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BEFORE THE ARIZONA CORPORATION COMMISSION

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KRISTIN K. MAYES, Chairman
GARY PIERCE
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BOB STUMP

IN THE MATTER OF THE REVIEW AND POSSIBLE REVISION OF ARIZONA UNIVERSAL SERVICE FUND RULES, ARTICLE 12 OF THE ARIZONA ADMINISTRATIVE CODE.	**Docket No. RT-00000H-97-0137**
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS.	Docket No. T-00000D-00-0672
	NOTICE OF FILING TESTIMONY

AT&T Communications of the Mountain States, Inc. and TCG Phoenix give notice of the filing of the public version of the Direct Testimony of Dr. Debra J. Aron and the Direct Testimony of Dr. Ola Oyefusi.

RESPECTFULLY SUBMITTED this 1st day of December, 2009.

GALLAGHER & KENNEDY, P.A.

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Arizona Corporation Commission
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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE REVIEW AND POSSIBLE REVISION OF ARIZONA UNIVERSAL SERVICE FUND RULES, ARTICLE 12 OF THE ARIZONA ADMINISTRATIVE CODE.	Docket No. RT-00000H-97-0137
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS.	Docket No. T-00000D-00-0672

DIRECT TESTIMONY OF

DR. DEBRA J. ARON

On Behalf of

AT&T Communications of the Mountain States, Inc. and TCG Phoenix

December 1, 2009

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AT&T COMMUNICATIONS OF THE MOUNTAIN STATES, INC.
AND TCG PHOENIX
DIRECT TESTIMONY OF DR. DEBRA J. ARON

I. Introduction and Qualifications

Q: PLEASE STATE YOUR NAME AND POSITION.

A: My name is Debra J. Aron. I am the Managing Director of the Evanston offices of LECG, LLC, ("LECG") and Adjunct Associate Professor at Northwestern University. LECG is an economics and finance consulting firm that provides economic expertise for litigation, regulatory proceedings, and business strategy. My business address is 1603 Orrington Avenue, Suite 1500, Evanston, IL, 60201.

Q: PLEASE DESCRIBE YOUR PROFESSIONAL QUALIFICATIONS.

A: I have a Ph.D. in economics, have taught economics at Northwestern University for most of the last 23 years, and have presented testimony on communications issues for over 12 years. I received a Ph.D. in economics from the University of Chicago in 1985, where my honors included a Milton Friedman Fund fellowship, a Pew Foundation teaching fellowship, and a Center for the Study of the Economy and the State dissertation fellowship. I was an Assistant Professor of Managerial Economics and Decision Sciences from 1985 to 1992, at the J. L. Kellogg Graduate School of Management, Northwestern University, and a Visiting Assistant Professor of Managerial Economics

and Decision Sciences at the Kellogg School from 1993-1995. I was named a National Fellow of the Hoover Institution, a think tank at Stanford University, for the academic year 1992-1993, where I studied innovation and product proliferation in multiproduct firms. Concurrent with my position at Northwestern University, I also held the position of Faculty Research Fellow with the National Bureau of Economic Research from 1987-1990. At the Kellogg School, I have taught M.B.A. and Ph.D. courses in managerial economics, information economics, and the economics and strategy of pricing. I am a member of the American Economic Association and the Econometric Society. My research focuses on communications markets, multiproduct firms, innovation, incentives, and pricing, and I have published articles on these subjects in several leading academic journals, including the *American Economic Review*, the *RAND Journal of Economics*, and the *Journal of Law, Economics, and Organization.* I currently teach a graduate course in the economics and strategy of communications industries at Northwestern University.

I have consulted on numerous occasions to the telecommunications industry on competition, costing, pricing, incentives, and regulation issues in the United States and internationally. I have testified before regulatory agencies and in judicial proceedings regarding the history, development, and trends in the telecommunications marketplace, pertaining both to wireline and wireless (terrestrial and non-terrestrial) technologies;

economic and antitrust principles of competition in industries undergoing deregulation; measurement of competition in telecommunications markets; the proper interpretation of Long Run Incremental Cost and its role in pricing; the economic interpretation of pricing and costing standards in the Telecommunications Act of 1996 ("TA96" or "the Act"); limitations of liability in telecommunications; Universal Service; and the pricing for mutual compensation for call termination. I have also testified before state regulatory commissions regarding the potential competitive effects of some of the largest telecommunications mergers in the last decade. Additionally, I have submitted affidavits to the Federal Communications Commission ("FCC") on a variety of topics including competition in telecommunications markets, economic principles of cost analyses, economic principles relevant to unbundling obligations, and empirical assessment of market power. I have consulted to carriers in Europe, Australia, Israel, and Latin America on interconnection and competition issues, and have consulted on issues pertaining to local, long-distance, broadband, wireless, and equipment markets. I have served as a testifying expert in various litigation matters involving wireless companies, satellite telephony, and other communications technologies. In addition, I have consulted in other industries regarding potential anticompetitive effects of bundled pricing and monopoly leveraging, market definition, and entry conditions, among other antitrust issues, as well as matters related to demand estimation and employee compensation and contracts. I recently testified in New Jersey regarding access reform in a proceeding

similar to this one. In July 1995, I assumed my current position at LECG. My professional qualifications are detailed in my curriculum vitae, which is attached as Exhibit DJA-1.

II. Context, Purpose, and Organization of This Testimony

Q: WHAT IS YOUR UNDERSTANDING OF THE SCOPE OF THIS PROCEEDING?

A: Several years ago, the Arizona Corporation Commission (ACC) opened two dockets, a generic docket to examine the costs of access services in Arizona (the "Access Charge Docket"), and a docket to review the rules of Arizona's Universal Service Fund (AUSF). In 2007, the Commission consolidated the two dockets in order to consider issues regarding access charges and universal service simultaneously.[1] After two years of discussion through workshops, comments filed by various parties, and procedural conferences that yielded no specific proposals, the Commission concluded that "access charges and AUSF should be reviewed to reflect the current realities in the communications industry," and decided to conduct evidentiary hearings to investigate

[1] Procedural Order, *In The Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of The Arizona Administrative Code and In The Matter of the Investigation of the Cost of Telecommunications Access*, before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, September 29, 2009 (hereafter *2009 09 Procedural Order*), p. 1.

these issues.[2] According to the Procedural Order issued by Judge Rodda, the hearings will cover, at the minimum, the following issues:

1. What carriers should be covered by access reform?
2. To what target level should access rates be reduced?
3. What procedures should the Commission implement to achieve the desired reduction in access rates?
4. Should carriers be permitted to contract for access rates that differ from their tariffed rates?
5. What revenue sources should be made available to carriers to compensate for the loss of access revenues?
6. How much of access cost recovery, if any, should be shifted to end users? What showing should be required for such a shift? What should be the role of "benchmark" rates and how should benchmarks be set?
7. Procedurally what will be required of a carrier if it seeks a "revenue neutral" increase in local rates?
8. Assuming that AUSF funds will also be used as a compensating revenue source, what specific revisions (including specific recommended amendment language) to the existing rules are needed to allow use of AUSF funds for that purpose?
9. Which carriers should be eligible for AUSF support?
10. What should be supported by AUSF? Access replacement only? High cost loops? Line extensions? Centralized administration and automatic enrollment for Lifeline and Link-up?
11. What should be the basis of AUSF contributions and what should be the structure of any AUSF surcharge(s)?
12. Any other specific revisions to the AUSF rules.[3]

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[2] *2009 09 Procedural Order*, p. 4.

[3] *2009 09 Procedural Order*, pp. 4-5. Parties may also address "additional matters that they believe are important to the Commission's investigation."

Q: PLEASE EXPLAIN THE PURPOSE AND ORGANIZATION OF YOUR DIRECT TESTIMONY.

A: The purpose of my direct testimony is to address Issues 1-3 and 5-6 in the Procedural Order issued by Judge Rodda on September 29, 2009. First, under Issues 1 and 2, I explain, on the basis of economic principles and analysis, the harmful effects the current switched access charge regime is having on Arizona consumers and on the competitive process. I explain that reducing the currently excessive intrastate switched access rates in Arizona will promote the objectives of Arizona telecommunications policy by:

(i) enhancing the welfare of consumers of telecommunications services in Arizona;

(ii) decreasing regulatory impediments to competitive neutrality between technologies;

(iii) reducing incentives for wasteful arbitrage; and

(iv) improving the efficiency of investment incentives.

Reducing intrastate access rates to interstate levels will therefore serve the public interest.

I then explain, under Issues 3, 5, and 6, that access reductions are properly seen as part of a holistic approach to access reform that must allow local exchange carriers ("LECs") an opportunity to recover access revenues that would be forgone on rate-regulated lines as a result of the policy change. These revenue opportunities can be provided in the form of increased retail prices alone or in combination with universal service support funds.

Each solution has merits and demerits, which I explain in hopes of assisting the Commission to develop a sound, holistic policy approach to access reform that advances social welfare in Arizona.

My testimony is organized as follows: Section III provides a summary of my conclusions. Section IV presents a brief history of the telecommunications policies in the U.S. that led to the current distorted access price regime, and the reforms adopted at the federal level to partially address these distortions. Section V describes the existing switched access regime in Arizona and how the intrastate switched access rates paid by wireline interexchange carriers ("IXCs") to LECs in Arizona differ from interstate switched access rates, as well as from the rates paid by CLECs for local call termination and from the rates paid by wireless companies for call termination, all of which functions are materially the same as intrastate switched access services provided to IXCs. I also describe the actions that have already been taken in many other states to reduce intrastate access charges. In Section VI, I describe the economic harms to consumers, competition, and investment that result from the existing asymmetries and inconsistencies of the current access regime, as well as the perverse incentives for regulatory arbitrage created by the distortions of the existing switched access regime. I explain that reducing intrastate access charges to parity with interstate access rates would benefit consumers, competition and investment, and reduce incentives for carriers to pursue wasteful and

opportunistic arbitrage opportunities. Section VII explains why, in light of the forgoing analysis, the Commission should order incumbent local exchange carriers ("ILECs") to decrease intrastate access rates to interstate levels, and order competitive local exchange carriers ("CLECs") to cap their rates at the level of the ILEC with which the CLEC competes. I explain that this policy will bring intrastate access charges in Arizona closer to the ILECs' costs, thereby enhancing economic efficiency. I also explain the unique regulatory and market characteristics of switched access that endow all LECs, including CLECs, with market power over access to their own customers, necessitating the proposed regulatory intervention. In Section VIII, I explain that access rate reductions must be seen as part of a holistic and revenue-neutral approach that allows rate-regulated carriers to recover the forgone access revenues on price-capped lines. Section IX summarizes the benefits to consumers and the economy from reforming intrastate access rates to interstate levels.

III. Summary of Conclusions

Q: DR. ARON, PLEASE SUMMARIZE THE CONCLUSIONS OF YOUR DIRECT TESTIMONY.

A: The Commission should order all local exchange companies in Arizona to decrease their intrastate switched access rates. ILECs should reduce their rates to the levels and structure of their corresponding interstate switched access rates. Each CLEC should

reduce its intrastate access charge levels and structure to that of the ILEC with whom it competes in a specific area. Doing so would bring intrastate access rates to more efficient levels and bring them closer into line with the fees charged by the same LECs providing the same functionality to competitors using other technologies. Bringing the rates closer to the ILECs' interstate charges, and bringing them more into alignment with rates charged to intermodal competitors and to other wireline providers for the same functionality, benefits consumers and competition and would promote the public interest.

Current intrastate access rates—the rates charged by wireline LECs to wireline IXCs for originating and terminating long distance telephone calls to their customers—are far above the rates that the same LECs charge to originate and terminate interstate calls, even though the functionality provided is the same. The LECs' intrastate switched access rates are even farther above the rates that the same LECs charge for the same functionality provided to CLECs to terminate local calls, and to mobile wireless service providers to terminate most intrastate wireless calls.

Figure 1 shows the average call origination and termination rates assessed by ILECs Qwest, Verizon and Arizona Local Exchange Carrier Association ("ALECA") members, as well as CLECs Cox and Integra, in Arizona.

Figure 1

Average Charges for Call Termination Services in Arizona

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]

[END HIGHLY CONFIDENTIAL INFORMATION]

The chart illustrates the disparities—which can only be described as huge—between the rates that LECs charge for the same functionality of call termination depending on the regulatory jurisdiction governing the call. Intrastate access rates in Arizona are multiples

of the rates charged by the same LECs for the same functionality if the call is jurisdictionally interstate, local or wireless.

For example, consider a customer in Phoenix who subscribes to Qwest for local services and to AT&T for long distance services. If that customer were to make a ten-minute call to a Verizon customer in Los Angeles, AT&T would pay Verizon a bit over **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** ■ **[END HIGHLY CONFIDENTIAL INFORMATION]** in interstate access charges to terminate the call, and would pay Qwest approximately **[BEGIN CONFIDENTIAL INFORMATION]** ■ **[END CONFIDENTIAL INFORMATION]** in interstate access charges to originate the call. Hence, AT&T would pay approximately **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** ■ **[END HIGHLY CONFIDENTIAL INFORMATION]** in access charges on that call. However, if the same customer were to make a ten-minute intrastate call from Phoenix to a Verizon customer in Parker, Arizona, AT&T would pay Verizon approximately **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** ■ **[END HIGHLY CONFIDENTIAL INFORMATION]** in intrastate access charges to terminate the call, and would pay Qwest approximately **[BEGIN CONFIDENTIAL INFORMATION]** ■ **[END CONFIDENTIAL INFORMATION]** in intrastate access charges to originate the call. Hence, for the in-state call, AT&T would pay over **[BEGIN HIGHLY**

CONFIDENTIAL INFORMATION] [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** in access charges. All together, AT&T would pay over ten times as much in access charges for the intrastate call, even though Qwest would be providing the same functionality to originate the call, and Verizon would be providing the same functionality to terminate the call in either case. Moreover, if the caller in Phoenix used her cell phone instead to call the same party in Parker, the wireless provider would pay only **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** to Verizon to terminate the call (and no intercarrier fees to originate the call).

Decreasing intrastate access charges would directly benefit consumers because economic principles dictate and the evidence across 50 states shows that when access fees go down, retail long distance prices go down as well. In fact, numerous states have already reformed ILEC intrastate access rates and targeted intrastate access rates to equal, or "mirror," interstate access rates, as AT&T proposes here. At least 16 states have imposed caps on CLEC intrastate access rates. Based on the historical relationship across 50 states between AT&T's intrastate access charges and its intrastate long distance prices over the last several years, the data indicate that the proposed access reform would lead to a decrease of 19 to 42 percent in AT&T's average intrastate long distance price in Arizona.

Moreover, the highly disparate access rates in the current system harm competition and distort investment by creating an artificial, regulatory-induced competitive disadvantage for wireline long distance providers as compared to their intermodal long distance competitors. Decreasing intrastate access rates to interstate levels would not eliminate the disparities across technology platforms but would significantly diminish them, creating a more level playing field and permitting a greater degree of competition on the merits, encouraging investment that better reflects the relative efficiencies of different technologies and service providers, and reducing incentives for wasteful and opportunistic arbitrage.

The harms from the current regulatory access regime in Arizona can be summarized to include the following:

- Consumers pay excessive prices for wireline intrastate toll services and are unduly discouraged by these uneconomically high prices from using and enjoying long distance service on the wireline network;

- Consumers are unduly discouraged from making wireline long distance calls in favor of using other communications alternatives, even where consumers might prefer the service characteristics of a wireline call;

- Competition between technologies is distorted by an access regime that permits other providers using alternative technologies to pay substantially lower rates for materially identical functionality as that provided to traditional wireline carriers at much higher rates, and that artificially disadvantages IXCs vis-à-vis other communications options that avoid the public switched telephone network ("PSTN") (and regulated interconnection charges) entirely;

- The incentive and ability of wireline long distance providers to invest in the provision of wireline long distance services is reduced because consumers are unduly discouraged from using those services;

- Arbitrage opportunities are created by regulatory distortions under which, for example, call-pumping schemes exploit access payers, and resources are wasted on enforcing traffic distinctions that have no economic basis but have significant pricing implications under the current system.

Existing intrastate access rates perpetuate an outmoded regulatory policy of the monopoly era by which LEC services were subsidized by long distance services. While access reform is sorely overdue in Arizona, it is appropriate that reform of intrastate access policy be viewed holistically, acknowledging the historical policy quid pro quo by which access rates subsidized below-cost retail prices for local services. A holistic policy reform will therefore provide an opportunity for LECs to recover the access revenues forgone on price-regulated lines through some combination of (i) increased retail prices on price-regulated lines and (ii) explicit support from the state universal fund.

Providing LECs the opportunity to recover the lost access revenues via retail price increases would be the most economically efficient means of recovering those revenues, and would best promote competition and efficient investment. If, however, the Commission finds that the price increase necessary to recover all access revenues that would be forgone due to the access rate reductions is untenable for universal service

reasons, a smaller price increase could be allowed and the remaining revenue could be recovered in universal service support. This method of revenue recovery respects the policy concern for limiting prices to "affordable" levels, albeit at the cost of some economic efficiency. At the same time, allowing cost recovery by providing universal service support imposes support burdens on customers who must pay for those subsidies, including some customers with below-average income. In light of the broad availability of wireless voice services and broadband-based voice services in the marketplace today, in assessing an appropriate benchmark the Commission would be well-served to scrutinize old assumptions about whether allowing retail prices to rise to fully recover the forgone access revenues would be likely to have any genuine effect on telephone penetration in Arizona.

Regardless of the method of revenue recovery chosen by the Commission, the Commission should recognize that today's convoluted patchwork structure of access/interconnection rates needs to be reformed to decrease intrastate access rates in Arizona to interstate levels so that:

- different technologies and companies can compete more closely on their merits;
- consumers can benefit from lower, more cost-based prices for wireline long distance telephony;

- consumers can choose among providers based more closely on the relative value provided;
- wasteful arbitrage activities are limited; and
- consumers in Arizona can more fully enjoy the benefits of all modern communications technologies.

IV. The Legacy Access Regime is No Longer Viable (Issues 1 and 2)

A. Switched Access Charges Were Originally Set to Provide "Implicit Subsidies" for Below-Cost Local Service Prices

Q: WHAT IS "SWITCHED ACCESS"?

A: Switched access is the service that a LEC provides to an IXC to transport the portion of the IXC's call that begins or terminates on the LEC's facilities. Consider, for example, a customer who subscribes to the long distance service of AT&T, and the local exchange service of Cox. Suppose that the customer makes a long distance call to a friend who receives local exchange service from Qwest. AT&T, the IXC in this example, does not have a direct connection to either customer but its network is interconnected with the local exchange facilities of both Cox and Qwest. When that call is dialed, it will travel over Cox's communications path, or "loop," from the calling customer's home to Cox's switch. Cox's switch will determine that the call is to be sent to the network of AT&T, the customer's long distance carrier, and it will route the call to Cox's transport facilities

that connect with AT&T's network. From that point, AT&T will transport the call to a point of interconnection with Qwest near the called party, where it will hand off the call to Qwest for delivery to the called party. Cox's delivery and handoff of the call from the calling customer's premises to AT&T's point of interconnection is called originating switched access service, and Qwest's receipt and delivery of the call to the called party is called terminating switched access service. On both sides, the access supplier provides the connection to an end-user.

Although the access services are identical regardless of the distance between the parties, the price that AT&T pays for those services is determined by whether the calling and called parties are in the same state (in which case intrastate switched access charges would apply) or different states (in which case interstate switched access charges would apply).

Consider another scenario. Suppose the customer served by Cox makes a *local* call to a neighbor who is served by Qwest. In that case, Cox must transport the call to Qwest's network for delivery to the called party. The terminating function that local exchange company Qwest provides to local exchange company Cox is the same in all material respects as the terminating function that Qwest provided to long distance provider AT&T in the previous scenario. The termination service provided by Qwest in this scenario has

the same economic characteristics as in the first scenario, but for historic reasons goes by a different name and is priced under a different regime.

Q: WHAT ARE SWITCHED ACCESS CHARGES?

A: "Switched access charges" (or, in shorthand, "access charges") is the regulatory term of art applied to the prices that wireline local telephone companies charge to wireline long distance providers to furnish switched access service. Access charges are a payment from one company to another (i.e., they are "intercarrier" charges) that derive from the fact that networks are interconnected and a call may have to traverse more than one carrier's network to be completed. When the terminating functionality is provided by one LEC to another LEC under a local area calling arrangement, the call-termination functionality provided is the same as the functionality provided to terminate a long distance call, but the intercarrier fee paid is called "reciprocal compensation."

For purposes of this testimony, I will use the term "access/interconnection regime" to mean the entire set of regulator-approved charges that wireline LECs charge to other carriers—wireline, wireless, incumbents, and CLECs—for the function of originating or terminating calls, whether local or long distance, intrastate or interstate. In some cases, these charges are set by the FCC and in other cases they are set or approved by state

regulators.[4] The Commission has control over only a part of the overall access/interconnection regime that affects carriers and customers in Arizona, and it is important in this proceeding for the Commission to understand the context of the rates under its supervision in the broader access/interconnection regime and the effect of that regime on consumers and the state's retail telecommunications marketplace.

Q: YOU REFERRED TO INCUMBENT WIRELINE PROVIDERS, CLECS, AND WIRELESS PROVIDERS. DO ALL OF THESE KINDS OF COMPANIES USE SWITCHED ACCESS SERVICE, OR THE EQUIVALENT FUNCTIONALITY, PROVIDED BY WIRELINE LOCAL TELEPHONE COMPANIES?

A: Yes. Though the terminology "switched access service" is used to refer to wireline LECs' origination and termination of wireline long distance calls, the same interconnection functionality is used by all of these kinds of companies. The service may fall under different regulatory categories and go by different names, but all of these companies use the comparable service, because any time one of their customers calls a customer of a wireline local telephone company it must be handed off to the LEC serving the called party so that the latter LEC can deliver the call to the called party. The current access/interconnection regime applies to all these different kinds of providers and calls under a mosaic of mismatched regulatory policies and rules. This results in a broad range of different prices that are charged for the same functionalities, which in turn derives

[4] In some states there appear to be no specific rules governing intrastate access rates charged by CLECs, though their interstate rates are governed and capped by the FCC.

from a regulatory history that has not been reformed in step with the technological and competitive changes in the industry.

Q: CAN YOU PROVIDE AN EXAMPLE OF THE PATCHWORK REGULATORY APPLICATION OF ACCESS CHARGES THAT YOU ARE DESCRIBING?

A: Yes. Consider a customer who purchases local exchange service from Qwest and long-distance service from AT&T. Every time that customer places a long distance call on her wireline phone, AT&T, not Qwest, charges the customer for the call. However, Qwest handles part of the call—specifically, the part that begins at the caller's location and ends at AT&T's network. Qwest takes such calls from the calling customer's home over Qwest's facilities to Qwest's switch at Qwest's local office, and then to Qwest's interconnection point with AT&T's network, while holding capacity open on its own switch and other facilities for the duration of the call. As I have described, Qwest is entitled, as a matter of current regulatory policy, to charge AT&T for that functionality to recover the costs that Qwest incurs. The fee is known as the originating switched access charge.

The functionality provided by Qwest is the same, however, regardless of whether the called party is located in the next town, the next state, or another country. Qwest provides the dial tone, determines where the call should go, and brings it to the interconnection point with AT&T's network. It is AT&T's responsibility to transport the

call to the carrier serving the called party who might be a few or several thousands of miles away.

As an analogy, consider the job of a taxicab driver who picks up passengers at home and drives them to Phoenix's Sky Harbor Airport. The driver's job is the same whether the passenger is going to catch a flight to Tucson, New York, or Paris, and one would expect the taxi fare to be the same. The current access charge system in the United States, however, is akin to the taxicab driver asking the passenger where she is flying to once she gets to the airport, and charging a much higher fare if she is flying to Tucson than if she is flying to New York or Paris.

Similarly, on the terminating end, when an AT&T long distance customer in New York places a call to a Qwest local customer in Arizona, AT&T hands that call off to Qwest in Arizona for final delivery to the customer. Qwest's functions in terminating the call are the same, regardless of whether the long distance call comes in from New York or a neighboring town in Arizona—just as a taxi driver's functions in taking a passenger home from the airport are the same regardless of where the passenger flew in from. In fact, Qwest's functions are the same even for a local call from a next door neighbor whose local provider is not Qwest. Because of the idiosyncrasies of intercompany regulation and different jurisdictions associated with different kinds of calls and different carriers, however, the price that Qwest charges for that service is vastly different in

Arizona depending on where that call originated. In fact, under the current anomalous rules, the price Qwest charges AT&T to terminate a call is substantially higher if it comes from a neighboring town in Arizona than if the call comes from New York.

Q: HOW WAS THE ACCESS CHARGE REGIME DEVELOPED?

A: Before the divestiture of the "Baby Bells" from AT&T in 1984, there was no such thing as "access charges." In the monopoly era of the late 1940s when long distance was still viewed as a luxury, the FCC and state regulators established a policy that imposed cross-subsidy obligations on long distance users to encourage universal subscription to the public switched telephone network by holding local service prices below cost, a policy known as "universal service." These cross-subsidies were implemented through a "separations and settlements" accounting process under which some of the costs of providing customers with access to the local telephone network were attributed to the long distance network and built into the (regulator-set) retail prices of long distance service.[5] While there is a disagreement as to their exact magnitude, there is a consensus

[5] Paul W. MacAvoy, THE FAILURE OF ANTITRUST AND REGULATION TO ESTABLISH COMPETITION IN LONG-DISTANCE TELEPHONE SERVICE, (Cambridge, Massachusetts: MIT Press, 1996), pp. 8-11; and Stephen Breyer, REGULATION AND ITS REFORM, (Cambridge, Massachusetts: Harvard University Press, 1982) (hereafter *Breyer 1982*), pp. 296-298. The cost allocation formulas were known as "separations," and the revenue side of the cost allocation formulas were known as "settlements" when paid to an independent telephone company and "divisions of revenues" when paid to AT&T affiliates; Gerald W. Brock, TELECOMMUNICATION POLICY FOR THE INFORMATION AGE: FROM MONOPOLY TO COMPETITION, (Cambridge, Massachusetts: Harvard University Press, 1994) (hereafter *Brock 1994*), pp. 66-70.

that the separations and settlements process produced retail prices that contained significant embedded cross-subsidies from long-distance to local services.[6]

Upon the AT&T divestiture in the mid-1980s, the separations and settlements process was abolished and replaced with an access charge regime that continued the cross-subsidy policy.[7] In the access charge regime, long distance companies are required to pay a fee (the access charge) to the local exchange company or companies serving the calling and called customers of a long distance call for the functionality of handling the call at the originating and terminating ends.[8]

In designing its new system of regulated interstate access charges, the FCC acknowledged that a system of cross-subsidies was incompatible with competition and,

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[6] Jerry Hausman, Timothy Tardiff, and Alexander Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *American Economic Review* 83, no. 2, (May 1993), p. 178; Larry Blank, David L. Kaserman, and John W. Mayo, "Dominant Firm Pricing with Competitive Entry and Regulation: The Case of IntraLATA Toll," *Journal of Regulatory Economics* 14, (1998), pp. 37, 39; David L. Kaserman, John W. Mayo, and Joseph E. Flynn, "Cross-Subsidization in Telecommunications: Beyond the Universal Service Fairy Tale," *Journal of Regulatory Economics* 2, (1990), pp. 232-235; Robert W. Crandall and Leonard Waverman, TALK IS CHEAP: THE PROMISE OF REGULATORY REFORM IN NORTH AMERICAN TELECOMMUNICATIONS, (Washington D.C.: The Brookings Institute, 1995), pp. 34-35; Alfred E. Kahn, "The Road to More Intelligent Telephone Pricing," *Yale Journal on Regulation* 1, (Spring 1984), pp. 140-144; and Peter Temin, "Cross Subsidies in the Telephone Network after Divestiture," *Journal of Regulatory Economics* 2 (1990), pp. 349-362.

[7] *Brock 1994*, pp. 180, 186.

[8] Order on Remand and Report and Order and Further Notice of Proposed Rulemaking, *In the Matter of High-Cost Universal Service Support and Federal-State Joint Board on Universal Service et al.*, before the Federal Communications Commission, FCC 08-262, (released November 5, 2008), (hereafter *2008 NPRM*), Appendix A, ¶ 165.

hence, it sought to implement procedures that reduced or eliminated them.[9] The FCC established access charges that significantly exceeded their incremental costs, but stated that it planned to reduce those access charges gradually over time.[10]

Some efforts were made in the 1980s and 1990s to reform access rates, but per-minute access rates remained—to use the FCC's characterization—"high."[11] At the time of divestiture in 1984, the interstate per-minute switched access rate was 17.26¢, and by 1996 it had declined substantially, but to the still very high rate of 6.16¢.[12] In fact, these relatively high switched access rates created an arbitrage opportunity by which new entrants built direct connections to business locations so that these business customers could bypass switched access charges by connecting directly to their long distance providers and avoiding the LEC entirely when they made long distance calls.[13]

B. Recognizing That the Old System of Implicit Subsidies Can No Longer Be Sustained, the FCC Has Adopted Significant Reforms

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9 The FCC concluded that "[a]rtificial pricing structures, while perhaps appropriate for use in achieving social objectives under the right conditions, cannot withstand the pressures of a competitive marketplace." See, Memorandum Opinion and Order, *In the Matter of MTS and WATS Market Structure*, before the Federal Communications Commission, FCC 83-356, (released August 22, 1983), ¶ 7.

10 *2008 NPRM*, Appendix A, ¶¶ 165-166.

11 *2008 NPRM*, Appendix A, ¶¶ 167-168.

12 "Trends in Telephone Service," Federal Communications Commission, Industry Analysis and Technology Division Wireline Competition Bureau, August 2008, (hereafter *2008 FCC Trends in Telephone Service*), Table 1.2.

13 *2008 NPRM*, Appendix A, ¶ 168; and Peter W. Huber, Michael K. Kellogg, and John Thorne, *The Geodesic Network II: 1993 Report on Competition in the Telephone Industry*, pp. 2.24-2.52.

Q: DID THE FCC ADOPT SIGNIFICANT REFORMS TO INTERSTATE SWITCHED ACCESS CHARGES FOLLOWING THE ENACTMENT OF THE TELECOMMUNICATIONS ACT OF 1996 ("TA96")?

A: Yes. The purpose of TA96 was to open local exchange markets to competition.[14] The inherent friction that already existed between a cross-subsidy policy and competition in long distance markets was magnified by the complete incompatibility between a cross-subsidy policy and competition in local exchange markets. TA96 therefore was the final straw in rendering the legacy system of implicit cross-subsidization of local service from long distance providers unworkable in the long term. Congress recognized, in fact, that the implicit subsidies built into the old system in which retail prices for basic local service were set below cost to encourage local subscribership while access rates were set well above cost in order to subsidize the below-cost retail prices for local service were not sustainable in a competitive marketplace. Congress, therefore, directed the FCC to eliminate or replace implicit subsidies with explicit subsidies thereby moving all interstate access rates towards cost-based levels.[15]

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[14] Telecommunications Act of 1996, Preamble; and, First Report and Order, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, before the Federal Communications Commission, FCC 96-325, (released August 8, 1996), (hereafter *1996 Interconnection Order*), ¶ 3.

[15] *2008 NPRM*, Appendix A, ¶ 169.

Q: WHY IS A CROSS-SUBSIDY POLICY NO LONGER VIABLE IN TODAY'S MARKET PLACE?

A: As I explained earlier, the original purpose of legacy cross-subsidy policies was to keep prices for residential local service artificially low, even if that meant keeping them below their true economic cost, to encourage universal subscription to telephone service. A key problem with that policy, however, is that it is counterproductive to the process of competition. In the long run, you can have efficient competition, or you can have implicit cross-subsidies built into regulated prices, but you cannot have both. Efficient competition is impeded and innovative investment is discouraged if retail prices are held below cost and cannot respond to market conditions (such as changes in production costs or demand).[16]

Moreover, not only are cross subsidies destructive to efficient competition, but competition ultimately undermines the cross subsidies. As excessive access rates keep wireline long distance prices higher than they would otherwise be, consumers are encouraged to switch to alternatives, such as wireless calls (which are not subject to the same level of termination costs, as I will explain shortly) and other options that bypass the PSTN entirely, such as computer-to-computer calling, social networking sites, or instant messaging. The decreased usage of wireline long distance service in turn causes

access revenues to decrease, drying up the very source of subsidy that the access rates were originally designed to provide. According to information compiled by the FCC, reporting ILECs' interstate interLATA billed access minutes carried by IXCs declined from a peak of 535.0 billion in 2000 to 372.0 billion in 2006—the most recent year with available information—a decline of 30 percent in just six years. In that same time period, intrastate interLATA minutes declined by about 33 percent, from 257.3 billion to 171.1 billion.[17] Hence, a system of subsidizing local exchange companies via access charges is not sustainable in the presence of competition that is severely eroding the source of subsidies.

Q: HAS THE FCC INSTITUTED ACCESS REFORM IN LIGHT OF THE MANDATES OF TA96?

A: Yes. In response to the mandate of TA96 to eliminate or replace implicit subsidies with explicit subsidies and move all interstate access rates towards cost-based levels, the FCC implemented significant access reforms in May 1997, May 2000, and November 2001 with the releases of its *Access Charge Reform Order*, *CALLS Order*, and *MAG Order*, respectively. The *Access Charge Reform Order* established rules that required the structure of access charges to more closely reflect cost-causation. The rules reduced the usage-sensitive (per-minute) interstate switched access rates by removing fixed, non-

[16] See Debra J. Aron and David E. Burnstein, "Regulatory Policy and the Reverse Cellophane Fallacy," June 1, 2008, available at SSRN: http://ssrn.com/abstract=1171292, forthcoming, *Journal of Competition Law & Economics.*

traffic sensitive costs from these charges and requiring incumbent LECs to recover these costs through flat-rated charges to their end-user customers.[18] The FCC acknowledged that these reforms would not "remove all implicit support from all access charges immediately," however, and concluded that a process of gradually reducing interstate access charges to cost over time was warranted.[19] Over a three-year period, the per-minute interstate switched access rate declined by over half, from 6.04¢ in January 1997 to about 2.85¢ in January 2000.[20]

The FCC and the industry nevertheless recognized that further reductions to switched access charges were warranted. The *CALLS Order* implemented further reductions to price cap ILECs' interstate switched access rates by adopting a proposal set forth by a consortium of local and long-distance providers.[21] The *CALLS Order* reduced ILECs' interstate switched access charges by reducing local switching and other traffic-sensitive rate elements. The FCC ordered large ILECs, other price cap LECs, and rural price cap ILECs to reduce their average traffic-sensitive rates to 0.55¢, 0.65¢, and 0.95¢ per

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17 *2008 FCC Trends in Telephone Service*, Table 10.2.

18 First Report and Order, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, before the Federal Communications Commission, FCC 97-158, (released May 16, 1997), (released May 16, 1997), (hereafter *1997 Access Reform Order*), ¶ 6.

19 *1997 Access Reform Order*, ¶ 9.

20 *2008 FCC Trends in Telephone Service*, Table 1.2.

21 Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report And Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, before the Federal Communications Commission, FCC 00-193, (released May 31, 2000), (hereafter *FCC CALLS Order*), ¶¶ 1-3. By "price cap ILECs," I mean ILECs that are subject to price cap regulation by the FCC.

minute, respectively, and established a new explicit universal support fund to help local exchange carriers offset the reduction in switched access charges received.[22]

In the *MAG Order*, the FCC implemented similar reforms to the access prices that could be charged by ILECs subject to rate-of-return regulation.[23] As with the *CALLS Order*, the *MAG Order*'s reforms were "designed to bring the American public benefits of competition and choice by rationalizing the access rate structure and driving per-minute rates towards lower, more cost-based levels.[24] The MAG Order provided for reductions in per-minute charges for rate-of-return ILECs and created a universal service support mechanism to replace implicit support with explicit support.[25] Interstate access rates achieved as a result of the *CALLS Order* and the *MAG Order* are, with minor modifications, the interstate access rates in effect today.[26]

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[22] *FCC CALLS Order*, ¶¶ 30, 32, 56, 162. Qwest and Verizon are subject to the 0.55¢ rate in Arizona. See, *FCC CALLS Order*, ¶ 144; Federal Communications Commission, "Carrier Filing History," http://www.fcc.gov/wcb/armis/carrier_filing_history; and Federal Communications Commission, "Verizon GTE Corporation (GTTC)," http://www.fcc.gov/wcb/armis/carrier_filing_history/COSA_History/gttc.htm.

[23] Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166, *In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers and Federal-State Joint Board on Universal Service et al.*, before the Federal Communications Commission, FCC 01-304 (released November 8, 2001), (hereafter *MAG Order*).

[24] *MAG Order*, ¶ 1.

[25] *MAG Order*, ¶¶ 15.

[26] *2008 FCC Trends in Telephone Service*, Table 1.2, and pp. 1-1, 1-2.

Q: DID THE FCC CONCLUDE THAT REDUCING INTERSTATE ACCESS RATES WOULD BENEFIT CONSUMERS?

A: Yes. The FCC concluded in the *CALLS Order* that the mandated restructuring and reduction of access charges would produce lower long distance prices to consumers, resulting in "significant consumer benefits."[27] The FCC drew similar conclusions in the *MAG Order*, as mentioned above.[28]

Q: HAS THE FCC ALSO SET LIMITS ON CLECS' INTERSTATE ACCESS RATES?

A: Yes. In 2001, the FCC concluded that CLECs have market power in the provision of switched access services and required that CLECs' interstate access rates in any geographic area be capped at the interstate access rates of the ILEC in that area.[29] Although the FCC identified those caps as an "interim measure" at the time, the FCC has not rescinded those caps and at least as recently as 2005, in its *Intercarrier Compensation Reform FNPRM*, has reiterated its conclusion (correctly, as I will explain in Section VII) that terminating access is a monopoly.[30]

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27 *FCC CALLS Order*, ¶¶ 28, 35.

28 See also *MAG Order*, ¶ 11.

29 Seventh Report and Order and Further Notice of Proposed Rulemaking, *In the Matter of Access Charge Reform and Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, before the Federal Communications Commission, FCC 01-146, (released April 27, 2001), (hereafter *CLEC Access Charge Reform Order*), ¶¶ 29, 31, 52.

30 See, for example, Further Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, before the Federal Communications Commission, FCC 05-33, (released March 3, 2005), (hereafter *Intercarrier Compensation Reform FNPRM*), ¶ 24. Regarding originating access, the FCC has not indicated any retreat from its 2001 conclusion that originating access is a monopoly service (See, *CLEC*

Q: HAS THE FCC RECOGNIZED THAT THE CURRENT ACCESS CHARGE AND INTERCONNECTION REGIME REQUIRES FURTHER REFORMS IN LIGHT OF THE COMPETITIVE DEVELOPMENTS IN THE INDUSTRY?

A: Yes. The FCC acknowledged shortly after the release of the 2000 *CALLS Order* that a comprehensive, unified, and competitively neutral regime was called for.[31] The FCC stated in a 2001 Notice of Proposed Rulemaking that the ad hoc nature of intercarrier compensation is an impediment to the development of competition,[32] and observed that "[i]nterconnection arrangements between carriers are currently governed by a complex system of intercarrier compensation regulations… [that] treat different types of carriers and different types of services disparately, even though there may be no significant differences in the costs among carriers or services."[33] The FCC has since received proposals, opened a subsequent rulemaking[34] and, according to the FCC, "compiled an extensive record over the past seven years."[35] However, despite passing the eight-year mark, the FCC has yet to issue an order on comprehensive reform.

Access Charge Reform Order, ¶ 29), and as recently as 2008 then-chairman Martin proposed eliminating originating access charges entirely. See, *2008 NPRM*, Appendix A, ¶ 229.

31 Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, before the Federal Communications Commission, FCC 01-132, (released April 27, 2001), (hereafter *2001 NPRM*), ¶¶ 1-2.

32 *2001 NPRM*, ¶¶ 11-18.

33 *2001 NPRM*, ¶ 5.

34 Further Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, before the Federal Communications Commission, FCC 05-33, (released March 3, 2005).

35 *2008 NPRM*, Appendix A, ¶ 187.

The FCC continues, nevertheless, to articulate the need for access reform and the detrimental effect that the current regime of ad hoc, excessive, and mismatched rates has on competition and consumers. On November 5, 2008, the FCC sought comments on an intercarrier compensation reform proposal drafted by then-FCC Chairman Martin. The Martin proposal articulates the following shortcomings with the *status quo* intercarrier compensation regulations:

> The differences in existing intercarrier compensation regimes impose significant inefficiencies on users and distort carriers' investment incentives, which can result in losses of billions of dollars in consumers and producers surplus. Possibly more important, these legacy regulatory regimes pose an obstacle to the transition to an all-IP broadband world. Because carriers currently can receive significant revenues from charging above-cost rates to terminate telecommunications traffic, they have a reduced incentive to upgrade their networks to the most efficient technology or to negotiate interconnection agreements that are designed to accommodate the efficient exchange of IP traffic, as both actions would likely lead to reduced intercarrier payments.[36]

Indeed, in its most recent proposal to reform interstate switched access charges the FCC proposed to implement even more restrictive measures on how CLECs and ILECs price interstate access.[37] At this time there is no indication as to whether or when an actual order might be issued, however. Thus, the passage of time has made clear that the Commission cannot assume the role of spectator and wait to see if and when the FCC takes action. Inaction by the Commission would have harmful consequences for

consumers, businesses, and competition in Arizona. The Commission should instead work to reduce the most egregious problems that fall within its own jurisdiction. States currently retain the same jurisdiction over intrastate rates they have had since access charges were first implemented in 1984 and, for reasons I address below, have more compelling social policy reasons to reduce intrastate access rates than ever before. Indeed, as I will discuss, many states have already implemented reforms.

V. The Current Access/Interconnection Charge Regime Is Highly Asymmetric (Issues 1 and 2)

A. Access Rates Paid by Wireline IXCs Are Much Higher for Intrastate Long Distance Calls Than for Interstate Long Distance Calls, and Are Much Higher Than Local Call Termination Rates, Even Though Those Rates Are All for the Same Functionality

Q: DID THE FCC'S ACCESS CHARGE REDUCTIONS THAT YOU HAVE DISCUSSED APPLY TO ALL LONG DISTANCE TELEPHONE CALLS?

A: No. The FCC implemented reductions to interstate switched access rates, which apply to interstate long distance calls, not intrastate long distance calls, which have historically been under state jurisdiction. As a result, wireline long distance providers are assessed much *higher* rates in Arizona for intrastate long distance calls than for origination and

[36] *2008 NPRM*, Appendix A, ¶ 189.
[37] *2008 NPRM*, Appendix A, ¶¶ 186-236.

termination of interstate calls even though (as I discussed above) the LEC's origination and termination functions are the same for interstate and intrastate calls.

Q: HOW ARE INTRASTATE ACCESS CHARGES APPLIED IN ARIZONA?

A: A LEC charges intrastate access fees for the origination or termination of long distance wireline circuit switched calls that originate *and* terminate in Arizona. Hence, a wireline call that originates in one local calling area in Arizona and terminates in another local calling area in Arizona is an intrastate long distance call to which intrastate access charges would apply.

Q: YOU EXPLAINED THAT THE FCC HAS DECREASED INTERSTATE ACCESS CHARGES SUBSTANTIALLY SINCE THEY WERE FIRST INSTITUTED IN THE 1980s. HAVE THERE BEEN CORRESPONDING REDUCTIONS IN THE ACCESS CHARGES APPLICABLE TO ARIZONA INTRASTATE TOLL CALLS?

A: No. Intrastate switched access charges in Arizona do not reflect federal reforms, leading to intrastate rates that are much higher than interstate rates (and cost-based rates) for the same function. As a result, Qwest's intrastate rates remain more than double its interstate rates. Other carriers are charging intrastate access rates that are an even larger multiple of their interstate rates; in fact, one carrier charges for intrastate switched access at a rate over 40 times higher than the fee charged for the same service if the call is interstate.

Q: WHAT ARE THE ACCESS RATES CHARGED TODAY BY INCUMBENT LECS IN ARIZONA TO WIRELINE IXCS?

A: The access rates charged by incumbent LECs in Arizona today are shown in Table 1, below.

It is useful to understand that access rates are not a single number but instead consist of many rate elements that combine to provide the access service. Some of these rate elements are priced on a flat rate (e.g., per month) basis, some on a per-minute-per mile basis, and some on a per minute basis. Depending on which elements are requested by the IXC seeking access, the configuration of the interconnection arrangement, and the number of minutes processed, the average per minute rate paid by one IXC can differ from the average paid by another, even to the same LEC. A common way to compare the access rates of one LEC to another's is to compute the average per minute rate paid to a given LEC by all IXCs, taking into account all the access rate elements purchased. The table below provides the average per minute intrastate rate paid to ILECs based on actual access revenues and access minutes of use provided by the LECs in discovery. The table also shows the carriers' average interstate access charges.

Table 1

Arizona ILEC Access Charges to Wireline IXCs for Call Origination and Call Termination Services

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]

[redacted]

[END HIGHLY CONFIDENTIAL INFORMATION]

* Carriers were asked to provide only revenues from elements rated on a minute-of-use basis. It appears, however, that Qwest's revenues include elements for both intrastate and interstate access that are not rated on a minute-of-use basis.

Sources: Qwest, Verizon, and ALECA responses to Staff's Data Request STF 1.1.

This table demonstrates the significant disparities in the regulated rates charged by the ILECs for originating and terminating telephone traffic. Qwest's average intrastate access charge of **[BEGIN CONFIDENTIAL INFORMATION]** [redacted] **[END CONFIDENTIAL INFORMATION]** is more than double its average interstate access charge of **[BEGIN CONFIDENTIAL INFORMATION]** [redacted] **[END CONFIDENTIAL INFORMATION].** Verizon's average intrastate access charge of **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** is *over 40* times as large as its average

interstate access charge of **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]**. The intrastate access rates charged on average by ALECA members of 11.42¢ per minute are about seven times as large as the interstate access charge of 1.66¢ per minute.

In addition, an IXC pays switched access charges not only for call termination but also for call origination if it does not also provide local service to the calling party (that is, if it is providing "stand-alone" long distance service to the customer).[38] Hence, an IXC providing stand-alone long distance service would pay **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** *per minute* to Verizon for an in-state toll call in Arizona, if Verizon were the local service provider to the called and calling parties. If the call crossed state boundaries, the per minute charges would instead be **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]**, assuming that Verizon's interstate access rate in the other state was comparable to Verizon's interstate rate in Arizona.

Q: YOU EXPLAINED EARLIER THAT THE FUNCTIONALITY PROVIDED BY A LEC TO TERMINATE A LONG DISTANCE CALL RECEIVED FROM AN IXC IS THE SAME AS THE FUNCTIONALITY PROVIDED BY THE LEC TO TERMINATE A LOCAL CALL RECEIVED FROM ANOTHER LEC. HOW DO

[38] A LEC that originates a call and also provides the long distance service on the call might, as an accounting matter, pay originating access to itself, but as a company, it does not bear the originating access fee as a cost.

THE CHARGES FOR TERMINATING A LONG DISTANCE CALL COMPARE TO THE CHARGES FOR TERMINATING A LOCAL CALL?

A: Although the services provided by the ILEC to terminate another carrier's traffic to the ILEC's customer are functionally the same whether the ILEC is terminating a local call or a toll call, there is a tremendous disparity between the regulated rates for terminating toll calls and local calls. For instance, according to data provided in discovery, a CLEC terminating a local call to a Verizon customer pays Verizon on average **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]**[39] for each minute of the call, whereas, as shown in Table 1, an IXC terminating an intrastate toll call to the same Verizon customer would pay Verizon approximately **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** per minute—over 200 times as much as the CLEC pays for the same terminating functionality.

Q: WHAT ARE THE ACCESS PRICES CHARGED BY CLECS IN ARIZONA?

A: Table 2 below provides the average per minute intrastate and interstate access rates charged by the CLECs that provided relevant data in response to Staff's discovery

[39] Verizon Companies Response to AT&T Data Request No. 2.12. Computed as 2008 local interconnection revenues divided by 2008 local interconnection minutes of use. Qwest and all other LECs in this proceeding were also asked to provide local interconnection revenues and minutes of use from 2003 to 2008 that would have permitted me to calculate the average reciprocal compensation rates they charge, but only Verizon and

requests. As with Table 1, Table 2 illustrates the disparities between interstate and intrastate rates charged by CLECs. In all cases, intrastate rates are multiples of the interstate rates.

Table 2

Arizona CLEC Access Charges to Wireline IXCs for Call Origination and Call Termination Services

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]

[END HIGHLY CONFIDENTIAL INFORMATION]

^ Carriers were asked to provide only revenues from elements rated on a minute-of-use basis. It appears, however, that Integra's and XO's revenues include elements that are not rated on a minute-of-use basis.

* Average of TCG, AT&T, and SBC LD

** Average of Electric Lightwave, Eschelon, and Mountain Communications

Sources: CLEC responses to Staff's Data Request STF 1.1.

Integra provided that information. See Qwest Responses to AT&T Data Request No. 3.12 and other LECs' Responses to AT&T Data Request No. 2.10. Some LECs have not yet responded to this request.

B. The Current System of Intercarrier Compensation Is Highly Asymmetric Across Technologies

Q: ARE ACCESS CHARGES APPLIED SYMMETRICALLY ACROSS TECHNOLOGIES?

A: No, not at all. The application of interconnection rates differs significantly across technologies, including wireless, VoIP, and other communications platforms.

Q: HOW ARE ACCESS CHARGES APPLIED DIFFERENTLY TO WIRELESS CALLS?

A: Wireless providers are not charged intrastate access rates for intrastate wireless calls except in very limited circumstances. Under FCC rules established in 1996, if a call originates on a wireless phone and goes to a LEC's customer without crossing the boundary of a Major Trading Area ("MTA"), it is considered a "local" call for purposes of interconnection fees (even if the call crosses a state boundary, a LATA boundary, and/or a LEC local calling area boundary) and the LEC charges reciprocal compensation rates, which are much lower than switched access rates.[40] Wireless carriers are subject to switched access rates only on calls that (1) terminate to a LEC customer, and (2) cross an MTA boundary.

[40] *1996 Interconnection Order*, ¶¶ 1034-1036.

Q: CAN YOU PLEASE DESCRIBE THE DIFFERENCES BETWEEN MTAS AND WIRELINE LOCAL CALLING AREAS IN ARIZONA?

A: Yes. The difference is huge. In fact, there are only three MTAs in all of Arizona, two of which extend well beyond Arizona's borders, while there are hundreds of local individual wireline calling areas in Arizona. Moreover, the two biggest cities in Arizona, Phoenix and Tucson, are in the same MTA. Figure 2 shows the rate centers that comprise the local calling areas of the Phoenix and Tucson areas and shows the Phoenix MTA, which is the MTA in which these two local calling areas reside. A wireline call originating in Phoenix must terminate within the Phoenix local calling area (i.e., must go to a customer in one of those Phoenix rate centers circled on the map) to qualify for reciprocal compensation rates for termination. In contrast, a wireless call originating in Phoenix could go to anywhere in the entire area indicated as the Phoenix MTA, which includes Tucson and most of the geographic area of Arizona, and still qualify to pay reciprocal compensation rates rather than the much higher intrastate switched access rates for the same functionality. Hence, for example, the IXC carrying a wireline call from Phoenix to Tucson would pay intrastate access charges to the LEC terminating the call (and the LEC originating the call); but if the call were placed on the customer's wireless phone, the wireless carrier would pay only reciprocal compensation rates to the same LEC to terminate the call to the same called party (and would pay no originating access charge at all).

Figure 3 expands Figure 2 to show the size of the three MTAs in Arizona and surrounding states. The Los Angeles MTA encompasses Southern California, a portion of Nevada, and a portion of Arizona. The El Paso-Albuquerque MTA extends beyond the state border and includes most of New Mexico and parts of Utah, Texas, and Colorado. For additional perspective, there are 93 separate local calling areas that lie within the Phoenix MTA. Any wireless call within the entire MTA qualifies for the reciprocal compensation rate for termination, rather than the (much higher) access rate.

Figure 2

MTAs Are Far Larger Than Local Calling Areas in Arizona

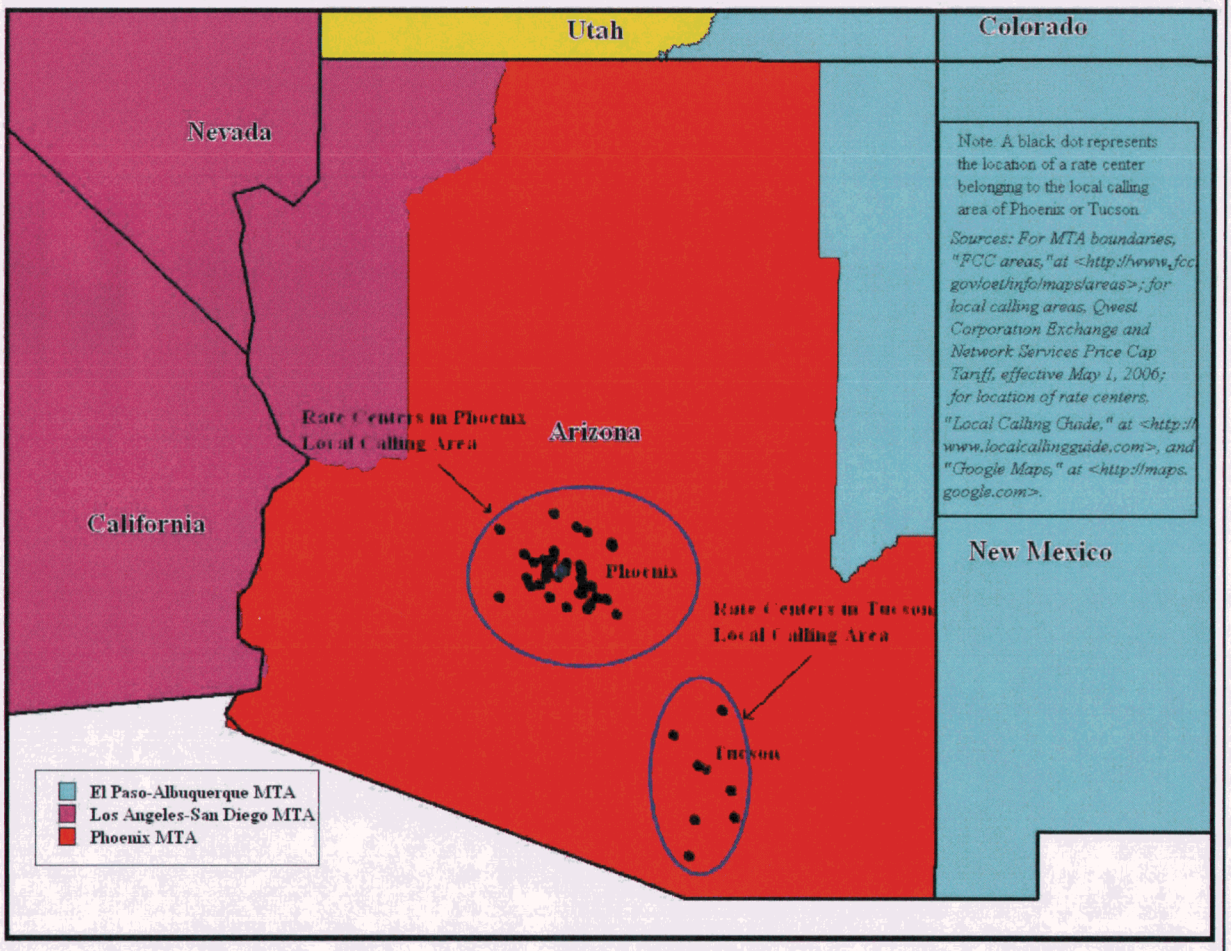
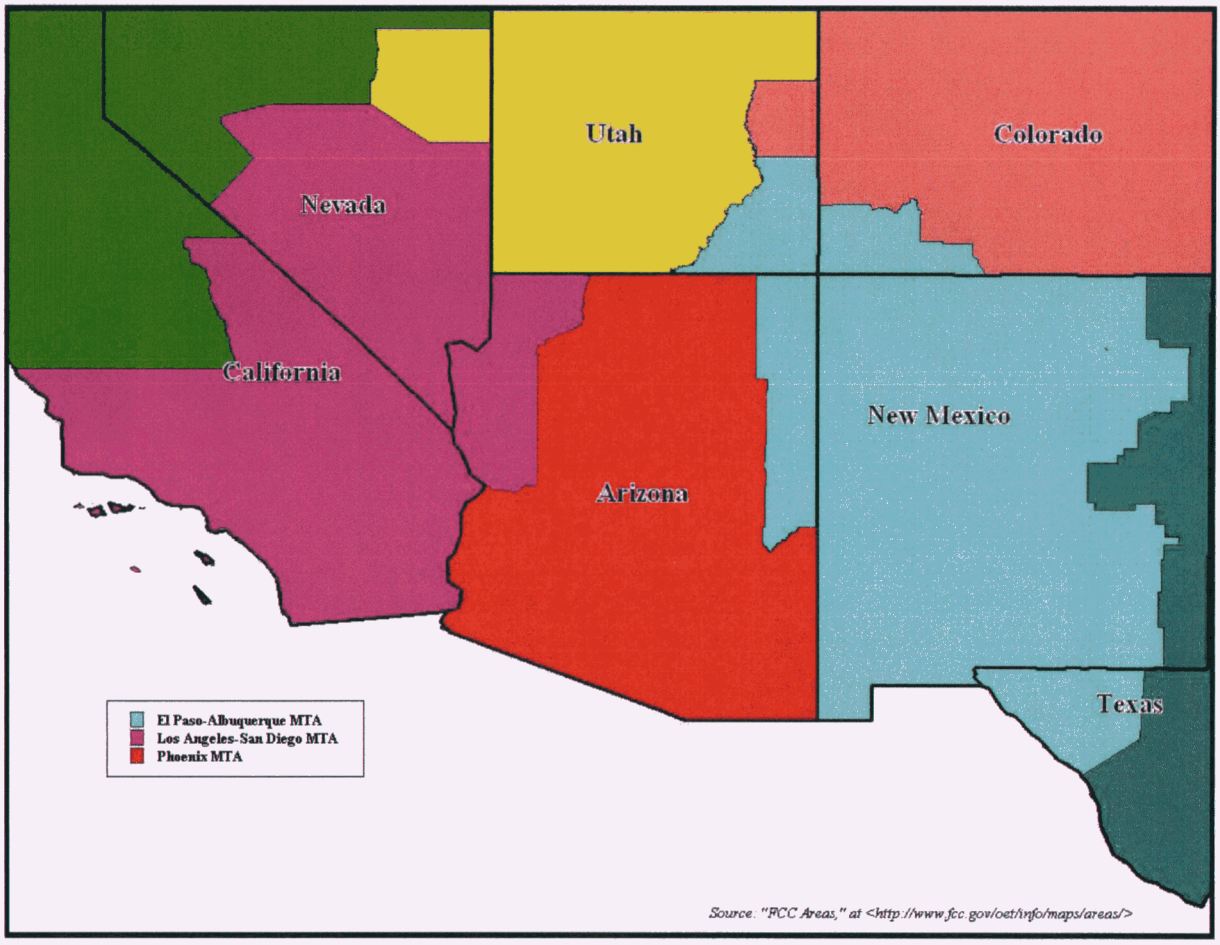


Figure 3

One MTA in Arizona Covers Most of the State and the Other Two Span Several States



Source: "FCC Areas," at <http://www.fcc.gov/oet/info/maps/areas/>

Q: WHAT RATES DO WIRELINE LECS IN ARIZONA CHARGE TO WIRELESS COMPANIES TO TERMINATE INTRAMTA CALLS?

According to the LECs' responses to discovery, the rates charged to terminate intraMTA wireless calls vary, but in all cases the termination rates for intraMTA wireless calls are far below the rates charged to wireline LECs for intrastate access, as Table 3 demonstrates:

Table 3

Arizona LEC Charges for Call Termination

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]

[redacted]

* [redacted]

[END HIGHLY CONFIDENTIAL INFORMATION]

** For Integra, intraMTA rates are the average of Electric Lightwave and Eschelon, computed as total reciprocal compensation revenues divided by reciprocal compensation minutes billed to wireless carriers. Integra's intrastate and interstate access rates are the average of Electric Lightwave, Eschelon, and Mountain Communications.

Sources: Qwest Supplemental Responses to AT&T's Data Requests 3.9, Cox Communications and Verizon Responses to AT&T's Data Request 2.9; Integra Responses to AT&T's Data Request 2.8; and Parties' Responses to Staff's Data Request STF 1.1.

Q: DO VOIP PROVIDERS PAY ACCESS CHARGES?

A: This is a disputed area of intercarrier compensation, which the FCC has not resolved. A number of carriers have petitioned the FCC seeking clarification or ruling on this issue, indicating that VoIP providers seek to avoid access charges by appealing to current

regulatory ambiguity.[41] To the extent that VoIP providers are currently able to avoid access charges, they also enjoy a competitive advantage over wireline IXCs, who must pay inflated intrastate access rates.

Q: DO ACCESS CHARGES APPLY TO OTHER BROADBAND FORMS OF COMMUNICATION, SUCH AS COMPUTER-TO-COMPUTER CALLING?

A: No. Communication methods that avoid the public switched telephone network entirely, such as computer-to-computer voice calling (an example is Skype-to-Skype), instant messaging, social networking such as Facebook, and email, are not subject to the access charge regime at all.[42]

C. Many Other States Have Already Reduced the Intrastate Access Rates that ILECs and CLECs Can Charge

[41] See, for example, *In the Matter of Feature Group IP Petition for Forbearance Pursuant to 47 U.S.C. Section 160(c) from Enforcement of 47 U.S.C. Section 251(g), Rule 51.701(a)(1), and Rule 69.5(b)*, before the Federal Communications Commission, Docket No. WC 07-256 (October 23, 2007); and *In the Matter of Petition of the Embarq Local Operating Companies for Limited Forbearance Under 47 U.S.C. Section 160(c) from Enforcement of Rule 69.5(a), 47 U.S.C. Section 251(b) and Commission Orders on the ESP Exemption*, before the Federal Communications Commission, Docket No. WC 08-8 (January 11, 2008).

[42] See Memorandum Opinion and Order, *In the Matter of Petition for Declaratory Ruling that pulver.com's Free World Dialup is Neither Telecommunications Nor a Telecommunications Service*, before the Federal Communications Commission, FCC 04-27 (released February 19, 2004), ¶¶ 15-22 (finding that peer-to-peer applications that connect users over the Internet and make no use of the public switched telephone network are not subject to common-carrier-type regulations). See, also, Jonathan E. Nuechterlein and Philip J. Weiser, *Digital Crossroads: American Telecommunications Policy in the Internet Age* (2007), and pp. 198-199, and p. 303 ("Because IP-to-IP calls never leave the Internet and never touch the public switched network, any compensation arrangements between the firms involved—i.e., ISPs, Internet backbone providers, and the VoIP provider itself—are unregulated.").

Q: **HAVE OTHER STATES REFORMED ILECS' INTRASTATE ACCESS RATES?**

A: Yes. In a number of states, major ILECs have been mandated to reduce intrastate access rates by state statute or administrative rules. These states include Maine,[43] Texas,[44] Michigan,[45] and New Mexico,[46] where the statute or administrative code has provisions ordering intrastate mirroring of interstate access rates. In other states, including Georgia,[47] Kansas,[48] Nevada,[49] and Wisconsin,[50] the statute mandates mirroring of interstate and intrastate access rates as a condition for granting ILECs retail pricing flexibility. An inspection of the major ILEC's interstate and intrastate tariffs shows that the local switching and Carrier Common Line charges are in fact approximately mirrored in each of these states.

Indiana also has a statutory mandate for the mirroring of interstate and intrastate access charges. The Indiana statute directs the state utilities commission to "consider the provider's rates and charges for intrastate access service to be just and reasonable if the intrastate rates and charges mirror the provider's interstate rates and charges" in all

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43 ME. REV. STAT. ANN. TIT. 35-A, Part 7, Chapter 71, § 7101-B. CODE ME. R. 65-407, Ch. 280, § 8B.
44 Public Utility Regulatory Act, Title II, Texas Utility Code, §§ 65.201-205, and 52.155 (2007).
45 Michigan Telecommunications Act, Chapter 484.2310, § 310 (1991).
46 N.M. ADMIN. CODE TIT. 17, Chapter 11, §§ 10.6, 10.8.C (current though July 1, 2008). In addition, the Oklahoma statute requires LECs serving 15 percent or more of the access lines in the state to keep intrastate access rates in parity with interstate access rates until its intrastate access revenues have been reduced by $16.5 million. O.S. § 17-139.103 D.3-4, E (1997); OAC 165:55-5-66(2).
47 GA. CODE. ANN. § 46-5-166(f)(1) and f(2) (1995).
48 KAN. STAT. ANN. §§ 66-2005(c), (f).
49 NEV. ADMIN. CODE ch. 704 § 704.6898; also § 704.68952.

proceedings where intrastate access rates are at issue, including interconnection agreements.[51] AT&T Indiana is the major ILEC in Indiana, and its intrastate local switching and common carrier line charges in Indiana are identical to its interstate rates.

In a number of states, access charge reductions have been ordered by state commissions without legislative requirement:

- The Illinois Commerce Commission ("ICC") adopted a mirroring policy in 1983, based on the recognition that "the costs associated with interstate and intrastate access minutes were essentially the same (since the network functions are the same) and that rate differentials could create significant rate arbitrage opportunities."[52] In 2000, the ICC directed ILECs to remove non-cost-based rate elements and reduce the rates in the cost-based elements of their intrastate switched access charges.[53] The current local switching intrastate rate in Illinois for AT&T, the major ILEC, is slightly *lower* than the interstate rate.
- In Ohio, the Public Utilities Commission has required ILECs to mirror intrastate and interstate access rates since 1987,[54] and it imposed the same requirement on CLECs in 2007.[55]

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50 See WIS. STAT. ANN. § 196.196, and in particular § 196.196(2)(b).

51 IND. CODE § 8-1-2.6-1.5 (c) (2).

52 Interim Order, *In the matter of Illinois Commerce Commission On Its Own Motion vs. Illinois Bell Telephone Company et al., Investigation Into Non-Cost Based Access Charge Rate Elements in the Intrastate Access Charges of Incumbent Local Exchange Carriers in Illinois et al.,* before the Illinois Commerce Commission, Docket Nos. 97-0601, 97-0602 and 97-0516, (December 16, 1998), 1998 Ill. PUC LEXIS 1148 at *12. See also, Order, *In the matter of Illinois Commerce Commission on its Own Motion vs. Illinois Bell Telephone Company; et al., Investigation Into Non-Cost Based Access Charge Rate Elements in the Intrastate Access Charges of Incumbent Local Exchange Carriers in Illinois et al.,* before the Illinois Commerce Commission, Docket Nos. 97-0601, 97-0602 and 97-0516, (March 29, 2000), (hereafter *2000 Illinois Order*), 2000 Ill. PUC LEXIS 1004 at *11-12.

53 *2000 Illinois Order*, at **118-131.

54 Opinion and Order, *In the Matter of the Commission Investigation Relative to Establishment of Intrastate Access Charges,* before the Public Utilities Commission of Ohio, Case No. 83-464-TP-COI (Subfile C), (March 12, 1987), 1987 Ohio PUC LEXIS 100 at *20.

55 Entry on Rehearing, *In the Matter of the Establishment of Carrier-to-Carrier Rules,* before the Public Utilities Commission of Ohio, Case No. 06-1344-TP-ORD, (October 17, 2007), ¶ 29, p. 18.

- In 1995, the Mississippi Public Service Commission issued an order requiring South Central Bell to reduce intrastate switched access to parity with interstate rates as of January 1, 1996, and to adjust its rates annually, "subject to a cap at parity throughout the life of the plan."[56]
- Also in 1995, the Commission approved Kentucky BellSouth's regulation plan subject to the requirement that BellSouth's switched access rate elements mirror interstate rates.[57]
- In 1997, the Tennessee Regulatory Authority ordered BellSouth to reduce its intrastate access rates to the level of its interstate access rates as of August 1, 1995, as part of a settlement in a dispute between BellSouth and MCI and Sprint.[58]
- In Massachusetts, the Department of Telecommunications and Energy ordered Verizon to lower its intrastate switched access charges "to the more cost-based interstate levels" while allowing for retail rate increases that were expected to "enhance[] efficiency without negatively impacting universal service."[59]
- In West Virginia, the Commission's 2007 Order approving Verizon's Market Transition (i.e., retail rate flexibility) Plan contains a provision that eliminates Verizon's Carrier Common Line Charge ("CCLC") and requires its intrastate traffic-sensitive rates to mirror interstate rates after a transition period.[60]

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[56] Final Order, *In re: Order of the Mississippi Public Service Commission Establishing a Docket to Consider Formulating a Properly Structured Price Regulation Plan for South Central Bell*, before the Mississippi Public Service Commission, Docket No. 95-UA-313, (November 1, 1995), p. 12.

[57] Order, *In the Matter of the Tariff Filing of BellSouth Telecommunications, Inc. to Mirror Interstate Access Rates*, before the Kentucky Public Service Commission, Case No. 98-065, (March 31, 1999), 1999 Ky. PUC LEXIS 102 at *1; Order, *In the Matter of: Application of BellSouth Telecommunications, Inc., d/b/a South Central Bell Telephone to Modify Its Method of Regulation*, before the Kentucky Public Service Commission, Case No. 94-121 (August 2, 1999), 1999 Ky. PUC LEXIS 75 at *1.

[58] Order, *In Re: Tariff Filing by BellSouth Telecommunications, Inc. to Reduce Intrastate Access Charges (Tariff 97-029)*, before the Tennessee Regulatory Authority, Docket No. 97-00185, (February 14, 1997), p. 1; "BellSouth Reduces Access Charges," *Communications Today*, February 3, 1997.

[59] Order, *In the matter of 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*, before the Massachusetts Department of Telecommunications and Energy, D.T.E. 03-31-Phase I, (May 8, 2002), p. 63.

[60] Commission Order, *In the matter of Petition for Approval of Joint Stipulation and Agreement for Settlement and Joint Petition for Expedited Approval of a Joint Stipulation for a Market Transition Plan for Verizon West Virginia Inc.*, before the Public Service Commission of West Virginia, Case No. 06-1935-T-PC, (March, 26, 2007), pp. 3, 12-14 of Joint Stipulation and Agreement for Settlement. Five other states that have imposed mirroring requirements are Alabama, Iowa, Nebraska, North Carolina, and Oregon. The Commission in

In all, I am aware of over 20 states that have reformed ILECs' intrastate access rates and have targeted the intrastate rates to interstate levels. As I will show later in this testimony, these reforms have brought significant and measurable benefits to consumers in those states.

Alabama required South Central Bell to maintain intrastate access charges at a level at or below interstate access rates as a condition for approving its price regulation plan. See Report and Order, *In Re Petition of South Central Bell Telephone Company to Restructure its Form of Regulation, et al., before the Alabama Public Service Commission*, Docket Nos. 24499, 24472, 24030, 24865, (September 1995), ¶ 09.04. This requirement was modified in the 2004 Price Cap Plan, which required BellSouth and other ILECs to cap intrastate access services at the "effective intrastate level," so that rates today are capped at the 2004 interstate level. In Iowa, the statute mandates carriers submitting a price regulation plan to include a proposal "for reducing the local exchange carrier's average intrastate access service rates to the local exchange carrier's average interstate access service rates in effect as of the last day of the calendar year immediately preceding the date of filing of the plan." See IA. CODE ANN. §§ 476.97.1, 476.97.3 (2008). Qwest's initial price plan was filed in 1998 and has been renewed at least twice, but it appears that the major components of its intrastate access charges (the local switching rates and the common carrier line charge) have not been revised since 2001, while interstate access rates have, so its intrastate rates do not mirror current interstate rates. See, Order Approving Renewed Price Regulation Plan, *In re: Qwest Corporation, Iowa Utilities Board*, Docket No. RPU-01-10, 2004 Iowa PUC LEXIS 566 (December 13, 2004); Qwest Corporation, Iowa Tariff No. 4, Access Service, sections 3.9 and 6.8.2 (A); and Qwest Corporation, Tariff FCC No. 1, sections 3.9 and 6.8.2 (A). The Nebraska Public Service Commission concluded in 1999 that the intrastate access charge structure for non-rural carriers "should approximate the interstate access charge structure," and in 2002, the Nebraska Commission reached the same conclusion for rural carriers. See Order, *Re: Investigation into Intrastate Access Charge Reform, before the Nebraska Public Service Commission*, Application No. C-1628, (January 13, 1999), pp. 7-8; and Findings and Conclusions, *In the Matter of the Nebraska Public Service Commission, on its own Motion, Seeking to Conduct an Investigation of Intrastate Access Charges for Rural ILECs*, before the Nebraska Public Service Commission, Application No. NUSF-28, (November 26, 2002), ¶¶ 27, 31. This order did not mandate strict mirroring between interstate and intrastate rates and current intrastate rates do not mirror interstate rates. In 2000, the North Carolina Utilities Commission ordered BellSouth to reduce its intrastate switched access charges, noting that this would lessen "the disparity between intrastate and interstate long distance rates." Order Regarding Joint Stipulation, *In the Matter of Application by BellSouth Telecommunications, Inc., For, and Election of, Price Regulation et al.*, North Carolina Utilities Commission, (July 24, 2000), 2000 N.C. PUC LEXIS 104 at *93-94. The Commission ordered a reduction in intrastate rates but not strict parity. Today's intrastate rates do not match interstate rates. The Public Utility Commission of Oregon approved Qwest's rate rebalancing plan in 2001, and required Qwest to reduce switched access rates to "bring Qwest's intrastate switched access rates closer to its currently lower interstate switched access rates." Order, In the matter of the Application of Qwest Corporation for an Increase in Revenues, before the Oregon Public Utility Commission, Order No. 01-810, (September 14, 2001), 2001 Ore. PUC LEXIS 449 at *17-18, 32. This plan apparently did not require parity between interstate and intrastate rates and the rates are not in parity today.

Q: YOU EXPLAINED THAT THE FCC CAPS CLECS' INTERSTATE ACCESS RATES AT THE LEVEL OF THE COMPETING ILEC. HAVE OTHER STATES LIMITED CLECS' INTRASTATE ACCESS RATES AS WELL?

A: Yes. In a number of states, CLECs' intrastate access rates have been capped at the level of the competing ILEC's rates. These states include Alaska,[61] Louisiana,[62] Maine,[63] Maryland,[64] Massachusetts,[65] Missouri,[66] New Hampshire,[67] New Mexico,[68] New York,[69] Ohio,[70] Pennsylvania,[71] Texas,[72] Virginia,[73] and Washington.[74]

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61 Alaska Intrastate Interexchange Access Charge Manual, §§ 001(d) and (e), 003, and 102 (April 28, 2004).

62 Order No. U-17949-TT, *In re: Development of regulatory plan for South Central Bell, including assessment of alternative forms and methods of regulation; depreciation methods and expensing; cost of capital; capital structure; and other related matters,* Louisiana Public Services Commission, March 15, 1996 (corrected May 3, 1996), Section 301 (k)(4) of Exhibit 1.

63 CODE ME. R. 65-407 Ch. 280 §§ 2J, 8B.

64 MD. REGS. CODE §§ 20.45.09.01, 20.45.09.02(b)(4), 20.45.09.02(b)(5)(a), 20.45.09.03(b).

65 Final Order, *In the matter of Petition of Verizon New England, Inc., MCImetro Access Transmission Services of Massachusetts, Inc., d/b/a Verizon Access Transmission Services, MCI Communications Services, Inc., d/b/a Verizon Business Services, Bell Atlantic Communications, Inc., d/b/a Verizon Long Distance, and Verizon Select Services, Inc. for Investigation under Chapter 159, Section 14, of the Intrastate Access Rates of Competitive Local Exchange Carriers*, before the Commonwealth of Massachusetts department of Telecommunications and Cable, D.T.C. 07-9, June 22, 2009.

66 Report and Order, *In the Matter of an Investigation of the Actual Costs Incurred in Providing Exchange Access Service and the Access Rates to be Charged by Competitive Local Exchange Telecommunications Companies in the State of Missouri*, before the Public Service Commission of the State of Missouri, Case No. TR-2001-65, August 26, 2003, Ordering Clause No. 4.

67 N.H. CODE ADMIN. R. ANN. (PUC) 431.07 and 449.07(f)(3).

68 N.M. ADMIN. CODE at 17.11.10.8.C; at 17.11.10.7.R; and at 17.11.10.2.

69 Opinion and Order Establishing Access Charges for New York Telephone Company and Instituting a Targeted Accessibility Fund, *In the matter of Proceeding on Motion of the Commission to Examine Issues Related to the Continuing Provision of Universal Service and to Develop a Regulatory Framework for the Transition to Competition in the Local Exchange Market; Proceeding on Motion of the Commission as to the Impact of the Modification of Final Judgment and the Federal Communications Commission's Docket 78-72 on Provision of Toll Service in New York State*, before the New York Public Service Commission, Case 94-C-0095, Case 28425, June 2, 1998, 1998 N.Y. PUC LEXIS 325 at *41.

70 Entry on Rehearing, *In the Matter of the Establishment of Carrier-to-Carrier Rules*, before the Public Utilities Commission of Ohio, Case No. 06-1344-TP-ORD, October 17, 2007, p. 18.

71 PA. CONN. STAT. ANN. Title 66, § 3017(c) (2008).

72 Public Utility Regulatory Act, Title II, Texas Utility Code, §52.155 (2007).

In addition, some states have a policy constraining access rates that applies equally to CLECs and ILECs. Examples of such states are Maine, where all carriers are required to mirror their own interstate access rates;[75] Connecticut, where the DPUC ordered all carriers to cap their intrastate access rates at 1.5¢ per minute;[76] and Indiana, where intrastate access rates for all carriers are considered just and reasonable if they mirror interstate rates.[77] In Illinois the Commission has issued orders over the years requiring individual CLECs to cap their access rates at the ILEC rate.[78] More recently, in June of 2009, the Staff of the Illinois Commerce Commission (ICC) submitted reports recommending that the ICC open investigations into whether the intrastate access charges

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73 VA. ADMIN. CODE. Chapter 417, 5-417-50 (E)(1).

74 WAC 480-120-540(2). In Missouri, New York, Ohio, Pennsylvania, and Texas, the ILEC cap may be lifted if CLECs demonstrate with a cost study that higher rates are warranted. I am aware of no state in which such a demonstration has been made. In addition, in California and Iowa, CLECs have been required to reduce their rates, but not quite to the ILEC level. In California, CLECs have been ordered to reduce their intrastate access charges "to the higher of AT&T's or Verizon's intrastate access charges, plus 10%." See Final Opinion Modifying Intrastate Access Charges, *Order Instituting Rulemaking to Review Policies Concerning Intrastate Access Charges*, before the Public Utilities Commission of the State of California, Rulemaking 03-08-018 (December 6, 2007). In Iowa, the Administrative Code orders CLECs that concur with the Iowa Telephone Association (ITA) Access Service Tariff No.1 to reduce their CCL charge if they offer service "in exchanges where the incumbent local exchange carrier's intrastate access rate is lower than the ITA access rate." See IAC 199—22.14(2)(d)(1)2.

75 CODE ME. R. 65-407 Ch. 280 §§ 2J, 8B.

76 Decision, *DPUC Investigation Of Intrastate Carrier Access Charges*, before the Connecticut Department of Public Utility Control, Docket No. 02-05-17 (February 18, 2004) 2004 Conn. PUC LEXIS 15 at *45-46.

77 IND. CODE § 8-1-2.6-1.5 (c) (2).

78 See, for example, Arbitration Decision, *AT&T Communications of Illinois, Inc., TCG Illinois and TCG Chicago Verified Petition for Arbitration of Interconnection Rates, Terms and Conditions and Related Arrangements with Illinois Bell Telephone Company (SBC Illinois) pursuant to Section 252 (b) of the Telecommunications Act of 1996,* before the Illinois Commerce Commission, 03-0239 (August 26, 2003), 2003 Ill. PUC LEXIS 715 at *352-353; and Arbitration Decision, *TDS Metrocom, Inc.: Petition for Arbitration of Interconnection Rates, Terms and Conditions and Related Arrangements with Illinois Bell Telephone Company d/b/a Ameritech Illinois Pursuant to Section 252(b) of the Telecommunications Act of 1996*, before the Illinois Commerce Commission, 01-0338 (August 8, 2001), 2001 Ill. PUC LEXIS 829 at *111-112.

assessed in Illinois by 5 CLECs are just and reasonable.[79] The Staff reports cite the actions by the FCC to cap interstate rates based on the FCC's finding that CLECs' rates for access reflect monopoly power, and cited the "excessive" rates of these CLECs in Illinois.[80] The ICC issued orders in July initiating investigations of these five CLECs' intrastate access charges as recommended by Staff.[81] Following these actions, as of the writing of this testimony, two of the CLECs under investigation have filed tariff changes reducing their intrastate rates to mirror their rates to those of AT&T and Verizon.[82]

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79 Illinois Commerce Commission Telecommunications Division Staff Reports dated June 26, 2009 recommending investigations into the intrastate access rates of McLeodUSA Telecommunications Services; Bullseye Telecom, Inc.; Delta Communications, LLC d/b/a Clearwave Communications; Nexus Communications, Inc. d/b/a TSI Telephone Company; and Norlight, Inc. d/b/a Cinergy Communications.

80 See, for example, Illinois Commerce Commission Telecommunications Division Staff recommending an investigation into the intrastate access rates of McLeodUSA Telecommunications Services, June 26, 2009, p. 4. ("Intrastate access rates charged by some Illinois CLECs are similar to those found to be excessive by the FCC.")

81 Order, *Investigation into whether Intrastate Access Charges of McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business Services are just and reasonable*, before the Illinois Commerce Commission, 09-0315 (July 8, 2009); Order, *Investigation into whether Intrastate Access Charges of Delta Communications, LLC d/b/a Clearwave Communications are just and reasonable*, before the Illinois Commerce Commission, 09-0314 (July 8, 2009); Order, *Investigation into whether Intrastate Access Charges of Nexus Communications, Inc. d/b/a TSI Telephone Company are just and reasonable*, before the Illinois Commerce Commission, 09-0316 (July 8, 2009); Order, *Investigation into whether Intrastate Access Charges of Norlight, Inc. d/b/a Cinergy Communications are just and reasonable*, before the Illinois Commerce Commission, 09-0317 (July 8, 2009); Order, *Investigation into whether Intrastate Access Charges of Bullseye Telecom, Inc. are just and reasonable*, before the Illinois Commerce Commission, 09-0313 (July 8, 2009).

82 Letter from Ronald Munn, Consultant to Nexus Communications, Inc. re: Changes to the Competitive Access Provider Services Tariff of Nexus Communications, Inc, August 19, 2009, attaching revised tariff pages 2 and 50 of the Competitive Access Provider Services Tariff, I.C.C. Tariff No. 2; Notice of Tariff Filing, *Investigation into whether Intrastate Access Charges of Norlight, Inc, d/b/a Cinergy Communications are just and Reasonable*, 09-0317 (August 24, 2009).

VI. Excessive Access Rates Harm Consumers, Harm Competition, and Distort Investment (Issues 1 and 2)

Q: WHY SHOULD THE COMMISSION BE CONCERNED ABOUT EXCESSIVE INTRASTATE ACCESS RATES IN ARIZONA?

A: Excessive intrastate access rates directly and indirectly harm consumers and businesses in Arizona. They directly harm consumers and businesses because higher intrastate access rates cause higher retail prices for long distance services. Excessive intrastate access rates also indirectly harm consumers and businesses by discouraging wireline long distance usage, driving up the cost of operating businesses in Arizona, distorting competition, and distorting investment. They also create arbitrage opportunities that waste resources generally, and they siphon revenues from IXCs and their customers for the benefit of chat lines and similar businesses that were not the intended beneficiaries of subsidies provided on the backs of long distance customers.

A. Excessive Access Rates Harm Consumers by Inflating Retail Prices of Long Distance Services

Q: HOW DO EXCESSIVE ACCESS PRICES DIRECTLY HARM CONSUMERS?

A: Excessive access prices harm consumers in several clearly identifiable ways. The most direct harm to consumers is that excessive access prices charged to long distance providers cause the prices consumers pay for retail long distance services to be higher

than they would otherwise be, so consumers pay more for the wireline long distance services they use.

When an access provider charges excessive prices for access services, those excessive prices generate revenue to the access provider but represent a cost to the company paying the access: the IXC. The IXC, in turn, must price its retail service higher to recover that cost. Excessive access prices therefore distort the pricing decisions of IXCs. This harms consumers and reduces consumer welfare by forcing the prices for (some) long distance services to be far in excess of the actual social cost of producing the services. For example, if it costs the local exchange company B, say, 0.1¢ per minute to provide access, but B charges the long distance company A, say, 1¢ per minute, the latter will have to price long distance to its customers to recover the 1¢ rather than the genuine social cost of 0.1¢. That increased cost to the IXC will result in higher long distance prices. Conversely, lower access prices will lead to lower retail long distance prices.

Q: ARE SWITCHED ACCESS CHARGES A SIGNIFICANT COMPONENT OF LONG DISTANCE PRICES?

A: Yes, they are. In Arizona, AT&T's average intrastate access expenses per minute were about **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** ■ **[END HIGHLY CONFIDENTIAL INFORMATION]** percent of AT&T's intrastate long distance revenues per minute as of 2008, as can be seen in Figure 4.

Figure 4

AT&T Arizona Intrastate Switched Access Expenses and Long Distance Revenues

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]

[END HIGHLY CONFIDENTIAL INFORMATION]

Q: WHAT IS THE IMPORTANCE OF THE FACT THAT INTRASTATE ACCESS EXPENSES CONSTITUTE SUCH A HIGH PERCENTAGE OF AT&T'S INTRASTATE LONG DISTANCE PRICES?

A: Intrastate access prices are an incremental cost of providing long distance service (i.e., each additional call minute causes the long distance provider to incur an additional access cost). Thus, material increases to the wholesale price of access would be expected to cause a material increase in the retail price of long distance service; and material decreases in the wholesale price of access would be expected to cause a material decrease in the retail price of long distance service.[83]

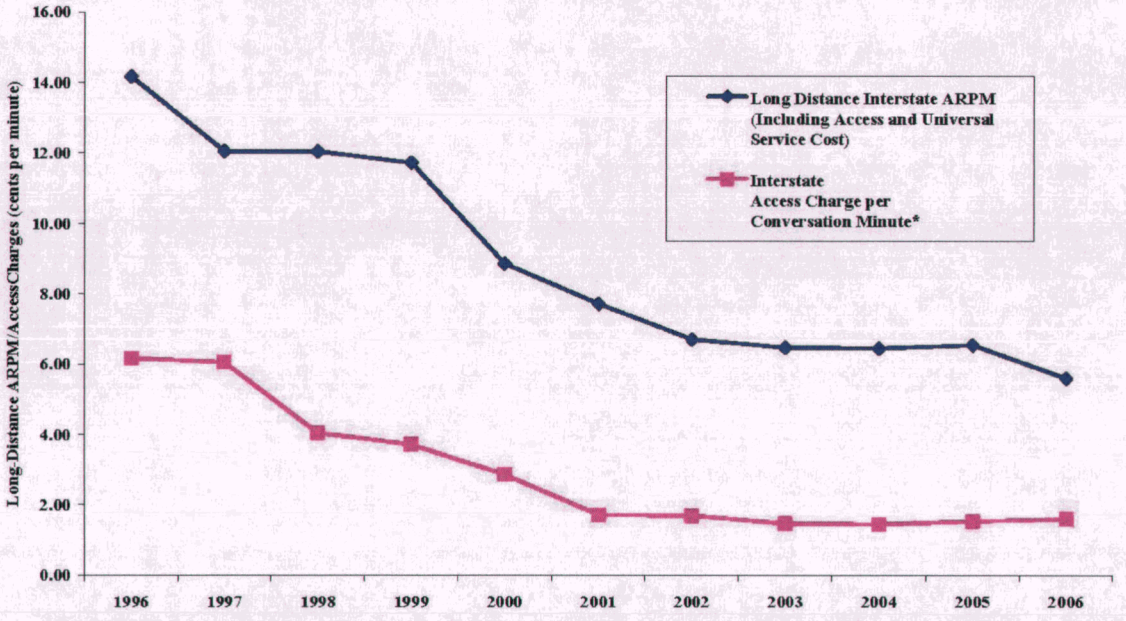
Q: IS THERE EVIDENCE THAT THERE IS IN FACT A RELATIONSHIP BETWEEN ACCESS RATES AND RETAIL LONG DISTANCE PRICES?

A: Yes. First, the positive correlation between access rates and prices is apparent from a simple visual inspection of the data on access charges and long distance rates over time since 1996.

Figure 5 shows the national average of per-minute interstate access charges and the average retail price (measured by average revenue per minute) of interstate long distance calls. As you can see, the downward trend in interstate access charges has been accompanied by a comparable trend in interstate long distance prices. Long distance prices have fallen as access rates have fallen.

Figure 5

Interstate Access Charges and Interstate Long Distance Average Revenue per Minute



* Access charges are the average rates (weighted by minutes of use) for all local exchange carriers that file access tariffs subject to price-cap regulation and all LECs in the National Exchange Carrier Association (NECA) pool. The average access charges reported by the FCC do not include revenue per minute from subscriber line charges or primary interexchange carrier charges (PICCs). The total charge per conversation minute consists of charges on the originating end of the call, which are adjusted for dialing and call setup time, plus charges on the terminating end.

Source: FCC 2008 Trends, Tables 1.2 and 13.4

[83] Robert S. Pindyck and Daniel L. Rubinfeld, MICROECONOMICS, 3rd ed. (Englewood Cliffs, New Jersey: Prentice Hall, 1995), pp. 492-494.

Q: DR. ARON, HAVE YOU BEEN ABLE TO TEST AND QUANTIFY THE RELATIONSHIP BETWEEN INTRASTATE ACCESS RATES AND INTRASTATE LONG DISTANCE PRICES?

A: Yes. In order to investigate the relationship between intrastate access rates and intrastate long distance prices, I requested and received data from AT&T on AT&T's intrastate access rates and intrastate long distance prices for the years 2004 through 2008 (most recently available), for all 50 US states.[84] The data are plotted in Figure 6. Each point represents a state in a particular year.

[84] Specifically, I requested and received intrastate access expense minutes, intrastate expense revenues (that is, the amount of money paid by AT&T for intrastate access), intrastate toll revenues, and intrastate toll minutes. From these data I calculated AT&T's average intrastate long distance per minute price charged in each state for each year and AT&T's average intrastate access charge paid for each state for each year of my data. I assumed (and I found using the statistical techniques discussed below) that the average retail price charged by AT&T in year t is related to the average intrastate access rate charged to AT&T in year t-1, which reflects the fact that in general and in this circumstance, prices do not adjust instantaneously to changes in input prices. Hence, each point in Figure 6 is AT&T's average per minute price for intrastate long distance service in state j in year t on the vertical axis and the intrastate access rate in state j in year t-1 on the horizontal axis.

Figure 6

AT&T's Intrastate Toll Price versus Access Cost in 50 States, 2005-2008

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[END HIGHLY CONFIDENTIAL INFORMATION]

It is apparent simply from visual inspection of Figure 6 that there is a strong positive relationship on average between the intrastate access rate paid by AT&T and the average per minute intrastate long distance price charged by AT&T. In states/years where the

access rate paid is higher (the variable on the horizontal axis), the price charged (the variable on the vertical axis) tends to be higher.

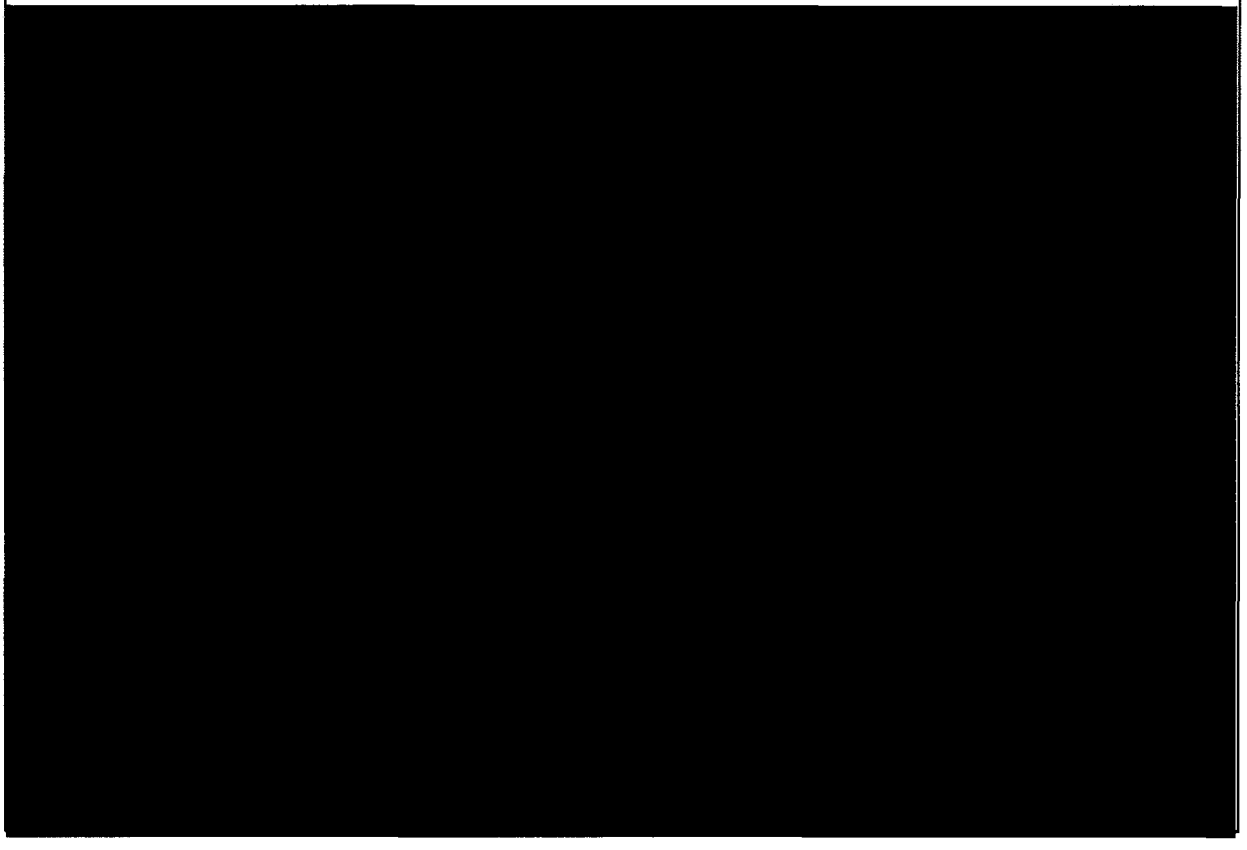
Q: I NOTICE THAT YOU HAVE CIRCLED THE POINTS RELATED TO ARIZONA. WHAT DOES THE PATTERN OF DATA IN ARIZONA SHOW?

A: These points are isolated and replicated in Figure 7. Examination of Figure 7 makes clear that there has been a strong positive relationship in Arizona between the level of intrastate access charges and the level of intrastate long distance prices over the last several years. In fact, in each year of the data the average price paid by AT&T for intrastate access went down, and so did the average price charged for intrastate long distance service.

Figure 7

AT&T's Intrastate Toll Price versus Access Cost in Arizona

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]



[END HIGHLY CONFIDENTIAL INFORMATION]

Q: **WHAT IS THE SIGNIFICANCE OF THE VERTICAL LINE?**

A: The vertical line in Figure 7 is the current average interstate access rate paid by AT&T in Arizona. Hence, it is approximately the average rate that would be paid for intrastate access if all LECs in Arizona were required to mirror their intrastate rates to their interstate rates. You can see that reducing the LECs' intrastate access rates to interstate levels would amount to a meaningful decrease in the average access rate paid by AT&T in Arizona. And one can see visually that if the pattern of relationship between intrastate access rates paid and intrastate long distance rates charged in Arizona is any indication, one would expect the lower access rates to result in significantly lower prices in Arizona for intrastate long distance service.

Q: **DO THE DATA TELL YOU ANYTHING ABOUT MAGNITUDE OF THE DECREASE IN RATES IN ARIZONA THAT ONE COULD EXPECT?**

Yes. First, I used standard statistical techniques to estimate the relationship between the intrastate access rates and the intrastate long distance prices in the 50 states. That estimated relationship is depicted in Figure 6 as the red line through the data. The fact that the data exhibit a positive and statistically significant relationship is not surprising given that the relationship is apparent visually from Figure 6, and it what one would predict on the basis of economic principles.

Using that estimated regression equation, I calculated what the relationship implies the retail price for intrastate long distance service in Arizona would be if the intrastate access rate were equal to interstate access rates in Arizona. I found that the implied price for intrastate long distance service in Arizona would provide a reduction of 19 percent to 42 percent[85] from AT&T's current average intrastate long distance prices in Arizona.

Q: WHAT DO YOU CONCLUDE FROM YOUR DATA ANALYSIS?

A: It is clear that lower intrastate access rates are associated with lower intrastate long distance prices. The effect is both visually apparent from the data, and statistically significant. The relationship in the data imply that if intrastate access rates were reduced to interstate levels in Arizona, one would expect reductions in AT&T's intrastate long distance prices on the order of 19 percent to 42 percent. These are material reductions that would provide a significant benefit to consumers and businesses in Arizona.

[85] The 19 percent is calculated as the percentage difference between AT&T's actual intrastate long distance price in 2008 and the price "predicted" by the regression model at the average interstate access rate paid by AT&T in Arizona. The 42 percent is the difference between the price "predicted" by the model at the actual intrastate access rates paid by AT&T in Arizona and the price "predicted" by the model at the average interstate access rate paid by AT&T. The first calculation assumes that the difference between the actual rate and the rate that goes through the regression line (the regression error) is random variation whose expected value is zero. The second calculation assumes that the difference between the actual rate and the rate that goes through the regression line (the regression error) is systematic to Arizona but unexplained by the model, and would therefore persist in its entirety at the lower access charge.

Q: WHY WOULD A COMPANY VOLUNTARILY DECREASE ITS PRICES JUST BECAUSE THE ACCESS CHARGES IT PAYS WENT DOWN?

A: Companies do not decrease prices out of altruism but out of the desire and fiduciary obligation to maximize their profits to the extent they can, given demand, cost, and market conditions. When the incremental cost of producing something goes down, a company *increases* its profits by *lowering* its prices, all else equal. The reason is that a price reduction stimulates demand, and selling a bit more becomes profitable (when it previously was not) when incremental costs are lower. This is an elementary economic and mathematical principle that is true even for a company that faces no competition whatsoever. It is the straightforward consequence of profit maximization, regardless of competitive pressures on prices, that the profit maximizing response to a decrease in incremental costs is a decrease in price, all else equal. Hence, regulators need not rely on hopes of altruistic behavior or even on competitive pressures to expect declines in retail prices as a result of access price reductions; and it is not surprising that the data demonstrate declines in retail prices associated with access rate declines over the various time periods, jurisdictions, carriers, and geographies studied. Even a company that is wholly insulated from competition would rationally decrease prices if its incremental costs fell.

Of course, long distance service is highly competitive, so competitive pressures reinforce the incentive to lower prices when incremental costs fall. A company experiencing a

decline in incremental cost enjoys an opportunity to compete more effectively and still cover costs by lowering its prices. This induces other competitors to lower their prices as well. A company decreases its price in response to a competitor out of an imperative to maintain its market position at previous levels or even to survive in competition with a lower-priced rival. Hence, incentives for profit maximization and competitive pressures both work in the same direction to induce companies to decrease prices when their incremental costs fall, and they reinforce one another. It is undoubtedly the case that the decreases in long distance prices that have occurred as the result of access price declines have been the result of these combined economic pressures, and they can be expected to be effective going forward as well.

B. Excessive Access Rates Also Harm Consumers by Causing Them to Use Less Long Distance Service Than They Would Choose at More Efficient Prices, and by Raising the Costs of Businesses Operating In Arizona

Q: IN WHAT OTHER WAYS DO EXCESSIVE ACCESS PRICES HARM CONSUMERS?

A: I have explained that higher access charges result in higher retail prices for long distance services. Those higher prices not only cause consumers to pay more for service—the direct effect I just discussed—but also cause consumers to use less of the service. The discouraging effect of higher prices is a normally good thing—an efficient effect of the price system—but only when prices reasonably reflect the underlying costs of producing

a product or service. Prices then are the means by which consumers' decisions about how much to consume of a given product or service reflect the underlying cost to society of the inputs used to create or provide that product or service. If, however, the price of a service far exceeds its real underlying cost, consumers will restrict their usage more than is justified by the societal cost of producing the product, and consumers thereby forgo consumption and enjoyment unnecessarily. This distortion of consumption as a result of distorted prices is known as "allocative inefficiency," and the loss of economic well-being that results is what economists refer to as a social "deadweight loss" to the economy. Allocative efficiency is reduced, and consumers are harmed, when regulation causes prices to be higher than prices that would more closely reflect cost-causation.

Q: IS THERE EVIDENCE THAT CONSUMERS DO IN FACT USE LONG DISTANCE SERVICE LESS AT HIGHER PRICES?

A: Yes. There is a considerable amount of literature demonstrating that usage of long distance is lower at higher prices and higher when prices are lower. The extent to which consumers respond to prices (if at all) is measured by the "elasticity" of demand. Several studies have quantified the price elasticity of demand for toll services for different time periods and for different jurisdictions (interstate, international, intrastate), and all have

found that decreases in long-distance prices cause increases in the consumption of long distance services, and vice versa.[86]

Q: WHAT DO THESE RESEARCH RESULTS MEAN IN PRACTICAL TERMS?

A: They mean that consumers change their calling habits by calling more when long distance prices go down. Years ago, for example, when long distance prices were many times what they are today, long distance calls were a luxury used only very sparingly. Long-distance calls were tightly rationed in households, the length of calls was closely monitored, and when the monthly bill arrived loved ones often argued about whether they were talking too long or making too many long-distance calls. Today, the entire mentality towards long-distance calling has changed as prices have declined

[86] See, Lester D. Taylor, TELECOMMUNICATIONS DEMAND IN THEORY AND PRACTICE, (Dordrecht: Kluwer Academic Publishers, 1994), pp. 129-148 and 296-314 and sources cited therein. See, also, Paul N. Rappoport and Lester D. Taylor, "Toll price elasticities estimated from a sample of U.S. residential telephone bills," *Information Economics and Policy* 9 (1997), pp. 51- 70; Donald J. Kridel, "A Consumer Surplus Approach to Predicting Extended Area Service (EAS) Development and Stimulation Rates," *Information Economics and Policy* 3 (1988), pp. 379-390; T.W. Appelbe, C.R. Dineen, D. L. Solvason, and C. Hsiao, "Econometric Modelling of Canadian Long Distance Calling: A Comparison of Aggregate Time Series Versus Point-to-Point Panel Data Approaches," *Empirical Economics* 17 (1992), pp. 125-140; Lester D. Taylor, "Competitive Own- and Cross-Price Elasticities in the Intralata Toll Market: Estimates from the Bill Harvesting II Database," Whitepaper (Fall 1996); Simran K. Kahai, David L. Kaserman, and John W. Mayo, "Is the 'Dominant Firm' Dominant? An Empirical Analysis of AT&T's Market Power," *Journal of Law and Economics* 39, (October 1996), pp. 499-517; Donald J. Kridel, Paul N. Rappoport, and Lester D. Taylor, "IntraLATA long-distance demand; carrier choice, usage demand and price elasticities," *International Journal of Forecasting* 18 (2002), pp. 545-559; Armando Levy, "A generalized additive Tobit model: An application to telecommunications demand," *Empirical Economics* 28 (2003), pp. 3-22; Clement G. Krouse and Jongsur Park, "Competition in the Interexchange Telecommunication Market," *Journal of Law and Economics* XLVI (April 2003), pp. 85-101; Michael R. Ward and Glenn A. Woroch, "Usage Substitution between Mobile Telephone and Fixed line in the U.S.," Whitepaper (May 2004); and David E. Burnstein, "An Examination of Market Power in the Intrastate Long-Distance Telephone Service Markets: Evidence from a Natural Experiment," *Journal of Law and Economics* XLVIII (April 2005), pp.149 -171.

precipitously, not only for wireline calling but also for wireless and VoIP calling, and alternatives to voice telephony, such as texting, email, social networking sites, instant messaging, and other services, so that long distance communications are no longer viewed as a luxury that must be closely rationed. Rather, consumers are more likely to consider which phone or other technology they will use for a given communication, based on the relative prices, convenience, and other characteristics—a phenomenon I will discuss shortly.

Q: ARE THERE OTHER WAYS THAT EXCESSIVE INTRASTATE ACCESS CHARGES HARM CONSUMERS?

A: Yes. Residential consumers are not the only customers who pay long distance rates—business customers in Arizona pay them also. When long distance prices are higher and business customers must pay the higher rates, their cost of doing business is higher in turn. This additional cost borne by businesses must either be passed through in the form of higher prices paid by the customers of those businesses, or in the form of contractions of the business.[87] Both of these effects harm not only the Arizona businesses themselves

[87] A survey of small businesses conducted by TeleNomic Research found that small businesses spend a considerable amount, on average $543 per month, for telecommunications services. The survey also determined that the cost burden of telecommunications services was higher for very small businesses. For example, firms with 0 to 4 employees were estimated to spend $82.81 per employee for local and long distance telephone service, while firms with 5 to 9 employees were estimated to spend $50.18 per employee and firms with 10 to 499 were estimated to spend $20.99 per employee. See, Stephen B. Pociask, "A Survey of Small Businesses' Telecommunications Use and Spending," TeleNomic Research, LLC, (March 2004).

but also their customers, who ultimately must face higher prices for a variety of goods and services.

C. Excessive and Disparate Access Rates Harm Competition

Q: HOW DO THE EXCESSIVE AND DISPARATE INTRASTATE ACCESS RATES IMPOSED UNDER THE CURRENT ACCESS REGIME HARM COMPETITION?

A: The current access regime significantly distorts competition across technologies. For example, the tremendous disparities in access rates paid by wireline carriers versus wireless carriers create a pronounced, and artificial, competitive advantage for wireless long distance services. As I explained earlier, for intrastate calls that are within an MTA, wireless companies pay for terminating access at reciprocal compensation rates, even if the call crosses a local calling area or LATA boundary. The same call on the wireline network would trigger intrastate originating and terminating access rates, which in Arizona are between **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** or even more times higher on average than the intraMTA rates paid by wireless companies to the same LECs, as shown in Tables 1, 2 and 3 above. Put differently, for wireline calls, the calling area in which (low) reciprocal compensation rates rather than (high) access rates apply is the LEC's (relatively small) traditional wireline local calling area. For wireless calls, the situation is reversed. The calling area in which (low) reciprocal compensation rates

rather than (high) access rates apply is the (relatively large) MTA. This difference in regulatory treatment has a profound effect on the costs of interconnection for the two kinds of carriers, because MTAs comprise far larger geographic areas than do wireline local calling areas, as I demonstrated earlier.

Q: WHAT IS THE EFFECT ON COMPETITION BETWEEN WIRELESS AND WIRELINE SERVICES OF THE VAST DIFFERENCES BETWEEN LOCAL CALLING AREAS AND MTAS?

A: To see the economic effect of these differences between MTAs and local calling areas, consider a call from an ILEC customer in Phoenix to an ILEC customer in Parker, and suppose the customer's long distance company is AT&T. Because Phoenix and Parker are in different local calling areas in Arizona, AT&T would pay approximately **[BEGIN CONFIDENTIAL INFORMATION]** [redacted] **[END CONFIDENTIAL INFORMATION]** in originating intrastate switched access charges to the ILEC serving Phoenix (Qwest) and **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** in terminating intrastate switched access charges to the ILEC serving Parker (Verizon), for each minute of the call (see Table 1). If, instead, the customer in Phoenix placed the call to the same telephone number from her wireless phone, the wireless carrier would pay nothing in originating access (but would incur the costs of call origination), since wireless companies self-provide long distance service, and would pay the called party's ILEC provider a

reciprocal compensation rate of **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** per minute to terminate the call, because Phoenix and Parker are in the same MTA (see Table 3). So the wireless carrier would pay less than **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** to the LEC for interconnection, while AT&T would pay **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [redacted] **[END HIGHLY CONFIDENTIAL INFORMATION]** in access charges per minutes—more than 25 times what the wireless carrier would pay. The wireless company, therefore, could offer a substantially lower price to its customers for the same call from Phoenix to Parker than it could if it had to pay the same intrastate access rates that AT&T must pay. These vast differences in rates charged by the local exchange company for the same access functionality substantially disfavors the wireline IXC and confers a competitive advantage on its wireless competitor in providing long distance services for no reason related to their relative efficiencies or value of service provided. When some businesses are favored by regulatory rules that are unrelated to underlying costs of doing business, the detrimental effect on the economy is known as "productive inefficiency." The example illustrates that the regulatory distortions in the access regime place wireline long distance providers at a significant competitive disadvantage. Those distortions, and the

resulting productive inefficiency, would be reduced (though not eliminated) by adopting a mirroring policy for intrastate access rates.[88]

Q: HOW DO THESE COST DIFFERENCES AFFECT CONSUMERS ON A DAY-TO-DAY BASIS?

A: These cost differences affect consumers' choicemaking behavior with regard to the different forms of communications available to them. Nowadays, people think nothing of making long-distance calls on their wireless phone. This is no surprise, since wireless carriers, who incur a per-minute cost for all calls that is a small fraction of the per-minute cost that wireline carriers incur for non-local calls have been pioneers in innovative, all-distance calling plans offering buckets of "anytime, anywhere" minutes. Moreover, consumers have options for instantaneous long-distance communications that avoid the PSTN entirely, such as email, instant messaging, social networking, and Skype-to-Skype calling, and whose providers bear no message-based interconnection charges to provide those services. The absence of access charges allows these providers to offer "free" alternatives for long distance communications to consumers that have access to the Internet—that is, these providers receive no money from customers for the communications service. Consumers respond to this array of options by weighing both the relative prices of their options and the characteristics of the available services (e.g.,

[88] As I explain later, the reform proposed by AT&T in this proceeding is an important step in the right direction and will benefit consumers and businesses in Arizona. However, it does not reduce intrastate access rates all the way to efficient levels and therefore should be viewed as a step in an ongoing effort.

convenience, call quality, voice versus text, and so forth) to decide on a case-by-case basis which option they will choose. The artificially high price of wireline long distance service, driven by artificially high access rates, discourages use of the wireline long distance service in favor of other technologies relative to what that use would be if wireline long distance prices were not so distorted by inflated access charges.[89]

For example, a mother may prefer to keep in touch with her child at college on the wireline phone, because she may prefer its service or handset characteristics to wireless or computer-to-computer calling. However, that family may nevertheless keep in touch largely or entirely by wireless phone and/or computer-to-computer calling (as well as email, instant messaging, and other communications options) because of the lower price. The fact that the family is discouraged from communicating on the wireline network by artificially high wireline long distance prices is an economic harm or "social welfare loss" associated with those distorted prices. The dollar magnitude of the harm can conceptually be measured as the forgone value that the family would have enjoyed from the wireline call that it would have otherwise chosen. More generally, the economic

[89] See, for example, Michael R. Ward and Glenn A. Woroch, "Usage Substitution between Mobile Telephone and Fixed line in the U.S.," Working Paper, May 2004, pp. 5, 11, 12, and 17 (Table 4). The authors construct a data set by aggregating household observations into a sample of observations at the LATA level, across ten quarters (3-month periods) from July 1999 to December 2001. The authors estimate the price effects on different types of wireline and wireless toll usage in the U.S. The authors produce six different estimates of the effect of wireline prices on wireless toll usage that range from -0.03 to 0.21. Because of data issues that limited the sample size employed for certain estimates, the authors indicate they have "most confidence" (p. 12) in two

harm from the distorted prices is the foregone value to all consumers from calls they did not make, but otherwise would have made, and calls they would have preferred to make on the wireline network, but made some other way due to the price distortion.

D. Excessive Access Rates Distort Investment

Q: HOW DO EXCESSIVE ACCESS RATES HARM EFFICIENT INVESTMENT INCENTIVES?

A: Investment incentives are driven by the prospect for future return on the investment. The prospects for future return on an investment depend, in turn, on the desire and willingness of consumers to use the services supported by that investment, which depend on the prices consumers must pay for the services. The chain of causation is as follows: artificially high access prices cause long distance companies to maintain higher retail prices to cover those costs;[90] higher long distance prices discourage consumers from using the wireline network to make long distance calls, driving usage below what it would otherwise be;[91] at higher costs and lower usage, the current and anticipated future

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of the six estimates, which range from 0.11 to 0.21. These results indicate that there is a positive relationship between wireline prices and wireless demand.

[90] See evidence in Section VI.A.

[91] See evidence in Section VI.B.

value of the network to investors is lower; investment in the wireline long distance network is discouraged.[92]

Incentives for future investment are of particular importance because investment is long-lived, and distorted investment decisions therefore harm consumers and the economy not only today but for years into the future. The effects of distorted prices on investment and innovation decisions are known as dynamic inefficiency, because investment and innovation have long-lived ("dynamic") effects. An economy makes the most efficient use of its resources when investment decisions reflect the relative efficiencies of and demands for different technologies, businesses, and uses. Distorted prices and the resulting distorted investment decisions create dynamic inefficiency in the economy.

When prices distorted by regulatory policy discourage use of a particular service or network, investment in that service is dampened, all else equal, because the investors would expect a lesser return or profit than they would absent the distortions. Put simply, the lower the demand for a service, the lower the incentive to invest in the facilities that provide it, all else equal. That is efficient from a social perspective if the loss of customers or lack of demand is the result of competition on the merits. However, if demand is weaker than it would otherwise be due to prices distorted by regulation,

[92] It is a standard economic tenet that investment into an asset is discouraged if the net present value of the asset is decreased. See Richard Brealey, Stewart Myers, and Franklin Allen, PRINCIPLES OF CORPORATE FINANCE (McGraw Hill/Irwin, 2006), Chapters 2, 5 and 6.

investment decisions are distorted as well, and the value of society's scarce investment resources is not maximized. In particular, investment in the facilities and infrastructure associated with the provision of wireline long distance service is discouraged below the level that would have occurred if demand were able to respond to prices that more closely reflected the true social costs. This dynamic inefficiency harms consumers today and in the future. Reducing the distortion by lowering excessive access prices and decreasing the disparities among access rates would improve dynamic efficiency by creating investment incentives that more closely align with consumer preferences and social costs.

Investors must decide how to allocate their investment funds across competing technologies, firms, and industries. When regulatory distortions are reduced, investment dollars can be allocated in closer relation to the underlying value of the different uses, as seen through the eyes of consumers. Consumers therefore benefit when dynamic efficiency is increased.

E. Excessive Access Rates Create Wasteful and Distortionary Arbitrage Behavior

Q: **ARE THERE OTHER DISTORTIONARY EFFECTS OF EXCESSIVE ACCESS CHARGES?**

A: Yes. Excessive access charges create artificial arbitrage opportunities by which access providers can exploit the differences between costs and regulated prices and exploit the

access payers in the process. When access charges substantially exceed cost, there is money to be made by receiving those fees. For example, suppose it cost 1¢ per minute to provide access but the access charge were 10¢ per minute (I chose these round numbers purely for ease of illustration, but access charges are often several multiples of cost). Then it would be very lucrative for an access provider to identify or even create a business that receives a large number of phone calls (a chat line is one example) and then sets itself up as the local exchange carrier (and thus the point of access) for that business. The chat line would generate a margin for the access provider of 9¢ per minute for every minute received, in my example. The access provider might give the chat line an extremely low price for local service, or even pay the chat line a fee or share of the access margin to make the chat line its customer. In turn, the chat line might pay end users a portion of that margin to encourage them to call the chat line to drum up more access fees.

Competition to become a chat line's LEC can drive profits out of the LEC's business (via, for example, lower prices or bigger transfer payments to the chat line provider), but would nevertheless not drive *access* rates down. Lowering its access rates would not put the LEC in any better position to attract customers such as chat lines—on the contrary, LECs with higher access rates could provide even bigger retail discounts (or kickbacks) to chat line providers. Hence, retail competition would simply force a transfer of the

arbitrage profits from the LEC to the chat line and/or its customers, without disciplining the access rates. It is no surprise that these arbitrage-based businesses are sometimes referred to as "call-pumping" schemes, an apt term because they act as a siphon from access payers subject to, and unable to avoid, the excessive access charges.

Q: ARE YOU AWARE OF ANY OTHER ARBITRAGE SCHEMES THAT ARISE FROM THE CURRENT ACCESS/INTERCONNECTION REGIME OF HIGHLY DISPARATE RATES?

A: Yes. The significant disparity between the rates for interstate access and intrastate access creates an incentive for terminating LECs to misclassify traffic so that they can bill the higher intrastate rather than interstate rates; and by the same token, it creates an incentive for access payers to misclassify traffic so that it is billed at the lower interstate rates. Similarly, the disparate access rates and reciprocal compensation rates create an incentive for access payers to misclassify traffic so that it appears to be local traffic rather than long distance traffic. The incentive for access payers to misclassify traffic is known as the "phantom traffic" problem. Analysts have estimated the amount of lost revenues to access providers due to phantom traffic to range from $600 million to $2 billion annually.[93] The incentive to avoid excessive access rates by misclassifying traffic so that

[93] Letter from Karen Brinkman of Latham and Watkins, LLC on behalf of a group of LECs to the FCC re: WC Docket 01-92, Intercarrier Compensation – Notice of *Ex Parte* Presentation, July 1, 2005, attaching a presentation by Balhoff & Rowe, LLC (which found a $600 million loss to rural carriers); Letter from Joseph Douglas of NECA to the FCC re: Intercarrier Compensation Reform, Docket Number 01-92, *Notice of Ex Parte Presentation*, May 2, 2007, attaching a NECA presentation that cites estimates by Raymond James (which

it is charged a lower price for the same terminating functionality is another artifact of the differential in prices that does not reflect a differential in the functionality provided.

All of the resources devoted to establishing mechanisms for identifying whether wireline traffic is interstate or intrastate, ensuring that traffic is not intentionally or accidentally misclassified, establishing traffic identification rules, and engaging in disputes over traffic identification, "phantom traffic," and "call pumping," are a deadweight loss to the economy that would be decreased or avoided if interstate and intrastate access rates were the same.

VII. The Commission Should Order ILECs and CLECs in Arizona to Decrease Intrastate Access Rates in Order to Increase Consumer Welfare, Enhance Competition, Encourage Efficient Investment, and Discourage Socially Wasteful Arbitrage Opportunities (Issues 1 and 2)

A. Ordering ILECs to Decrease Intrastate Access Rates to Interstate Levels Will Enhance Economic Efficiency by Bringing Access Rates Closer to Cost

Q: SHOULD THE COMMISSION ORDER ILECS IN ARIZONA TO DECREASE INTRASTATE ACCESS RATES TO INTERSTATE LEVELS?

A: Yes.

estimates a $2 billion loss to the industry overall) and Balhoff & Rowe (which estimates a $600 million loss to rural carriers).

Q: **WHY?**

A: In light of the myriad disparities in the current access regime that I have discussed, and the fact that intrastate access rates in Arizona are the holdover of the legacy system that has been substantially revised and reformed for all other interconnection charges, decreasing intrastate access rates to interstate levels would benefit consumers and promote competition on the merits. As an economic matter, prices for switched access service should not be higher than the cost of providing access service.[94] As I have explained, however, current intrastate rates are an artifact of the legacy regulatory policy of using access rates set well above cost to cross-subsidize local service. Cross-subsidy mechanisms are incompatible with the policy goal of promoting consumer welfare and advancing competition on the merits, by which the success and failure of competitors are determined on the basis of their relative costs, efficiencies, and quality of services, and not by regulatory asymmetries. All of the evidence of which I am aware indicates that decreasing ILECs' intrastate switched access rates to interstate levels would bring them closer to cost as well as lessen the disparities across technologies, jurisdictions, and types of calls. Excessive access prices harm consumers, and highly disparate access prices distort and harm competition—and thereby also harm consumers, as I discussed earlier.

[94] See, for example, Mark Armstrong, "The Theory of Access Pricing and Interconnection," in *Handbook of Telecommunications Economics*, ed. M.E. Cave et al., Vol.1, (Amsterdam: Elsevier Science B. V., 2002), pp. 356-379, and sources cited therein. In addition, some economists argue that the efficient interconnection price is zero (i.e., "bill and keep"). See, e.g., Patrick DeGraba, "Bill and Keep at the Central Office as the Efficient

Further, these prices distort investment decisions and create incentives for regulatory arbitrage that exploits access payers and wastes social (i.e., Arizona's) resources.

Q: WHAT IS THE BASIS FOR YOUR OPINION THAT DECREASING ILECS' INTRASTATE SWITCHED ACCESS RATES TO INTERSTATE LEVELS WOULD BRING THEM CLOSER TO THE ILECS' COSTS?

A: My opinion is based on my analysis of the overall pattern and history of access rates and access reform. As I discussed above, it is clear that interstate switched access rates were set well above the ILECs' costs. Intrastate rates remain much higher than the corresponding interstate rates and higher still than (purportedly) cost-based rates for reciprocal compensation, even though all of these rates are charged for the same function. Hence, reducing intrastate switched access rates would bring them closer to the ILECs' costs. This conclusion is consistent with the FCC's investigation and analysis to establish rates for terminating ISP-bound traffic and reciprocal compensation, including wireless traffic; the FCC's analysis in the course of interstate access reform; and the participation of Qwest, Verizon, and other ILECs in advocating the interstate rates that are essentially the ones in effect today.

Interconnection Regime," Federal Communications Commission, OPP Working Paper No. 33, (Dec. 2000) ¶ 2, n. 3 and citations in Appendix C to the *Intercarrier Compensation Reform FNPRM*.

Q: COULD YOU PLEASE DESCRIBE THE FCC'S ANALYSES BY WHICH ONE CAN CONCLUDE THAT INTERSTATE ACCESS RATES AT LEAST COVER COSTS, AND THEREFORE INTRASTATE ACCESS RATES SIGNIFICANTLY EXCEED COST?

A: The FCC established reciprocal compensation rates for terminating ISP-bound traffic to start at 0.15¢ per minute and gradually decrease over time to 0.07¢ (that is, 15/100 of a penny and 7/100 of a penny, respectively) per minute.[95] These reciprocal compensation rates are many times lower than the current per minute rate that ILECs in Arizona charge a landline toll carrier to complete an interstate toll call. The FCC concluded that these rates (which are well below the current interstate access rates) were sufficient to recover costs:

> These rates reflect the downward trend in intercarrier compensation rates contained in recently negotiated interconnection agreements, suggesting that they are sufficient to provide a reasonable transition from dependence on intercarrier payments while ensuring cost recovery.[96]

In the *CALLS Order*, as I discussed previously, the FCC adopted the access reform proposal set forth by a consortium of local and long distance providers. The current interstate access rates charged by Qwest, Verizon, and Citizens, which are much lower than their intrastate rates in Arizona, are the result of the reductions imposed in the

[95] See, Order on Remand and Report and Order, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Intercarrier Compensation for ISP-Bound Traffic*, before the Federal Communications Commission, FCC 01-131, (released April 27, 2001), (hereafter *2001 Order on Remand*), ¶¶ 8, 89, and footnote 177; and *2008 NPRM*, ¶ 3.

[96] *2001 Order on Remand*, ¶ 8.

CALLS Order. The FCC concluded that these "significant and immediate reductions to per-minute carrier access charges will bring those rates *closer to cost* and translate into lower per-minute long-distance rates."[97] Not only did Qwest, Verizon and Citizens not object to these interstate access charge reductions as being below cost or otherwise confiscatory, they participated in bringing those reductions about—Verizon as a member of the CALLS consortium that advocated for the price reductions, and Qwest and Citizens as commenters that generally supported the proposal.[98] Similarly, ALECA members' current interstate rates are a result of the *MAG Order* that mandated interstate rate reductions towards cost,[99] and as shown in Table 1, these rates are many times below current intrastate rates. ALECA participated in this proceeding and supported the MAG proposal.[100] To my knowledge, no ILEC in Arizona has sought review of its interstate switched access rates on the ground that such rates were below cost.[101] This lends

97 *FCC CALLS Order*, ¶ 2. (Emphasis added.)

98 *FCC CALLS Order*, footnote 1, and ¶ 48, footnote 67. See also Citizen Utilities Company Letter to the FCC re: *Ex Parte* Presentation in CC Docket Nos. 94-1, 96-45, 99-249 and 96-262 dated February 4, 2000; and Comments of Citizens Communications on the Revised Plan of the Coalition for Affordable Local and Long Distance Calling ("CALLS"), *In the Matter of Price Cap Performance Review for Local Exchange Carriers, Federal-State Joint Board on Universal Service, Low-Volume Long Distance Users, and Access Charge Reform*, before the Federal Communications Commission, CC Docket Nos. 94-1, 96-45, 99-249 and 96-262, March 31, 2000.

99 *MAG Order*, ¶ 1.

100 See Comments of the Arizona Local Exchange Carriers Association, *In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers and Federal-State Joint Board on Universal Service et al.*, before the Federal Communications Commission, CC Docket Nos. 00-256 and 96-45 et al., February 26, 2001.

101 See, for example, Verizon Companies Responses to AT&T Discovery Request No. 2.15.

support to my conclusion that these incumbents' interstate access rates are at least compensatory and that their intrastate rates are multiples of cost.

B. CLEC Rates Should Be Capped at ILECs' Level in the Intrastate Jurisdiction as They Are in the Interstate Jurisdiction Because CLECs Have Market Power With Respect to Access to Their Customers

Q: SHOULD CLEC RATES BE CAPPED AT THE LEVEL OF THE ILEC WITH WHICH THEY COMPETE?

A: Yes.

Q: BUT AREN'T CLEC ACCESS RATES DISCIPLINED BY COMPETITION?

No, they are not. CLECs, as well as ILECs, possess market power in the provision of switched access service. The fact that CLECs face extensive competition in the retail market for *local exchange service* does not render the market for wholesale *switched access* service competitive. This is because (i) IXCs cannot choose which local carrier will originate or terminate their end users' calls; (ii) the party that does make the choice of local carriers (the IXC's end-use customer or the person the customer calls) is not the party that pays for switched access service (the IXC); and (iii) regulatory restrictions on long distance price de-averaging, as well as logistical restrictions on doing so prevent IXCs from charging a customer more for a particular call based on the access charges that will apply to that specific call; therefore IXCs cannot send a price signal to the end users

to discourage them from choosing (or calling people who choose) LECs with high access charges.

The FCC found in 2001 that these three factors enable CLECs to impose excessive access charges[102] and accordingly issued an order capping CLECs' interstate access rates. The FCC noted that it did not want to

> permit CLECs to continue to tariff the access rates they charge IXCs at the level they see fit, without any guidelines to ensure their reasonableness. [The FCC found] persuasive the IXC arguments that it is highly unusual for a competitor to enter a market at a price dramatically above the price charged by the incumbent, absent a differentiated service offering.[103]

It decided, therefore, that "the reasonable rate for CLEC access service is the rate that the ILECs are charging for similar service in the market."[104]

Because the same conditions are present at the intrastate level, CLEC intrastate access rates should be capped as well.

C. AT&T's Proposal to Reduce Intrastate Access Rates to Interstate Levels Would Not Bring Rates All the Way to Parity Across Technologies But Is a Positive Step that Will Benefit Consumers and Businesses in Arizona

[102] The FCC found that CLEC market power "is attributable to" three specific factors: the fact that access charges are paid by the IXC rather than the person who decides who the access provider will be (the calling and called parties); the IXC has "little practical means of affecting the caller's choice of access provider;" and regulatory restrictions on retail rate deaveraging by IXCs. *CLEC Access Reform Order*, ¶ 31.

[103] *CLEC Access Charge Reform Order*, ¶ 37.

[104] *CLEC Access Charge Reform Order*, ¶ 61.

Q: IS AT&T'S PROPOSAL TO REDUCE INTRASTATE ACCESS RATES TO THE ILECS' INTERSTATE LEVELS SUFFICIENT TO FULLY REFORM THE DISTORTIONS ATTENDANT TO THE CURRENT ACCESS RATE SYSTEM?

A: No, but this proposal is best seen as a step in the right direction that can be completed immediately. Interstate access rates themselves may well be far above the cost of providing call termination and origination services, and continue to be the subject of reform efforts. AT&T's proposal in this proceeding therefore does not fully drive access rates to cost or to parity across technologies. But its proposal will increase consumer welfare and promote competition, which are material benefits to the public that should not be sacrificed in the pursuit of perfection. Nor should these steps, once taken, be allowed to impede further progress on the dismantling of a regulatory structure that no longer serves consumer interests.

VIII. Access Rate Reduction Should Be Part of a Holistic, Revenue Neutral Reform of the Access Regime (Issues 3, 5, and 6)

Q: SHOULD THE COMMISSION GIVE CARRIERS THE OPPORTUNITY TO EARN REVENUES THAT COMPENSATE FOR THE LOSS OF ACCESS REVENUES THEY WOULD EXPERIENCE AS A RESULT OF INTRASTATE ACCESS REFORM?

A: Yes, with respect to lines on which retail service rates are regulated. Those opportunities may be provided either via the flexibility to increase retail rates or through universal

service funds. If a provider has been granted full pricing flexibility on certain lines (e.g., lines on which the customer is purchasing service in unregulated bundles), or on all lines, there is no longer any justification for allowing excessive access rates to subsidize those lines, and no compensation for reducing access rates on those lines is called for. The provider would already have the opportunity to recover its local service costs in the retail market as competition permits.

Q: WITH RESPECT TO LINES THAT ARE SUBJECT TO RETAIL RATE REGULATION, WHY IS IT SOUND PUBLIC POLICY TO PROVIDE AN OPPORTUNITY FOR THE CARRIER TO RECEIVE REVENUES TO COMPENSATE FOR THE ACCESS REVENUES THAT WOULD BE FORGONE AS A RESULT OF ACCESS REFORM?

A: As I have discussed, access rates were established 25 years ago as part of a cross-subsidy scheme that was intended to permit ILECs to recover costs of residential basic local exchange service (such as the cost of the local loop) through inflated access charges imposed on IXCs, rather than through retail prices charged to end-user customers. This was a regulatory quid pro quo in which regulated companies held retail prices below compensatory levels in exchange for subsidy-producing access charges. With the development of competition in local and long distance markets, particularly intermodal competition, this policy is no longer viable and it is imperative that the Commission facilitate competition on the merits and promote consumer welfare by bringing intrastate access prices down to reduce to the maximum extent possible the implicit subsidies.

Bringing access prices down, however, without permitting a corresponding adjustment upwards to the other price-capped services or seeking other means for carriers subject to retail rate regulation to compensate for lost access revenues, would inappropriately ignore the regulatory history that led to the current concerns with access prices. At the same time, and for the same reasons, it is appropriate and consistent with sound policy principles to reduce switched access rates as part of a holistic policy approach that includes increases in the prices for other rate-regulated services or access to explicit subsidies.

Q: YOU TESTIFIED THAT THE COMMISSION COULD PROVIDE FOR COMPENSATING REVENUES TO OFFSET REVENUES FORGONE AS A RESULT OF COMMISSION-ORDERED ACCESS REFORM BY EITHER PERMITTING INCREASES IN REGULATED RETAIL RATES FOR BASIC LOCAL SERVICE, AND/OR BY PROVIDING INCREASED ACCESS TO UNIVERSAL SERVICE FUNDS. IS ONE METHOD PREFERABLE TO THE OTHER?

A: Both methods have their merits and demerits. From a purely economic perspective, it is generally superior to permit retail prices to adjust to levels that at least recover costs. But from a policy perspective, the Commission may wish to support retail prices at "affordable" levels, even if they are below cost in some areas, to promote the state's universal service objectives.

Q: WHAT DO YOU MEAN BY "FROM A PURELY ECONOMIC PERSPECTIVE"?

A: The purely economic perspective is one in which overall consumer welfare is maximized. Economic analysis focuses on the efficient use of resources to best respond to consumers' tastes and preferences, which means the use of society's scarce resources in a way that maximizes the overall consumer welfare that those resources can produce, given the different ways that they could be deployed, and given consumers' desires.

Q: WHY IS IT GENERALLY SUPERIOR, FROM AN ECONOMIC PERSPECTIVE, TO PERMIT PRICES TO ADJUST TO LEVELS THAT AT LEAST RECOVER COSTS?

A: Prices affect the decisions that consumers make about what to consume and how much to consume, as I have already discussed. Consumers make efficient decisions about what goods and services to consume if the prices they face reflect the costs that society incurs to supply them with those goods and services. Prices that reflect costs therefore encourage a socially efficient allocation of society's resources to competing uses. Prices that fall short of costs cause consumers to over-use those services, which is inefficient because society's resources that could be used for something that would provide more value to consumers are diverted to a less-valued use, to the detriment of consumers overall.

Q: YOU HAVE EXPLAINED WHY, FROM A PURELY ECONOMIC PERSPECTIVE, IT IS GENERALLY SUPERIOR TO ALLOW RETAIL PRICES TO ADJUST TOWARD COST-BASED LEVELS THAN TO PERPETUATE

SUBSIDIZED PRICES. ARE THERE REASONS THAT REGULATORS MIGHT NEVERTHELESS REASONABLY CHOOSE TO PERMIT RECOVERY OF SOME OF THE FORGONE ACCESS REVENUES THROUGH UNIVERSAL SERVICE SUPPORT INSTEAD?

A: Yes, there can be in certain circumstances. Regulators can face conflicting social policy goals. One goal is certainly to maximize overall consumer (social) welfare. Another goal, however, may be to promote universal service, even at the expense of overall social welfare. To balance these objectives, AT&T proposes that (1) the Commission adopt a benchmark mechanism by which the access reduction is partly compensated by retail rate increases, with the rest funded by universal service support; and (2) Lifeline rates not increase under the plan.[105]

Q: WHAT DO YOU MEAN BY "UNIVERSAL SERVICE"?

A: By universal service, I mean that all consumers (or nearly all of them) have telephone service available to them at reasonable rates.[106] The concept of universal service as a social policy goal is based on the premise (which I am neither endorsing nor rejecting here) that telephone service is of such unique importance to individuals' health and

[105] See Direct Testimony of Dr. Ola Oyefusi, *In The Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of The Arizona Administrative Code and In The Matter of the Investigation of the Cost of Telecommunications Access*, before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, December 1, 2009 (hereafter *Oyefusi Direct*).

[106] See, e.g., ARIZ. ADMIN CODE R14-2-1113 (establishing a universal service fund to "assure the continued availability of basic telephone service at reasonable rates"), and the Telecommunications Act of 1996, Sec. 254 (establishing, among others, the following principles of universal service: availability of quality services at "just, reasonable and affordable rates;" nationwide access to advanced telecommunications and information services; availability of such services to all consumers, including those in "low income, rural, insular, and high

welfare that we have an obligation as a society to ensure that all Americans have access to it.

It is generally understood that 100 percent telephone penetration is not possible for a variety of reasons, including the fact that at any point in time, some people are in the process of moving or changing telephone providers, some may not want telephone service at any price, and other factors. Nevertheless, overall telephone penetration (accounting for wireless and other voice technologies) in the US today is very close to the 100 percent policy ideal, and in Arizona today is 93 percent.[107]

Q: WHAT WOULD BE THE EFFECT ON OVERALL TELEPHONE PENETRATION—AND THEREFORE UNIVERSAL SERVICE GOALS--OF INCREASING PRICES OF REGULATED TELEPHONE SERVICES TO RECOVER LOST ACCESS REVENUES DUE TO ACCESS REFORM?

A: In principle, telephone penetration could go up, down, or stay the same. However, a number of factors indicate that overall telephone penetration is likely to be resilient to price increases on regulated local telephone service in Arizona, and overall penetration could indeed increase. These factors include the facts that: (1) other means of communications, such as wireline and broadband-based telephony are widely available, and wireless penetration in Arizona is nearly universal; (2) an increase in wireline prices

cost areas" at rates that are "reasonably comparable" to those charged in urban areas; and access to advanced telecommunications services in schools, libraries and rural health care facilities.

due to access reform would be part of a holistic access reform policy that would be expected to result in lower wireline long distance prices, as I discussed earlier, which would tend to counterbalance increased prices for local exchange services; and (3) explicit policies have been implemented in Arizona to protect low-income consumers from any negative effects of increases to regulated rates.

For example, suppose for the sake of argument that allowing prices of basic regulated local service to rise, holding all other prices constant, would cause a significant share of customers to stop subscribing to regulated telephone service. In today's marketplace, this would not imply that these customers would be without telephone service. These customers might decide to rely instead on their wireless service, or, if they are among the few in Arizona that do not have wireless service, begin subscribing to it; or they may decide to switch instead to VoIP services, assuming such services are available in their area.

Wireless service is certainly widely available in Arizona. As of June 2008, there were 4.9 million mobile wireless subscribers in Arizona, compared to 2 million seven years

[107] "Telephone Subscribership in the United States (Data through March 2009)," Alexander Belinfante, Industry Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission, August 2009, Table 2.

ago, representing a growth of 145 percent,[108] and most of the state has wireless coverage, with a significant portion of it being served by three or more wireless providers.[109] Nationwide, 20 percent of households have no wireline service and rely on wireless service as their local telephone service.[110] The percentage is even higher in the Phoenix MSA, where, according to information provided in discovery by Qwest, the percentage of wireless-only households (i.e., those with wireless but no traditional wireline service) has reached 25 percent.[111] Indeed, 97 percent of the population in Arizona over the age of 15 has a wireless phone.[112] Studies have also found that lower income customers are more likely than are higher income customers to "cut the cord" and have wireless service only, rather than have wireline service and no wireless service.[113]

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[108] "Local Telephone Competition: Status as of June 20, 2008," Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, July 2009 (hereafter *FCC Local Competition Report*), Table 14.

[109] Twelfth Report, *In the Matter of Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993 and Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, before the Federal Communications Commission, FCC 08-28, (released February 4, 2008), Map B-7, p. 140.

[110] Stephen J. Blumberg and Julian V. Luke, "Wireless Substitution: Early Release of Estimates from the National Health Interview Survey, July-December 2008," Centers for Disease Control and Education (CDC), May 6, 2009.

[111] Qwest Supplemental Response to AT&T Discovery Request No. 3-8, p. 3 of Attachment A. This is consistent with a study based on 2007 data that found that the percentage of wireless-only households in Arizona was higher than the national percentage (18.9% and 14.7%, respectively). See Stephen J. Blumberg and Julian V. Luke, "Wireless Substitution: State-level Estimates from the National Health Interview Survey, January–December 2007," *National Health Statistics Reports*, Number 14, March 11, 2009.

[112] The percentage of all residents in Arizona with a wireless phone is 76 percent. *FCC Local Competition Report*, Table 14; and U.S. Census Bureau, "2008 American Community Survey, Selected Population Profile in the United States – Arizona."

[113] See, for example, Charles S. Golvin *et al.*, "Cord-Cutting Reaches One In 20 Mobile Households," Forrester Research, May 5, 2005, p. 2; Keith Mallinson, "Personal Wireless Calling Surpasses Wireline Calling: A

Broadband service is also widely available in Arizona. According to the FCC's most recent report, as of June 2008, all Zip Codes in Arizona had at least three providers of high-speed service, and 57 percent of Zip Codes had ten or more.[114] The FCC also reports that in Arizona, 84 percent of homes where ILECs offer local telephone service have xDSL available, and 99 percent of homes where cable providers offer service have broadband cable service available.[115]

If customers switch from wireline to wireless service (or simply drop their wireline service and retain the wireless service they already have); or switch to broadband based telephony (as part of a broadband package, for example, this would not decrease overall telephone penetration and would therefore not damage universal service goals. It would be a reflection of consumer preferences, when consumers are able to face prices that more fully reflect actual costs. Of course, if, in some areas, no wireless, broadband, or other alternative services were available, and if the increase in wireline local service prices (all else equal) were enough to make a significant number of customers choose not to buy any telephone service at all, that might affect the goal of universal service.

Wireless Substitution Update," Yankee Group Analyst Report, August 2005, p. 2; and Amy Cravens, "Cutting the Cord: Consumer Wireline Erosion," In-Stat Analyst Report, December 2005, p. 2.

[114] "High-Speed Services for Internet Access: Status as of June 30, 2008," Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, July 2009 (hereafter *FCC Broadband Report*), Table 17.

[115] *FCC Broadband Report*, Table 14.

The foregoing discussion, however, accounts for only half of the picture. If local service prices are increased to compensate for access rate reductions, the access rate reductions themselves would be expected to cause long distance prices to decline, as I have already explained. Lower wireline long distance prices would stimulate demand not only for wireline long distance service, but for access to the wireline network (i.e., basic local service), all else equal. The net effect of increased local exchange prices and reduced long distance prices could increase demand not only for long distance service but also for local exchange access—therefore leading to *increased* wireline telephone penetration.

Q: IS THERE EVIDENCE THAT ACCESS RATE REBALANCING—I.E., REDUCED ACCESS RATES AND COMPENSATING INCREASED LOCAL SERVICE RATES—CAN IN FACT CAUSE TELEPHONE PENETRATION TO INCREASE?

A: Yes. In a study published in the *American Economic Review* by economist Jerry Hausman and colleagues Timothy Tardiff and Alexander Belinfonte,[116] the authors analyze telephone penetration and prices from 1984 to 1990, and find that "an increase in basic [retail local] access prices combined with a decrease in long-distance toll prices

[116] Jerry Hausman, Timothy Tardiff, and Alexander Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *The American Economic Review*, 83:2 (May 1993) (hereafter *Hausman et al. 1993*), pp. 181-182. The authors estimate the effect on telephone penetration from changes in the price for local service and the prices for interstate and intrastate (intraLATA and interLATA) toll services. Employing a panel data set from 1984 to 1988 of up to 500 different geographic locations in the U.S., the authors estimate a binary logit model where the left-hand-side (dependent) variable is the proportion of households with telephone service and the right-hand-side (independent) variables are telephone prices and demographic variables of households. The authors find that at 1990 average U.S. prices and penetration levels, the own-price elasticity for local service is -0.005, whereas the cross-price elasticity of demand for local service

(via a decrease in long-distance access prices) could well lead to an *increase* in telephone penetration."[117] They conclude that "the evidence ... tends to show that increased penetration [that occurred during the time period studied] resulted in part from the combined effect of higher monthly basic [retail local] access charges and lower long-distance prices" during this period.[118]

Q: ARE THERE ANY SAFEGUARDS IN ARIZONA FOR LOW-INCOME CUSTOMERS TO RECEIVE TELEPHONE SERVICE IF RETAIL PRICES FOR LOCAL EXCHANGE SERVICE WERE TO RISE?

A: Yes. Pursuant to Arizona Statute, heads of household that are 65 or older and have a household income at or below the poverty level are eligible for a telecommunications service assistance program. LECs are required to provide assistance to eligible recipients in the form of a credit of 17 percent on their charges.[119] The Arizona Department of Economic Security administers additional telephone discount programs through agreements with Qwest for households meeting certain poverty criteria, such as the Telephone Assistance Program for the Medically Needy, which pays for basic telephone service for individuals who have a medical need for a telephone in the home; and the Lifeline Telephone Discount Program, which provides a discount of $8.04 to the basic

is -0.0086 with respect to the price of intraLATA toll, -0.0019 with respect to the price of intrastate interLATA toll, and -0.0055 with respect to the price of interstate toll.

[117] *Hausman et al. 1993*, p. 182.

[118] *Hausman et al. 1993*, p. 183.

[119] A.R.S. 46-701, 702, and 703.

telephone rates of eligible households.[120] Households with low income are also eligible for financial assistance through federal programs such as Lifeline Assistance, which provides discounts on basic monthly service, and Link-Up America, which assists households with the costs of setting up phone service (wireless or wireline). Residents in tribal communities may qualify for enhanced Lifeline assistance and expanded Link-Up support, which provide additional discounts on monthly telephone service or set-up costs.[121]

Q: DR. ARON, CLEARLY SOME CONSUMERS WOULD BENEFIT FROM BEING ALLOWED TO PAY BELOW-COST PRICES THAT ARE SUBSIDIZED WITH UNIVERSAL SERVICE SUPPORT. ARE THERE DOWNSIDES TO THIS SYSTEM IN ADDITION TO THE PURELY ECONOMIC NEGATIVE EFFECTS ON OVERALL CONSUMER WELFARE AND COMPETITION THAT YOU HAVE EXPLAINED?

A: Yes. If some customers are allowed to pay below-cost prices, subsidized by universal service funds, some other customers are providing the subsidy. For example, universal service support tends to flow to high cost areas, which tend to be more rural areas. Urban customers, then, tend to be net payers into the subsidy. There is no reason to believe that such a system of cross subsidies is "fair" given that urban customers may well face higher prices for housing, food, and other costs of living. Moreover, many urban

[120] Arizona Department of Economic Security, "Telephone Discount Programs," at https://egov.azdes.gov/cmsinternet/intranet.aspx?id=2346&menu=34.

[121] See, FCC website, "Lifeline and Link-Up: Affordable Telephone Service," at http://www.fcc.gov/cgb/consumerfacts/lllu.html; and "Tribal Initiative: Financial Assistance," at http://www.fcc.gov/indians/financialassistance.html.

customers (like many rural customers) live in households with low income, and there is no obvious social policy objective being served by requiring these urban households to subsidize rural households, including rural households with higher income levels. In addition, increased universal service funding imposes a greater cost on Arizona businesses, who would also shoulder part of the subsidy burden as telephone customers. Imposing costs on businesses is detrimental to the business climate in Arizona, and increases the prices paid by consumers for the goods and services produced by those businesses.

Q: ARE THERE NO "PURELY ECONOMIC"—I.E., EFFICIENCY—BENEFITS TO UNIVERSAL SERVICE SUPPORT?

A: There may be. The benefits of universal telephone subscription extend beyond the benefit to the individual consumers whose prices are subsidized. When one additional person attaches to the network, there is an externality effect because a potential benefit is experienced by all customers on the network: they can call (or receive calls from) an additional person. Whether this "network externality" is significant today is also an empirical question, but at least as a matter of theory this effect can provide an economic justification for encouraging network subscription even if it requires subsidy.

Q: WHAT IS THE ROLE OF "BENCHMARKS" IN THIS ANALYSIS?

A: The idea of benchmarks is the following. Suppose that access reform would reduce access revenue for a given ILEC by $5 per line per month (using hypothetical numbers for purposes of exposition), and that the current retail price for basic local service were $15 per line per month. One means of recovering that $5 in lost access revenue due to access reform would be to increase the retail price of service by $5 (to $20). Another would be to keep the retail price of service the same but provide a $5 subsidy via a universal service fund. The former would be the most efficient in the economic sense of encouraging efficient competition, investment, and resource allocation, as I have explained. The latter would be the least likely to cause a decline in wireline telephone penetration, because there would still be the expected decrease in long distance prices (due to the reduced access rates) but a much smaller increase in local service prices.[122] There is no free lunch, however. The larger is the draw from the universal service fund, the greater is the economic inefficiency and cost to society caused by distorted competition, distorted consumption decisions by consumer, and distorted incentives for investment by providers; and the greater is the cost burden to the customers providing the subsidy, as I have explained. Hence, it would generally be desirable to compensate the carriers for reduced access revenues at least partly by increasing retail prices. One way

to achieve this would be to identify a price level for retail service that would recover some of the forgone access revenues at which customers would not be likely to defect from the network in significant numbers (i.e., a reasonably "tolerable" or "affordable" retail price level); and if that is not sufficient, to make up the rest of the access reduction with universal service funds. For example, suppose that there was reason to believe that if the price were to rise to $18 (again using hypothetical numbers), this would cause minimal decrease in subscribership due to the higher local price. Then the benchmark could be set at $18, which would permit recovery of $3 of the $5 of forgone access revenues, and the remaining $2 could be recovered from universal service funds. This solution would likely be superior to a solution of recovering the entire decrease in access revenues from universal service funds because it would at least partially rationalize the retail price toward a more efficient level, it would impose less subsidy burden on the customers supplying the subsidy, and it would go further toward diminishing the wide range of retail rates across the sate, bringing these rates closer together.[123] It would be less efficient than a solution of fully recovering the forgone access revenues from retail

[122] Even if the entire decrease in access revenues were covered by increased universal service support, that support would have to come from somewhere. Assuming it comes from the industry and not general tax revenues, there would generally be some increased cost to consumers to fund the universal service system.

[123] For example, Arizona Telephone Co.'s 1FR rate is $9.25 per month, while Midvale Telephone Exchange's (Rio Verde) 1FR rate is over two and a half times higher, at $24.46 per month. See ALECA Responses to Staff Discovery Request No. 1.3. Assuming the benchmark were set above the $9.25 rate but below the $24.46 rate, the benchmark would provide an opportunity for Arizona Telephone Co. to increase its rate without providing an opportunity for Midvale to do so, thereby bringing the two carriers' prices closer together. Dr. Oyefusi explains in his direct testimony how the benchmark is applied in scenarios such as this (see *Oyefusi Direct*).

prices, but may impose a lower potential risk to universal service goals (to the extent there is any material risk).

Finally, a practical downside to adopting a benchmark rather than recovering all of the forgone access revenues in the form of higher prices is that doing so would raise the empirical challenge of identifying a "benchmark" price that minimizes the social burden on the customers providing the subsidy, while not meaningfully impeding universal service goals.

Q: COULD YOU PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING THE TRADEOFFS BETWEEN REVENUE RECOVERY VIA HIGHER RETAIL PRICES, VERSUS DRAWS FROM A UNIVERSAL SERVICE FUND?

A: Yes. Economics is clear in teaching us that allowing retail prices to rise to a level that at least covers costs would generally advance overall consumer welfare by promoting an efficient allocation of resources, promoting efficient investment in alternative technologies, and promoting efficient competition. However, it is possible that such prices would impede social universal service objectives by discouraging some consumers from attaching to the telephone network at all. In such cases, there may be a conflict between advancing overall consumer welfare and advancing universal service policy objectives, and policy makers may choose to promote the latter at some expense of the former by permitting prices to remain below cost and subsidizing the difference via universal service funds. The facts in Arizona suggest that there are significant market

and regulatory safeguards to protect universal service goals so that overall telephone penetration is likely to be resilient to price increases, however. Because universal service mechanisms have a cost in the form of decreased overall social welfare and potentially "unfair" burdens imposed on the subsidizing customers, before instituting a universal service support mechanism to compensate for forgone access revenues policy makers should therefore at a minimum consider whether increasing retail prices to recover the access loss would in fact result in reduced telephone penetration, and (on the flip side) consider whether universal service support would be likely to meaningfully increase penetration.

Q: BY ORDERING A REDUCTION IN INTRASTATE ACCESS CHARGES, WOULD THE COMMISSION BE ABDICATING ANY REGULATORY RESPONSIBILITY TO THE LOCAL EXCHANGE CARRIERS?

A: No. On the contrary, the current system of support is crumbling as long distance minutes fall, LEC lines decline, and the subsidy source erodes, as I have already described. It is imperative both to provide a sustainable policy for wireline local exchange companies that currently rely on access rates to support below-cost local exchange prices, and for the ability of wireline long distance providers to compete on a more level playing field with other technologies, to reduce the currently-excessive intrastate access rates in Arizona. Of course, it would not be sustainable as a matter of economics nor advisable as a matter of policy credibility for regulators to rescind the subsidies embedded in access

rates, but fail to alleviate regulatory restrictions that may have forced some local exchange rates below cost. It would be most efficient to allow local exchange carriers the opportunity to increase local exchange prices to recover the forgone access revenues, but if the social policy objective of maintaining local exchange rates below cost is still considered necessary, an explicit means to fund these prices, such as a universal service fund, must be implemented.

IX. Concluding Comments

Q: CAN YOU PLEASE SUMMARIZE THE BENEFITS TO CONSUMERS AND THE ECONOMY FROM REFORMING INTRASTATE ACCESS RATES TO MIRROR INTERSTATE RATES?

A: Yes. Reforming the access regime by reducing intrastate access rates in Arizona as part of a holistic regulatory approach that provides for offsetting revenues via retail rate relief and/or universal service support can be expected to benefit consumers in the following ways:

- Prices for wireline intrastate long distance services would be expected to fall, which would directly benefit consumers and in turn would stimulate more usage of the wireline long distance network and enhance opportunities for consumers to use the technology that best suits their needs at the time;

- Distortions in the competitive process between wireline, broadband, and wireless technologies would be reduced so that consumers could make decisions that reward providers more closely for their relative efficiencies, service characteristics, and value

in the eyes of customers, rather than on the basis of artificially high wireline long distance services prices that distort consumer behavior;

- Investment incentives would be better aligned with the relative merits of different service providers and technologies; and

- Wasteful arbitrage activities would be less attractive and would therefore likely be reduced.

Q: DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A: Yes, it does.

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IBM Chair, Kellogg Graduate School of Management, Northwestern University, 1986-1987.

RESEARCH INTERESTS

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TEACHING

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PUBLICATIONS AND WORKING PAPERS

"Investment in Next Generation Networks and Wholesale Telecommunications Regulation," with Robert W. Crandall, November 3, 2008, http://ssrn.com/abstract=1294910.

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Contributing author, *ABA Section of Antitrust Law, Telecom Antitrust Handbook, (2005)*, (Chicago: American Bar Association), 2005.

"The Proper Treatment of Spare Network Capacity in Regulatory Cost Models," with Ana Danies, May 2005.

"State Commissions Systematically Have Set UNE Prices Below Their Actual Costs," with Frank Pampush and E. Gerry Keith, 2004.

"Broadband Adoption in the United States: An Empirical Analysis," with David E. Burnstein, in *Down to the Wire: Studies in the Diffusion and Regulation of Telecommunications Technologies,* Allan Shampine, ed., (Nova Science Publishers, Hauppauge, NY, 2003).

"Developments in the Theory of Vertical Foreclosure as Applied to Regulated Telecommunications Markets" (March, 2002), Prepared for Presentation at The American Bar Association Section of Antitrust Law, 50th Annual Spring Meeting.

"Modifications at HHIs for Vertical Supply Relationships" with Wenqing Li and James Langenfeld, White Paper submitted to European Commission, February 2000.

"Economic Theories of Tying and Foreclosure Applied—And Not Applied—in *Microsoft,*" with Steven S. Wildman, *Antitrust*, vol. 14, no. 1, 1999, pp.48-52.

"Effecting a Price Squeeze Through Bundled Pricing," with Steven S. Wildman, in *Competition, Regulation, and Convergence: Current Trends in Telecommunications Policy Research*, Gillett and Vogelsang, eds. (New Jersey: Lawrence Erlbaum Associates, Inc.) 1999, pp. 1-17.

"Worldwide Wait? How the Telecom Act's Unbundling Requirements Slow the Development of the Network Infrastructure," with Ken Dunmore and Frank Pampush, *Industrial and Corporate Change*," vol.7, no. 4, 1998, pp. 615-621.

"The Pricing of Customer Access in Telecommunications," with Steven S. Wildman, *Industrial and Corporate Change*, vol. 5, no. 4, 1996, pp. 1029-1047.

"Bonus and Penalty Schemes as Equilibrium Incentive Devices, With Application to Manufacturing Systems," with Pau Olivella, *Journal of Law, Economics, and Organization*, 10, Spring 1994, pp. 1-34.

"Diversification as a Strategic Preemptive Weapon," *Journal of Economics and Management Strategy*, 2, Spring 1993, pp. 41-70.

"Using the Capital Market as a Monitor: Corporate Spin-offs in an Agency Framework," *RAND Journal of Economics*, 22, Winter 1991, pp. 505-518.

"Firm Organization and the Economic Approach to Personnel Management, *American Economic Review*, vol. 80, no. 2, May 1990, pp. 23-27.

"The Introduction of New Products," with Edward P. Lazear, *American Economic Review*, vol. 80, no. 2, May 1990, pp. 421-426.

"Ability, Moral Hazard, Firm Size, and Diversification," *RAND Journal of Economics*, 19, Spring 1988, pp. 72-87.

"Worker Reputation and Productivity Incentives," *Journal of Labor Economics*, vol. 5, no. 4, October 1987, part 2, pp. S87-S106.

"The Role of Managerial Ability and Moral Hazard in the Determination of Firm Size, Growth and Diversification," Ph.D. Dissertation, University of Chicago, August 1985.

REPRESENTATIVE PRESENTATIONS

"Pricing Principles and Pricing Methodologies for Essential Facilities," The 36th Research Conference on Communication, Information and Internet Policy (TPRC), September 27, 2008.

"Regulatory Policy and the Reverse Cellophane Fallacy," with David E. Burnstein, 17th Biennial International Telecommunications Society Conference, Montréal, Québec, Canada, June 24-27, 2008.

"The Use of Economic Analysis in 'Industry Expert' Testimony," CLE course, XPRT Forum, March 7, 2008.

Presentations to the New Jersey Board of Public Utilities and to the New Jersey Legislature's Telecommunications Utilities Committee regarding the economic principles for a forward-looking regulatory agenda in light of the facts of competition nationwide and in New Jersey, and the costs of regulation, October – November 2006.

"The Interaction of Regulation with Economics and Financial Analysis in Litigation, Policy, and Strategy Consulting," CLE course, XPRT Forum, October 7, 2006.

"Comments on 'Economic Analysis in FCC Merger Proceedings,'" Conference on Economic Analysis and FCC Decisionmaking, presented by the Federal Communications Bar Association (FCBA) and Stanford Institute for Economic Policy Research (SIEPR), Washington D.C., March 15, 2006.

"Economic Principles for Consumer Protection Rules," Pri Telecom / Tech Briefing, Santa Clara, California, October 11, 2005.

"The Proper Treatment of Spare Network Capacity in Regulatory Cost Models," Presentation at the Advanced Workshop in Regulation and Competition, Center for Research in Regulated Industries, Skytop, Pennsylvania, May 2005.

"Telecommunications Regulation: What's Obsolete? What Will Become Obsolete?" Presentation at the State and City Telecom Reform Conference, Heartland Institute, Chicago, Illinois, December 2004.

"Trends in Telecommunications Demand & Supply," Presentation at the 46th Annual NARUC Regulatory Studies Program, Michigan State University, August 2004.

"The Economic Costs of Proposed Wireless Regulations in California," Presentation to Commissioners Brown and Kennedy, California Public Utilities Commission, San Francisco, California, April 2004.

"The Economics of UNE Pricing: Presentation to Staff," Ex parte presentation to the staff of the FCC, in FCC WC Docket No. 03-173: Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, March 2004.

"The High Cost of Proposed New Wireless Regulations," Presentation to the Pacific Research Institute conference "Regulating Wireless in California: Bill of Rights... or Wrongs?," San Francisco, April 2003.

"The TELRIC Showdown," Panelist, NARUC Staff Subcommittee on Telecommunications, 2002 Annual Convention, Chicago, Illinois, November 2002.

"Economic Principles for Efficient Pricing of Municipal Rights-of-Way," National Association of Telecommunications Officers and Advisors (NATOA), Chicago, Illinois, September 2002.

"Trends in Voice and Broadband Competition in Telecommunications Markets: Markets, Strategies, and Regulation," 82nd Annual Convention of the Indiana Telecommunications Association, Lexington, Kentucky, June 2002.

"Broadband Deployment in the United States," Emerging Opportunities in Broadband Symposium, Northwestern University, Evanston, Illinois, December 2001.

"Local Competition in Illinois," Illinois Telecommunications Symposium, Northwestern University, Evanston, Illinois, December 2000.

"Licensing and Access to Innovations in Telecommunications and Information Services," Telecommunications Policy Research Conference, Alexandria, Virginia, September 2000.

"Effecting a Price Squeeze Through Bundled Pricing," Federal Communications Commission, Washington, D.C., May 1999.

"Competitive and Strategic Use of Optional Calling Plans and Volume Pricing Plans," The Institute for International Research Conference for Competitive Pricing of Telecommunications Services, Chicago, Illinois, July 1998.

"Effecting a Price Squeeze Through Bundled Pricing," Consortium for Research in Telecommunications Policy Conference, University of Michigan, Ann Arbor, Michigan, June 1998.

"The Pricing of Customer Access in Telecommunications," Conference on Public Policy and Corporate Strategy for the Information Economy, Evanston, Illinois, May 1996.

"Diversification as a Strategic Preemptive Weapon," University of Iowa, Iowa City, Iowa, February 1994.

"Diversification as a Strategic Preemptive Weapon, "University of Buffalo, Buffalo, New York, February 1994.

"Diversification as a Strategic Preemptive Weapon," University of Southern California, Los Angeles, California, December 1993.

"Strategic Pricing," Winter Meetings of the Econometric Society, Discussant, Anaheim, California, December 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Michigan State University, Lansing, Michigan, November 1993.

"Diversification as a Strategic Preemptive Weapon," Rutgers University, New Brunswick, New Jersey, November 1993.

"Diversification as a Strategic Preemptive Weapon," University of California at Santa Cruz, Santa Cruz, California, November 1993.

"Diversification as a Strategic Preemptive Weapon," Graduate School of Business, Stanford University, Stanford, California, November 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Purdue University, West Lafayette, Indiana, September 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Summer Meetings of the Econometric Society, Boston University, Boston, Massachusetts, June 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," University of California, Department of Economics, Berkeley, California, May 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Stanford University, Graduate School of Business, Stanford, California, May 1993.

"Diversification as a Strategic Preemptive Weapon," Stanford University, Graduate School of Business, Stanford, California, April 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Hoover Institution, Stanford, California, April 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," University of California, Graduate School of Business, Berkeley, California, February 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Stanford University, Department of Economics, Stanford, California, February 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Hoover Institution, Stanford, California, January 1993.

"Pricing Strategies," Session Discussant, 1992 North American Winter Meeting of The Econometric Society, Anaheim, California, January 1992.

"Diversification as a Strategic Preemptive Weapon," University of Toronto, Toronto, Canada, November 1991.

"Diversification as a Strategic Preemptive Weapon," Queen's University, Kingston, Ontario, Canada, November 1991.

"Bonuses and Penalties as Equilibrium Incentive Devices, with Application to Manufacturing Systems," University of Chicago, Chicago, Illinois, June 1991.

"The Timing of Entry into New Markets," Summer Meetings of the Econometric Society, University of Pennsylvania, Philadelphia, Pennsylvania, June 1991.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," University of Chicago, Chicago, Illinois, April 1991.

"Bonuses and Penalties as Equilibrium Incentive Devices, with Application to Manufacturing Systems," Winter Meetings of the Econometric Society, Washington, D.C., December 1990.

"Corporate Spin-offs in an Agency Framework," University of Washington, Seattle, Washington, October 1990.

"The Timing of Entry Into New Markets," University of British Columbia, Vancouver, British Columbia, October 1990.

"Corporate Spin-offs in an Agency Framework," Texas A&M University, College Station, Texas, April 1990.

"Firm Organization and the Economic Approach to Personnel Management," Winter Meetings of the American Economic Association, New York, New York, December 1989.

"Corporate Spin-offs in an Agency Framework," Western Finance Association Meetings, Seattle, Washington, June 1989.

"Corporate Spin-offs in an Agency Framework," University of Rochester, Rochester, New York, May 1989.

"Corporate Spin-offs in an Agency Framework," North American Summer Meetings of the Econometric Society, Minneapolis, Minnesota, June 1988.

"Competition, Relativism, and Market Choice," North American Summer Meetings of the Econometric Society, Berkeley, California, June 1987.

"Competition, Relativism, and Market Choice," University of Chicago, Chicago, Illinois, April 1987.

"Rate Reform and Competition in Electric Power," Discussant, Conference on Competitive Issues in Electric Power, Northwestern University, Evanston, Illinois, March 1987.

"Worker Reputation and Productivity Incentives," New Economics of Personnel Conference, Arizona State University, Tempe, Arizona, April 1986.

"Ability, Moral Hazard, and Firm Diversification," Various Universities, 1985, 1994, including Yale University, University of Rochester, Stanford University, University of Minnesota, California Institute of Technology, Duke University, Northwestern University,

Brown University, Harvard University, University of California - Los Angeles, University of Pennsylvania.

ACADEMIC JOURNAL REFEREEING

Dr. Aron has served as a referee for *The Rand Journal of Economics, the Journal of Political Economy, the Journal of Finance, the American Economic Review, the Quarterly Journal of Economics, the Journal of Industrial Economics, the Journal of Economics and Business, the Journal of Economic Theory, the Journal of Labor Economics, the Review of Industrial Organization, the European Economic Review, the Journal of Economics and Management Strategy, the International Review of Economics and Business, the Quarterly Review of Economics and Business, Management Science, the Journal of Public Economics, the Journal of Institutional and Theoretical Economics*, and the National Science Foundation.

SELECTED TESTIMONY AND OTHER ENGAGEMENTS

Deposition testimony on damages in a matter before the United States District Court, Western District of Texas, Austin Division, regarding intercarrier "access fees" for exchange of Internet Protocol telecommunications traffic, October 2009.

Expert testimony before the New Jersey Board of Public Utilities regarding intrastate switched access charges and retail rate rebalancing, September 2009.

Expert testimony before the Circuit Court for the Third Judicial Circuit, Madison County, Illinois in class action matter pertaining to allegations that a statutory refund required of defendant telephone company was improperly distributed, October 2009.

Advice and presentation to executives of a large Israeli telecommunications company regarding the Israeli regulatory regime, unbundling obligations, pricing, costing, and competitive reform, February 2009.

Deposition testimony in a matter before the Delaware Circuit Court regarding a contractual dispute between wireless telecommunications companies, on the issue of irreparable harm pertaining to alleged violation of exclusive territory provisions, November 2008.

Written expert evidence before the Canadian Radio-television and Telecommunications Commission in the matter of an application to expand the unbundling obligations of the ILECs for the provision of certain broadband services; regarding the effects of the requested unbundling obligations on competition, investment, and social welfare in Canada, July 2008.

Deposition and jury trial testimony in a matter before the Superior Court of the State of California, County of Los Angeles on the telecommunications business environment and viability of particular telecommunications business models in the late 1990s/early 2000s in

a matter regarding an alleged breach of contract in the mobile satellite services industry, April/July 2008.

Written expert declarations before the California Public Utilities Commission in the matter of a rulemaking regarding whether to adopt, amend, or repeal regulations governing the retirement by incumbent local exchange carriers of copper loops and related facilities used to provide telecommunications services; regarding the effects of copper retirement regulation on investment incentives for next generation networks, January 2008.

Analysis of US and global subsea telecommunications fiber capacity investments and swap arrangements during the late 1990s and early 2000s, in a litigation matter alleging failure of defendant to disclose material information to plaintiffs (case settled before expert disclosure), 2008.

Written testimony before the Public Utility Commission of Texas regarding the regulatory philosophy of universal service policy, and competitive implications of proposed universal service distribution mechanisms, November 2007.

Expert evidence before the Canadian Radio-television and Telecommunications Commission regarding the economically appropriate methodology for pricing wholesale telecommunications services and essential facilities, October 2007.

Expert testimony before the Indiana Utility Regulatory Commission regarding the competitive effects on a new entrant in the video services marketplace of disclosure of highly detailed deployment data, August 2007.

Deposition testimony in a matter before the Oklahoma Court of Tax Review regarding the market factors affecting valuation of telecommunications assets during the relevant tax year of the dispute, June 2007.

Written evidence before the Canadian Radio-television and Telecommunications Commission regarding the proper economic principles that should govern determination of regulatory costs, and the effects of regulatory cost determination on economic efficiency and competition, May 2007.

Expert testimony before the New Jersey Board of Public Utilities regarding its review of telecommunications regulations and proposal to establish new regulations on incumbent and competitive wireline carriers, March 2007.

Analysis of competitive effects and effects on consumer welfare of deployment of IP video services in competition with incumbent video services providers, 2007.

Damages analysis as consulting expert in an international arbitration matter regarding disputed availability of and access to subsea and terrestrial telecommunications fiber capacity from mid 1990s through mid 2000s, with focus in Asia and Europe, 2007.

Expert testimony before the Michigan Public Service Commission regarding the competitive effects of total service resale of telecommunications services, and restrictions on resale pertaining to aggregation of demand for volume discounts, November 2006.

Preliminary Expert Report of Debra J. Aron, "The U.S. Long-haul Fiber Optic Network Industry: 1996-2001," in a matter in the Superior Court of the state of California involving disputed investment in long haul capacity in the U.S., June, 2006.

Expert testimony before the Kentucky Public Service Commission, Tennessee Regulatory Authority, and Mississippi Public Service Commission regarding the competitive effects of the proposed AT&T acquisition of BellSouth, June 2006.

Deposition testimony in a matter before the Oklahoma Court of Tax Review regarding the status of competition for wireline local exchange telephone service in Oklahoma and the likely economic effect of such competition on the forward looking value of company assets, March 2006.

Expert testimony before the California Public Utilities Commission regarding the competitive landscape in California and the desirability of establishing a Uniform Regulatory Framework for the telecommunications industry in the state of California, February 2006.

Deposition testimony and trial testimony in the Court of Chancery in the state of Delaware In and For New Castle County and in Circuit Court of Cook County, Illinois County Department, Chancery Division, regarding the possibility of "irreparable harm" to Sprint Nextel's wireless affiliates in connection with Sprint's acquisition of Nextel Corporation, November 2005 – July 2006.

Expert testimony before the California Public Utilities Commission and the Public Utilities Commission of Ohio evaluating the economic benefits and competitive impacts of the proposed acquisition of AT&T by SBC, June–August 2005.

Expert testimony before the Oklahoma Corporation Commission regarding the proper economic principles for reduced regulation of retail telecommunications services and regarding the determination of the amount of a supersedeas bond to quantify the economic harm likely to result from the award of a stay of Commission order that would grant pricing flexibility and require broadband investment, June – August 2005.

Expert testimony before the Kansas Corporation Commission regarding the sustainability of competition in communications markets in Kansas, June 2005.

Cost and economic analysis for a large telecommunications firm regarding tariffed volume and term-discounted pricing plans for special access services based on regulatory requirements for consistency of prices with cost structure, March 2005.

Expert testimony before the Missouri Public Service Commission evaluating the potential competitive reclassification of local telephone service in Missouri, January 2005.

Expert testimony before the Public Utilities Commission of Ohio and the Public Service Commission of Wisconsin regarding the effects of UNE pricing on the competitive telecommunications markets, July 2004.

Expert testimony before the Florida Public Service Commission and the Georgia Public Service Commission, written expert testimony before the public utilities commissions in Mississippi, Alabama, North Carolina, South Carolina, Tennessee, and Kentucky, and

deposition testimony, regarding the proper principles for determining which network elements should be provided to competitors on an unbundled basis at regulated rates; including testimony in support of a business case model of the viability of efficient competitive entry in specific geographic markets in each aforementioned state, January-March 2004.

Ex parte presentation "The Economics of UNE Pricing," to the Federal Communications Commission staff, with William Rogerson, March 2004.

White Papers, "The Economics of UNE Pricing," December 2003, and "A Further Analysis of the Economics of UNE Pricing," January 2004, with William Rogerson, submitted to the Federal Communications Commission in FCC WC Docket No. 03-173: Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers.

White Paper, "The Effects Of Below-Cost TELRIC-Based UNE Prices On CLEC And ILEC Investment," submitted to the Federal Communications Commission in FCC WC Docket No. 03-173: Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, January 2004.

Expert testimony before the Illinois Commerce Commission regarding the proper determination of Total Element Long Run Incremental Cost (TELRIC) for establishing prices for network elements, March 2004.

Expert testimony before the Illinois General Assembly regarding the effects of current regulated UNE pricing of telecommunications elements on competitive telecommunications markets in Illinois, May 2003.

Expert testimony before the Public Utilities Commission of Ohio on issues related to rights-of-way fees charged to electric, water, and telecommunications companies in the City of Toledo, Ohio, March 2003.

Reports evaluating the cost impacts and public policy implications of the proposed California Consumer Protection rules on wireless carriers and customers, February 2003 and September 2003.

Expert testimony before the state regulatory commissions in Ohio, Illinois, Indiana, and Kansas on the economic principles for evaluating anticompetitive claims regarding "winback" pricing by incumbent telecommunications carriers, 2002 - 2003.

Report pertaining to the economic and antitrust analysis of price squeezes, and the suitability of imputation rules as a protection against an anticompetitive price squeeze, for a carrier in a foreign market, 2002.

Expert testimony before the Michigan Public Service Commission pertaining to allegations of anticompetitive effects of long term contracts, 2002.

For a small manufacturer of telecommunications equipment, consulting support to evaluate the antitrust implications of a proposed acquisition, 2002.

White Paper submitted to the Texas Public Service Commission pertaining to the competitive effects of "winback" and "retention" pricing, 2002.

In Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the new Regulatory Framework for Pacific Bell and Verizon California Incorporated, written declaration submitted to the California Public Utilities Commission pertaining to the economic incentives created by modifications to the State's alternative regulation plan and competitive reclassification of services, 2002.

Statement to the Federal Communications Commission regarding the potential economic causes of sustained price increases for cable television services, 2002.

Expert testimony before the Kansas Corporation Commission regarding the antitrust principles relevant to establishing rules for competitive reclassification of services under governing state law, 2002.

For a national wireless telecommunications carrier, consulting support pertaining to litigation regarding access charges, 2001.

Expert testimony before the Missouri Public Service Commission pertaining to price squeeze allegations in the long-distance market, 2001.

Expert affidavit submitted to the Circuit Court in the state of Wisconsin, pertaining to irreparable harm caused if court declined to grant a stay of disputed performance remedy plan, 2001.

Expert testimony before the public utilities commissions of Illinois, Ohio, California, and Indiana, pertaining to the economic viability of constructing and provisioning ADSL services, including market definition and examination of competitive conditions, 2001.

Expert testimony before the Illinois Commerce Commission pertaining to the proper economic principles governing unbundling obligations, 2001.

In the matter of H & R Mason Contractor's et al. v. Motorola, Inc. et al., before the Circuit Court of Cook County, Illinois, expert affidavit examining the economic impediments to class certification, focusing on the determinants of price in the relevant equipment markets, April 2001.

For a competitive local exchange provider in a foreign market, consulting support regarding the proper determination of avoided costs for resale of incumbent services, April 2001.

For a major Japanese telecommunications equipment manufacturer, evaluated the revenue potential and desirability of entering several advanced services equipment markets worldwide, for the purposes of assisting the client to evaluate a proposed acquisition, February 2001.

Expert testimony in the Illinois Commerce Commission's Investigation Into Certain Payphone Issues, examined the economic and public policy issues pertaining to pricing of access lines for independent pay telephone providers, April 2001.

In the matter of the Illinois Public Utility Commission's Investigation Into Tariff Providing Unbundled Local Switching And Shared Transport, expert testimony regarding economic antitrust perspectives on obligations of firms to affirmatively help their competitors, and related public policy issues, April 2001.

In response to Request for Consultations by the U.S. Trade Representative (USTR) with the Government of Mexico before the World Trade Organization (WTO) regarding barriers to competition in Mexico's telecommunications market, analyzed regulated switched access rates in the U.S. in comparison with those charged by Telmex, November 2000.

Declaration submitted to the Texas Public Utility Commission, analyzed proposed regulation aimed at preventing incumbents from executing a price squeeze; developed a framework for evaluating claims of a price squeeze consistent with antitrust principles of predation, August 2000.

For a taxicab company, analysis of regulatory requirements in the City of Chicago pertaining to valuation of medallions and valuation of capital for purposes of regulatory ratemaking proceeding, 2000.

Written and oral testimony before the public utility commissions of Illinois and Michigan in various arbitration matters pertaining to the proper compensation for the use by competitors of client's facilities for foreign exchange services, 2000.

For a firm in the aluminum fabrication industry, in the matter of a potential merger between vertically integrated competitors, developed a methodology for adjusting the HHI measure of market concentration to account for the vertical control by the merging parties of downstream competitors, 2000.

For a large newspaper publisher, in the possible acquisition of the San Francisco Chronicle, analyzed the potential antitrust impediments to an acquisition by the client of the Chronicle, including issues of geographic and product market definition, the interplay between advertising markets and customer markets, and the relevant implications of the Newspaper Preservation Act, 1999.

Testimony before the Illinois Commerce Commission regarding the proper economic interpretation of the standards for declaring a service competitive under the Illinois Public Utilities Act, and quantification of the extent of competition in relevant Illinois markets, including discussion of market definition; the relevance of entry conditions; the relevance of resale competition and analysis of various resale entry strategies; the interdependence of resale and facilities-based entry strategies; and implementation of a technology-based method of measuring market participation, 1999-2000.

For a firm in the consumer mapmaking business, analyzed market definition, concentration, and efficiencies from a proposed merger, 1999.

Affidavit submitted jointly with Robert G. Harris to the Federal Communications Commission in the matter of "unbundled network elements" and commenting on the proper interpretation of the "Necessary and Impair" standard, including discussion of entry conditions and the business-case approach to valuation of an entry strategy, April 1999; reply affidavit May 1999.

Affidavit, "An Analysis of Market Power in the Provision of High-Capacity Access in the Chicago LATA," submitted to the Federal Communications Commission, including an analysis of the US DOJ merger guidelines and their applicability to regulatory relief in a regulated market, as well as extensive empirical modeling of the costs and business case for network buildout of high capacity facilities, February 1999.

White Paper, "Proper Recovery of Incremental Signaling System 7 (SS7) Costs for Local Number Portability," submitted to the Federal Communications Commission, April 1999.

PROFESSIONAL ORGANIZATIONS

Member, American Economic Association

Member, Econometric Society

Associate Member, American Bar Association

Past Member, Telecommunications Policy Research Conference Program Committee

November 2009

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
KRISTIN K. MAYES - Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE REVIEW AND POSSIBLE REVISION OF ARIZONA UNIVERSAL SERVICE FUND RULES, ARTICLE 12 OF THE ARIZONA ADMINISTRATIVE CODE.	DOCKET NO. RT-00000H-97-0137
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS.	DOCKET NO. T-00000D-00-0672

DIRECT TESTIMONY OF

DR. OLA OYEFUSI

On Behalf of

AT&T Communications of the Mountain States, Inc. and TCG Phoenix

PUBLIC VERSION

December 1, 2009

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INTRODUCTION - WITNESS QUALIFICATIONS AND PURPOSE

Q. DR. OYEFUSI, PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Ola A. Oyefusi, and my business address is 7125 Columbia Gateway Drive, Columbia, Maryland 21046.

Q. DR. OYEFUSI, BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am a Lead Carrier Relations Manager in AT&T's National Access Management Organization. In that capacity, I am responsible for all matters affecting AT&T's costs to interconnect its network with those of all other carriers, regardless of class of service or technology, in twenty-six states.

Q. DR. OYEFUSI, PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

A. I hold a Ph.D. in Economics from George Mason University in Fairfax, Virginia. Additionally, I hold M.A. and B.S. degrees in Economics from Morgan State University in Baltimore, Maryland.

I began my career with AT&T in 1999 and have been responsible for matters related to AT&T's access and local interconnection expenses since then. Among other duties, I am responsible for reviewing and interpreting access tariffs and managing AT&T's wholesale costs of providing long distance service.

Prior to joining AT&T, from 1991 until 1999, I was employed by the Public Service Commission of the District of Columbia as an economist and Commission advisor. In those capacities, I reviewed and analyzed rate filings submitted by telecommunications

and energy companies. I also prepared revenue and cost analyses to support testimony and comments on issues affecting the telecommunications and energy industries. Before that, I have taught economics and held research positions, between 1985 through 1991, at George Mason University's Center for Study of Public Choice and at Morgan State University.

Q. DR. OYEFUSI, PLEASE BRIEFLY SUMMARIZE YOUR RECENT EXPERIENCE IN ACCESS CHARGE PROCEEDINGS.

A. I recently testified in New Jersey regarding access reform in a proceeding similar to this one. I have been actively involved on issues related to access charges in several other states. I testified on AT&T's behalf in switched access charge proceedings in New Hampshire, Massachusetts, Virginia, and Pennsylvania, and I am currently preparing testimony for an Illinois proceeding investigating the access charges of CLECs, some of which are involved in this case. I generally provided economic support for access complaints or interventions by AT&T in all states. I have also developed presentations on forward-looking economic costs in state proceedings to establish rates for unbundled access. A list of the proceedings in which I have been a witness is attached as OAO_Exhibit A.

While I was at the District of Columbia Public Service Commission ("DC PSC"), I provided economic advice in a 1997 unbundled access proceeding involving Verizon DC's predecessor, Bell Atlantic-Washington, D.C., Inc. I also reviewed and interpreted tariff applications involving revisions of existing services and the introduction of new services submitted by Verizon DC and provided recommendations to the Commissioners. Prior to 1997, I provided written and oral testimony on behalf of the District of Columbia

PSC Staff in rate cases involving Potomac Electric Power Company and Verizon DC's earlier predecessor, the Chesapeake and Potomac Telephone Company.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. My testimony addresses Issues 1 through 12 in the procedural order of September 29, 2009. In summary, I will explain why the Commission should (i) reduce the intrastate switched access rates of all Arizona incumbent local exchange carriers ("ILECs") to parity with their corresponding interstate switched access rates, (ii) cap the switched access rates of any CLEC operating in an ILEC's service territory at that same ILEC's interstate level, and (iii) allow carriers to recover the reductions in access revenue through flexibility in retail rates and, if necessary, in limited circumstances through universal service support.

I will also explain that since 1984, intrastate access charges paid by long distance interexchange carriers ("IXCs") without exception to local exchange carriers have remained at exceedingly high levels in order to maintain the historic subsidy flow from long distance consumers to support local exchange service below cost. And because access charges are a principal component of the cost to provide wireline long-distance service, high access charges force wireline interexchange carriers ("IXCs") to maintain higher retail prices for long-distance service. This forces consumers of wireline long distance service across the state to pay more for long distance, in order to subsidize lower local service rates for consumers in some areas.

While economists and policy makers have debated for twenty-five years whether the arrangement of implicit subsidies in access helped consumers, there is now general agreement that such implicit subsidies cannot be maintained in today's highly

competitive telecommunications market. The intrastate switched access rates in effect today still reflect monopoly-era thinking, when wireline long distance rates were set far in excess of cost in order to subsidize basic local telephone service, and consumers who wished to communicate over long distances had no real choice other than to pay the high long-distance rates. Today, Arizona consumers have a broad range of options for their in-state long distance communications, including wireless carriers, e-mail, social networking websites, and VoIP providers – none of which pay subsidy-laden intrastate access charges in the same manner as wireline IXCs like AT&T.

As things now stand, intrastate access charges as high as 13¢ per minute are being imposed almost exclusively on long distance interexchange carriers such as AT&T, while competing means of communications are generally able to complete their calls for as little as 7/100ths of a cent per minute ($0.0007) (or in some cases, nothing) because federal law and the FCC have established very low call completion rates *for every other type of traffic except intrastate switched access.* The charts included later in this testimony graphically underscore the point.

Not surprisingly, the regulatory-driven rate disparities for competing services are driving customers *away* from traditional wireline long distance and *toward* substitute services not saddled with the access cost burden. For example, parents use Skype or Vonage to stay in touch with kids in college. Text messaging is replacing voice calling, particularly among those under 30. As of June 2008, Arizona had almost 5 million wireless subscribers, which means that 76 percent of all Arizona residents – that is *residents*, not households – now have a wireless phone. Even more striking, 97 percent

of Arizonans over the age of 15 (i.e. excluding children below the high school age) have a wireless phone.

When one segment of the market is singled out and forced to incur subsidy obligations that its competitors do not face, the results are predictable. Arizona consumers are using traditional wireline long distance less, in part because they perceive it to be overpriced relative to other options not saddled with the access subsidy obligations. It was one thing to impose subsidy obligations on a single segment of the communications industry – IXCs – when consumers had no other choice but to use those IXCs. However, it is quite another thing today, when IXCs are only one of many communications options available to consumers, to force IXCs to bear subsidy obligations their competitors do not face. Clearly, that needs to change.

AT&T and other wireline IXCs cannot compete effectively when they must pay intrastate switched access rates as high as 13 cents per minute and their competitors generally do not. This disparity in pricing has discouraged some consumers from using the traditional wireline network for their long distance calling, a fact underscored by the **[BEGIN CONFIDENTIAL INFORMATION]** ■ **[END CONFIDENTIAL INFORMATION]** drop in Qwest's intrastate access minutes in just the last two years.[1]

As I explain in my Testimony, the first step in eliminating anti-competitive subsidies from the LECs' intrastate switched access charges is to reduce those rates to parity with the LECs' interstate switched access charges. Those interstate rates are more than compensatory, and will continue to provide contribution to the LECs' joint and

[1] See Qwest Response to Staff Data Request STF 01-001 and STF 01-002.

common costs. Also, the interstate rates are much higher than the cost-based rates that the LECs charge for the materially identical function of local call termination.

Approximately 33 states have adopted some type of reform to intrastate switched access rates, and more than 20 have taken steps similar to the straightforward approach that AT&T recommends here: to order reduction of (or to begin the process of reducing) ILECs intrastate switched access rates to levels at or below their interstate switched access rates.[2] Those states have recognized, as the Commission should here, that high access charges harm consumers by driving long-distance prices higher and by preventing wireline IXCs from competing fully and fairly for their business. And as some of these other states have done, the Commission should allow incumbent local exchange carriers the opportunity to rebalance the amount of revenue reductions through a combination of rate flexibility for retail local service and through modifications to the existing Arizona universal service fund. Essentially, ILECs would have the opportunity to recover more of their local service costs from local service rates or from explicit, broadly funded universal service subsidies, rather than implicit subsidies in wholesale access rates that apply to only one group of competing providers. That way, the customers who caused the local exchange carriers to incur local service costs will be asked to pay for them, not the captive access service customers (the IXCs). The Commission can then rely on competition to constrain rates for all services.

As I describe below, there is a simple way to implement meaningful access charge reforms, allow carriers to recover the reductions in revenue, and keep local service rates

[2] When other types of access reform, besides ILECs parity, are considered (e.g. with some other form of constraints on ILECs and CLECs) the number of states with reform increases to about 33. See Dr. Aron's Direct Testimony at Section V(C).

at reasonable levels. The Commission should first require all LECs to reduce their intrastate switched access rates to parity with the corresponding interstate rates, and at the same time it should give ILECs the flexibility, but not a mandate, to increase rates up to a reasonable benchmark level (subject to reasonable limits on annual rate increases during a transition period). To the extent that the allowed rate increases are not sufficient to recover the reductions in access revenues, an ILEC will be allowed to obtain explicit subsidies from the AUSF. As I show below, Qwest has proposed benchmarking methods that would yield a benchmark of about $16.50, which is quite reasonable, and in fact represent the low end of a reasonable range of possible benchmarks. In fact, setting a benchmark of $18 would still leave most ILECs' local service rates at about the same level, in real inflation-adjusted terms, as when the Commission last fixed those rates, while balancing off most of the access rate reductions proposed here and thereby minimize the level of additional AUSF support contribution.

In short, my Testimony will show that the LECs' intrastate access rates can no longer be deemed just, reasonable or non-discriminatory. I will show that reducing those rates will benefit consumers in multiple ways by allowing the competitive market to work with fewer artificial regulatory distortions. The current system simply cannot be sustained, as ALECA members have recognized in their whitepaper[3], and as consumers in Arizona are starting to transition to a broadband platform and/or wireless services the access subsidies supporting the universal service goal will vanish. The extremely low retail rates must therefore increase when it can no longer be supported by the current implicit subsidy source.

[3] ALECA members have recognized this lack of sustainability. See whitepaper titled "The Case for Arizona Access Charge Reform," by *the Arizona Local Exchange Carrier Association (ALECA), dated November 2, 2006.*

Q. COULD YOU PLEASE SUMMARIZE YOUR RESPONSES TO ISSUES 1 THROUGH 12?

A. Yes. Below are brief summaries of my responses.

- ***Issue 1 Response*** - All Arizona local exchange companies who operate under the jurisdiction of the Arizona Corporation Commission (specifically Qwest, Verizon, all independent telephone companies regulated by the ACC, including the ALECA members, and the CLECs) should have their access charges reformed.

- ***Issue 2 Response*** - The Commission should order all LECs to reduce their intrastate switched access rates and structure to match their corresponding interstate rates. This will also result in "capping" CLECs' intrastate rates so that they cannot exceed the corresponding rates of the ILECs in whose service territory they compete, because those caps exist on their interstate rates.

- ***Issue 3 Response*** -- AT&T recommends that the Commission require all Incumbent local exchange carriers, no later than 60 days after the effective date of necessary revisions to the AUSF rules approved in its order in this proceeding, to reduce their intrastate switched access rates to the ILECs' interstate rate structures and levels and, within 60 days of the date of this order, require all CLECs to adjust their intrastate tariffs so that their access charges do not exceed those assessed by the ILEC in whose territory they operate. Each ILEC should also be directed to update and mirror its intrastate tariff anytime it changes its interstate rates in the future and CLECs should file conforming changes to match those of the ILEC with which they compete.

- ***Issue 4 Response*** - Individual companies should be allowed to adjust or respond to business needs by entering into special business arrangements that reflect changing market conditions. Because of the time it normally takes to arrive at a regulatory solution (months or even years depending on the complexity of the issues involved) companies may suffer undue economic harm if not allowed the flexibility to derive business solutions in the form of mutual agreements.

- ***Issue 5 Response*** - The Commission should allow all carriers to recover access revenue reductions by giving them flexibility to increase their retail rates for local service, and in certain cases (i.e. when retail rate increase by an incumbent local exchange carrier will not be sufficient for revenue neutral recovery), ILECs should be eligible receive access replacement revenue from the Arizona universal service fund.

- ***Issue 6 Response*** – The Commission should establish a benchmark mechanism that allows carriers to recover part of their access reduction from increased retail rates to end users up to the benchmark level, and, in certain cases, the balance if any could be recovered by allowing incumbent LECs to draw support from an

Access Replacement Fund drawn from a modified AUSF. I will describe below a reasonable approach to setting a benchmark level

- ***Issue 7 Response*** – To calculate the AUSF support provided to offset access rate reductions, incumbent local exchange carriers would first calculate and verify the amount of access revenue lost when ***intrastate*** access rates are reduced to their corresponding ***interstate*** levels. Then, they would calculate the additional revenue from authorized rate increases for retail local services, if rates were raised up to the benchmark level. The difference would be the amount of access replacement revenue to be made available from the AUSF. Any carrier may also file to increase other rates to offset revenues lost as a result of intrastate access rate decreases on a showing that such rate increases are revenue neutral to the access rate decreases.

- ***Issue 8 Response*** – The current AUSF rules do not clearly authorize the use of AUSF support to recover reductions in access revenues, nor are they designed to fund support for that purpose. They should thus be revised to include at least the following: (i) a provision that allows eligible carriers to draw from the fund to recover lost switched access revenue, specifically describing how the amount to be drawn would be calculated, and identifying the supporting documentation that the eligible carrier must provide in order to qualify for a revenue replacement support; (ii) provisions describing the contribution methodology, the sources of contributions to the fund; (iii) a provision that provides carriers an option to recover their contribution assessment rate thorough a surcharge; and (iv) a provision that specifies eligibility criteria for carriers to draw access replacement support from the fund. The Rules for the distribution of high-cost support would not be affected.

- ***Issue 9 Response*** – CLECs do not need to draw access replacement revenue from the AUSF; they should have the flexibility to increase local retail rates sufficiently to recover any forgone access revenue as a result of the proposed access reform. Only ILECs whose retail rates have been traditionally set as part of the legacy subsidy system should be allowed to receive access replacement support from the modified AUSF, after they had first looked to recover their own lost access revenues through retail rate flexibility to a benchmark level adopted by the Commission.

- ***Issue 10 Response*** – The proposed revisions to allow either the retail rate flexibility or receipt of access replacement revenue from the AUSF should be implemented such that carriers are neither net gainers nor losers of revenue as a result of access reform. The result should be revenue neutral, and it should not result in any change to the existing High Cost support. Rather, it would simply be a separate source of support that serves a separate purpose.

- ***Issue 11 Response*** – Contributions to the AUSF, to satisfy the existing support needs and the proposed access revenue replacement function here, should come

from *all* telecommunications providers, on an equitable, non-discriminatory and competitively neutral basis. As a general matter, the contribution methodology employed for the AUSF should mirror the approach currently implemented for the federal USF, i.e. based upon a percentage of interstate/international retail (end user) telecommunications revenues. At present, the intrastate counterpart of that approach in Arizona will be for the AUSF contribution to be based upon a percentage of the total Arizona's retail intrastate telecommunications revenues.

- ***Issue 12 Response*** - AT&T will file specific AUSF rules language with its reply testimony after it has reviewed other parties' direct testimony on these issues.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. **Section II** provides a brief background and history of switched access charges and explains why the current switched access charges are no longer just and reasonable given the dramatic changes to the telecommunications industry during the last decade. I show that excessive switched access rates are creating competitive distortions that harm competition, consumers, and Arizona's economy. In general, I will illustrate the problems that arise when wireline IXCs are required to pay intrastate access charges their competitors do not pay, and why this practice is so discriminatory and harmful to consumers.

Section III answers the specific questions posed by the ALJ's procedural order. I begin by demonstrating that the Commission should apply its reforms equally to all LECs, rather than giving preferential treatment to some LECs (Issue 1). Next, I show that the Commission should reduce all ILECs' intrastate access rates to match their corresponding interstate rates, thereby giving Arizona consumers the benefits of reforms adopted at the federal level and joining the many other states that have implemented interstate parity (Issues 2 and 3). I will also explain that the Commission should simultaneously require the CLECs to mirror the specific rates of the ILECs with which they compete; again

following reforms adopted at the federal level and replicating the outcome that would be expected in a competitive market. I will show how consumers will benefit from reductions to the LECs' intrastate access rates. I will also discuss how interstate parity will simplify billing, reduce carrier costs, reduce incentives for arbitrage, and discourage or prevent illicit schemes some carriers have devised to take advantage of (or avoid) high intrastate access rates. After that, I will demonstrate that carriers should be permitted to contract for access rates that differ from tariffed rates, so that carriers can voluntarily develop, negotiate, and enter into arrangements that provide even greater benefits to consumers (Issue 4).

I then turn to issues related to the recovery of access revenue reductions and AUSF support. I will begin that discussion by describing what revenue sources, if any, should be made available to LECs to compensate for the reduction in access revenues that will result from access rate reform (Issues 5 and 6). As I explain below, that recovery should come from a combination of (i) flexibility to set retail rates for local service and, (ii) for carriers that can demonstrate that they cannot recover their costs without increasing rates above an affordability benchmark established by the Commission, explicit support from the AUSF. I will then discuss the procedure for carriers to obtain support from the AUSF "revenue neutral" recovery of access reductions and the method for determining support amounts (Issue 7). Next, I will describe how the AUSF rules should be revised to allow for this explicit support, the eligibility requirements for carriers to obtain support, and the contribution methodology (Issues 8 through 12).

II. BACKGROUND AND HISTORY OF SWITCHED ACCESS CHARGES.

A. LONG-DISTANCE CALLS AND SWITCHED ACCESS SERVICE.

Q. PLEASE EXPLAIN WHAT SWITCHED ACCESS CHARGES ARE.

A. Switched access charges are the fees that a local exchange carrier assesses upon wireline long distance providers when the LEC originates or terminates long distance calls made or received by the LEC's local service subscribers. The LEC owns the "loop" that connects those subscribers to the LEC's switch and the rest of the public switched telephone network. For example, when a Qwest basic local service subscriber in Tucson wants to use AT&T's long distance service to call a Citizens-Frontier basic local service subscriber in Kingman, AT&T must (i) pay Qwest an *originating* switched access charge for the carriage of the call from the subscriber's location to AT&T's network, and (ii) pay Citizens-Frontier a *terminating* switched access charge for the delivery of the call from AT&T's network to the called party in Kingman. If the same Qwest subscriber in Tucson makes an AT&T intrastate long distance wireline call to another Qwest subscriber in Prescott, AT&T must pay Qwest *both* originating and terminating intrastate access charges.

Q. WHAT FUNCTIONS DOES A LEC PERFORM WHEN IT PROVIDES ORIGINATING SWITCHED ACCESS SERVICE?

A. When a consumer places an interexchange call (either an intrastate or interstate call) from a wireline phone, the call travels from the calling party's location over loop provided by the LEC that serves that caller,[4] to that LEC's local serving office (sometimes called an "end office" or "central office"). There, the call is directed to the LEC's local switch,

[4] Loop costs are considered "non traffic sensitive" because they do not vary if the customer uses the loop for only local calling, only long distance calling, or not at all. Nor do the costs vary if the customer uses the line for hours a day, or for mere minutes a day. Thus, as a matter of sound economic theory and following cost causation principle, it is more appropriate to recover these costs via fixed monthly charges assessed to the end user customer.

which electronically routes the call along a wired path known as a transport trunk to the interexchange carrier's point of presence ("POP"). At that point, the LEC hands the call off to the interexchange carrier and the originating access service ends.[5] The origination functionality is performed in the same manner, using the same equipment and facilities, regardless of the identity of the interexchange carrier, regardless of the intercarrier compensation regime that applies to the call, and regardless of the call's ultimate destination (interstate or intrastate). I provide an illustration of originating access in the diagram provided in response to the next question.

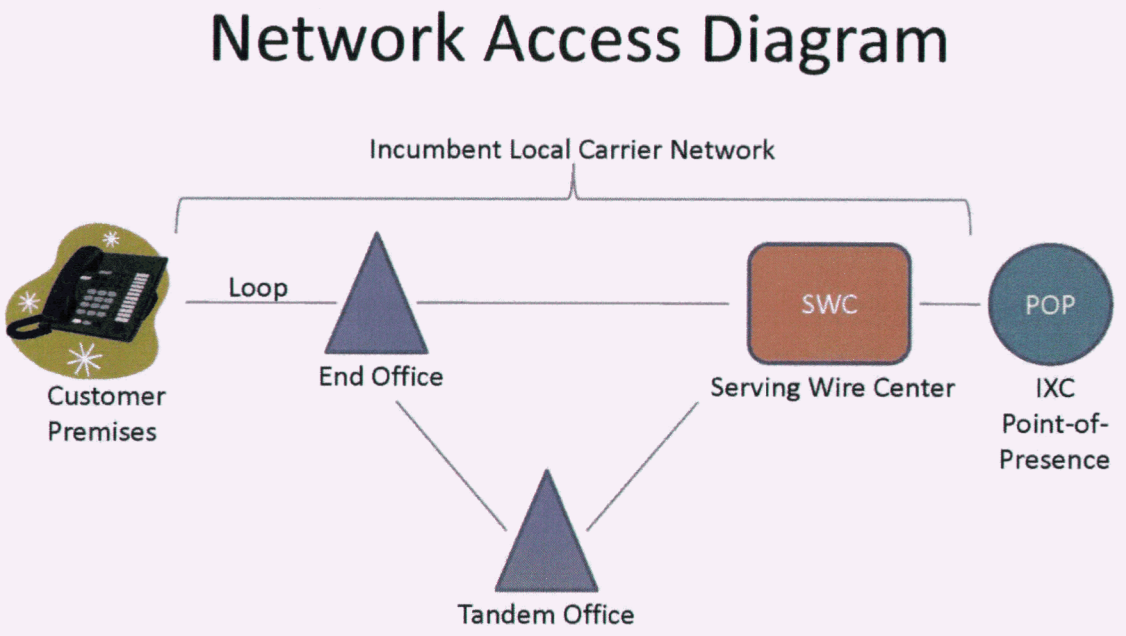
Q. WHAT FUNCTIONS DOES THE LEC PERFORM WHEN IT PROVIDES TERMINATING ACCESS SERVICE?

A. The process for completing or "terminating" a call to a wireline phone works the same way as originating access, but in reverse. Picking up where I left off in the previous illustration, after the IXC receives a call from the originating LEC, the IXC carries the call on its own network to its switch nearest the called party's location. From there, the IXC hands off the call to the LEC that serves the party on the receiving end of the call. The terminating LEC performs the same functions as an originating local carrier, just in reverse order: it uses its tandem switching (if necessary) and local transport facilities to take the call from the IXC's switch to the local switch in the end office that serves the called party, and that switch then routes the call over the terminating LEC's local loop to the called party's telephone based upon the called number. As with call origination, call termination is provided in materially the same manner, using the same equipment and facilities, regardless of the identity of the IXC, regardless of the intercarrier compensation

[5] Depending upon the transport arrangements the access purchaser has made with the other carrier (ILEC or CLEC), the call may first be routed from an end office to a LEC or CLEC intermediate "tandem" switch before being delivered to the purchaser's switch, sometimes termed its "Point of Presence" or "POP."

regime that applies to the call, and regardless of whether the call comes from an intrastate or interstate location.

The diagram below illustrates originating and terminating access.[6]



[6] This diagram only shows the shared facilities option. The IXC can choose to interconnect directly at either the End Office or the Tandem via switched dedicated facilities; in either case, the function performed by the ILEC is the same.

B. THE ILECS' CURRENT INTRASTATE SWITCHED ACCESS RATES ARE INFLATED BY IMPLICIT SUBSIDIES.

Q. PLEASE PROVIDE A BRIEF OVERVIEW OF THE HISTORICAL DEVELOPMENT OF THE ARIZONA LECS' INTRASTATE SWITCHED ACCESS RATES.

A. Historically, a single monopolist controlled both local and long distance phone service in its assigned territory, and the applicable state commission regulated its prices. At that time, Arizona and other states set prices for some services (such as long-distance toll service, and local service for business customers) above cost, to subsidize below-cost prices for other services (such as residential local service in high-cost areas).[7] Consumers had little choice but to pay those regulated prices if they wanted to make long-distance calls.

With the breakup of the Bell System in 1984, local and long-distance service were "split" and the system of interstate and intrastate switched access charges, assessed by local carriers on long-distance IXCs, was established. IXCs carried (interLATA) long distance calls between their long distance switching facilities and paid switched access charges to the LECs to connect the call from the end-user locations to the IXC switches. Continuing the old practice of using long-distance prices to subsidize local service, switched access charges were set far in excess of the related switching and transport costs, to generate a subsidy for the LECs to keep local exchange service rates below cost. The IXCs then recovered their switched access expense through the retail prices they assessed to their end-user long distance customers. Thus, for consumers, the implicit subsidy in access charges was in many was like a hidden surcharge buried in their long distance rates.

[7] Qwest also concludes that high access charges are subsidizing local retail rates. See Qwest Response to Staff Data Request STF 01-024(c).

Economists recognize that this system sacrificed economic efficiency in pursuit of universal service, and that it could be sustained only as long as traditional wireline long distance calls were consumers' only real option for long distance voice communications. In that closed system, it was mechanically possible to overprice long distance in order to under-price basic local phone service as a way to promote "universal service," because consumers options for escaping the high prices for long-distance service were far more limited and far less adequate substitutes (e.g., mail, telegraph, or no communications at all).

Q. IS IT STILL POSSIBLE IN TODAY'S MARKET TO COUNT ON OVER-PRICED LONG-DISTANCE SERVICE IN ORDER TO SUBSIDIZE LOCAL PHONE SERVICE?

A. No. Such subsidies cannot be maintained in today's highly competitive and technologically diverse telecommunications market, simply because it is no longer a "closed" environment. New competitors, most of them substantially less regulated, have deployed new technologies (some not even contemplated when the access charge regime was established in 1984) to give consumers a broad range of options for long distance communications. These competitors do not pay the excessive access charges to the same extent that wireline long-distance carriers, like AT&T, must pay. Customers who want to communicate over long distances can use wireless phones, Voice over Internet Protocol ("VoIP"), electronic mail, instant messaging, Skype, or other alternatives in place of wireline long-distance calling, and thus avoid paying high access charges.

Q. DOESN'T THIS ADVANCE COMPETITION IN ARIZONA?

A. No. High access charges put one group of competitors (wireline IXCs) at a huge, artificial and unfair competitive disadvantage. AT&T and other wireline IXCs are being forced to

pay excessive access charges to subsidize the LECs' local service, while other communications services do not have to bear the same burden. Efficient competition—competition that maximizes consumer benefits--is advanced when consumers can pick among competitors based on real economic differences like quality, customer service, and real economic cost, not purely artificial differences.[8] AT&T wants to compete for Arizona long distance consumers, but if the Commission fails to remove the huge and artificial cost disadvantage that AT&T must bear, then AT&T cannot offer consumers the same competitive rates that it could offer if that unfair disadvantage were removed. The Commission's policy should be to level the competitive playing field such that consumers should decide the market's winners and losers.

Q. HOW LARGE IS THE COMPETITIVE DISADVANTAGE THAT HIGH INTRASTATE SWITCHED ACCESS CHARGES IMPOSE TODAY?

A. As things now stand, intrastate access charges as high as 13 cents per minute, ***for only one end*** of an in-state call, are being imposed almost exclusively on long distance interexchange carriers such as AT&T. Meanwhile, new forms of communications which be used in place of traditional long distance communications – internet service providers, VoIP providers,[9] text messaging providers,[10] e-mail providers,[11] wireless carriers,[12] social

[8] I would expect Qwest to agree, given the remarks of its CEO that "these charges greatly exceed their actual costs and vary greatly based upon unrelated factors, such as the type of call, the jurisdiction of the call, or the identity of the carrier. Such distinctions are neither practical nor rational in today's communications industry." See Remarks of Qwest Chairman and CEO Edward A. Mueller at the 120th annual National Association of Regulatory Utility Commissioners (NARUC) convention in New Orleans on Nov. 17, 2008.

[9] VoIP providers include "interconnected" providers such as cable operators or Vonage, which offer services that can make calls to and receive calls from the public switched telephone network. See *47 C.F.R. § 9.3.* Other providers such as Skype are generally "non-interconnected" and operate computer-to-computer; consumers perceive those calls as "free."

[10] Text messaging providers include wireless providers, and a range of other texting options.

[11] E-mail providers include America On-Line (AOL), and Internet providers, as well as Yahoo, Hot Mail and a large number of other providers.

[12] Wireless carriers include Verizon Wireless, AT&T Mobility, Sprint/NexTel, T-Mobile, and others.

networking websites,[13] – are generally able to complete their calls for as little as 7/100ths of a cent per minute ($0.0007), or in the case of e-mail traffic (or social networking websites), essentially for free. The difference between access charges and the 7/100ths of a cent wireless intraMTA call termination rate is ***more than 18,000%***. No one can seriously defend a regime where one type of carrier is charged so much more than another for the same functionality. The following table illustrates these massive disparities:

Figure 1

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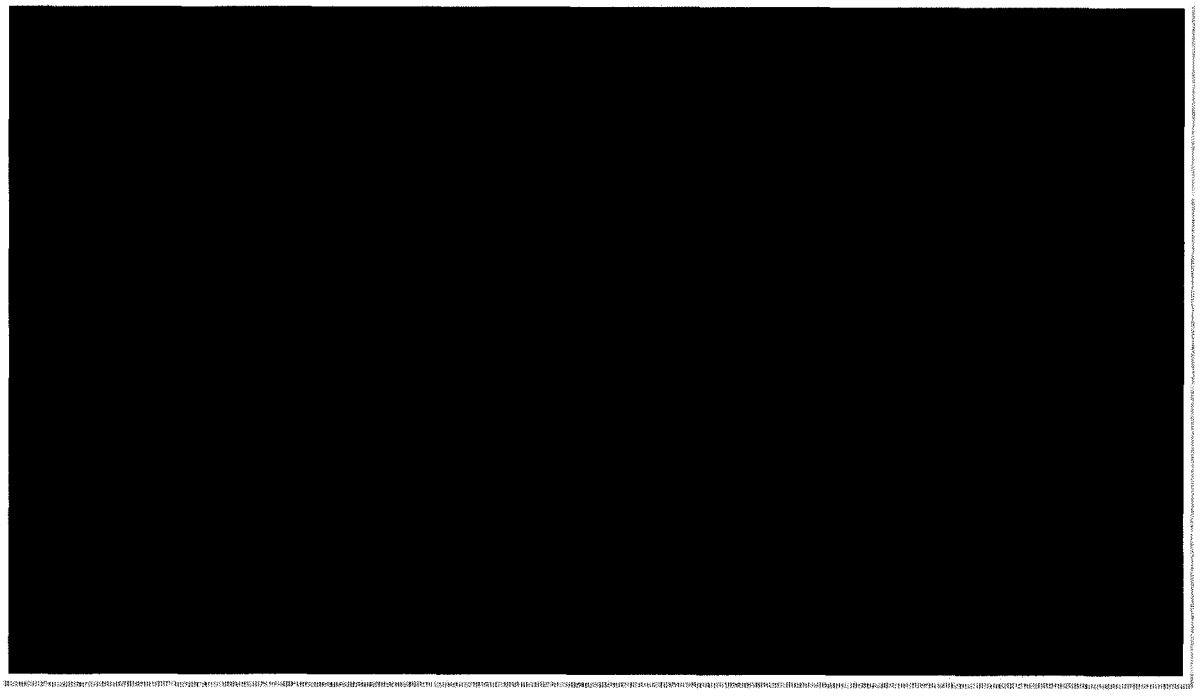

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Q. COULD YOU ILLUSTRATE THE DISPARITY BETWEEN ARIZONA CARRIERS' INTRASTATE AND INTERSTATE ACCESS RATES?

[13] Social Networking sites include Facebook, Twitter, MySpace, LinkedIn, and others.

A. Yes, the disparity is demonstrated by the next chart:

Figure 2

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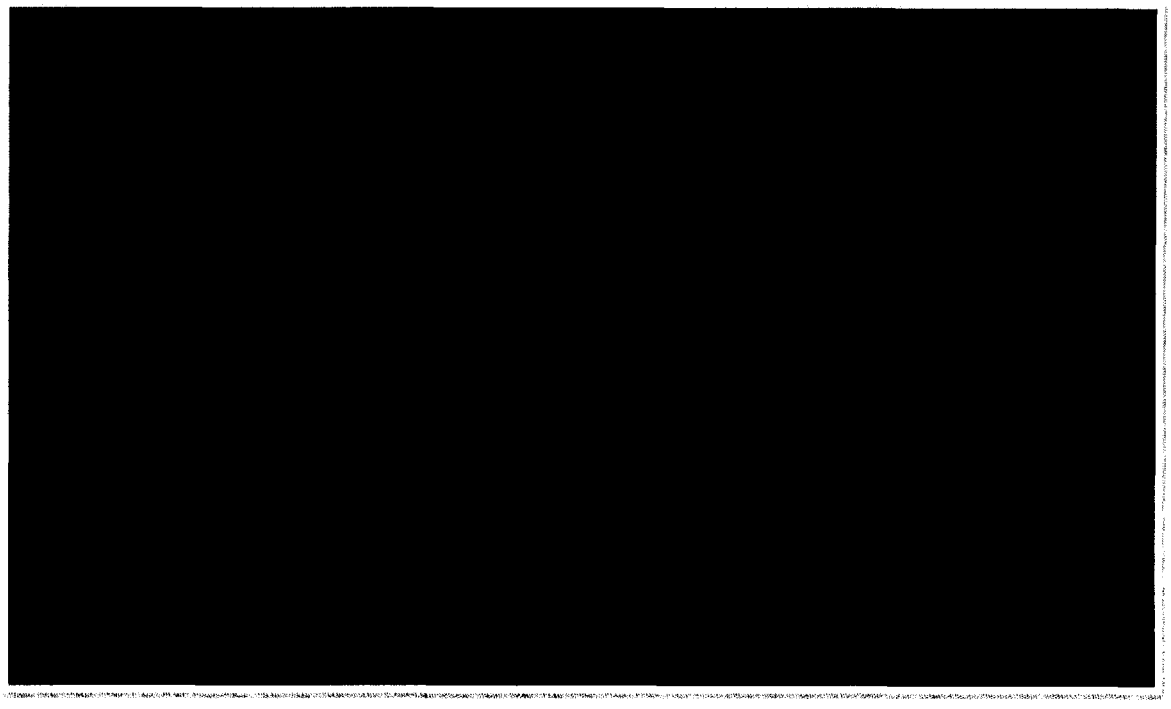

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As one can see from the chart, intrastate access rates can be as high as 4,000% more than the corresponding interstate rate, even though from a LEC's perspective both intrastate and interstate switched access services involve the same function and the LEC incurs the same cost.

Q. WHY IS THERE SUCH A DISPARITY BETWEEN INTRASTATE AND INTERSTATE SWITCHED ACCESS RATES, WHEN THE UNDERLYING FUNCTION IS THE SAME?

A. The disparity is purely artificial, driven by legacy regulation. The FCC regulates interstate switched access rates while state commissions have oversight authority on

intrastate switched access rates. Originally, the system of subsidies existed at the federal level too, but over several years the FCC has implemented significant reforms to the federal regime. These federal reforms have significantly reduced - although not eliminated - the implicit subsidies that had been buried in interstate switched access rates. As I show below, it is time (and in fact past time) for this Commission to adopt similar reforms at the state level.

Q. YOU POINTED OUT THAT INTRASTATE SWITCHED ACCESS CHARGES INCLUDE A SUBSIDY THAT WAS INTENDED TO "HELP" CONSUMERS BY REDUCING LOCAL EXCHANGE PRICES, BUT HAVE THESE SUBSIDIES REALLY HARMED CONSUMERS?

A. Unquestionably, yes. First, high access charges mean that consumers are paying more than they should for intrastate long distance. While access rates vary across Arizona LECs, such that some LECs charge rates that are lower than others, the effects are spread across consumers throughout Arizona, not just those served by the LECs with the highest access charges. By law, IXCs must maintain statewide averaged long distance rates, so excessive LEC access charges drive up the price of all long-distance calls: they affect calls from Tucson to Flagstaff just as much as they affect calls from Kingman to Holbrook.[14]

A deeper problem is that the access subsidy distorts and overstates the true cost of wireline long-distance service, and prevents IXCs from fully competing against other communications services like wireless carriers and e-mail or social networking websites. Likewise, implicit subsidies distort the true price of wireline local services, because local carriers subsidize below-cost local rates through high access charges. Consumers are

[14] Section 254(g) of the Act requires IXCs to geographically average their interstate toll rates and thereby spread high-cost access charges across all of their end users. As a practical matter, IXCs often do the same with intrastate toll rates to enable uniformity in billing. *See* 47 U.S.C. § 254(g).

best served when prices reflect underlying cost and all competitors can compete on a level playing field.

As I discuss later, the high access rates has motivated some chat line operators and other unsavory actors to game the systems and create traffic pumping schemes – which ultimately harms all consumers.

III. RESPONSES TO SPECIFIC ISSUES RAISED BY PROCEDURAL ORDER

ISSUE 1: WHAT CARRIERS SHOULD BE COVERED BY ACCESS REFORM?

Q. WHAT CARRIERS SHOULD BE COVERED BY ACCESS REFORM?

A. All Arizona local exchange companies who operate under the jurisdiction of the Arizona Corporation Commission (specifically Qwest, Verizon, all independent telephone companies regulated by the ACC, including the ALECA members, and the CLECs) should have their access charges reformed in order to promote efficient competition in the Arizona telecommunications industry, and keep Arizona ahead of the transition toward efficient adoption of different types of innovative technologies, e.g. broadband.[15] High access charges and implicit subsidies hurt consumers and competition no matter which LEC collects them. The Commission has all of these LECs before it now. It should address all LECs equally, now, rather than allowing some LECs to continue collecting implicit subsidies and distorting the telecommunications market for all consumers across the state.

[15] Dr. Aron discusses in her testimony how continuing with the current implicit subsidy system can impede efficiency and discourage investment and innovation.

Q. THE CLECS DID NOT HAVE HISTORICAL MONOPOLIES ON LOCAL SERVICE. WHY SHOULD THEY HAVE THEIR ACCESS CHARGES REDUCED ALONG WITH THE ILECS' CHARGES?

A. For at least four reasons. First, and most importantly, while CLECs did not and do not have market power in retail local service, they (and other LECs) do have market power in the wholesale access market. If an AT&T end user calls a home or business served by a CLEC, AT&T *must* deliver the call to that CLEC and pay that CLEC's terminating access charge no matter how high that charge is. AT&T simply has no choice. It is not permitted to block the call, nor can it deliver it to a different LEC and avoid the high access expense. Moreover, AT&T cannot charge a higher long-distance price for that call (or for calls to customers of that CLEC), to give the end user an incentive to avoid calling that CLEC's customers. Instead, AT&T has to average its long-distance prices for all customers in a geographic region.

The same is true for originating access: If an AT&T end user chooses a particular CLEC for local service, AT&T has to accept that end user's long-distance calls and pay that CLEC's originating access charges. AT&T cannot block calls, it cannot forbid its end users to choose a particular CLEC for local service, and because of geographic averaging requirements AT&T cannot charge higher rates to end users that use a particular CLEC for local phone service. Under these circumstances, consumers receive incorrect price signals and are unaware of the true cost of the service they receive, and they select a CLEC without knowing that their decisions cause their long-distance carrier to pay the CLEC's excessive access charges.

Second, implicit subsidies and inflated access charges are harmful no matter what LEC assesses the charges and collects them. The harm comes because IXCs (and their

retail customers) *have to pay* those charges, without an opportunity to refuse doing business with the CLEC, the way firms can in a competitive market.

Third, the access service that CLECs provide is identical, in all material respects, to the access service that ILECs provide. CLECs should not receive preferential treatment, and they should not receive higher payments than the ILECs for what is the same function. Such an artificial advantage distorts competition for local service, on top of the distortion that high access charges cause for long-distance communications. It gives CLECs the opportunity to use their inflated access charges to undercut the local exchange rates of the ILECs so that they can win over the end user, who does not know (or care) that the CLEC is only offering a "good deal" on local service because its access charges are extraordinarily high.

Fourth, the fact that CLECs did not have historical monopolies on retail local service gives the Commission even *more* reason to reform CLEC access rates. As I discussed earlier, traditionally, ILECs charged high switched access rates to subsidize below-cost local service and thus promoted universal service in rural areas. This was the basic *quid pro quo* of the monopoly era. But unlike ILECs, CLECs do not have an obligation to provide service to any customer. CLECs pick and choose their retail customers, and they do not have to provide below-cost service to anyone anywhere. So there is no *quid pro quo*: handing a subsidy to a CLEC is just handing a subsidy to the CLEC, with no benefits for universal service.

ISSUE 2 – TO WHAT TARGET LEVEL SHOULD ACCESS RATES BE REDUCED?

Q. SHOULD INTRASTATE SWITCHED ACCESS RATES BE REDUCED?

A. Yes. As I describe in more detail in part (A) below, a meaningful and immediate reduction in intrastate switched access rates is necessary. The massive implicit subsidies in the LECs' current access rates harm consumers by artificially driving up the retail price of wireline long distance service, and by unfairly disadvantaging one set of long-distance competitors (wireline IXCs), which prevents consumers from achieving the benefits of full and fair competition. Moreover, continuing to give massive implicit subsidies for the old circuit-switched network distorts LECs' incentives to invest in new broadband facilities.

As I discuss in part (B) below, reducing the LECs' intrastate switched access rates will benefit consumers by reducing long-distance prices and promoting full and fair competition. I also show that reducing intrastate switched access rates will encourage efficient broadband deployment in Arizona.

More fundamentally, the old idea of implicit subsidies simply cannot be sustained in today's competitive market and as those subsidies erode, support for universal service in Arizona will vanish.

Q. WHAT TARGET LEVEL SHOULD THE COMMISSION USE IN REDUCING INTRASTATE SWITCHED ACCESS RATES?

A. The Commission should order all LECs to reduce their intrastate switched access rates and structure to match their corresponding interstate rates.[16] In addition to the benefits

[16] Although my proposal for the CLECs discussed above is that their intrastate rates are capped at the levels of ILECs in whose territories the CLECs compete, this essentially will mean that the CLECs will also mirror their

that will flow from reducing intrastate switched access rates generally, this "parity" approach will yield several other benefits. First, parity is straightforward and allows the Commission to capitalize on reforms adopted at the federal level (just as many other states have done) while still keeping access rates above the related costs. Second, parity between interstate and intrastate rates follows logically from the fact that both intrastate and interstate switched access service are materially the same functions and should be charged at the same price. Third, eliminating the disparity between interstate and intrastate rates will simplify billing and decrease the incentive that the present system creates for harmful arbitrage and fraud. I will discuss these benefits in more detail, later in part (C).

A. THE COMMISSION SHOULD IMMEDIATELY REDUCE THE LECS' INTRASTATE SWITCHED ACCESS RATES.

Q. IN GENERAL TERMS, PLEASE DESCRIBE THE RATE STRUCTURE OF THE ILECS' INTRASTATE SWITCHED ACCESS CHARGES IN ARIZONA.

A. As a general matter, each ILEC has traffic sensitive rates for the switching function and any transport functions it provides to IXCs. In addition, each ILEC has something called a "Carrier Common Line Charge" (CCLC), which is a per minute of use charge that is not cost based, does not exist on the interstate rate regime, and is nothing more than a subsidy rate element designed from the beginning to subsidize basic local telephone service.[17]

interstate rates since pursuant to FCC rules their interstate rates have been capped at the competing ILEC's interstate rate levels since 2001.

[17] Attached as OAO_Exhibit B is a list of the ILECs' Carrier Common Line Charges as obtained from their tariffs.

Q. HOW MUCH DO THE ILECS CHARGE FOR INTRASTATE ORIGINATING AND TERMINATING SWITCHED ACCESS IN ARIZONA?

A. As shown in the tables below, the ILECs' intrastate switched access rates range anywhere from about 2 cents per minute to as high as 13 cents per minute for either originating or terminating access. So for an intrastate toll call that originates *and* terminates in Arizona, AT&T must pay the applicable ILEC or ILECs as much as 4 to 26 cents per minute for switched access.

Q. DO SOME ILEC ACCESS CHARGES EXCEED AT&T'S AVERAGE RETAIL LONG DISTANCE PRICE?

A. Unfortunately, yes. As I show in the chart below, some ILECs assess AT&T per-minute access charges in excess of the average price the competitive long distance market would allow AT&T to collect from its retail consumers for every access minute. For those particular ILECs, AT&T loses money on every minute of long distance calls originated and terminated in those ILECs' service territories, even without taking AT&T's other costs into account. These examples are illustrated below.

[BEGIN CONFIDENTIAL INFORMATION]

[END CONFIDENTIAL INFORMATION][18]

[18] In addition to comparing the long distance price with the average switched access rates among all ALECA members, AT&T has attached as OAO_Exhibit C charts comparing the switched access rates of Citizens-Frontier and Verizon.

Q. HOW MUCH MORE ARE ARIZONA ILECS' INTRASTATE RATES HIGHER THAN THEIR CORRESPONDING INTERSTATE RATES?

A. As discussed and illustrated earlier, the Arizona ILECs' intrastate rates are as much as 4,000% higher than interstate.

Q. IF ILECS USE THE SAME PROCESS AND FACILITIES FOR CALL ORIGINATION AND TERMINATION AS YOU DISCUSS EARLIER, WHY ARE THEIR INTRASTATE SWITCHED ACCESS RATES SO MUCH HIGHER THAN THEIR INTERSTATE RATES?

A. The ILECs' intrastate switched access rates were set during the time that access rates were *intentionally allowed* to exceed their incremental costs by a substantial amount in order to generate subsidies for local service rates. Although similar subsidies exist in interstate charges, the FCC has implemented a series of reforms that reduced the level of interstate subsidies. The Commission has yet to implement those reforms at the state level, so there is currently a large gap between interstate and intrastate rates.

Q. DO THE CLECS' CHARGE HIGHER INTRASTATE RATES THAN THE ILECS IN WHOSE SERVICE TERRITORIES THEY OPERATE?

A. Yes, the CLECs' rates are generally higher.

Q. PLEASE EXPLAIN WHY THE CLECS' INTRASTATE RATES ARE SO MUCH HIGHER THAN THE ILECS INTRASTATE RATES OR THE CLECS INTERSTATE RATES?

A. Originally, the market entry by CLECs was meant to create competition for local service, and such competition was expected to infect switched access service and help constrain access charges, but that has not happened after at least 13 years of CLEC presence in telecommunications business. The reason is that the CLECs, like ILECs, have market power over the facilities that connect their customer to the rest of the public switched telephone network. The physical structure of the public switched telephone network makes it impossible for more than one LEC to serve any single telephone line connecting

a customer's premises.[19] So if an end user places a long-distance call to, or from, a CLEC's line, the IXC *has to pay* the CLEC's access charge. It cannot ask some other LEC to originate or terminate the call. And because of requirements in federal law that IXCs charge averaged prices, the IXC cannot selectively increase its long-distance prices on calls made to or from CLECs, in order to recover the access cost and send a signal to the end user to choose lower-cost LECs.

The CLECs are taking advantage of all of these factors. They understand that if the law precludes an IXC from selectively imposing higher toll rates on its customers who take CLEC local exchange service, the CLEC has the opportunity to charge excessive access rates. Those access rates will simply be averaged into the IXC's statewide toll prices. In short, market forces cannot, and do not, discipline CLEC access rates. The IXC cannot reasonably establish long distance prices that are specific to the LEC that originates or terminates a call. Because by law IXC prices are averaged on a statewide basis, the CLEC's end-user customer is insulated from knowing that his or her long distance calling is imposing disproportionately high costs on the IXC. If left on their own, the CLECs have an incentive to increase access rates as much as they can. In this environment, the Commission needs to establish an appropriate cap on CLEC access rates as the FCC has done since 2001.[20]

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[19] As discussed earlier, other reasons include: 1) difficulty to geographically deaverage toll prices makes it impractical for IXCs to pass higher access costs directly to the end user that selects a LEC with high access rates – they are simply spread and essentially paid for by all consumers in the state, including those that select the more efficient low access LECs; 2) due to federal prohibition against call blocking IXCs cannot reject calls from or to a LEC that charges high access rate.

[20] *See In the Matter of Access Charge Reform, Reform of Access Charges Imposed by Competitive Local Exchange Carriers,* CC Docket No. 96-262, Seventh Report and Order and Further Notice of Proposed Rulemaking, 16 FCC Rcd 9923 (2001) ("*CLEC Access Reform Order*").

Q. HOW DOES THE GROWTH OF COMPETITION AFFECT THE CURRENT ACCESS CHARGE SYSTEM?

A. With the growth in competition that I described earlier, the current system becomes unsustainable. Implicit subsidies are incompatible with a competitive market, because consumers will choose alternatives that allow them to avoid the subsidies and because the competitors that have to bear the subsidy burden (in this case, IXCs) cannot fully compete. Since competition is now widespread and is intensifying in segments of the communications marketplace, providers should be recovering the costs of their retail services from their own retail customers, rather than relying on subsidy payments from other carriers. The Commission now has a great opportunity to modify its policy to promote effective competitive outcomes that would benefit all Arizonans.

Competition has grown not only in the long distance market, but also in the market for local retail service, and the ILECs themselves have recognized that fact.[21] With competition this evident, the original purpose for which the implicit subsidies were established has diminished, if not disappeared. Universal service does not need the same subsidies, because consumers already have so many alternative options for their local retail service.[22]

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[21] See the following: i) Qwest 2008 annual 10K report, pp. 9, 12, 31: https://materials.proxyvote.com/Approved/749121/20090316/AR_36466/HTML2/default.htm;
ii) Qwest July 30, 2009 10Q report, p.46: http://phx.corporate-ir.net/phoenix.zhtml?c=119535&p=irol-SECText&TEXT=aHR0cDovL2NjYm4uMTBrd2l6YXJkLmNvbS94bWwvZmlsaW5nLnhtbD9yZXBvPXRlbmsmaXBhZ2U9NjQzODA0MiZhdHRhY2g9T04mc1hCUkw9MQ%3d%3d
iii) Frontier 2008 annual 10K report, pp. 5, 7, 10: http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzMyMzg0fENoaWxkSUQ9MzE0Njk2fFR5cGU9MQ==&t=1

[22] If, however, the Commission believes subsidies would be appropriate in some areas or for a limited class of consumers, those subsidies should be explicit, and they should be drawn from a broad universal service fund to which all providers contribute in a competitively neutral manner. In a market where AT&T and other long distance companies must compete against a host of new technologies and new entrants that do not incur access charges in the same way, there is simply no reason to maintain intrastate access rates higher than interstate rates for the same functions.

Q. PLEASE EXPLAIN FURTHER HOW COMPETITION IS NOW WIDESPREAD IN ALL SEGMENTS OF THE COMMUNICATIONS MARKET.

A. The manner in which consumers communicate has completely changed. Never before have consumers enjoyed so many communications choices. They can order goods and services over the Internet. They can network with their friends and colleagues through Facebook, Twitter, MySpace, Linked In and a host of other social networking websites. They can send a friend a text message on their mobile phone. They can obtain government information and forms with a mouse click. They can obtain voice services from a local telephone company, a long distance company, a wireless carrier, a cable operator, or from a VoIP provider such as Vonage or Skype that allows them to utilize their broadband computer connection for voice calls.

Q. PLEASE EXPLAIN THE DIFFERENT TYPES OF COMPETITION THAT HAVE GROWN IN RECENT YEARS.

A. Let's begin with wireless service: as of June 2008, Arizona had almost 5 million wireless subscribers, which means that at the end of 2008 some 76% of Arizona residents – that is *residents*, not households – had a wireless phone,[23] And after excluding children younger than 15 years of age, Dr. Aron has shown in her testimony that 97% of the state's resident's have a wireless phone. In June 2003, there were 2.6 million wireless subscribers, which mean that the number of wireless customers has increased in Arizona by 87% in six years alone.

[23] In the Matter of Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993; Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services; WT Docket No. 08-27, Thirteenth Report, Released January 16, 2009 ("FCC Thirteenth Competition Report"). This Report can be found at http://hraunfoss.fcc.gov/edocs_public/attachmatch/DA-09-54A1.pdf. The population of Arizona at year end 2008 was 6,500,180, so 76% of Arizonans had a wireless phone. See http://factfinder.census.gov/servlet/SAFFPopulation?_event=Search&geo_id=01000US&_geoContext=01000US%7C04000US42&_street=&_county=&_cityTown=&_state=04000US04&_zip=&_lang=en&_sse=on&ActiveGeoDiv=geoSelect&_useEV=&pctxt=fph&pgsl=010&_submenuId=population_0&ds_name=null&_ci_nbr=null&qr_name=null&reg=null%3Anull&_keyword=&_industry=++

Wireless carriers serve consumers across all of Arizona, including the ALECA territories. That is consistent with the FCC's findings that, nationally, approximately 98.5% of the U.S. population living in rural counties has at least one or more carriers offering mobile telephone service.[24] Other national reports reveal similar observations; a growing number of consumers are now deciding to rely *exclusively* on wireless services. A recent May 6, 2009, study from the Center for Disease Control observed that "one of every five American homes (20.2%) had only wireless telephones during the second half of 2008," and that the trend is accelerating.[25]

Likewise, text messaging has literally exploded since the Commission last looked at LEC access rates. The FCC reports that as of December 2007, customers sent 48.1 billion text messages a month compared to only 2.8 billion in December 2003.[26]

Technologies such as DSL, broadband cable and VoIP have also become more popular and those providers are challenging interexchange carriers in the marketplace. The FCC reports that as of June 2008, there were 2,860,516 high speed lines in service in Arizona, a number that has likely grown in the nearly eighteen months since the FCC gathered that data.[27] The same report shows that every zip code in Arizona has at least three high speed providers, and about 57% of those zip codes have at least ten high speed providers. Any customer with a high speed connection can use that connection for Internet access, e-mail, and social networking, as well as for free computer-to-computer service such as Skype, or a computer to PSTN, to make voice calls and avoid traditional

[24] FCC Thirteenth Competition Report at ¶104. Paragraph 102 of the Report defines a "rural area" as a county with a population density of 100 persons or fewer per square mile.

[25] Blumberg and Luke, *Wireless Substitution, Early Release Estimates from the Nation Health Interview Survey, July –December, 2008*, http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless200905.htm.

[26] FCC Thirteenth Competition Report at p. 7.

[27] http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-292191A1.pdf

subsidy-laden long distance prices. As of the end of 1st Quarter 2009, Skype reported over 443 million users worldwide; adding 37.9 million new users in the 1st Quarter 2009 alone.[28]

Q. HOW DO THESE CHANGES SUPPORT AN IMMEDIATE REDUCTION IN INTRASTATE SWITCHED ACCESS RATES?

A. Suffice it to say, *none* of the alternatives to wireline long distance service is saddled with access charges or subsidies in the same way as traditional wireline long distance. Not only is it inequitable to impose a disproportionate subsidy burden on one industry segment – IXCs – but, as importantly, because the competitive alternatives I have described are eroding wireline long distance traffic and thus the implicit subsidies in access charges, the LECs cannot continue to rely on access subsidies going forward. The Commission can now conclude that there is no reasonable argument for requiring IXCs to continue paying high anti-competitive access charges that their competitors do not pay.

Q. YOU POINTED OUT THAT OTHER SERVICE PROVIDERS DO NOT INCUR ACCESS CHARGES IN THE SAME WAY AS IXCS. HOW ARE OTHER PROVIDERS CHARGED DIFFERENTLY?

A. Only wireline IXCs incur intrastate switched access charges on virtually all of their intrastate long distance calls. By contrast, other carriers incur access charges only on a small portion or none of their traffic. It is beyond debate that the lion's share of the access charge burden falls squarely on the IXCs.

Wireless carriers, for example, pay access charges only on long distance calls that are routed outside the "Major Trading Area" ("MTA") where the call originated. All wireless calls *within* a MTA are treated as "local." As a practical matter, that means most

[28] http://ebayinkblog.com/2009/04/22/newsroom-april-2009/

intrastate wireless calls are not subject to intrastate access charges because MTAs are very large – in fact in Arizona a single MTA covers the majority of the state. The Phoenix MTA (#27) covers most of Arizona, and spans from the southern to northern border of the state, with only small parts of the state on the upper western and eastern sides covered by the Los Angeles-San Diego MTA (#2) and El Paso-Albuquerque MTA (#39) respectively.[29] All calls within MTA #27 are intraMTA calls, and are treated as local calls subject only to FCC-established reciprocal compensation termination charges. For carriers such as Qwest in Arizona that have opted into the FCC's ISP Remand Decision that reciprocal compensation rate is $0.0007 per minute, while other carriers assess their Commission-approved local call termination charge for intraMTA wireless call termination.[30]

Similarly, VoIP-originated calls are not subject to originating access charges and, in some instances, are terminated at reciprocal compensation rates instead of the much higher switched access rate.[31] Text messaging, instant messaging and email providers *pay no terminating charges at all* – not even the much lower rates that wireless and VoIP providers pay.

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[29] http://wireless.fcc.gov/auctions/data/maps/mta.pdf.

[30] Qwest reports that, pursuant to interconnection agreements, it charges for intraMTA traffic reciprocal compensation rates in the range of bill and keep (i.e. $0) to $0.0009 per minute. See Qwest Supplemental Response to AT&T Data Request 03-009S1.

[31] There have been disputes about the appropriate treatment of VOIP traffic caused by the arbitrage opportunities that some VOIP providers want to seize, and they contend that the FCC's "ESP exemption" excuses them from paying access charges for interconnection with PSTN. See AT&T's July 17, 2008 Ex-parte filing in "Re Developing a Unified Intercarrier Compensation Regime, CC Docket No. 01-92; High Cost Universal Service Support, WC Docket No. 05-337; Federal-State Joint Board on Universal Service; CC Docket No. 96-45; Inter-carrier Compensation for ISP-Bound Traffic, WC Docket No. 99-68; Establishing Just and Reasonable Rates for Local Exchange Carriers. WC Docket No. 07-135. Some ILECs have opposed the VOIP provider's position, thus leading one to conclude that the issue of VOIP compensation remains ambiguous and unresolved and pragmatically VOIP calls are not consistently assessed the high access charges that are imposed on 100% of wireline IXC traffic. See also Petition of Feature Group IP for Forbearance from Section 251(g) of the Communications Act and Sections 51.701(b)(1) and 69.5(b) of the Commission's Rules, WC Docket No. 07-256 (filed October 23, 2007); Petition of Embarq Local Operating Companies for Forbearance from Enforcement of Section 251(b) of the Communications Act and Commission Orders on ESP Exemption, WC Docket No. 08-8 (filed January 11, 2008).

In short, this patchwork of rates for the same call completion functionality is anti-competitive and unsustainable. AT&T and other wireline long distance carriers cannot be expected to compete effectively if they must pay high intrastate access charges while their competitors can complete calls for a fraction of a penny or for nothing at all.

Q. DO LECS USE THE SAME FACILITIES TO TERMINATE WIRELINE, WIRELESS AND VOIP CALLS?

A. Yes. Once the call has reached the LEC's network and is handed off to the LEC either at the end office switch or tandem switch, the process for terminating the call is materially the same whether it is a wireline, wireless or VoIP call.[32] This is another reason it is no longer acceptable to require wireline IXCs to pay high switched access charges, when competitors using different technologies pay much less or nothing for call origination and termination.

Q. ARE ASYMMETRIC RATES FOR TERMINATION HARMFUL TO COMPETITION, CONSUMER WELFARE, AND ECONOMIC GROWTH IN ARIZONA?

A. Yes, the asymmetry is harmful to all three. As Dr. Aron already explains in her testimony, the best (i.e. most valued) use of the society's scarce resources is when they are committed to uses that "respond to consumer's tastes and preferences."[33] There is evidence that consumers are beginning to change their preferences in favor of broadband and other technologies, thereby slowly abandoning the presently subsidized PSTN circuit network. For example, the trend across the country and in Arizona is that communications services are increasingly being provided on the broadband platform, or other technologies, and consumers are getting all of their communication needs bundled

[32] Wireless and VoIP calls originate on different networks and therefore undergo protocol conversion where they are translated to the LECs' network protocol. This is transparent to the LEC.

[33] See Dr. Aron's Direct Testimony at Section VI (E).

from one source.[34] Therefore, it is wasteful for society (i.e. for Arizonans) to continue allowing the current implicit subsidy system to continue to distort and "inhibit competitors' ability" to operate on merit. With declining intrastate toll usage, subsidy sources will evaporate and consumers who are heavily reliant on extraordinarily low priced services will no longer have access to that support. It is too early to discern what blend of pricing structures (e.g. either the newer bundled pricing for broadband and wireless services or a different variety) would prevail, but it is not likely to be the current implicit subsidy system. The Commission should act now to encourage an efficient transition, and at the same time cushion consumers from a price shock, by gradually transitioning the subsidy laden system towards more realistic prices. Moreover, because broadband services have never had implicit subsidy sources like access charges, they have been priced higher than local phone service rates which have reflected such implicit subsidies. Gradually adjusting end user local phone services charges to eliminate implicit subsidies will therefore better prepare consumers for the transition to (higher) broadband service charges, and therefore may better encourage broadband service adoption, a national goal.

[34] ILECs have realized this trend and are already taken steps to deploy broadband capability in their network, including by the ALECA members in rural Arizona. For example, TDS states, in its 2008 annual report, that it "continues to add broadband customers and increase data revenues through its ILEC operations, and the company is attracting commercial customers with high-speed broadband and voice solutions through its competitive local exchange carrier (CLEC) business. TDS Telecom's strategy of bundling broadband, voice, and video services is helping the company offset the revenue loss from a decline in voice service physical access lines," and "...at the end of 2008, approximately 90 percent of TDS Telecom's ILEC lines had access to DSL capability, and 85 percent of its ILEC DSL customers received 1.5 Mbps or faster service, with 52 percent having 3 Mbps or faster service. The company offers its commercial customers in certain markets speeds of up to 1G." See **http://media.corporate-ir.net/media_files/IROL/67/67422/2008AR/html/letter.html**.
This type of effort should be encouraged, not hampered or stalled by continuing the existing antiquated pricing system.

However, continuing to implicitly subsidize the legacy network when consumer preferences are migrating to broadband services or other technologies provides the wrong incentives for companies and distorts investment decisions as I mention above.

Q. IN LIGHT OF THESE CHANGES IN THE TELECOMMUNICATIONS INDUSTRY, CAN THE ARIZONA ILECS' EXISTING HIGH INTRASTATE ACCESS CHARGES STILL BE CONSIDERED JUST AND REASONABLE?

A. No. The emergence of these competitive alternatives means that even if the ILECs access charges were once thought to be just and reasonable, they can no longer be considered "just" or "reasonable" as competition from multiple sources and multiple technologies has exploded. Rather, excessive access charges must be viewed for what they are – an impediment to competition and a harm to Arizona consumers. No system can be considered "just and reasonable" if it arbitrarily handicaps some competitors and favors others.

Time is of the essence in correcting this problem. In 2008, IXCs (or, more specifically, the IXCs' customers) paid the Arizona LECs approximately $56 Million, more than if intrastate switched access rates had been reduced to parity with interstate rates.[35] *Every day* IXCs (or, to be more precise, IXCs' *customers*) are paying the Arizona LECs $155,000 more than if intrastate switched access rates were set at interstate levels.[36] That is a huge competitive disparity that demonstrates the current intrastate access rates are unjust and unreasonable. The Commission should eliminate that disparity.

[35] These numbers are based on third party Highly Confidential data submitted by LECs in response to data request. The vintage varies ALECA submitted 2007 while others are based on 2008 data. Also the ALECA data are aggregated and are not provided on a carrier by carrier basis. AT&T may adjust its analysis once more updated data are received.

[36] *Id.* See OAO_Exhibit D.

Q. DOES THE GROWTH OF ROBUST COMPETITION AFFECT ONLY IXCS?

A. No. As I have noted, the dramatic changes to the competitive market put the ILECs at risk if intrastate access rates remain at such high levels. The characteristics of today's communications marketplace are such that consumers are showing preference for getting all of their communications needs from only one source, including local service. Therefore, to the extent high long distance rates are a contributing factor in consumers' decisions to move to different technologies, it is also going to be a factor in consumers' decisions to discontinue ILECs' wireline local service altogether and to seek bundled packages from alternative technologies. As that is occurring, ILECs are being forced to recover their costs from a continually shrinking customer base. Ironically, then, high access charges are drying up the stream of subsidies they were supposed to provide, and the ILECs have expressed concerns as noted earlier.[37]

The ILECs' concerns are not merely theoretical. In Arizona, they have lost 30% of their access lines since 2003, and in the last two years alone, the line loss has averaged 8% per year.[38] Undoubtedly, because the implicit subsidies embedded in wireline long distance rates adversely affect consumer perceptions of value, an ever-increasing number of consumers are deciding to forego wireline service altogether. I previously noted the May 6, 2009, report from the Center for Disease Control that "more than one of every five American homes (20.2%) had only wireless telephones during the second half of

[37] The ILECs themselves have recognized that subsidies exist in access charges and have acknowledged the trend across the country where there are continued push to have the subsidies removed. They are also aware that facilities-based local competitors and other non-traditional providers have targeted their customers, and they are bracing for continued revenue losses from access services as they continue to lose those customers. See e.g. Frontier 2008 Annual 10K Report; and Qwest Response to Staff Data Request STF 01-024.

[38] Based on AT&T analysis of ILEC's data submitted to NECA. Source: NECA USF Data Submission for 2002 to 2007, Universal Service Fund Data, NECA Study Results, DL070_CAT_13_LOOPS (Released September 2008); http://www.fcc.gov/wcb/iatd/neca.html.

2008," and that the trend is accelerating.[39] At least in part, consumers are deciding to forego wireline service in favor of other technologies (e.g. wireless, VOIP, text messaging, social networking, etc.) because they perceive traditional wireline long distance calls to be expensive, relative to these alternative forms of communication that are sometimes available at no charge.

B. ARIZONA CONSUMERS AND LECS WILL BENEFIT FROM REDUCING INTRASTATE SWITCHED ACCESS RATES.

Q. WILL MEANINGFUL REDUCTIONS IN LECS' SWITCHED ACCESS RATES BENEFIT ARIZONA CONSUMERS?

A. Yes. First, intrastate switched access charges are a principal component of the wholesale cost that IXCs incur when they provide retail long-distance service. In fact, as I described earlier, today in certain instances AT&T must today pay per-minute intrastate access charges that are *higher* than its per-minute retail prices for long-distance service. Obviously, high wholesale costs drive up retail prices; conversely, decreases in the wholesale cost of providing a service lead to a decrease in retail prices for that service. It is a basic economics principle that all firms will maximize profit by reducing price when their variable input costs are reduced. Thus, it is not surprising that economic research confirms that wholesale cost reductions do result in lower retail prices.

Q. PLEASE EXPLAIN HOW ACCESS REDUCTIONS HAVE RESULTED IN LOWER RETAIL LONG DISTANCE RATES. WOULD THAT TREND CONTINUE?

A. Historical trends have shown that consumers' toll prices have consistently declined following decreases in switched access rates. Dr. Aron presents a trend chart in her

[39]Blumberg and Luke, *Wireless Substitution, Early Release Estimates from the Nation Health Interview Survey, July – December, 2008*, http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless200905.htm.

testimony that represents that the series of FCC's actions that reduced access charges over many years have resulted in lower interstate long distance prices for consumers.[40] Since competition for long distance service is even more robust now than in the past, any decrease in intrastate access charges ordered in this proceeding will definitely benefit Arizona consumers.[41]

The events of recent years are also instructive and lend more support to the conclusion that reductions in access charges would be followed by decreases in long distance prices. Recently, reductions in long distance prices have not only taken place through tariff changes for a la carte service. Carriers in Arizona and other parts of the country have introduced different lower priced calling plans in the form of bundled packages. Each time a consumer selects a lower priced bundled package, that consumer receives an effective price reduction and therefore real benefits. AT&T expects this trend will continue because as access charges decline IXCs are even better positioned to reduce end user toll prices.

Indeed, this wholly unremarkable proposition – that industry-wide cost reductions will result in lower prices – has been proven time and again, in research including in the independent study Dr. Aron presents showing that lower intrastate access charges – which form a major portion of the cost of retail long distance services - are in fact materially associated with lower AT&T's intrastate toll prices.

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[40] Intrastate and interstate access are similar in all material respect, and they involve the same companies who lowered interstate prices (as expected by economics) when they experienced reduction in their interstate access expenses. Therefore one would expect the same economic incentive would prevail if intrastate access charges were reduced.

[41] The interexchange market is highly competitive and that competition has reinforced price reduction as predict by economics. The IXCs reduce their toll rates to 1) compete against competitors lowering rates in response to industry-wide cost reductions, and 2) compete against competitors using technologies that do not incur access expenses, at least not in the same manner as IXCs.

Q. IN WHAT OTHER WAYS WILL CONSUMERS BENEFIT FROM ACCESS REDUCTIONS?

A. While it would be premature for AT&T to predict in advance all the different ways its long distance prices will change when access rates are reduced – in competitive markets, firms are generally unable to predict what form price competition will take - I can affirm here that there are two prices AT&T will reduce if intrastate access reductions are implemented as AT&T propose here. First, AT&T will reduce its $1.49 per line in-State Connection Fee ("ISCF") applicable to its stand-alone long distance customers. The fee will be eliminated entirely when all Arizona LECs' intrastate access charges are at parity with their interstate access rates. Second, as it has done in other states when access charges have been reduced, AT&T will reduce in-state rates for its prepaid calling cards. That is a potentially important consumer benefit, because many low income consumers use prepaid cards in lieu of traditional subscription wireline long distance.

C. THE COMMISSION SHOULD USE INTERSTATE "PARITY" AS THE TARGET FOR REDUCING INTRASTATE SWITCHED ACCESS RATES.

1. INTERSTATE "PARITY" IS A STRAIGHTFORWARD APPROACH THAT WILL REDUCE ACCESS RATES BUT KEEP THOSE RATES ABOVE COST.

Q. WHAT APPROACH SHOULD THE COMMISSION TAKE TO REDUCE INTRASTATE ACCESS RATES?

A. As many other states have already done, the Commission should require all local exchange carriers to reduce their intrastate switched access rates to mirror their own interstate rate structures and levels.[42] Thereafter, each ILEC should be directed to update its intrastate tariff at the very same time it changes its interstate rates, so that its intrastate

[42] In this regard, if implemented in the revenue neutral manner proposed by AT&T there is no need for this proceeding to undertake cost review.

rates continue to mirror its interstate access rates. The CLECs should also be required to adjust their intrastate tariffs within 60 days of the date of the order here such that their access charges do not exceed those assessed by the ILEC with whom they compete. For ILECs, these changes should take effect after the Commission has restructured the AUSF to ensure that ILECs could rebalance part of the access reduction with access replacement funding when retail rate flexibility is not sufficient.

Q. WHAT ARE THE BENEFITS OF USING "PARITY" WITH INTERSTATE RATES AS THE TARGET FOR ACCESS REFORM?

A. The first benefit is that "parity" is a straightforward approach. As I described earlier, the FCC has already implemented significant reforms to interstate switched access rates. The Commission can take advantage of those reforms without having to reinvent the wheel, simply by requiring the LECs to reduce their intrastate switched access rates to match the corresponding rate structure and rate levels.

Further, because interstate access rates are still above cost, and because intrastate access involves the same functions and the same cost, the Commission can be comfortable that interstate rates will still be sufficient to cover intrastate access costs, without having to analyze complex and highly contentious cost studies. Thus, many other states have already taken the same "parity" approach that AT&T proposes here, as detailed in Dr. Aron's testimony and in OAO_Exhibit F attached to my testimony.

Q. HAVE ANY OF THE LECS CLAIMED THAT THEIR INTERSTATE ACCESS RATES ARE BELOW INCREMENTAL COST?

A. To the best of my knowledge, none of the LECs have *successfully demonstrated* in any state or in the federal arena that their interstate switched access rates are below relevant

incremental costs or any other reasonable measure of cost.[43] I am not aware of a single instance in which the FCC or any court has ever found any Arizona LEC's interstate switched access rates to be below relevant cost.

Q. THE FCC HAS ESTABLISHED COST BASED RATES THAT APPLY WHEN CARRIERS DELIVER LOCAL CALLS TO ONE ANOTHER. DO THE FCC FINDINGS REGARDING LOCAL CALL TERMINATION RATES SERVE TO CONFIRM THAT LEC INTERSTATE ACCESS RATES ARE ABOVE INCREMENTAL COST?

A. Yes. Initially the FCC set local call termination rates at $0.0015, but then decreased them to $0.0007[44], specifically finding that:

> These rates reflect the downward trend in intercarrier compensation rates contained in recently negotiated interconnection agreements, suggesting that they are sufficient to provide a reasonable transition from dependence on intercarrier payments ***while ensuring cost recovery***.[45]

The FCC's cost based rate is well below the LECs' interstate switched access rates which, as illustrated in Figure 1, can be as low as 0.07 cents. Long distance calls terminate in the same manner as local calls (using either end office or tandem office facilities) and the routing involved in termination of all types of calls is identical, so the cost of terminating a local call is the same in all material respects as the cost of

[43] AT&T has asked the LECs in this proceeding to identify any instances where they have claimed their interstate rates are below incremental cost, and the LECs did not provide any response that indicates this assertion is untrue. Also, given that most of the LECs' access volumes are likely to be interstate minutes, then it stands to reason that if the LECs' interstate switched access rates were set below cost and not compensatory, it would have a significant negative effect on the company's profitability and would have provided a strong incentive to challenge such rates.

[44] All RBOCs and many ILECs have adopted the FCC's ISP-bound rate of $.0007 for their interconnection agreements. For these carriers that have adopted the FCC's ISP order, this same rate is the reciprocal compensation they will charge for intra-MTA wireless traffic, VoIP traffic and local wireline traffic.

[45] *See In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Intercarrier Compensation for ISP Traffic*, CC Docket No. 96-98, and No. 99-68, at 6 (April 27, 2001) (remanded on other grounds, *WorldCom, Inc. v. FCC*, 288 F.3d 429 (D.C. Cir. 2002), cert. den., *Core Communications, Inc. v. FCC*, 538 U.S. 1012 (2003), subsequent mandamus, *In Re: Core Communications, Inc.*, 531 F.3d 849 (2008); order on remand, *In the Matter of High Cost Universal Support, et al*, WC Docket No. 05-337 (released Nov. 5, 2008) (emphasis supplied).

originating or terminating a long-distance call. So the fact that the LECs' interstate switched access rates are well above the FCC's rates for local call termination (which the FCC found sufficient to cover cost) confirms that the LECs' interstate switched access rates are also well above any applicable measure of cost.[46]

2. PARITY WILL REDUCE BILLING COSTS AND ELIMINATE HARMFUL ARBITRAGE OPPORTUNITIES.

Q. IN ADDITION TO ITS SIMPLICITY, WILL UNIFYING INTRASTATE AND INTERSTATE SWITCHED ACCESS RATES AND RATE STRUCTURES ALSO REDUCE LEC BILLING COSTS?

A. Yes. Unified rates can reduce LEC billing costs, if for no other reason than the LECs will only have one set of rates to bill instead of two. Every Arizona LEC – ILEC and CLEC - already has in place interstate rates and rate structures that comply with the FCC's interstate access requirements. Likewise, every LEC already has mechanisms in place that enable it to track, rate and bill access customers for interstate switched access services. Once a LEC reduces its intrastate switched access rates to match - in both rate level and rate structure - its counterpart interstate rates, it can simply use its existing rate structures and billing mechanisms to bill the matching intrastate rates. Indeed, once parity is implemented, the LECs will *eliminate* the costs associated with maintaining two different rate structures and billing mechanisms for the same switched access functions.

Q. WILL "PARITY" BETWEEN INTRASTATE AND INTERSTATE SWITCHED ACCESS RATES REDUCE OPPORTUNITIES FOR FRAUD AND ARBITRAGE?

A. Yes. The wide disparity between interstate and intrastate access rates creates opportunities and incentives for carriers to engage in "call pumping," "phantom traffic"

[46] These comparisons demonstrate that there is no need to go through the lengthy and complex processes that would be involved in calculating the actual cost of intrastate switched access service to the last fraction of a penny, as long as no party is suggesting that intrastate rates should be reduced to cost.

and similar arbitrage schemes. Adopting symmetrical rates and rate structures will help to reduce these problems.

With regard to "call pumping" schemes, some local providers, spurred on by the ability to benefit from high intrastate access prices, have developed processes that encouraged the creation of chat rooms, adult services and other questionable services that can generate high volumes of intrastate access traffic. The carriers then kick back a share of their access revenues to these providers. These schemes have generated a series of complaints and other litigation proceedings before the FCC and state commissions (e.g. Iowa Utility Board), and recently have drawn the interest of the chairmen of three separate U.S. Congressional Committees: Chairmen Waxman, Boucher, and Stupak.[47] These arbitrage schemes are quite serious and difficult to control under the current pricing system, as AT&T has expressed:

> "....AT&T and other are engaged in litigations with many current perpetrators for their violations of existing law, but given the ease with which these schemes are implemented and shifted rapidly to other locations, it is clear that after-the-fact, case-by-case litigation could never fully protect the public interest...." P.1.

"Phantom traffic" is the term used to describe schemes to disguise the jurisdictional nature of calls in an attempt to treat intrastate calls as interstate in order to take advantage of lower interstate switched access rates. These schemes may involve inefficient routing of calls, attempts to mislabel the originating points of calls, and attempts to deliver traffic without sufficient information for the LEC to determine the jurisdictional nature of the call.[48]

[47] See AT&T Letter dated October 27, 2009 to Honorable Henry A. Waxman (Chairman, Committee on Energy and Commerce), Honorable Rick Boucher (Chairman, Sub-Committee on Communications, Technology, and the Internet), and Honorable Bart Stupak (Chairman, Committee on Oversight and Investigation) – Attached as OAO_Exhibit E.

[48] See Qwest Response to Staff Data Request STF 01-005.

Disputes over "call pumping" and "phantom traffic" will be reduced once intrastate and interstate switched access rates are set at the same levels and share the same rate structure.

Q. HAVE ANY LECS AGREED THERE ARE BENEFITS TO HAVING UNIFIED INTER- AND INTRASTATE ACCESS RATES?

A. Yes. About one year ago Qwest Chairman and CEO Edward A. Mueller made the following remarks before a NARUC conference:

> "We need new rules that treat all minutes and all companies the same. Voice or data, IP or switched, wireless or wireline, a minute is a minute and our intercarrier compensation rules should treat them the same.
> We support proposals by the FCC and others to significantly reduce terminating switched access charges. These charges greatly exceed their actual costs and vary greatly based upon unrelated factors, such as the type of call, the jurisdiction of the call, or the identity of the carrier. Such distinctions are neither practical nor rational in today's communications industry. We also believe that these changes should be revenue neutral for the affected local exchange carriers through changes in subscriber line charges, local rates, or other revenue replacement mechanisms.... it is important that we recognize that the opportunities for individual companies to exploit the existing rules -- through arbitrage **[i.e. traffic pumping]** -- will not be eliminated until that transition is complete."[49] (emphasis added).

Likewise, the ALECA members have recently suggested, in a whitepaper, that the current system is unsustainable and that the Commission should reduce their intrastate rates to mirror their interstate counterparts:

> "In order to provide immediate Arizona access rate reform, the intrastate composite rate needs to be at the level of the interstate composite rate. This reduction, if taken in isolation would cause significant economic hardship on the ALECA members and may cause the failure of these enterprises. This type of reform can only be successful if accompanied by a revenue offset which preserves revenue neutrality for rural carriers."

[49] Qwest Chairman and CEO Edward A. Mueller's remarks at the 120th annual National Association of Regulatory Utility Commissioners (NARUC) convention in New Orleans on Nov. 17, 2008.

The Commission should take the first step toward a unified switched access system by adopting AT&T's proposal for intrastate-interstate parity.[50] In addition, this reform will help keep the traffic pumpers out of Arizona once the incentives to engage in their scams have been reduced.

3. OTHER STATES HAVE ADOPTED THE SAME "PARITY" APPROACH.

Q. HAVE OTHER STATES REDUCED INTRASTATE ACCESS RATES?

A. Yes. Numerous states, including New Mexico, Massachusetts, Illinois, and Texas, have mirrored reforms the FCC has already adopted. These state commissions require local exchange carriers' intrastate switched access rates to mirror their interstate switched access rates, and thereby have taken steps towards eliminating market distortions and therefore increased competitiveness in telecommunications.[51]

Like Qwest and ALECA, Verizon also supports reform as is clear from its actions in other states where it is an ILEC and where its access rates have been substantially reduced. In West Virginia, for example, Verizon agreed to reduce its intrastate switched access rates to interstate levels in return for the same retail local exchange pricing flexibility.[52]

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[50] Although this proceeding and AT&T's proposal do not address a comprehensive unification of all intercarrier charges, it will certainly be a step in the right direction.

[51] The other states include Alabama, Georgia, Indiana, Iowa, Kansas, Kentucky, Maine, Mississippi, Nebraska, Nevada, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Tennessee and Wisconsin. Citations to the statutes or commission policies implementing such policy changes are listed in OAO_Exhibit F.

[52] Petition by Verizon West Virginia Inc., Bell Atlantic Communications, Inc., dba Verizon Long Distance, MCIMetro Access Transmission Services LLC, dba Verizon Access Transmission Services, and MCI Communication Services Inc., dba Verizon Business Services requesting that Commission initiate a general investigation of the intrastate switched access charges of competitive local exchange carriers operating in WV and motion for confidential treatment of certain information provided under seal, April 25, 2008, at pages 3-4.

ISSUE 3 – WHAT PROCEDURES SHOULD THE COMMISSION IMPLEMENT TO ACHIEVE THE DESIRED REDUCTION IN ACCESS RATES?

Q. WHAT PROCEDURES SHOULD THE COMMISSION IMPLEMENT TO ACHIEVE THE REDUCTION IN INTRASTATE ACCESS RATES?

A. This is a legal issue which our counsel will address in briefing. But, as I understand it, we recommend that the Commission require all incumbent local exchange carriers, no later than 60 days after the effective date of necessary revisions to the AUSF rules approved in this Order, to reduce their intrastate switched access rates to the ILECs' interstate rate structures and levels and, within 60 days of the date of this order, require all CLECs to adjust their intrastate tariffs so that their access charges do not exceed those assessed by the ILEC in whose territory they operate. Each ILEC should also be directed to update and mirror its intrastate tariff anytime it changes its interstate rates in the future and CLECs should file conforming changes to match those of the ILEC with which they compete.

Q. WHAT IF AN ILEC OR A CLEC DOES NOT MAKE THE REQUIRED FILINGS TO ADJUST THEIR INTRASTATE ACCESS RATES AS YOU HAVE DESCRIBED?

A. Again, this is a legal issue which we will address in briefing, but I understand our position to be that the Commission should institute an Order to Show Cause against any carrier which does not make such a filing as to why their intrastate rates should not be reduced.

ISSUE 4 - SHOULD CARRIERS BE PERMITTED TO CONTRACT FOR ACCESS RATES THAT DIFFER FROM THEIR TARIFFED RATES?

Q. SHOULD THE COMMISSION PERMIT CARRIERS TO CONTRACT FOR ACCESS RATES THAT DIFFER FROM TARIFFED RATES?

A. Unquestionably, yes. But first, like Issue 3 this is also a legal matter that our counsel will address in AT&T's brief. I provide only an economic perspective as follows. The "parity" approach I described above is a straightforward step that this Commission can take quickly, and it makes a good general rule for all LECs. Parity will make significant progress in reducing implicit subsidies, and it will generate significant benefits for consumers and competition. But parity is not designed to be a *complete* reform, nor is it designed to eliminate implicit subsidies *entirely*. The FCC or the Commission may decide to implement additional reforms later. But in the meantime, individual companies should be allowed to develop and negotiate additional reforms on their own, and they should be allowed to enter into contracts that give them the opportunity to react to changing market conditions. Generally, it takes a relatively long time to arrive at a regulatory solution (months or years depending on the complexity of the issues involved). Sometimes it takes several years to even begin an investigation. Therefore, during the periods between regulatory reviews, companies may suffer undue economic harm if not allowed the flexibility to derive business solutions in form of mutual agreements to help them avert potential losses.[53]

[53] For example, it has been eight years since the FCC initiated investigation into further interstate access reform and more than four years since it initiated its ongoing comprehensive investigation of intercarrier compensation. See In the Matter of Developing a Unified Intercarrier Compensation Regime, Federal Communications Commission, *Further Notice of Proposed Rulemaking*, FCC 05-33, Mar. 3, 2005. Likewise, the Arizona access proceeding was initiated as far back as 2000.

While contracts may provide additional relief, a generic ruling that applies to all carriers is still necessary to establish just and reasonable prices that will apply when separate agreement is not reached. For a non-competitive service like switched access, a generic ruling is needed to protect access buyers from the LECs' natural desire to exploit their market power and charge excessive access rates. With a general pricing rule in place, additional stability is ensured when no separate contract exists between parties. Further, a generic ruling is more efficient in the long run given the number of companies operating in the market and the transaction costs involved in negotiating a contract with everyone.[54]

D. ACCESS REFORM WITH REVENUE NEUTRAL REBALANCING WILL PROTECT AGAINST REVENUE LOSSES, ALIGNS ECONOMIC INCENTIVES WITH CONSUMER PREFERENCES, AND PROMOTE BROADBAND ADOPTION IN ARIZONA.

ISSUE 5 - WHAT REVENUE SOURCES SHOULD BE MADE AVAILABLE TO CARRIERS TO COMPENSATE FOR THE LOSS OF REVENUES?

Q. SHOULD CARRIERS BE ALLOWED TO RECOVER THE REDUCTION OF ACCESS REVENUES THAT WILL RESULT FROM ACCESS CHARGE REFORM?

A. Yes. The Commission should allow carriers to recover lost access revenue by increasing their retail rates for local service, and in certain cases, by drawing revenue replacement from the state universal service fund. This proposal will be implemented in two steps. First, the Commission should give all carriers the opportunity to increase retail rates for local service up to a "benchmark" established by the Commission (to the extent they do

[54] This is not unusual, as telephone companies often try to avoid the rigidity of tariffs by including provisions that enables Individual Case Basis (ICB) contracts so that they can be able to respond quickly to their customer needs in a fashion that accommodates the going business concerns. Although the access related contracts may be different because they pertain to a wholesale service, the concept is similar in that it generally enables businesses the flexibility to respond, when necessary, to market circumstances.

not already have that flexibility); however, the Commission should not require carriers to raise local service rates by any amount. Rather, the actual decision to raise price, and the amount (within the constraints of the benchmark cap), should be left to the carriers as they are best positioned to make decisions about their own businesses.

For the second step, to the extent that the "benchmark" rate is not sufficient for a qualifying LEC to recover all of that LEC's access reductions, that LEC would be eligible to receive support from the Arizona universal service fund (AUSF) and its level of support will be determined as if it had raised its retail local rate up the benchmark level.

Q. WHY IS IT APPROPRIATE TO GIVE CARRIERS THE FLEXIBILITY TO INCREASE RETAIL RATES FOR LOCAL SERVICE?

A. The flexibility to restructure prices is part of effective access reform. As discussed earlier, high access rates under the monopoly regime were established to promote universal service objectives: retail prices for local service were held at artificially low, below-cost levels, and access rates were, in turn, set high to offset the shortfall. Thus, it makes perfect sense that as access charges are reduced, the Commission should also relax the restrictions on retail prices that were the other side of the access trade-off to an extent. That will allow local service prices to rise to more realistic levels and balance out the potential access revenue reduction.

Moreover, giving carriers the flexibility to adjust retail prices creates the right consumer incentives because it gives consumers the correct price signal – one that better reflects the underlying cost of service. If retail prices for traditional switched local service are held at artificially low, below-cost levels, consumers will demand more of that service than they

otherwise should, and as discussed earlier companies decisions to invest in the alternative technologies will be distorted by artificial (incorrect) price signals that are not based on society's real cost. Therefore, giving carriers the flexibility to increase prices will encourage consumers to use the right quantity of the previously subsidized service once the true costs are revealed. It also encourages consumers to use the right quantities of alternative services like broadband, based on merits, and companies are incented to invest in a manner that better reflects consumer preferences.[55]

That said, I want to reiterate that I am not advocating that the Commission *mandate* any price increases: it should simply reduce the old artificial restrictions and give carriers the flexibility to increase retail prices. In addition, the Commission can still achieve universal service goals. As I stated earlier, price increases would still be limited to an reasonable "benchmark" and, to the extent any ILEC needs additional support to make up for the reduction in the legacy access subsidies, AT&T is proposing that the ILEC be eligible to receive access replacement support from the Arizona universal service fund.

Q. WHAT ARE THE RISKS IN TAKING NO ACTION?

A. As I stated earlier, the present scheme (where some LECs charge extraordinarily low (below-cost) retail rates for local service while they collect implicit subsidies from extraordinarily high access rates) cannot be sustained. As consumers and the industry continue to migrate from the traditional public switched telephone network ("PSTN") towards alternative systems of delivering telecommunications (which includes

[55] For additional detail about how incentives for investment are affected by excessive access rates, see Dr. Aron direct testimony, Section VI (D).

broadband), the sources for these subsidies will shrink and eventually disappear. Ironically, the system that was initially designed to help consumers stay connected to the traditional network may be creating an unsustainable situation where consumers' ability to connect to the new network is threatened. Without action the system that the access subsidies were intended to support appear to be headed for a collapse.

Q. WOULD THE LECS BE HARMED IF ACCESS REDUCTIONS ARE REVENUE NEUTRAL?

A. No, almost by definition. As discussed above, the Commission should allow the ILECs to recover lost access revenues by first granting them additional retail rate flexibility up to a "benchmark" rate. To the extent the benchmark rate is not enough for any particular ILEC to recover all of its access revenue reductions, the ILEC would be eligible for universal service support. That way, ILECs will still have the opportunity to collect the same revenues and recover the cost of providing local service, just from more competitively neutral sources: the local service customers that cause that cost to be incurred and the AUSF (which would be broadly funded), rather than from wireline IXCs and their customers.

ISSUE 6 – HOW MUCH OF ACCESS COST RECOVERY, IF ANY, SHOULD BE SHIFTED TO END USERS? WHAT SHOWING SHOULD BE REQUIRED FOR SUCH A SHIFT? WHAT SHOULD BE THE ROLE OF "BENCHMARK" RATES AND HOW SHOULD THE BENCHMARKS BE SET?

Q HOW MUCH OF ACCESS COST RECOVERY, IF ANY, SHOULD BE SHIFTED TO END USERS?

A. As much as will allow retail rates to be more reasonable and reveal the true cost of service to consumers. Dr. Aron explains why recovering forgone access revenues from end users increases efficiency and promotes competition. But I discuss here specifically how retail rate flexibility can be implemented in a revenue neutral manner, and still increase efficiency or promote competition as Dr. Aron suggests. As discussed earlier, carriers will be allowed the opportunities to increase their retail rates up to a benchmark set by the Commission. The difference between the old retail rates and the benchmark (i.e. the amount of increase per line) times the carrier's line count represents the amount that might be recovered from end users. Note, however, that under AT&T's proposal carriers would not be *required* to increase their rates by any amount; it is up to the carriers to decide how much of the *allowed* rate increases they will actually implement.

Q. HOW SHOULD THE COMMISSION DETERMINE THE BENCHMARK?

A. Dr. Aron describes the guidelines for an effective benchmark.[56] Specifically;

(1) the Commission should set this policy now as part of AUSF rule changes which would be necessary for the ILECs to rebalance part of their access reductions;

(2) the Commission should ensure that, *first*, the benchmark allows as much cost recovery from end users as possible subject to affordability concerns. This will

[56] See Dr. Aron Direct Testimony, Section VI(D).

encourage the right consumer incentives and at the same time limit the amount of recovery to be obtained from the AUSF, so that fund contributions are not increased too dramatically,[57]

(3) the gap between urban and rural retail rates should be narrowed[58] in accordance with Congressional guidance that rates should be reasonably comparable for similar services in urban and rural areas,[59] and since such artificial disparity cannot be sustained going forward as the current system transforms into a subsidy-free broadband system.

A couple of possibilities are a benchmark based on the highest urban retail rates in Arizona, or on the weighted average retail rates of ILECs in Arizona, increased by a factor[60] (e.g. 125 percent as suggested by Qwest).[61] For illustration, the highest urban retail residential rate of $13.18 is assessed by Qwest and if one applies Qwest's suggested factor of 125 percent, the benchmark would be $16.48. Alternatively, if the Commission were to start with the weighted average residential retail rate of $13.16 (i.e. retail rates and line counts from 14 Arizona ILECs), and applying the adjustment factor of 125 percent would yield a hypothetical benchmark of $16.45.[62] As I explain below, these

[57] Often, when issues regarding universal service fund are being discussed, there is a tendency to forget that its source, as a Pennsylvania ALJ recently concludes, "....is not ***free money*** to be plundered at will and without concern for its origins or for whether it is the best use of the money." See Recommended Decision of PA PUC Administrative Law Judge Susan D. Colwell, in "Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund, Docket No. I-00040105. (emphasis added).

[58] Providers should look to their own end users and recover their costs through higher end-user rates and the USF should be used only to support carriers serving low income customers and high cost areas where cost-based rates would exceed a benchmark.

[59] *See* 47 U.S.C. § 254(b)(3).

[60] According to Qwest, increasing Qwest's rate by 125 percent will ensure that the urban rural retail rates are comparable. See Qwest Response to Staff Data Request STF 01-013.

[61] Qwest suggests that its retail rates should be increased by 125 percent to set a benchmark. See Id.

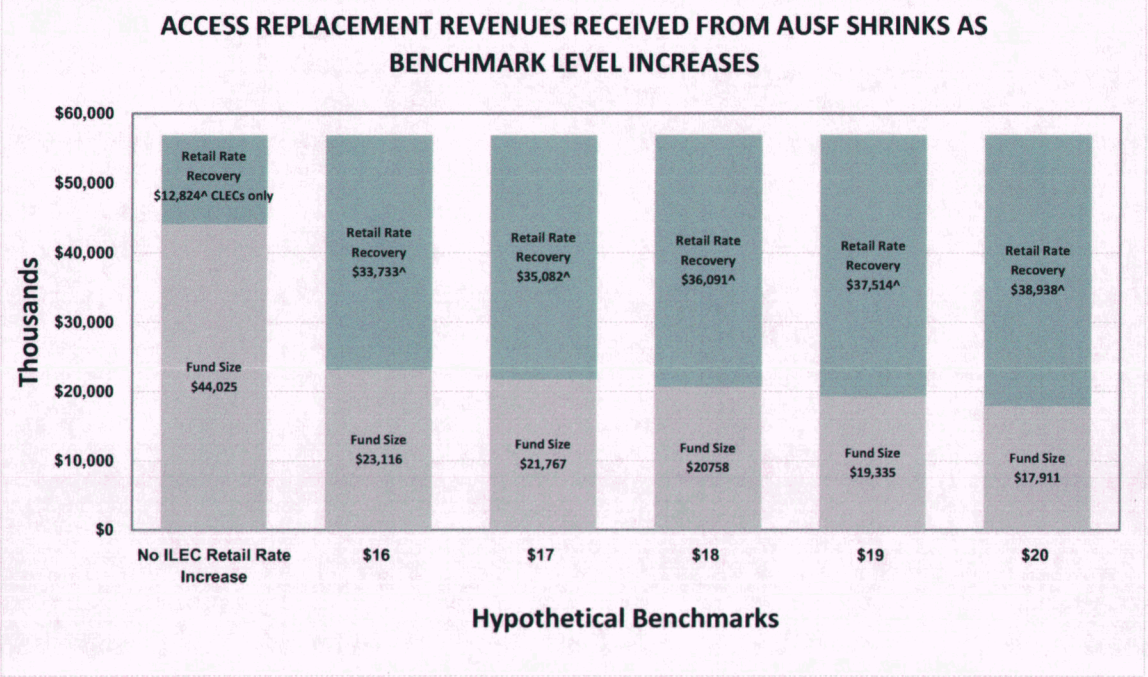
[62] Since the Qwest urban rate and Arizona's state-wide weighted average are below the national average residential rate of $15.62, AT&T believes that either $16.34 or $16. 48 represents the low end of a reasonable range of benchmark levels. See FCC's Reference Book of Rates, Price Indices, & Household Expenditures for Telephone

figures are quite reasonable, and in fact represent the low end of a reasonable range of possible benchmarks.

To minimize demands on the AUSF, the Commission should adjust the initial benchmark for inflation or by any other reasonable amount. The following chart illustrates that the AUSF fund size will decrease as the benchmark level is increased:

Service, Released August 28, 2008, Industry Analysis & Technology Division, Wireline Competition Bureau. (Table 1.1 - Rates as of October 15, 2007).

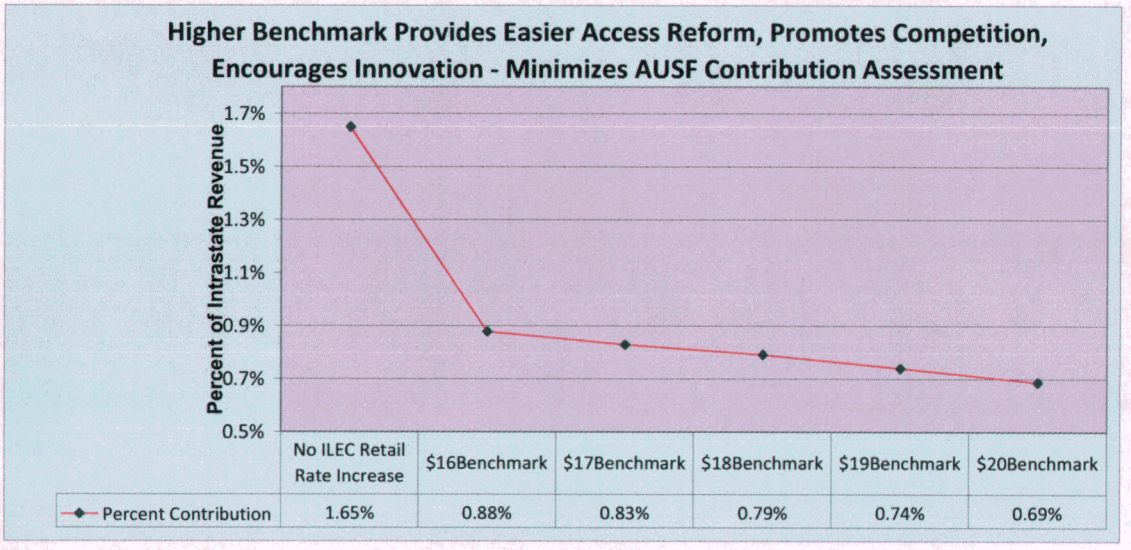
Figure 4



Notes:
Based on Responses to Data Request.
Benchmark Ranges are Hypothetical samples for illustration purpose only. Commission will set final benchmark.
^ Retail Rate Recovery - means amount that could be recovered by increasing retail local exchange rates. ILECs are assumed to have flexibility to increase retail local rates up to benchmark, but are not mandated to do so. CLECs should have sufficient retail rate flexibiliy to allow full recovery from end-user retail rate increase.

Likewise, the contribution impact (i.e. amount of contribution assessment to telecommunications provider and their customers) will decrease as the benchmark level increases. This is illustrated by the next chart:

Figure 5



Notes:
1). Based in part on analysis of access revenue reduction and access replacement requirement as illustrated in Figure 4 above.
2). Benchmark Ranges are Hypothetical samples for illustration purpose only. Commission will set final benchmark.
3). % Assessment (Contribution) = Total 12 month AUSF Fund Requirement ÷ Total 12 month Arizona retail intrastate telecommunications service revenues.
4) Intrastate Revenue from FCC Monitoring Report, released December 2008, Table 1.15 Intrastate Telecommunications Revenues: 2006 End-User

Q. WILL BASIC SERVICE REMAIN AFFORDABLE IF RETAIL RATES ARE ALLOWED TO INCREASE TO THE "BENCHMARK" AMOUNT QWEST SUGGESTS?

A. Absolutely: in fact, Qwest's suggestions would yield a benchmark at the low end of a reasonable range. In most instances, rates would increase to levels that still fall below what they would have been if they had just kept up with inflation since the last time those rates were changed. An AT&T analysis of fourteen Arizona ILECs (based on publicly

available data) reveals that the weighted average inflation adjusted retail rates for residential local service would be $17.50 compared with the $13.16 paid today, on average.[63] This means, as a practical matter, if one of the benchmarks identified above were adopted, each customer's price for service in real terms (that is, adjusted for inflation) would not have changed.

In addition, the benchmark proposed by Qwest is consistent with or below those set by other states; for example, New Mexico's benchmark is $13.86[64], Indiana has a $17.15 benchmark for residential basic local service ($23.60 for single line business), Pennsylvania's benchmark is $18,[65] and New York has a $23.00 rate cap. In Alaska, a benchmark of $25.00 has been proposed by Alaska Commission Staff and would increase by $5.00 annually until it reaches $40.00.[66] Also, end users across the country pay $50.00 or more on bundled packages and other services from newer technologies such as wireless and broadband where prices are free of subsidies.[67]

To further illustrate the reasonableness of these benchmarks, consider a benchmark of $18. Based on my preliminary analysis, the rate rebalancing required to bring retail rates of most LECs (excluding the CLECs) to an $18 (a round number chosen

[63] With inflation, the adjusted retail rates calculations range from $11.89 to $29.49 for residence and $22.44 to $57.15 for business.

[64] This initial benchmark was established by New Mexico Commission's order dated April 15, 2004 where the Commission indicated the benchmark may be re-determined every three years. As of the filing of this testimony, I have not been able to determine if such review had occurred. In the Matter of a Notice of Inquiry to Develop a Rule to Implement House Bill 776, Relating to Access Charge Reform, Case No. 05-00211-UT, Order Dated April 15, 2004, page 12.

[65] A Pennsylvania ALJ has recently recommended to the PA PUC that the $18 retail rate cap should be removed so that ILECs will have unlimited pricing flexibility.

[66] Regulatory Commission of Alaska, Staff's Memorandum, July 13, 2009, page 22.

[67] According to a GAO report, bundled packages which contain television, High-Speed internet, and local telephone has been the preferred business strategy by Broadband Services Providers and these bundles can be offered at an average discounted price of $117.28, while the High-Speed internet portion alone (if purchased a la carte) could cost as much as $55.46 on average. See U.S. General Accounting Office Report to U.S. Senate Subcommittee on Antitrust, Competition Policy and Consumer Rights, Committee on the Judiciary, titled, "Wired-Based Competition Benefitted Consumers in Selected Markets," February 2004, page 12.

for illustration) benchmark level will offset about $36 Million out of the total $56 Million access revenue reductions that that will result if all LECs reduced their intrastate access rates as AT&T proposes here. This would cause retail local rates to rise, on statewide average, by no more than $1.58 per line per month[68], and result in a weighted Arizona average residential rate no more than $15.00 per line per month:[69] Plainly, Qwest's suggested benchmarks (approximately $16.50), are significantly lower than reasonable range:[70]

[68] For Qwest and the CLECs, a retail rate increase of no more than $1.00 will be sufficient to recover all access revenue that will be forgone if the Commission reduced their intrastate access rates to the interstate target. The ALECA companies will need an average of $12.11 per line per month in additional revenue to be revenue neutral, and $10.58 can be recovered from their retail rate flexibility opportunities up to the $18.00 benchmark, if adopted by the Commission. They will then receive access replace support for the balance of $1.54 per line per month from the AUSF.

[69] CLECs should the allowed unlimited retail rate flexibility, and they would not be subject to the proposed benchmark

[70] CLECs should the allowed unlimited retail rate flexibility, and they would not be subject to the proposed benchmark

Table 1

[BEGIN CONFIDENTIAL INFORMATION]

[END CONFIDENTIAL INFORMATION]

As the table above demonstrates, a statewide weighted average increase of $1.58 per line would still leave retail rates below where they would have been had they been allowed to increase by inflation since the tariff effective dates. Keep in mind that carriers will not be *required* to raise their rates all the way up to the benchmark, or by any amount. Because these ILECs face substantial competition from cable, wireless, VoIP providers and others, the extent to which rates would actually rise is likely to be constrained by the threat of competition. The Commission can rest assured, therefore that retail customers have the

option to choose alternatives if they think a LEC's new prices are not consistent with real value. In other words, unlike in the case of switched access (where access buyers have no real choice among sellers), market forces in the local retail market will eventually determine what retail rate level will prevail. It is then up to the LECs to react in whatever way they think best in their business judgment; e.g. increase price, improve efficiencies, or expand the scope of their product offerings to generate new revenues.[71]

Q. WHAT TYPES OF DATA SHOULD CARRIERS PROVIDE TO CALCULATE THE AMOUNT OF REVENUE REPLACEMENT TO BE DRAWN FROM AUSF?

A. To recover any access replacement revenue from the AUSF, a carrier should be required to provide a report that identifies (1) the amount of its switched access reduction,[72] (2) the amount of revenue it would recover if it raised its retail rates to the benchmark level,[73] and (3) the net funding for which it qualifies i.e., the amount of its switched access reduction in (1) less the amount it would recover if it raised its rates to the benchmark level in (2).

Q. SUPPOSE HYPOTHETICALLY THAT THE BENCHMARK WOULD GIVE A PARTICULAR LEC THE FLEXIBILITY TO INCREASE LOCAL SERVICE RATES BY $10.00 PER MONTH. ARE YOU SUGGESTING THAT THIS INCREASE SHOULD OCCUR IMMEDIATELY?

A. No. Intrastate access rates should be reduced immediately to intrastate levels, so that consumers can benefit as soon as possible from the lower long distance prices that would be expected to result. Regarding retail prices for local services, to make for a smoother

[71] The benchmark process proposed herein only suggests that the ILECs must be given an opportunity to offset access reductions; it is not a mandate that they do so. Those decisions are left to the ILECs.

[72] Specifically, access reduction will be calculated as: the product of the difference of Intrastate Rate Less the Interstate Rate (Target Rate) Times the annual Intrastate Minutes of Use. That is,

Intrastate Rev. Loss = (Intrastate Rate – Interstate Rate) x (Annual Intrastate MOU)

[73] To calculate this figure, a carrier would, i) collect the number of lines as of year-end the most recent calendar year prior to when the report is being prepared; ii) multiply the line count figure in (i) by the difference between current retail rate and the benchmark to derive the incremental retail revenue.

transition in such cases, the Commission can phase the benchmark in over a period of time by setting a maximum annual price increase. Under this approach, an ILEC would only have the opportunity to increase its monthly retail rate by a maximum of $2.00 per line and charge that new monthly rate for one year. Using the hypothetical $10.00 retail rate increase as an example, the Commission would give an ILEC flexibility to increase its local retail rate by only $2.00 per year until it reaches the benchmark. During this phase-in period, any remaining access reduction that the LEC is not able to recover through the retail rate increase could be drawn from AUSF access replacement fund I discuss in more detail below. Of course, the AUSF support would be phased down each year as the LEC is able to increase its local rates by an additional increment of $2.00 per line.[74]

Q. PLEASE PROVIDE EXAMPLES TO ILLUSTRATE HOW THIS COULD WORK?

A. I have prepared a set of hypothetical illustrations that assume a benchmark of $18.00, and a $2.00 maximum annual increase allowed. For each of these three illustrations, I look at two time periods: "Step 1," which occurs 60 days following the effective date of the revised AUSF rules; and "Step 2," which occurs on the same date one year later. All Arizona ILECs would be required to reduce their switched access rates to interstate parity at Step 1.

<u>Case #1 (an ILEC)</u>

- The ILEC's access revenue reduction equals $6.00 per line per month (i.e. total reduction in access revenue, divided by the carrier's total line count)

[74] Once all carriers retail rate have been increase up to the benchmark such that no ILEC has any more flexibility, and suppose the Commission still desires to reduce the fund size the benchmark level could be raised annually like in the Alaska staff's recommendation to the Alaska Commission, i.e. that the benchmark level should increase by $5.00 annually until it reaches $40.00.

- The ILEC's current retail rate is $15.00 per month. Thus, the ILEC would be allowed to increase its rates up to the $18.00 benchmark and recover up to $3.00 per line from end users, but subject to the maximum annual increase of $2.00 on the monthly rate.

- At Step 1, access reform takes effect immediately, and the ILEC's access revenues will be reduced by $6.00 per line.

- At this step, the ILEC will have the opportunity to increase its retail rate by $2.00, the maximum annual price increase allowed under the "phase in" approach.

- The ILEC will then have the opportunity to draw support from the AUSF. Also at Step 1, the carrier would be eligible for $4.00 per line per month in AUSF support (the $6.00 per-line reduction in access revenues, minus the $2.00 the carrier is allowed to obtain through the above increases in retail local service rates). Note that this is true even if the ILEC chose not to raise rates by the full $2.00 per line.

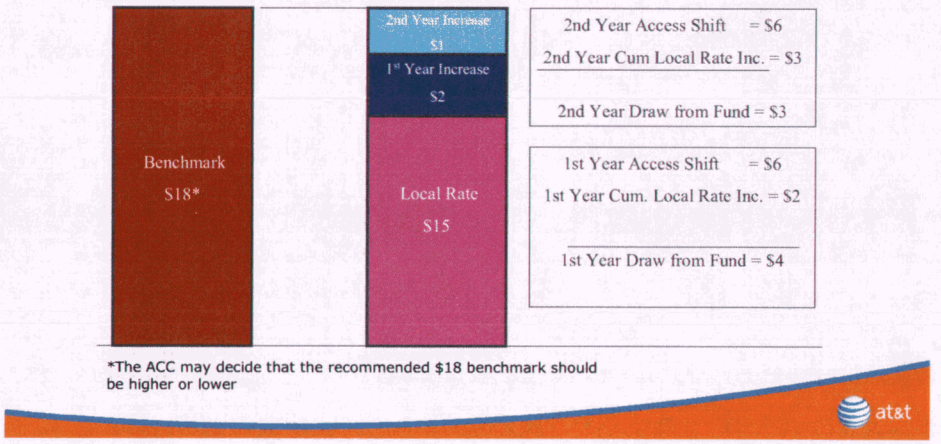
- At Step 2, the carrier has additional flexibility to increase its local service rates by another $1.00, to reach the $18.00 benchmark level. The $2.00 per-year maximum increase under the phase-in plan is no longer a consideration, because the carrier's retail rate can reach the benchmark level without an increase of $2.00 or more.

- Again in Step 2, the carrier will be eligible for $3.00 per line in support from the AUSF: the portion of the $6.00 per-line access revenue reduction that is not recovered by the $3.00 in retail rate increases allowed at Steps 1 and 2 combined.

I illustrate this Case 1 scenario graphically in the chart below.

Figure 6

ILECS DRAWING FROM THE ACCESS REPLACEMENT FUND
CASE #1 - RATES BELOW BENCHMARK

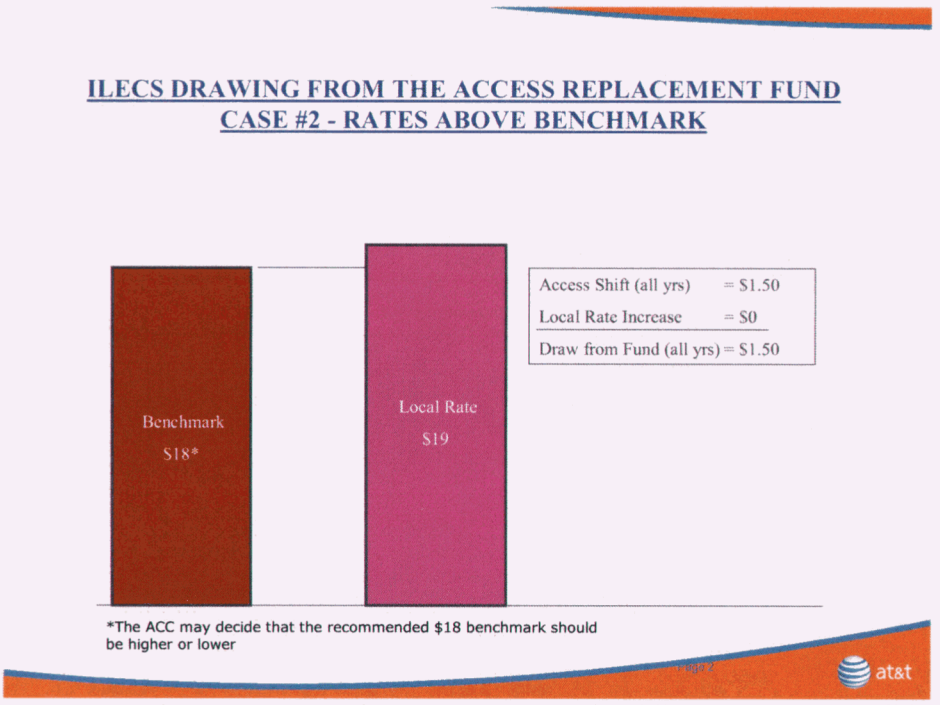


Case #2 (an ILEC)

- The ILEC's access reduction (or shift) equals $1.50 per line per month (i.e. total amount of access reduction divided by the ILEC's total line count)
- The ILEC's current retail rate is $19.00 per month. Because the ILEC's rate is already above the $18.00 benchmark, it will not receive any flexibility to raise its rates further, and will instead have to recover the total access reduction of $1.50 per line from the AUSF Access Replacement Fund.
- As before, access reform takes effect immediately at Step 1.
- The ILEC's retail rate remains the same at $19.00 per month.

I illustrate Case 2 scenario by the chart below.

Figure 7

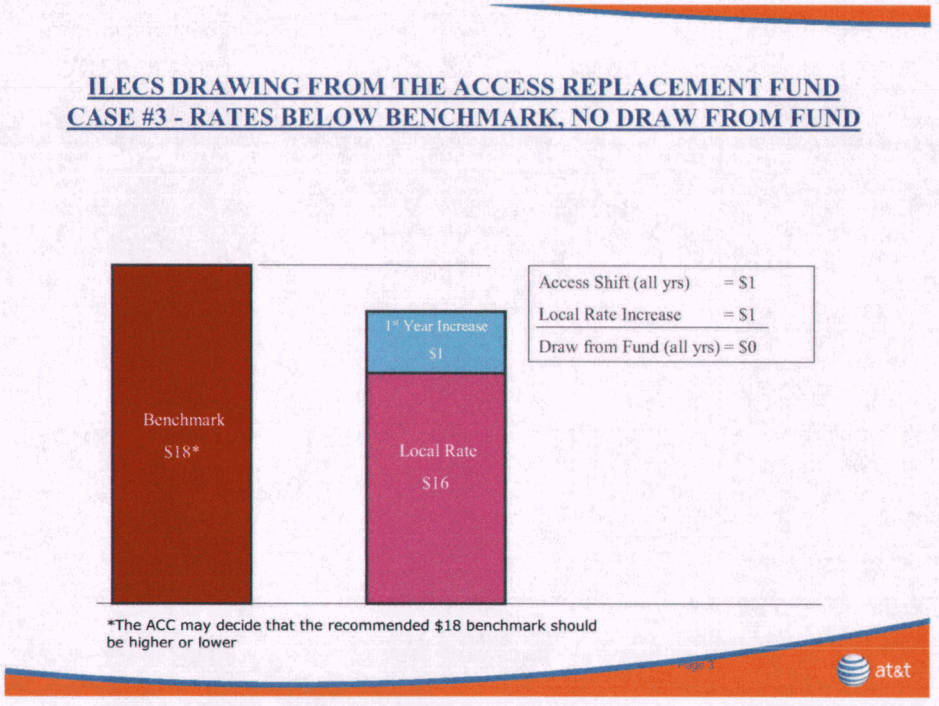


Case #3 (an ILEC)

- The ILEC's access reduction (or shift) equals $1.00 per line per month (i.e. total amount of access reduction divided by the ILEC's total line count)
- The ILEC's current retail rate is $16.00 per month.
- At Step 1, access reduction takes effect immediately and the carrier will have the opportunity to increase its retail rates to recover its lost revenue. Because the access revenue reduction works out to only $1.00 per line per month, the ILEC may increase its retail rate by the full $1.00, because the new rate of $17.00 will still be below the $18.00 benchmark, and the $1.00 increase will still be below the maximum annual price increase of $2.00.
- In this case, the carrier can elect to increase its retail rate to $17.00, but it would not be eligible for any AUSF Access Replacement Fund support because its retail rate flexibility is sufficient to recover its total access revenue reduction in a revenue neutral manner.

The Case 3 scenario is shown in the chart below.

Figure 8



ISSUE 7 – PROCEDURALLY WHAT WILL BE REQUIRED OF A CARRIER IF IT SEEKS A "REVENUE NEUTRAL" INCREASE IN LOCAL RATES?

Q. HOW SHOULD THE COMMISSION DETERMINE THE RETAIL RATE INCREASE IS REVENUE NEUTRAL?

A. At a minimum, effective implementation of access reform would involve the following steps.

At step 1, the amount of access reduction will be determined using the carrier's 1) ***intrastate*** originating and terminating switched access minutes and revenue billed to other providers (excluding billing to affiliates, if any) for the most recent full calendar year prior to its request; and 2) ***interstate*** originating and terminating switched access minutes and revenue billed to other providers (excluding billing to affiliates, if any) for the most recent full calendar year prior to its request. The access reduction will be calculated by taking the difference between the average per-minute intrastate rate (intrastate switched access revenue divided by intrastate switched access minutes) and the average per-minute interstate rate (interstate revenue divided by interstate minutes), and then multiplying that difference by the intrastate switched access minutes.

At step 2, the carrier will determine the amount of additional revenue available to it from local rate flexibility. To determine this amount, the carrier must provide: 1) the current rate, 2) the benchmark rate, and 3) the demand quantity (e.g. number of lines, not including lifeline) in the most recent full calendar year for each service that would be affected by the increase. The carrier would then calculate the total amount of additional revenue that would be expected if it raised rates up to the benchmark level, by taking the difference between the benchmark rate and the current rate and then multiplying that difference by the ILEC's most recent line count (excluding lifeline).

At step 3, the carrier would compare the revenue opportunity (calculated in step 2) with the access revenue reduction (calculated at step 1) to determine if additional support would be required from the AUSF to offset the access revenue reduction. The carrier must also prove that the total of incremental revenue from its retail rate increase and its draw from the AUSF (combined) is not greater than the amount of access reduction. If it is, the amount of distribution from the fund will be decreased to the level at which it would be just sufficient to offset the access revenue reduction (in other words, any retail rate increases should first have the effect of reducing the ILEC's eligible AUSF support).

The retail rate increase opportunity should leave end-user rates at or below the benchmark and should not produce additional revenues greater than the amount of access revenue the carrier lost. Procedurally, carriers would implement the rate increase by filing tariff changes to increase other rates, together with data demonstrating the overall revenue neutrality of the decrease in intrastate access revenues compared to the revenues to be received from the tariff changes.

These AUSF procedural steps should only apply to ILECs, and not the CLECs. As I explain under Issues 8 and 9, only ILECs should be eligible to draw support from the AUSF Access Replacement Fund. CLECs should, of course, be given the retail rate flexibility needed to compensate for access revenue reductions (to the extent they do not already have it).

ISSUE 8 - ASSUMING THAT AUSF FUNDS WILL ALSO BE USED AS A COMPENSATING REVENUE SOURCE FOR REDUCTIONS IN SWITCHED ACCESS REVENUES, WHAT SPECIFIC REVISIONS (INCLUDING SPECIFIC RECOMMENDED AMENDMENT LANGUAGE) TO THE EXISTING RULES ARE NEEDED TO ALLOW USE OF AUSF FUNDS FOR THAT PURPOSE?

Q. YOU STATED EARLIER THAT THE AUSF MUST BE RESTRUCTURED TO ENABLE THE REVENUE NEUTRAL REBALANCING OF THE CARRIERS' ACCESS REDUCTIONS. PLEASE DESCRIBE WHAT CHANGES MUST BE MADE.

A. To the extent the Commission decides to give carriers the ability to use the AUSF for the access revenue replacement described under Issues 6 and 7, the Commission needs to revise the existing AUSF rules. The current AUSF rules do not clearly authorize the use of AUSF support to recover reductions in access revenues, nor are they designed to collect contributions to fund support for that purpose. The revisions needed would consist of at least the following: (i) a provision that allows eligible carriers to receive support for the lost switched access revenue, specifically describing how the amount to be drawn would be calculated, and identifying the supporting documentation that the eligible carrier must provide in order to qualify for a revenue replacement support; (ii) provisions describing the contribution methodology, the sources of contributions to the fund, and provision that provides carriers an option to recover their contribution assessment through a surcharge;[75] and (iii) lastly a provision that specifies eligibility criteria for carriers to draw access replacement fund. AT&T will file specific AUSF rules language with its reply testimony after it has reviewed other parties' direct testimony on these issues.

[75] Contribution methods and surcharge calculation are explained in further detail later in Issue 11.

ISSUE 9 – WHICH CARRIERS SHOULD BE ELIGIBLE FOR AUSF SUPPORT?

Q. SHOULD ILECS AND CLECS BE TREATED THE SAME? SHOULD ALL CARRIERS BE ALLOWED TO DRAW REVENUE REPLACEMENT SUPPORT?

A. No. CLECs do not need to receive access replacement revenue from AUSF, because, as discussed earlier CLECs should have the opportunity to increase retail rates, and if necessary, they should be authorized to increase their maximum price level adequately to allow them to remain revenue neutral after their access rates are reduced.

Only ILECs should be eligible for access replacement AUSF revenue and the amount distributed should be determined after considering the amount of revenue that would be available if they increased retail rate up to the benchmark level. As I described earlier, the ILECs' access charges were designed to provide additional revenues that implicitly subsidized prices for basic local service in rural and high-cost areas, in particular to incumbent local carriers who had (and continue to have) universal service obligations to be ready, willing, and able to serve certain residential customers throughout their respective service territories.

These implicit subsidies, however, can no longer be relied upon to support an ILEC's provision of universal service in Arizona. To ensure that the State continues to achieve its universal service objectives, the Commission should supplement ILEC rate increases to a benchmark with explicit support through the Arizona Universal Service Fund.

By contrast, CLECs stand in a very different position from the ILECs. They have never been subjected to any legacy system that created implicit subsidies for universal service objectives, they could determine which geographic areas to serve, and they have

been given the opportunity to price their services under a more flexible system than existed traditionally for the ILECs, and one they felt allowed them best to be successful in the competitive marketplace.

ISSUE 10 – WHAT SHOULD BE SUPPORTED BY AUSF? ACCESS REPLACEMENT ONLY? HIGH COST LOOPS? LINE EXTENSIONS? CENTRALIZED ADMINISTRATION AND AUTOMATIC ENROLLMENT FOR LIFELINE AND LINK-UP?

Q. WOULD THE REVISIONS YOU HAVE PROPOSED REQUIRE ANY CHANGE IN THE EXISTING HIGH COST LOOP SUPPORT AND LINE EXTENSIONS PROCESSES?

A. No. The proposed revisions should be limited to revenue replacement functions such that carriers are neither net gainers nor net losers from the proposed restructure. The result should be revenue neutral as discussed above. Carriers receiving High Cost support under the current system should continue to receive such support, and other carriers that do not currently receive High Cost support would not begin to do so – in order to achieve a revenue neutral reform as proposed above.[76]

ISSUE 11 - WHAT SHOULD BE THE BASIS OF AUSF CONTRIBUTIONS AND WHAT SHOULD BE THE STRUCTURE OF ANY AUSF SURCHARGE(S)?

Q. WHAT SHOULD BE THE SOURCE OF FUNDS FOR THE AUSF?

A. Contributions to the AUSF, to satisfy the existing support needs and the access revenue replacement function proposed here, should come from *all* telecommunications providers, on an equitable, non-discriminatory and competitively neutral basis. One of the central problems of the present system is that carriers who pay high intrastate access charges – largely wireline IXCs and ultimately their customers -- not only have obligations to contribute to explicit subsidies provided by the Arizona Universal Service

[76] The access replacement support is incremental to the high-cost support, so all that needs to be done is to add provisions to enable the access replacement mechanism. Likewise, it is incremental to Lifeline and Link-up, and not meant to disturb availability of, eligibility for, and the retail rates charged for Lifeline and Link-up.

Fund, but also have to bear the burden of the implicit subsidies in access charges that are not borne by their competitors to the same extent (if at all). As I have explained, that system imposes a competitive disadvantage upon the IXCs, who are saddled with high access charges. To the extent the old implicit subsidies are now replaced with explicit support, all providers of intrastate telecommunications should be required to contribute on an equitable and nondiscriminatory basis to support universal service goal throughout Arizona.[77]

Q. ARE THE EXISTING AUSF CONTRIBUTION REQUIREMENTS EQUITABLE AND NONDISCRIMINATORY?

A. I respectfully do not believe so. Currently, the AUSF rules specify that one-half of AUSF funding is to be borne by "Category 1" providers (largely local exchange carriers and wireless carriers), on the basis of access lines and interconnecting trunks, respectively, and one-half of AUSF funding is to be borne by "Category 2" service providers, i.e., providers of intrastate toll service (or other service providers as permitted under R14-2-1204(B)(3)), on the basis of intrastate toll revenues. Not only does a different contribution methodology apply depending on the type of service provider and service, but perhaps more importantly, the 50-50 allocation of AUSF funding responsibility may well no longer accurately reflect the providers' relative level of activities in Arizona in a manner that is equitable and nondiscriminatory.

Q. HOW SHOULD THE CURRENT CONTRIBUTION SYSTEM BE RESTRUCTURED?

A. As a general matter, at this time, AT&T believes that the contribution methodology employed for the AUSF (and all state USFs) should mirror the approach currently

[77] 47 U.S.C. § 254(f) authorizes states to require that "[e]very telecommunications carrier that provides intrastate telecommunications services shall contribute, on *an equitable and nondiscriminatory basis*, in a manner determined by the State to the preservation and advancement of universal service in that State" (emphasis added).

implemented for the federal USF. Consistency between federal and state funds facilitates carrier administration of their contribution and remittance obligations. Since federal USF contributions method is currently based upon a percentage of interstate/international retail (end user) telecommunications revenues, the AUSF contribution should be based upon a percentage of the total retail intrastate telecommunications revenues in Arizona.[78] Moreover, all contributing carriers should be allowed the option to recover their contributions from their end users. As I illustrate below, based on current data, that will be less than 1 percent of a carrier's end user charges.

Q. PLEASE ILLUSTRATE HOW THE CONTRIBUTION ASSESSMENT WILL BE CALCULATED.

A. The Commission must first determine the assessment factor which can be calculated as follows:

- Assessment Factor (percent) = Total 12 month AUSF Fund Requirement ÷ Total (most recent calendar year) Arizona retail intrastate telecommunications service revenues.

This percentage will be assessed equally on all providers of telecommunications service in Arizona. Each provider's dollar assessment will be calculated as follows:

- Provider's Assessment = Assessment Factor (percent) x Provider's (most recent calendar year) retail intrastate telecommunications service revenues.

Table 2 below shows that, based on the range of assumed benchmark levels (i.e. $16.00 to $20.00), the percent contribution assessment is less than 1 percent of total

[78] However, I note that changes to the federal USF contribution methodology have been under consideration for some time. At the federal level, AT&T has supported a move to a telephone numbers or numbers- and dedicated connections-based contribution methodology. If the federal contribution methodology is adopted in the future, the AUSF contribution approach should change as well, subject to a reasonable transition period, to maximize national uniformity between the state and federal systems which simplifies contribution administration for providers required to contribute to the state and federal funds.

telecommunications revenues received by Arizona telecommunications providers (i.e. ILECs, CLECs, Wireless, and IXCs).

Table 2

SELECTING A HIGHER BENCHMARK WILL REDUCE THE THE AUSF CONTRIBUTION ASSESSMENT, AND KEEP RATES AT A REASONABLE LEVEL							
Recovery based on:	**Tot Telecom Retail Rev**						
ILEC	$690,000,000	25.38%					
CLEC	$314,000,000	11.55%					
Toll	$115,000,000	4.23%					
Wireless	$1,600,000,000	58.85%					
Total	**$2,719,000,000**	100.00%					
USF Fund Requirement	**No Benchmark**	**$16Benchmark**	**$17Benchmark**	**$18Benchmark**	**$19Benchmark**	**$20Benchmark**	
Current USF Fund	$750,000	$750,000	$750,000	$750,000	$750,000	$750,000	
Access Replacement Distribution	$44,099,422	$23,117,005	$21,767,190	$20,758,365	$19,335,368	$17,911,348	
USF Recovery - % Revenue Approach							
% Contribution Assessment	**1.65%**	**0.88%**	**0.83%**	**0.79%**	**0.74%**	**0.69%**	
Note:							
Based on							
1) AT&T analysis of the amount of access reduction at interstate parity							
2) ILECs' current retail rates provided in discovery							
3) Number of Lines from data submitted by ILECs to NECA							
4) Intrastate Revenue from FCC Monitoring Report, released December 2008, Table 1.15 Intrastate Telecommunications Revenues: 2006 End-User							

ISSUE 12 – ANY OTHER SPECIFIC REVISIONS TO THE AUSF.

Q. DOES AT&T PROPOSE ANY CHANGES TO THE AUSF OTHER THAN THOSE DESCRIBED ABOVE?

A. No

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

OAO_Exhibit A

List of Testimonies by Dr. Ola Oyefusi

State	Docket No.	Subject	Date
New Jersey	Docket No. TX08090830	In the Matter of the Board's Investigation and Review of Local Exchange Carrier Intrastate Access Rates	February 13, 2009 (Initial Testimony), April 20, 2009 (Reply), June 22, 2009 (Rebuttal)
Pennsylvania	Docket No. I-00040105	Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund	December 10, 2008 (Direct), January 15, 2009 (Rebuttal), & February 10, 2009 (Surrebuttal)
Massachusetts	07-9	Petition for Investigation under Chapter 159, Section 14 of the Intrastate Switched Access Rates of Competitive Local Exchange Carriers	August 20, 2008 (Pre-filed)
Virginia	Case No. PUC-2007-00108	Petition of Sprint Nextel for reductions in the intrastate carrier access rates of Central Telephone Company of Virginia and United Telephone-Southeast, Inc.	August 1, 2008
New Hampshire	DT 06-067	Bayring Petition into investigation of Verizon New Hampshire's practice of imposing access charges, including carrier common line, on calls which originate from Bayring's network and terminate on wireless carriers' networks.	March 9, 2007 & April 20, 2007
New Jersey	TT 04060442	Application of Verizon New Jersey, Inc. for a Revision of Tariff B.P.U.- N.J. No. 2, providing for a Revenue Neutral Rate Restructure Including a Restructure of Residence and Business Basic Exchange Service and Elimination of $.65 Monthly Credit	January 18, 2005 (Rebuttal)
New Jersey	TO 01020095	Application of Verizon New Jersey for approval (i) of a new alternative regulation plan, (ii) to reclassify multi-line regulated business as competitive services.	January 9, 2005 (Direct) & February 4, 2005 (Rebuttal)
Pennsylvania	C-20027195	Remand of Verizon access reduction proceeding	June 29, 2005
Pennsylvania	R-00049812	Verizon Pennsylvania Inc.'s Petition for Expedited Adoption of an Interim Rate Pending Determination of Final Rates for Time and Material	November 15, 2004 (Direct) & December 7, 2004 (Rebuttal)
Pennsylvania	C-20027195	Investigation into VZ access rates	July 18, 2003

Virginia	PUC-2002-00088	Petition of Cavalier Telephone LLC for injunction against Verizon Vriginia Inc. for Violations of interconnection agreement and for expedited relief to order Verizon to provision Unbundled Network Elements in accordance with the Telecommunications Act of 1996	June 2, 2003
Delaware	96-324, Phase II	In the matter of the application of Verizon Delaware Inc. for approval of its Statement of Terms and Conditions under section 252(f) of the Telecommunications Act of 1996 and code of conduct	September 14, 2001
District of Columbia	Formal Case No. 962	In the Matter of the Implementation of the District of Columbia Telecommunications Act of 1996 and Implementation of the Telecommunications Act of 1996	October 9, 2001
DC	Formal Case No. 814, Phase IV	Rate design for telecommunications services, development of productivity measurements under a price cap plan, use of incremental cost as a price floor for competitive telecommunications services, criteria for determining competitive telecommunications services, critique of the alternative incentive regulation adopted in Phase III, and classification of telecommunications services	July 1, 1995
DC	Formal Case No. 920	Telecommunications needs of residents, business community and government entities in the District of Columbia, introduction of new telecommunications services in the District of Columbia, and mechanisms for reviewing and monitoring Bell Atlantic's construction plans and budget	March 18, 1994
DC	Formal Case No. 926	Rate design and determination of total factor productivity	July 30, 1993
DC	Formal Case No. 814, Phase III	Market structure, determination of market share, pricing flexibility, and significance of economies of scale and economies of scope	October 13, 1992
DC	Formal Case No. 912	Rate structure, pricing information and energy conservation	April 3, 1992

OAO_Exhibit B

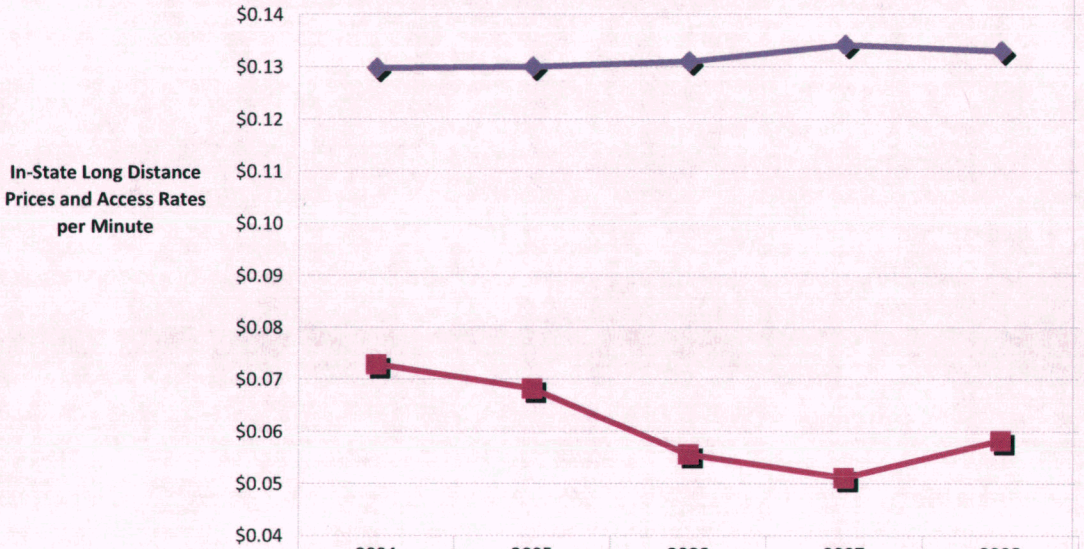
Arizona Access Rates - Carrier Common Line			
	Range		
	Originating		Terminating
Table Top Telephone Company	3.60¢	To	4.00¢
Southwestern Tel	1.00¢	To	22.93¢
Copper Valley Telephone, Inc	2.00¢	To	2.00¢
Arizona Telephone Company	1.00¢	To	3.02¢
Valley Tel Coop Inc	5.89¢	To	5.89¢
Midvale Telephone Exchange	2.00¢	To	5.44¢
South Central Utah Telephone Association	3.62¢	To	5.12¢
Accipter (Zona Communications)	1.00¢	To	2.42¢
Citizens Frontier-Rural	1.94¢	To	4.82¢
Citizens Frontier-White Mountain	2.42¢	To	10.46¢
Citizens Frontier-Navajo	1.00¢	To	2.27¢
Verizon	2.43¢	To	7.18¢
Qwest	None		

Notes:

Sources - Publicly available access tariffs

Rates per minute of use as defined in the carrier's access tariff

Verizon's Excessive Access Rates Exceed AT&T Long Distance Prices, Substantially Inhibite Competition, and Prevent Lower Prices for Arizona Consumers



	2004	2005	2006	2007	2008
Verizon Avg Sw Access Rate	.1298	.1300	.1310	.1342	.1330
AT&T Avg In-State LD Price	.0729	.0682	.0556	.0511	.0582

Citizen's Average Access Rates Exceed AT&T Long Distance Prices, Substantially Inhibe Competition, and Prevent Lower Prices for Arizona Consumers

	2004	2005	2006	2007	2008
Citizens/Frontier Avg Sw Access Rate	.1097	.1033	.0971	.1040	.1239
AT&T Avg In-State LD Price	.0729	.0682	.0556	.0511	.0582

OAO_Exhibit D

BEGIN HIGHLY CONFIDENTIAL

	How much more IXCs pay to the Arizona carriers by paying Intrastate vs Interstate Access Rates			
Carrier	Annually	Per Day	Per Month	%
[redacted]				

Notes:
[redacted]

Sources - AT&T analysis of data from Responses to Staff Discovery Request, AT&T Discovery Request.

END HIGHLY CONFIDENTIAL

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October 27, 2009

The Honorable Henry A. Waxman
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, DC 20515-6115

The Honorable Rick Boucher
Chairman
Subcommittee on Communications, Technology and the Internet
Committee on Energy and Commerce
U.S. House of Representatives
2187 Rayburn House Office Building
Washington, DC 20515

The Honorable Bart Stupak
Chairman
Committee on Oversight and Investigations
U.S. House of Representatives
2268 Rayburn House Office Building
Washington, DC 20515

Dear Chairmen Waxman, Boucher, and Stupak:

I am responding to your letter to our Chairman and CEO, Randall Stephenson, dated October 14, 2009. AT&T is pleased to assist the Committee in its review of traffic pumping abuses of the access charge regime that governs compensation for the termination of long distance calls to the local premises of actual end users.

Traffic pumping schemes involve unscrupulous incumbent local exchange carriers ("ILECs"), as well as "competitive" local exchange carriers ("CLECs"), many established for the sole purpose of engaging in scams, that: (i) establish grossly excessive access charges under false pretenses; (ii) offer kickbacks to operators of calling services that agree to advertise their services (typically for "free") to anyone who dials telephone numbers assigned by the LECs; and (iii) bill AT&T and other interexchange carriers ("IXCs") "terminating" access charges for millions of calls and billions of minutes of communications between non-residents of the small communities the LECs purport to serve. AT&T and others are engaged in litigation with many current perpetrators for their violations of existing law, but given the ease with which these schemes are implemented and shifted rapidly to other locations, it is clear that after-the-fact, case-by-case litigation could never fully protect the public interest. Accordingly, AT&T and others have also sought action from the FCC and state commissions to put an end to these

practices. Legitimate competitive LECs and conference service providers have likewise urged the FCC to put an end to traffic pumping abuses.[1]

The enormous public harms from these schemes are well-documented and indisputable. By significantly inflating long distance carriers' costs, traffic pumping forces ordinary long-distance customers throughout the nation to fund the schemers' windfall profits. The lure of those windfall profits has diverted the resources and focus of real LECs away from their proper role of providing high quality local services to actual residents. These schemes have depleted already strained universal service fund resources, as traffic pumping LECs ("TP LECs") seek and obtain millions of dollars in high-cost Universal Service Fund ("USF") support on the basis of "access lines" they claim to provide to their free calling service partners. Traffic pumping can degrade service to ordinary customers by clogging up transport and switching facilities. And, because these schemes use ordinary telephone numbers, they provide ungated access to "free" pornographic content, thus circumventing the laws designed to ensure that parents can prevent their children from accessing such content.[2]

One need only consider the case of Aventure Communications Technology, LLC to understand the nature and scope of the traffic pumping problem. To obtain its Certificate of Public Convenience and Necessity and its eligibility for universal service support, Aventure represented to the Iowa Utilities Board ("IUB") that it intended to provide local exchange service in numerous rural exchanges in Iowa and aggressively to market those services to the Iowa residents of those communities. Instead, Aventure set up chat and other traffic pumping schemes – which it did exclusively for more than two years, without constructing a local exchange network and without serving a single real Iowa resident Iowa residential service customer. To inflate its access revenues even further, Aventure concocted a truly absurd call routing scheme that had it billing for more than 200 miles of "local" transport through three states. Aventure has received further windfalls in the form of millions of dollars in USF high-cost support by representing that it would use moneys it received to provide USF-supported services and by misrepresenting the number of lines it served.

Traffic pumping schemes are unlawful in many respects, as the Iowa Utilities Board ("IUB") recently concluded after an exhaustive review of an extensive factual record developed in a two year proceeding involving eight incumbent and competitive LECs operating in rural

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1 *See, e.g.*, Ex parte letter from Counsel to the Rural Independent Competitive Alliance to FCC filed October 23, 2008 in FCC Docket No. 07-135 ("RICA agrees that the access stimulation issues may be addressed by establishing a requirement for CLECs to revise and reduce their tariff access rates in the event that traffic exceeds specified thresholds"); Ex Parte letter from David Frankel, CEO of ZipDX LLC to FCC, filed August 28, 2009 in FCC Docket No. 07-135 ("the abuse of rural access charges has been allowed to linger for far too long. . . . This undermines fragile funding mechanisms and will impede broadband enhancements. Rule clarifications proposed by ZipDX are non-controversial for any legitimate player not attempting to game the system").

2 *See* 47 U.S.C. § 228.

areas of Iowa that have been a hotbed of traffic pumping activity. The IUB found that these TP LECs violated their own tariffs, violated the law and, in a failed effort to hide their unlawful behavior, even fabricated and backdated documents in an attempt to transform their free calling partners into "end user customers" and their own switching facilities where the chat and conferencing equipment was located into "end user premises."

As described in more detail below, the IUB proceeding, which addresses Iowa *intra*state access charges, is one of many ongoing proceedings currently pending before federal courts and the FCC in which the lawfulness of the LECs' access charge billings in connection with traffic pumping schemes is being litigated. To be clear, AT&T is complying with the FCC's June 2007 declaratory ruling that prohibits call blocking.[3] Rather, AT&T continues to deliver calls associated with the traffic pumping schemes, and, in accordance with the TP LECs' own tariffs and established law, has followed accepted industry practices by disputing the charges and withholding payment pending resolution of those disputes.

Against this backdrop, we respond below to your specific questions.

1. **Is your company currently engaged in any disputes with rural ILECs or other rural carriers over the payment of terminating access charges?**

   a. **If so, please describe the nature and basis of such disputes and provide the Committee with the names of those companies and the total disputed dollar amount at issue in each dispute with each company.**

   b. **Please describe all steps your company has taken in these disputes. For example, is your company currently involved in litigation or regulatory proceedings related to the disputes?**

AT&T is currently involved in a number of access charge disputes with traffic pumping LECs. In 2006 the traffic volumes and corresponding billings of certain LECs located in very rural areas inexplicably began to skyrocket. These rural areas are sparsely populated (often only a few hundred people) and have typical call volumes of only a few thousand minutes per month. Yet, suddenly, and with no explanation, some LECs began billing AT&T for millions – even tens of millions – of minutes per month for calls to these rural areas. Even if every resident of these areas spent every waking minute of every day on long-distance calls, the resulting call volumes still would not even begin to approach the billed call volumes. As just one example, a "competitive" LEC that was supposedly serving customers in very sparsely populated areas on the border of Utah and Nevada suddenly began in April 2006 to bill AT&T terminating access for more than *ten million* minutes of calls in a single month.

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[3] *See* Declaratory Ruling and Order, Establishing Just and Reasonable Rates for Local Exchange Carriers, 22 FCC 2d. 11629, ¶ 5 (2007) ("carriers cannot engage in self help by blocking traffic to LECs allegedly engaged in the [traffic pumping] conduct described herein").

AT&T began investigating these unusual calling volumes and discovered that virtually all of these calls were placed to only a few telephone numbers. AT&T personnel called these numbers and determined that they were associated with so-called "free" chat and conference services, international calling, and other services. Several of the "chat lines" offered obscene and pornographic content and allowed as many as 270 out-of-state callers simultaneously to conduct conversations by calling a single telephone number, typically with the capability for callers to access a "back room" to conduct one-on-one conversations. Other telephone numbers provided "free" international calling by allowing callers to dial an Iowa (or Minnesota, Utah or South Dakota) telephone number and then enter an international telephone number to which the TP LEC would then route the call. At least one TP LEC appeared to be using autodialing equipment to place tens of thousands of calls to both wireless and wireline customers in an attempt to entice them (*e.g.*, by offering commercial credit cards, often *without* the knowledge of the credit card company) to call a telephone number in the TP LEC's local exchange, and when such customers placed those calls, the TP LEC billed terminating access service fees to the long distance carrier that delivered the call. None of the high volume telephone numbers AT&T investigated appeared to be associated with any actual residential or business customers of these LECs. And for each minute associated with these schemes, the TP LECs were billing extremely high access charges, typically 3 to 10 cents/minute (and in one case more than 23 cents/minute).

Upon discovering that these TP LECs were engaged in these traffic pumping schemes, AT&T informed them that it was disputing their charges, and, in early 2007, AT&T initiated litigation in Iowa against many of the TP LECs and calling service providers engaged in these schemes. This was the first of many lawsuits, some initiated by AT&T and/or other interexchange carriers and some initiated by TP LECs. Some of these disputes have since been settled under confidential terms, but others continue to be actively litigated.

In July 2007, the FCC suspended the tariff filings of a number of incumbent LECs suspected of engaging in (or preparing to engage in) traffic pumping, ordering them either to prove that their charges were lawful by providing cost justification or to return to the National Exchange Carriers Association ("NECA") tariff "pool," where they could no longer profitably engage in such schemes (because any earnings would then be shared with the hundreds of other LECs that participate in the NECA pool, making it impossible for the TP LEC to pay the necessary kickbacks to its free calling partners).[4] Although traffic pumping activity by incumbent LECs has fallen off dramatically in the wake of this FCC decision, supposed "competitive" LECs, which operate under different rules, have more than made up the difference – indeed, there are now individual "rural" CLECs that are generating more than 100 million minutes of traffic pumping calls *each month*.

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[4] *See* Order Designating Issues for Investigation, *Investigation of Certain 2007 Annual Access* Tariffs, 22 FCC Rcd. 16109 (2007). The FCC also provided the LECs with a third option under which they were required to add terms to their tariffs that they would immediately and significantly reduce their access rates if their traffic volumes increased significantly, thus significantly reducing incentives to engage in traffic pumping. *Id.*

Federal Court Litigation. Today AT&T is involved in the following federal court lawsuits against traffic pumping LECs: (i) in the Southern District of New York, AT&T is involved in litigation with All American Telephone Company, Chase.Com and E-Pinnacle (all Utah/Nevada CLECs); discovery is ongoing in this dispute that involves approximately $15 million in access billings to AT&T; (ii) in the Southern District of Iowa, AT&T is involved in litigation with Aventure Communications Technology, LLC (an Iowa CLEC); this case, which involves approximately $15 million in access billings to AT&T, is currently stayed pending action by the FCC; and (iii) in South Dakota District Court, AT&T is involved in litigation with Sancom Inc. and Northern Valley Communications, LLC (both South Dakota CLECs); discovery is ongoing in this dispute that involves approximately $25 million in access billings to AT&T.

State Public Utility Commission Proceedings. AT&T is also a party to ongoing proceedings related to the Iowa Utilities Board's September 21, 2009 Order.[5] In that order, the IUB – after more than two years of proceedings that included depositions and document discovery from traffic pumping LECs, thousands of pages of briefing and expert testimony, and live hearings – found that the traffic pumping LECs had "manufacture[d] evidence, after the fact" and "concealed truths from the Board and the FCC" to make it appear that their free calling service partners' ("FCSPs") bridging and other equipment were "end users" and that the LEC central offices where that equipment was located were "end user premises" that justified the billing of terminating access charges for calls to such equipment. *Id.* at 30, 34. The IUB found that, in truth, "none of the FCSCs associated with the [LECs] were end users for purposes of the [LECs'] intrastate exchange access tariffs, none of the intrastate toll traffic associated with the FCSCs terminated at the end user's premises, and much of the intrastate toll traffic associated with the FCSCs did not terminate in the Respondents' certificated local exchange area." *Id.* at 53-54. The IUB thus concluded that "intrastate access charges did not apply to calls to the FCSCs and should not have been billed to the IXCs for calls to numbers assigned to the FCSCs." *Id.*[6]

AT&T is a participant in additional proceedings before the IUB that have been initiated in response to this IUB Order. First, the traffic pumping LECs have filed petitions for reconsideration of the order, and AT&T is opposing those petitions. Second, pursuant to the IUB

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[5] *See, e.g., Qwest v. Superior Tel. Coop.*, Final Order, Docket No. FCU 07-2, at 61-62 (Iowa Utilities Board, Sep. 21, 2009) ("IUB Order").

[6] The IUB was especially troubled by the fact that the LECs had "partnered with FCSCs that provided free calling services for indecent or pornographic content" and that "there were no technological measures in place to protect minors from making calls to access these pornographic services, such as a 1-900 number, which enables parents to place a block on the call." IUB Order At 61-62. The Board found this "lack of any mechanism for parents to regulate their minor children's access to pornographic or indecent services over the telephone is contrary to the public interest." *Id.* In addition, the IUB further found that these traffic pumping schemes led to "other schemes, such as the improper backdating of invoices and contracts, traffic laundering, telephone numbering abuses, and potentially misrepresented universal service fund (USF) certifications." *Id.* at 8.

Order, there are ongoing proceedings to determine the amount of refunds that the Iowa traffic pumping LECs owe to AT&T and other long-distance carriers. Third, the IUB has opened a rulemaking proceeding to adopt rules designed prospectively to discourage traffic pumping.

AT&T is also a participant in proceedings that the Public Service Commission of Utah has initiated to assess whether All American's state authorization should be rescinded. The certificate that Utah granted to All American in 2006 was expressly conditioned on All American's representation that it would not provide service in rural portions of the state. In fact, All American has operated *solely* in the areas it said it would not serve, has no real customers, and has done nothing but engage in traffic pumping.

FCC Proceedings. AT&T is also a party to three ongoing FCC proceedings involving traffic pumping. First, AT&T is opposing frivolous petitions filed by Iowa TP LECs seeking to have the FCC preempt the IUB Order. The IUB Order addressed *intra*state terminating access charges that Congress placed squarely within the jurisdiction of the IUB.

Second, AT&T is participating in a rulemaking proceeding initiated by the FCC in 2007 in response to allegations of traffic pumping to assess the need for rule changes to ensure that "rules governing the tariffing of traffic-sensitive switched access services by local exchange carriers (LECs) are ensuring that rates remain just and reasonable, as required by section 201(b) of the Communications Act of 1934, as amended (the Act)."[7]

Third, pursuant to a referral order by the United States District Court for the Southern District of New York, AT&T has filed a complaint with the FCC against All-American, Chase.Com, and e-Pinnacle for engaging in a scheme to create sham entities solely for the purpose inflating access charges. Under this scheme, an ILEC called Beehive Telephone Company and its traffic pumping partner Joy Enterprises – an adult chat line operator – devised a plan to avoid the FCC rules that would have required Beehive to reduce its access rates to reflect the enormous amount of Joy-related traffic volumes it was generating. The plan was to create "competitive" LECs to bill the access charges for the traffic pumping minutes, so that those additional volumes would not be attributed to Beehive. To accomplish the shift, Beehive and Joy made a few paper changes, such as reassignment of Beehive's telephone numbers and facilities to All American, Chase.Com and e-Pinnacle, so that these CLECs would then bill AT&T for the traffic associated with the Beehive/Joy traffic pumping schemes. As AT&T's complaint explains, it has long been settled that creating "a company that purport[s] to be a bona fide carrier but which instead [is] simply a sham creation, designed to facilitate an arrangement among several entities to capture access revenues that could not otherwise be obtained by lawful tariffs" is an unjust and unreasonable practice that violates the Communications Act.[8]

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[7] Notice of Proposed Rulemaking, *Establishing Just and Reasonable Rates for Local Exchange Carriers*, 22 FCC Rcd 17989, ¶ 1 (2007).

[8] *AT&T and Sprint Petitions for Declaratory Ruling on CLEC Access Charge Issues*, 16 FCC Rcd. 19158, ¶ 22, n.33 (2001) ("*CLEC Access Declaratory Ruling*"); *see Establishing Just and Reasonable Rates for Local Exchange Carriers*, 22 FCC Rcd. 11629, ¶ 6 n.20 (the

2. Has your company withheld payment of access charges relating to disagreements about the appropriate rate?

a. If so, when did your company begin withholding payments and how much was withheld or is being withheld from whom?

As permitted by established FCC precedent and the TP LECs' tariffs, AT&T has disputed and withheld payment of certain access charge billings associated with traffic pumping.[9] AT&T is currently withholding payment of terminating access charges from the following TP LECs: All American Telephone Company (as of April, 2006), Aventure Communications Technology (as of October, 2006), Chase.Com (as of April, 2006), E-Pinnacle (as of April, 2006), North County (as of September, 2008), Northern Valley Communications (as of January, 2008), Sancom (as of January, 2008), Spencer Municipal Communications Utility (as of January, 2008), and Capital Telephone Company (as of July 2007). The total amount of disputed charges that AT&T has withheld pending resolution of the disputes is approximately $60 million as of September 30, 2009.

3. What do you estimate the actual cost of terminating traffic to be on a per minute basis?

Although traffic pumping LECs have not disclosed their costs associated with their traffic pumping schemes, the public filings of NECA confirm that, to the extent they incur any costs at

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Commission has "found that an arrangement between a chat line service provider and competitive access provider (formed by an ILEC for purposes of the arrangement) that did not provide local exchange service and had no customers other than the chat line was a sham"); *AT&T Corp.* v. *FCC*, 317 F.3d 227, 233 (D.C.Cir. 2008) ("the entire arrangement was devised solely in order to circumvent regulation . . . [and] deserves to be treated as a sham").

[9] It is well established that the "responsibility for correct billings remains with the carriers" providing the service, *e.g., Tele-Valuation, Inc.* v. *AT&T Corp.*, 73 F.C.C.2d 450, ¶ 8 (1979), and that access customers are not obligated to pay for tariffed services that were not actually provided. *See, e.g., Iowa Network Servs., Inc.* v. *Qwest*, 385 F.Supp. 2d 850, 903-04 (S.D. Iowa 2005), *aff'd* 466 F.3d 1090 (8th Cir. 2006) (carrier under no obligation to pay where services were not provided under a "valid and applicable tariff"). Certain TP LECs have claimed that prior FCC decisions have held that it is illegal "self-help" to withhold payment for tariffed services, but those decisions arose in circumstances where, unlike here, it was undisputed that the tariffed services were actually provided and properly billed pursuant to an applicable tariff. *See, e.g., Business WATS, Inc.* v. *AT&T*, 7 FCC Rcd. 7942, ¶ 2 (1992). Indeed, the TP LECs' tariffs expressly contemplate that an access customer may withhold payment of terminating access charges pending the resolution of a dispute over whether service has been provided and charges have been properly assessed, *see, e.g.*, Northern Valley Commc'ns L.L.C., F.C.C. Tariff No. 2, § 2.4.1(D)(4) (effective Nov. 16, 2004), and the language in these tariffs is indistinguishable from the language in other tariffs that the FCC has authoritatively interpreted, concluding that "a customer may withhold payment of disputed charges pending resolution of the dispute." *See AT&T v. Beehive*, 17 FCC Rcd. 11641, ¶ 26 & n.91 (2002).

all, the per minute costs incurred by traffic pumping LECs (even accounting for a reasonable return) to deliver traffic to the bridging equipment of their free calling partners is exceedingly small (and certainly much less than one tenth of a penny per minute).

NECA represents rural ILECs subject to FCC cost of service regulation. Pursuant to the FCC's rules, NECA makes annual filings with the FCC that report the costs of its member ILECs. The highest cost annual report submitted by NECA ("Band 8") reports the costs and computes rates for the smallest rural ILECs. As of June 2009, there were 490 rural ILECs represented in the Band 8.[10] These ILECs have an average of 1,500 lines[11] serving widely dispersed residential and business customers that generate an average of less than 500 minutes of exchange access traffic per month per line.[12]

Based on this network cost structure – one designed to serve widely dispersed residential and business customers that make relatively few calls – NECA has developed a per minute access rate that allows Band 8 ILECs to recover these costs plus an 11.25 percent return. To compute these rates, NECA estimates the average cost of the switches, lines, and other infrastructure used by such LECs to serve their residential and business customers and spreads those costs over the total number of annual access minutes that Band 8 ILECs are expected to serve, which for 2009 is 3.5 million minutes.[13] Based on these calculations, NECA reported to the FCC in 2009 that Band 8 LECs must charge about 3.3 cents per minute to recover their

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[10] *See* National Exchange Carrier Association, Inc., Access Service Tariff F.C.C. No. 5, Transmittal NO. 1245, (filed with the FCC, June 15, 2009).

[11] The most recent publicly available report showing the number of lines for NECA band 8 ILECs is for 2007 from a report filed on Sep. 30, 2008 (*see* NECA's Overview of Universal Service Fund, USF08AF.ZIP, available at http://www.fcc.gov/wcb/iatd/neca.html). The 2009 report has not yet been submitted to the FCC. However, the line counts are not likely to change significantly because the number of lines served by band 8 ILECs has historically varied very little.

[12] To compute the average monthly minutes per line for Band 8 LECs, AT&T divided the total number of minutes generated by Band 8 ILECs in 2008 as reported by NECA (*see* Network Usage by Carrier, Annual submission by NECA of Access Minutes of Use, NETWU08.ZIP, available at http://www.fcc.gov/wcb/iatd/neca.html) by 12 (to obtain average monthly minutes) and then AT&T divided that amount by the number of lines for Band 8 LECs.

[13] To compute the average minutes per year for Band 8 LECs, AT&T divided the total number of minutes generated by Band 8 ILECs in 2008 as reported by NECA (*see* Network Usage by Carrier, Annual submission by NECA of Access Minutes of Use, NETWU08.ZIP, available at http://www.fcc.gov/wcb/iatd/neca.html) by the total number of NECA members reported by NECA as of June 2009 (*see* National Exchange Carrier Association, Inc., Access Service Tariff F.C.C. No. 5, Transmittal NO. 1245 (filed with the FCC, June 15, 2009)).

facilities costs and earn an 11.25 percent return.[14] This is the rate "mirrored" by many so-called rural CLECs that are engaged in traffic pumping.

Given these calculations, it is clear that, even if traffic pumping LECs had the same cost structure as the Band 8 NECA ILECs (in fact, as shown below traffic pumping LECs' incur much, much lower costs to the extent they incur any real costs at all), the per minute rates that traffic pumping LECs need to recover those costs would be a tiny fraction of the NECA rate. Whereas Band 8 LECs must spread their costs over an average of only about 3.5 million minutes per year, the pornographic chat and other services offered by traffic pumpers routinely generate that much traffic each *month* (and often much more). A traffic pumping LEC with typical NECA band 8 cost structure that generates monthly volume of 3.5 million minutes could recover its costs and a reasonable return by charging less than one third of a cent per minute.[15]

But even that greatly overstates the rate needed by TP LECs to recover their costs and earn a return, because the cost structure for TP LECs is not remotely similar to that of Band 8 ILECs. Whereas Band 8 ILECs have built out actual network infrastructure with lengthy wire "loops" buried or strung on poles to serve hundreds of widely dispersed residences and businesses located in their services areas, many TP LECs have built virtually nothing to serve their free calling partners. Rather, such LECs typically co-locate bridging and other equipment in the central office near the switch, so that connecting their partners' equipment requires only few feet of cables. Some traffic pumpers even avoid the cost of the switch by collocating their traffic pumping equipment in a central office of another LEC and by relying on that other LEC's switch to direct their traffic pumping calls to their equipment. Consequently, the costs that traffic pumping LECs must recover through their per minute rates are only a tiny fraction of the costs that must be recovered by Band 8 ILECs, which means that the actual per minute rates that traffic pumping LECs need to recover their costs are extremely small, and certainly well below a tenth of a penny per minute.

4. Do you charge other carriers to terminate traffic on your network? If so, how much do you charge for terminating access on a per minute basis? If you charge different rates in different areas, please provide a range of charges.

AT&T provides and charges others for both interstate and intrastate terminating access services, as follows:

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[14] *See* National Exchange Carrier Association, Inc., Access Service Tariff F.C.C. No. 5, Transmittal NO. 1245, Vol 5, Exhibit 12, Workpaper 1 of 12 (filed with the FCC, June 15, 2009).

[15] As the FCC has pointed out, the additional costs of serving more minutes are very low or zero. *See, e.g.,* Notice of Proposed Rulemaking, *Establishing Just and Reasonable Rates for Local Exchange Carriers,* WC Docket No. 07-136, ¶ 14 (released Oct. 2, 2007) ("It is well established that there is a large fixed cost to purchasing a local switch and that the marginal or incremental cost of increasing the capacity of a local switch is low (some contend that it is zero.").

Within AT&T's 22 state franchise service areas, AT&T operates both as an ILEC and, to a limited extent, as a CLEC. AT&T's interstate rates are governed by federal law. AT&T's ILEC per minute interstate terminating access rates, for example, are governed by the FCC's "CALLS Order."[16] AT&T's intrastate access charges are subject to applicable state laws. Some states require that AT&T's intrastate terminating access rates mirror its interstate rates, and other states provide for different intrastate access rates. Overall AT&T's statewide average per minute terminating access charges within AT&T's franchise service areas fall within the range of about a tenth of a penny up to about a half a penny per minute.

Outside of AT&T's franchise territory, AT&T operates only as a CLEC. Rates vary by and within states. Overall, AT&T's statewide average per minute terminating access charges outside of AT&T's franchise area range from about four tenths of a penny to about 1.3 cents per minute.

5. How much do you receive annually in terminating access charges?

The total amount of terminating access charges that AT&T ILECs and CLECs receive can depend upon many factors. For the calendar year 2008 the AT&T ILECs and CLECs provided, in total, between $700 million and $800 million in per minute terminating access services to their access customers to allow them to complete calls over AT&T's local telephone networks that provide wireline connections to tens of millions of residences and businesses.

6. How much do you pay to others in terminating access charges?

The total amount of terminating access charges that AT&T pays to others can depend upon many factors. For the calendar year 2008 AT&T paid to others between $700 million and $800 million in per minute terminating access charges.

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We trust that the foregoing information aids in your understanding of these issues. We respectfully suggest that, to ensure that you have a comprehensive view of the ways in which the legacy access charge regime suffers from and enables fraud and abuse, you not limit your inquiry by focusing on either the providers of end-user calling services, such as Google Voice, or the LECs that engage in traffic pumping schemes. Calling services like Google Voice, MagicJack and Speakeasy are enabled by wholesale transport providers partners like Bandwidth.com and YMax. These transport providers play an increasingly central role in the transiting of traffic, but the manner in which they assess and pay access charges is often unclear and potentially inconsistent with existing rules and limitations; therefore, they, too, deserve your thoughtful attention. For instance, it would be helpful to understand whether, in connection with Google Voice, Bandwidth.com or any other CLEC assesses originating or terminating switched access on calls in-bound to a Google Voice number or on 8YY toll-free calls placed by a Google Voice

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16 Sixth Report and Order, Access Charge Reform, *Price Cap Performance Review for Local Exchange Carriers*, 15 FCC Rcd. 12962 (2000).

user and, if so, whether the assessment is for the entire duration of the calls, which network facilities are used in each circumstance, and what, if any, access functions are actually performed. This type of information would better inform you, the FCC and other stakeholders regarding the best way to guard against further abuses of the access charge framework. In this regard, it is important to understand the disproportional impact of traffic pumping on inter-exchange carriers such as AT&T given that providers such as Google Voice, MagicJack and Speakeasy take the position that they are not subject to the FCC order prohibiting the blocking of calls to high cost rural areas.

Please let me know if we can be of further assistance in connection with these matters.

Sincerely,

cc: The Honorable Joe Barton, Ranking Member
The Honorable Cliff Stearns, Ranking Member
Subcommittee on Communications,
Technology, and the Internet
The Honorable Greg Walden, Ranking Member
Subcommmittee on Oversight and
Investigations

STATES WITH INTRASTATE/INTERSTATE ACCESS PARITY

States that Mandate Intrastate/Interstate Parity by Statute for Certain Carriers

Six states have mandated reduction of intrastate access rates to interstate rate levels by statute, and some have also directed the state utilities commission to ensure compliance through further proceedings and tariff oversight. These states are listed below with a summary of relevant state activities.

Maine: In Maine, the legislature ordered the commission to ensure intrastate mirroring of interstate switched access rates: "By May 31, 2005, the commission shall insure that intrastate access rates are equal to interstate access established by the Federal Communications Commission as of January 1, 2003."[1] The Maine public utilities commission implemented the statutory directive by adopting a rule requiring each local exchange carrier to implement access mirroring by June 1, 2003, and to refresh the mirrored rates on June 1 every two years thereafter.[2]

Texas: The Texas legislature established interstate-intrastate access parity with a directive to incumbent local exchange companies to "reduce both the company's originating and terminating per minute of use switched access rates in each market to parity with the company's respective federal originating and terminating per minute of use switched access rates" on the date the last market of that incumbent carrier is deregulated.[3] The statute also requires a "transitioning ILEC" – an ILEC for which at least one, but not all, of its markets has been deregulated – that has greater than 3 million access lines, to reach parity after a phased reduction.[4] The statute further requires incumbent carriers that have established parity to maintain parity on an ongoing basis for all switched access rates.[5] Importantly, in order to prevent abusive CLEC access rate practices, the statute further requires all CLECs to charge switched access at rates no higher than (a) the prevailing rates charged by the incumbent carrier serving that area; or (b) a statewide average ILEC composite switched access rate as calculated by the state commission.[6]

Other statutory provisions, however, shield certain ILECs from the requirement to reduce intrastate access charges to parity with interstate rates. Specifically, "transitioning" ILECs with fewer than 3 million access lines and "newly designated transitioning" ILECs are governed by

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[1] Maine Revised Statutes Annotated, Title 35-A, Chapter 71, sec. 7101-B Access Rates (effective May 2, 2003).

[2] Code of Maine Rules, 65-407 Ch. 280, section 8B (current through Aug. 2008).

[3] V.T.C.A., Utilities Code, sec. 65.201(a).

[4] V.T.C.A., Utilities Code, sec. 65.202(a).

[5] *Id.* at sec. 65.201(b) & 65.202(b).

[6] *Id.* at sec. 52.155 (and allows for higher rates only upon commission approval).

other rate reduction provisions that could lead to parity with interstate rates but do not mandate parity. Transitioning carriers are subject to phased rate reductions, but are required to reach parity only when 75% of their exchanges are deregulated by the Commission.[7] In addition, there are statutory provisions that permit certain ILECs (primarily small and rural companies) to elect incentive regulation under Chapter 59 of the Public Utility Regulation Act. ILECs electing incentive regulation under Chapter 59 are not subject to the requirement that intrastate access be reduced to parity with interstate rates.[8]

Oklahoma: Oklahoma by statute requires each local telecommunications service provider serving 15% or more of the access lines in the state to maintain intrastate switched access tariffs "in parity with the *terms and conditions* of the interstate access tariffs of that company," and to ensure on an ongoing basis to "maintain the terms and conditions of the intrastate access tariffs of that company so that they are in parity with the terms and conditions of the interstate tariffs of that company."[9] There is no current parity requirement for Switched Access *rates* for Oklahoma. Oklahoma had previously required mirroring until certain revenue reduction targets had been met.[10] Oklahoma carriers will no longer be required to flow through any access reductions effective July 1, 2009.

Michigan: The Michigan Telecommunications Act requires local carriers with more than 250,000 access lines to establish intrastate MOU access rates that do not exceed their interstate counterparts in order to be considered "just and reasonable.[11] Currently, AT&T Michigan and Verizon (soon to be Frontier) are the only local carriers that meet this threshold.

Indiana: By statute, Indiana provides that in any proceeding before the state commission, including any interconnection agreement or statement of generally available terms and conditions, "the commission shall consider the provider's rates and charges for intrastate access service to be just and reasonable if the intrastate rates and charges mirror the provider's interstate rates and charges."[12] The Indiana commission has approved parity arrangements over the years both for large and small incumbent local exchange companies.[13]

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[7] V.T.C.A., Utilities Code, secs. 65.203 & 65.204.

[8] V.T.C.A., Utilities Code, secs. 59.025 (Commission cannot reduce the switched access rates of carriers electing infrastructure commitment under Chapter 59).

[9] 17 Oklahoma Statutes sec. 17-139.103.D.4 (1997).

[10] Id. at 3.

[11] Michigan Compiled Laws, chap. 484.2310, sec. 310(2) (1991).

[12] Indiana Code chap. 8-1 -2 .6. sec. 1.5 (c) (2) (2006).

[13] *See, e.g.,* Re: Universal Service Reform. Cause No. 42144.2004 W.L. 1170315 at par.38. *See also, Re: Indiana Bell Telephone Company. Inc.*, Cause No. 42405 (2004 WL 2309824 at par.22) (continuing mirroring of Indiana Bell intrastate and interstate switched access rates).

Georgia: By statute enacted in 1995, Georgia required all Tier 1 and Tier 2 local exchange carriers to reduce their switched access rates to interstate levels. The statute mandates for Tier 1 carriers that "The rates for switched access ... shall be no higher than the rates charged for interstate access by the same local exchange company."[14] Based on this requirement, AT&T (the only Tier 1 carrier in Georgia), must maintain parity between its intrastate and interstate switched access charges. The statute required Tier 2 carriers to reduce, by July 1, 2000, their intrastate rates to parity with their July 1, 1995 interstate rates.[15]

New Mexico: The legislature in 2005 amended the Rural Telecommunications Act of New Mexico to require intrastate switched access rates to mirror interstate rates.[16] Current commission administrative rules implementing the legislation provide that effective January 1, 2008, "a local exchange carrier's intrastate switched access charges may not exceed the interstate switched access charges approved by the federal telecommunications commission as of January 1, 2006, and its intrastate switched access elements and structure shall conform to the interstate switched access elements and structure approved by [the FCC)]."[17] The rules also provide a mechanism to require carriers to continue to mirror updated interstate switched access rates.[18]

States that Mandate Intrastate/Interstate Parity by Statute, but Directly or Indirectly Tie Access Reform to a Carrier's Plan for Alternative Regulation/Price Regulation

Two states establish intrastate-interstate switched access parity by statute, but tie the reduction to parity to a participating local exchange carrier's plan for alternative regulation. This approach generally produces, at a minimum, a revenue-neutral event.

Kansas: Kansas statutes provide for reduction of switched access rates to interstate levels, with corresponding allowances for increases in retail local exchange rates: "Subject to the Commission's approval, all local exchange carriers shall reduce intrastate access charges to interstate revels as provided herein. Rates for intrastate switched access, and the imputed access portion of toll, shall be reduced over a three-year period with the objective of equalizing interstate and intrastate rates in a revenue neutral, specific and predictable manner. The Commission is authorized to rebalance local residential and business service rates to offset the intrastate access and toll charge reductions."[19] While Kansas does not necessarily tie access rate reductions to a participating local exchange carrier's plan for alternative regulation, any

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[14] Ga. Code Ann. sec. 46-5-166(f)(1)(1995).

[15] *Id.* at (f)(2).

[16] NMSA Sections 63-9H-1 et seq. (2005, amending 1978 law).

[17] N.M. Admin. Code 17. 11.1 0.8(C) (2005).

[18] *Id.* at 17. 11. 10.8(I).

[19] Kansas Code chap. 66. Sec. 66-2005(c)(1996).

reductions are subject to the Commission's approval. The Kansas Corporation Commission is expected to rule by the end of the year in a docket considering whether to reduce Embarq's intrastate access rates to parity with its interstate rates.

Wisconsin: Wisconsin statutes establish a system for local exchange companies to elect price regulation, and for price-regulated local companies to reduce intrastate access rates to interstate levels.[20] Price-regulated local exchange carriers with more than 150,000 local lines are directed that "Intrastate access service rates ... may not exceed the utility's interstate rates for similar access services."[21] The directive includes eliminating half of all carrier common line charges within one year, a prohibition against reinstating these charges, and elimination of all carrier common line charges within the earlier of two years or authorization to provide interLATA services.[22] The statute provided a more graduated scale for access reductions for carriers with fewer than 150,000 lines.[23]

Wisconsin's statutes also establish a system to allow a telecommunications utility to file for approval of an alternative regulation plan ("ARP").[24] The statute lists factors that the Commission must assess in considering an ARP, but there is no specific requirement regarding intrastate switched access charge reductions. Carriers typically include such reductions in their plans, but the reductions are not required to establish parity with interstate rates. Typically, these rates are set with reference to benchmarks the Commission established in a 1993 proceeding.

Only Verizon and AT&T have elected price regulation and, therefore, these are the only carriers subject to the state's mirroring requirement. All other independent companies are either regulated through the terms of their alternate regulation plan or have retained rate of return regulation.

States That Mandate Intrastate/Interstate Parity or Cost-Based Pricing by Commission Order, Rule or Tariff, Including Where Subsequently Modified

Nine state commissions have instituted mirroring or near-mirroring of interstate switched access rates for local exchange carriers, although two have subsequently modified this approach. These states generally permit carriers to implement some form of alternative price regulation to ensure revenue neutrality.

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[20] *See generally*, Wis. Stat. Ann. 196. 196.

[21] *Id* at 196.196(2)(b)1.

[22] *Id.* at 196.196(2)(b)1-3.

[23] *Id.* at 196.196(2)(b)3.(c).

[24] Wis. Stat. Ann. 196.195(12).

Alabama: In 1995, the Alabama Public Service Commission allowed South Central Bell to elect price regulation with various conditions, including requiring South Central Bell to maintain intrastate access charges at a level not to exceed interstate access rates for a period of five years. After expiration of the five year period, South Central Bell was required to continue to cap these rates at "the lower of the intrastate rates in effect on July 1, 1999, or the effective interstate prices and structures approved by the FCC."[25] Subsequently, in December 2004, the Commission adopted a Price Flexibility Plan for BellSouth that capped BellSouth's combination of the traffic sensitive per minute charge for originating and terminating switched access service at the then "effective intrastate level (including any non-traffic sensitive rate elements)."[26]

The Price Flexibility Plan for ILECs is the same as BellSouth's for intrastate switched access rates. The Price Flexibility Plan for Large CLECs and the Small CLECs/Toll Service Provider Streamlined Regulation Plan do not address switched access services.

Ohio: ILECs in Ohio have been required by the Ohio Public Utilities Commission to mirror their federal access rate structure for intrastate switched access rates, a policy in place since 1987.[27] In 2007, the Commission reiterated its support for earlier orders requiring the four largest incumbent local exchange carriers to mirror their then-current interstate switched access rates for intrastate access services.[28] At the same time, the Commission also ordered competitive local exchange carriers to mirror their respective interstate rates.[29] Note that the Commission has made an exception to the mirroring requirement with respect to the CCLC. The Commission capped the intrastate CCLC at 1987 levels. Nonetheless, Ameritech, CBT and Verizon have taken steps to reduce or eliminate the intrastate CCLC due to merger conditions and alternative regulation plans. ILECs other than the four largest incumbents mirror interstate rates that were in effect a decade ago.

Illinois: The Illinois Commerce Commission ("ICC") has aggressively reduced intrastate switched access rates. In 2000, the ICC ordered the larger incumbent local carriers to remove all non-cost-based rate elements from intrastate switched access rates, and also to reduce all remaining cost-based access rate elements to their underlying long run service incremental costs,

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[25] *In Re Petition of South Central Bell Telephone Company to Restructure its Form of Regulation, etc.,* Docket Nos. 24499, 24472, 24030, 24865, Report and Order, September, Ala. P.S.C. (1995) at par. 9.03.

[26] *In Re Proposed Revisions to the Price Regulation and Local Competition Plan*, Docket No. 28590, Order Approving Alabama Telecommunications Regulation Plan, December, Ala. P.S.C. (2004) at Appendix A, page 9, section 7.C.

[27] *In Re Modification of Intrastate Access Charges*, Case No. 00-127-TP-COI, Opinion and Order, (2001 WL 283031) at par. 2, citing *In the Matter of the Commission's Investigation Relative to Establishment of Intrastate Access Charges*, Case No. 83-464-TP-COI, Subfile C (Mary 21, 1982 and March 12, 1987).

[28] *In the Matter o/the Establishment of Carrier-to-Carrier Rules,* Case No. 06-1344-TP-ORD, Entry on Rehearing, Ohio P.U.C.(2007), at par. 29, p. 18.

[29] *Id.*

plus a reasonable allocation of shared and common costs.[30] Illinois intrastate switched access rates appear to be at or below interstate rates based on tariff filings.

The mid-size carriers are under rate-of-return regulation and generally try to mirror interstate rates. Proposed changes to the small independent companies' switched access rates are subject to the ICC's jurisdiction upon carrier complaint. CLECs are not subject to a mirroring requirement; their switched access rates are subject, however, to a statutory "just and reasonable" standard.

Massachusetts: The Massachusetts Department of Telecommunications and Energy established intrastate mirroring of interstate switched access rates in 2002, while also allowing for retail rate rebalancing: "Currently, intrastate switched access charges are higher than interstate switched access charges. This creates a situation where it could cost more for Massachusetts customers to make a call across the state than it does to make a call across the country. The Department concludes that this is inefficient. .. [T]herefore, intrastate switched access charges will be lowered to the more cost-based interstate levels."[31] In noting that the access revenues should be made up by retail rate increases, the Department also stated that "experience has shown that such rate-rebalancing enhances efficiency without negatively impacting universal service."[32]

In an order issued June 22, 2009, the Department of Telecommunications and Cable directed that all CLEC intrastate switched access rates be established at or below Verizon's intrastate switched access rates, which, in turn, are required to be set at the levels of Verizon's intrastate switched access rates. The Department required that CLEC rates would be capped at Verizon's rate effective one year from the date of its Order.[33]

Kentucky: In 1995, the Kentucky Commission approved a price regulation plan for BellSouth that required BellSouth to implement switched access rates that mirrored analogous interstate access rate elements.[34] The Commission later stated that its earlier Order "clearly and

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[30] *Illinois Commerce Commission, On Its Own Motion vs. Illinois Bell Telephone Company et al. Investigation Into Non-Cost Based Access Charge Rate Elements in the Intrastate Access Charges of Incumbent Local Exchange Carriers in Illinois, etc.,* 97-0601, 97-0602 and 97-0516 (March 29, 2000), at 46 through 50.

[31] *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. etc.,* 2002 Mass. PUC Lexis 10 (May 8, 2002), at 36.

[32] *Id.*

[33] *Petition of Verizon New England, Inc., et al for Investigation under Chapter 159, Section 14 of the Intrastate Access Rates of Competitive Local Exchange Carriers*, D.T.C. 07-9, Final Order, released June 22, 2009.

[34] *Application of BellSouth Telecommunication, Inc., d/b/a South Central Bell Telephone Company to Modify Its Method of Regulation,* Case No. 94-121 (1995), Order; 1995 WL 135116 Ky. 1628 (1999), 1999 WL 135116 (Neb. P .S.C.), at 7. The Commission initially exempted the PICC and TIC for originating access and capped terminating rates at the levels of originating rates. The Commission also gave guidelines for residential and

unequivocally required mirroring of interstate access rates as the FCC changed access rates," and required mirroring rates to be effective no later than 30 days after the FCC changed interstate rates.[35] The Commission in later years approved further access reductions for BellSouth and Cincinnati Bell, citing public interest benefits associated with removing economically inefficient subsidies.[36]

In July 2006, statutory revisions effectively changed this regulatory scheme. Current statutory provisions permit telephone utilities the option to elect a price regulation plan as described within the statute.[37] Under price regulation, an electing utility's rates for intrastate switched-access service "shall not exceed its rates for this service that were in effect on the day prior to the date the utility filed its notice of election."[38] Accordingly, Kentucky's switched access rates are capped and no longer need to mirror interstate rates. AT&T-KY filed notice of its price regulation plan election on July 12, 2006.

Oregon: In 2001, the Commission approved a Qwest rate rebalancing plan that provided substantial access reform. The Commission required Qwest to reduce switched access rates by decreasing the local switching rate and eliminating the carrier common line charge, a move calculated to "bring Qwest's intrastate switched access rates closer to its currently lower interstate switched access rates ... an equitable development with respect to consumers . . ."[39]

Tennessee: BellSouth Telecommunications Inc. ("BellSouth") agreed to reduce intrastate switched access charges to achieve parity between intrastate and interstate switched access rates that existed as of August 1, 1995 under agreement with certain interexchange carriers operating in Tennessee. This agreement was never filed with nor approved by the Tennessee Regulatory Authority ("TRA"). On January 31, 1997, BellSouth filed with the TRA a tariff to implement the first step of these reductions. The TRA initiated a docket to consider this tariff filing,[40] and issued an Order approving BellSouth's tariff as filed.[41] The TRA also approved all subsequent tariff filings made to reduce rates under the agreement with IXCs.

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business rate rebalancing initiatives. *Id.* at 5.

[35] *Telecomm, Inc.'s Application to Restructure Rates,* Case No. 97-074, Neb. P.S.C. (1997). *See also,* Tariff Filing of BellSouth Telecommunications, Inc. to Mirror Interstate Rates, Case No. 98-065 (1999).

[36] *See, e. g., Review of BellSouth Telecomm, Inc.'s Price Regulation Plan,* Case No. 99-434 Ky. P.S.C. (2000), at 5.

[37] Ky. Rev. Stat. 278.543.

[38] *Id.* at 278.543(4).

[39] *Re: Qwest Corporation, UT 125/Phase II,* Order No. 01-810, 213 P.U.R. 4th 78 (2001).

[40] *In Re: Tariff Filling by BellSouth Telecommunications. Inc. to Reduce Intrastate Access Charges.* Docket No. 9700185. Ten. R.A. (1997).

[41] *Id.* The TRA's Order also required "the long distance companies certified to provide service within Tennessee to file tariffs as described in (TRA) Rule 1220-4-.55(2)(d). That rule requires the long distance companies to flow-through this access reduction to ratepayers in the form of lower long distance rates."

West Virginia: By Order of the Commission in March of 2007 approving Verizon's Market Transition Plan ("MTP"), Verizon will eliminate the carrier common line charge from its intrastate switched access rates and mirror interstate traffic-sensitive switched access rates over a phase-in period through year-end 2010. Verizon will be granted pricing flexibility for basic local exchange services commensurate with the revenue reductions attributable to switched access decreases. At the conclusion of the phase-in period, all Verizon intrastate switched access rates are expected to mirror interstate rates.[42] A recent ALJ Recommended Decision, if adopted by the Commission, will require CLECs to mirror Verizon's intrastate rate by year-end 2010 as well.[43]

States that by Tariff Establish Intrastate Access Rates Near Parity with Interstate Rates

LECs in two states have established by tariff intrastate switched access rates that are virtually at parity with corresponding interstate rates.

Mississippi: The BellSouth (AT&T) terminating intrastate access charges "are currently at parity with the FCC interstate rates and will be adjusted annually subject to a cap at parity."[44] The intrastate rates in total for a two-ended call are marginally higher than interstate rates ($0.0095 intrastate vs. $0.0088 interstate). The commission first ordered BellSouth to mirror intrastate and interstate switched access rates as part of a 1995 price regulation docket. The mirroring requirement remained in place as part of the 2002 price regulation proceeding and again following the 2006 deregulation proceeding. BellSouth (AT&T) is the only LEC currently required to mirror intrastate and interstate switched access rates.

North Carolina: The current BellSouth per-minute, two-ended intrastate access rate is almost identical to interstate rates at $0.0092, compared with an interstate rate of $0.0088.[45]

Nevada Requires That Intrastate Switched Access Rates Be Consistent With Federal Law

The rates, terms and conditions for switched and special access services are currently regulated in Nevada and must be consistent with federal law.[46] Carriers may reduce switched access

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[42] *Petition for Approval of Joint Stipulation and Agreement for Settlement and Joint Petition for Expedited Approval of a Joint Stipulation for a Market Transition Plan for Verizon West Virginia Inc.,* Case No. 06-1935-T-PC., W.V.P.S.C. (2007).

[43] *Petition of Verizon West Virginia Inc. et als.,* Case No. 08-0656-T-GI (March 4, 2009).

[44] BellSouth Telecommunications, Inc. Mississippi, Access Services Tariff, effective January 1, 2008.

[45] *See generally,* BellSouth Access Services Tariff, sec. E.6, for Mississippi, North Carolina, Alabama, South Carolina and Florida.

[46] Nevada Revised Statutes 704.68873.

charges to parity with the associated interstate switched access rates without a rate proceeding. The Public Utilities Commission of Nevada may deregulate switched access services provided by a competitive supplier (AT&T Nevada is one) upon its own motion or acting upon a carrier petition.[47]

[47] Nevada Revised Statutes 704.68879.