INTRODUCTION

Four years after the Telecommunications Act of 1996 (the "Act") was passed, it is clear that the Act has effected a shift in the telecommunications market. Increased competition has meant increased choices for some consumers, along with the potential for increased confusion. Competition has emerged in a spotty fashion with new entrants focusing primarily upon the lucrative business accounts clustered in the most densely populated urban areas of the state.

This is perhaps natural, since under the current rate structure low-cost, urban business customers have been subsidizing high-cost customers by paying rates that are higher than the actual costs to serve them. Thus, new entrants realize substantial margins by serving low cost customers in urban areas and pricing below the tariffed rates of the incumbent carrier. This leads to rate arbitrage. The way to avoid rate arbitrage is by recognizing, as this Commission did in Docket No. U-3021-96-448 ET AL. that unbundled network element prices should be deaveraged in concert with deaveraging of retail prices. (Decision No. 60635, pp. 21-22)

Although U S WEST recognizes that its retail rates should be deaveraged in phases over time to avoid consumer "rate shock", U S WEST still believes that the Commission should do its utmost to limit consumer confusion and arbitrage. Thus, in ordering UNE deaveraging, the
Commission should recognize that deaveraging of wholesale rates drives the deaveraging of retail rates. In other words, where cheaper wholesale rates prevail, cheaper retail rates prevail. Conversely, where higher wholesale rates prevail, ultimately, higher retail rates will follow. Therefore, an elaborate or complex scheme for UNE deaveraging will ultimately result in a similar scheme for retail deaveraging.

Accordingly, U S WEST has submitted a deaveraging proposal which relies heavily upon the way retail basic exchange prices are structured in Arizona, and which deaverages prices based upon the FCC requirements of cost-related loop rates in three geographic zones. Under U S WEST's proposal, loop prices are deaveraged based upon relative costs while preserving, to the greatest extent possible, the base rate area and zone increments which makes a rate design intelligible to a customer, and in Arizona results in cost-based rate differences among the various geographic zones. U S WEST's approach is simple: service areas are differentiated according to the retail base rate area and incremental zones, the relative costs to serve each zone is determined, and prices are deaveraged according to the relative costs incurred to serve each zone.

AT&T's proposal, on the other hand, fails to minimize either customer confusion, or rate arbitrage, and produces multiple zones within each geographic area (e.g., 5 zones in metropolitan Phoenix). When the FCC required the deaveraging of UNE rates it was with the understanding that, ultimately, implicit subsidies would be eliminated and retail prices would more closely reflect cost to provide service. AT&T's proposal ignores the existing retail structure in Arizona which means that until the retail structure can be adjusted there will be no connection between retail rates and the underlying wholesale costs. When retail does move toward the underlying wholesale structure, under AT&T's proposal, Arizona will end up with a retail structure similar to the one the Commission abandoned in 1991. (Million, U S WEST Ex. 1, p. 9)

1 U S WEST assumes the base rate areas with the expanded boundaries as recommended by David Teitzel in Docket No. T-1051B-99-105, see Teitzel testimony, filed January 8, 1999, p. 42.
When all of the relevant factors are considered, US WEST's proposal for UNE deaveraging is plainly better and is the one that this Commission should adopt.

**STATEMENT OF THE CASE**

In August 1996, the Federal Communications Commission (FCC) issued its Local Competition Order which implemented section 251 of the Telecommunications Act of 1996. Section 51.507(f) required each state public utilities commission to establish different rates for interconnection and unbundled network elements (UNEs) in at least three geographic areas within the state to reflect geographic cost differences. The Court of Appeals for the Eighth Circuit, however, subsequently stayed and then vacated this deaveraging rule. Based on those decisions, this Commission did not establish different rates for different geographic areas. However, in January 1999, the United States Supreme Court reversed, in part, the Eighth Circuit's decision. Thereafter, on May 7, 1999, the FCC stayed the effectiveness of the rule in order to allow it more time to address universal service concerns.

In November 1999, the FCC lifted the stay effective May 1, 2000. In the Matter of the Federal-State Joint Board on Universal Service, CC Docket 96-45, Ninth Report and Order and Eighteenth Order on Reconsideration, FCC 99-306, ¶ 120 (released November 2, 1999). The FCC order provides that by May 1, 2000, "states are required to establish different rates for interconnection and UNEs in at least three geographic areas pursuant to section 51.507 (f) of the Commission's rules." Id.

Accordingly, on March 30, 2000, this Commission issued an order establishing this docket and set a procedural schedule. The parties filing testimony were US WEST, NEXTLINK and AT&T, and they filed simultaneous direct testimony on April 24, 2000. These same parties filed simultaneous responsive testimony on May 1, 2000, and, in addition, the Staff for the Arizona Corporation Commission filed rebuttal testimony, as well.
STATEMENT OF FACTS

A. Deaveraging of UNE (wholesale) rates is inextricably linked to the deaveraging of retail rates

At the outset, as US WEST noted in the testimony of Teresa K. Million (Million, US WEST Ex. 1, pp. 3, 6-8; 5/11/00 Tr. pp. 11-15), it is a matter of public policy and economic reality that the deaveraging of UNE (wholesale) rates is inextricably linked with the deaveraging of retail rates. Discrepancies between the retail and wholesale price structures undermine competition and competitive neutrality. In addition, as US WEST showed, deaveraging of wholesale rates without the deaveraging of retail rates does not promote competition, is not fair, and is not consistent with Congress' intent when it drafted the Telecommunications Act. (Id.) Of course, US WEST recognizes that it will take time for implicit subsidies to be replaced by explicit subsidies, and therefore for retail rates to become entirely consistent with wholesale costs.

The intent of the Telecommunications Act is to provide competitive choices to all consumers, regardless of where they live in the state. If UNE rates are deaveraged, UNE rates will be reduced in lower-cost urban areas, and increased in higher-cost areas. Competitors will flock to the urban business markets, like downtown Phoenix and Tucson, where UNE rates are low and retail rates are higher, while completely ignoring higher-cost rural areas. This scenario is not deaveraging; it is simply a UNE price decrease in low-cost densely populated urban areas. When retail and wholesale prices are synchronized, there is the possibility of UNE based competition because competitors will see opportunity in both densely populated and outlying areas. (Million, US WEST Ex. 1, p. 8.) In fact, this Commission has previously recognized that UNE rates and retail prices should be deaveraged in concert. Specifically, in Docket No. U-3021-96-448 ET AL., the Commission concluded "we share US WEST's concerns that geographic deaveraging would need to occur for US WEST retail customers at the same time it occurs at the wholesale level." (Decision No. 60635, pp. 21-22)
B. U S WEST's deaveraging method

Based on its belief that wholesale and retail rates are inextricably linked, U S WEST proposed a deaveraged wholesale rate structure consistent with the retail rate structure in Arizona. Such a structure results in three distance-based cost-related zones, i.e., base rate area and two zone increments. Costs in each of the three zones were grouped together and the relative loop investments were calculated for each zone. The investment for each zone was then compared to the statewide average investment and a percentage was determined by dividing the zone investments by the statewide investment. These percentages were multiplied by the statewide average unbundled loop rate of $21.98 to determine the deaveraged price for each zone. U S WEST used this approach, in part, because it is logical and easily understood by consumers. The results of U S WEST's method are rates of $20.12 for the base rate area, $40.65 for Zone 1 and $63.70 for Zone 2. This methodology is cost-related, and is consistent with the FCC's rules under CFR 51.507(f).

As the evidence showed, there are numerous advantages to this Commission using U S WEST's base rate area and zone increment deaveraging approach. For example, because retail rates in a competitive environment will necessarily be drawn toward the level of wholesale rate deaveraging, retail customer perspectives are essential in the selection of a deaveraging method. This method of deaveraging is relatively easy to administer in Arizona because the zone increment structure already exists for retail purposes. Further, this deaveraging method is generally compatible with the systems U S WEST uses to provision service, bill customers, and manage the network, thus minimizing costs to implement billing and other changes.

Finally, given that the deaveraging is intended to

---

2 At Commission Staff's request, U S WEST also submitted a late filed exhibit with rates based on the current retail zone structure. The resulting rates are as follows: $18.96 for the base rate area, $34.94 for Zone 1 and $56.53 for Zone 2.
occur by May 1, 2000, or in Arizona's case by June 29, 2000, this methodology would be
relatively simple to implement. (Million, U S WEST Ex. 1, pp. 3, 11.)

C. AT&T's UNE deaveraging proposals

AT&T, on the other hand, did not consider the existing retail structure in its proposal.
The AT&T proposal estimates average loop costs by wire center generated using the HAI model.
AT&T then applies a factor so that the average cost, utilizing the HAI model equals the statewide
average loop cost (i.e., $21.98) as determined by the Commission. (Denny AT&T Ex. 1, pp. 11-
12.) The resulting average loop costs are then sorted by wire center and assigned to zones. An
average loop rate is then developed for each zone. In his direct testimony AT&T's witness,
Douglas Denney, submitted four possible sets of rates.

The reason there are so many cost and rate calculations for the Commission to consider
under AT&T's proposals is that, as Mr. Denney admits, there are any number of ways under this
method to group wire center costs into zones. (Denny, AT&T Ex. 1, pp. 15-16; 5/11/00 Tr. pp.
98-99) As U S WEST points out, unlike its own objective approach, the AT&T method is
subjective and susceptible to manipulation.

AT&T's method results in 5 different rates in the Phoenix metropolitan area, alone. This
proposal could eventually result in a retail rate structure similar to a structure the Commission
abandoned in Arizona in 1991. Mr. Denney suggests that because AT&T's method is wire center
based, it will be easy to identify customers by zone and that CLECs will be burdened if they have
to pay a "look-up" charge to determine a customer's zone. (Denny, AT&T Ex. 1, p. 8.) This
argument is unfounded since U S WEST currently does not charge CLECs for making inquiries
or facilities checks. Thus, the retail zone information needed under U S WEST's proposed zone
increment method is readily available to the CLECs. In addition, Mr. Denney evidently assumes
that there will necessarily continue to be a link between telephone numbers and wire centers, and
that CLECs will only be serving existing customers in Arizona.
D. **Staff's UNE deaveraging proposal**

Staff proposes to deaverage the unbundled loop UNE on a wire center basis using three zones. Staff's method for determining cost is based on the FCC's universal service model, also known as the Synthesis Model, on grounds that it is a neutral model that has been subject to review, although not by the Arizona Commission. Using the Synthesis Model, Staff determined average loop costs by wire center. These average loop costs are the result of averaging the costs of varying loop lengths and densities across a wire center. Loop length and density are the factors that drive geographic cost differences in loops. Staff then selected three zones based on wire center cost and averaged those costs to determine the average UNE loop rate per zone. These loop rates were adjusted by a factor to put them on an equivalent basis with the statewide average loop rate.

Based on the testimony and attendant schedule originally filed on May 1, 2000, by Staff witness Matthew Rowell, it is evident that Mr. Rowell made more than one grouping of wire centers in determining what zones to establish. Mr. Rowell subsequently corrected Schedule 1 on May 8, 2000 to reflect the zones described in his testimony. According to Mr. Rowell, the grouping of wire centers under Staff's method (and presumably AT&T's method) is a "matter of judgment." (Rowell, Staff Ex. 1, p. 4.)

Staff questioned U S WEST about the loop model ("LoopMod") it used to develop the relative investments by zone. Staff appeared concerned that LoopMod had not been filed previously in Arizona and so had not been subject to review. LoopMod is the replacement model for U S WEST's previously filed RLCAP model. LoopMod has been updated to address concerns raised by other parties in their review of RLCAP. Although, Staff did not ask similar questions of AT&T, the HAI model submitted by AT&T has also not been filed previously or subject to review in Arizona. HAI 5.0a is a later version of the Hatfield model 2.2.2 that AT&T submitted
previously in Arizona. AT&T has also made changes to HAI in an effort to update the way it calculates loop costs. (Denny, AT&T Ex. 1, p. 11, footnote 10.)

ARGUMENT

III. AT&T's HAI PROPOSALS ARE ARBITRARY, AND OPEN TO MANIPULATION

As was plainly evident from both U S WEST's cross-examination and from a review of AT&T's exhibit, the HAI model proposals are arbitrary, and open to manipulation, and thus produce average prices that are no more accurate than other methods. The evidence showed that there was nothing precise, objective, or even scientific about AT&T's wire center groupings. In fact, AT&T's proposal of four different sets of costs merely supports U S WEST's contention that there is no single "true" cost upon which to base deaveraged rates, and therefore, it is appropriate to consider other factors in determining geographic zones. Nevertheless, AT&T conveniently grouped only the five wire centers in downtown Phoenix in Zone 1. AT&T arbitrarily assigned zones based on wire center costs on grounds that $5 increments most closely reflected cost differences in Zones 1 through 4, then lumped all wire center costs from $30.70 to $336.34 into Zone 5. AT&T could have just as easily grouped the wire centers into $10 increments and made Zone 5 reflect all wire centers above $50. The obvious net result of AT&T's arbitrary groupings was a low $12.75 loop rate in Zone 1. (Denny, AT&T Ex. 1, Attachment A.)

By choosing only a few of the lowest cost wire centers, AT&T was able to manipulate the results to produce a very low loop rate for Zone 1. Downtown Phoenix is very likely to be the only place that AT&T will compete in Arizona. The result of this type of rate manipulation is merely an opportunity for rate arbitrage. Under AT&T's proposals, CLECs would enjoy the benefit of a more than 40 percent UNE price decrease in downtown Phoenix ($21.98 to $12.75), but would not pursue UNE-based competition in the high-cost areas of Arizona, leaving U S WEST to serve those customers at basic exchange retail rates that do not recover the cost of the loop.
Not surprisingly, of the seven states in U S WEST's region that have deaveraged UNEs, three (New Mexico, South Dakota and Utah) adopted U S WEST's MSA approach, and two (Colorado and Wyoming) have chosen U S WEST's zone increment approach, similar to the proposal for Arizona. In North Dakota the deaveraged rates have been stipulated in an agreement between the parties. To date only one state, Washington, has adopted a five zone method based on groupings of wire-center costs. (Million, 5/11/00 Tr. p. 50) However, Washington's retail structure, unlike Arizona's, is not based on base rate areas and zone increments. It should also be noted that the method proposed by AT&T and the CLECs was adopted in principle only; Washington's commission did not adopt AT&T proposed rates.

In addition, Mr. Denney essentially acknowledged his assignment of wire centers to various zones was arbitrary, and that the Commission could choose different break points than the break points he used. (Denny, 5/11/00 Tr. pp. 98-99.) It appears as though Mr. Denney applied his break points to ensure that the unbundled loop price in Zone 1 (downtown Phoenix) remains low, that the majority of unbundled loops in Arizona (Zones 1 and 2) are priced below $20, and that loops in the outlying areas where AT&T is not likely to compete (the 71 wire centers in Zone 5) are priced in excess of $50.

Finally, the arbitrariness of the AT&T proposal is made manifest when one considers that it results in the city of Phoenix being divided among Zones 1 through 5. The problem will be exacerbated when retail deaveraging follows wholesale deaveraging, as it must. For example, consumers in Phoenix – living within a six-mile radius of the Phoenix South wire center – will pay retail rates based upon UNE prices, ranging from $12 to in excess of $50, that have no connection to the retail structure. Accordingly, AT&T's proposals are neither consumer-friendly, nor transparent.

II. THE WIRE CENTER METHODS PROPOSED BY STAFF AND AT&T ARE NOT MORE ACCURATE

Both AT&T and Arizona Staff challenged U S WEST for proposing a deaveraging plan
that is highly averaged because almost 95% of customers are in the base rate area. This should
not be a surprising result in Arizona, since nearly 85% of customers are concentrated in the two
metropolitan areas of Phoenix and Tucson. Nevertheless, the FCC must have contemplated that
any deaveraging plan would contain an element of averaging, otherwise states would have been
required to create more than three deaveraged zones. (Million, U S WEST Ex. 1, p. 12.) Just
because AT&T and Staff have produced loop costs by wire center does not mean that those costs
are not also highly averaged.

The two principal drivers of geographic cost differences in the loop UNE are loop length
and density. By grouping costs and averaging them across wire centers, Staff and AT&T have
chosen to ignore the differences in loop cost between customers that are close to a central office
in densely populated areas, and those that are far away from a central office in more sparsely
populated areas, within any given wire center. Their methods take loop costs by wire center that
range from $11 to $336 according to AT&T's model ($12 to $334 according to Staff's
calculations) and average them across three or five zones.

At best, picking the wire centers to group into zones of similar cost is a matter of
judgment, at worst it is pure rate manipulation. Ultimately, the result is highly averaged rates,
and zones that contain anywhere from 10% of customers to 60% of customers. Nowhere in the
FCC's rules does it say that deaveraging should be based on the average relative cost of wire
centers. Nor does the FCC give any guidance in its rules about the appropriate percentage of
customers that should fall into each zone. What the FCC does say is that there should be at least
three zones and those zones must be cost-related. (Million, U S WEST Ex. 1, p. 12.)

U S WEST's method establishes three zones. It bases its deaveraging on Arizona's retail
structure, and uses distance of the customer from the central office and the density of the area in
which the customer resides to calculate average loop rates for the three zones. While this method
averages the loop investments for all customers within the base rate areas and each of the zone
increments, it differentiates between the zones based on loop length and density.

III. **U S WEST'S ZONE INCREMENT APPROACH MAKES SENSE FOR ARIZONA**

As stated, U S WEST's UNE deaveraging proposal makes sense for Arizona, and accomplishes the FCC's goal to have cost-related loop rates and three zones. The base rate area and zone increments proposed by U S WEST result in three cost-related zones. U S WEST's loop rates represent geographic deaveraging in the sense that they are developed using loop length and density information, the two drivers of loop cost differences.

AT&T and Staff expressed concerns that customers be easily identified with zones and that U S WEST's zone increment would place a burden on CLECs in making such an identification. The "burden" that they are concerned about is a look-up charge that is non-existent in U S WEST's current pre-order process. They contend that establishing zones by wire centers provides an easy and publicly available method for identifying customers within zones. A CLEC need only know the customer's existing NNX (assuming it has a list of wire centers by NNX and zone) to locate the customer within a zone. This argument does not take into effect that not all customers will have existing telephone numbers. Presumably, CLECs will be competing for new customers in Arizona, as well as U S WEST's existing customers. Nor does this argument recognize that in the future, local number portability removes the link between telephone number and wire center. Therefore, as a practical matter, since CLECs use U S WEST systems in the pre-order process to identify existing customers, and facilities and locations for new customers and new locations, identifying zones by wire centers is not any easier in the long run. U S WEST's proposal is based on the existing retail rate structure and, thus, all of the information necessary to identify customers within the base rate area and zone increments is easily available to CLECs through the pre-order process.
U S WEST's zone increment approach is understandable to consumers, is relatively easier
to administer, is generally compatible with existing computer systems, and is relatively simple to
implement in a timely manner. (Million, U S WEST Ex. 1, p. 11, 5/11/00 Tr. pp. 45-49)

CONCLUSION

For all of these reasons, U S WEST respectfully submits that the Commission should
adopt U S WEST's reasonable, compliant and competition-friendly UNE deaveraging proposal.

RESPECTFULLY SUBMITTED this 26 day of May, 2000.

U S WEST Communications, Inc.

By: Timothy Berg
FENNEMORE CRAIG, P.C.
3003 North Central, Suite 2600
Phoenix, Arizona 85012-2913
(602) 916-5421
(602) 916-5999 (fax)

Thomas M. Dethlefs
Senior Attorney, Law Department
U S WEST COMMUNICATIONS, INC.
1801 California Street
Suite 5100
Denver, CO 80202
(303) 672-2948
(303) 295-7049 (Fax)
Attorneys For U S WEST
Communications, Inc.

ORIGINAL and 10 copies of the
foregoing hand-delivered for
filing this 26 day of May, 2000
to:

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

COPY of the foregoing hand-delivered
this 26 day of May, 2000, to:
THREE COPIES of the foregoing  
hand-delivered this day of  
May, 2000 to :  

Jerry Rudibaugh, Chief Arbitrator  
Hearing Division  
ARIZONA CORPORATION COMMISSION  
1200 West Washington  
Phoenix, AZ 85007  

COPY of the foregoing mailed  
this day of May, 2000, to:  

Stephen J. Duffy  
RIDGE & ISAACSON, P.C.  
3101 North Central Avenue, Ste. 1090  
Phoenix, Arizona 85012-2638  

Richard S. Wolters  
AT&T  
1875 Lawrence Street, Room 1575  
Denver, CO 80202-1847  

Michael W. Patten  
BROWN & BAIN  
P.O. Box 400  
Phoenix, AZ 85001-0400  

Michael Grant  
GALLAGHER & KENNEDY  
2575 E. Camelback Rd.  
Phoenix, AZ 85016-9225