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Arizona Corporation Commission
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BEFORE THE ARIZONA CORPORATION COMMISSION

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1996 CONSOLIDATED COST ARBITRATION

IN THE MATTER OF THE PETITION OF MCIMETRO ACCESS TRANSMISSION SERVICES, INC. FOR ARBITRATION WITH US WEST COMMUNICATIONS, INC. OF INTERCONNECTION RATES, TERMS, AND CONDITIONS PURSUANT TO 47 U.S.C. §252(b) OF THE TELECOMMUNICATIONS ACT OF 1996

Docket Nos. U-3175-96-479
E-1051-96-479

CONSOLIDATED WITH:
U-2428-96-417
E-1051-96-417
U-2752-96-362
E-1051-96-362
U-3016-96-402
E-1051-96-402
U-3021-96-448
U-3245-96-448
E-1051-96-448
U-3009-96-478
E-1051-96-478
U-2432-96-505
E-1051-96-505
U-3155-96-527
E-1051-96-527

REPLY BRIEF OF

MCIMETRO ACCESS TRANSMISSION SERVICES, INC.

I. INTRODUCTION

The Arbitrators should adopt the Hatfield study and resultant prices for unbundled network elements and interconnection and should adopt MCI's avoided cost discount of 22.5%. The MCI proposal is consistent with Telecommunications Act of 1996 and relevant FCC orders and will encourage competition. The adoption of USWC's

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pricing proposal will result in burdening new entrants with USWC cost inefficiencies and will discourage and defer the emergence of effective competition in Arizona and the benefits the public derives from competition.

II. PRICING FOR UNBUNDLED ELEMENTS, INTERCONNECTION AND COLLOCATION

USWC focuses its argument in its Closing Statement on the inputs into the Hatfield Model. USWC criticizes the Hatfield inputs and maintains that the inputs used in preparing the USWC cost studies and resultant prices should be used by the Arbitrators. In comparing the inputs of USWC to those in the Hatfield study, the Arbitrators must note that USWC bears the burden of proof with respect to all issues of material fact. USWC has not met this burden of proof. Its "black box" cost studies certainly do not provide adequate, verifiable support for its proposed prices. Three examples from USWC's Closing Statement illustrate this point.

USWC argues that its inputs are better because they use Arizona information. (USWC Closing statement at p. 6). There is a significant flaw in using certain USWC Arizona historical data. USWC's historical data is not based on the operations of a company facing competition and free of substantial regulatory intervention. The data is derived from a monopoly operating in a heavily regulated environment in which it can pass its costs on to its customers through rate cases. Consequently, USWC's historical operations have limited value as inputs into a model which attempts to identify the TELRIC of unbundled elements and interconnection. Moreover, USWC's "historical data" often is based on the entire 14 state USWC region, not just Arizona. Ironically, where the use of Arizona data is required (*i.e.* cost of capital and depreciation), the Hatfield Model uses Arizona state specific inputs and USWC does not.

Another example of USWC's failure to meet its burden of proof is sharing of structure. USWC calculates sharing based in large part on USWC's actual experience and past ability to share structure. (USWC Closing statement pp. 12-13). It is not

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appropriate to use USWC's history as indicative of the likely extent of sharing on a forward looking basis. The extent of sharing to assume on a forward looking basis is likely to be greater than USWC's historical experience for at least two reasons.

First, the advent of new technologies and innovative applications for telecommunications, the growth and demand for telecommunications services and institutional changes such as the Telecommunications Act, all lead to a larger number of companies seeking connections for their customers. Each of these customers is a potential sharer of structure. At least some of these new carriers will prefer the greater coordination and control that comes from owning facilities. This decision to own facilities creates the potential for sharing structure and this potential is likely to increase in the future. (MCI Exhibit 6, p. 10, lines 7-20).

The second reason sharing is likely to increase arises from the incentives of a competitive, as compared to a regulated monopoly, market. Both regulation and monopoly alter incentives in ways that are likely to reduce sharing, and sharing can therefore be expected to increase as regulation and monopoly both diminish. Regulation minimizes the monopolist's incentive to minimize costs and, at worst, creates a positive incentive to incur greater costs. If regulation gives a company the impression that the incurrence of costs creates an entitlement to future recovery, the firm will be, at best, indifferent to opportunities for sharing structure. Rate of return regulation creates an incentive to increase profits by collecting an allowed rate of return on a larger rate base. These effects will lead a monopolist to fail to attach significant importance to opportunities for structure sharing as a means to reduce costs. (MCI Exhibit 6, pp. 10-11).

USWC, as a monopolist, will evaluate the sharing of structure with competitors differently than would a competitive firm. Since a monopoly is a valuable asset, protection of the monopoly justifies expenses. Thus, the adoption of practices

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which facilitate sharing of structure increases the amount of sharing that takes place and reduces the incumbent's costs. Such practices make entry easier, thus hastening the development of competition. Failing to seek out opportunities to reduce costs by adopting practices which facilitate the sharing of structure can therefore be regarded as the cost which USWC incurs to protect its monopoly. (MCI Exhibit 6, p. 11, lines 10-18).[1]

A final example of USWC's failure to meet its burden of proof involves USWC's simplistic argument that if its cost of building loops is significantly below its proposed price, new entrants would build new facilities throughout the state in pursuit of potential profits. (USWC Closing Statement, p. 5). USWC's argument fails to take into account the limits on how fast a company can build loops and the vast up-front capital expenditures necessary to replicate the USWC system. Nor does USWC take into account whether there will be sufficient demand to generate adequate revenue to justify the cost of duplicative systems. These factors will make it more feasible to purchase loops from USWC rather than build loops initially. More importantly, the public will receive the benefits of competition more rapidly if loop prices are based on reasonable cost analysis, not USWC's inflated analysis.

MCI will not repeat the arguments contained in its prior filings on transport and termination charges and non-recurring costs such as installation charges, except to note the following. First, the Commission has adopted bill and keep for transport and termination charges. This Commission rule is controlling unless changed by a new rule making proceeding. Second, the Arbitrators should consider that emerging competition will be encouraged if as many costs as possible are recovered through recurring rather than non-recurring charges. Up front, non-recurring charges serve as a barrier to entry.

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[1]Similar regulated monopoly disincentives infect the inputs USWC uses for the drop, aerial and fill factors and other network engineering matters.

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III. RESALE

It is critical that wholesale rates be established in a way that will not deter carriers from pursuing the resale option. Unless the discount is sufficient for MCI to make a profit once it has taken into account the cost of purchasing or leasing these items as well as its own costs, such as marketing, billing and customer service expenses, resale may not be a viable strategy for entry into the market. Resale is particularly important to reach residential users and customers outside a large metropolitan area so they may enjoy the benefits of competition.

USWC attempts to attack the MCI avoided cost model fall short. MCI will not repeat in this brief its responses to USWC's various attempts to reduce the percentage. Apparently aware of the failure of its prior attacks, USWC attempts to present new evidence in its Closing Statement. First, USWC claims that its customer expense calculation is impacted in part by its recently created "new market unit." USWC criticizes MCI's calculations for not taking into account this unit, even though this is USWC's first mention of the unit. USWC does not explain why the new unit was needed or its impact on the discount. (USWC Closing Statement, p. 33). Second, USWC presents a new service-by-service discount study which the other parties had no opportunity to examine during the arbitration. (USWC Closing Statement, p. 33).

In light of this new service-by-service discount study, MCI's arguments against using the service-by-service discount bear repeating. First, MCI believes that available data is insufficient for an accurate service-by-service discount. The Arbitrators should note that USWC's own avoided cost discount is necessarily an estimate based on its experience selling access on a wholesale basis. (USWC Closing Statement, p. 26). Second, MCI's across the board discount approach has been approved by the FCC. In fact, MCI used the identical underlying data to calculate its discount as was used by the FCC. Third, as has been substantiated by USWC's newly provided service-by-service discount study, a service-by-service discount will discourage competition in the residential market. The Arbitrators should note that the residential discount in USWC's new study is the lowest discount and substantially below MCI's proposed discount of 22.5%. Since resale will be the primary path for new entrants to provide residential service, a minimal discount will create a barrier to entry into that market. A uniform discount eliminates any incentive by either party to manipulate service-by-service discounts.

USWC incorrectly claims that MCI's witness, Mr. DiTirro, approves of service-by-service discounts. (USWC Closing Statement, p. 28). To the contrary, Mr. DiTirro testified that a service-by-service analysis allows too many arbitrary allocations. (Transcript, p. 1521, lines 5-16).

USWC argues that avoided costs should be determined using TELRIC and that the Eighth Circuit stay provides the Commission the freedom to do so. (USWC Closing Statement, p. 26). This Commission should exercise its discretion to use embedded costs. The discount, pursuant to the Telecommunications Act, is applied to USWC's retail rates. Such existing retail rates are based on embedded costs so the same standard should be used in determining discounts. USWC attempts to hint that somehow the FCC must have made a mistake because it "strangely adopts the TELRIC for all except avoided costs." (USWC Closing Statement, p. 26 ¶ 20). The FCC knew what it was doing and this Commission should understand the logic of using embedded costs to calculate the discount when a discount has been taken on retail rates based on embedded costs. (USWC Closing Statement, p. 27).

USWC argues that geographic deaveraging should not be allowed in the wholesale market until it exists in the retail market. USWC's argument is simply another attempt to stall competition. Geographic deaveraging of retail rates contains numerous policy considerations not present in the wholesale arena. To accept USWC's argument will unnecessarily delay the advent of competition in the local exchange market and the benefits derived by the public in that market.

IV. CONCLUSION

MCI respectfully requests that the Arbitrators adopt the unbundling and interconnection prices sponsored by MCI and AT&T based on the Hatfield study and adopt the 22.5% wholesale discount proposed by MCI.

RESPECTFULLY SUBMITTED this 24th day of January, 1997.

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