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May 28, 2002

VIA HAND DELIVERY

Blanca S. Bayo, Director
Division of Records and Reporting
Betty Easley Conference Center
4075 Esplanade Way
Tallahassee, Florida 32399-0870

Re: Docket No.: 990649B-TP

Dear Ms. Bayo:

On behalf of Z-Tel Communications, Inc., I am enclosing the original and 15 copies of Z-Tel Communications, Inc.'s Post-Hearing Statement of Issues and Positions and Post-Hearing Brief.

Please acknowledge receipt and filing of the above by stamping the duplicate copy of this letter and pleading by returning the same. Thank you for your assistance in this matter.

Thank you for your assistance in this matter.

Yours truly,

Joseph A. McGlothlin

JAM/mls
Enclosure

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Investigation into pricing of unbundled network elements (Sprint/Verizon track)	))))	Docket No. 990649B-TP Filed: May 28, 2002

POST-HEARING STATEMENT OF ISSUES AND POSITIONS AND POST-HEARING BRIEF OF Z-TEL COMMUNICATIONS, INC.

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PRELIMINARY STATEMENT

Pursuant to rule 28-106.215, Florida Administrative Code, Z-Tel Communications, Inc. files its Post-Hearing Brief and its Post-Hearing Statement of Issues and Positions, which contain a summary statement of the positions developed and supported in this brief. The following abbreviations are used in this brief. Z-Tel Communications, Inc. is referred to as "Z-Tel". Verizon Florida, Inc. is referred to as "Verizon". BellSouth Telecommunications, Inc. is shortened to "BellSouth". References to the transcript are designated (Tr.)

INTRODUCTION

Verizon has proposed UNE rates that are orders of magnitude higher than those which the Commission has allowed BellSouth to place into effect. The threat which such inordinately high UNE rates would pose to competition is both obvious and ominous. The Commission must scrutinize Verizon's proposed rates and cost model closely, and determine whether they are well conceived or merely a thinly veiled effort by Verizon to destroy the prospects for competition in its Florida region. Z-Tel devoted much of its efforts in this proceeding to this critical analysis. Z-Tel's witness, Dr. George Ford, fashioned a highly instructive tool -- a "sanity test" -- which the Commission can use to facilitate its determination. The sanity test provides this Commission with a valid way with which to gauge whether Verizon's proposed rates bear a relationship with loop and switching *rates* in Florida that is consistent with similar relationships between

underlying *costs* of providing the loops and switching in Florida. Because the UNE rates must be cost-based, it is logical to expect a reasonable correlation between the ratio of two carriers' rates and the ratio of their related costs. Any significant departure from this logical correlation would flag a need to understand and, where warranted, act on the discrepancy.

Dr. Ford's test of the "sanity" of Verizon's loop and switching rates (the "TELRIC Test") employs the FCC's Hybrid Proxy Cost Model ("HCPM"), a publicly available cost proxy which provides regulators an independent check on the accuracy of incumbent LEC cost studies.[1] That is the role the HCPM assumes in Dr. Ford's testimony. The FCC uses this same cost model to make multimillion- dollar judgments in Universal Service dockets, transferring millions of universal service dollars among local exchange carriers across and within states. Further, Dr. Ford's "TELRIC Test" is based directly on a sanity test developed by the FCC to evaluate TELRIC compliance, and is a helpful, independent tool -- designed by the FCC and reliant entirely on cost estimates generated by the FCC -- with which this Commission can gauge whether Verizon's loop and switching rates comply with the TELRIC standard.

Dr. Ford's sanity test indicates that Verizon's proposed loop and switching rates grossly exceed the level that would be warranted by the ratio of the costs of providing the UNEs.

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[1] (Federal Communications Commission, www.fcc.gov/wcb/tapd/hcpm/): C.A. Bush, D.M. Kennet, J. Prisbey, W.W. Sharkey, and Vaikunth Gupta, *Computer Modeling of the Local Telephone Network,* October, 1999, p. 2 (Federal Communications, www.fcc.gov/wcb/tapd/hcpm/).

Accordingly, both (sets of) rates should be closely examined.

Such an examination was conducted by Gregory J. Darnell, August H. Ankum and Sidney L. Morrison, who testified on behalf of the ALEC Coalition. Their findings bear out the indication of the sanity test that the loop and switching rates are overstated. After applying Dr. Ford's sanity test, and conducting a review of the testimony of Messrs. Darnell, Ankum and Morrison, the Commission should reject the proposed cost model inputs and algorithms of Verizon. Given the evidence, the rates proposed by Verizon for approval in this proceeding exceed by far the limits of what could be considered acceptable. They would impede substantially the development of both facilities-based competition and competition based on unbundled elements in large portions of the Florida local telephone market.

An important contributor to Verizon's overstatement of loop and switching rates is an inflated cost of capital input to the cost model. The evidence of record clearly shows that the cost of capital values proposed by Verizon and Sprint are too high. The importance of determining the cost of capital for Verizon and Sprint accurately cannot be overstated. The cost of capital value is an important element of the cost studies; small changes in the cost of capital assumption can alter most UNE rates materially. In this phase of the proceedings, the Commission should not depart from the well-reasoned cost of capital analysis that this Commission adopted recently in the BellSouth phase of this same proceeding. Applying this

Commission's own methodology for estimating the cost of capital in the earlier phase, and taking into account current economic conditions, the cost of capital for Verizon and Sprint should fall in the range of 8.0% to 8.5%, with Sprint's cost of capital possibly being slightly higher than Verizon's.

ARGUMENT

Issue 1

What factors should the Commission consider in establishing rates and charges for UNEs (including deaveraged UNEs and UNE combinations)?

Z-TEL's POSITION: **The Commission should take into account the sanity test developed by the FCC and formulated for this case by Dr. George Ford. The test that Verizon's proposed UNE rates for loops and switching are not consistent with what a TELRIC methodology, as interpreted by this Commission, would produce.**

While the Commission has authorized BellSouth (pending the completion of additional proceedings) to charge $10.61, $14.91, and $28.21 for a two-wire analog loop; Verizon proposes to charge $22.17, $30.91, and $77.39 for the same UNE. (TR. 290; Ex. 36 at 54-55). Further, Verizon's per-line switching costs will exceed those produced by BellSouth's approved rate by a factor of more than two. (Exhibit 9). The obvious question that the Commission must answer is whether this conspicuous -- and, to the prospects for competition, dangerous -- discrepancy is justified by differences in the carriers' respective costs of providing UNEs. The testimony of Dr. George Ford establishes that BellSouth's loop and switching rates fail to pass a "sanity test" (or "TELRIC test"— the sanity test is an indicator of whether a UNE rate meets the TELRIC

standard).[2] (Tr. 288). The TELRIC test was developed by the FCC, and the use of the FCC's HCPM for such a test was approved and used by the FCC for identical purposes. The FCC uses the TELRIC Test in Section 271 proceedings to determine whether an ILEC's UNE rates comply with the FCC's TELRIC standard. *See, In the Matter of Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, 16 FCC Rcd 6237 (Jan. 2001); *In the Matter of Application of Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions) And Verizon Global Networks Inc., For Authorization to Provide In-Region, InterLATA Services in Massachusetts,* 16 FCC Rcd 8988 (Apr. 2001); *In the Matter of Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 To Provide In-Region, InterLATA Services in Arkansas and Missouri,* 16 FCC Rcd 20719 (Nov. 2001); *In the Matter of Application of Verizon Pennsylvania Inc., Verizon Long Distance, Verizon Enterprise Solutions, Verizon Global*

[2]While Dr. Ford's "sanity test" is an effective tool in analyzing whether a rate complies with TELRC, it should not be used to arrive at a specific rate value. In the FCC's view, the HCPM model is appropriate only for relative cost comparisons in the context of TELRIC studies.

Networks Inc., and Verizon Select Services Inc. for Authorization To Provide In-Region, InterLATA Services in Pennsylvania, 16 FCC Rcd 17419 (Sep. 2001). Dr. Ford used his sanity test – which, like the FCC's test, utilizes the FCC's Hybrid Cost Proxy Model (HCPM or USF model) – to assess the relative costs of providing UNEs across the Verizon and BellSouth territories in Florida. (Tr. 287). Using the UNE cost data supplied by the HCPM, he compared the relationship of the UNE costs and rates between the two carriers. (Tr. 287-290). The principle underlying the test is that the ratio of UNE rates between two carriers should roughly approximate the corresponding ratio of UNE costs. If the costs are identical, then the rates should be roughly identical. (Tr. 288). Through this comparison the Commission can identify the "zone of reasonableness" of proposed UNE rates across carriers.

Dr. Ford performed his sanity test by comparing the costs of providing elements between BellSouth and Verizon in Florida. The results of the test show that the two carriers' costs of providing elements are roughly the same, with costs tending to be somewhat lower in Verizon's service area. (Tr. 287-288) Applying the principles of the sanity test, one would therefore expect that Verizon's rates would actually be slightly less than those of BellSouth.[3] However, as stated above, Verizon's proposed UNE rates inexplicably are orders of magnitude *higher* than

[3] This is not to imply that the current UNE rates for BellSouth are set at an appropriate level. Rather, in Docket 990649A-TP, Dr. Ford has testified that an application of the same sanity test indicates that the BellSouth's Florida UNE-P loop rate is overstated.

the rates set for BellSouth. Quite obviously, the loop rates proposed by Verizon ($22.17, $30.91, and $77.39) are not even remotely similar to those approved for BellSouth ($10.61, $14.91, and $28.21). (TR. 290; Ex. 36 of 54-55). Because the carriers' costs are roughly identical, this highly disparate relationship between rates exposes Verizon's efforts to reduce competition by inflating the input prices of its potential competitors.

Verizon did nothing in this case to justify the discrepancy. Instead, Verizon sought to discredit the TELRIC Test that revealed its blatant attempt to rob its customers of the right to choose a local exchange carrier other than Verizon in a competitive environment. (Tr. 290). This Commission, having already shown its interest in promoting competition in the State of Florida, should reject Verizon's effort to protect its monopoly in the state.

Rather than attempt to defend its grossly inflated loop and switching charges, Verizon focused its efforts on persuading this Commission that the sanity test designed by the FCC and presented by Dr. Ford in his testimony should be discounted. For example, Verizon asserted that the FCC has not "authorized" the use of its sanity test in a manner employed by Dr. Ford. Verizon. Verizon's very premise is wrong. Nothing in the FCC's orders purports to restrict the use of the HCPM in analyses that can stand on their own, as Dr. Ford's clearly can. In addition, the material provided with the installation files of the HCPM states, "a publicly available cost proxy model can be useful to regulators by providing an independent check on the accuracy of

incumbent LEC cost studies."[4] Second, Verizon asserted that the HCPM cannot be used to compare the costs of carriers within a state, but only between states. Verizon's argument is as foolish as it is wrong. In Alabama, Kentucky and North Carolina, three states in which both BellSouth and Verizon are carriers, BellSouth and Verizon received nearly $45 million in high-cost support (Year 2000) based on the results of the HCPM (Universal Service Monitoring Report, CC Docket No. 92-202, October 2001, Table 3.26). Obviously, the HCPM can be used to compare the costs of carriers within a state. Furthermore, in its application of the TELRIC Test, the FCC stated its preference that the two carriers operate in states that are geographically proximate. *In the Matter of Application of Verizon Pennsylvania Inc., Verizon Long Distance, Verizon Enterprise Solutions, Verizon Global Networks Inc., and Verizon Select Services Inc. for Authorization To Provide In-Region, InterLATA Services in Pennsylvania,* 16 FCC Rcd 17419 at ¶63 (Sep. 2001). Verizon echoes this point in its testimony. (TR. 476). Clearly, the implication is that with *proximity* one finds *similarity*.[5] What could be more geographically proximate—and therefore similar, for comparative purposes-- to Florida than Florida?

Verizon claims that Dr. Ford's TELRIC Test did not use the most up-to-date version of the HCPM. (TR. 480-482). However, *at no time in this case did Verizon undertake to quantify*

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[4] C.A. Bush, D.M. Kennet, J. Prisbey, W.W. Sharkey, and Vaikunth Gupta, *Computer Modeling of the Local Telephone Network*, October 1999, p. 2 (Federal Communications Commission, www.fcc.gov/wcb/tapd/hcpm/).
[5] While the FCC prefers geographic proximity, the cost model fully takes into account differences in geographical conditions across states.

the difference in the results that would be associated with the use of the version that it contends should have been employed. The record demonstrates this is because the difference is immaterial. (Tr. 325). In his deposition, Dr. Ford offered to provide Verizon with an updated analysis based on the most current version of the HCPM. Verizon, uninterested in the facts of the case that were contrary to its efforts to impede competition, declined his offer. Dr. Ford conducted the update anyway, and filed his updated analysis (over Verizon's strenuous protests) with the Commission. It was entered into the record in this proceeding as Exhibit No. 9. The results of the updated analysis, based on the latest, publicly-available HCPM information and the exact same HCPM output files used by the FCC is its application of the TELRIC Test, did not result in any material changes to Dr. Ford's earlier test. Rather than discredit Dr. Ford's testimony, the results of the updated analysis showed that Verizon's rates were slightly *more* overstated than Dr. Ford had previously calculated.[6]

Another point raised by Verizon is that the HCPM (and Dr. Ford's test) utilizes generic nationwide default input values rather than company specific, state specific data for certain inputs. Verizon's criticism is irrelevant. The only input which may vary legitimately in a forward-looking network by carrier is the cost of capital, and whether or not it should vary

[6] Further, it is simply not true that the version of the HCPM initially utilized by Dr. Ford is faulty. Rather, the version of the HCPM initially utilized by Dr. Ford was the same version which the FCC found so trustworthy as to utilize it in allocating *hundreds* of millions of dollars of money in its Universal Service Fund case. That the FCC utilized the older version of the HCPM in such a manner bespeaks volumes about its reliability.

between carriers is questionable. Nevertheless, no two firms could be more alike financially and otherwise than Verizon and BellSouth, so the cost of capital should not vary materially between the two firms at any given point in time. The fact that the HCPM does not use state-specific assumptions for a few inputs such as labor is irrelevant in this context because we are comparing costs within a single state. Thus, any adjustment in labor rates should affect the final cost estimates proportionally and leave the results of the TELRIC test unchanged.

Furthermore, the FCC routinely uses the TELRIC Test to compare costs across states, so that agency apparently believes that variations in state-specific assumptions have no bearing on the validity of the TELRIC Test.

To summarize, the TELRIC Test is a useful sanity test of the proposed rates of incumbent local exchange monopolists. Verizon's choice to attack the usefulness of the TELRIC Test rather than defend its inflated cost estimates is revealing. Without question, the incumbents have powerful incentives to deter competitive entry by inflating element rates, and Verizon clearly has acted on those incentives in this case. However, none of Verizon's criticisms of the TELRIC Test lead one to conclude that Verizon's costs of providing UNEs are twice as high as BellSouth's costs. Both Verizon's loop and switching costs need to be reduced to about one-half their current levels to be consistent with TELRIC principles (as interpreted by this Commission in the BellSouth phase).

Issue 2

(a) What is the appropriate methodology to deaverage UNEs and what is the appropriate rate structure for deaveraged UNEs?

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T, Worldcom, and FDN.**

(b) For which of the following UNEs should the Commission set deaveraged rates?

(1) loops (all);
(2) local switching;
(3) interoffice transport (dedicated and shared);
(4) other (including combinations).

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T, WorldCom, and FDN.**

Issue 3

(a) What are xDSL capable loops?

(b) Should a cost study for xDSL-capable loops make distinctions based on loop length and/or the particular DSL technology to be deployed?

Z-TEL's POSITION: **No Position.**

Issue 4

(a) Which subloop elements, if any, should be unbundled in this proceeding, and how should prices be set?

(b) How should access to such subloop elements be provided, and how should prices be set?

Z-TEL's POSITION: **No Position.**

Issue 5

For which signaling networks and call-related databases should rates be set?

Z-TEL's POSITION: **No Position.**

Issue 6

Under what circumstances, if any, is it appropriate to recover non-recurring costs through recurring rates?

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T, WorldCom, and FDN.**

Issue 7

What are the appropriate assumptions and inputs for the following items to be used in the forward-looking recurring UNE cost studies?

(a) network design (including customer location assumptions);

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T, WorldCom, and FDN.**

(b) depreciation;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T, WorldCom, and FDN.**

(c) cost of capital;

Z-TEL's POSITION: **As to Issue 7(c), Z-Tel contends that the Commission should reject the proposed cost of capital of Verizon and Sprint. The Commission should harmonize its decision in the BellSouth track with that of this proceeding when calculating the appropriate cost of capital to be used when setting UNE rates.**

The cost of capital is a highly important element in setting the UNE rates. Even small changes in the cost of capital can materially affect UNE rates. Because of the near universal effect of an overstatement of the cost of capital across element rates , the incumbent LECs routinely overstate the cost of capital in their cost models. This case is no exception: the cost of capital values for both Verizon and Sprint have been overstated and should be closely examined by the Commission.

As it examines this issue, the Commission should bear in mind that the instant exercise is a continuation of an earlier proceeding during which the Commission considered the cost of capital that should be applied to the business of providing UNEs by BellSouth. It is appropriate to ask, "How much of the earlier analysis is applicable to the issue as it pertains to Verizon and

Sprint?" Z-Tel submits that, to the extent that the Commission's earlier analysis was well-reasoned, the objective of consistency argues for the continued application of the methodology developed earlier in this proceeding.

Z-Tel also submits that in the earlier phase of this proceeding the Commission entered many findings and employed rationales that were well reasoned and should be applied to Verizon and Sprint. For instance, in the BellSouth order the Commission stated that it was determining the cost of capital of providing UNEs, indicating its belief that the basic analysis would be applicable beyond the specific ILEC being considered at the time. Order No. PSC-01-1181-FOF-TP, at page 164. To determine the cost of equity capital, the Commission employed the Capital Asset Pricing Model, or CAPM approach. The CAPM was -- and remains -- a good choice. It is theoretically sound. Further, the result of a CAPM analysis is a function of stock market prices. Therefore, the CAPM satisfies the requirement that the approach be forward-looking particularly well. (TR. 279).

In the first phase of this proceeding, after considering various possibilities the Commission determined that the RBOCs and GTE constitute the companies that are "comparable" to BellSouth. The Commission employed a yield-spread approach to the estimation of debt costs, and determined that short-term debt constitutes an important element of capital structure. Based on a wealth of information, the Commission settled on a capital structure

consisting of 60% equity and 40% debt, where equity is overweighed relative to book values. (TR. 285).

These findings from the first phase of this proceeding provide a sound conceptual basis for the determination of the cost of capital that should be associated with the provision of UNEs. In the absence of reasons why the analysis should be jettisoned or altered, Z-Tel believes this very good analytical framework should be extended to the consideration of the cost of capital that should be applied to Verizon and Sprint. Z-Tel submits that no persuasive reason to change the basic framework was presented by any of the cost of capital witnesses. Moreover, the changes that were suggested by witnesses for the ILECs run counter to proper theory and practice.

Updating the cost of capital estimates for the current phase of the proceeding should be relatively straightforward. However, consistency with the earlier phase of this proceeding does not imply that the Commission should simply apply to Verizon and Sprint the same values that it developed for BellSouth. While the approach and methodology are applicable, the measurements of economic conditions that supply the inputs are markedly different now than when the analysis for BellSouth was performed. Specifically, the yield on 10 year Treasury bonds has declined by 150 basis points; commercial paper has dropped by 400 basis points; the prime rate has dropped by 390 basis points; the yield on "A" rated bonds has diminished by 75

basis points; and the yield on "Baa" rated bonds is lower by 50 basis points. (TR. 301, 323). It should be no surprise, then, that the same general methodology, when applied with current information, will yield significantly different cost of capital values.

The thrust of the testimony presented by Z-Tel witness Dr. George Ford was to continue to apply the approach and rationale developed by the Commission in the first phase of the proceeding. In his testimony, when calculating the cost of debt, Dr. Ford recognized the importance of both the long-term and the short-term yield spreads. (TR. 274-278). He included short-term debt as a component of capital structure. (TR. 274-278). He assumed a capital structure consisting of 60% equity and 40% debt. (TR. 285). He used the CAPM method of estimating the cost of equity. (TR. 279, 286). Following the approach established in Phase A, he regarded the RBOCs and GTE as the comparable group, because they (1) provide UNEs and (2) derive substantial revenues from their local exchange businesses. (Order No. PSC-01-1181-FOF-TE at 170). Within the CAPM, Dr. Ford employed actual, historical Beta values (TR. 284). All of these assumptions and methods *directly mirror* the Commission's calculation of the cost of capital in the BellSouth phase of this proceeding. Each assumption made by Dr. Ford is the Commission's assumption, and not derived independently by Dr. Ford. Thus, the prospects for bias -- overstating or understating the cost of capital to favor one side or the other -- are eliminated completely.

With his updated analysis, Dr. Ford calculated a cost of capital for UNE elements of 8.50%. Z-Tel urges the Commission to affirm the reasonableness of its Phase A approach and to adopt 8.50% as the appropriate input for Verizon and Sprint.

In addition to replicating the Commission's analysis set forth in the BellSouth Order, Dr. Ford critiqued the estimates of the forward-looking cost of capital derived by Verizon's witness Vander Weide and Staff witness Draper. Dr. Ford performed alternative calculations based on his corrections to those witnesses' approaches. He showed that regardless of the choice of estimation algorithm, when theoretically appropriate assumptions, inputs, and comparables are used, the estimated cost of capital for Verizon and Sprint is about 8% to 8.5%.

The need for adjustments to the other witnesses' calculations was significant. The bulk of Dr. Vander Weide's approach was rejected directly by this Commission in the BellSouth phase of this proceeding. For example, Dr. Vander Weide uses the S&P Industrial companies as the relevant, comparable group of firms for the UNE business. The S&P Industrials include a diverse array of companies, many of which -- such as Disney, Eastman Kodak, Heinz, and Coca-Cola -- are not telecommunications companies.. In Phase A, this Commission rejected the use of comparable firms that neither participated in the local exchange telecommunications business nor sold unbundled elements, opting instead to use the RBOCs and GTE as the appropriate group of comparable firms. Order No. PSC-01-1811-FOF-TP at 170. According to the

Commission's own conclusions in this proceeding, Dr. Vander Weide employs an overly broad group of comparable firms that are in no way comparable to the risk faced by a firm in the UNE business. [7]

Second, in direct conflict with the Commission's earlier decision, Dr. Vander Weide's analysis failed to include short-term debt as an important element in the determination of cost of capital. Overall, the cost of capital analysis performed by Dr. Vander Weide improperly and entirely ignores the Commission's determinations in Phase A of this proceeding. In fact, Dr. Vander Weide's procedures and assumptions do not simply ignore the Commission's determinations, but *directly contradict* nearly every determination made by this Commission in Phase A. The methodology utilized in the BellSouth phase can — and, for the sake of consistency, should -- be applied in this case. (Tr. 273). Any improvements or additions to the Commission's methodology should be consistent with, not contradictory to, its earlier determinations.

Dr. Ford also addressed the cost of capital analysis submitted by Staff witness Mr. Draper. Dr. Ford points out that Mr. Draper's analysis is flawed in a number of ways. First, Mr. Draper estimated the cost of equity based on a DCF model that actually inverts the growth rate

[7] In his testimony, Dr. Vander Weide acknowledges that provisioning of UNEs "presents its own unique risk[s]." (TR. 420-21).

components of the traditional analysis. Mr. Draper's cost of equity analysis utilizes a two-stage DCF model. Theoretically, in such an analysis, the first stage of growth allows for a short period of high growth by the company, while the second tier assumes a sustained period of growth at a lower growth rate. The two-stage model is designed specifically to ensure that the long-term growth rate does not exceed the long-term growth rate in the economy; indeed, this relationship of growth rates is why there is a second stage of growth in the model! Mr. Draper's application of the two-stage model is flawed, of course, because the analysis provides for a short, initial period of growth at a *low* growth rate followed by a sustained period of growth at a *high* rate. The growth rate assumptions are inverted. Further, Mr. Draper' estimated sustained growth rate is about twice as high as the long-term growth rate of the economy. (Tr. 305). In phase A, the Commission rejected an analysis made by BellSouth witness Billingsley which used similarly high growth rates. As the Commission recognized in Phase A, the inherent flaw with setting sustained growth rates at too high a level is that it assumes that the company will eventually grow as large as the economy. Order No. PSC-01-1811-FOF-TP at 169-170. Therefore, the Commission should reject the growth assumptions included in the two-stage DCF analysis supported by Mr. Draper.

Second, Mr. Draper employed an inappropriate set of comparable firms in estimating the cost of equity, some of which were specifically rejected as relevant comparables in the BellSouth

Phase. As stated above, the Commission in Phase A supported the use of RBOCs and GTE as comparable companies for use in a DCF analysis.[8] Order No. PSC-01-1811-FOF-TP at 170-171. In his DCF analysis, Mr. Draper's list of comparables included AT&T, BellSouth, CenturyTel, Qwest, Sprint, Telephone & Data Systems ("TDS") and Verizon. Of these, only two, Verizon and BellSouth, are recognized as RBOCs and thus are appropriate comparable companies consistent with the method approved in Phase A. (Tr. 306). Although many of Mr. Draper's companies do provide telecommunications service of one type or another, it is nevertheless improper to utilize them as a proxy for Sprint or Verizon as a UNE provider. Qwest is an inappropriate choice as a comparable because its financial characteristics – stock Beta, projected long-term growth, and earnings expectations – differ greatly from that of the RBOCs. (Tr. 307). Further, AT&T, CenturyTel, and TDS are inappropriate because, among other reasons, none of their revenues come from the sale of UNEs. (Tr. 308). Moreover, the Commission determined that providing local exchange service was a similarly important criterion in determining comparable companies. Order No. PSC-01-1811-FOF-TP at 170. Therefore, AT&T and TDS should be excluded from the list of comparables because AT&T is primarily not a local exchange carrier, and TDS receives only about 25% of its revenues from local exchange service. (Tr. 308).

[8] By virtue of its merger with Bell Atlantic, GTE has been removed from the list of RBOCs. This leaves only the Regional Bell operating companies.

Mr. Draper's cost of equity estimates are overstated, in part, by his inclusion of Qwest in the group of comparables. Qwest should not be included as a comparable to the business of supplying UNEs. Instead, the list of comparables should include the RBOCs, consistent with the order in Phase A. In the alternative, Dr. Ford suggests that Sprint may also be included in the list of comparables. Sprint meets two of the requirements set forth in Phase A: it sells unbundled network elements and provides local exchange service. However, Sprint's exclusion from the group of comparables in justified by consistency throughout this proceeding. In any case, Sprint's inclusion or exclusion has only a small effect on the estimated cost of capital.

Third, Mr. Draper adopts an incorrect proxy for short-term debt costs, thereby erroneously inflating the cost of debt. In his testimony, Mr. Draper calculates the short-term debt by using the prime rate associated with bank loans as a proxy. However, this methodology is inconsistent with the Commission's decision in Phase A. There, the Commission employed the cost of commercial paper as a proxy for the cost of short-term debt. The Commission was right to use commercial paper as a proxy for short-term debt; the cost of commercial paper is a better indicator of short term debt because commercial paper is a more substantial component of short term debt than bank loans for local exchange carriers. (Tr. 297). In rebuttal, Dr. Ford provided estimates of short-term debt costs by including bank loans, but weighted bank loans and commercial paper appropriately.

Fourth, Mr. Draper's CAPM analysis overstated the cost of equity by using inflated Betas, a measure of risk. Value Line's Beta values, which were used by Mr. Draper, are not actual Beta values based on historical performance. Instead, they reflect arbitrary adjustments advocated by a financial theorist named Blume, who posited that over time *portfolio* Betas (not firm or industry betas) will tend toward unity. The Blume adjustment, when applied to individual firm Betas, arbitrarily increases all Betas less than one and arbitrarily decreases all Betas greater than one. Because most of the comparables used by Mr. Draper have Betas less than one, a result of using "Blume-adjusted" Beta values is to overstate the composite Beta for his "comparables." At a Beta of 1.55, Qwest (which has very different business characteristics than the typical RBOC) is an outlier that "single-handedly" distorts Mr. Draper's CAPM analysis. Mr. Draper's resulting assumed Beta of 1.02 is substantially higher than the 0.66 employed by the Commission in the BellSouth phase, and considerably larger than any BOC Beta. Further, an above-unity value for Beta carries the implicit assumption that the business of supplying UNEs is more risky than the market as a whole—an assumption which conflicts with the Commission's order in phase A of this proceeding. (TR. 314).

Importantly, in his testimony Mr. Draper did not espouse the purported theoretical basis for using the inflated Blume Betas. Apparently, he simply used Value Line as a source of data without first critically evaluating that data. Critical analyses of the Blume Betas, cited by Dr.

Ford in his response to Mr. Draper, question the validity of the Blume Betas particularly in regulatory proceedings such as this one. The primary flaw in the Blume theory when applied to individual firms or industries is that the underlying conceptual framework of Blume fails to distinguish between firms and industries, but focuses on portfolios of stocks. While the overall theory is suspect, the Blume adjustment is particularly inappropriate for industries that are characterized by high equity investments and prices designed to recover all costs, including explicitly the cost of capital. (TR. 317). More importantly, an examination of the Beta of RBOCs over extended periods demonstrates that -- contrary to the Blume hypothesis -- the Beta of RBOCs has moved lower (i.e., further from unity) over time.

Consistently with the Phase A decision, which used actual Betas, and the record in this proceeding the Value Line Betas should be rejected in favor of actual, historical values for Beta.

Despite the notable shortcomings of Mr. Draper's analysis, once needed adjustments are made the approach has some value. Using Mr. Draper's analysis as a framework, Dr. Ford made changes to the analysis to bring it into conformity with financial theory and practice as well as the Commission's decision in Phase A.

The result of Dr. Ford's proposed adjustments to Mr. Draper's analyses suggest that the cost of capital for Sprint and Verizon should fall between 8.0 to 8.5%, with the cost of capital for Sprint being slightly higher than Verizon's. (Tr. 322-23).

(d) tax rates;

Z-TEL's POSITION: **No Position.**

(e) structure sharing;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(f) structure costs;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(g) fill factors;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(h) manholes;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(i) fiber cable (material and placement costs);

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(j) copper cable (material and placement costs);

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(k) drops;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(l) network interface devices;

Z-TEL's POSITION: **No Position.**

(m) digital loop carrier costs;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(n) terminal costs;

Z-TEL's POSITION: **No Position.**

(o) switching costs and associated variables;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(p) traffic data;

Z-TEL's POSITION: **No Position.**

(q) signaling system costs;

Z-TEL's POSITION: **No Position.**

(r) transport system costs and associated variables;

Z-TEL's POSITION: **No Position.**

(s) loadings;

Z-TEL's POSITION: **No Position.**

(t) expenses;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(u) common costs;

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

(v) other.

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

Issue 8

What are the appropriate assumptions and inputs for the following items to be used in the forward-looking non-recurring UNE cost studies?

(a) network design;

(b) OSS design;

(c) labor rates;

(d) required activities;

(e) mix of manual versus electronic activities;

(f) other.

Z-TEL's POSITION: **Z-Tel adopts the position of AT&T and WorldCom.**

Issue 9

(a) What are the appropriate recurring rates (averaged or deaveraged as the case may be) and non-recurring charges for each of the following UNEs?

(1) 2-wire voice grade loop;

(2) 4-wire analog loop;

(3) 2-wire ISDN/IDSL loop;

(4) 2-wire xDSL-capable loop;

(5) 4-wire xDSL-capable loop;

(6) 4-wire 56 kbps loop;

(7) 4-wire 64 kbps loop;

(8) DS-1 loop;

(9) high capacity loops (DS3 and above);

(10) dark fiber loop;

(11) subloop elements (to the extent required by the Commission in ssue 4);

(12) network interface devices;

(13) circuit switching (where required);

(14) packet switching (where required);

(15) shared interoffice transmission;

(16) dedicated interoffice transmission;

(17) dark fiber interoffice facilities;

(18) signaling networks and call-related databases;

(19) OS/DA (where required).

Z-TEL's POSITION: **Z-Tel asserts that Verizon's proposed UNE rates are severely overstated. A "sanity test," derived from the FCC's TELRIC test, indicates they should be no

higher than the rates approved for BellSouth.[1]**

(b) Subject to the standards of the FCC's Third Report and Order, should the Commission require ILECs to unbundle any other elements or combinations of elements? If so, what are they and how should they be priced?

Z-TEL's POSITION: **No Position.**

Issue 10

What is the appropriate rate, if any, for customized routing?

Z-TEL's POSITION: **No Position.**

Issue 11(a)

What is the appropriate rate if any, for line conditioning, and in what situations should the rate apply?

Z-TEL's POSITION: **No Position.**

Issue 11(b)

What is the appropriate rate, if any, for loop qualification information, and in what situations should the rate apply?

Z-TEL's POSITION: **No Position.**

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[1]This is not to imply a view by Z-Tel that BellSouth's current rates are set at an appropriate level.

Issue 12

Without deciding the situations in which such combinations are required, what are the appropriate recurring and non-recurring rates for the following UNE combinations:

(a) "UNE platform" consisting of: loop (all), local (including packet, where required) switching (with signaling), and dedicated and shared transport (through and including local termination);

<u>Z-TEL's POSITION:</u> **Z-Tel asserts that Verizon's proposed UNE rates are severely overstated. A "sanity test," derived from the FCC's TELRIC test, indicates they should be no higher than the rates approved for BellSouth.[1]**

(b) "extended links," consisting of:

(1) loop, DSO/1 multiplexing, DS1 interoffice transport;

(2) DS1 loop, DS1 interoffice transport;

(3) DS1 loop, DS1/3 multiplexing, DS3 interoffice transport.

<u>Z-TEL's POSITION:</u> **Z-Tel adopts the position of AT&T and WorldCom.**

Issue 13

When should the recurring and non-recurring rates and charges take effect?

<u>Z-TEL's POSITION:</u> **Z-Tel adopts the position of AT&T and WorldCom.**

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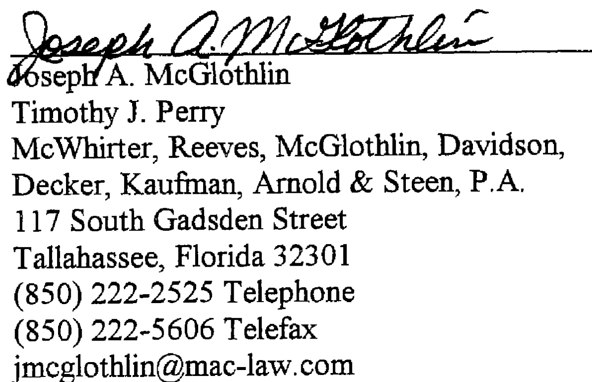
[1]This is not to imply a view by Z-Tel thatBellSouth's current rates are set at an appropriate level.

CONCLUSION

For the reasons developed in this Brief, the Commission should reject Verizon's grossly overstated UNE rate proposal.



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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of Z-Tel Communications, Inc.'s Post Hearing Statement and Issues and Positions and Post-Hearing Brief was on this 29th day of May 2002, sent via (*) Hand Delivery, Email and U.S. Regular Mail, to the following names and addresses.

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