on market forces. With regard to new services, we agree that in order to encourage innovation, pricing flexibility for new services is also warranted, subject to the applicable price floor rules.

D. Re-Pricing Issues

1. Introduction

In the Phase I Order, the Department ordered Verizon to re-price the following services: switched access, PAL, PASL, collocation, special construction, and residential Touch Tone.
Touch Tone is a service provided to Verizon residential customers that do not use arotary dial phone. Only 8.7 percent of Verizon’s Massachusetts customers continue touse rotary dial or “pulse” phones (Exh. AG-VZ 2-8).

Close Phase I Order at 61-64, 94-95, 105. The Department also required Verizon to calculate the new residential dial-tone line rate that would result from revenue-neutral reductions in access pricing. Id. at 63, 105. These directives were made in order to create a consistent regulatory framework and pricing standard for all wholesale services and to improve the efficiency of pricing.

2. Positions of the Parties

a. Verizon

Verizon proposes to increase its residential dial-tone line rate by $2.44 per month (from $9.91 to $12.35 per month) in order to offset the revenue loss resulting from the re-pricing ordered in the Phase I Order for Verizon’s switched access, Touch Tone, PAL, PASL, and collocation services (Exh. VZ-2, at 14).
The $2.44 per month increase to the residential dial-tone line rate would affect theminority of Verizon’s customers that do not currently have Touch Tone service (Tr. 2,at 109-110). For Verizon’s customers that do currently have Touch Tone service, theincrease would be $1.95 per month (id. at 110).

Close Verizon states that this rate increase will affect 2,745,851 residential customers in

Massachusetts, excluding the 163,605 LifeLine customers (Exh. AG-VZ 1-4). Verizon's LifeLine program provides statewide assistance to eligible Massachusettscustomers in the form of a discount in the monthly rates for one exchange service line. In order to receive this discount, customers must be participating in an eligible state orFederal assistance program, such as Supplemental Security Income, Food StampBenefits, or Fuel Assistance, and must meet eligibility guidelines on file with therelevant government agency. The rate reduction appears on the customer's monthly billand is determined as a specified amount of the state or Federal assistance received bythe customer (Exh. AG-VZ 5-4, Att. 1).

Close Verizon argues that no party has questioned Verizon's calculation of the Department-ordered offsets (VZ Brief at 5). Verizon argues that it has calculated its revenue losses based upon historical data, which is consistent with Department requirements (VZ Reply Brief at 4). Verizon further argues that the revenue-neutral approach reflects the continuation of the Department's rate re-balancing process initiated in D.P.U. 89-300 (1990), and is not associated strictly with ROR regulation (id. at 9).

Verizon argues that, in order to be consistent with the Department's rate re-balancing policy established in the late 1980s, and also because residential dial-tone is the most inelastic service of its offerings, "if the Department determines that Switched Access charges should be lowered, the offset should be made by an increase in . . . the Residence Dial Tone Line rate" (Exh. VZ-5, at 4).
As discussed above in Section III.C, Verizon did not include in its Phase I ComplianceFiling any calculations relating to reductions in Verizon's special access rates. Inresponse to Department questioning, Verizon states that reducing special access rates toUNE levels would necessitate an additional $0.01 per month increase to the residentialdial-tone line rate (using current demand assumptions), and a possible increase of up to$4.00 per month or more if all interstate special access lines were reduced to UNEpricing levels (Supp. RR-DTE-1; Exh. DTE-VZ 3-4; Tr. 2, at 112-113).

Close Verizon argues that, contrary to the Attorney General's characterization, the revenue-neutral filing for the reduction in switched access charges will not result in additional revenue for Verizon (id. at 1). Verizon argues that the "predominant" portion of the offset which accounts for switched access re-pricing to interstate levels is approximately $1.98 per month (see Exh. VZ-2, Att. A, Tab B (revised 8/28/02), Workpaper 1). The amount of Verizon's proposed monthly switched access offset is calculated asfollows: (line 22a, Switched Access Rate reduction w/o [demand] stimulation) / (line23, Access Lines Incurring Offset) / (12 months) or (-$61,225,920) / (2,582,246) / (12)= $1.98 (see Exh. VZ-2, Att. A, Tab B (revised 8/28/02), Workpaper 1).

Close

In addition, contrary to the Attorney General's argument that the approval of Verizon's proposal depends on the effect of the switched access rate changes on retail toll customers, Verizon argues that the Department has consistently re-balanced rates on a revenue neutral basis by gauging the effect on Verizon, not on its end users (VZ Reply Brief at 5). Further, Verizon argues that recovery of its revenue losses from residential customers is not discriminatory as the Attorney General contends (id. at 9). According to Verizon, its proposal to recover its revenue losses is based on Ramsey-efficient pricing principles (id.). Verizon argues that the Attorney General's witness, Dr. Gabel, agrees that Ramsey pricing principles would produce rates that place greater responsibility for cost recovery on services having the lowest elasticity of demand (id. at 7). Verizon argues that there is general agreement, with the exception of Dr. Gabel, that demand for residence customer access (i.e., dial tone) is highly inelastic, therefore, recovery of lost revenue from the residence class is reasonable (id.).

In addition, Verizon states that in the Phase I Order, the Department ordered Verizon to file a proposal to re-price PAL, PASL, and collocation services in a UNE-based manner (Exh. DTE-VZ 2-1). According to Verizon, its proposal includes an increase to the residential dial-tone line rate to offset the revenue effect of re-pricing these services, which is consistent with the revenue-neutral approach adopted by the Department for other reductions in wholesale rates (Exh. VZ-1, at 7). Verizon argues that the amount of the total offset required by the re-pricing of collocation services would be $15,925 per annum, and that the total offset amount to the residential dial-tone line rate would be reduced by the additional revenue generated by the re-pricing of PAL and PASL of approximately $345,000 (id. at 7, and Tab B, Att. 1, Workpaper1).

Further, Verizon proposes to eliminate the separate charge for Touch Tone service (id. at Tab B, Att. 1, Workpaper 1). Elimination of this separate charge, argues Verizon, will result in an additional increase of $0.47 per month to 238,879 non-Touch Tone subscribers (Exh. AG-VZ 1-4). Verizon argues that, consistent with Department precedent, because 91.3 percent of Verizon's residential customers subscribe to Touch Tone service, the service should be considered ubiquitous, and, as such, should be absorbed into the basic residential service rate (Exh. AG-VZ 2-8). Contrary to the Attorney General's claim that Verizon's Touch Tone proposal would be discriminatory, Verizon argues that it is reasonable and appropriate to consider this service as an integral element of basic service (VZ Reply Brief at 13).

Finally, to compensate for the proposed increase to the residential dial-tone line rate resulting from proposed offsets, Verizon proposes to increase the LifeLine credit equal to the proposed increase in dial-tone rates to maintain existing rate levels for LifeLine customers and that any future increase in the Dial Tone Line rate will result in an equal increase in the LifeLine credit (Exh. VZ-2, at 14). In this way, Verizon argues that LifeLine customers will be unaffected by any increase in the rate for basic dial-tone service (id.). Similarly, Verizon proposes that any rate increases to its service connection charges to install a network access line will "automatically result in an increase in the Link[-U]p America discount" (Tr. 1, at 51).
Verizon's Link-Up America program is a network connection assistance program thatprovides reduced connection charges for eligible households, consistent with

theLifeLine eligibility criteria (Exh. AG-VZ 5-5; see Tariff M.D.T.E. No. 10, sec. 1.7.1-1.7.2).

Close

b. Attorney General

The Attorney General argues that the Department should reject Verizon's proposal to increase residential dial-tone line rates to recover estimated revenues from reductions for switched access and other services (AG Brief at 9). The Attorney General argues that because Verizon bases its proposal on estimated – not actual – lost revenue, Verizon may reap a windfall if its actual revenue losses are not as much as its estimated losses (id. at 11). A more fair approach, argues the Attorney General, would be for Verizon to recover only its actual lost revenue and conduct an earnings review to ensure that the increases are necessary for Verizon to obtain reasonable compensation (id.).

Further, the Attorney General argues that there is no record evidence that shows that interexchange carriers will pass along their savings from reduced intrastate access charges to Verizon's customers, such that increases in residential dial-tone may not be revenue-neutral to the customer (id. at 11-12). In addition, the Attorney General argues that lost revenue from reductions in PAL, PASL, collocation, and special access rates would come from both business and residential customers, while residential customers are unjustly and discriminatorily being asked to compensate for all of the lost revenues (id. at 12). Moreover, argues the Attorney General, the concept of revenue-neutrality is used under rate of return regulation, which, according to the Attorney General, the Department has concluded is inappropriate for Verizon's residential services (id.).

In addition, the Attorney General argues that charging customers for Touch Tone service when they have not requested it would be unfair (id. at 13). The Attorney General argues that Verizon has presented no evidence to support its proposal to change Touch Tone from an optional to a mandatory service, and that the monthly dial-tone line increase from Verizon's re-pricing would unfairly fall on Verizon's residential customers who have not requested Touch Tone service (id. at 13-14).

c. AT&T

AT&T argues that in order to enable competition, the Department must establish efficient prices that move away from traditional residual pricing methods (Tr. 3, at 292). AT&T states that in the Phase I Order, the Department found that the reduction in switched and special access rates must be made up by increasing residential dial-tone rates (Exh. ATT-1, at 26 n.11). However, AT&T argues that the Department's determination that residential dial-tone rates must increase as a result of the reductions in access pricing is inconsistent with the regulatory approach the Department seeks to implement to transition to a competitive residential marketplace (id.). AT&T argues that determining efficient input prices is independent from establishing subsidy-free residential rates; and that “[o]nly in the by-gone era of ratemaking in which policymakers sought ‘to keep the Company whole’ would such logic apply” (id. at 27 n.11; see AT&T Reply Brief at 10). AT&T argues that to link together a reduction of input prices with an increase in residential rates in order to achieve efficient pricing levels is “the wrong logic for getting to what may be ultimately the right conclusion” (Tr. 3, at 292). AT&T argues that to do so “would be, in a sense, unjust and unreasonable” and urges the Department “to not perpetuate the cost-of-service, ‘make-whole’ logic of linking these two sets of prices” (id. at 293; see Exh. ATT-1, at 27 n.11).

3. Analysis and Findings

Although the Department ordered the re-pricing of Verizon’s switched access, PAL, PASL, collocation, special construction, and residential Touch Tone services as part of Phase I of this proceeding (see Phase I Order at 61-64, 94-95, 105), and discussed whether Verizon was in compliance with our directives in the Track A section of this Order, the focus of the Department and the parties in our Track B proceeding has been the effect that this re-pricing will have on the rates for Verizon’s residential services. Verizon argues that, consistent with the Department’s tentative conclusions in the Phase I Order, all of the revenue losses resulting from the Department-ordered re-pricing should be made up by revenue-neutral increases to Verizon’s residential dial-tone line charge.

As an initial matter, the Department agrees with Verizon that it is appropriate to eliminate the separate charge for residential Touch Tone service and to price switched access at interstate levels. In the Department’s first rate re-balancing Order, we stated:

[to] the extent that subscription to a service like touch tone (or any other supplemental service) becomes so widespread as to be considered basic service to most customers, there may be no real difference between maintaining the rates above cost for that supplemental service, or reducing the rate for the supplemental service and increasing the basic monthly charge. Indeed, if the cost for a universally accepted supplemental service is very low, at some point it may be appropriate to eliminate the separate charge altogether and make the service part of basic exchange service.

D.P.U. 89-300, at 146-147 (1990). We agree with Verizon that 91.3 percent of Verizon’s residential customers subscribing to Touch Tone service constitutes, in effect, ubiquitous subscription to this service and that the separate charge should be eliminated. Similarly, as part of its review of Verizon’s fifth price cap filing, the Departmentallowed Verizon to eliminate the separate charge for Touch Tone for Verizon’s businesscustomers. Verizon, D.T.E. 99-102, at 16-18 (2000).

Close Because the cost for this “universally accepted supplemental service” is low, we will eliminate the separate charge and make Touch Tone part of Verizon’s basic residential service, consistent with our related holdings in D.P.U. 89-300 (1990) and

D.T.E. 99-102 (2000). As additional support for the inclusion of Touch Tone into basic residential service, theDepartment can look to the FCC’s designation of Dual Tone Multi-Frequency signaling(i.e., Touch Tone) as a “core” service to be supported by universal service. See In theMatter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45,Report and Order, FCC 97-157, at ¶ 61 (rel. May 8, 1997).

Close It is also appropriate to lower switched access rates to interstate levels, as we concluded in the Phase I Order. Otherwise, it could cost customers more to make calls across the state than it does to make calls across the country.

Turning to a discussion of the Department-ordered re-pricing of certain wholesale services, including access services, we conclude that the concept of pricing for basic residential services we have adopted in this proceeding, and the concept of “revenue-neutral price changes” between wholesale and retail services, are not incompatible because we are only moving partially towards efficient rates. As discussed above in Section IV.B.3, the pricing structure we adopt in this proceeding for Verizon’s basic residential services is consistent with the goals established in the Department’s IntraLATA Competition Order and continues to move all rates towards their economically efficient levels. If we were moving rates to the ideal level where all wholesale services are priced at UNE levels and all retail services are priced to recover UNE and retailing costs, then it would not be appropriate to link revenue losses on one side with revenue increases on the other, as AT&T suggests. However, for the reasons discussed above, we are not willing to move fully to economically ideal rates at this time. Therefore, it is appropriate and fair that movement on one side of the ledger be matched with symmetrical movement on the other side. For example, it would not be fair to increase residential retail rates by an amount that produces more revenue than Verizon is losing from reductions towards efficient rates in other areas, and vice versa.

We also agree with Verizon that an increase in the LifeLine credit is necessary to maintain existing rate levels for Verizon’s customers receiving assistance through the LifeLine program. Therefore, we order Verizon to increase its LifeLine credit commensurate with the increase adopted in this proceeding for Verizon’s basic residential service. In addition, consistent with Verizon’s proposed plan, we find that any future increases to Verizon’s monthly rates for one- or two-party Unlimited Basic Exchange Service, Low Use and Standard Residence Measured Service 4E (Four Element), and Residence Measured, Circle Calling, Suburban, Metropolitan, Bay State East, and Call Around 413 services shall be met by an increase to its LifeLine credit; and any future increases to Verizon’s Element 1 or Element 2 service connection charges shall be met by an equal increase to its Link-Up America discount.

E. Quality of Service Plan

1. Introduction

In the Price Cap Order, the Department adopted a price cap form of regulation for

Verizon that included a Service Quality Plan designed to evaluate the overall level of service provided by Verizon to its retail customers. D.P.U. 94-50, at 229. Under the Service Quality Plan established in the Price Cap Order, any increase in rates would be subject to Verizon meeting specified levels of service quality for its retail customers. The Service Quality Plan focused on twelve key measures in the three service categories of installation, maintenance, and service response. Id. at 77-78 (see also Exh. DTE-VZ 1-3). Depending on the level of performance, points were assigned to each individual measure, and combined to produce a monthly Service Quality Index ("SQI") score. Id. at 78. The SQI operated by requiring that Verizon maintain or achieve a Department-mandated 33-point level of service quality. Id. at 236. If the total SQI score for a given month was less than the required 33 points, or if three or more of the twelve individual measures used to calculate the SQI scored zero points, the Department assessed Verizon a financial penalty that increased the productivity offset of one twelfth of one percent for each month in which the SQI criteria was not met. Id. at 238. By increasing the productivity offset, the retail revenues received by Verizon were reduced by the penalty amount (Exh. DTE-VZ 3-7).

In the Phase I Order at 105, the Department directed Verizon to include as part of its compliance filing a proposed Service Quality Plan with associated penalties to succeed the formula adopted in the Price Cap Order.

2. Positions of the Parties

a. Verizon

In the Phase II (Track B) evidentiary proceeding, Verizon argues that the Massachusetts telecommunications market is sufficiently competitive to discipline Verizon to provide high quality service to its retail customers, and, therefore, there is no need for the Department to impose any retail service standards and penalties (Exh. VZ-4, at 1-2, 18-19; Tr. 2, at 138; VZ Brief at 19-20).
Verizon asserts that it is currently the only telecommunications carrier in Massachusettssubject to Department-imposed retail service quality standards (VZ Brief at 20). Verizon further asserts that the Department's application of service qualityrequirements to one carrier only is discriminatory and could distort the competitiveprocess (VZ Reply Brief at 23).

Close If the Department finds that a service quality plan is necessary, Verizon argues that retention of the Service Quality Plan adopted in the Price Cap Order (as proposed in Verizon's Phase I Compliance Filing, governing both Verizon's retail residential and business services) will ensure that if Verizon's retail service quality falls below the Department threshold, Verizon will be subject to a penalty (Exh. VZ-4, at 2-4).

Verizon argues that in lieu of a penalty payment based on a productivity offset of one twelfth of one percent (as required in the Price Cap Order), Verizon will forfeit one twelfth of one percent of annual retail revenue for every month that either the overall

performance level was less than the existing 33-point level, or if three or more of the twelve individual service items that comprise the SQI fell below a specific threshold on a statewide basis in a given month (Exh. VZ-1, at 8-9, Tab A at 5). Verizon proposes that at the conclusion of each calendar year, it would incur a financial penalty if it does not meet the service quality requirements in any of the preceding twelve months (Exh. VZ-2, Att. 2, at 5). The penalty payment would be made as a one-time credit to all residence and business lines on an annual basis (Exh. VZ-1, at 8-9, Tab A at 5).
Verizon asserts that it would petition the Department to have monthly service qualityresults modified during periods of emergency, catastrophe, natural disaster, severestorms, or other events beyond Verizon's control (Exh. VZ -4, Att. 2, at 6).

Close Verizon states that the proposed penalty provision is intended to replicate the penalty mechanism established in the Price Cap Order, adjusted to reflect the fact that Verizon's proposed alternative regulation plan does not include a price cap formula (Exh. DTE-VZ 1-9).

Finally, Verizon argues that the Attorney General's suggestion to open a new Department investigation to examine Verizon's service quality measurements and thresholds is untimely and should be rejected (VZ Reply Brief at 24). Verizon argues that the Attorney General had the opportunity within the instant proceeding to present alternatives to Verizon's proposed service quality plan, and the Attorney General chose not to do so (id.). Moreover, Verizon argues that although its current service quality standards were established in 1995, the fundamental needs and desires of customers have not changed since that time; therefore, changes to the current plan are unnecessary (id. at 24-25).

b. Attorney General

The Attorney General argues that the Department should reject Verizon's proposal to eliminate service quality requirements, and should maintain an effective retail service quality standards and reporting system (Exhs. AG-1, at 5; DTE-AG 1-1; AG Brief at 30-32). The Attorney General argues that the Department cannot rely on market forces alone to correct Verizon's incentive to cut service quality where there is no effective competition, and that the Department should not hold Verizon to lower retail performance standards than the Department requires of electric or natural gas distribution companies (AG Reply Brief at 15-16). The Attorney General further argues that the vast majority of telephone customers depend on Verizon to establish the service quality level, either directly as a provider of retail services, or indirectly through CLECs' use of UNE-P or resale (Exh. DTE-AG 1-1). In support of his position, the Attorney General relies upon a recent FCC study that indicates at least 93% of all end users depend on Verizon to set the level of service quality (id. at Att. A). If the Department does not continue the productivity factor in a price cap formula, the Attorney General agrees that Verizon should make one-time payments to its retail customers for any substandard retail service (AG Brief at 31).

However, the Attorney General argues that the current service quality plan containing twelve service quality categories and mandated service thresholds is outdated and does not reflect changing markets or Verizon's ability to provide increasingly higher quality service (id. at 32-33). Therefore, the Attorney General argues that the Department should undertake a further investigation to analyze ten years of Verizon's consumer complaint and service quality data, as well as to review the different types of service quality items and thresholds used in other jurisdictions (id. at 33-34; see Exh. DTE-VZ 1-8). As a result of this further investigation, the Attorney General argues that Verizon's service quality standards should be revised and service thresholds should be raised (AG Brief at 34-35).

3. Analysis and Findings

As an initial matter, we disagree with Verizon's position that a continuation of the Department's monitoring of Verizon's retail service quality is unnecessary and discriminatory. In the Price Cap Order, the Department concluded that because price cap regulation introduces a financial incentive for the regulated firm to reduce costs, a well-designed price cap plan must also include some form of protection against reduction in service quality; otherwise, the regulated entity could increase its profits by reducing service quality. Price Cap Order at 235-236. The Department's adoption of a price cap form of regulation for Verizon therefore included a service quality plan designed to evaluate the overall level of service provided by Verizon to its retail customers.

Although Verizon is no longer subject to price cap regulation, competition for some customers may introduce a financial incentive for the regulated entity to reduce costs by reducing service quality to other customers, so we conclude that there should continue to be some form of protection against a reduction in service quality. Therefore, given that Verizon's residential retail services will be regulated under the alternative form of regulation we have established in this proceeding, the Department finds it reasonable and appropriate to continue a retail service quality plan and penalty mechanism for these services. While the decisions of other state utility commissions are not determinative, our approach is consistent with the actions of the California, Connecticut, Maine, New York, and Pennsylvania utility regulatory commissions, which have continued to require service quality plans for Verizon under alternative regulatory regimes (see Exh. DTE-VZ 1-8).

We also determine that the imposition of retail service quality monitoring on Verizon alone is not discriminatory. Although we have not conducted a full analysis of the extent of competition for Verizon's residential services in Phase II of this proceeding (as we did with Verizon's business services in Phase I), Verizon continues to be classified as a dominant provider of telecommunications services in Massachusetts for both business and residential services. Since 1985, the Department has differentiated in the application of regulatory requirements to different carriers based on estimates of market power. Therefore, consistent with that long-standing regulatory framework, we do not find it necessary at this time to either impose retail service quality standards on all telecommunications service providers or to eliminate all retail service quality requirements for Verizon.

We likewise do not determine that our finding of sufficient competition for

Verizon’sretail business service in Phase I of this proceeding negates the need for continuedmonitoring of service quality for Verizon’s business services. As the Attorney Generalhas pointed out, a significant number of Verizon’s competitors (namely, those thatprovide service through resale and UNEs) rely on Verizon’s provision of servicequality, and the Department must continue to enforce service quality standards toensure that both Verizon’s customers and customers of competing LECs continue toreceive reasonable service.

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However, the Department will consider the Attorney General’s contention that Verizon’s current service quality plan may be outdated. A majority of the existing service quality standards are based on 1992-1993 performance data (Exh. DTE-VZ 1-5), and, therefore, may be set at a level below that which is reasonable in today’s marketplace. In the years since the development of the current service quality plan in the Department’s Price Cap Order in 1995, the telecommunications industry has undergone significant changes, including the introduction of new technologies and an increase in the importance of network reliability. Therefore, the Department agrees with the Attorney General that it may be appropriate to conduct a comprehensive review of Verizon’s retail service quality and service delivery throughout the state. The Department will consider whether opening such an investigation is appropriate.

In the interim, the Department determines that it is appropriate to accept Verizon’s suggestion to continue the existing service quality plan (including Verizon’s proposed revisions to the penalty provision). Verizon has met or exceeded the service quality thresholds during the period covered by the last four annual price cap filings, and extending the existing plan will ensure that retail customers continue to receive customary levels of service quality while the Department conducts its review.

V. ORDER

After due notice, hearing, and consideration, it is

ORDERED: That Verizon New England, Inc. d/b/a Verizon Massachusetts’ June 5, 2002 regulatory plan for Verizon’s retail intrastate telecommunications services is approved in part, and denied in part, as set forth above; and it is

FURTHER ORDERED: That Verizon New England, Inc. d/b/a Verizon Massachusetts must submit a regulatory plan for Verizon’s retail intrastate telecommunications services that is consistent with the determinations set forth above, and that this plan shall be filed with the Department no later than 30 days from the date of this Order; and it is

FURTHER ORDERED: That the December 13, 2002 Motion of AT&T for Summary Judgment or, in the Alternative, for Leave to Present Evidence and File Briefs Regarding Verizon’s Failure to Comply with the Department’s Phase I Order is dismissed, as set forth above; and it is

FURTHER ORDERED: That Verizon New England, Inc. d/b/a Verizon Massachusetts shall comply with all directives contained herein.

By Order of the Department,

_____________/s/_____________________

Paul B. Vasington, Chairman

_____________/s/_____________________

James Connelly, Commissioner

_____________/s/_____________________

W. Robert Keating, Commissioner

_____________/s/_____________________

Deirdre K. Manning, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).