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BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK,
CHAIRMAN

RENZ D. JENNINGS,
COMMISSIONER

JIM IRVIN,
COMMISSIONER

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 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

MCIMETRO ACCESS TRANSMISSION SERVICES, INC.'S EXCEPTIONS TO PROPOSED OPINION AND ORDER

MCImetro Access Transmission Services, Inc. ("MCI") respectfully requests that the Arizona Corporation Commission modify several provisions of the Arbitrators' recommended order.

Despite the fact that the Arbitrators use the Hatfield Model as a starting point for determining the costs of unbundled elements and conclude that MCI's method of calculating the avoided cost discount for resale is the most reasonable, the

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Arbitrators propose that the Commission adopt certain other concepts which will at a minimum defer, if not prevent, the development of a truly competitive local exchange market in Arizona.

The two primary problems are the adoption of US West's proposal to use three lines per living unit, rather than two, and the adoption of US West's proposal to weigh the resale discount according to different types of services. The use of three lines per living unit drives the unbundled loop price up to $16.41, which is less economically viable than the two line per living unit structure used in the Hatfield model. The weighing of the resale discount by service categories reduces the residential discount to 10.05%, well below an economically viable number. The result of these two provisions in the proposed order will be to stifle competition in the residential market and thereby deny the benefits of competition to most Arizona consumers. This result undoubtedly was unintended by the Arbitrators and should be modified by the Commission.

MCI's specific exceptions to the proposed order are set forth below with references to the proposed order.

1. **<u>Cost of Capital</u> (Order, §8 II(B)(1), pp. 6-8)**

The Commission should use the cost of capital adopted in the most recent US West rate case. The Arbitrators did use the capital structure and cost of debt from the most recent US West rate case. However, the Arbitrators propose a greater cost of equity than in the rate case, raising the composite cost of capital to 10.06%.

The record does not support the increased cost of equity. US West's monopoly position continues to protect its investors from the risks normally associated with competitive companies.

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The Commission should use the cost of capital adopted in USWC's most recent Arizona rate case: 9.75%. Siwek, ATT Exhibit 5, pp. 20-21. The Hatfield model uses this Commission approved cost of capital.

2. **Depreciation** **(Order §II(B)(2), pp. 8-10)**

The Commission should use the depreciation factors adopted in the most recent US West rate case, not the factors set forth in the US West sponsored depreciation study.

Depreciation rates, like the cost of capital, represent an important component of USWC's cost studies underlying its proposed prices for interconnection and unbundled network elements. Like the cost of capital, higher depreciation rates translate into higher costs, which in turn translated into higher interconnection and unbundled network element prices. Easton, Tr., p. 371: 17-20.

USWC's depreciation rates adopted by the Arbitrators are too high because USWC has substantially decreased economic lives compared to the lives currently approved by the Commission. This shortening of lives drives up the prices charged to new entrants.

USWC has an incentive to want higher depreciation rates in its cost studies. Among other things, USWC would prefer to have higher depreciation rates on plant accounts used to provide monopoly services, and a lower depreciation rates on plant accounts used to provide competitive services, which is precisely the opposite of what the true economic lives of those accounts would indicate. Zepp, ATT Exhibit 9, p. 35: 7-13.

USWC's proposed depreciation rates are inconsistent with the projected lives for telephone equipment prescribed by this Commission. By law, USWC cannot change depreciation lives without an appropriate proceeding at the Commission which USWC has not pursued. Commission staff has not had the

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opportunity to study (and retain consultants to evaluate) the USWC proposed depreciation lives. USWC's proposed depreciation lives are inconsistent with the recommended ranges for projected lives of telephone equipment adopted by the FCC. They are inconsistent with the type of equipment and assumed fill factors used in USWC's own cost studies.

USWC prepared no specific depreciation studies for this case. The only "study" submitted for the record in support of USWC's proposed depreciation rates is a 1995 report entitled *Depreciation Lives for Telecommunications Equipment: Review & Update* prepared by Technology Futures, Inc. ("TFI").[1] USWC also referred to a depreciation filing at the Commission in 1995. Easton, Tr., pp. 374: 22 - 375: 20. However, that "filing" was never docketed and has not been pursued by USWC or evaluated by the Commission.

The TFI study proposed by US West and adopted by the Arbitrators utilizes unreasonably high depreciation rates that renders the study unreliable as a basis for establishing interconnection and unbundled network element prices in this proceeding. The Commission should continue to use the depreciation lives currently adopted by the Commission. The Hatfield model uses the Commission approved Arizona depreciation rates.

3. **Corporate Overhead** (Order, §II(B)(4), pp. 11-13)

The Commission should adopt a 10% overhead factor, not the 15% proposed by the Arbitrators.

USWC arbitrarily allocates common costs to network elements. USWC calculates prices for a network element by, among other things, allocating a portion

[1] It is worth pointing out that this TFI report expressly acknowledges that it was sponsored and supported by a group of companies that can clearly be characterized as incumbent local exchange companies (or ILECs) rather than competitive local exchange companies (or CLECs).

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of common costs to the elements. However, USWC failed to provide any support for its method of allocating common costs back to network elements. Without such support, the Arbitrators run the risk of including USWC's inefficient cost structure on new entrants thereby stifling competition. In the case of general overhead allocation, the Arbitrators recognized that the USWC allocation (25%) is significantly too high. The Hatfield allocation of overhead (*i.e.* 10%) is a more reasonable approach. The evidence does not support the compromise of 15% proposed by the Arbitrators. As the Arbitrators admit, the Commission rules provide for a 10% factor.

4. **<u>Maintenance Costs</u> (Order, §II(B)(6), pp. 13-14)**

The Commission should use the Hatfield Model's 30% reduction because the 15% factor in the proposed order does not adequately take into account increased efficiencies stimulated by competition and improved technology.

5. **<u>Network Design - Feeder and Distribution Fill Factors</u> (Order, §II(C)(2)**

The Commission should approve use of two lines per living unit, not three. If not, the Commission will increase the loop cost making it more difficult for emerging competition. A three line per living unit allowance results in a model that under utilizes plant and inflates cost estimates. Cross examination of USWC witnesses made it clear that 3 pair placement is excessive and amounts to gold-plating the network. Santos-Rach, Tr., pp. 272: 22 - 275: 18; Orrell, Tr., pp. 615: 16 - 617: 15; Donovan, Tr., pp. 867: 3 - 868: 19; Artman, Tr., pp. 1245: 24 - 1246: 6. Only a small percentage (7%) of Arizona customers even use 2 lines. Orrell, Tr., pp. 548: 18 - 549: 3. By using 3 pair, USWC lowers the fill factor and increases its cost. Orrell, Tr., p. 616: 2-11.

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6. **Geographic Deaveraging** (Order §II(C)(5), pp. 20-21)

The Commission should deaverage loop costs now and not defer as proposed by the Arbitrators.

While all the parties agreed that in the long term geographic deaveraging is appropriate, MCI and the other new entrants explained that geographic deaveraging of wholesale rates should not have to await geographic deaveraging of retail rates. Hubbard, Tr. pp. 1284-1285. To do so would unnecessarily delay the advent of competition in the local exchange market and the benefits derived by the public in that market.

7. **Avoided Cost Discount** (Order, §III(C), pp. 32-35)

The Commission should adopt an across the board avoided cost discount of 22.5% as set forth in the MCI avoided cost model. It should not adopt US West's proposed weighted discount approach because it will keep most Arizona residential consumers from reaping the benefits of competition in the near future.

A. **Overview: Resale Of Telecommunications Services Is Critical To The Development Of Effective Competition In The Local Exchange Market.**

The Act requires incumbent local exchange carriers to offer for resale, at wholesale rates, any telecommunications service that the carrier provides at retail. *47 U.S.C. §251(c)(4)(A).* Further, the Act prohibits incumbents from imposing unreasonable or discriminatory conditions or limitations on resale. *47 U.S.C. §251(c)(4)(B).* As the FCC has observed, "Resale will be an important entry strategy both in the short term for many new entrants as they build out their own facilities and for small businesses that cannot afford to compete in the local exchange market by purchasing unbundled elements or by building their own networks." *FCC Order ¶ 32.* For most new entrants, if the journey to competition begins with a single step, that single step is resale. Accordingly, it is critical that wholesale rates and nonprice

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terms and conditions be established in a way that will not deter carriers from pursuing the resale option.

The long distance market provides the paradigm for the development of competition through resale. MCI and other carriers first entered the long distance market in the 1970's as resellers of AT&T's long distance services. Since its initial foray into the long distance market as a reseller, MCI has gone on to develop its own ubiquitous network to provide long distance service on a nationwide basis. As a result of competition, the long distance market has grown and prices have dropped.

The resale provisions of the Act enable a new entrant to enter the market as a "middleperson," by purchasing local exchange service from USWC at wholesale and then reselling that service to end users at retail. "Resale" in this context is not significantly different from any other arrangement whereby goods or services are purchased at wholesale and then resold to consumers. MCI's profit is the difference between MCI's cost of providing the service and the price it charges for that service. DiTirro, MCI Exhibit 3, pp. 8: 13 - 9: 22. MCI's costs, in turn, include not only what MCI must pay USWC for the service it purchases, but also the costs that MCI will incur in retailing the service, such as marketing, billing, and customer service expenses. DiTirro, MCI Exhibit 3, p. 5: 8-17. In other words, MCI cannot, as suggested by USWC, simply pass a discount on to consumers. MCI will incur retail costs avoided by USWC. To the extent MCI is more efficient, it can pass a savings on to customers, who will then experience the benefit of competition.

Such a resale strategy offers a variety of benefits. First, because of the significant time and expense a carrier must invest in order to develop its own network, full blown facilities-based competition will not happen overnight. Through resale, a new entrant will be able to build up a customer base that will justify the expense of establishing its own network. In this way, resale promotes the expeditious development of competition.

Moreover, resale will bring the benefits of competition to all consumers. Again, because of the "sunk costs" that a carrier must incur to place its own network, facilities-based competition is most likely to emerge first in large metropolitan areas, where more consumers can be served by a less geographically expansive network. Indeed, MCI has existing facilities in the Phoenix area. At the same time, resale will also allow the residents of greater Arizona to enjoy the benefits of competition. With competition will come not only benefits of market-based pricing, but also non-price benefits of improved customer service and increased product innovation.

B. <u>A Single Discount Should Apply to All Services, Including Residential</u>

The FCC has expressed its general approval of MCI's avoided cost methodology. *FCC Order §925.* Moreover, the single discount rate proposed by MCI, to be applied to all of USWC's retail services, minimizes administrative burdens and properly allocates avoided costs among separate services. *See FCC Order at §916.* A service by service discount has two additional disadvantages. First, USWC data available to MCI does not allow MCI to calculate a verifiable service by service discount. DiTirro, Tr., p. 1521: 11-16. Second, a service by service discount may discourage competition in the residential market based on USWC's proposal, as adopted by the Arbitrators, to have a much more minimal discount for residential service. Since resale will be the primary path for new entrants to provide residential service, a minimal discount will create a barrier to entry in that market. A uniform discount eliminates any incentive by either party to manipulate service by service discounts.

USWC's motives for advocating a pricing structure biased against the resale option are clear. To the extent that USWC can persuade the Commission to adopt wholesale rates that discourage entry in the resale market, USWC will not only be able to discourage competition from resellers, but to hinder the development of facilities-based competition. The Commission should recognize USWC's "policy considerations" for what they are: part of an ongoing effort to forestall competition.

C. **<u>No Adjustment Should be Made to the MCI Avoided Cost Discount</u>**

The Arbitrators propose reducing the MCI avoided cost model's discount from 22.5% to 20.22% because the Arbitrators disagree with MCI's treatment of property taxes and certain marketing (*i.e.* product management) expenses. MCI respectfully disagrees with these adjustments.

To the extent that property taxes are considered operating expenses, a portion of these costs should be avoided in relation to the fact that USWC will have a reduced need for staff and the supporting facilities. DiTirro, Tr., pp. 1561: 8 - 1562: 15. MCI believes that a portion of property taxes equal to the overall avoided cost discount should be avoided. Since these avoided costs would be added to the numerator, the overall impact of the property and other taxes account would be nil. DiTirro, Tr., pp. 1559: 3 - 1560: 10.

USWC included most of the product management costs because, it argues, these costs have benefit to CLECs. However, these costs are incurred relevant to USWC's marketing strategy and have little or no benefit to CLECs such as MCI. Moreover, even if these studies did have some relevance to MCI's business plan, the various studies and analysis have not been offered to MCI for its use. DiTirro, MCI Exhibit 6, p. 5. Consequently, 90% of these expenses should be avoided, not 75% as proposed by the Arbitrators.

CONCLUSION

For the most part, the proposed Opinion and Order provides a thoughtful and balanced analysis of the cost and price issues, but unless it is modified

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in a few key areas, it will have the unintended consequence of hurting, not helping, Arizona's development of a competitive local exchange market.

RESPECTFULLY SUBMITTED this 17th day of July, 1997.

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