BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation into Pricing of Unbundled Network Elements	)))	Docket No. 990649B-TP

SURREBUTTAL TESTIMONY OF

DENNIS B. TRIMBLE

ON BEHALF OF

VERIZON FLORIDA INC.

SUBJECT: POLICY

March 18, 2002

SURREBUTTAL TESTIMONY OF DENNIS B. TRIMBLE

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Dennis B. Trimble. My business address is 600 Hidden Ridge, Irving, Texas, 75015.

Q. ARE YOU THE SAME DENNIS B. TRIMBLE WHO PREVIOUSLY FILED DIRECT TESTIMONY IN THIS DOCKET?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. I respond to various assertions and policy recommendations made in the Rebuttal Testimonies of ALEC Coalition witnesses Ankum, Darnell, and Fischer; Z-Tel Communications, Inc. (Z-Tel) witness Ford; and KMC Telecom III, Inc. (KMC) witness Wood.

Q. PLEASE SUMMARIZE THE POINTS YOU MAKE IN RESPONSE TO THE ALECS' REBUTTAL TESTIMONY.

A. 1. <u>The stock market's view of the capitalized worth of the ALEC industry</u> is not an appropriate consideration in setting unbundled network element (UNE) rates. The FPSC must instead follow the FCC's current UNE pricing rules and the Telecommunications Act of 1996 (Act), both of which require cost-based pricing. In any event, many factors other than UNE rates are more likely to directly affect the performance of ALEC stock prices. The ALECs developed their business plans with full knowledge of the ILECs' UNE rate structures and made their entry plans assuming success under these rate structures.

2. It is, likewise, improper to set Verizon's UNE rates based on <u>comparisons to rates established for other incumbent local exchange carriers (ILECs) or in other states.</u> Again, the FPSC needs to adhere to the FCC's pricing rules, rather than irrelevant statistics.

3. The FPSC is not required to <u>deaverage each ILEC's rates; the existence of different rates for ILECs across the state satisfies the FCC's deaveraging requirement.</u> Efficient competition will not develop if further deaveraging occurs in the absence of a rational relationship between UNE rates and retail rates. If the FPSC decides it must deaverage Verizon's UNE rates, then only Verizon's alternate proposal adheres to FCC pricing rules and mitigates, to the extent possible, uneconomic arbitrage of the Company's retail offerings.

4. The ALEC Coalition's criticisms of Verizon's <u>development of a fixed allocator for recovery of common costs</u> (not only for statewide UNE rates, but for deaveraged UNE rates) are unfounded and incorrectly represent Verizon's procedures. Verizon's methodology is rational, supported by the FCC, and results in the least distortion of rates as between geographic areas.

5. A la carte pricing of switch features is economically sound, does not unduly complicate ordering, comports with the FCC's pricing rules, and properly assures that the cost causer pays the costs it incurs.

II. THE STOCK MARKET'S VIEW OF THE CAPITALIZED WORTH OF ALECS SHOULD PLAY NO PART IN THE DETERMINATION OF UNE RATE LEVELS

Q. WHAT ARE THE POSITIONS OF KMC WITNESS WOOD AND ALEC COALITION WITNESS ANKUM CONCERNING THE ALECS' PURPORTED NEED FOR LOWER UNE RATES?

A. Mr. Wood peppers his testimony with statements that indicate the entire fate of the ALEC industry hinges on ordering UNE rates that will guarantee ALEC profits. (*See, e.g.*, Wood RT at 2, 3, 8 ("If CLECs cannot reach positive cash flow and SUSTAIN it, then our industry is DEAD" , 11 ("our investors deserve a return on their investment – and that is a basic fact of our national economy" , 12, 15.) These statements advocating naked corporate welfare are Mr. Wood's sole support for lowering current UNE rates.

Dr. Ankum is somewhat subtler. He spends over six pages reviewing the changes in market capitalization of various telecommunication firms (Ankum RT, pp. 19–25), and from that he concludes that the "CLEC industry can no longer afford to shoulder the burden of anti-competitive

[UNE] proposals." (Ankum RT, p. 4)

Q. PLEASE COMMENT ON THE VIEWS OF DR. ANKUM AND MR. WOOD.

A. Dr. Ankum's and Mr. Wood's comments must be dismissed as irrelevant rhetoric designed to improperly influence UNE pricing decisions. Their implications that the existing level of UNE rates has caused the financial decline of the ALEC industry or that lower UNE rates will be the salvation for the ALEC industry have no economic or factual support.

Are we to assume that AT&T's fall in market capitalization is due to UNE rate levels? Not according to the media accounts I have read, which ascribe AT&T's troubles to disastrous investments in cable facilities, significant reduction in toll prices due to the entry of efficient competition, and the like. These are not UNE issues, but management decision issues and/or the expected results of a competitive marketplace.

Likewise, rather than blaming any financial difficulties on UNE rates, the smaller ALECs should ask themselves the following, more directly relevant questions:

- did your initial business plan correctly identify your operating efficiencies?
- did the investment community fairly value your company from day 1?
- did you follow your business plan?

- did you spend your venture capital wisely?
- did you understand the full set of ILEC rate structures and cost characteristics? Which ILEC services are priced to support social goals?
- are the customers you targeted in your business plan willing to buy your service?
- do your cash flow needs require that you expand your operations to less valuable customer sets?

It defies logic to suggest that the current financial woes of many ALECs can be explained in terms of UNE rates. First, when the ALECs decided to enter each market, they knew what the UNE rates were at that time; most state UNE rates, including Florida's, were established in late 1996 and early 1997 (prior to the rise in ALECs' stock market capitalization). The ALECs also knew precisely what the ILECs' tariffed rates were for each and every service. They should have had estimates of their own cost structures regarding marketing to customers, building facilities, maintaining facilities, etc. They could identify (or should have identified) which customer sets were valuable based on simply arbitraging the ILECs' disoriented rate structures. All I see is an industry that is fraught with bad business planning and an inability to deliver to the expectations upon which business plans were built. Perhaps the ALECs believed the results of the cost studies that they have proposed in various states and those cost studies proved deficient in identifying their true actual costs.

Q. IS IT PROPER FOR THE COMMISSION TO CONSIDER INFORMATION ABOUT CERTAIN ALECS' FINANCIAL TROUBLES IN SETTING RATES FOR VERIZON?

A. No. The Act and the FCC's rules implementing the Act require UNE rates to be cost-based. The FCC's pricing rules do not consider or permit preferential treatment for particular competitors. In fact, the corporate welfare the ALECs seek is directly contrary to the ultimate goal of the Act, which is facilities-based competition. Competitors will never build their own facilities if they can continue to buy UNEs at fire-sale prices.

Competition does not ensure the survival of competitors, but allows for the existence of efficient firms. Put another way, entry into competitive markets does not guarantee that the firm will be profitable; it just guarantees that if the firm is efficient and customers value their products, then it will have an opportunity to earn a profit. To imply that UNE rates must be lowered to ensure the continued existence of specific firms, whether they be efficient or not, reaches far beyond this Commission's interest in promoting the creation of an efficient marketplace. This Commission's interest is in protecting competition, not particular competitors.

III. THE ALECS' COMPARATIVE ANALYSIS OF UNE RATES IS NOT USEFUL FOR THIS PROCEEDING

Q. ALEC WITNESSES ANKUM, DARNELL, FORD, AND WOOD ALL

ADVISE THE COMMISSION THAT IT SHOULD SET VERIZON'S UNE RATES BASED, AT LEAST IN PART, ON RATES ESTABLISHED FOR OTHER ILECS AND IN OTHER STATES. DO YOU AGREE WITH THIS APPROACH?

A. No. As the Commission has recognized, UNE rates are supposed to be company-specific, which means, in this case, based on the costs Verizon will incur in providing UNEs in Florida with its network. The rates of other companies (regardless of the state in which they operate) are obviously not based on Verizon's costs. The Commission need not (and, indeed, cannot) look to other jurisdictions or use proxies to set Verizon's rates. It need only carefully review Verizon's costs, as presented in Verizon's cost study filed in this case. As even Dr. Ankum admits, the Commission must set TELRIC-based rates (Ankum RT at 13). This admission is at odds with any approach that would factor in other states' rates, which have nothing to do with Verizon's TELRICs in Florida.

Consideration of rates from other states is not, in any event, a responsible basis for ratesetting. It is very dangerous to consider these other rates without a complete understanding of the context in which they were adopted, including, for example, inquiry into whether the rates were properly based on forward-looking pricing rules or political or other considerations; and whether UNE ratesetting was accomplished in conjunction with other objectives.

Dr. Ankum, for instance, advises the Commission to look to New York for guidance in setting UNE rates, but neglects to tell the Commission the New York Commission allowed local rate increases in conjunction with adoption of the new UNE rates. In this proceeding, of course, I have recommended against further deaveraging UNE rates without moving retail rates closer to their underlying costs.

Q. CAN YOU COMMENT ON DR. FORD'S "ZONE OF REASONABLENESS APPROACH?"

A. Dr. Ford claims to have "used the FCC's Hybrid proxy Cost Model ("HCPM")" to compare the costs of providing UNEs between Verizon and BellSouth. Dr. Ford did not produce specific rates, but attempted to provide a "zone of reasonableness" as a "sanity check" on Verizon's rates. (Ford RT at 20.) I will leave specific comment on Dr. Ford's approach to Verizon surrebuttal witnesses Dr. Tardiff and Mr. Murphy, but my general observation stands: the only proper basis for setting Verizon's UNE rates is Verizon's cost studies—not costs or rates of other carriers.

Q. CAN YOU GIVE US AN EXAMPLE OF HOW DR. FORD'S COMPARATIVE ANALYSIS FAILS TO YIELD ANY USEFUL INFORMATION IN SETTING VERIZON'S RATES?

A. Yes, on page 23 of his Rebuttal Testimony, Dr. Ford compares two of Verizon's a la carte switch feature prices to a fixed port feature rate that was ordered for BellSouth. Specifically, he asserts that BellSouth was ordered to provide all features for $3.40, while Verizon proposes to charge $4.20 for just two features. In my Direct Testimony, I proposed rates for hundreds of different features; most of the commonly used features are priced at less than $0.30 each. But Dr. Ford ignored the total picture and picked two of the more costly features (features that are also not in high demand) to add up for his comparison. Such misleading comparisons provide no useful information about ratesetting for Verizon.

Q. ALEC COALITION WITNESS DARNELL PROPOSES THAT THE FPSC IMPLEMENT "INTERIM" UNE RATES, WITHOUT ANY TRUE-UP, FOR VERIZON, BASED ON APPROVED OR PENDING BELLSOUTH UNE RATES. PLEASE COMMENT ON THIS PROPOSAL.

A. The ALEC Coalition has no regard for due process or for its own agreements. Mr. Darnell asks the Commission to merely assume that cost-based rates for Verizon should be similar to those set for BellSouth. Neither the Act nor the FCC's pricing rules permit ratesetting based on assumptions, rather than a Company's specific cost data. Moreover, AT&T and MCI agreed to Verizon's existing loop rates, in a stipulation approved on February 22, 2000 (*Investigation into the Pricing of Unbundled Network Elements*, Order No. PSC-00-0380-S-TP), and they should be held to that agreement.

In any event, it would be impossible, in practical terms, to simply superimpose BellSouth's UNE rates on Verizon, which has different provisioning, ordering, and billing systems. Mr. Darnell's proposal deserves no serious consideration.

IV. THE ALEC COALITION'S DEAVERAGING PROPOSAL IS JUST AN ATTEMPT TO FURTHER UNECONOMIC RATE ARBITRAGE

Q. DR. ANKUM CONCLUDES THAT THE FCC REQUIRES THE STATES TO DE-AVERAGE EACH COMPANY'S UNE RATES INTO AT LEAST THREE RATE ZONES (ANKUM RT, PP. 98 – 99). DO YOU AGREE WITH HIS CONCLUSION?

A. No, the FCC has never made such a ruling. In an Order concerning a deaveraging waiver request by the Ohio Commission, the FCC stated:

> We note that Ohio argues it may not need this waiver. As it points out, the FCC has never ruled that states must create company-specific zones for each carrier in the state, but only that the state commissions must have at least three deaveraged rate zone in total....This issue, however, is beyond the scope of our consideration of waiver petitions.
>
> (*Petitions for Waiver of the Section 51.507(f) UNE Deaveraging Requirement*, Order, 15 FCC Rcd 23353 (2000).)

Q. DR. ANKUM ASSERTS THAT IF UNE RATES ARE NOT DEAVERAGED, EFFICIENT USE OF EXISTING RESOURCES WILL BE DISCOURAGED. PLEASE COMMENT ON THIS ASSERTION.

A. I agree that efficiency is a laudable objective, but the Commission cannot consider efficiency in UNE rates without also considering efficiency in retail rates. State policymakers have always attempted to balance economic efficiency with social objectives (*e.g.*, universal service goals); historically, social objectives were given more weight than economic efficiency. That is why implicit subsidies remain in the ILECs' retail rate structures. As I have testified, these subsidies need to be removed for local markets to operate efficiently. To create a truly efficient marketplace, Verizon's retail rates need to be aligned with its UNE rates, where both reflect their underlying cost structures within a geographic area. To deaverage one set of rates without deaveraging the other exacerbates the uneconomic arbitrage of Verizon's existing retail rate structures. Further deaveraging UNEs will also assure that customers in high cost areas will never see the benefits of a competitive marketplace.

Mr. Wood agrees that the FPSC should not ignore end user rates when setting UNE rates. (Wood RT, pp. 21-22) But instead of removing subsidies, Mr. Wood asks the commission to subsidize and/or support UNEs, just as various retail offerings are currently supported. Aside from violating the FCC's pricing rules, this activity would only introduce more economic inefficiencies into the marketplace.

Q. DR. ANKUM STATES IF UNE PRICES DO NOT REFLECT COST, THEN THE DEVELOPMENT OF COMPETITION WILL BE IMPAIRED AND THE RATEPAYERS OF FLORIDA WILL BE DEPRIVED OF AN OPTIMALLY EFFICIENT NETWORK AT COMPETITIVE PRICES. DO YOU AGREE WITH THIS STATEMENT?

A. No. The ratepayers of Florida probably have the most efficient network they could have at this time, given the social objectives that have historically driven ILEC pricing. Setting UNE prices based on geographically deaveraged costs will not change the underlying network; it will only ensure that the ILEC's ability to modernize its network in higher-cost areas becomes financially harder to do. Throughout his discussion, Dr. Ankum has conveniently ignored Verizon's disoriented retail rate structures, as well as the potential impact of his proposals on universal service objectives and competition for rural areas. Many of Dr. Ankum's statements may apply to markets with a competitively neutral playing field, but that condition does not exist in local telecommunications markets. The FPSC should recognize Dr. Ankum's statements for what they are–the ALEC's attempt to obtain enhanced abilities to arbitrage Verizon's retail rate structures, not for the benefit of Florida's telecommunications consumers, but solely for the financial benefit of the ALECs.

Q. PLEASE DESCRIBE THE ALEC COALITION'S PROPOSED METHODOLOGY FOR DEAVERAGING UNE LOOP RATES.

A. ALEC Coalition witness Fischer presented this proposal at pages 7–8 of his Rebuttal Testimony. He recommends that the lower and upper boundary of each deaveraged zone should be determined such that they are both within + or – 20 percent of the average cost of the loop in that deaveraged zone. Mr. Fischer claims that this methodology allows zones "to be created solely upon underlying cost characteristics, and not due to some artificial grouping of wire centers" (Fischer RT, p. 8). Mr. Fischer's primary proposal results in eight zones for Verizon, with only one wire center in the lowest cost zone and 18 wire centers in the 4 highest cost zones (Fischer Ex. WRF-2).

Q. WAS THE DEAVERAGED ZONE PROPOSAL YOU SUBMITTED IN YOUR DIRECT TESTIMONY BASED ON SOME "ARTIFICIAL GROUPING OF WIRE CENTERS"?

A. No. The three-zone proposal I presented was based solely on the underlying cost characteristics of Verizon's wire centers. Again, I emphasize that this is an alternative proposal to be used only if the FPSC determines that it must deaverage each ILEC's UNE loop rates.

Q. DID MR. FISCHER PROPOSE ANY ALTERNATIVE DEAVERAGED RATE STRUCTURE?

A. Yes, based on the Commission's decision that three zones was sufficient for BellSouth, he collapsed his proposed 8-zone structure for Verizon into 3 zones using the following aggregation (Fischer Exhibit WRF-3):

New Zone 1 = Original Proposed zones 1 & 2

New Zone 2 = Original Proposed zone 3

New Zone 3 = Original Proposed zones 4 – 8

Q. WHAT LEVEL OF COST VARIATION EXISTS IN MR. FISCHER'S ALTERNATIVE 3-ZONE STRUCTURE?

A. His proposal has no standard breakpoints, but Mr. Fischer's Exhibit WRF-

3 contains the information necessary to develop the following ranges of cost deviation in each zone:

Table 1

ALEC COALITION'S 3-ZONE PROPOSAL

Zone	Percentage Variation from Average Cost	
	Lower Bound	Upper Bound
1	-43%	+17%
2	-14%	+20%
3	-30%	+447%

Q. MR. FISCHER STATES THAT VERIZON'S PROPOSAL TO USE A 200 PERCENT COST VARIATION STANDARD RESULTS IN UNE RATES THAT ARE OVERLY AVERAGED (FISCHER RT, P. 10). PLEASE COMMENT ON THIS STATEMENT.

A. Mr. Fischer's characterization of Verizon's methodology is misleading. Verizon's 3-zone deaveraging proposal did not employ a "200% cost variation standard," as Mr. Fischer uses the term. Verizon's proposal segmented wire centers into zones depending on whether the wire centers' costs were (1) below the statewide average cost, (2) above the statewide average cost but below 200% of the statewide average cost, or (3) above 200% of the statewide average cost. The results of this methodology were presented in my Exhibit DBT-3 for 2-wire loops. That Exhibit provides sufficient information to compute the lower and upper bound percentage variations from the average cost for each proposed zone. The results of these calculations are presented in Table 2.

Table 2

VERIZON'S 3-ZONE PROPOSAL

	Percentage Variation from Average Cost	
Zone	Lower Bound	Upper Bound
1	-53%	+20%
2	-17%	+47%
3	-38%	+173%

Verizon's zones 1 and 2 are relatively close to Mr. Fischer's zones in terms of absolute deviation, but Verizon's zone 3 contains a significantly smaller amount of total variation, which was one of the primary reasons Mr. Fischer originally proposed six zones.

Q. MR. FISCHER STATES THAT ONE OF THE PROBLEMS OF "OVERLY AVERAGED" RATES IS THAT THEY ARE LARGELY UNRELATED TO THE COST INCURRED BY THE ILECS TO PROVIDE THE RELEVANT SERVICES. (FISCHER RT, P. 13). PLEASE COMMENT ON THIS STATEMENT.

A. It makes no sense. Verizon's proposed rates are not "overly averaged." The price paid in each zone is directly related to the average cost incurred from provisioning all the customers there. Mr. Fischer's statement only makes sense if the ALEC intends to selectively target customers, in which case, the price paid may be either higher or lower than the cost to provision those customers.

One way to assess whether or not a deaveraging scheme is fair would be to ascertain what percent of the lines are allegedly priced above their underlying cost due to averaging. This would occur when the estimated cost within the wire center is below the average cost for the geographic zone. Based on the statistics presented in Mr. Fischer's Exhibit WRF-3 and my Exhibit DBT-3, I have made this comparison. The results are shown in Table 3.

Table 3

COMPARISON OF 3-ZONE PROPOSALS

	Percent of Lines in Wire Centers With Costs Below Average Cost
Verizon	51%
ALEC Coalition	47%

Verizon's 3-zone proposal and the ALEC Coalition's 3-zone proposal are very similar, but Verizon's proposal has a slightly better balance (since the other side of the coin is that the remaining lines are priced too low). Verizon's proposal thus mitigates more uneconomic arbitrage than does the ALEC Coalition's proposal.

V. THE ALEC COALITION'S COMMON COST RECOVERY PROPOSAL IS INAPPROPRIATE AND MISLEADING

Q. WHAT IS THE ALEC COALITION'S POSTITON CONCERNING VERIZON'S PROPOSED RECOVERY OF COMMON COSTS?

A. Mr. Fischer asserts that: (1) Verizon computed two common cost factors and chose the higher of the two; (2) Verizon does not consistently apply its common cost allocator as a percentage to deaveraged zone rates; and (3) Verizon's common costs inappropriately include amounts for activities "that are adverse to the interests of ALECs." (Fischer RT, pp. 23-28.)

A. DIFFERENT COMMON COST FACTORS

Q. DID VERIZON COMPUTE TWO SEPARATE COMMON COST RECOVERY FACTORS AND CHOOSE THE HIGHER OF THE TWO?

A. No. Mr. Fischer alleges that Attachment Q in Verizon's ICM-FL Expense documentation constitutes the computation of a factor to be used to mark-up direct costs to facilitate the recovery of common costs. This is not true. The computation of the percentage in Attachment Q is just for informational purposes to show the relationship between Verizon's total common costs and its total regulated revenues. This explanation was provided by Verizon in response to question number 36 of AT&T and MCI's First Set of Interrogatories.

Q. HOW SHOULD A COMMON FIXED ALLOCATOR BE COMPUTED TO GIVE THE COMPANY AN OPPORTUNITY TO RECOVER ITS TOTAL COSTS?

A. The correct mathematical method for computing a common cost factor is to divide common costs by total direct costs as I did in Exhibit DBT-1, attached to my Direct Testimony. To expand on the discussion in my Direct Testimony (at pages 28–29), Verizon's fixed allocation factor was determined using the following formula:

Fixed Allocator = TCC / DC

where: TCC = Total Common Costs, and

DC = Direct Costs

The objective of the formula is to create a mechanism such that when direct costs are marked up to create prices, the resulting price sets allow the firm a theoretical opportunity to recover its total costs, which are the sum of its total direct costs and its total common costs (Total Costs = DC + TCC). Using the above formula, prices are developed such that:

Prices = DC * (1 + Fixed Allocator) or

= DC * (1 + (TCC/DC)) , which results in

= DC + TCC = Total Costs

Thus, the formula gives the Company an opportunity to recover its total costs. Mr. Fischer's assertion that the fixed allocator should be based on total direct costs divided by total revenues would only lead to a massive understatement (and under- recovery) of the Company's total costs. The Commission should reject Mr. Fischer's recommendation as a self-serving, mathematically incorrect sham.

Q. ON PAGE 25 OF HIS REBUTTAL TESTIMONY, MR. FISCHER STATES THAT "WHILE USING DIRECT COSTS AS THE DENOMINATOR MAY BE AN ACCEPTABLE METHOD, THE VERIZON PREDECESSOR, GTE, TYPICALLY USED TOTAL REGULATED REVENUES AS THE DENOMINATOR." IS THIS ASSERTION CORRECT?

A. Absolutely not. At GTE, I had total responsibility for the determination of

UNE pricing policies and I can state unequivocally that GTE never used Mr. Fischer's asserted methodology in any UNE pricing case.

B. USE OF A COMMON COST FACTOR IN DETERMINING DEAVERAGED RATES

Q. ON PAGES 26 AND 27 OF HIS REBUTTAL TESTIMONY, MR. FISCHER OBJECTS TO VERIZON'S USE OF A UNIFORM AMOUNT OF COMMON COSTS ACROSS DEAVERAGED ZONES. DOES MR. FISCHER HAVE ANY RATIONAL OBJECTIONS?

A. No, the ALEC Coalition's position has no rational underpinnings. It is instead based on the objective of enhancing the ALECs' abilities to generate profits from only a few targeted customers, while ignoring the rest of Verizon's service territory.

Mr. Fischer claims that Verizon's proposal "is inconsistent with the concept of deaveraging costs where higher cost areas bear the cost required to serve the area." (Fischer RT, p. 27.) This rationale has absolutely no economic support. Common costs cannot be directly attributed to any specific product or service, let alone any specific product in a specific geographical area. There is no basis to assume that geographic areas that require higher investment costs should also require more support from those activities that account for the company's common costs (*e.g.*, human resources or accounting and finance).

Assigning a fixed amount of common cost recovery to the same UNE regardless of where the it is purchased is fair, rational, and unbiased—unlike Mr. Fisher's proposed method.

An example helps illustrate this point. Verizon's proposed fixed allocator is approximately 14 percent. If we take Mr. Fischer's eight zone deaveraging proposal for 2-wire loops (Fischer Ex. WRF-2), the average costs within each of his zones vary from approximately $10 to $200, with a statewide average cost of about $24. Applying the fixed allocator to the statewide average cost, as Verizon has proposed, would mean that the sale of each loop would generate about $3.40 (or $24 times 0.14) to the recovery of the Company's common costs, regardless of where it is located.

Mr. Fischer contends that since the direct costs of a UNE loop vary between geographic areas, the absolute amount of common cost recovery should reflect those direct cost differences. Using the above numbers, Mr. Fischer would conclude that the correct amount of common cost recovery from each UNE 2-wire loop should vary from $1.40 in the least cost area ($10 times 0.14) to $28.00 in the most costly area ($200 times 0.14). It makes no sense that the sale of a UNE loop in the most costly area should pay for 1 hour of a human resource employee's time while the sale of a loop in the least costly area would only pay for about 3 minutes of the same employee's time.

The distortions that result from zone-based recovery of common costs led the Public Utility Commission of Oregon to order a uniform dollar amount of common costs per line when determining the deaveraged rates of UNE loops:

> We further find that utilizing a percentage markup would cause significantly larger increases in proposed Zone 3 loop UNE rates than in Zone 1 and 2. We therefore reject the use of a percentage in this instance, because it will produce a burdensome distortion in the interconnection agreement negotiation process in those high-cost areas. We find that applying a markup of a uniform dollar amount per-line to UM733 costs, which we deaveraged in this order, will avoid this price distortion.
>
> (Public Utility Commission of Oregon, Docket UT 148, UM 963, Order No. 00-481, August 31, 2000, page 11)

The FPCS should likewise adopt Verizon's proposed uniform common cost mark-up for deaveraged UNE rates.

Q. WHAT SEEMS TO BE THE INTENT BEHIND MR. FISCHER'S PROPOSAL?

A. It appears that the ALECs' intent is to generate expense reductions for the services they intend to buy in the only areas they intend to serve--the low cost areas that have the most profit potential (due to Verizon's disoriented retail rate structures). If the ALECs planned to compete in all areas, then they would probably support Verizon's proposal. But the ability to perform uneconomic rate arbitrage is concentrated in the low cost areas, as that is where the easy money is.

Verizon's proposal is rational, attempts to minimize undue price distortions between geographic areas, and is economically sound. There is no basis for Mr. Fischer's proposal, other than enhancing the ALECs' profits in the low-cost areas the ALECs already target.

C. EXTERNAL RELATIONS AND LEGAL COSTS MUST BE RECOVERED

Q. MR. FISCHER ASSERTS THAT EXTERNAL RELATIONS AND LEGAL COSTS SHOULD NOT BE RECOVERED BECAUSE HE BELIEVES THOSE COSTS ARE "ADVERSE TO THE INTERESTS OF ALECS." (FISCHER RT , PP. 27-28) PLEASE COMMENT ON MR. FISCHER'S POSITION.

A. Verizon has the right to recover in its UNE rate structures all the costs it incurs that are associated with the Company's obligation to offer UNEs. The Act clearly specifies that UNE rates must be just and reasonable and may include a reasonable profit. Profit is not obtainable unless all costs associated with the provision of UNEs are recovered, and that includes external relations and legal costs.

In addition, the FCC's current pricing rules specify that the prices for UNEs shall equal the sum of (1) the forward-looking economic cost of the element plus (2) a reasonable allocation of forward-looking common costs (Section 51.505). The FCC's pricing rules also state:

> The sum of the allocation of forward-looking common costs for all elements and services ***shall equal*** the total forward-looking common costs, exclusive of retail costs, attributable to operating the incumbent LECs total network, so as to provide all the elements and services offered.
>
> (FCC Rule Section 51.505(c)(2)(B), emphasis added)

Section 51.505(c)(2)(B) excludes only retail costs; it does not exclude any external relations and legal costs associated with the provision of UNEs. Likewise, Section 51.505(b) describes what factors may not be considered as forward-looking common costs and those are only (1) embedded costs, (2) retail costs, (3) opportunity costs, and (4) revenues to subsidize other services.

There does not appear to be any disagreement that external relations and legal costs are common costs incurred by Verizon due to the provision of UNEs. Thus, the Commission must reject Mr. Fischer's recommendation to deny Verizon recovery of these costs.

VI. VERIZON'S PROPOSAL FOR PRICING OF VERTICAL SERVICE UNES IS APPROPRIATE AND SUPPORTABLE

Q. PLEASE COMMENT ON THE ALEC COALITION'S RATE PROPOSAL FOR SWITCH FEATURES, AS DESCRIBED BY DR. ANKUM.

A. The ALEC Coalition proposes to: (1) include all switch features in the monthly port costs (Ankum RT, p. 90); and (2) adopt a proxy rate for Verizon based on BellSouth's switching rates. This proposal completely ignores the fact that different end users desire to use different switch features, that the underlying costs for individual features vary dramatically, and that end users add and delete features as they desire. Verizon's more reasonable rate proposal is based on its costs filed in this proceeding, the knowledge that end users have differing preferences, and that the Company has the right to recover the costs involved in the provision of switch features to ALECs.

Q. DR. ANKUM CONTENDS THAT VERIZON'S PROPOSAL IS ANTI-COMPETITIVE AND NOT CONSISTENT WITH COST CAUSATION (ANKUM RT, P. 89). PLEASE COMMENT ON THESE ASSERTIONS.

A. I have no idea how Dr. Ankum can say that Verizon's proposal is not consistent with cost causation. As Mr. Tucek states in his Surrebuttal Testimony, feature costs are determined by the cost of software, feature-specific hardware, and by increased processor usage caused by feature activation. As such, each individual switch feature has a specific forward-looking cost and those costs vary significantly depending on the feature.

Dr. Ankum's belief that Verizon's proposal is anti-competitive is apparently based on his assumption that a la carte switch feature pricing will be cumbersome and impose artificial costs. (Ankum RT, p. 89.) In this regard, he analogizes Verizon's proposal to a restaurant requiring a customer to order individual french fries, rather than allowing him to buy a plate of french fries—a system that would greatly increase the restaurant's costs. (Ankum RT, p. 89).

This analogy fails. First, one would expect the cost of each french fry to be the same; that is not true for switch features, which vary in cost. Second, the restaurant would know the cost of a plate of french fries, and that cost would not vary from customer to customer—unlike an end user's consumption of switch features. Third, customers are not likely to return one french fry and order a different french fry or request a refund, as consumers of switch features might well do.

We can rely on a more appropriate restaurant analogy to better understand Dr. Ankum's proposal. Instead of selling bottles of wine for varying prices that reflect their underlying costs, a restaurant decides to determine the average "per-customer" cost of the wine that it currently sells and offers wine to all customers at that fixed amount (whether or not they actually consume any wine). My guess is that the overall cost structure of the restaurant will dramatically increase, since the number of customers drinking wine will increase and all customers are likely to enhance the quality of wine that they order. Dr. Ankum's proposal is definitely not consistent with cost causation.

Q. DO YOU HAVE ANY OTHER CONCERNS REGARDING THE PRICING OF SWITCH FEATURES?

A. Yes, Verizon's proposal best complies with rational pricing principles. If the FPSC orders all local switching costs to be recovered only through port charges or minute-of-use charges, the FPSC must recognize that Verizon's proposed port and end office switching costs include no amounts associated with switch features. Therefore, if the Commission rejects Verizon's a la carte rate structure for switch features, then Verizon's monthly port cost or its per minute of use cost must be adjusted to include an amount for the recovery of feature costs at a level of average demand that incorporates the fact that there is no limit on the number of features ordered.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.