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July 1, 2002

Arizona Corporation Commission
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Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

Re: Qwest Corporation's Cost Of Telecommunications Access
Docket No. T-00000D-00-0672

Dear Clerk:

Enclosed for filing in the above matter are the original and ten copies of the Testimony of Harry M. Shooshan, III, and Testimony of Scott McIntyre. If you have any questions, please do not hesitate to contact me.

Very truly yours,

FENNEMORE CRAIG, P.C.

T. Berg

Timothy Berg

TB/jmw
Enclosures

cc: All Parties of Record (see attached list)

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of the foregoing filed this 1st day of
July, 2002 with:

Docket Control
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1200 West Washington
Phoenix, AZ 85007

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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE	)	
INVESTIGATION OF THE COST OF	)	DOCKET NO. T-00000D-00-0672
TELECOMMUNICATIONS ACCESS	)	

DIRECT TESTIMONY

OF

SCOTT A. MCINTYRE

DIRECTOR – PRODUCT AND MARKET ISSUES

QWEST CORPORATION

JULY 1, 2002

DIRECT TESTIMONY OF SCOTT A. MCINTYRE
INDEX OF TESTIMONY

EXECUTIVE SUMMARY

Restructuring access is one vital step toward the broader policy goal of establishing appropriate economic pricing, at both the federal and state levels, for retail products and services, intra- and interstate access, unbundled network elements and interconnection. Appropriate economic pricing reduces the opportunity for arbitrage and improves the ability of telecommunications providers to invest economically. This drives market behavior that enhances competition and ultimately benefits consumers.

The current patchwork of intercarrier compensation mechanisms, including access, are based on pre-divestiture and pre-Telecommunications Act regulatory schemes that no longer further the policies of recent law or this Commission. They reflect and reinforce artificial distinctions among carriers, and create unavoidable opportunities for economically irrational, regulation-driven arbitrage.

As Qwest made clear in its intercarrier compensation comments currently pending before the Federal Communications Commission (FCC)1, over the long term, the public policy goal for intercarrier compensation, including access, should be a simple, predictable, and market-oriented regime that applies to any hand-off of traffic on the

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[1] *In the Matter of Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92. *See*, Comments of Qwest Communications International, Inc. filed August 21, 2001 and Reply Comments of Qwest Communications International, Inc. filed November 5, 2001.

public switched network. To that end, Qwest proposed a unified bill-and-keep regime for intercarrier compensation, under which each carrier would recover from its end users the costs of its own access facilities, including the cost of its loops and of the terminating switching function. Until we achieve that unified, simple, predictable, market-oriented regime, the FCC and state commissions should work symbiotically to support policies that move the industry further toward those broader goals. With the FCC's completion of an initial restructure of interstate access, through implementation of its *CALLS* Order[2], the timing is right for addressing access at the state level.

In September 2000, the Arizona Corporation Commission (hereinafter ACC or Commission) initiated an investigation into intrastate access charge reform. On December 3, 2001, the Commission issued a Procedural Order soliciting comments to questions that would be helpful in determining how to proceed with the investigation. Qwest appreciates the opportunity to provide the Commission with its position on these very important and complex issues.

The stipulated Price Cap Plan resulting from the last rate case, included a $15M switched access reduction to be implemented in $5M per year increments over three years

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[2] Simply put, the so-called *CALLS* Plan instituted a transitional access restructure for larger ILECs by reducing interstate switched access and implementing an interstate end user subscriber line charge. That shifted revenue recovery from end users through toll charges to end users through flat rated monthly rates. *See, Access Charge Reform, Sixth Report and Order*, 15 FCC Rcd 12962 (2000) ("*CALLS* Order"). A similar transitional plan has been adopted for non-price cap LECs. *See Multi-Association Group (MAG)*

beginning in 2001. Two of the $5M reductions have been implemented and the third $5M reduction is scheduled for April 2003. After this last switched access reduction, Qwest's switched Access revenues will still be approximately (see Confidential #1). This revenue level is higher than what would be generated from rates comparable to interstate charges by approximately (see Confidential #2).

In this testimony, I will outline Qwest's proposed plan to restructure intrastate switched access on a revenue neutral basis by reducing intrastate switched access prices close to the interstates levels and offsetting the reduction with an Intrastate Subscriber Line Charge (ISLC) of approximately $1.15 per month for each residence and business access line.

Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers, Notice of Proposed Rulemaking, 16 FCC Rcd 460 (2001).

INTRODUCTION OF WITNESS

Q. PLEASE STATE YOUR NAME, TITLE AND ADDRESS.

A. My name is Scott A. McIntyre. I am employed by Qwest Corporation (Qwest) as Director – Product and Market Issues. My business address is Room 3009, 1600 7th Avenue, Seattle, WA, 98191.

Q. PLEASE REVIEW YOUR EDUCATION, WORK EXPERIENCE, AND PRESENT RESPONSIBILITIES.

A. I earned a Bachelor of Science degree in Electrical Engineering at the University of Washington in 1974. I have worked for Qwest (formerly U S WEST Communications, Inc. and before that, Pacific Northwest Bell) since 1970. In the past 32 years, I have held many positions that have given me a broad understanding of the telecommunications business. I have experience in the installation and repair of local residence and business telephone services. I also have experience in analyzing and planning new central office equipment and interoffice network facilities. I have performed cost analyses on many aspects of the business and analyzed departmental budgets in great detail. From 1987 to 1999, I managed private line voice and data products. This included the development, pricing and marketing for a wide range of products serving business customers across Qwest's fourteen-state region.

Since July 1999, I have been in my current position as a policy and pricing expert, representing Qwest on issues involving various services. I also represent Qwest on issues concerning competition and performance measures. This wide range of experience has provided me with an understanding of how services are provided, the pricing and marketing that support these services and the impacts of regulation and competition.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN ARIZONA OR OTHER STATES IN QWEST'S TERRITORY?

A. Yes. I have testified in Qwest's last rate case (Docket T-01051B-99-0105) and more recently in support of Qwest's tariff filing introducing a Local Service Freeze option for customers (Docket T-01051B-02-0073). I have also testified on several different occasions in Oregon, Washington, Colorado, Nebraska, New Mexico, Utah, Wyoming, Iowa, and Minnesota.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to explain Qwest's proposal for access reform in response to the Commission's Procedural Order dated May 21, 2002. Qwest's intrastate switched access prices in Arizona are substantially higher than comparable FCC interstate prices and will remain so after the Company has made the final reduction in switched access prices that was provided for in its price cap plan.

In this testimony, I will describe how further switched access restructuring can be accomplished on a revenue neutral basis by reducing intrastate switched access close to the interstate level and offsetting the reduction though implementation of a competitively neutral ISLC for each residential and business line. The confidential numbers referenced in my testimony are found in my proprietary exhibit, SAM-1.

POLICY GOALS SUPPORTING FURTHER SWITCHED ACCESS RESTRUCTURE

Q. WHY IS FURTHER INTRASTATE SWITCHED ACCESS RESTRUCTURING NECESSARY?

A. Qwest believes that further revenue neutral reductions in intrastate switched access prices are necessary in order to move closer towards parity with interstate prices. The Price Cap Plan includes language indicating that the eventual goal is to achieve such parity. Achieving parity reduces regulatory-driven arbitrage and creates economic pricing that promotes investment and drives sustainable competition.

The current patchwork of intercarrier compensation mechanisms, including switched access rates, is based on pre-divestiture and pre-Telecommunications Act regulatory schemes that no longer further the policies of recent law or this Commission. They reflect and reinforce artificial distinctions among carriers, customers, and services. They also create opportunities for uneconomical, irrational, regulation-driven arbitrage. Until we achieve a unified, intercarrier compensation structure, including switched access, the industry will continue to misapply investment. When competitors are faced with an underlying rate structure that drives unsound investments, they either make those investments, knowing that the rules are subject to change, but hoping that they will not change significantly, or they will choose not to invest at all. In either case, consumers are prevented from the benefits of fair and robust competition.

Q. WILL CONSUMERS BENEFIT FROM QWEST'S PROPOSED SWITCHED ACCESS RESTRUCTURE?

A. Yes. Since the intrastate toll market is highly competitive, it is reasonable to assume that toll providers will pass through intrastate switched access reductions in the form of lower toll rates. Competitive pressures, rather than additional regulation, should be allowed to drive those reductions to customers. The reductions could save Arizona customers millions of dollars in toll rates. Longer-term benefits will come in the form of a more rational and competitively neutral rate platform. This will allow competition to grow in an environment where capital investments have a greater chance to benefit the investor. This, in turn, will encourage more competitive investment. In the current situation, some investments are based on niche services that may only be short-term arbitrage opportunities. Other investments may only be viable if regulatory rules stay the same, while still others may rely on regulatory rules changing in the near future. This environment puts all investment on shaky ground and consumers pay the price in the form of limited competition that is not equally available to all customers. Robust competition requires that archaic regulatory rate platforms be changed to competitively neutral structures that can be sustained over the long term.

SUBSIDIES AND SWITCHED ACCESS

Q. ARE THERE STILL SUBSIDIES IN QWEST'S CURRENT INTRASTATE SWITCHED ACCESS PRICES?

A. Yes, and they fall into two categories. The first is the clearly identifiable subsidy produced by Carrier Common Line (CCL) charges. The CCL charge has no direct access cost component and therefore represents pure contribution to the business. This rate element is a mechanism that was established to support the Non-Traffic Sensitive (NTS) portion of basic exchange service, which is the loop. The other less obvious form of subsidy is a historical, public policy-based component designed to keep basic exchange prices low. This public policy component is not as well defined as the CCL charge, but it is a form of subsidy as well. Subsidies are certainly debatable issues, however, depending upon how one defines the factors that determine whether subsidies exist. The applicable cost of providing a service is certainly one area that has been and will be argued from various perspectives and without a clearly agreed upon cost base, subsidies can not be clearly quantified. In any case, the restructuring of intrastate switched access should be continued, as proposed by Qwest, even if quantification of subsidies or their very existence is not agreed upon. Too much consideration of subsidies will only divert attention from the real goal of accomplishing a rational access restructure that will be sustainable in a fully competitive telecommunication market. Once access is fully restructured and priced at competitively neutral rates, the issue of subsidies in switched access prices will become moot.

Q. WHAT DOES THE HISTORY OF SWITCHED ACCESS PRICES HAVE TO DO WITH THE EXISTENCE OF CURRENT SUBSIDIES?

A. When switched access rates were first created, with the divestiture of the Bell

System, they included more contribution than would have been normal from a market perspective. Prior to the divestiture of the Bell System, and the proliferation of competition in the long distance market, long distance prices were kept high in support of low local service rates for public policy reasons. The concept of universal service drove this implicit subsidy in toll rates. Toll service was still considered somewhat of a luxury and it made sense, from a policy perspective, to keep these rates artificially high to promote the concept of universal local service. This subsidy was intended to support the Non-Traffic Sensitive (NTS) portion of local service. The NTS portion of local service is the loop, the cost of which does not vary with usage. Switched access prices were developed to keep long distance carriers on equal ground competitively, while maintaining significant support for local service. The easily identifiable implicit subsidy was the CCL charge, but maintaining relatively high prices for other switched access rate elements also supported this concept. The amount of this contribution, above cost, which is higher than might otherwise be reasonable in a competitive market, is a matter of public policy. This higher contribution level helped offset low basic exchange rates.

Q. WHY IS IT IMPORTANT TO KEEP THIS HISTORICAL PERSPECTIVE IN MIND AS WE RESTRUCTURE ACCESS PRICES?

A. Because there have been so many changes in the industry. Technology has changed and this has driven significant cost changes. Prices have changed and pricing philosophies have changed. This means that while the original intent of high switched access prices might have been to support the NTS costs of local service, there is no identifiable trail for this hidden support. To deal with restructuring now, we must understand that there once was the intent to support NTS costs, even though there is no current formula to determine how much of this intended support exists in today's environment.

Q. IS IT POSSIBLE TO MOVE AHEAD WITH ACCESS REFORM EVEN THOUGH THIS SUBSIDY ISSUE REMAINS VAGUE?

A. Yes. The FCC has done it, and the states should also. There are no disadvantages to significant revenue neutral reductions in intrastate switched access and there are several benefits that I will describe in more detail later. There are also no detriments to a competitively neutral ISLC. On the whole, customers should experience toll rate reductions that balance out the ISLC and rational competition for local and toll services will provide additional benefits. The consumer should be the ultimate winner in all aspects of this proposal. This makes Qwest's proposal clearly in the public interest, since it is the public that has the most to gain in the long run.

SWITCHED ACCESS RESTRUCTURE

Q. WHAT RESTRUCTURE OF SWITCHED ACCESS PRICES IS QWEST PROPOSING IN THIS PROCEEDING?

A. Qwest proposes to further restructure intrastate switched access on a revenue neutral basis by reducing intrastate switched access prices closer to the current interstate levels and offsetting the reduction with a competitively neutral ISLC. This will eliminate the CCL charge completely and reduce the prices for many other access rate elements. Current intrastate switched access revenue is approximately (see Confidential #3). After the next $5M reduction in April 2003, the revenue level will be approximately (see Confidential #1). Establishing prices near interstate levels will reduce intrastate switched access revenues to approximately (see Confidential #4). This reduction of approximately (see Confidential #2) should be offset on a revenue neutral basis by the introduction of an ISLC applied to each residential and business line.

Q. WHY DOES QWEST'S PROPOSAL ONLY "APPROXIMATE" THE FCC PRICE?

A. Qwest's proposal contemplates an intrastate switched access reduction to a level "near" the current interstate prices, rather than "to" the interstate prices because the Arizona intrastate switched access tariff structure does not match the interstate tariff structure at this time. The difference between the structures is based on the treatment of signaling. Signaling elements are included in switched access prices, as part of local switching, at the state level, but not at the interstate level because of an interstate signaling restructure completed in May 2000. In that May 2000 interstate restructure, signaling rate elements were removed on a revenue neutral basis from the local switching portion of the interstate access structure and established as stand-alone rate elements. That signaling restructure has not been accomplished in Arizona. In order to reduce intrastate access prices to interstate levels, signaling would have to be separated out from the intrastate access rate structure as it was from the interstate rate structure. For purposes of this proposal, however, signaling has been left in the intrastate switched access rate structure as part of the local switching rate element. Qwest continues to believe the signaling issue should eventually be addressed as part of the overall intercarrier compensation reform effort, which Qwest believes, should be addressed in a separate proceeding.

Q. HOW MUCH REVENUE DOES THE SIGNALING COMPONENT REPRESENT IN QWEST'S ARIZONA SWITCHED ACCESS REVENUES?

A. Signaling represents approximately (see Confidential #5) of the current intrastate switched access revenues.

Q. HOW MUCH OF QWEST'S CURRENT REVENUES COME FROM THE CARRIER COMMON LINE CHARGE?

A. Currently the CCL represents about (see Confidential #6). After the next scheduled reduction in switched access that will occur in April 2003, this amount will be approximately (see Confidential #7).

Q. WHY IS QWEST PROPOSING AN ISLC TO OFSET ITS INTRASTATE SWITCHED ACCESS REDUCTION?

A. As stated earlier, Qwest believes that further restructuring of intrastate switched access is necessary to reduce jurisdictional pricing disparity, including the issues associated with such disparity, and to promote rational economic pricing. For the long term, the proposed access price reductions are more appropriately recovered through implementation of an ISLC. The ISLC is a flat rate charge attributed to the customer, who is the user of the loop. It is competitively neutral and sustainable as a long-term method of recovering this support because it recovers costs associated with the service being provided.

Q. HOW MUCH OF AN ISLC WOULD BE REQUIRED TO OFFSET QWEST'S PROPOSED INTRASTATE SWITCHED ACCESS REDUCTIONS?

A. Qwest is proposing an intrastate switched access reduction of approximately (see Confidential #2). The reduction should be accomplished, for the most part, by applying Qwest's currently tariffed interstate switched access rates to Qwest's existing intrastate switched access rate structure. Based on a line count for residence and business customers of just under (see Confidential #8) access lines Qwest estimates the amount of the offsetting ISLC to be approximately $1.15 per month for each business and residential access line.

Q. WHY SHOULD SUCH A RESTRUCTURE BE REVENUE NEUTRAL?

A. The pricing restructure proposed here is largely driven by public policy and the need to establish competitively neutral pricing platforms. As the telecommunications market becomes more and more competitive, it is important to eliminate many of the pricing policies of the past 100 years. This will allow for robust competition without pricing anomalies that confuse customers and generate inefficient investment. Revenue neutrality insures that companies are not penalized for the progressive restructuring of rates that are in the long term best interests of competition and consumers. In theory, this restructure will be revenue neutral to consumers as a whole, so it should be revenue neutral to Qwest and other parties participating in access restructure.

Q. HAS THE FCC SHIFTED ITS PUBLIC POLICY CONCERNING HIGH CONTRIBUTION IN SWITCHED ACCESS RATES?

A. Yes. Over the past several years, the FCC has reduced interstate switched access prices and increased the End User Common Line (EUCL) charge. This has effectively transferred the local service support from switched access rates to the EUCL charge. These charges are flat rate charges applied on a per line basis. This has shifted local service support paid by carriers through switched access rates back to end users, where it should be.

Q. IS THE SWITCHED ACCESS RESTRUCTURE PROPOSED BY QWEST IN THIS FILING CONSISTENT WITH THIS NEW FCC POLICY?

A. Yes. The intrastate switched access reductions and corresponding revenue neutral offsets proposed by Qwest are consistent with the action and direction of the FCC in its Intercarrier Compensation docket and, specifically, in its *CALLS* Order. Qwest believes that interstate switched access will continue to decline as the FCC moves closer to a bill and keep regime for all intercarrier compensation[3]. As Qwest has indicated, it supports moving to bill and keep and has stated such in its comments filed with the FCC in the Intercarrier Compensation Docket. The FCC completed its initial restructure of interstate switched access in 2000, through implementation of its *CALLS* Order[4]. Qwest's proposal is completely consistent with that Order. In fact, the FCC recently approved another increase in the federal EUCL to $6.00 per access line.[5] With Qwest's proposed additional restructure, intrastate switched access prices will move closer to parity with interstate prices, accomplishing a significant step toward more rational economic pricing for intercarrier compensation.

Q. WHAT ARE THE BENEFITS OF RESTRUCTURING SWITCHED ACCESS PRICES?

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[3] See, provided herewith, "*Declaration f William P. Rogerson* " dated November 5, 2001.

[4] Simply put, the so-called *CALLS* Plan instituted a transitional access restructure for larger ILECs by reducing interstate switched access and implementing an interstate end user subscriber line charge. That shifted revenue recovery from end users through toll charges to end users through flat rated monthly rates. *See, Access Charge Reform, Sixth Report and Order*, 15 FCC Rcd 12962 (2000) ("*CALLS* Order"). A similar transitional plan has been adopted for non-price cap LECs. *See Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers, Notice of Proposed Rulemaking*, 16 FCC Rcd 460 (2001).

A. The five key benefits are that such a restructure will:

1) Reduce the incentive for uneconomic bypass of the switched network;

2) Remove economic penalties for carriers that rate average their toll plans;

3) Reduce the confusion to customers who have to deal with many rate plans driven by a wide variety of switched access prices;

4) Eliminate toll usage rated support for end-user NTS flat-rated costs; and,

5) Eliminate the hidden support that all users of the network pay, but in various and incalculable ways.

Q. WOULD YOU PLEASE EXPLAIN EACH OF THESE PROBLEMS MORE FULLY?

A. Certainly.

1) Uneconomic bypass often occurs when service providers bypass the switched network with dedicated facilities. These facilities are attractive because switched access prices are relatively high. To the degree that these bypass facilities carry local traffic, they merely represent a competitive alternative. To the degree that they carry toll traffic, they bypass switched access and therefore bypass the support for local service that is built into current rates. The crossover point between paying switched access prices and providing dedicated bypass facilities shifts toward bypass the higher the switched access

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[5] FCC Order released June 5, 2002 in CC Docket No. 96-262, *Cost Review Proceeding for Residential and Single Line Business Subscriber Line Charge (SLC) Caps.*

prices are. These dedicated facilities are typically not used to as great a capacity as they would be if utilized as part of the switched network. This creates wasted capacity and the cost of this waste is borne in one way or another by all ratepayers. In the simplest sense, those bypassing the network (or a portion of it) no longer contribute to the cost of that network and therefore the cost is borne solely by those not bypassing. Lower switched access prices mean that more service providers and customers will utilize the switched network that is more efficient with more use.

2) Even though state access prices differ from interstate prices, or differ from state to state, or from LEC to LEC, interexchange carriers must price rates to cover costs in the aggregate. This means that if one state or LEC has higher than average switched access prices, the carrier will have to decide whether to create a specific rate plan for that area or accept lower contribution. Specific rate plans cost more to manage and accepting lower contribution is also a form of cost that must be absorbed. In either case, the carrier may choose to withhold some services in that area or create higher priced plans. The customer pays the price for this inefficiency.

3) To the degree that carriers choose to address the variety of widely different switched access rate structures with widely different toll rate plans, customer confusion is multiplied. There are enough marketing reasons to create multiple

rate plans without adding the complexity of widely different switched access prices to the mix.

4) Currently, toll customers are paying more through higher toll prices caused by higher switched access prices than the actual cost of the resources used. Those who use more toll services pay disproportionately more because toll and the underlying switched access prices are driven by minutes of use rather than a flat rate. The underlying cause of these higher prices was driven initially by a usage-based recovery of flat rated NTS costs. A sound economic structure is the basis for a sound competitive environment and the structure will not be sound as long as customers are receiving more or less than they are paying for.

5) Since switched access prices are higher than they need to be in a fully competitive environment, carriers will choose to pass on these uneconomic costs in a variety of ways. Since the prices vary from jurisdiction to jurisdiction, different carriers will recover these costs in a variety of ways. Some may charge urban customers more because there is more ability to pay. Some may charge urban customers less because there is more competition. Some may have more rate plans to address these variations. In any case, the cost recovery mechanism is hidden from the ultimate consumer. Because of this, consumers will have a difficult time making sound choices between providers. There are enough differences between providers because of size,

service area, and marketing approach already. Adding the complexity of how to recover for higher than necessary switched access costs adds to the fact that these costs are not paid by the cost-causer.

OTHER PROVIDERS

Q. SHOULD OTHER SERVICE PROVIDERS SUCH AS ILECS AND CLECS ALSO RESTRUCTURE ACCESS ACCORDING TO QWEST'S PROPOSAL?

A. Yes. As the FCC has done with its MAG[6] plan, the state Commission of Arizona should also have a plan for access charges that match or nearly match FCC interstate prices, by all providers in the state. This will benefit consumers by reducing arbitrage, confusing pricing plans for toll services and the opportunity for confusing rate structures for services. Eventually, the competitive marketplace will weed out some of this confusion as consumers better understand the industry and their options. In the meantime, using the FCC rates as a guideline is a reasonable short-term solution. Allowing local providers to adjust their prices on a revenue neutral basis allows their participation without penalty in a process that will benefit consumers and providers in the long run. Providers regulated by the Commission should be allowed to make these adjustments on a revenue neutral

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[6] Multi-Association Group (MAG) Plan CC-00-256

basis. All providers should be required to participate in achieving parity with interstate rates for switched access.

Q. SHOULD THE ISLC BE THE SAME FOR ALL PROVIDERS ACROSS THE STATE?

A. Ideally, yes. This would insure that it is competitively neutral. It would be unwise to have different providers competing for service with different ISLC rates.

CREATING AN ISLC

Q. WOULD AN ISLC CREATE A SUBSIDY FOR QWEST IN ITS PROVISION OF TOLL SERVICE?

A. No. First, these are revenues that Qwest collects today. Part of this revenue is currently generated by CCL charges, that are a form of pure subsidy. In this sense, Qwest would be receiving no more "subsidy" than it might be now. Taking CCL revenues as an example, these revenues are generally considered to be pure subsidy, since there is no direct access related cost for this rate element. This revenue does not flow into the revenue stream of any other product however. This revenue represents contribution to the running of the business. It seems obvious that the existence of this revenue allows other services to produce less contribution than they otherwise might be required to produce and still maintain the financial health of the company. It cannot be considered a true subsidy however, unless some other service is operating below its incremental cost. Even then, there would be no direct revenue transfer, and the discussion of whether a subsidy exists could be debated endlessly. Many services contribute different amounts to the company. The fact that one product or service may contribute more, even significantly more, is not proof that it is subsidizing other products. The only proof that a subsidy exists is when a service is offered **below** its cost. Even then, where the support comes from is infinitely debatable, not provable to the satisfaction of various parties, and ultimately, an unnecessary exercise. In the specific case, as long as toll services are provided at prices that cover their cost, they are not being subsidized.

Q. WOULD THE ISLC CHARGE EVER HAVE TO CHANGE IN THE FUTURE?

A. There are various concepts under consideration by the industry and the FCC, which could fundamentally change how access charges are collected. Qwest has been supporting a bill and keep approach to access charges in the FCC's current docket on intercarrier compensation.

Additionally, the FCC's *CALLS* plan will remain in effect until 2005. At that time, the FCC is expected to have completed its current intercarrier compensation docket and will have a new regime in place. Although the future structure is unknown at this time, it will be important to be in step with the FCC, so that future evolution in switched access prices will not create large changes in the future. How these concepts are developed may have a future impact on this new ISLC, but not to a great significance. After this rate adjustment is made in Arizona, Qwest will only have about (see Confidential #4) in annual switched access revenues. Due to the emerging competitive landscape, this revenue will not dramatically change year to year and may even decline. In the future, shifting additional access revenues to the ISLC could result in an increase, but it would be a modest change.

Q. DOES QWEST PROPOSE TO MATCH ALL OF THE RATE ELEMENTS CURRENTLY IN THE FCC INTERSTATE TARIFF FOR SWITCHED ACCESS?

A. Not quite all, but almost all elements will be matched. The FCC rate structure includes some rate plans that do not exist and are unnecessary in the intrastate tariff. Qwest's proposal is to use the current state tariff structure, with the exception of the signaling elements and replace the current prices with the FCC rates. Since the local switching element will continue to encompass signaling, it will be higher than the FCC switching rate. Qwest will propose a signaling restructure in a future tariff filing.

CONCLUSION

Q. PLEASE SUMMARIZE YOUR POSITION ON QWEST'S

RESTRUCTURING PLAN FOR SWITCHED ACCESS?

A. To achieve a market-oriented regime, the FCC and the Arizona Commission should work to support policies that move the industry toward lowering intrastate switched access prices on a revenue neutral basis to the interstate level. With the FCC's completion of an initial restructure of interstate switched access, through implementation of its *CALLS* Order, the timing is right for this Commission to reduce the jurisdictional gap by moving state switched access prices closer to the federally tariffed level.

It is also appropriate to recognize that the FCC has taken significant steps to move support for local services back to the end user in a way that is consistent with cost causation. The FCC has indicated that it will continue with this philosophy in its current and future proceedings as the competitive nature of telecommunications continues to evolve. It is appropriate for the states to follow that lead and not stay too far behind. When the next generation of FCC rulings on access reform are implemented, Arizona should be in a position to follow that lead without exposing end-users to significant rate impacts. This will allow competitors to respond with services and pricing that is most beneficial for customers. The FCC signals have been clear on its direction. Aggressive competition will require clear signals from the Arizona Commission also to encourage capital investment in a capital intensive industry. The clearer those signals and their similarity with the FCC's signals, the more willing the investment will be.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE	)	
INVESTIGATION OF THE COST OF	)	DOCKET NO. T-00000D-00-0672
TELECOMMUNICATIONS ACCESS	)	

EXHIBIT

OF

SCOTT A. MCINTYRE

DIRECTOR – PRODUCT AND MARKET ISSUES

QWEST CORPORATION

JULY 1, 2002

Arizona Corporation Commission
Docket No. T-00000D-00-0672
Qwest Corporation SAM-1
Exhibits of Scott A. McIntyre
July 1, 2002

Confidential # 1	Redacted
Confidential # 2	Redacted
Confidential # 3	Redacted
Confidential # 4	Redacted
Confidential # 5	Redacted
Confidential # 6	Redacted
Confidential # 7	Redacted
Confidential # 8	Redacted

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

IN THE MATTER OF INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS	))))	**DOCKET NO. T-00000D-00-0672** **AFFIDAVIT OF SCOTT A. MCINTYRE**
STATE OF WASHINGTON	))	
COUNTY OF KING	))	

Scott A. McIntyre, of lawful age being first duly sworn, deposes and states:

1. My name is Scott A. McIntyre. I am Director – Product and Market Issues for Qwest Corporation in Seattle, Washington. I have caused to be filed written direct testimony in support of Qwest Corporation in Docket No. T-00000D-00-0672.

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

Scott A. McIntyre

Scott A. McIntyre

SUBSCRIBED AND SWORN to before me this 25th day of June, 2002.

Lori L. White

Notary Public residing at Seattle, Washington

My Commission Expires: 7/10/03

LORI L. WHITE
COMMISSION EXPIRES
NOTARY PUBLIC
7-10-03
STATE OF WASHINGTON

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE	)	
INVESTIGATION OF THE COST OF	)	DOCKET NO. T-00000D-00-0672
TELECOMMUNICATIONS ACCESS	)	

DIRECT TESTIMONY

HARRY M. SHOOSHAN III

ON BEHALF OF QWEST CORPORATION

JULY 1, 2002

DIRECT TESTIMONY OF HARRY M. SHOOSHAN III
INDEX OF TESTIMONY

EXECUTIVE SUMMARY

Qwest Arizona currently charges substantially different rates for a number of what are functionally the same services: interstate switched access, intrastate switched access, and local termination at the tandem and end office. The disparities are based on the type of traffic being transmitted and the type of carrier seeking interconnection. These price disparities create incentives for arbitrage that, in turn, undermine the existing rate structure. As a result, entry by efficient competitors is undermined, uneconomic entry is encouraged and consumers are put at risk.

The disparity is especially great between Qwest Arizona's interstate and intrastate switched access rates. Switched access rates have been historically high as a mechanism to recover, not only switched access direct costs, but also the non-traffic-sensitive costs of the network. The current Qwest Arizona price regulation plan encompasses a mechanism to improve this situation. Through this provision, Qwest agreed to reduce its intrastate switched access by $5 million in each of the three years of the plan in return for greater flexibility to price its other services. This will reduce, but not eliminate, the disparity between interstate and intrastate switched access prices. As a result, incentives for arbitrage will still exist and carriers will continue to have the incentive to "disguise" traffic.

Qwest Arizona's proposal in this proceeding to restructure intrastate switched access charges represents another important step in the direction of achieving economically efficient rates and reducing the opportunities for arbitrage. I recommend that the ACC move further toward parity among prices paid by connecting carriers by allowing Qwest Arizona to restructure its rates so that its intrastate switched access rates nearly mirror their interstate counterparts and so that a complimentary ISLC of approximately $1.15 is implemented at the same time to arrive at a revenue-neutral rate restructuring in Basket 2 of the Qwest Arizona price regulation plan. This rate restructuring will include elimination of the inefficient per-minute CCLC and will remove an important incentive for arbitrage. Continuing progress toward efficient rates is vital to the development of an efficiently competitive market in Arizona, including for residential telephone services.

While additional work is needed to eliminate all opportunities for arbitrage among the various carrier compensation charges, any further changes by the ACC can await action by the Federal Communications Commission following the expiration of the CALLS plan to further harmonize all switched access and other termination rates.

I. IDENTIFICATION OF WITNESS

Q1. PLEASE STATE YOUR NAME, EMPLOYER AND POSITION.

A1. My name is Harry M. Shooshan III. I am a principal and co-founder of Strategic Policy Research, Inc. ("SPR"), a public policy and economics consultancy located at 7979 Old Georgetown Road, Suite 700, Bethesda, Maryland, 20814.

Q2. PLEASE STATE YOUR QUALIFICATIONS.

A2. Before co-founding Strategic Policy Research, Inc. ("SPR"), I served for eleven years on Capitol Hill. I was chief counsel and staff director of what is now the Subcommittee on Telecommunications and the Internet of the U.S. House of Representatives. As a consultant, I have specialized in communications public policy analysis, regulatory reform and the impact of new technology and competition. I have co-authored several studies on the relationship between telecommunications infrastructure and economic development, including a major study for the Pennsylvania Chamber of Business and Industry. I have also advised firms on business strategies and market opportunities.

I have testified before several Congressional committees, before the Federal Communications Commission ("FCC") and numerous state commissions, including those in Illinois, New York, Pennsylvania, New Jersey, Tennessee, and Louisiana. My testimony before state commissions has been on topics related to price regulation, the impact of competition and the reclassification of services. I also served as an advisor to the Iowa Utilities Board and to the staff of the Arizona Corporation Commission ("ACC") where my work included the development of alternative regulation/price regulation plans and implementation of the Telecommunications Act of 1996. The price regulation plan I recommended in Arizona on behalf of the Staff addressed the issue of rate restructuring, including the need to reduce intrastate carrier access charges. I have also been involved in our firm's work with OFTEL, the telecoms regulatory body in the United Kingdom which adopted the first price regulation plan for an incumbent provider in 1983[1] and has largely achieved rebalanced rates. From 1978 to 1991, I was an adjunct professor of law at Georgetown University Law Center, teaching regulation and communications law.

A copy of my curriculum vitae is appended to this testimony as Exhibit 1.

Q3. HAVE YOU TESTIFIED PREVIOUSLY BEFORE THE ACC?

A3. Yes. I filed testimony in Docket No. T-01051B-99-0105 setting out my recommendations for a price regulation plan that also addressed the need for reform of intrastate carrier access charges. I testified on behalf of Staff in the same proceeding in support of the price-regulation plan agreed to by the Staff and

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[1] OFTEL, "A Brief History of Recent U.K. Telecoms and Oftel," www.oftel.gov.uk/about/history.htm#1 (obtained June 7, 2002).

Qwest. More recently, I appeared before the ACC on behalf of Qwest in Docket No. T-00000A-00-0194, Phase II, regarding the establishment of UNE prices.

II. PURPOSE OF TESTIMONY

Q4. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A4. The purpose of my testimony, on behalf of Qwest Corporation ("Qwest"), is to support its proposal for further reform of carrier access charges in Arizona. Specifically, Qwest seeks to restructure its carrier switched access charges and introduce an intrastate subscriber line charge ("ISLC") in Arizona. I provide public policy support for Qwest's proposed restructuring of intrastate switched access rates and for the creation of the ISLC, which, combined, amount to a revenue-neutral restructuring of Qwest's rates. I further discuss the need for such rate restructuring, including the need to eliminate arbitrage opportunities caused by price disparities. In my opinion, this rate restructuring constitutes the next significant step in reforming switched access charges that was begun under the price regulation plan implemented for Qwest Arizona in April 2001.

III. OVERVIEW OF INTERCARRIER COMPENSATION, OF WHICH ACCESS IS ONE COMPONENT

Q5. PLEASE DESCRIBE THE CURRENT SITUATION WITH REGARD TO INTERCARRIER COMPENSATION, WHICH INCLUDES INTRASTATE SWITCHED ACCESS.

A5. Currently, Qwest provides local interconnection, interstate switched access, and intrastate switched access. To supply any of these three services, Qwest provides essentially the same functionality; *viz.*, it carries calls between its own customers and other carriers. While the services are functionally the same, they are provided at very different prices, depending largely on which entity (i.e., local or long-distance carrier) is purchasing them and for what purpose. The existing rate structure contains numerous price disparities that are not cost-based, i.e., the prices for various forms of switching and interconnection between networks is determined by type of traffic transmitted rather than by different network functions involved. The prices that other carriers pay (or, in the case of local calls originated by Qwest, that other carriers receive) do not differ because of cost, since costs are largely the same for all three services. Rather, the differences derive from a series of regulatory decisions made at different times in different jurisdictions and intended to further different public policy objectives.

For example, switched access charges reflect the regulatory policy of the pre-divestiture Bell System. In the pre-divestiture period, toll rates were set well above costs. The contributions from toll services (revenues less incremental costs) were used to cover fixed and common costs of the network. This, in turn, permitted local service to be priced below cost. After divestiture, switched access prices continued to make this contribution. Initially, the FCC and state commissions opted for maintaining high access charges, rather than restructuring rates to reflect a changing world.[2] While both federal and state access charges have been reduced considerably over time, intrastate switched access charges remain high in the Qwest states, where they still typically exceed the rate for the comparable interstate services.

Q6. HOW DO QWEST'S PRICES FOR VARIOUS TYPES OF INTERCARRIER COMPENSATION IN ARIZONA COMPARE?

A6. Table 1 below contains Qwest Arizona's intercarrier compensation rates for switched interstate access, switched intrastate access, and local interconnection at

[2] One of the principal effects of divestiture was that AT&T no longer had the incentive to support high access charges and, indeed, became one of the most vocal proponents of reducing those prices (although not of rebalancing per se since AT&T's historical position has been, in effect, that ILEC shareholders should "fund" the reductions in switched access). There has also been a spirited argument about whether and to what extent AT&T and other long distance carriers have "flowed through" access reductions to their own customers. *See, for example*, John Haring, Jeffrey H. Rohlfs, and Harry M. Shooshan III, "Disabilities of Continued Asymmetric Regulation of AT&T," prepared for AT&T (June 30, 1995), and "William E. Taylor and J. Douglas Zona, "An Analysis of the State of Competition in Long-Distance Telephone Markets," (May 1995), for contrasting views.

the tandem and at the end office. Each rate is expressed in dollars per minute of use.

Table 1

Current Intercarrier Compensation Rates for Qwest Arizona			
Interstate Switched Access	Intrastate Switched Access	Local Termination at Qwest's Tandem	Local Termination at Qwest's End Office
$0.0055	$ 0.0371	$0.00508	$0.0028
Interstate and intrastate switched access rates are the sum of all switched revenues in the switched access category of services divided by total local switching minutes. Local termination at Qwest's tandem is calculated as one minute of tandem switching, plus one-minute of tandem transmission (not a distance-sensitive rate element), plus one minute of local switching at the end office.			

This chart clearly shows that intrastate switched access rates are out of sync with the other interconnection rates that Qwest charges for traffic originating and/or terminating in its Arizona service area. The most glaring disparity is between the rates for intrastate switched access and interstate switched access, which are physically identical offerings. Qwest's intrastate switched access price is almost *seven times* the price for interstate switched access. By contrast, the price for local termination at Qwest's tandem is not very different from that for interstate switched access service. The additional costs related to transport and tandem switching explain the price difference between local termination at the tandem and at the end office.

To its credit, Qwest agreed to reduce intrastate access rates by $5 million each year during the term of the recently-adopted price cap plan. These phased reductions are offset by additional "headroom" in Basket 3 (the basket that contains the most competitive service offerings). Qwest has assumed the risks involved with trying to make up for these reductions in switched access prices through flexible pricing of services that already face considerable competition. Moreover, since these reductions, while substantial, do not bring intrastate switched access rates to parity with interstate switched access rates, the problem will persist. I discuss subsequently the necessary actions to achieve a fully efficient rate structure.

Q7. DO THE EXISTING DISPARATE INTERCARRIER COMPENSATION RATES SERVE THE PUBLIC INTEREST? WHY OR WHY NOT?

A7. I contend that maintaining disparate rates for what is effectively the same service is not in the public interest for the following reasons:

- The current rate structure offers myriad opportunities for arbitrage, which diminishes the productivity of the local telecommunications sector. In the long run, the inevitable result of productivity loss is higher rates. Eventually, arbitrage will cause the existing rate structure to collapse (unless regulators redress the problem first);

- The current rate structure undermines the growth of efficient local telecommunications competition; and
- The current rate structure is completely unsuitable for the future, in which packet technology will play an ever-increasing role.

Q8. WHAT DO YOU MEAN BY THE TERM "ARBITRAGE OPPORTUNITIES" AND HOW DO THEY DISTORT THE MARKET?

A8. By "arbitrage opportunities," I mean the false (uneconomic) incentives that are created by having such disparate prices for intercarrier compensation. These false incentives distort the market in three major ways:

- They lead competitors to focus on customers who have disproportionately large amounts of toll traffic;
- They encourage the disguising of calls; and
- They induce the avoidance of the wireline telephone network in favor of alternative networks (e.g., wireless and cable) and the substitution of alternatives to switched voice service (e.g., Voice Over Internet Protocol or "VoIP").

Q9. WILL YOU PLEASE ELABORATE?

A9. Yes. As a result of the high intrastate switched access prices, new entrants are attracted to serve customers that have disproportionately large amounts of intrastate toll traffic. Yet, these are the very customers who are expected to provide sizable contributions (revenues less incremental costs) to help sustain the current rate structure. A CLEC can profitably serve these customers even if its costs are significantly higher than those of Qwest. Thus, the effect of the current rate structure is to invite competition that raises costs and lowers productivity of the total local telecommunications sector, encompassing both Qwest and its competitors.

The remaining Qwest customers are worse off because the CLEC captured the customers in question, not because the CLEC was truly more efficient but because it was able to take advantage of the arbitrage opportunity. The current rate structure makes Qwest's remaining customers, in effect, involuntary parties to a transaction between the CLEC and its customer that leaves those customers worse off.

If the CLEC has higher costs than the ILEC, the losses to Qwest's customers exceed the gains to the CLEC and its customers. The difference is the aggregate loss of productivity to the local telecommunications sector.

Of course, it is possible that the CLEC is *more* efficient than Qwest. The CLEC may have a state-of-the-art fiber-optic network. It may also be able to enjoy economies of scope by supplying local telephone service, together with long-distance service and/or broadband Internet access. Even in this case, however, the current rate structure still leads to a subsidy from Qwest ratepayers to the CLEC's shareholders and ratepayers. Furthermore, if the CLEC is efficient, the subsidy is completely unnecessary. The CLEC would have the incentive to enter on the basis of its superior efficiency, even in the absence of a subsidy.

This type of arbitrage can be expected to grow rapidly over the next several years. A great deal of capacity has already been deployed and is available to provide service to business customers who have disproportionately large toll usage. For example, among the companies that offer facilities-based services in Arizona is Cox Communications. Through its Cox Business Services, Cox Communications supplies local and long distance telephone, high-speed Internet access, data transport, and video solutions over a "state-of-the-art fiber-optic-based broadband network," in Phoenix and in Tucson.[3] Phoenix is also among the cities where Electric Lightwave and Allegiance have deployed networks as well.[4] Though a number of CLECs did not fare well in the recent recession, their facilities remain in place, and other carriers have acquired some of their assets, or they have emerged from bankruptcy without the load of debt they had been carrying. The fiber deployed by these CLECs and others will support substantial growth without the need for much additional infrastructure investment.

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[3] Downloaded from www.coxbusiness.com/systems/az-phoenix; and /az-tucson (obtained June 12, 2002).

[4] Downloaded from www.eli.net/phoenix.html and www.algx.com/about_allegiance/locations.jsp (obtained June 12, 2002).

Q10. PLEASE ELABORATE ON THE OTHER FORMS OF ARBITRAGE.

A10. The existing rate structure also invites other forms of arbitrage, as I mentioned above. Since Qwest often cannot determine whether a call is local, intrastate or interstate (e.g., if the customer uses a dedicated link to an IXC for both local and long-distance calls), customers and other carriers have the incentive and ability to disguise toll calls as local calls and intrastate calls as interstate calls. By doing so, the other carrier can benefit from the most favorable terms of interconnection—including being paid for terminating calls. In either case, it can evade paying carrier access. The cost savings (incentives for evasion) are especially great for intrastate switched access charges in the Qwest states.

It is hard to assess how much disguising of calls actually occurs, because the carriers that do so try to conceal it. In any event, it is obvious that carriers have the ability and incentive to disguise some calls. It would therefore be folly to assume in the absence of empirical evidence that the practice is small or insignificant.

I believe that if restructuring is going to take a long time to complete, Qwest should audit its carrier customers, which it is permitted to do in its tariff, and the ACC should examine any findings. If the ACC finds that a carrier is disguising calls, sufficiently large fines should be levied to make the practice unprofitable (i.e., the amount of the fine times the probability of getting caught should exceed the savings from disguising calls). If a carrier is found to have a sustained and systematic practice of disguising calls, its certificate should be revoked. The current rate structure is difficult enough to sustain without its additionally depending on an unenforced "honor system."

Of course, such regulatory intervention is really the "second best" solution to the problem. A much better solution is to fix the problem itself by rationalizing the rate structure. With a rational rate structure, the payments of the carriers that purchase access or interconnection would depend on the activities that Qwest performs on their behalf—not on what they report on the honor system in the different jurisdictions.

The current rate structure also affords artificial incentives for customers to use mobile (or other wireless) networks to make toll calls.[5] Mobile carriers obtain connection to the ILEC network through local interconnection rates agreed to under the terms of Section 251 of the Telecommunications Act of 1996. This pricing scheme enables mobile carriers to originate and terminate long-distance calls to/from ILEC customers within a broad service area (that may span many ILEC local calling areas) on favorable terms—including being paid for terminating calls. The same long-distance calls over a wireline network would, however, be subject to carrier access charges.

[5] The same incentives apply to the use of cable telephony.

This arbitrage will continue to grow as the wireless industry grows, and the wireless industry is growing very rapidly. According to CTIA, usage on cellular phones is increasing 75 percent every year.[6] Wireless companies are all providing "big bucket" plans in which no distinction is made among minutes based on whether they are local, intrastate or interstate.

Finally, customers of all sizes, from large corporations to the single-line residential customer, are starting to use their computers and Internet connections to make voice calls using VoIP. The quality of service of VoIP for calls carried over the Internet is generally significantly lower than those carried on traditional circuit-switched networks. It is, however, possible for carriers that specialize in VoIP to use their own facilities for long-haul transmission and offer quality equal to traditional circuit-switched voice telecommunications. VoIP traffic appears to be local traffic, as the user calls his local ISP. The caller, however, could be conversing with a person in another town or even in another state or country. Thus, a long-distance call looks like a local call for billing purposes. As VoIP grows—and that growth is inevitable—the current pricing regime will become increasingly difficult to sustain.

This threat is more than mere potential. Today, about 5 percent of Internet users worldwide are using their computers to make voice phone calls. Ovum estimates

[6] Yuki Noguchi, "More Cell-Phone Users Cut Ties to Traditional Service," *The Washington Post* (December 28, 2001) from www.washtech.com.

that that will increase to 23 percent by 2006.[7] About $3 billion of U.S. telephone company revenues with shift over to VoIP by the end of 2004, according to Forrester Research, Inc.[8] The adoption rate of VoIP in large U.S. businesses increased from 5 percent to 19 percent over a six-month period in 2001. Similarly for small and medium organizations, the adoption rate increased from 7 to 13 percent over the same six-month period in 2001.[9]

Q11. WHAT EFFECTS DO YOU THINK THESE FORMS OF ARBITRAGE WILL HAVE?

A11. In the long run (and perhaps not too long-run at that) the existing rate structure will collapse. Sophisticated consumers and carriers are finding more and more ways to use new technology to evade high intrastate switched access services. The other types of arbitrage that I described are also growing rapidly. As a result, the rates paid by each remaining user for Qwest services must increase if Qwest is to cover its total costs and have the ability and incentive to make infrastructure investments. Consumers who are the beneficiaries of this distorted rate structure

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[7] Ovum estimate, 2000. From www.cisco.com, "Facts and Stats" page (downloaded January 29, 2002). Cisco estimates that worldwide VoIP was under $1 billion in 1999 and will increase to about $8 billion by 2004. Similarly, other IP communications, voice-enabled e-commerce and enhanced services, are expected to generate collectively about $10 billion dollars worldwide. [Mike Volpi, Chief Strategy Officer, Cisco, Systems, "Voice-over-IP: A Tornado Market" (March 27, 2001).]

[8] Forrester Research, 2000, from www.cisco.com (downloaded January 29, 2002).

[9] "The Future of VOIP," posted on www.voipwatch.com (October 25, 2001).

today could end up paying more in the future than they would have had rates been rationalized sooner. And those consumers are more likely to encounter "rate shock" as prices for other services rise rapidly once it is clear that the current approach is no longer sustainable.

The dynamic described in the above paragraph seems inevitable. The economic harms from *not* rationalizing intrastate prices will grow rapidly over time. Eventually, regulators will have no reasonable alternative to rationalizing the rate structure.

The dislocations that will be caused by the inevitable collapse of the rate structure will grow over time. Until the problem is fixed, CLECs will understandably respond to incentives and become more and more entrenched in arbitrage operations. When rates are ultimately restructured, much of the investment that CLECs made to utilize arbitrage may become unproductive. Some CLECs may even fail. Beginning the restructuring process now can minimize these problems. It is important for regulators to send a credible signal to the market that a rationalized rate structure is on the way. To be credible, the signal should consist of a specific long-term plan plus some significant immediate progress.

Q12. WHAT ARE THE CONSEQUENCES OF THE CURRENT RATE STRUCTURE FOR THE GROWTH OF EFFICIENT FACILITIES-BASED LOCAL TELECOMMUNICATIONS COMPETITION?

A12. The current rate structure undermines the growth of efficient facilities-based local telecommunications competition. Large business customers are attractive customers for CLECs under the current rate structure. They can often be efficiently served with fiber-optic technology, because they are in dense business areas, or sometimes because a single end-user location is enormous, in itself. In addition, large business users are likely to have a disproportionately large amount of toll traffic.

Many large business customers would continue to be attractive customers, even if rates were restructured. They could still often be efficiently served with fiber-optic technology. The extent of their use of intrastate toll would, however, be much less relevant to their decision whether or not to go with a CLEC. This would induce CLECs to shift some of their focus to businesses that have large volumes of local calls (e.g., real estate firms).

More importantly, restructuring rates would give CLECs greater incentive to compete for residential customers. For example, wireline CLECs could use some combination of fiber optics, coaxial cable, and copper wire to offer a combination of telephone service, broadband Internet access, and video programming. Such competition would be very constructive. Not only would it provide competition for telephone and broadband Internet service, but it would also undermine the monopoly position of cable television companies, to the benefit of their customers. This type of competition is not occurring on any significant scale.

In this case, these hold-over regulatory pricing policies are working to suppress competition for residential customers. The economics of offering residential telephone service to compete with the incumbent are simply not very attractive under the current rate structure.

Q13. WHAT LESSONS FOR EFFICIENT PRICING CAN BE LEARNED FROM THE HISTORY OF THE TELECOMMUNICATIONS INDUSTRY OR OTHER INDUSTRIES?

A13. The key lesson, which has been borne out in the history of telecommunications as well as in other industries, is that socially engineered pricing regimes are unsustainable and counterproductive once the industry is opened to competition. When regulators decide to allow and promote competition in a regulated industry, they should move toward a market-based pricing structure as quickly as practicable. In such a structure, prices in competitive markets only slightly exceed incremental costs; additionally, the regulated firm is afforded the opportunity to recover its total costs. Experience has shown that the risks of not pricing in this manner can be enormous.

The history of the transportation industry offers a splendid example of how great those risks can be.[10] During the early period of monopoly, the railroads had a rate structure with higher rates for transport of more valuable (primarily manufactured) goods and lower rates for lower-value (primarily agricultural) goods. This "value of service" approach worked satisfactorily during the monopoly period but became unsustainable in the face of competition by common-carrier trucking. Because of competition, continuing to charge high prices for transport of manufactured goods was counterproductive. It simply resulted in losing the business to trucking competition.

The pricing policy that was called for is as follows:

- Lower prices for transport of high-value goods so as to be competitive with trucks but still cover incremental costs; and
- Raise prices for transport of low-value goods sufficiently to afford the railroad the opportunity to recover its total costs, including the fixed costs of the roadbed.

Had the Interstate Commerce Commission ("ICC"), which regulated railroad rates, followed this pricing policy, railroads would probably have remained viable.

[10] A critique of the regulation of the railroad is contained in John R. Meyer, Merton J. Peck, John Stenason and Charles Zwick, *The Economics of Competition in the Transportation Industries* (Cambridge: Harvard University Press, 1959).

In reality, the ICC continued its obsolete policy of value-of-service pricing until Congress legalized market-based pricing in 1980 with the Staggers Act. In the meantime, the revenue base of the railroads continually eroded, as they lost more and more business to competition. As a result, the railroads suffered varying degrees of financial distress, and many went bankrupt before the Staggers Act was passed. Lastly, as a result of mis-regulation, the U.S. railroad industry devolved, over a period of several decades, from one of the premier industries in the United States to an international disgrace.

The history of the airline industry offers similar lessons. The Civil Aeronautics Board ("CAB") had regulatory authority over interstate airline services. Its policy was to keep fares in high-density long-haul markets above cost and fares in low-density short-haul markets below costs.[11] Airlines could not charge less in dense markets. They could, however, add services and flights (decreasing the percentage of seats filled), both of which drove up costs and led to continual price increases.

The poor performance of the airline industry under regulation eventually led to the Airline Deregulation Act in 1978. As a result of deregulation, travelers (especially recreational travelers) have benefited from lower prices on major

[11] *Regulatory Reform: What Actually Happened*, L. Weiss and M. Klass, eds. (Little, Brown & Company: 1986) at 43.

routes. At the same time, efficient competition, using small planes, has been attracted to less-dense markets.

The implications for the telecommunications industry are still unfolding. At the time when the AT&T divestiture was announced, the telecommunications rate structure was the result of considerable social engineering by both the FCC and by state regulators. It did not even remotely resemble a market-based pricing structure.

At this point the history of telecommunications diverged sharply from that of railroad or airlines. The FCC, unlike the pre-deregulation ICC and CAB, recognized the problem and took preventive measures. These included reform of the Division of Revenues (or Separations) process and the imposition of SLCs. More recently, the FCC has become more aggressive in restructuring interstate switched-access charges.[12] As a result of these policies, some telecommunications prices have moved much closer to market-based levels.

Even now, however, eighteen years after the AT&T divestiture, telecommunications prices still deviate substantially from market-based rates. The CLEC industry (led by the large IXCs) has the incentive to continue to exploit whatever arbitrage opportunities are offered by the existing rate structure. It remains to be

[12] FCC, *Sixth Report and Order* in CC Docket Nos. 96-262 and 94-1; *Report and Order* in CC Docket No. 99-249; and *Eleventh Report and Order* in CC Docket No. 96-45, known as the *CALLS Order* (released May 31, 2000).

seen whether telecommunications regulators will rise to the challenge and take the further steps necessary to achieve a market-based rate structure. If they do not, the telecommunications industry may experience serious problems similar to those of the pre-deregulation railroad and airline industries.

IV. RESTRUCTURING SWITCHED ACCESS RATES IN ARIZONA

Q14. HOW CAN THE PROBLEMS YOU DESCRIBED ABOVE BE AVOIDED OR MITIGATED IN ARIZONA?

A14. Qwest Arizona's access rates must be rationalized if these problems are to be avoided and the full benefits of local telecommunications competition are to be realized. As Table 1 above illustrates, first and foremost, intrastate switched access charges must be lowered. However, if such reductions are not accomplished on a revenue-neutral basis, Qwest's ability and incentives to make infrastructure investments (especially those required to deploy the packet-switched technology that is demanded by today's growing data and Internet applications) will be greatly diminished. If this undesirable outcome is to be averted, regulators must afford Qwest the opportunity to earn compensatory revenues from other services, *e.g.*, through revenue-neutral rate restructuring. As intrastate switched access rates are lowered, offsetting revenues could come from the creation of an ISLC that would also be a rate element in Basket 2 under the

Qwest price cap regulation. Indeed, the Arizona constitutional requirement that the ACC permit Qwest the opportunity to earn a fair rate of return obliges the ACC to approve a revenue-neutral rate restructuring. To lower switched access rates without implementing an ISLC simultaneously would violate this provision.

Q15. EARLIER, YOU STATED THAT ARIZONA HAS MADE PROGRESS TOWARD ACHIEVING PARITY BETWEEN INTERSTATE AND INTRASTATE ACCESS. WHAT FURTHER ACTIONS ARE NECESSARY IN ARIZONA?

A15. The current Qwest Arizona price regulation plan embodies a reduction in intrastate switched access rates of $5 million for each year of the plan. Despite these substantial reductions, at the end of the plan, Qwest's rates for intrastate and interstate access will not be at parity.[13] Further, the CCLC rate element remains in Qwest's intrastate switched access rate structure today. As a result, the opportunities and incentives for arbitrage that I described earlier will continue to exist. Moreover, the continued reliance on the CCLC per-minute charges to recover what are actually per-line costs of the network is inefficient. In my opinion, the best way to move toward parity as soon as possible and to promote

[13] In my initial testimony for Staff in the price regulation proceeding, I had recommended that intrastate switched access rates be reduced to the point of parity with interstate rates over the term of the plan. Concessions made by Qwest in other areas of the final plan approved by the ACC were appropriately deemed more important to having a balanced price regulation plan.

economic efficiency is the adoption of an ISLC in conjunction with lowering Qwest's intrastate switched access rate elements.[14]

Q16. CAN YOU DESCRIBE WHAT EXACTLY WOULD OCCUR IN QWEST'S COST AND RATE STRUCTURE WHEN YOU SPEAK OF A REVENUE-NEUTRAL RATE RESTRUCTURING?

A16. Yes. Switched access rates for years have been designed to recover, not only the direct costs of switched access, but also the non-traffic sensitive ("NTS") costs of the local network. There are indeed costs behind these rates; NTS costs of the network in addition to switched access direct costs.[15] Among the switched access rate elements designed to recover such costs has been the carrier common line charge ("CCLC"), which Qwest seeks to eliminate in this proceeding. The switched access revenues have not exceeded their direct cost simply to provide greater profit to Qwest. The prices in question were developed through the intricate traditional ratemaking processes of state and federal regulators to meet public policy objectives, as I described earlier. In this new environment where many firms can and do compete with Qwest, such inefficient pricing can no longer

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[14] In this proceeding, Qwest is proposing to mirror its interstate switched access rate elements with the exception of those associated with signalling. The continuation of intrastate signalling charges that Qwest has eliminated in its interstate tariff would remain the only outstanding difference between Qwest's intrastate and interstate switched access service rates.

[15] John Haring and Harry M. Shooshan III, *Cutting the Gordian Knot of Rate Rebalancing*, prepared for the 29th Annual Conference of the Institute of Public Utilities, "Reconciling Competition and Regulation," *(continued)*

be sustained. The establishment of an ISLC, a monthly-per-line charge, efficiently recovers the NTS costs that had been previously borne by switched access customers.

Q17. WHAT ARE THE BENEFITS OF QWEST'S PROPOSAL TO RESTRUCTURE RATES BY INTRODUCING AN ISLC IN ARIZONA?

A17. The benefits of Qwest's proposal to restructure rates by introducing an ISLC to balance the switched access reduction are significant. First, reducing switched access rates almost to the interstate level, as Qwest proposes here, substantially reduces any opportunity for arbitrage by long-distance carriers by disguising intrastate traffic as interstate. As I showed above, Qwest's current intrastate switched access rates are more than seven times the interstate level. Second, economic efficiency is maximized by bringing rates to their efficient levels and having the cost causer pay for the costs that he or she causes. Continued reliance on the CCLC per-minute charges neither meets this objective of efficiency nor accords with the principles of cost causation. In contrast, flat per-line charges are an economically efficient mechanism for recovering costs that are not traffic sensitive. Further progress should be made in recovering NTS costs from flat-rate charges. As I discussed above, both the switched access rate reduction and the

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Williamsburg, Virginia, December 5, 1997.

implementation of an ISLC must occur concurrently. To implement only half the solution would be unfair and contrary to the constitutional requirements placed on the ACC. Qwest's proposed ISLC for Arizona will lead to further gains in promoting efficient competition and avoiding inviting unproductive arbitrage.

Q18. HOW DO ISLC CHARGES REFLECT CHANGES IN SWITCHING TECHNOLOGY AND COSTS?

A18. ISLC charges reflect changes in switching technology and costs very well. The nature of switching costs has changed significantly over time with advances in digital technology. Switching costs today are more line-driven than traffic-sensitive. It is not unreasonable to model switching costs now as depending entirely on the number of line-side ports and the number of trunk-side ports. Switching costs in such a model can be reasonably recovered entirely as fixed monthly charges. (From the perspective of a carrier or large end user, however, the costs may be traffic-sensitive, because additional traffic may require the use of more trunks or lines, respectively.) The proposed changes in Qwest's switched access rates and the introduction of an ISLC are precisely the rate design that reflects the changes that have occurred in switching costs over the years.

Q19. WHAT ARE THE UNIVERSAL-SERVICE IMPLICATIONS OF QWEST'S PROPOSING A PER-LINE ISLC CHARGE AS PART OF ITS REVENUE-NEUTRAL RATE RESTRUCTURING?

A19. Universal-service objectives have been achieved for all intents and purposes for decades. Today more than 90 percent of U.S. households are connected to the telecommunications network.[16] In Arizona, steady progress has been made over the years. For example, over the past twenty years, the household penetration rate increased from 88 percent to 93 percent.[17] In my opinion, the modest ISLC proposed by Qwest would not at all jeopardize universal service,[18] especially with the protections afforded by the existing price regulation plan.[19]

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[16] FCC, Common Carrier Bureau, "Trends in Telephone Service" (August 2001) at Table 17.3.

[17] FCC, Wireline Competition Bureau, "Trends in Telephone Service" (May 2002) at Table 17.2.

[18] Alexander Larson, Tom Makarewicz and Calvin S. Monson, "The Effect of Subscriber Line Charges on Residential Telephone Bills," *Telecommunications Policy* (December 1989). The authors examined the impact of the interstate SLC implemented by the FCC following the AT&T divestiture and the resulting decreases in long distance charges. Among the findings of their analysis were that the average customer's long-distance bill fell by $6.48, more than offsetting what was at the time $2.60 SLC (at 340). Forty-six percent of the customers whose bills were analyzed experienced a total telephone bill reduction (at 342). Further, customers, whose bills decreased, experienced decreases of around $10 per month on average, while customers, whose bills increased, experienced increases of less than $2 per month on average (at 344).

[19] Arizona Corporation Commission, Decision No. 63487, Docket No. T-01051B-00-0369 (March 30, 2001).

Q20. IN THE LONG TERM, WHAT SHOULD BE THE POLICY OBJECTIVE OF THE ACC REGARDING CARRIER ACCESS AND OTHER INTERCARRIER COMPENSATION?

A20. Over the long term, the ACC's public-policy goal should be to have a unified price for intrastate switched access, interstate switched access, and local interconnection. These rates all apply to the same function of carrying calls between the ILEC's customers and other carriers. All that differs today is the price and the entities that qualify to purchase the service. Multiple prices for the same functionality are always an open invitation to arbitrage.

The FCC has announced its intention to reconcile local interconnection and interstate access after the current CALLS plan expires in 2005. I believe that state regulators should be making progress in that direction, as well.

In particular, I believe that the ACC should move quickly to reduce Qwest's intrastate switched access charges further in the direction of their interstate levels[20] and to implement an ISLC of approximately $1.15 as proposed by Qwest.

For the long term, the FCC is contemplating adopting some form of bill-and-keep for interstate access—an approach supported by Qwest. Nevertheless, the ACC need not rush to moving intrastate switched access rates to a bill-and-keep system

[20] With Qwest's intrastate signalling rate elements as the only exception to mirroring interstate switched access rates at this time.

until the FCC implements it. At that point, however, to delay to implement bill-and-keep would invite further arbitrage, a return to the current situation.

V. CONCLUSION

Q21. COULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?

A21. Yes. I recommend that the ACC move further toward parity among prices paid by carriers that connect to Qwest Arizona's network by approving Qwest's proposal in this proceeding to restructure its rates so that intrastate switched access rates closely mirror their interstate counterparts and so that a complimentary ISLC of approximately $1.15 is implemented at the same time to arrive at a revenue-neutral rate restructuring in Basket 2 of the Qwest Arizona price cap plan. This rate restructuring will include elimination of the inefficient per-minute CCLC and will greatly minimize one aspect of arbitrage open to connecting carriers. While further work is needed, this movement toward efficient rates is vital to the development of an efficiently competitive market in Arizona, including for residential telephone services.

Q22. DOES THIS CONCLUDE YOUR TESTIMONY?

A22. Yes, it does.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS	)))	DOCKET NO. T-00000D-00-0672

EXHIBIT OF

HARRY M. SHOOSHAN III

ON BEHALF OF QWEST CORPORATION

JULY 1, 2002

CURRICULUM VITAE

HARRY M. SHOOSHAN III

Received a B.A. *magna cum laude* from Harvard University in Government and a J.D. from Georgetown University Law Center.

Before co-founding Strategic Policy Research, Inc. ("SPR"), Mr. Shooshan served for eleven years on Capitol Hill. He was chief counsel and staff director of what is now the Subcommittee on Telecommunications and the Internet of the U.S. House of Representatives and was active in congressional efforts to reform the nation's communications laws.

Mr. Shooshan specializes in communications public policy analysis, regulatory reform and the impact of new technology and competition. He also advises on business strategies and market opportunities.

Mr. Shooshan is the author of numerous studies and articles dealing with various aspects of the video marketplace, including the transition to digital television and the impact of the Internet. He is one of the nation's leading authorities on telecommunications infrastructure and its relationship to economic development and to the global competitiveness of U.S. businesses.

Mr. Shooshan coordinates SPR's telecommunications and electronic mass media practice in Europe and has advised clients in the United Kingdom, Canada and the Caribbean.

Mr. Shooshan has testified before several congressional committees, before the Federal Communications Commission ("FCC") and numerous state commissions. He has also testified as an expert witness in litigation concerning broadcasting, cable and wireless cable, and in proceedings before the Copyright Arbitration Royalty Panel concerning satellite broadcasting.

From 1978 to 1991, he was an adjunct professor of law at Georgetown University Law Center, teaching regulation and communications law.

EDUCATION

GEORGETOWN UNIVERSITY LAW CENTER
J.D., Communications Law, 1975

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B.A., Government, *magna cum laude*, 1968

EMPLOYMENT

	STRATEGIC POLICY RESEARCH, INC.—Bethesda, Maryland
1992-Present	*Principal.* Telecommunications and public policy consulting services for a variety of clients in the telecommunications industry.
	NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.—Washington, D.C.
1989-1992	*Vice President.* Telecommunications and public policy consulting services for a variety of clients in the telecommunications industry.
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1980-1989	*Principal.* Telecommunications and public policy consulting services for a variety of clients in the telecommunications industry.
	SUBCOMMITTEE ON COMMUNICATIONS, INTERSTATE AND FOREIGN COMMERCE COMMITTEE, U.S. HOUSE OF REPRESENTATIVES—Washington, D.C.
1975-1980	*Chief Counsel/Staff Director.* Legislative, oversight and investigating activities relating to telecommunications.
	SUBCOMMITTEE ON COMMUNICATIONS AND POWER, INTERSTATE AND FOREIGN COMMERCE COMMITTEE, U.S. HOUSE OF REPRESENTATIVES—Washington, D.C.
1974-1975	*Staff Director.* Legislative, oversight and investigating activities relating to telecommunications and energy.
	U.S. HOUSE OF REPRESENTATIVES—Washington, D.C.
1969-1974	*Administrative Assistant to the Honorable Torbert H. Macdonald.* Legislative and political coordination and support.

PROFESSIONAL ACTIVITIES

Member, Federal Communications Bar Association.

TESTIMONIES

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Arizona Corporation Commission
Docket No. T-00000D-00-0672
Qwest Corporation - HMS-1
Exhibit of Harry M. Shooshan III
July 1, 2002

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"Access to Broadband Networks." Remarks to the Montgomery County Council. Rockville, Maryland. January 27, 2000.

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"Toward a National Broadband Policy in Telecommunications." Remarks at the *Michigan State University Institute of Public Utilities 31st Annual Conference*. Williamsburg, Virginia. December 8, 1999.

"Implications for State Regulators of FCC's Broadband Policy." Panelist, U S West Regional Oversight Committee Meeting. Denver, Colorado. September 27, 1999.

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"Benefits of Lifting the MFJ Restriction on Information Services." Remarks before the *MFJ Symposium* sponsored by the Public Utility Commission of Ohio. Columbus, Ohio. January 25, 1991.

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"Telecommunications Infrastructure: A Framework For Public Policy Analysis." Remarks prepared for *Bellcore's Seventh Issues Management Fall Conference*. Florham Park, New Jersey. October 1, 1990.

"Changing Technology and Converging Markets: U.S. Telecommunications in Transition." Presented at the *Integration of Telecommunications and Broadcasting Conference* sponsored by *The Economist* Conference Unit. London, England. September 17-18, 1990.

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With John Haring. "The Demand for Information Services and the Case for Regulatory Reform in Telecommunications." Presented to the Bellcore/Bell Canada Industry Forum. Hilton Head, South Carolina. April 1990.

With Jeffrey H. Rohlfs. "Will Price Caps Correct Major Economic Flaws in the Current Regulatory Process?." Presented at the *20th Annual Williamsburg Conference*. Williamsburg, Virginia. December 5-7, 1988.

"Exercise of Congressional Influence *Vis-à-vis* the FCC and Judge Greene: Some Changing Relationships." Presented at the *Northern Telecom Law Department Seminar*. Pebble Beach, California. May 13-15, 1988.

With Jeffrey H. Rohlfs and Susan W. Leisner. "The Negative Effects of Tax Reform on the Telephone Industry: Making Up the $15 Billion Difference." Presented at the *15th Annual Telecommunications Policy Research Conference*. Airlie, Virginia. September 27-30, 1987.

"Mass Media and the First Amendment: Separate but Unequal." Presented to the *Association for Education in Journalism and Mass Communication 1984 Convention*. Gainesville, Florida. August 1984.

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"Cable and Enhanced Services: Legal and Regulatory Barriers." Presented at *EASCON '81*. Washington, D.C. November 18, 1981.

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Remarks prepared for the Technical Committee on Media of the White House Conference on Aging. New York. January 14, 1981.

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

IN THE MATTER OF INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS	)	**DOCKET NO. T-00000D-00-0672**
	)	**AFFIDAVIT OF HARRY M. SHOOSHAN III**
STATE OF MARYLAND	)	
COUNTY OF MONTGOMERY	)	

Harry M. Shooshan III, of lawful age being first duly sworn, deposes and states:

1. My name is Harry M. Shooshan III. I am President of Strategic Policy Research, Inc., Bethesda, Maryland. I have caused to be filed written direct testimony and exhibits in support of Qwest Corporation in Docket No. T-00000D-00-0672.

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

HARRY M. SHOOSHAN III

SUBSCRIBED AND SWORN to before me this 25th day of June, 2002.

Adrienne Wells Vendig
Notary Public residing at
Bethesda, Maryland

My Commission Expires: ______________
Adrienne Wells Vendig, Notary Public
Montgomery County
State of Maryland
My Commission Expires Sept. 1, 2002