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July 14, 2010

VIA COURIER

Mr. Jeff Derouen
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, KY 40602

Re: MCI Communications, Services, Inc., Bell Atlantic Communications. Inc., NYNEX Long Distance Company, TTI National, Inc., Teleconnect Long Distance Services & Systems Company and Verizon Select Services, Inc., Complainants v. Windstream Kentucky West, Inc., Windstream Kentucky East, Inc.-Lexington, and Windstream Kentucky East, Inc.-London, Defendants
PSC 2007-00503

Dear Mr. Derouen:

Enclosed for filing in the above-captioned case are copies of the Direct Testimony of Dr. Debra J. Aron and Dr. Ola Oyefusi on behalf of BellSouth Telecommunications, Inc., d/b/a AT&T Kentucky and AT&T Communications of the South Central States, LLC.

Portions of the Direct Testimony of Dr. Aron and Dr. Oyefusi contain confidential commercial information and AT&T files herewith its Petition for Confidentiality pursuant to 807 KAR 5:001, Section 7, seeking protection of that material. Specifically, AT&T requests the Commission to grant confidentiality to the information highlighted on Pages 8-9, 29-32, 38, 41, 44, 46, 52-53, and 71 of Dr. Aron's Direct Testimony and on Pages 13-17, 20-22, 36, 43-44, and 49 and in Exhibits OAO-4 and OAO-7 of Dr. Oyefusi's Direct Testimony. One proprietary copy and 10 edited copies are provided to the Commission. An edited copy of the filing is provided to parties of record. A proprietary copy is provided to counsel for Windstream pursuant to a previously-executed Non-Disclosure Agreement.

Copies of the affidavits of AT&T's witnesses are filed today. The original affidavits will be filed in the near future.

Should you have any questions, please let me know.

Sincerely,

Mary K. Keyer

Enclosures

cc: Parties of Record

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EDITED

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

MCI COMMUNICATIONS SERVICES, INC., BELL ATLANTIC COMMUNICATIONS, INC., NYNEX LONG DISTANCE COMPANY, TTI NATIONAL, INC., TELECONNECT LONG DISTANCE SERVICES & SYSTEMS COMPANY AND VERIZON SELECT SERVICES, INC.	)	
Complainants	)	CASE NO. 2007-00503
vs.	)	
WINDSTREAM KENTUCKY WEST, INC., WINDSTREAM KENTUCKY EAST, INC. – LEXINGTON AND WINDSTREAM KENTUCKY EAST, INC. – LONDON	)	
Defendants	)	

PETITION FOR CONFIDENTIALITY OF
BELLSOUTH TELECOMMUNICATIONS, INC. D/B/A AT&T KENTUCKY
AND AT&T COMMUNICATIONS OF THE SOUTH CENTRAL STATES, LLC

Petitioners, BellSouth Telecommunications, Inc. d/b/a AT&T Kentucky and AT&T Communications of the South Central States, LLC (collectively, "AT&T"), by counsel, hereby move the Public Service Commission of the Commonwealth of Kentucky (the "Commission"), pursuant to KRS 61.878 and 807 KAR 5:001, § 7, to classify as confidential the highlighted information in the Direct Testimony of Dr. Debra J. Aron and the Direct Testimony of Dr. Ola A. Oyefusi, filed on behalf of AT&T. The material that is highlighted contains company specific market and financial information of Windstream and AT&T.

The Kentucky Open Records Act exempts certain information from the public disclosure requirements of the Act, including confidential and/or proprietary information, the disclosure of which would permit an unfair commercial advantage to competitors. KRS 61.878(1)(c)1. To qualify for the commercial information exemption and, therefore, keep the information confidential, a party must establish that disclosure of the commercial information would permit an unfair advantage to competitors and the parties seeking confidentiality if openly discussed. KRS 61.878(1)(c)1; 807 KAR 5:001 § 7. The Commission has taken the position that the statute and rules require the party to demonstrate actual competition and the likelihood of competitive injury if the information is disclosed.

The information for which AT&T seeks confidentiality contains carrier-specific marketing, financial and market share information. Specifically, the information that is highlighted on Pages 8-9, 29-32, 38, 52-53, and 71 of Dr. Aron's Direct Testimony and on Pages 13-17, 20-22, 43-44, and 49 and in Exhibit OAO-7 of Dr. Oyefusi's Direct Testimony is information related to or derived from Windstream's company-specific data regarding its revenues, local switching minutes, and market share. The information highlighted on Pages 41, 44 and 46 of Dr. Aron's Direct Testimony and on Pages 15 and 36 and in Exhibit OAO-4 of Dr. Oyefusi's Direct Testimony is information regarding or derived from AT&T's company-specific data regarding its long distance business, specifically, its intrastate access costs and expenses, its toll pricing, and its toll revenues. This data contains market sensitive information that could compromise both Windstream and AT&T in their competitive positions in their respective markets.

Public disclosure of the identified information would provide competitors that provide services similar to AT&T and Windstream, namely CLECs, IXCs, and other competitors, with an unfair competitive advantage. The Commission should also grant confidential treatment to the information for the following reasons:

(1) The information for which AT&T is requesting confidential treatment is not known outside of AT&T or Windstream;

(2) The information is not disseminated within AT&T and is known only by those of AT&T's employees who have a legitimate business need to know and act upon the information;

(3) AT&T seeks to preserve the confidentiality of this information through appropriate means, including the maintenance of appropriate security at its offices; and

(4) By granting AT&T's petition, there would be no damage to any public interest.

For the reasons stated herein, the Commission should grant AT&T's request for confidential treatment of the identified information.

Respectfully submitted,

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COUNSEL FOR BELLSOUTH
TELECOMMUNICATIONS, INC.
D/B/A AT&T KENTUCKY AND
AT&T COMMUNICATIONS OF THE SOUTH
CENTRAL STATES, LLC

829274

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served on the following individuals by mailing a copy thereof, this 14th day of July 2010.

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Mary K. Keyer

COMMONWEALTH OF KENTUCKY

KENTUCKY PUBLIC SERVICE COMMISSION

COUNTY OF Cook

STATE OF Illinois

BEFORE ME, the undersigned authority, duly commissioned and qualified in and for the State and County aforesaid, personally came and appeared Debra Aron, who being by me first duly sworn deposed and said that she is appearing as a witness on behalf of BellSouth Telecommunications, Inc. d/b/a AT&T Kentucky and AT&T Communications of the South Central States, LLC before the Kentucky Public Service Commission in Docket Number 2007-00503, *In the Matter of: MCI Communications Services, Inc., Bell Atlantic Communications, Inc., NYNEX Long Distance Company, TTI National, Inc., Teleconnect Long Distance Services & Systems Company, and Verizon Select Services, Inc., Complainants v. Windstream Kentucky West, Inc., Windstream Kentucky East, Inc.–Lexington and Windstream Kentucky East, Inc.–London, Defendants*, and if present before the Commission and duly sworn, her statements would be set forth in the annexed direct testimony consisting of 81 pages and 1 exhibits.

Debra Aron

SWORN TO AND SUBSCRIBED BEFORE ME
THIS 13th DAY OF JULY, 2010

Notary Public

OFFICIAL SEAL
LESLEY BATES
Notary Public - State of Illinois
My Commission Expires Jun 25, 2011

My Commission Expires: June 25, 2011

827374

DIRECT TESTIMONY OF DR. DEBRA J. ARON

On Behalf of

BellSouth Telecommunications, Inc., d/b/a AT&T Kentucky and AT&T Communications of the South Central States, LLC

BEFORE THE KENTUCKY PUBLIC SERVICE COMMISSION
Docket No. 2007-00503

July 14, 2010

******* EDITED VERSION *******

Table of Contents

I. Introduction and Qualifications

Q: PLEASE STATE YOUR NAME AND POSITION.

A: My name is Debra J. Aron. I am Principal and Managing Director at Navigant Economics and Adjunct Associate Professor at Northwestern University. Navigant Economics is an economics and finance consulting firm that provides economic expertise for litigation, regulatory proceedings, policy debates, and business strategy. My business address is 1603 Orrington Avenue, Suite 1500, Evanston, IL, 60201.

Q: PLEASE DESCRIBE YOUR PROFESSIONAL QUALIFICATIONS.

A: I received a Ph.D. in economics from the University of Chicago in 1985, have taught economics at Northwestern University for most of the last 25 years, and have presented testimony on communications issues for over 14 years. I currently teach a graduate course in the economics and strategy of communications industries at Northwestern University. I was an Assistant Professor of Managerial Economics and Decision Sciences from 1985 to 1992, at the J. L. Kellogg Graduate School of Management, Northwestern University, and a Visiting Assistant Professor of Managerial Economics and Decision Sciences at the Kellogg School from 1993-1995. I was named a National Fellow of the Hoover Institution, a think tank at Stanford University, for the academic year 1992-1993, where I studied innovation and product proliferation in multiproduct firms. I have published articles on communications markets, multiproduct firms, innovation, incentives, and pricing in several leading academic journals, including the *American Economic Review*, the *RAND Journal of Economics*, and the *Journal of Law, Economics, and Organization.*

Q: DR. ARON, HAVE YOU TESTIFIED IN REGULATORY PROCEEDINGS BEFORE REGARDING TELECOMMUNICATIONS ISSUES?

A: Yes. I have consulted on numerous occasions to the telecommunications industry on competition, costing, pricing, incentives, and regulation issues in the United States and internationally. I have testified before regulatory agencies and in judicial proceedings regarding the history, development, and trends in the telecommunications marketplace, pertaining both to wireline and wireless (terrestrial and non-terrestrial) technologies; economic and antitrust principles of competition in industries undergoing deregulation; measurement of competition in telecommunications markets; the proper interpretation of Long Run Incremental Cost and its role in pricing; the economic interpretation of pricing and costing standards in the Telecommunications Act of 1996 ("TA96" or "the Act"); limitations of liability in telecommunications; Universal Service; and the pricing for mutual compensation for call termination. I have also testified before state regulatory commissions regarding the potential competitive effects of some of the largest telecommunications mergers in the last decade. Additionally, I have submitted affidavits to the Federal Communications Commission ("FCC") on a variety of topics including competition in telecommunications markets, economic principles of cost analyses, economic principles relevant to unbundling obligations, and empirical assessment of market power. I have consulted to carriers in Europe, Australia, Israel, and Latin America on interconnection and competition issues, and have consulted on issues pertaining to local, long-distance, broadband, wireless, and equipment markets. I have served as a testifying expert in various litigation matters involving wireless companies, satellite telephony, and other communications technologies. In addition, I have consulted

in other industries regarding potential anticompetitive effects of bundled pricing and monopoly leveraging, market definition, and entry conditions, among other antitrust issues, as well as matters related to demand estimation and employee compensation and contracts. I recently testified in New Jersey and in Arizona regarding access reform in proceedings similar to this one, and my research on the effects of intrastate access reform has been accepted for presentation at the 38th Conference on Communication, Information, and Internet Policy (TPRC) at the George Mason University School of Law in October, 2010.

My professional qualifications are detailed in my curriculum vitae, which is attached as Exhibit DJA-1.

II. Context, Purpose, and Organization of This Testimony

Q: WHAT IS YOUR UNDERSTANDING OF THE SCOPE OF THIS PROCEEDING?

A: This proceeding is the result of a request by Verizon that the Public Service Commission of Kentucky (the "Commission") reduce the intrastate switched access rates of Windstream Kentucky West, LLC and Windstream Kentucky East, LLC (collectively, "Windstream").[1] In the order initiating the investigation, the Commission recognized the need for "a comprehensive review of intra-state access charges," but, to date, has not yet opened an investigation of all 18 incumbent local exchange carriers ("ILECs") in

[1] Order, *In the Matter of MCI Communications Services, Inc., Bell Atlantic Communications, Inc., NYNEX Long Distance Company, TTI National, Inc., Teleconnect Long Distance Services & Systems Company and Verizon Select Services, Inc., v. Windstream Kentucky West, Inc., Windstream Kentucky East, Inc. – Lexington and Windstream Kentucky, East – London*, before the Public Service Commission, Commonwealth of Kentucky, Case No. 2007-00503, March 11, 2009, (hereafter *2009 03 KYPSC Order*), p. 1.

Kentucky.[2] The Commission noted, however, that "the decisions rendered in this proceeding will likely be applied to future complaints by switched access customers who are similarly situated to Verizon in their allegations and pricing concerns."[3]

Q: PLEASE EXPLAIN THE PURPOSE AND ORGANIZATION OF YOUR DIRECT TESTIMONY.

A: The purpose of my direct testimony is to explain, on the basis of economic principles and analysis, the harmful effects the current intrastate switched access charge regime in Kentucky, and Windstream's access rates specifically, are having on Kentucky consumers and on the competitive process. AT&T Kentucky, the largest ILEC in Kentucky, reduced its intrastate access rates to its interstate rates 15 years ago, but other local exchange carriers have been permitted to continue to charge excessive rates for intrastate access. I explain that reducing the currently-excessive intrastate switched access rates of Windstream and other incumbent and competitive local exchange carriers in Kentucky will promote the objectives of Kentucky telecommunications policy by:

(i) enhancing the welfare of consumers of telecommunications services in Kentucky;

(ii) decreasing regulatory impediments to competitive neutrality between technologies;

(iii) reducing incentives for wasteful arbitrage

(iv) reducing legacy inequities across Kentucky consumers; and

(iv) improving the efficiency of investment incentives.

[2] *2009 03 KYPSC Order*, pp. 5-7.

[3] *2009 03 KYPSC Order*, p. 8.

Reducing Windstream's intrastate access rates to interstate levels, and establishing a framework for future access reform of the rest of the local exchange carriers in Kentucky, will therefore serve the public interest.

My testimony is organized as follows: Section III provides a summary of my conclusions. Section IV presents a brief history of the telecommunications policies in the U.S. that led to the current distorted access price regime, and the reforms adopted at the federal level to partially address these distortions. Section V describes the existing switched access regime in Kentucky and how the intrastate switched access rates paid by wireline long distance providers—both interexchange carriers ("IXCs") and intrastate toll providers—to Windstream in Kentucky differ from interstate switched access rates, as well as from the rates paid by CLECs for local call termination and from the rates paid by wireless companies for call termination, all of which functions are materially the same as intrastate switched access services furnished to long distance providers. In Section VI, I describe the economic harms to consumers, competition, and investment that result from the existing asymmetries and inconsistencies of the current access regime, as well as the perverse incentives for regulatory arbitrage created by the distortions of the existing switched access regime. I explain that reducing intrastate access charges to parity with interstate access rates would benefit consumers, competition, and investment, reduce incentives for carriers to pursue wasteful and opportunistic arbitrage opportunities, and reduce implicit cross-subsidies that arbitrarily impose cost burdens on some Kentucky customers for the benefit of others. Sections VII and VIII explain why, in light of the forgoing analysis, the Commission should order Windstream to decrease intrastate access rates to interstate levels. I explain that this policy will bring intrastate access charges

closer to its costs, thereby enhancing economic efficiency. In Section IX, I explain that access rate reductions must be seen as part of a holistic and revenue-neutral approach that allows rate-regulated carriers to recover the forgone access revenues from higher retail rates and, if necessary, from a Kentucky Universal Service Fund ("KUSF"). Section X summarizes the benefits to consumers and the economy from reforming intrastate access rates to interstate levels.

III. Summary of Conclusions

Q: DR. ARON, PLEASE SUMMARIZE THE CONCLUSIONS OF YOUR DIRECT TESTIMONY.

A: The Commission should order Windstream to decrease its intrastate switched access rates to the levels and structure of its corresponding interstate switched access rates, and should proceed with comprehensive access reform of all LECs' rates in Kentucky. Doing so will bring intrastate access rates to more efficient levels and bring them closer into line with the fees LECs charge to intermodal competitors for the same functionality. AT&T Kentucky has mirrored its intrastate rates to its interstate rates for many years, to the benefit of consumers in Kentucky. Reform for only some LECs, however, limits the benefits that accrue to consumers, creates competitive inequities, and forces consumers in some parts of Kentucky to subsidize those in other parts of the Commonwealth. The time is past due for the reform that this Commission undertook 15 years ago to be applied equally to all LECs in Kentucky—starting with Windstream, since the Commission has chosen to address reform sequentially. Bringing Windstream's rates into alignment with its interstate charges, and bringing them more into alignment with the rates charged to

intermodal competitors and to other wireline providers for the same functionality, benefits consumers and competition and would promote the public interest.

The harms from the current regulatory access regime in Kentucky can be summarized to include the following:

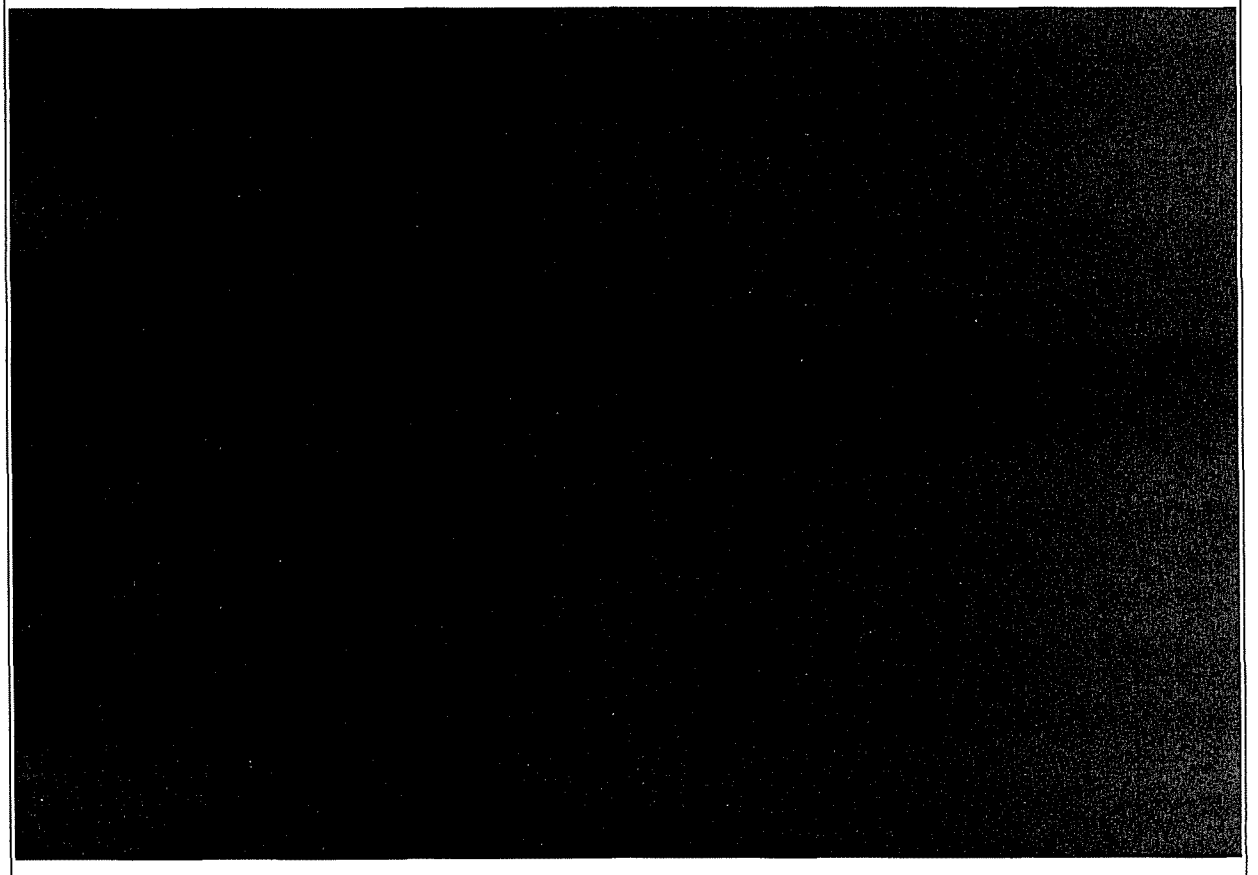
- Consumers pay excessive prices for wireline intrastate toll services and are unduly discouraged by these uneconomically high prices from using and enjoying long distance service on the wireline network;
- Consumers are unduly discouraged from making wireline long distance calls in favor of using other communications alternatives, even where consumers might prefer the service characteristics of a wireline call;
- Competition between technologies is distorted by an access regime that permits other providers using alternative technologies to pay substantially lower rates for materially identical functionality as that provided to traditional wireline carriers at much higher rates, and that artificially disadvantages wireline long distance providers vis-à-vis other communications options that avoid the public switched telephone network ("PSTN") (and regulated interconnection charges) entirely;
- The incentive and ability of wireline long distance providers to invest in the provision of wireline long distance services are reduced because consumers are unduly discouraged from using those services, and the incentives of incumbents to invest in broadband networks are distorted by the countervailing incentive to protect access revenue streams;
- Arbitrage opportunities are created by regulatory distortions under which, for example, call-pumping schemes exploit access payers, and resources are wasted on enforcing traffic distinctions that have no economic basis but have significant pricing implications under the current system;
- Some consumers—including low-income consumers in AT&T Kentucky's footprint—are forced to pay unduly high wireline long distance prices to subsidize telephone service of other consumers, including wealthy consumers that may happen to reside in Windstream's footprint.

Windstream's current intrastate access rates—the rates it charges to wireline long distance providers for originating and terminating long distance telephone calls to its customers—are far above the rates that it charges to originate and terminate interstate

calls, even though the functionality provided is the same. Figure 1 shows the average call origination and termination rates assessed by Windstream East and Windstream West in Kentucky. The chart illustrates the disparities between the rates that Windstream charges for the same functionality of call termination or origination depending on the regulatory jurisdiction governing the call. Windstream's intrastate access rates in Kentucky are many times higher than the rates charged for the same functionality if the call is jurisdictionally interstate.

Figure 1

Average Charges for Call Origination or Termination Services in Kentucky*



This very significant rate disparity makes it far more costly for wireline long distance providers to handle an intrastate call than an interstate call. For example, consider a customer in Lexington who subscribes to Windstream East for local services and to AT&T Communications of the South Central States (hereafter, "AT&T Communications," which is the AT&T long distance affiliate that serves Kentucky) for long distance services. If that customer were to make a ten-minute call to a Windstream customer in Cumberland, Ohio, AT&T Communications would pay Windstream a bit over [redacted] in interstate access charges to terminate the call, and approximately [redacted] in interstate access charges to originate the call (assuming that Windstream's interstate access rate in Ohio is comparable to Windstream's interstate rate in Kentucky). Hence, AT&T Communications would pay approximately [redacted] in access charges on that call. If the same customer, however, were to make a 10-minute intrastate call from Lexington to a Windstream customer in Elizabethtown, Kentucky, AT&T Communications would pay Windstream approximately [redacted] in intrastate access charges to terminate the call, and approximately [redacted] in intrastate access charges to originate the call. Hence, for the in-state call, AT&T Communications would pay Windstream over [redacted] in access charges. All together, AT&T Communications would pay over [redacted] times as much in access charges for the intrastate call, even though Windstream would be providing the same functionality to originate the call and terminate the call in either case.

Decreasing intrastate access charges would directly benefit consumers because economic principles dictate and the evidence across 50 states shows that when access fees go down,

retail long distance prices go down as well. In fact, numerous states have already reformed intrastate access rates and targeted intrastate access rates to equal, or "mirror," interstate access rates, as Dr. Oyefusi demonstrates in his direct testimony. In fact, Kentucky's major ILEC, AT&T Kentucky, mirrors its intrastate rates to its interstate levels.[4] As a result, AT&T Kentucky charges the same rates for intrastate access as it does for interstate access and has done so for 15 years. It is time for all LECs to be held to the same standard because doing so will benefit consumers and facilitate efficient competition.

Moreover, the rates that Windstream charges to wireline long distance carriers for intrastate access service are several times higher than the rates that Windstream charges for the very same functionality to wireless carriers to terminate intrastate wireless calls that are made to Windstream's customers. These highly disparate rates for the same call termination functionality harm competition and distort investment by creating an artificial, regulatory-induced competitive disadvantage for wireline long distance providers as compared to their intermodal long distance competitors. Decreasing intrastate access rates to interstate levels will not eliminate the disparities across technology platforms but will significantly diminish them, creating a more level playing field and permitting a greater degree of intermodal competition on the merits, encouraging investment that better reflects the relative efficiencies of different

[4] See Order, *In the Matter of Application of BellSouth Telecommunications, Inc., d/b/a South Central Bell Telephone to Modify Its Method of Regulation*, before the Kentucky Public Service Commission, Case No. 94-121, (July 20, 1995), (hereafter *1995 BellSouth Regulation Plan Order*), p. 54. Revisions to the statute made in July 2006 do not require AT&T Kentucky to mirror its interstate rates, but to cap its intrastate access rates at a level that does not exceed its rates as of July 2006. See, KRS 278.543. The effect is the same, however, as AT&T Kentucky's current tariffed intrastate rates mirror its interstate rates.

technologies and service providers, reducing hidden cross-subsidies from some Kentucky consumers to others, and reducing incentives for wasteful and opportunistic arbitrage.

Existing intrastate access rates perpetuate an outmoded regulatory policy of the monopoly era by which LEC services were subsidized by long distance services. While access reform is sorely overdue in Kentucky, it is appropriate that reform of intrastate access policy be viewed holistically, acknowledging the historical policy quid pro quo by which above-cost access rates subsidized below-cost retail prices for local services. A holistic policy reform will therefore provide an opportunity for LECs to recover the relevant access revenues forgone through some combination of (i) increased retail prices and, if necessary, (ii) explicit support from a state universal fund.

Providing Windstream the opportunity to recover the lost access revenues via retail price increases would be the most economically efficient means of recovering those revenues, and would best promote competition and efficient investment. If, however, the Commission finds that the price increase necessary to recover all access revenues that would be forgone due to the access rate reductions is untenable for universal service reasons, a smaller price increase could be allowed and the remaining revenue could be recovered in universal service support. This method of revenue recovery respects the policy concern for limiting prices to "affordable" levels, albeit at the cost of some economic efficiency. At the same time, allowing cost recovery by providing universal service support imposes support burdens on customers who must pay for those subsidies, including some customers with below-average income. In light of the broad availability of wireless and broadband-based voice services in the marketplace today, in assessing an

appropriate benchmark the Commission would be well-served to scrutinize old assumptions about whether allowing retail prices to rise to fully recover the forgone access revenues would be likely to have any genuine effect on telephone penetration in Kentucky.

Regardless of the method of revenue recovery chosen by the Commission, the Commission should recognize that today's convoluted patchwork structure of access/interconnection rates should be reformed immediately in this proceeding for Windstream and as soon as possible for the other LECs in Kentucky whose intrastate access rates remain above their interstate rates. Intrastate access rates should be decreased to interstate levels so that:

- Different technologies and companies can compete more closely on their merits;
- Consumers can benefit from lower, more cost-based prices for wireline long distance telephony;
- Consumers can choose among providers based more closely on the relative value provided;
- Wasteful arbitrage activities are limited;
- Consumers in some parts of Kentucky are not forced to subsidize residents of other parts of the state purely because of which company happens to be the local exchange carrier where they live; and
- Consumers in Kentucky can more fully enjoy the benefits of all modern communications technologies.

IV. <u>The Legacy Access Regime Is No Longer Viable</u>

A. Switched Access Charges Were Originally Set to Provide "Implicit Subsidies" for Below-Cost Local Service Prices

Q: WHAT IS "SWITCHED ACCESS"?

A: Switched access is the service that a LEC provides to a long distance provider to transport the portion of the long distance call that begins or terminates on the LEC's facilities. Consider, for example, a customer who subscribes to the long distance service of AT&T Communications, and the local exchange service of Insight Communications, a CLEC in Kentucky. Suppose that the customer makes a long distance call to a friend who receives local exchange service from Windstream. AT&T Communications, the long distance provider in this example, does not have a direct connection to either customer but its network is interconnected with the local exchange facilities of both Insight and Windstream. When that call is dialed, it will travel over Insight's communications path, or "loop," from the calling customer's home to Insight's switch. Insight's switch will determine that the customer uses AT&T Communications for long distance service, and it will route the call to Insight's transport facilities that connect with AT&T Communications' network. From that point, AT&T Communications will transport the call to a point of interconnection with Windstream near the called party, where it will hand off the call to Windstream for delivery to the called party. Insight's delivery and handoff of the call from the calling customer's premises to AT&T Communications' point of interconnection is called originating switched access service, and Windstream's receipt of the call and delivery to the called party is called terminating switched access service. On both sides, the access supplier (the LEC) provides the connection to an end-user.

Although the access services are identical regardless of the distance between the parties, the price that AT&T Communications pays for those services is determined by whether

the calling and called parties are in the same state (in which case intrastate switched access charges would apply) or different states (in which case interstate switched access charges would apply).

Consider another scenario. Suppose the customer served by the CLEC Insight makes a *local* call to a neighbor who is served by Windstream. In that case, Insight must transport the call to Windstream's network for delivery to the called party. The terminating function that local exchange company Windstream provides to local exchange company Insight is the same in all material respects as the terminating function that Insight provided to long distance provider AT&T Communications in the previous scenario. The termination service provided by Windstream in this scenario has the same economic characteristics as in the first scenario, but for historic reasons goes by a different name ("local interconnection") and is priced under a different regime ("reciprocal compensation").

Q: WHAT ARE SWITCHED ACCESS CHARGES?

A: "Switched access charges" (or, in shorthand, "access charges") is the regulatory term of art applied to the prices that wireline local telephone companies charge to wireline long distance providers to furnish switched access service. Access charges are a payment from one company to another (i.e., they are "intercarrier" charges) that derive from the fact that networks are interconnected and a call may have to traverse more than one carrier's network to be completed. When the terminating functionality is provided by one LEC to another LEC under a local area calling arrangement, the call-termination

functionality provided is the same as the functionality provided to terminate a long distance call, but the intercarrier fee paid is called "reciprocal compensation."

For purposes of this testimony, I will use the term "access/interconnection regime" to mean the entire set of regulator-approved charges that wireline LECs charge to other carriers—wireline, wireless, incumbents, and CLECs—for the function of originating or terminating calls, whether local or long distance, intrastate or interstate. In some cases, these charges are set by the FCC and in other cases they are set or approved by state regulators. [5] The Commission has control over only a part of the overall access/interconnection regime that affects carriers and customers in Kentucky, and it is important in this proceeding for the Commission to understand the context of the rates under its supervision in the broader access/interconnection regime and the effect of that regime on consumers and the state's retail telecommunications marketplace.

Q: DO WIRELINE PROVIDERS, CLECS, VOIP PROVIDERS, AND WIRELESS PROVIDERS USE SWITCHED ACCESS SERVICE, OR THE EQUIVALENT FUNCTIONALITY, PROVIDED BY WIRELINE LOCAL TELEPHONE COMPANIES?

A: Yes. Though the terminology "switched access service" is used to describe the origination and termination functions wireline local exchange companies provide for wireline long distance calls, the local exchange companies also provide the same interconnection functionality to companies using all of these other technologies. The service may fall under different regulatory categories and go by different names, but all of these companies use the comparable service, because any time one of their customers

[5] In some states there appear to be no specific rules governing intrastate access rates charged by CLECs, though their interstate rates are governed and capped by the FCC.

calls a customer of a wireline local telephone company, that wireline local telephone company must deliver the call to its customer (i.e., the called party). The current access/interconnection regime applies to all these different kinds of providers and calls under a mosaic of mismatched regulatory policies and rules. This results in a broad range of different prices being charged for the same functionalities, which in turn derives from a regulatory history that has not been reformed in step with the technological and competitive changes in the industry.

Q: CAN YOU PROVIDE AN EXAMPLE OF THE PATCHWORK REGULATORY APPLICATION OF ACCESS CHARGES THAT YOU ARE DESCRIBING?

A: Yes. Perhaps the simplest example is the mismatched regulatory treatment of interstate versus intrastate traffic. Consider a customer who purchases local exchange service from Windstream and long-distance service from AT&T Communications. Every time that customer places a long distance call on her wireline phone, AT&T Communications, not Windstream, charges the customer for the call. However, as I explained earlier, Windstream handles part of the call—specifically, the part that begins at the caller's location and ends at AT&T Communications' network. Windstream takes such calls from the calling customer's home over Windstream's facilities to Windstream's switch at Windstream's local office, and then to Windstream's interconnection point with AT&T Communications' network, while holding capacity open on its own switch and other facilities for the duration of the call. As I have described, Windstream is entitled, as a matter of current regulatory policy, to charge AT&T Communications for that functionality to recover the costs that Windstream incurs. The fee is known as the originating switched access charge.

The functionality provided by Windstream is the same, however, regardless of whether the called party is located in the next town, the next state, or another country. Windstream provides the dial tone, determines where the call should go, and brings it to the interconnection point with AT&T Communications' network. It is AT&T Communications' responsibility to transport the call to the carrier serving the called party who might be a few or several thousands of miles away.

As an analogy, consider the job of a taxicab driver who picks up passengers at home and drives them to Lexington's Blue Grass Airport. The driver's job is the same whether the passenger is going to catch a flight to Covington, Chicago, or Houston, and one would expect the taxi fare to the airport to be the same. The current access charge system in the United States, however, is akin to the taxicab driver asking the passenger where she is flying to once she gets to the airport, and charging a much higher fare if she is flying to Covington than if she is flying to Houston or Chicago.

Similarly, on the terminating end, when an AT&T Communications long distance customer in New York places a call to a Windstream local customer in Kentucky, AT&T Communications hands that call off to Windstream in Kentucky for final delivery to the customer. Windstream's functions in terminating the call are the same, regardless of whether the long distance call comes in from New York or a neighboring town in Kentucky—just as a taxi driver's functions in taking a passenger home from the airport are the same regardless of where the passenger flew in from. In fact, Windstream's functions are the same even for a local call from a next door neighbor whose local provider is not Windstream. Because of the idiosyncrasies of intercompany regulation

and different jurisdictions associated with different kinds of calls and different carriers, however, the price that Windstream charges for that service is vastly different in Kentucky depending on where that call originated. Under the current anomalous rules, the price Windstream charges AT&T Communications to terminate a call is substantially higher if it comes from a neighboring town in Kentucky than if the call comes from New York.

Q: HOW WAS THE ACCESS CHARGE REGIME DEVELOPED?

A: Before the divestiture of the "Baby Bells" from AT&T in 1984, there was no such thing as "access charges." In the monopoly era of the late 1940s when long distance was still viewed as a luxury, the FCC and state regulators established a policy that imposed cross-subsidy obligations on long distance users to encourage universal subscription to the public switched telephone network by holding local service prices below cost, a policy known as "universal service." These cross-subsidies were implemented through a "separations and settlements" accounting process under which some of the costs of providing customers with access to the local telephone network were attributed to the long distance network and built into the (regulator-set) retail prices of long distance service.[6] While there is a disagreement as to their exact magnitude, there is a consensus

[6] Paul W. MacAvoy, THE FAILURE OF ANTITRUST AND REGULATION TO ESTABLISH COMPETITION IN LONG-DISTANCE TELEPHONE SERVICES, (Cambridge, Massachusetts: MIT Press, 1996), pp. 8-11; and Stephen Breyer, REGULATION AND ITS REFORM, (Cambridge, Massachusetts: Harvard University Press, 1982), pp. 296-298. The cost allocation formulas were known as "separations," and the revenue side of the cost allocation formulas were known as "settlements" when paid to an independent telephone company and "divisions of revenues" when paid to AT&T affiliates; Gerald W. Brock, TELECOMMUNICATION POLICY FOR THE INFORMATION AGE: FROM MONOPOLY TO COMPETITION, (Cambridge, Massachusetts: Harvard University Press, 1994), (hereafter *Brock 1994*), pp. 66-70.

that the separations and settlements process produced retail prices that contained significant embedded cross-subsidies from long-distance to local services.[7]

Upon the AT&T divestiture in the mid-1980s, the separations and settlements process was abolished and replaced with an access charge regime that continued the cross-subsidy policy.[8] In the access charge regime, long distance companies are required to pay a fee (the access charge) to the local exchange company or companies serving the calling and called customers of a long distance call for the functionality of handling the call at the originating and terminating ends.[9]

In designing its new system of regulated interstate access charges, the FCC acknowledged that a system of cross-subsidies was incompatible with competition and, hence, it sought to implement procedures that reduced or eliminated them.[10] The FCC

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[7] Jerry Hausman, Timothy Tardiff, and Alexander Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *American Economic Review* 83, no. 2, (May 1993), (hereafter *Hausman et al. 1993*), p. 178; Larry Blank, David L. Kaserman, and John W. Mayo, "Dominant Firm Pricing with Competitive Entry and Regulation: The Case of IntraLATA Toll," *Journal of Regulatory Economics* 14, (1998), pp. 37, 39; David L. Kaserman, John W. Mayo, and Joseph E. Flynn, "Cross-Subsidization in Telecommunications: Beyond the Universal Service Fairy Tale," *Journal of Regulatory Economics* 2, (1990), pp. 232-235; Robert W. Crandall and Leonard Waverman, TALK IS CHEAP: THE PROMISE OF REGULATORY REFORM IN NORTH AMERICAN TELECOMMUNICATIONS, (Washington D.C.: The Brookings Institute, 1995), pp. 34-35; Alfred E. Kahn, "The Road to More Intelligent Telephone Pricing," *Yale Journal on Regulation* 1, (Spring 1984), pp. 140-144; and Peter Temin, "Cross Subsidies in the Telephone Network after Divestiture," *Journal of Regulatory Economics* 2 (1990), pp. 349-362.

[8] *Brock 1994*, pp. 180, 186.

[9] Order on Remand and Report and Order and Further Notice of Proposed Rulemaking, *In the Matter of High-Cost Universal Service Support and Federal-State Joint Board on Universal Service et al.*, before the Federal Communications Commission, FCC 08-262, (released November 5, 2008), (hereafter *2008 NPRM*), Appendix A, ¶ 165.

[10] The FCC concluded that "[a]rtificial pricing structures, while perhaps appropriate for use in achieving social objectives under the right conditions, cannot withstand the pressures of a competitive marketplace." See, Memorandum Opinion and Order, *In the Matter of MTS and WATS Market Structure*, before the Federal Communications Commission, FCC 83-356, (released August 22, 1983), ¶ 7.

established access charges that significantly exceeded their incremental costs, but stated that it planned to reduce those access charges gradually over time.[11]

Some efforts were made in the 1980s and 1990s to reform access rates, but per-minute access rates remained—to use the FCC's characterization—"high."[12] At the time of divestiture in 1984, the interstate per-minute switched access rate was 17.26¢, and by 1996 it had declined substantially, but to the still very high rate of 6.16¢.[13] In fact, these relatively high switched access rates created an arbitrage opportunity by which new entrants built direct connections to business locations so that these business customers (and the long distance companies who served them) could bypass switched access charges by connecting directly to their long distance providers and avoiding the LEC entirely when they made long distance calls.[14]

B. The FCC, Recognizing That the Old System of Implicit Subsidies Can No Longer Be Sustained, Has Adopted Significant Reforms

Q: DID THE FCC ADOPT SIGNIFICANT REFORMS TO INTERSTATE SWITCHED ACCESS CHARGES FOLLOWING THE ENACTMENT OF THE TELECOMMUNICATIONS ACT OF 1996?

A: Yes. The purpose of TA96 was to open local exchange markets to competition.[15] The inherent friction that already existed between a cross-subsidy policy and competition in

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[11] *2008 NPRM*, Appendix A, ¶¶ 165-166.

[12] *2008 NPRM*, Appendix A, ¶¶ 167-168.

[13] "Trends in Telephone Service," Federal Communications Commission, Industry Analysis and Technology Division Wireline Competition Bureau, August 2008, (hereafter *2008 FCC Trends in Telephone Service*), Table 1.2.

[14] *2008 NPRM*, Appendix A, ¶ 168; and Peter W. Huber, Michael K. Kellogg, and John Thorne, *The Geodesic Network II: 1993 Report on Competition in the Telephone Industry*, pp. 2.24-2.52.

[15] Telecommunications Act of 1996, Preamble; and, First Report and Order, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, before the Federal Communications Commission, FCC 96-325, (released August 8, 1996), (hereafter *1996 Interconnection Order*), ¶ 3.

long distance markets was magnified by the complete incompatibility between a cross-subsidy policy and competition in local exchange markets. TA96 therefore was the final straw in rendering the legacy system of implicit cross-subsidization of local service from long distance providers unworkable in the long term. Congress recognized, in fact, that the implicit subsidies built into the old system in which retail prices for basic local service were set below cost to encourage local subscribership while access rates were set well above cost in order to subsidize the below-cost retail prices for local service were not sustainable in a competitive marketplace.' Congress, therefore, directed the FCC to eliminate or replace implicit subsidies with explicit subsidies, thereby moving all interstate access rates towards cost-based levels.[16]

Q: WHY IS A CROSS-SUBSIDY POLICY NO LONGER VIABLE IN TODAY'S MARKET-PLACE?

A: The original purpose of legacy cross-subsidy policies was, as I explained earlier, to keep prices for residential local service artificially low, even if that meant keeping them below their true economic cost, to encourage universal subscription to telephone service. A key problem with that policy, however, is that it is counterproductive to the process of competition. In the long run, you can have efficient competition, or you can have implicit cross-subsidies built into regulated prices, but you cannot have both. Efficient competition is impeded and innovative investment is discouraged if retail prices are held

[16] *2008 NPRM*, Appendix A, ¶ 169.

below cost and cannot respond to market conditions (such as changes in production costs or demand).[17]

Moreover, not only are cross subsidies destructive to efficient competition, but competition ultimately undermines the cross subsidies. As excessive access rates keep wireline long distance prices higher than they would otherwise be, consumers are encouraged to switch to alternatives, such as wireless calls (which are not subject to the same level of termination costs, as I will explain shortly) and other options that bypass the PSTN entirely, such as computer-to-computer calling, social networking sites, or instant messaging. The decreased usage of wireline long distance service in turn causes access revenues to decrease, drying up the very source of subsidy that the access rates were originally designed to provide. According to information compiled by the FCC, reporting ILECs' interstate interLATA billed access minutes carried by IXCs declined from a peak of 535.0 billion in 2000 to 372.0 billion in 2006—the most recent year with available information—a decline of 30 percent in just six years. In that same time period, intrastate interLATA minutes declined by about 33 percent, from 257.3 billion to 171.1 billion.[18] Hence, a system of subsidizing local exchange companies via access charges is not sustainable in the presence of competition that is severely eroding the source of subsidies.

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[17] See Debra J. Aron and David E. Burnstein, "Regulatory Policy and the Reverse Cellophane Fallacy," June 1, 2008, available at SSRN: http://ssrn.com/abstract=1171292, forthcoming, *Journal of Competition Law & Economics*.

[18] *2008 FCC Trends in Telephone Service*, Table 10.2.

Q: HAS THE FCC INSTITUTED ACCESS REFORM IN LIGHT OF THE MANDATES OF TA96?

A: Yes. In response to the mandate of TA96 to eliminate or replace implicit subsidies with explicit subsidies and move all interstate access rates towards cost-based levels,[19] the FCC implemented significant access reforms in May 1997, May 2000, and November 2001 with the releases of its *Access Charge Reform Order*, *CALLS Order*, and *MAG Order*, respectively. The *Access Charge Reform Order* established rules that required the structure of access charges to more closely reflect cost-causation. The rules reduced the usage-sensitive (per-minute) interstate switched access rates by removing fixed, non-traffic sensitive costs from these charges and requiring incumbent LECs to recover these costs through flat-rated charges to their end-user customers.[20] The FCC acknowledged that these reforms would not "remove all implicit support from all access charges immediately," however, and concluded that a process of gradually reducing interstate access charges to cost over time was warranted.[21] Over a three-year period, the per-minute interstate switched access rate declined by over half, from 6.04¢ in January 1997 to about 2.85¢ in January 2000.[22]

The FCC and the industry nevertheless recognized that further reductions to switched access charges were warranted. The *CALLS Order* implemented further reductions to price cap ILECs' interstate switched access rates by adopting a proposal set forth by a

[19] TA96, §254(e); and S. Rep., No. 104-230 at p. 131.

[20] First Report and Order, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, before the Federal Communications Commission, FCC 97-158, (released May 16, 1997), (hereafter *1997 Access Reform Order*), ¶ 6.

[21] *1997 Access Reform Order*, ¶ 9.

[22] *2008 FCC Trends in Telephone Service*, Table 1.2.

consortium of local and long-distance providers.[23] The *CALLS Order* reduced ILECs' interstate switched access charges by reducing local switching and other traffic-sensitive rate elements. The FCC ordered large ILECs, other price cap LECs, and rural price cap ILECs to reduce their average traffic-sensitive rates to 0.55¢, 0.65¢, and 0.95¢ per minute, respectively, and established a new explicit universal support fund to help local exchange carriers offset the reduction in switched access charges received.[24]

In the *MAG Order*, the FCC implemented similar reforms to the access prices that could be charged by ILECs subject to rate-of-return regulation.[25] As with the *CALLS Order*, the *MAG Order*'s reforms were "designed to bring the American public benefits of competition and choice by rationalizing the access rate structure and driving per-minute rates towards lower, more cost-based levels."[26] The *MAG Order* provided for reductions in per-minute charges for rate-of-return ILECs and created a universal service support mechanism to replace implicit support with explicit support.[27] Interstate access rates

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[23] Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report And Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, before the Federal Communications Commission, FCC 00-193, (released May 31, 2000), (hereafter *FCC CALLS Order*), ¶¶ 1-3. By "price cap ILECs," I mean ILECs that are subject to price cap regulation by the FCC.

[24] *FCC CALLS Order*, ¶¶ 30, 32, 56, 162. AT&T Kentucky is subject to the 0.55¢ rate in Kentucky, and Windstream is subject to the 0.65¢ rate. See, *FCC CALLS Order*, ¶ 144, 162.

[25] Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166, *In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers and Federal-State Joint Board on Universal Service et al.*, before the Federal Communications Commission, FCC 01-304, (released November 8, 2001), (hereafter *MAG Order*).

[26] *MAG Order*, ¶ 1.

[27] *MAG Order*, ¶ 15.

achieved as a result of the *CALLS Order* and the *MAG Order* are, with minor modifications, the interstate access rates in effect today.[28]

AT&T Kentucky and Windstream are price cap LECs at the federal level and are therefore subject to the *CALLS Order*. AT&T Kentucky, as a large ILEC, was required by the *CALLS Order* to reduce its interstate rates to 0.55¢ per minute. Windstream, as a non-rural price-cap LEC in Kentucky under the *CALLS Order*, was required to reduce its interstate rates in Kentucky to 0.65¢ per minute.[29]

Q: DID THE FCC CONCLUDE THAT REDUCING INTERSTATE ACCESS RATES WOULD BENEFIT CONSUMERS?

A: Yes. The FCC concluded in the *CALLS Order* that the mandated restructuring and reduction of access charges would produce lower long distance prices to consumers, resulting in "significant consumer benefits."[30] The FCC drew similar conclusions in the *MAG Order*, as mentioned above.[31]

C. The FCC Has Recognized that Further Reform Is Needed to Facilitate Efficient Competition and Promote Efficient Deployment of Broadband Networks

[28] *2008 FCC Trends in Telephone Service*, Table 1.2, and pp. 1-1, 1-2.

[29] *FCC CALLS Order*, ¶ 28; and Order, *In the Matter of Windstream Petition for Conversion to Price Cap Regulation and for Limited Waiver Relief*, before the federal Communications Commission, FCC 08-81 (released March 18, 2008), ¶¶ 2-4, 15-16.

[30] *FCC CALLS Order*, ¶¶ 28, 35.

[31] See also *MAG Order*, ¶ 11.

Q: HAS THE FCC RECOGNIZED THAT THE CURRENT ACCESS CHARGE AND INTERCONNECTION REGIME REQUIRES FURTHER REFORMS IN LIGHT OF THE COMPETITIVE DEVELOPMENTS IN THE INDUSTRY?

A: Yes. The FCC acknowledged shortly after the release of the 2000 *CALLS Order* that a comprehensive, unified, and competitively neutral regime was called for.[32] The FCC stated in the *2001 NPRM* that the ad hoc nature of intercarrier compensation is an impediment to the development of competition,[33] and observed that "[i]nterconnection arrangements between carriers are currently governed by a complex system of intercarrier compensation regulations... [that] treat different types of carriers and different types of services disparately, even though there may be no significant differences in the costs among carriers or services."[34] The FCC has since received proposals, opened a subsequent rulemaking[35] and, according to the FCC, "compiled an extensive record over the past seven years."[36] However, despite passing the nine-year mark, the FCC has yet to issue an order on comprehensive reform.

Q: IS THE FCC CONCERNED ABOUT THE EFFECT OF EXCESSIVE ACCESS RATES ON THE DEPLOYMENT OF BROADBAND NETWORKS IN THE US?

A: Yes. The FCC has been clear that it considers the current access regime of excessive access rates to impede broadband deployment. For example, on November 5, 2008, the FCC sought comments on an intercarrier compensation reform proposal drafted by then-

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[32] Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, before the Federal Communications Commission, FCC 01-132, (released April 27, 2001), (hereafter *2001 NPRM*), ¶¶ 1-2.

[33] *2001 NPRM*, ¶¶ 11-18.

[34] *2001 NPRM*, ¶ 5.

[35] Further Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, before the Federal Communications Commission, FCC 05-33, (released March 3, 2005), (hereafter *Intercarrier Compensation Reform FNPRM).*

[36] *2008 NPRM*, Appendix A, ¶ 187.

FCC Chairman Martin. The Martin proposal articulates the following shortcomings with the status quo intercarrier compensation regulations:

> The differences in existing intercarrier compensation regimes impose significant inefficiencies on users and distort carriers' investment incentives, which can result in losses of billions of dollars in consumers and producers surplus. Possibly more important, these legacy regulatory regimes pose an obstacle to the transition to an all-IP broadband world. Because carriers currently can receive significant revenues from charging above-cost rates to terminate telecommunications traffic, they have a reduced incentive to upgrade their networks to the most efficient technology or to negotiate interconnection agreements that are designed to accommodate the efficient exchange of IP traffic, as both actions would likely lead to reduced intercarrier payments.[37]

More recently, the FCC has reiterated its intention to further reduce access rates and ultimately eliminate them entirely, in its National Broadband Plan.[38] In that Plan, the FCC expressed particular concern about the detrimental effects of the current access regime on the incentives to invest in broadband facilities. As the FCC observed, "Because providers' [access] rates are above cost, the current system creates disincentives to migrate to all IP-based networks…[which] hinders the transformation of America's networks to broadband." [39]

Q: SHOULD THE KENTUCKY COMMISSION HOLD OFF ON ACCESS REFORM UNTIL THE FCC HAS ACTED ON ITS ACCESS REFORM AGENDA?

A: No. At this time there is no indication as to how or when the FCC will act on its access reform agenda nor on the Broadband Plan's recommendations. Hence, the passage of time has made clear that the Commission cannot assume the role of spectator and wait to

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[37] *2008 NPRM*, Appendix A, ¶ 189.

[38] "Connecting America: The National Broadband Plan," Federal Communications Commission, March 16, 2010, (hereafter *National Broadband Plan*), p. 148.

[39] *National Broadband Plan*, p. 142. Please also see the full paragraph quotation in Section VI.D, below.

see if and when the FCC takes action. Inaction by the Commission would have harmful consequences for consumers, businesses, and competition in Kentucky. The Commission should instead work to reduce the most egregious problems that fall within its own jurisdiction. States currently retain the same jurisdiction over intrastate rates they have had since access charges were first implemented in 1984 and, for reasons I address below, have more compelling social policy reasons to reduce intrastate access rates than ever before. Indeed, as Dr. Oyefusi discusses, many states have already implemented reforms.

V. The Current Access/Interconnection Charge Regime Is Highly Asymmetric

A. The Access Rates Wireline Long Distance Providers Pay for Intrastate Long Distance Calls Are Much Higher Than the Access Rates They Pay for Interstate Long Distance Calls, and Are Much Higher Than Local Call Termination Rates, Even Though Those Rates Are All for the Same Functionality

Q: DID THE FCC'S ACCESS CHARGE REDUCTIONS THAT YOU HAVE DISCUSSED APPLY TO ALL LONG DISTANCE TELEPHONE CALLS?

A: No. The FCC implemented reductions to interstate switched access rates, which apply to interstate long distance calls, not intrastate long distance calls, which have historically been under state jurisdiction. In 1995, this Commission ordered AT&T Kentucky, the major ILEC, to reduce its intrastate access rates to its interstate rates,[40] but ILECs such as Windstream face no such requirement. As a result, wireline long distance providers that interconnect with Windstream or LECs other than AT&T Kentucky are assessed much *higher* rates in Kentucky for intrastate long distance calls than for origination and termination of interstate calls even though (as I discussed above) the LEC's origination

[40] *1995 BellSouth Regulation Plan Order*, p. 54.

and termination functions are the same for interstate and intrastate calls. In fact, Windstream's average intrastate rates are over [redacted] times its interstate rates.

Q: TODAY, WHAT ACCESS RATES DOES WINDSTREAM CHARGE KENTUCKY WIRELINE LONG DISTANCE PROVIDERS?

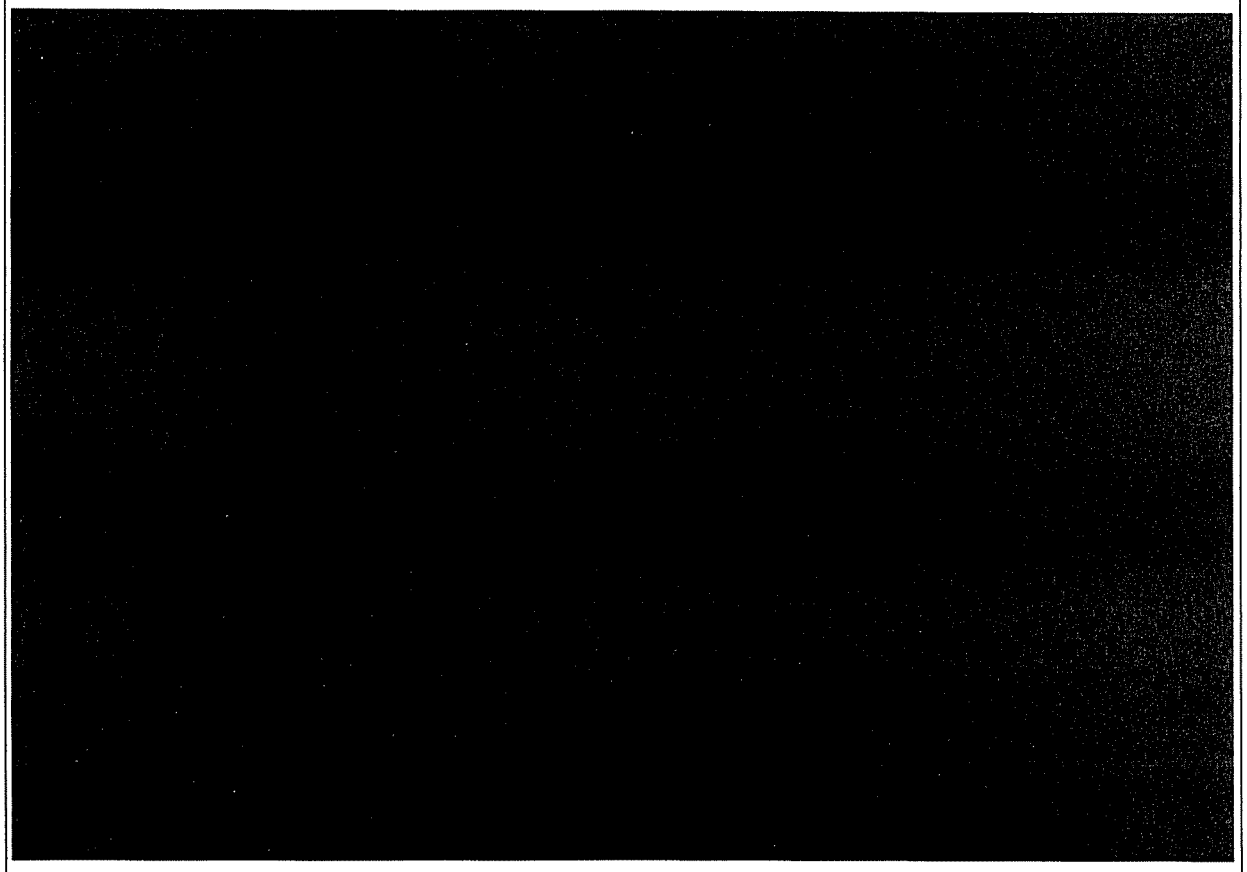
A: The access rates charged by Windstream in Kentucky today are shown in Figure 1, below.

It is useful to understand that access rates are not a single number but instead consist of many rate elements that combine to provide the access service. Some of these rate elements are priced on a flat rate (e.g., per month) basis, some on a per-minute-per mile basis, and some on a per minute basis. Depending on which elements are requested by the long distance provider seeking access, the configuration of the interconnection arrangement, and the number of minutes processed, the average per minute rate paid by one long distance provider can differ from the average paid by another, even to the same LEC. A common way to compare the access rates of one LEC to another's or of one LEC across jurisdictions is to compute the average per minute rate paid to a given LEC by all long distance providers, taking into account all the access rate elements purchased. The figure below provides the average per minute intrastate rate paid to Windstream based on actual access revenues and access minutes of use provided by Windstream in discovery. Because Windstream has two separate operating companies in Kentucky—Windstream East, and Windstream West—and they charge different rates, I have reported their intrastate rates separately as well as the overall Windstream average in Kentucky. The figure also shows Windstream's average interstate access charges for Windstream

East and Windstream West, and Windstream's overall average interstate access rate in Kentucky.

Figure 1

Average Charges for Call Origination or Termination Services in Kentucky*



This figure demonstrates the significant disparities in the regulated rates charged by the ILECs for originating and terminating telephone traffic. Windstream East's average intrastate access charge of [redacted] per minute is more than [redacted] times its average interstate access charge of [redacted] per minute, and Windstream West's intrastate access charge of

[redacted] per minute is over [redacted] times its average interstate access charge of [redacted] per minute.

In addition, a long distance provider pays switched access charges not only for call termination but also for call origination if it does not also provide local service to the calling party (that is, if it is providing "stand-alone" long distance service to the customer).[41] Hence, a company providing stand-alone long distance service would pay on average [redacted] per minute to Windstream for an in-state toll call in Kentucky, if Windstream were the local service provider to the called and calling parties. If the call went from a Windstream West customer to a Windstream East customer (or vice versa), the stand-alone long distance company handling that call would pay [redacted]. In stark contrast, if the call crossed state boundaries, the per minute charges would instead be [redacted], assuming that Windstream's interstate access rate in the other state was comparable to Windstream's interstate rate in Kentucky.

Q: YOU EXPLAINED EARLIER THAT THE FUNCTIONALITY PROVIDED BY A LEC TO TERMINATE A LONG DISTANCE CALL RECEIVED FROM A LONG DISTANCE PROVIDER IS THE SAME AS THE FUNCTIONALITY PROVIDED BY THE LEC TO TERMINATE A LOCAL CALL RECEIVED FROM ANOTHER LEC. HOW DO THE CHARGES FOR TERMINATING A LONG DISTANCE CALL COMPARE TO THE CHARGES FOR TERMINATING A LOCAL CALL?

A: Although the services provided by the ILEC to terminate another carrier's traffic to the ILEC's customer are functionally the same whether the ILEC is terminating a local call or a toll call, there is a tremendous disparity between the regulated rates for terminating toll calls and local calls. For instance, according to a 2008 filing by Windstream before

[41] A LEC that originates a call and also provides the long distance service on the call might, as an accounting matter, pay originating access to itself, but as a company, it does not bear the originating access fee as a cost.

the FCC, Windstream's negotiated reciprocal compensation rates across its entire nationwide territory averaged 0.89¢ per minute,[42] whereas, as shown in Figure 1, a long distance provider terminating an intrastate toll call to the same Windstream customer would pay Windstream nearly [redacted] times as much as the CLEC pays for the same terminating functionality. According to information from interconnection agreements provided to me by AT&T Kentucky, AT&T's CLEC exchanges local traffic with Windstream East at 1.33¢ per minute, which is [redacted] Windstream East's average intrastate access rates. With Windstream West, AT&T's CLEC in Kentucky exchanges local traffic at 1¢ per minute, or [redacted] Windstream West's intrastate access rates.

B. The Current System of Intercarrier Compensation Is Highly Asymmetric Across Technologies

Q: ARE ACCESS CHARGES APPLIED SYMMETRICALLY ACROSS TECHNOLOGIES?

A: No, not at all. The application of interconnection rates differs significantly across technologies, including wireless, VoIP, and other communications platforms.

Q: HOW ARE ACCESS CHARGES APPLIED DIFFERENTLY TO WIRELESS CALLS?

A: Wireless providers are not charged intrastate access rates for intrastate wireless calls except in very limited circumstances. Under FCC rules established in 1996, if a call originates on a wireless phone and goes to a LEC's customer without crossing the boundary of a Major Trading Area ("MTA"), it is considered a "local" call for purposes

[42] Reply Comments of Windstream Communications, Inc., *In the Matter of High Cost Universal Service Support, et al.*, before the Federal Communications Commission, WC Docket No. 05-337 et al., December 22, 2008, p. 6. Windstream offers local service in 23 states across the United States.

of interconnection fees (even if the call crosses a state boundary, a LATA boundary, and/or a LEC local calling area boundary)[43] and the LEC charges interconnection rates that are governed by the reciprocal compensation rules established in the Act.[44] These rules require that reciprocal compensation rates be based on the incremental cost of providing interconnection.[45] Because access rates were designed, as I have explained, to include a subsidy to local exchange service providers, reciprocal compensation rates are generally (by design) substantially lower than access rates, especially intrastate access rates. In fact, in its 2001 *ISP Remand Order*, the FCC adopted a reciprocal compensation regime that imposed a gradually declining cap on intercarrier compensation for ISP-bound traffic, beginning at $.0015 per minute-of-use and declining to $.0007 per minute-of-use and imposed a "mirroring rule" giving ILECs the benefit of the rate cap only if they offer to exchange all traffic subject to reciprocal compensation at the same rates.[46] For carriers that do not opt into the exemption they nevertheless must establish reciprocal compensation rates that are approved by the state commission subject to the cost-based standard established by federal law. Wireless carriers are subject to subsidy-laden switched access rates only on calls that (1) terminate to a LEC customer, and (2) cross an MTA boundary.[47]

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[43] *2008 NPRM*, ¶ 19.

[44] *1996 Interconnection Order*, ¶ 1036.

[45] TA96, §252(d)(2).

[46] Order on Remand and Report and Order, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Intercarrier Compensation for ISP-Bound Traffic,* before the Federal Communications Commission, FCC 01-131, (released April 27, 2001), (hereafter *ISP Remand Order*), ¶ 8.

[47] In fact, according to interconnection agreements available on the Commission's web site, in some cases wireless carriers have negotiated agreements that permit them to avoid switched access rates even on inter-MTA calls. See, for example, Commercial Mobile Radio Services Interconnection Agreement between Windstream Kentucky East, LLC – Lexington & Windstream Kentucky East – London and Crossroads Wireless Holding, LLC d/b/a Crossroads

Q: CAN YOU PLEASE DESCRIBE THE DIFFERENCES BETWEEN MTAS AND WIRELINE LOCAL CALLING AREAS IN KENTUCKY?

A: Yes. The difference is huge. In fact, almost all of the geographic area of Kentucky, including four of Kentucky's five largest urban areas, are within the same MTA, which also extends into parts of Indiana and Illinois. Four other MTAs intersect (relatively small parts of) Kentucky, and those MTAs cover multiple states, one covering part of Tennessee and extending through most of Mississippi, and another covering much of West Virginia and parts of Virginia, Indiana, and a significant portion of Ohio. In contrast, the state of Kentucky is broken up into hundreds of local individual wireline calling areas. Only wireline calls that originate and terminate within the same one of those relatively small local calling areas qualify for reciprocal compensation rates, while in-state calls that go from one local calling area to another are subject to intrastate access rates. A wireless call, in contrast, can originate from anywhere within the MTA and terminate to anywhere else within the MTA (even if it crosses multiple state borders) and qualify for reciprocal compensation rates for terminating the call to a wireline customer. Hence, wireless carriers enjoy a significant and artificial competitive advantage because they can avoid intrastate switched access rates on intrastate calls over the vast majority of Kentucky's territory.

These facts are illustrated in the map in Figure 2. Figure 2 shows the rate centers that comprise the local calling areas of the Lexington and Louisville areas and shows the Lexington-Louisville-Evansville MTA, which is the MTA in which these two local

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Wireless, July 31, 2008 Attachment 4; Commercial Mobile Radio Services Interconnection Agreement between Windstream Kentucky East, LLC and West Virginia PCS Alliance, d/b/a NTELOS, June 9, 2009, Attachment 4; and Commercial Mobile Radio Services Interconnection Agreement between Windstream Kentucky East, LLC and Powertel Memphis Inc. & T-Mobile Central LLC, May 21, 2009, Attachment 4.

calling areas reside. As the map shows, a wireline call originating in Lexington must terminate within the Lexington local calling area (i.e., must go to a customer in one of those Lexington rate centers circled on the map) to qualify for reciprocal compensation rates for termination. In contrast, a wireless call originating in Lexington could go to anywhere in the entire area indicated as the Lexington-Louisville-Evansville MTA, which includes Louisville and a large portion of the geographic area of Kentucky, and still qualify to pay reciprocal compensation rates rather than the much higher intrastate switched access rates for the same functionality. Hence, for example, the IXC carrying a wireline call from Lexington to Louisville would pay intrastate access charges to the LEC terminating the call (and the LEC originating the call); but if the call were placed on the customer's wireless phone, the wireless carrier would pay only reciprocal compensation rates to the same LEC to terminate the call to the same called party (and would pay no originating access charge at all).

Figure 3 expands Figure 2 to show the size of the five MTAs in Kentucky and surrounding states. For additional perspective, AT&T Kentucky and Windstream alone have over 70 separate local calling areas that lie within the Lexington-Louisville-Evansville MTA. As I have explained, any wireless call within the entire MTA qualifies for the relevant reciprocal compensation rate for termination, rather than the (much higher) access rate.

Figure 2

MTAs Are Far Larger Than Local Calling Areas in Kentucky

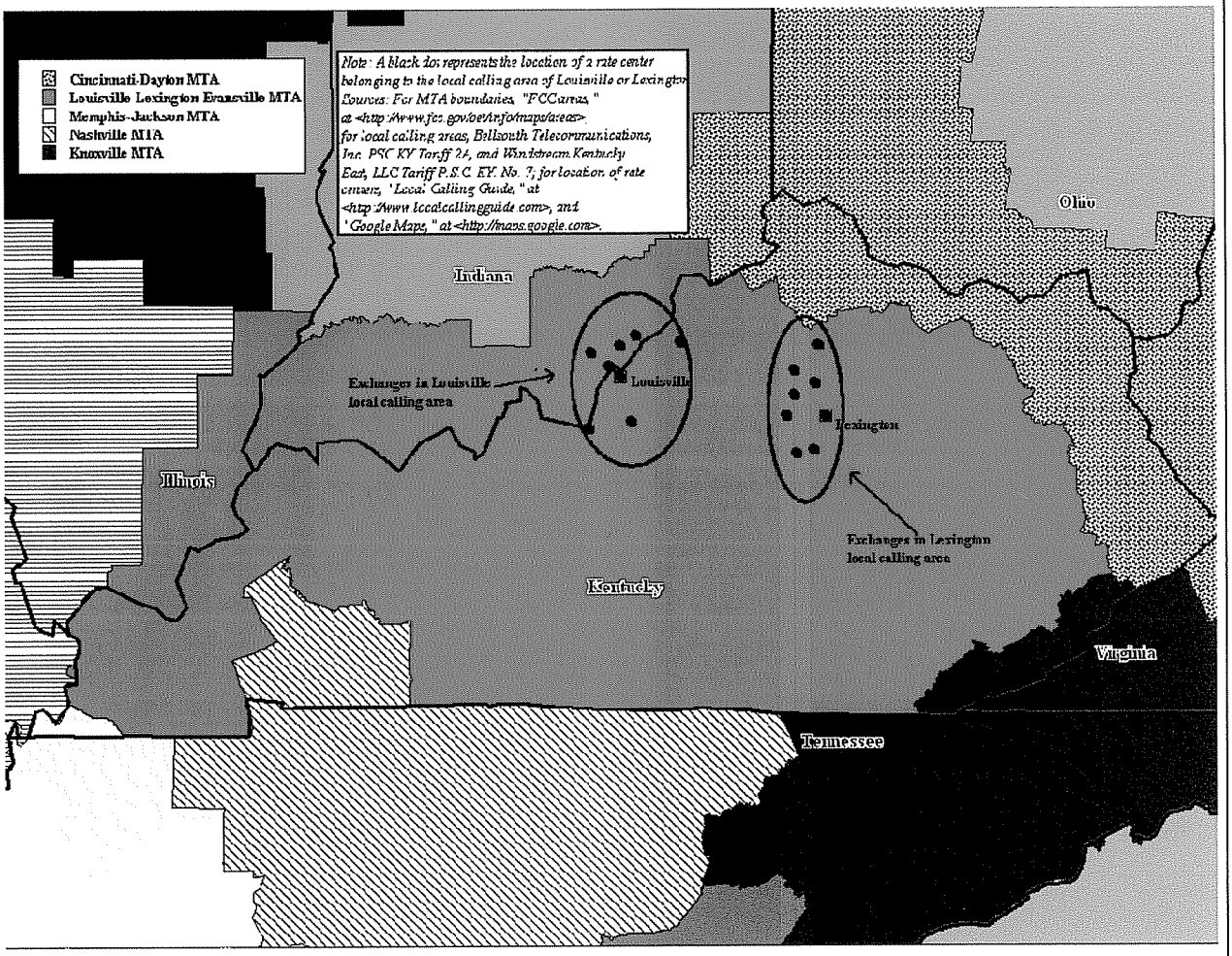
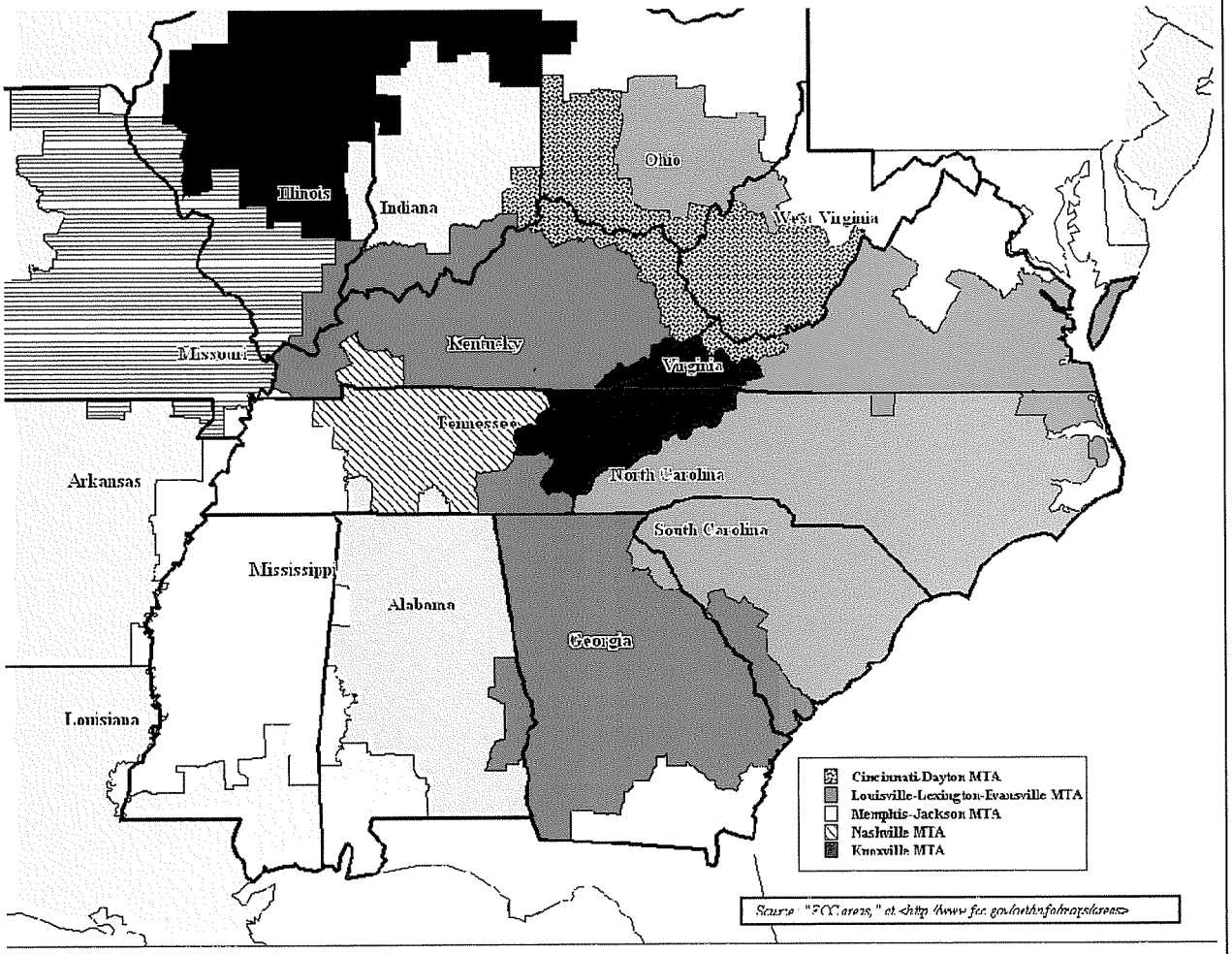


Figure 3

One MTA in Kentucky Covers a Large Portion of the State and the Others Span Several States



Q: WHAT RECIPROCAL COMPENSATION RATES DO LECS CHARGE TO WIRELESS COMPANIES TO TERMINATE INTRAMTA CALLS IN KENTUCKY?

A: AT&T Kentucky charges 0.07¢ per minute to wireless carriers to terminate intrastate wireless calls to its customers.[48] I am not privy to the rates charged by Windstream or other LECs, but 0.07¢ per minute is a common rate for terminating wireless traffic because it is the rate prescribed by the FCC for reciprocal compensation for all carriers who opt in to the *ISP Remand Order*.[49] For other LECs that do not opt in, their reciprocal compensation rates must nevertheless be approved by the state commission according to the standard that they must be cost-based, as I explained earlier.[50]

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[48] See, for example, Interconnection Agreement between BellSouth Telecommunications, Inc. and Cellco Partnership d/b/a Verizon Wireless, July 22, 2002, (amended January 2008), Attachment B-1.

[49] The *ISP Remand Order* permits LECs, if they "opt in," to limit to $.0007 per minute the amount they pay to the terminating carrier when the LEC sends ISP traffic. In exchange for the right to limit the rate it pays for termination of ISP traffic, the LEC must agree as part of the opt- in to charge only $.0007 per minute for termination of incoming local and wireless traffic. See *ISP Remand Order*, ¶ 8. The FCC determined that $.0007 per minute is compensatory for call origination and termination functionality. *ISP Remand Order*, ¶¶ 8, 92-93.

[50] In fact, some of Windstream's interconnection agreements with wireless carriers appear on the Commission's website. See, http://psc.ky.gov/agencies/psc/reports/intercon_1.html. The rates that Windstream charges for wireless call termination in these agreements range from 0.4¢ to 1.5¢, which are [redacted] Windstream's intrastate access rates. See, for example, Commercial Mobile Radio Services Interconnection Agreement between Windstream Kentucky East, LLC – Lexington & Windstream Kentucky East – London and Crossroads Wireless Holding, LLC d/b/a Crossroads Wireless, July 31, 2008 Attachment 4; Commercial Mobile Radio Services Interconnection Agreement between Windstream Kentucky East, LLC and Powertel Memphis Inc. & T-Mobile Central LLC, May 21, 2009, Attachment 4; Commercial Mobile Radio Services Interconnection Agreement between Windstream Kentucky East, LLC and West Virginia PCS Alliance, d/b/a NTELOS, June 9, 2009, Attachment 4; Commercial Mobile Radio Services Interconnection Agreement between Kentucky ALLTEL, Inc. and ALLTEL Communications Inc. F/K/A 360° Communications, 2002, Attachment 4; Commercial Mobile Radio Services Interconnection Agreement between ALLTEL Kentucky, Inc. and NPCR, Inc. d/b/a Nextel Partners, February 20, Attachment 4; Commercial Mobile Radio Services Interconnection Agreement Between ALLTEL Communications Service Corporation and Sprint Spectrum L.P., 2000, Attachment 4; Commercial Mobile Radio Services Interconnection Agreement Between Kentucky ALLTEL, Inc. and Telecorp Communications, Inc., 2002, Attachment 4; Commercial Mobile Radio Services Interconnection Agreement Between ALLTEL Kentucky, Inc., Kentucky ALLTEL, Inc. and Verizon Wireless, June 17, 2005, Attachment 1; Commercial Mobile Radio Services Interconnection Agreement Between ALLTEL Alabama, Inc., et al., and VoiceStream Wireless Corporation, 2001, Attachment 4.

Q: DO VOIP PROVIDERS PAY ACCESS CHARGES?

A: This is a disputed area of intercarrier compensation, which the FCC has not resolved. A number of carriers have petitioned the FCC seeking clarification or ruling on this issue, indicating that VoIP providers seek to avoid access charges by appealing to current regulatory ambiguity.[51] To the extent that VoIP providers are currently able to avoid access charges, they also enjoy a competitive advantage over wireline long distance providers, who must pay inflated intrastate access rates.

Q: DO ACCESS CHARGES APPLY TO OTHER BROADBAND FORMS OF COMMUNICATION, SUCH AS COMPUTER-TO-COMPUTER CALLING?

A: No. Communication methods that avoid the public switched telephone network entirely, such as computer-to-computer voice calling (an example is Skype-to-Skype), instant messaging, social networking such as Facebook, and email, are not subject to the access charge regime at all.[52]

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[51] See, for example, Petition for Forbearance, *In the Matter of Feature Group IP Petition for Forbearance Pursuant to 47 U.S.C. Section 160(c) from Enforcement of 47 U.S.C. Section 251(g), Rule 51.701(a)(1), and Rule 69.5(b)*, before the Federal Communications Commission, Docket No. WC 07-256 (October 23, 2007); and Petition for Forbearance, *In the Matter of Petition of the Embarq Local Operating Companies for Limited Forbearance Under 47 U.S.C. Section 160(c) from Enforcement of Rule 69.5(a), 47 U.S.C. Section 251(b) and Commission Orders on the ESP Exemption*, before the Federal Communications Commission, Docket No. WC 08-8 (January 11, 2008).

[52] See Memorandum Opinion and Order, *In the Matter of Petition for Declaratory Ruling that pulver.com's Free World Dialup is Neither Telecommunications Nor a Telecommunications Service*, before the Federal Communications Commission, FCC 04-27 (released February 19, 2004), ¶¶ 15-22 (finding that peer-to-peer applications that connect users over the Internet and make no use of the public switched telephone network are not subject to common-carrier-type regulations). See, also, Jonathan E. Nuechterlein and Philip J. Weiser, *Digital Crossroads: American Telecommunications Policy in the Internet Age* (Cambridge, Massachusetts: MIT Press, 2007), and pp. 198-199, and p. 303 ("Because IP-to-IP calls never leave the Internet and never touch the public switched network, any compensation arrangements between the firms involved—i.e., ISPs, Internet backbone providers, and the VoIP provider itself—are unregulated").

VI. Excessive Access Rates Harm Consumers, Harm Competition, and Distort Investment

Q: WHY SHOULD THE COMMISSION BE CONCERNED ABOUT EXCESSIVE INTRASTATE ACCESS RATES IN KENTUCKY?

A: Excessive intrastate access rates directly and indirectly harm consumers and businesses in Kentucky. They directly harm consumers and businesses because higher intrastate access rates cause higher retail prices for long distance services. Excessive intrastate access rates also indirectly harm consumers and businesses by discouraging wireline long distance usage, driving up the cost of operating businesses in Kentucky, distorting competition, and distorting investment. They also create arbitrage opportunities that waste resources generally, and they siphon revenues from long distance providers and their customers for the benefit of chat lines and similar businesses that were not the intended beneficiaries of subsidies provided on the backs of long distance customers.

A. Excessive Access Rates Harm Consumers by Inflating Retail Prices of Long Distance Services

Q: HOW DO EXCESSIVE ACCESS PRICES DIRECTLY HARM CONSUMERS?

A: Excessive access prices harm consumers in several clearly identifiable ways. The most direct harm to consumers is that excessive access prices charged to long distance providers cause the prices consumers pay for retail long distance services to be higher than they would otherwise be, so consumers pay more for the wireline long distance services they use.

When an access provider charges excessive prices for access services, those excessive prices generate revenue to the access provider but represent a cost to the company paying the access: the wireline long distance provider. The long distance provider, in turn, must

price its retail service higher to recover that cost. Excessive access prices therefore distort the pricing decisions of long distance providers. This harms consumers and reduces consumer welfare by forcing the prices for (some) long distance services to be far in excess of the actual social cost of producing the services. For example, if it costs the local exchange company B, say, 0.1¢ per minute to provide access, but B charges the long distance company A, say, 1¢ per minute, the latter will have to price long distance to its customers to recover the 1¢ rather than the genuine social cost of 0.1¢. That increased cost to the long distance provider will result in higher long distance prices. Conversely, lower access prices will lead to lower retail long distance prices.

Q: ARE SWITCHED ACCESS CHARGES A SIGNIFICANT COMPONENT OF LONG DISTANCE PRICES?

A: Yes, they are. In fact, intrastate access fees are the single most important component of the overall cost of providing in-state long-distance service. In Kentucky, AT&T Communications' average intrastate access expenses per minute were over [redacted] percent of AT&T Communications' intrastate long distance revenues per minute as of 2008.

Q: WHAT IS THE IMPORTANCE OF THE FACT THAT INTRASTATE ACCESS EXPENSES CONSTITUTE SUCH A HIGH PERCENTAGE OF AT&T COMMUNICATIONS' INTRASTATE LONG DISTANCE PRICES?

A: Intrastate access prices are an incremental cost of providing long distance service (i.e., each additional call minute causes the long distance provider to incur an additional access cost). Thus, material increases to the wholesale price of access would be expected to cause a material increase in the retail price of long distance service; and material

decreases in the wholesale price of access would be expected to cause a material decrease in the retail price of long distance service.[53]

Q: IS THERE A DIRECT RELATIONSHIP BETWEEN ACCESS RATES AND RETAIL LONG DISTANCE PRICES?

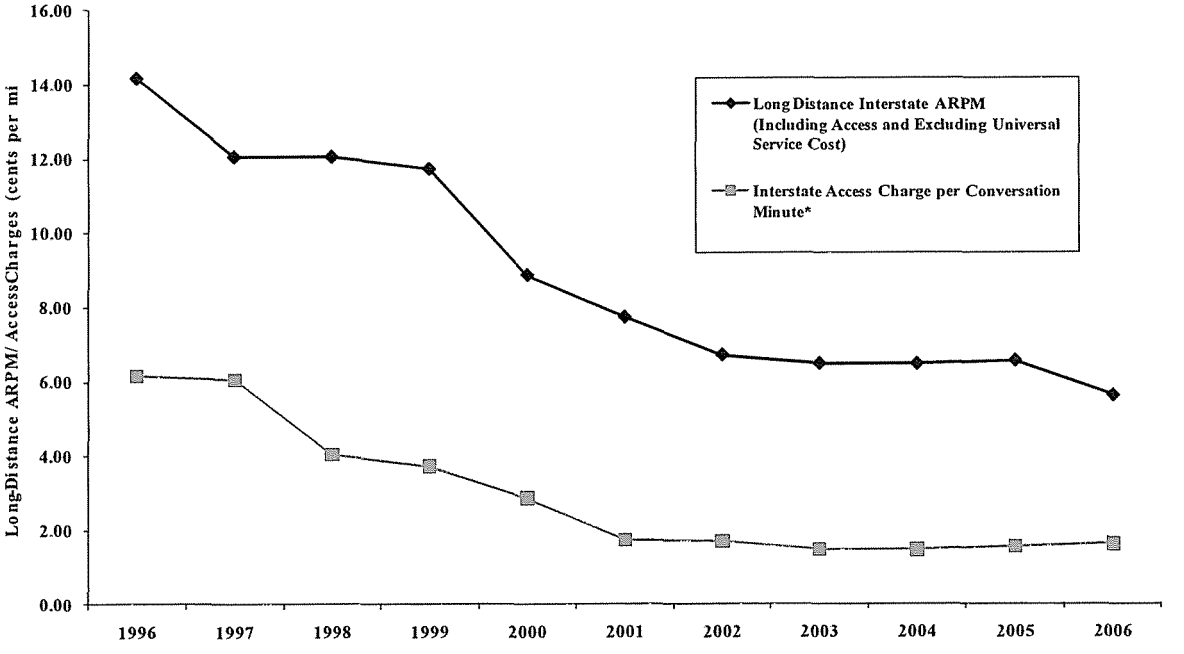
A: Yes. First, based on FCC data, average interstate switched access fees nationwide fell by just under five cents between 1996 and 2006, due to FCC intervention. During that same time, interstate long distance prices, which are unregulated, fell by nearly double that amount—9 cents—due to profit maximization and competitive forces. As access rates come down, retail long distance prices come down.

Indeed, this positive correlation between access rates and retail long distance prices is apparent from a simple visual inspection of FCC data on interstate access charges and interstate long distance rates over time since 1996. Figure 4 shows the national average of per-minute interstate access charges and the average retail price (measured by average revenue per minute) of interstate long distance calls. As you can see, the downward trend in interstate access charges has been accompanied by a comparable trend in interstate long distance prices. Long distance prices have fallen as access rates have fallen.

[53] Robert S. Pindyck and Daniel L. Rubinfeld, MICROECONOMICS, 3rd ed. (Englewood Cliffs, New Jersey: Prentice Hall, 1994), pp. 492-494.

Figure 4

Interstate Access Charges and Interstate Long Distance Average Revenue per Minute



* Access charges are the average rates (weighted by minutes of use) for all local exchange carriers that file access tariffs subject to price-cap regulation and all LECs in the National Exchange Carrier Association (NECA) pool. The average access charges reported by the FCC do not include revenue per minute from subscriber line charges or primary interexchange carrier charges (PICCs). The total charge per conversation minute consists of charges on the originating end of the call, which are adjusted for dialing and call setup time, plus charges on the terminating end.

Source: FCC 2008 Trends, Tables 1.2 and 13.4

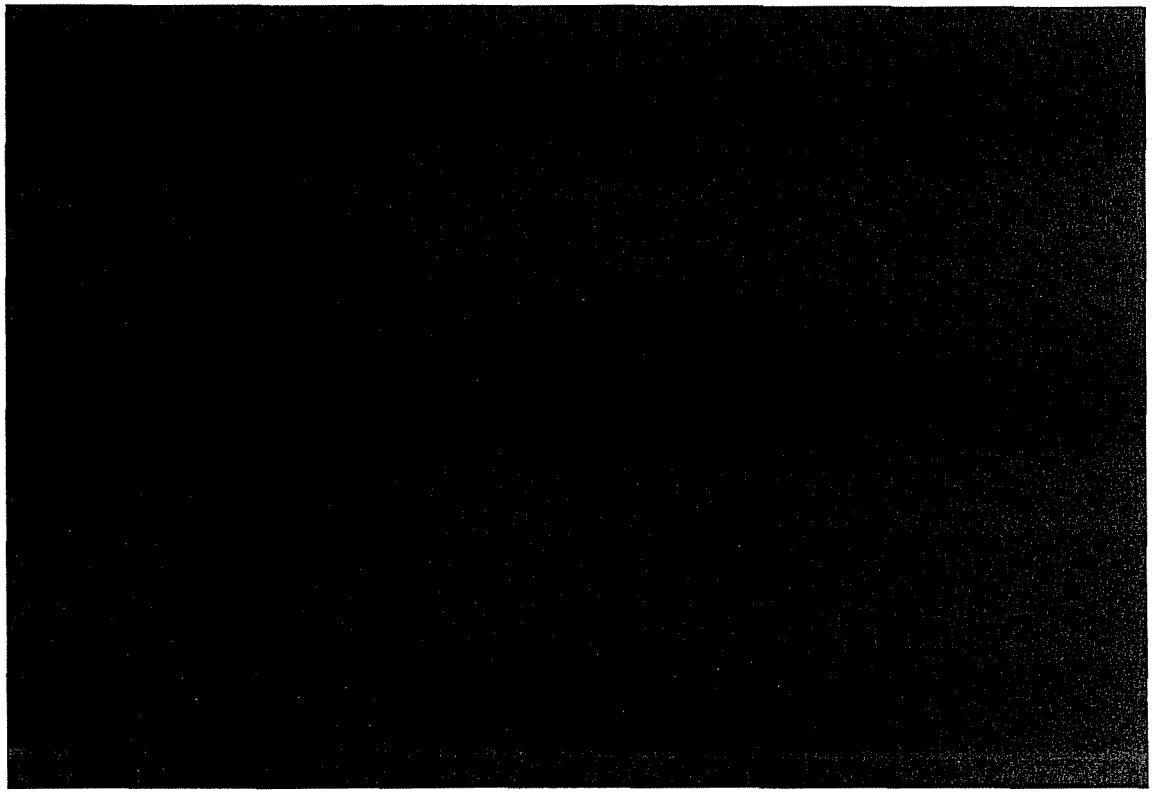
Q: DR. ARON, HAVE YOU BEEN ABLE TO TEST AND QUANTIFY THE RELATIONSHIP BETWEEN INTRASTATE ACCESS RATES AND INTRASTATE LONG DISTANCE PRICES?

A: Yes. In order to investigate the relationship between intrastate access rates and intrastate long distance prices, I requested and received data for the various AT&T Communications entities regarding intrastate access rates and intrastate long distance prices for the years 2004 through 2008 (most recently available at the time of my

request), for all 50 U.S. states.[54] The data are plotted in Figure 5. Each point represents a state in a particular year.

Figure 5

AT&T's Intrastate Toll Price versus Access Cost in 50 States, 2005-2008



[54] Specifically, I requested and received intrastate access expense minutes, intrastate expense revenues (that is, the amount of money paid by the AT&T Communications entities for intrastate access), intrastate toll revenues, and intrastate toll minutes. From these data I calculated AT&T's average intrastate long distance per minute price charged in each state for each year and AT&T's average intrastate access charge paid for each state for each year of my data. I assumed (and I found using the statistical techniques discussed below) that the average retail price charged by AT&T in year t is related to the average intrastate access rate charged to AT&T in year t-1, which reflects the fact that in general and in this circumstance, prices do not adjust instantaneously to changes in input prices. Hence, each point in Figure 6 is AT&T's average per minute price for intrastate long distance service in state j in year t on the vertical axis and the intrastate access rate in state j in year t-1 on the horizontal axis.

Looking across all states over several years it is apparent that where and when intrastate access rates are high, intrastate toll prices are high. It is apparent simply from visual inspection of Figure 5 that there is a strong positive relationship on average between the intrastate access rate paid by AT&T and the average per minute intrastate long distance price charged by AT&T. In states/years where the access rate (the variable on the horizontal axis) paid is higher, the price charged (the variable on the vertical axis) tends to be higher.

Q: DO THE DATA TELL YOU ANYTHING ABOUT MAGNITUDE OF THE DECREASE IN KENTUCKY LONG DISTANCE PRICES THAT ONE COULD EXPECT WHEN ACCESS CHARGES ARE REDUCED?

Yes. First, I used standard statistical techniques to estimate the relationship between the intrastate access rates and the intrastate long distance prices in the 50 states. That estimated relationship is depicted in Figure 5 as the red line through the data. The fact that the data exhibit a positive and statistically significant relationship is not surprising given that the relationship is apparent visually from Figure 5, and it is what one would predict on the basis of economic principles.

Using that estimated regression equation, I calculated what the relationship implies the retail price for intrastate long distance service in Kentucky would be if all LECs in Kentucky reduced their intrastate access rates to their interstate level so that the average intrastate access rate paid by AT&T Communications were equal to average interstate access rates paid by AT&T Communications in Kentucky. I found that the implied price paid by end-use customers for intrastate long distance service in Kentucky would provide

a reduction of 31 percent from AT&T Communications' current average intrastate long distance prices in Kentucky.[55]

Q: WHAT DO YOU CONCLUDE FROM YOUR DATA ANALYSIS?

A: It is clear that lower intrastate access rates are associated with lower intrastate long distance prices. The effect is both visually apparent from the data, and statistically significant. The relationship in the data imply that if intrastate access rates for all carriers were reduced to interstate levels in Kentucky, one would expect reductions in AT&T Communications' intrastate long distance prices up to 31 percent. These are material reductions that would provide a significant benefit to consumers and businesses in Kentucky.

Q: WHY WOULD ANY COMPANY VOLUNTARILY DECREASE ITS PRICES JUST BECAUSE THE ACCESS CHARGES IT PAYS WENT DOWN?

A: As I have indicated, traditional wireline long distance providers today face substantial competition from VoIP, wireless carriers, social networking web sites, and other providers largely immune from intrastate access charges. Reductions in access charges enable wireline long distance providers to reduce their end-user prices to become more competitive with other technologies.

But even if those other competitors did not exist, the traditional long distance carriers would still have an incentive to reduce their end-user retail long distance prices when access chargers are reduced. Companies do not decrease prices out of altruism but out of the desire and fiduciary obligation to maximize their profits to the extent they can, given

[55] This percentage is computed assuming that all LECs reduce their intrastate charges to interstate levels, as AT&T Kentucky has already done. Over [redacted] of AT&T Communications' intrastate access expenses in Kentucky are intrastate access payments to Windstream's operating companies.

demand, cost, and market conditions. When the incremental cost of producing something goes down, a company *increases* its profits by *lowering* its prices, all else equal. The reason is that a price reduction stimulates demand, and selling a bit more becomes profitable (when it previously was not) when incremental costs are lower. This is an elementary economic and mathematical principle that is true even for a company that faces no competition whatsoever. It is the straightforward consequence of profit maximization, regardless of competitive pressures on prices, that the profit maximizing response to a decrease in incremental costs is a decrease in price, all else equal. Hence, regulators need not rely on hopes of altruistic behavior or even on competitive pressures to expect declines in retail prices as a result of access price reductions; and it is not surprising that the data demonstrate declines in AT&T's retail intrastate long distance prices associated with intrastate access rate declines over the various time periods, jurisdictions, carriers, and geographies studied. Even a company that is wholly insulated from competition would rationally decrease prices if its incremental costs fell, and a company that faces vigorous competition would have little choice but to do so.

Of course, long distance service is highly competitive, so competitive pressures reinforce the incentive to lower prices when incremental costs fall. A company experiencing a decline in incremental cost enjoys an opportunity to compete more effectively and still cover costs by lowering its prices. This induces other competitors to lower their prices as well. A company decreases its price in response to a competitor out of an imperative to maintain its market position at previous levels or even to survive in competition with a lower-priced rival. Hence, incentives for profit maximization and competitive pressures both work in the same direction to induce companies to decrease prices when their

incremental costs fall, and they reinforce one another. It is undoubtedly the case that the decreases in long distance prices that have occurred as the result of access price declines have been the result of these combined economic pressures, and they can be expected to be effective going forward as well.

Q: DR. ARON, YOU HAVE EXPLAINED THAT AT&T KENTUCKY, THE LARGEST ILEC IN KENTUCKY, HAS ALREADY REFORMED ITS ACCESS RATES. WOULD FURTHER ACCESS REFORM OF OTHER LECS' ACCESS RATES HAVE ANY SIGNIFICANT EFFECT?

A: Yes. The analysis I just presented demonstrates that further reform would significantly benefit consumers. As I explained, the data indicate that if all the LECs in Kentucky followed AT&T Kentucky's lead and reduced their intrastate access rates to their interstate levels, intrastate long distance rates would be expected to decline by a very substantial 31 percent. This calculation incorporates into it the fact that AT&T Kentucky has already reduced its intrastate access rates to interstate levels, so the estimated decline in long distance rates is the additional effect from reforming the rest of the LECs in Kentucky.

B. Excessive Access Rates Also Harm Consumers by Causing Them to Use Less Long Distance Service Than They Would Choose at More Efficient Prices, and by Raising the Costs of Businesses Operating In Kentucky

Q: IN WHAT OTHER WAYS DO EXCESSIVE ACCESS PRICES HARM CONSUMERS?

A: I have explained that higher access charges result in higher retail prices for long distance services. Those higher prices not only cause consumers to pay more for service—the direct effect I just discussed—but also cause consumers to use less of the service. The discouraging effect of higher prices is a normally good thing—an efficient effect of the

price system—but only when prices reasonably reflect the underlying costs of producing a product or service. Prices then are the means by which consumers' decisions about how much to consume of a given product or service reflect the underlying cost to society of the inputs used to create or provide that product or service. If, however, the price of a service far exceeds its real underlying cost, consumers will restrict their usage more than is justified by the societal cost of producing the product, and consumers thereby forgo consumption and enjoyment unnecessarily. This distortion of consumption as a result of distorted prices is known as "allocative inefficiency," and the loss of economic well-being that results is what economists refer to as a social "deadweight loss" to the economy. Allocative efficiency is reduced, and consumers are harmed, when regulation causes prices to be higher than prices that would more closely reflect cost-causation.

Q: IS THERE EVIDENCE THAT CONSUMERS DO IN FACT USE LONG DISTANCE SERVICE LESS AT HIGHER PRICES?

A: Yes. The proposition that consumption of any product or service is lower at higher prices, and higher at lower prices, is so fundamental an economic phenomenon that it is called the "first law of demand."[56] The fact that long distance service would follow the first law of demand therefore scarcely requires empirical demonstration. There is, nevertheless, a considerable amount of literature demonstrating that usage of long distance is lower at higher prices and higher when prices are lower. The extent to which consumers respond to prices (if at all) is measured by the "elasticity" of demand. Several studies have quantified the price elasticity of demand for toll services for different time periods and for different jurisdictions (interstate, international, intrastate), and all have

[56] See, for example, Hal R. Varian, INTERMEDIATE MICROECONOMICS: A MODERN APPROACH, 3rd ed., (New York: W.W. Norton & Company, Inc., 1993), p. 146.

found that decreases in long-distance prices cause increases in the consumption of long distance services, and vice versa.[57]

Q: WHAT DO THESE RESEARCH RESULTS MEAN IN PRACTICAL TERMS?

A: They mean that consumers change their calling habits when long distance prices go down. Years ago, for example, when long distance prices were many times what they are today, long distance calls were a luxury used only very sparingly. Long-distance calls were tightly rationed in households, the length of calls was closely monitored, and when the monthly bill arrived loved ones often argued about whether they were talking too long or making too many long-distance calls. Today, the entire mentality towards long-distance calling has changed as prices have declined precipitously, not only for wireline calling but also for wireless and VoIP calling, and alternatives to voice telephony, such as texting, email, social networking sites, instant messaging, and other services, so that long distance communications are no longer viewed as a luxury that must be closely rationed. Rather, consumers are more likely to consider which phone or other technology they will

[57] See, Lester D. Taylor, TELECOMMUNICATIONS DEMAND IN THEORY AND PRACTICE, (Dordrecht: Kluwer Academic Publishers, 1994), pp. 129-148 and 296-314 and sources cited therein. See, also, Paul N. Rappoport and Lester D. Taylor, "Toll price elasticities estimated from a sample of U.S. residential telephone bills," *Information Economics and Policy* 9 (1997), pp. 51- 70; Donald J. Kridel, "A Consumer Surplus Approach to Predicting Extended Area Service (EAS) Development and Stimulation Rates," *Information Economics and Policy* 3 (1988), pp. 379-390; T.W. Appelbe, C.R. Dineen, D. L. Solvason, and C. Hsiao, "Econometric Modelling of Canadian Long Distance Calling: A Comparison of Aggregate Time Series Versus Point-to-Point Panel Data Approaches," *Empirical Economics* 17 (1992), pp. 125-140; Lester D. Taylor, "Competitive Own- and Cross-Price Elasticities in the Intralata Toll Market: Estimates from the Bill Harvesting II Database," Whitepaper (Fall 1996); Simran K. Kahai, David L. Kaserman, and John W. Mayo, "Is the 'Dominant Firm' Dominant? An Empirical Analysis of AT&T's Market Power," *Journal of Law and Economics* 39, (October 1996), pp. 499-517; Donald J. Kridel, Paul N. Rappoport, and Lester D. Taylor, "IntraLATA long-distance demand; carrier choice, usage demand and price elasticities," *International Journal of Forecasting* 18 (2002), pp. 545-559; Armando Levy, "A generalized additive Tobit model: An application to telecommunications demand," *Empirical Economics* 28 (2003), pp. 3-22; Clement G. Krouse and Jongsur Park, "Competition in the Interexchange Telecommunication Market," *Journal of Law and Economics* XLVI (April 2003), pp. 85-101; Michael R. Ward and Glenn A. Woroch, "Usage Substitution between Mobile Telephone and Fixed line in the U.S.," Whitepaper (May 2004); and David E. Burnstein, "An Examination of Market Power in the Intrastate Long-Distance Telephone Service Markets: Evidence from a Natural Experiment," *Journal of Law and Economics* XLVIII (April 2005), pp. 149-171.

use for a given communication, based on the relative prices, convenience, and other characteristics—a phenomenon I will discuss shortly.

Q: ARE THERE OTHER WAYS THAT EXCESSIVE INTRASTATE ACCESS CHARGES HARM CONSUMERS?

A: Yes. Residential consumers are not the only customers who pay long distance rates—business customers in Kentucky pay them also. When long distance prices are higher and business customers must pay the higher rates, their cost of doing business is higher in turn. This additional cost borne by businesses must either be passed through in the form of higher prices paid by the customers of those businesses, or in the form of contractions of the business.[58] Both of these effects harm not only the Kentucky businesses themselves but also their customers, who ultimately must face higher prices for a variety of goods and services.

C. Excessive and Disparate Access Rates Harm Competition

Q: HOW DO THE EXCESSIVE AND DISPARATE INTRASTATE ACCESS RATES IMPOSED UNDER THE CURRENT ACCESS REGIME HARM COMPETITION?

A: The current access regime significantly distorts competition across technologies. For example, the tremendous disparities in access rates paid by wireline carriers versus wireless carriers create a pronounced, and artificial, competitive advantage for wireless long distance services. As I explained earlier, for intrastate calls that are within an MTA,

[58] A survey of small businesses conducted by TeleNomic Research found that small businesses spend a considerable amount, on average $543 per month, for telecommunications services. The survey also determined that the cost burden of telecommunications services was higher for very small businesses. For example, firms with 0 to 4 employees were estimated to spend $82.81 per employee for local and long distance telephone service, while firms with 5 to 9 employees were estimated to spend $50.18 per employee and firms with 10 to 499 were estimated to spend $20.99 per employee. See, Stephen B. Pociask, "A Survey of Small Businesses' Telecommunications Use and Spending," TeleNomic Research, LLC, (March 2004).

wireless companies pay for terminating access at rates that are governed by reciprocal compensation (cost-based) rules rather than (subsidy-based) access rules, even if the call crosses a local calling area or LATA boundary. Hence, the same call on the wireline network would trigger intrastate originating and terminating access rates, which are generally much higher on average than the intraMTA rates paid by wireless companies to the same LECs. Put differently, for wireline calls, the calling area in which (low) reciprocal compensation rates rather than (high) intrastate access rates apply is the LEC's (relatively small) traditional wireline local calling area. For wireless calls, the situation is reversed. The calling area in which (low) reciprocal compensation rates rather than (high) intrastate access rates apply is the (relatively large) part of Kentucky covered by the MTA. This difference in regulatory treatment has a profound effect on the costs of interconnection for the two kinds of carriers, because MTAs comprise far larger geographic areas than do wireline local calling areas, as I demonstrated earlier.

Q: WHAT IS THE EFFECT ON COMPETITION BETWEEN WIRELESS AND WIRELINE SERVICES OF THE VAST DIFFERENCES BETWEEN LOCAL CALLING AREAS AND MTAS?

A: To see the economic effect of these differences between MTAs and local calling areas, consider a call from an ILEC customer in Lexington to an ILEC customer in Elizabethtown, and suppose the customer's long distance company is AT&T Communications. Because Lexington and Elizabethtown are in different local calling areas in Kentucky, AT&T Communications would pay approximately [redacted] per minute in originating and terminating intrastate switched access charges to the Windstream, the ILEC serving Lexington and Elizabethtown. If, instead, the customer in Lexington placed the call to the same telephone number from her wireless phone, the wireless

carrier would pay nothing in originating access (but would incur the costs of call origination), since wireless companies generally self-provide long distance service, and would pay the called party's ILEC provider a reciprocal compensation rate as low as 0.07¢ per minute to terminate the call, because Lexington and Elizabethtown are in the same MTA. So the wireless carrier may pay 0.07¢ to the LEC for interconnection, while AT&T Communications would pay [redacted] in access charges per minute—more than [redacted] times what the wireless carrier would pay. The wireless company, therefore, could offer a substantially lower price to its customers for the same call from Lexington to Elizabethtown than it could if it had to pay the same intrastate access rates that AT&T Communications must pay. These vast differences in rates charged by the local exchange company for the same access functionality substantially disfavor the wireline long distance provider and confer a competitive advantage on its wireless competitor in providing long distance services for no reason related to their relative efficiencies or value of service provided. When some businesses are favored by regulatory rules that are unrelated to underlying costs of doing business, the detrimental effect on the economy is known as "productive inefficiency." The example illustrates that the regulatory distortions in the access regime place wireline long distance providers at a significant competitive disadvantage. Those distortions, and the resulting productive inefficiency, would be reduced (though not eliminated) by adopting a mirroring policy for intrastate access rates.[59]

[59] As I explain later, the reform proposed by AT&T in this proceeding is an important step in the right direction and will benefit consumers and businesses in Kentucky. However, it does not reduce intrastate access rates all the way to efficient levels and therefore should be viewed as a step in an ongoing effort.

Q: HOW DO THESE COST DIFFERENCES AFFECT CONSUMERS ON A DAY-TO-DAY BASIS?

A: These cost differences affect consumers' decision-making behavior with regard to the different forms of communications available to them. Nowadays, people think nothing of making long-distance calls on their wireless phone. It is no surprise that wireless carriers, who incur a per-minute cost for all calls that is a small fraction of the per-minute cost that wireline carriers incur for non-local calls, have been pioneers in innovative, all-distance calling plans offering buckets of "anytime, anywhere" minutes. Moreover, consumers have options for instantaneous long-distance communications that avoid the PSTN entirely, such as email, instant messaging, social networking, and Skype-to-Skype calling, and whose providers bear no message-based interconnection charges to provide those services. The absence of access charges allows these providers to offer "free" alternatives for long distance communications to consumers that have access to the Internet—that is, these providers receive no money from customers for the communications service. Consumers respond to this array of options by weighing both the relative prices of their options and the characteristics of the available services (e.g., convenience, call quality, voice versus text, and so forth) to decide on a case-by-case basis which option they will choose. The artificially high price of wireline long distance service, driven by artificially high access rates, discourages use of the wireline long distance service in favor of other technologies relative to what that use would be if wireline long distance prices were not so distorted by inflated access charges.[60]

[60] See, for example, Michael R. Ward and Glenn A. Woroch, "Usage Substitution between Mobile Telephone and Fixed line in the U.S.," Working Paper, (May 2004), pp. 5, 11, 12, and 17 (Table 4). The authors construct a data set by aggregating household observations into a sample of observations at the LATA level, across ten quarters (3-month periods) from July 1999 to December 2001. The authors estimate the price effects on different types of

For example, a mother may prefer to keep in touch with her child at college on the wireline phone, because she may prefer its service or handset characteristics to wireless or computer-to-computer calling. However, that family may nevertheless keep in touch largely or entirely by wireless phone and/or computer-to-computer calling (as well as email, instant messaging, and other communications options) because of the lower price. The fact that the family is discouraged from communicating on the wireline network by artificially high wireline long distance prices is an economic harm or "social welfare loss" associated with those distorted prices. The dollar magnitude of the harm can conceptually be measured as the forgone value that the family would have enjoyed from the wireline call that it would have otherwise chosen. More generally, the economic harm from the distorted prices is the foregone value to all consumers from calls they did not make, but otherwise would have made, and calls they would have preferred to make on the wireline network, but made some other way due to the price distortion.

D. Excessive Access Rates Distort Investment, Including Broadband Investment

Q: HOW DO EXCESSIVE ACCESS RATES HARM EFFICIENT INVESTMENT INCENTIVES?

A: Investment incentives are driven by the prospect for future return on the investment. The prospects for future return on an investment depend, in turn, on the desire and willingness of consumers to use the services supported by that investment, which depend on the prices consumers must pay for the services. The chain of causation is as follows:

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wireline and wireless toll usage in the U.S. The authors produce six different estimates of the effect of wireline prices on wireless toll usage that range from -0.03 to 0.21. Because of data issues that limited the sample size employed for certain estimates, the authors indicate they have "most confidence" (p. 12) in two of the six estimates, which range from 0.11 to 0.21. These results indicate that there is a positive relationship between wireline prices and wireless demand.

artificially high access prices cause long distance companies to maintain higher retail prices to cover those costs;[61] higher long distance prices discourage consumers from using the wireline network to make long distance calls, driving usage below what it would otherwise be;[62] at higher costs and lower usage, the current and anticipated future value of the network to investors is lower; investment in the wireline long distance network is discouraged.[63]

Incentives for future investment are of particular importance because investment is long-lived, and distorted investment decisions therefore harm consumers and the economy not only today but for years into the future. The effects of distorted prices on investment and innovation decisions are known as dynamic inefficiency, because investment and innovation have long-lived ("dynamic") effects. An economy makes the most efficient use of its resources when investment decisions reflect the relative efficiencies of and demands for different technologies, businesses, and uses. Distorted prices and the resulting distorted investment decisions create dynamic inefficiency in the economy.

When prices distorted by regulatory policy discourage use of a particular service or network, investment in that service is dampened, all else equal, because the investors would expect a lesser return or profit than they would absent the distortions. Put simply, the lower the demand for a service, the lower the incentive to invest in the facilities that provide it, all else equal. That is efficient from a social perspective if the loss of

[61] See evidence in Section VI.A.

[62] See evidence in Section VI.B.

[63] It is a standard economic tenet that investment into an asset is discouraged if the net present value of the asset decreases. See Richard A. Brealey, Stewart C. Myers, and Franklin Allen, PRINCIPLES OF CORPORATE FINANCE (Boston: McGraw Hill/Irwin, 2006), Chapters 2, 5 and 6.

customers or lack of demand is the result of competition on the merits. However, if demand is weaker than it would otherwise be due to prices distorted by regulation, investment decisions are distorted as well, and the value of society's scarce investment resources is not maximized. In particular, investment in the facilities and infrastructure associated with the provision of wireline long distance service is discouraged below the level that would have occurred if demand were able to respond to prices that more closely reflected the true social costs. This dynamic inefficiency harms consumers today and in the future. Reducing the distortion by lowering excessive access prices and decreasing the disparities among access rates would improve dynamic efficiency by creating investment incentives that more closely align with consumer preferences and social costs.

Investors must decide how to allocate their investment funds across competing technologies, firms, and industries. When regulatory distortions are reduced, investment dollars can be allocated in closer relation to the underlying value of the different uses, as seen through the eyes of consumers. Consumers therefore benefit when dynamic efficiency is increased.

Q: WHAT DO THESE PRINCIPLES OF INVESTMENT INCENTIVES IMPLY ABOUT INVESTMENT IN BROADBAND NETWORKS?

A: The access rate regime of distorted retail prices, asymmetric access rate burdens, technology bias, and cross-subsidies affects the incentives of market participants to invest in next generation networks. As I noted earlier, the FCC has identified above-cost interconnection rates as a disincentive to broadband deployment. Specifically, the FCC explained in its Broadband Plan,

> Broadband providers have begun migrating to more efficient IP interconnection and compensation arrangements for the transport and termination of IP traffic. Because providers' rates are above cost, the current system creates disincentives to migrate to all IP-based networks. For example, to retain ICC revenues, carriers may require an interconnecting carrier to convert Voice over Internet Protocol (VoIP) calls to time-division multiplexing in order to collect intercarrier compensation revenue. While this may be in the short-term interest of a carrier seeking to retain ICC revenues, it actually hinders the transformation of America's networks to broadband.[64]

E. Excessive Access Rates Create Wasteful and Distortionary Arbitrage Behavior

Q: ARE THERE OTHER DISTORTIONARY EFFECTS OF EXCESSIVE ACCESS CHARGES?

A: Yes. Excessive access charges create artificial arbitrage opportunities by which access providers can exploit the differences between costs and regulated prices and exploit the access payers in the process. When access charges substantially exceed cost, there is money to be made by receiving those fees. For example, suppose it cost 1¢ per minute to provide access but the access charge were 10¢ per minute (I chose these round numbers purely for ease of illustration, but access charges are often several multiples of cost). Then it would be very lucrative for an access provider to identify or even create a business that receives a large number of phone calls (a chat line is one example) and then sets itself up as the local exchange carrier (and thus the point of access) for that business. The chat line would generate a margin for the access provider of 9¢ per minute for every minute received, in my example. The access provider might give the chat line an extremely low price for local service, or even pay the chat line a fee or share of the access margin to make the chat line its customer. In turn, the chat line might pay end users a

[64] *FCC Broadband Plan*, p. 142.

portion of that margin to encourage them to call the chat line to drum up more access fees.

Competition to become a chat line's LEC can drive profits out of the LEC's business (via, for example, lower prices or bigger transfer payments to the chat line provider), but would nevertheless not drive *access* rates down. Lowering its access rates would not put the LEC in any better position to attract customers such as chat lines—on the contrary, LECs with higher access rates could provide even bigger retail discounts (or kickbacks) to chat line providers. Hence, retail competition would simply force a transfer of the arbitrage profits from the LEC to the chat line and/or its customers, without disciplining the access rates. It is no surprise that these arbitrage-based businesses are sometimes referred to as "call-pumping" schemes, an apt term because they act as a siphon from access payers subject to, and unable to avoid, the excessive access charges.

Q: ARE YOU AWARE OF ANY OTHER ARBITRAGE SCHEMES THAT ARISE FROM THE CURRENT ACCESS/INTERCONNECTION REGIME OF HIGHLY DISPARATE RATES?

A: Yes. The significant disparity between the rates for interstate access and intrastate access creates an incentive for terminating LECs to misclassify traffic so that they can bill the higher intrastate rather than interstate rates; and by the same token, it creates an incentive for access payers to misclassify traffic so that it is billed at the lower interstate rates. Similarly, the disparate access rates and reciprocal compensation rates create an incentive for access payers to misclassify traffic so that it appears to be local traffic rather than long distance traffic. The incentive for access payers to misclassify traffic is known as the "phantom traffic" problem. Analysts have estimated the amount of lost revenues to

access providers due to phantom traffic to range from $600 million to $2 billion annually.[65] The incentive to avoid excessive access rates by misclassifying traffic so that it is charged a lower price for the same terminating functionality is another artifact of the differential in prices that does not reflect a differential in the functionality provided.

All of the resources devoted to establishing mechanisms for identifying whether wireline traffic is interstate or intrastate, ensuring that traffic is not intentionally or accidentally misclassified, establishing traffic identification rules, and engaging in disputes over traffic identification, "phantom traffic," and "call pumping," are a deadweight loss to the economy that would be decreased or avoided if interstate and intrastate access rates were the same.

Q: HAS THE FCC OFFERED ANY INDICATION THAT ARBITRAGE DUE TO EXCESSIVE ACCESS RATES IS A SERIOUS PROBLEM?

A: Yes. In its recent Broadband Plan, the FCC stated,

> Most ICC rates are above incremental cost, which creates opportunities for access stimulation, in which carriers artificially inflate the amount of minutes subject to ICC payments. For example, companies have established "free" conference calling services, which provide free services to consumers while the carrier and conference call company share the ICC revenues paid by interexchange carriers. Because the arbitrage opportunity exists, investment is directed to free conference calling and similar schemes for adult entertainment that ultimately cost consumers money, rather than to other, more productive endeavors.

...

[65] Letter from Karen Brinkman of Latham and Watkins, LLC on behalf of a group of LECs to the FCC re: WC Docket 01-92, Inter-Carrier Compensation – Notice of *Ex Parte* Presentation, July 1, 2005, attaching a presentation by Balhoff & Rowe, LLC (which found a $600 million loss to rural carriers); Letter from Joseph A. Douglas of NECA to the FCC re: Intercarrier Compensation Reform, Docket Number 01-92, *Notice of Ex Parte Presentation*, May 2, 2007, attaching a NECA presentation that cites estimates by Raymond James (which estimates a $2 billion loss to the industry overall) and Balhoff & Rowe (which estimates a $600 million loss to rural carriers).

> Moreover, fewer terminating minutes ultimately mean a smaller revenue base for intercarrier compensation. ... Even rate-of-return carriers, who are permitted to increase per-minute rates so they have the opportunity to earn their authorized rate of return, acknowledge that the current system is "not sustainable" and could lead to a "death spiral" as higher rates to offset declining minutes exacerbate arbitrage and non-payment. As the small carriers recognize, revenues are also decreasing due to arbitrage and disputes over payment for VoIP traffic.[66]

F. The Current System of Excessive and Asymmetric Interconnection Rates Forces Consumers in Some Parts of Kentucky to Subsidize Consumers in Other Parts of the Commonwealth Through Excessive Long Distance Charges

Q: DOES THE CURRENT SYSTEM OF EXCESSIVE AND ASYMMETRIC INTERCONNECTION CHARGES, IN WHICH AT&T KENTUCKY MIRRORS ITS INTERSTATE RATES BUT WINDSTREAM AND OTHER LECS DO NOT, HARM ALL CONSUMERS EQUALLY?

A: No. Some consumers—namely, those who live in areas where the LEC is permitted to charge excessive access rates in order to subsidize below-cost local rates—benefit at the expense of long distance consumers in other areas, who must pay the subsidies. Specifically, the current system forces long distance consumers in AT&T Kentucky's footprint to subsidize consumers in Windstream's footprint, via the excessive long distance prices all long distance customers in Kentucky must pay in order to cover the excessive access rates Windstream charges.

Q: WOULD REFORM OF WINDSTREAM'S INTRASTATE ACCESS RATES BENEFIT CONSUMERS ONLY IN WINDSTREAM'S ILEC FOOTPRINT?

A: No. Decreasing Windstream's intrastate access rates would cause not only the intrastate long distance prices paid by consumers in Windstream's footprint to decline, it would also cause intrastate long distance prices paid by consumers throughout the state to

[66] *FCC Broadband Plan*, p. 142. (Footnotes omitted).

decline. Long distance prices are required to be averaged within a state,[67] even though access rates paid to different LECs in different areas may vary significantly (as they do in Kentucky). This is why long distance customers throughout the state bear the burden of Windstream's excessive access charges. Customers in AT&T Kentucky's footprint must pay a significant premium for intrastate long distance service over AT&T Communications' intrastate access costs in the AT&T Kentucky footprint, in order to subsidize customers in Windstream's footprint.

VII. The Commission Should Order Windstream to Decrease Intrastate Access Rates in Order to Increase Consumer Welfare, Enhance Competition, Encourage Efficient Investment, and Discourage Socially Wasteful Arbitrage Opportunities

A. Ordering Windstream to Decrease Intrastate Access Rates to Interstate Levels Will Enhance Economic Efficiency by Bringing Access Rates Closer to Cost

Q: SHOULD THE COMMISSION ORDER WINDSTREAM TO DECREASE INTRASTATE ACCESS RATES TO INTERSTATE LEVELS?

A: Yes.

Q: WHY?

A: In light of the myriad disparities in the current access regime that I have discussed, and the fact that Windstream's intrastate access rates in Kentucky are the holdover of the legacy system that has been substantially revised and reformed for all other interconnection charges, decreasing intrastate access rates to interstate levels would

[67] Report and Order, *Policy and Rules Concerning the Interstate, Interexchange Marketplace and Implementation of Section 254(g) of the Communications Act of 1934, as amended*, before the Federal Communications Commission, CC Docket No. 96-61, FCC 96-331, (released August 7, 1996), ¶¶ 7, 9, 42.

benefit consumers and promote competition on the merits. As an economic matter, prices for switched access service should not be higher than the cost of providing access service.[68] As I have explained, however, current intrastate rates are an artifact of the legacy regulatory policy of using access rates set well above cost to cross-subsidize local service. Cross-subsidy mechanisms are incompatible with the policy goal of promoting consumer welfare and advancing competition on the merits, by which the success and failure of competitors are determined on the basis of their relative costs, efficiencies, and quality of services, and not by regulatory asymmetries. All of the evidence of which I am aware indicates that decreasing ILECs' intrastate switched access rates to interstate levels would bring them closer to cost as well as lessen the disparities across technologies, jurisdictions, and types of calls. Excessive access prices harm consumers, and highly disparate access prices distort and harm competition—and thereby also harm consumers, as I discussed earlier. Further, these prices distort investment decisions and create incentives for regulatory arbitrage that exploits access payers and wastes social (i.e., Kentucky's) resources.

Q: WHAT IS THE BASIS FOR YOUR OPINION THAT DECREASING ILECS' INTRASTATE SWITCHED ACCESS RATES TO INTERSTATE LEVELS WOULD BRING THEM CLOSER TO THE ILECS' COSTS?

A: My opinion is based on my analysis of the overall pattern and history of access rates and access reform. As I discussed above, it is clear that interstate switched access rates were

[68] See, for example, Mark Armstrong, "The Theory of Access Pricing and Interconnection," in *Handbook of Telecommunications Economics*, eds. Martin E. Cave, Sumit K. Majumdar, and Ingo Vogelsang,Vol.1, (Amsterdam: Elsevier Science B. V., 2002), pp. 356-379, and sources cited therein. In addition, some economists argue that the efficient interconnection price is zero (i.e., "bill and keep"). See, e.g., Patrick DeGraba, "Bill and Keep at the Central Office as the Efficient Interconnection Regime," Federal Communications Commission, OPP Working Paper No. 33, (Dec. 2000), ¶ 2, n. 3 and citations in Appendix C to the *Intercarrier Compensation Reform FNPRM.*

set well above the ILECs' costs. Intrastate rates remain much higher than the corresponding interstate rates and higher still than (purportedly) cost-based rates for reciprocal compensation, even though all of these rates are charged for the same function. Hence, reducing intrastate switched access rates would bring them closer to the ILECs' costs. This conclusion is consistent with the FCC's investigation and analysis to establish rates for terminating ISP-bound traffic and reciprocal compensation, including wireless traffic; the FCC's analysis in the course of interstate access reform; and the participation of Qwest, Verizon, and other ILECs in advocating the interstate rates that are essentially the ones in effect today.

Q: COULD YOU PLEASE DESCRIBE THE FCC'S ANALYSES BY WHICH ONE CAN CONCLUDE THAT INTERSTATE ACCESS RATES AT LEAST COVER COSTS, AND THEREFORE INTRASTATE ACCESS RATES SIGNIFICANTLY EXCEED COST?

A: The FCC established reciprocal compensation rates for terminating ISP-bound traffic to start at 0.15¢ per minute and gradually decrease over time to 0.07¢ (that is, 15/100 of a penny and 7/100 of a penny, respectively) per minute.[69] These reciprocal compensation rates are many times lower than the current per minute rate that ILECs in Kentucky charge a landline toll carrier to complete an interstate toll call. The FCC concluded that these rates (which are well below the current interstate access rates) were sufficient to recover costs:

> These rates reflect the downward trend in intercarrier compensation rates contained in recently negotiated interconnection agreements, suggesting

[69] See, *ISP Remand Order*, ¶¶ 8, 89, and footnote 177; and *2008 NPRM*, ¶ 3.

that they are sufficient to provide a reasonable transition from dependence on intercarrier payments while ensuring cost recovery.[70]

In addition, the current interstate access rates charged by Windstream, which are much lower than their intrastate rates in Kentucky, are the result of the reductions imposed in the *CALLS Order*. The FCC concluded in the *CALLS Order* that these "significant and immediate reductions to per-minute carrier access charges will bring those rates *closer to cost* and translate into lower per-minute long-distance rates."[71] Windstream admits in discovery that it has not sought review of its interstate switched access rates on the ground that such rates are below cost.[72] This lends support to my conclusion that these incumbents' interstate access rates are at least compensatory and that their intrastate rates are multiples of cost.

VIII. AT&T's Proposal to Reduce Windstream's Intrastate Access Rates to Interstate Levels Will Not Bring Rates All the Way to Parity Across Technologies But Is a Positive Step that Will Benefit Consumers and Businesses in Kentucky

Q: IS AT&T'S PROPOSAL TO REDUCE INTRASTATE ACCESS RATES TO THE ILECS' INTERSTATE LEVELS SUFFICIENT TO FULLY REFORM THE DISTORTIONS ATTENDANT TO THE CURRENT ACCESS RATE SYSTEM?

A: No, but this proposal is best seen as a step in the right direction that can be completed immediately. Interstate access rates themselves may well be far above the cost of providing call termination and origination services, and continue to be the subject of reform efforts. AT&T's proposal in this proceeding therefore does not fully drive access rates to cost or to parity across technologies. But its proposal will increase consumer

[70] *ISP Remand Order*, ¶ 8.

[71] *FCC CALLS Order*, ¶ 2. (Emphasis added.)

[72] See Windstream's Responses to AT&T's First Set of Data Requests, No. 10.

welfare and promote competition, which are material benefits to the public that should not be sacrificed in the pursuit of perfection. Nor should these steps, once taken, be allowed to impede further progress on the dismantling of a regulatory structure that no longer serves consumer interests.

IX. Access Rate Reduction Should Be Part of a Holistic, Revenue Neutral Reform of the Access Regime

Q: DR. ARON, YOU EXPLAINED EARLIER IN YOUR TESTIMONY THE HISTORY OF ACCESS RATES AND THE REASON THEY WERE ESTABLISHED AT EXCESSIVE LEVELS. WHY IS THE POLICY HISTORY BEHIND THE CURRENT RATES RELEVANT TO THIS PROCEEDING?

A: It is important for the Commission to understand the regulatory history to understand why access reform should be conducted in a holistic manner, with due respect for the context of the broader policy framework. As I have discussed, access rates were established 25 years ago as part of a cross-subsidy scheme that was intended to permit ILECs to recover costs of residential basic local exchange service (such as the cost of the local loop) through inflated access charges imposed on long distance providers, rather than through retail prices charged to end-user customers. This was a regulatory quid pro quo in which regulated companies held retail prices below compensatory levels in exchange for subsidy-producing access charges. Long distance companies, in the era before intermodal competition, would pass those excessive access rates through to their customers in the form of higher prices with less concern that they would lose customers to other technologies. With the development of competition in local and long distance markets, particularly intermodal competition, this policy is no longer viable and it is imperative that the Commission facilitate competition on the merits and promote

consumer welfare by bringing intrastate access prices down to reduce to the maximum extent possible the implicit subsidies.

Bringing access prices down, however, without permitting a corresponding adjustment upwards to the other price-capped services or seeking other means for carriers subject to retail rate regulation to compensate for lost access revenues, would inappropriately ignore the regulatory history that led to the current concerns with access prices. At the same time, and for the same reasons, it is appropriate and consistent with sound policy principles to reduce switched access rates as part of a holistic policy approach that includes increases in the prices for other rate-regulated services and, if necessary, access to explicit subsidies from Universal Service funds.

Q: YOU TESTIFIED THAT THE COMMISSION COULD COMPENSATE LECS FOR ACCESS REVENUE LOSSES BY PERMITTING THEM TO INCREASE RETAIL PRICES FOR LOCAL SERVICES OR BY PERMITTING THEM TO DRAW FROM A (YET TO BE CREATED) KENTUCKY UNIVERSAL SERVICE FUND. IS ONE METHOD PREFERABLE TO THE OTHER?

A: Yes. From a purely economic perspective, it is generally superior to permit retail prices to adjust to levels that at least recover costs. But from a policy perspective, the Commission may wish to support retail prices at "affordable" levels, even if they are below cost in some areas, to promote the state's universal service objectives.

Q: WHAT DO YOU MEAN BY "FROM A PURELY ECONOMIC PERSPECTIVE"?

A: The purely economic perspective is one in which overall consumer welfare is maximized. Economic analysis focuses on the efficient use of resources to best respond to consumers' tastes and preferences, which means the use of society's scarce resources in a way that

maximizes the overall consumer welfare that those resources can produce, given the different ways that they could be deployed, and given consumers' desires.

Q: WHY IS IT GENERALLY SUPERIOR, FROM AN ECONOMIC PERSPECTIVE, TO PERMIT PRICES TO ADJUST TO LEVELS THAT AT LEAST RECOVER COSTS?

A: Prices affect the decisions that consumers make about what to consume and how much to consume, as I have already discussed. Consumers make efficient decisions about what goods and services to consume if the prices they face reflect the costs that society incurs to supply them with those goods and services. Prices that reflect costs therefore encourage a socially efficient allocation of society's resources to competing uses. Prices that fall short of costs cause consumers to over-use those services, which is inefficient because society's resources that could be used for something that would provide more value to consumers are diverted to a less-valued use, to the detriment of consumers overall.

Q: YOU HAVE EXPLAINED WHY, FROM A PURELY ECONOMIC PERSPECTIVE, IT IS GENERALLY SUPERIOR TO ALLOW RETAIL PRICES TO ADJUST TOWARD COST-BASED LEVELS THAN TO PERPETUATE SUBSIDIZED PRICES. ARE THERE REASONS THAT REGULATORS MIGHT NEVERTHELESS REASONABLY CHOOSE TO PERMIT RECOVERY OF SOME OF THE FORGONE ACCESS REVENUES THROUGH UNIVERSAL SERVICE SUPPORT INSTEAD?

A: Yes, there can be in certain circumstances. Regulators can face conflicting social policy goals. One goal is certainly to maximize overall consumer (social) welfare. Another goal, however, may be to promote universal service, even at the expense of overall social welfare. To balance these objectives, AT&T proposes that (1) the Commission adopt a benchmark mechanism by which the access reduction is partly compensated by retail rate

increases, with the rest funded by universal service support; and (2) Lifeline rates not increase under the plan.[73]

Q: WHAT DO YOU MEAN BY "UNIVERSAL SERVICE"?

A: By universal service, I mean that all consumers (or nearly all of them) have telephone service available to them at reasonable rates.[74] The concept of universal service as a social policy goal is based on the premise (which I am neither endorsing nor rejecting here) that telephone service is of such unique importance to individuals' health and welfare that we have an obligation as a society to ensure that all Americans have access to it.

It is generally understood that 100 percent telephone penetration is not possible for a variety of reasons, including the fact that at any point in time, some people are in the process of moving or changing telephone providers, some may not want telephone service at any price, and other factors. Nevertheless, overall telephone penetration (accounting for wireless and other voice technologies) in the U.S. today is very close to the 100 percent policy ideal, and in Kentucky today is 93 percent.[75]

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[73] Direct Testimony of Dr. Ola Oyefusi, *In the Matter of MCI Communications Services, Inc., Bell Atlantic Communications, Inc., NYNEX Long Distance Company, TTI National, Inc., Teleconnect Long Distance Services & Systems Company and Verizon Select Services, Inc., v. Windstream Kentucky West, Inc., Windstream Kentucky East, Inc. – Lexington and Windstream Kentucky, East – London*, before the Public Service Commission, Commonwealth of Kentucky, Case No. 2007-00503, July 14, 2010, (hereafter *Oyefusi Direct Testimony*).

[74] See, Telecommunications Act of 1996, Sec. 254 (establishing, among others, the following principles of universal service: availability of quality services at "just, reasonable and affordable rates;" nationwide access to advanced telecommunications and information services; availability of such services to all consumers, including those in "low income, rural, insular, and high cost areas" at rates that are "reasonably comparable" to those charged in urban areas; and access to advanced telecommunications services in schools, libraries and rural health care facilities.

[75] Alexander Belinfante , "Telephone Subscribership in the United States (Data through November 2009)," Industry Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission, February 2010, Table 2.

Q: WHAT WOULD BE THE EFFECT ON OVERALL TELEPHONE PENETRATION—AND THEREFORE UNIVERSAL SERVICE GOALS—OF INCREASING PRICES OF REGULATED TELEPHONE SERVICES TO RECOVER LOST ACCESS REVENUES DUE TO ACCESS REFORM?

A: In principle, telephone penetration could go up, down, or stay the same. However, a number of factors indicate that overall telephone penetration is likely to be resilient to price increases on regulated local telephone service in Kentucky, and overall penetration could indeed increase. These factors include the facts that: (1) other means of communications, such as wireline and broadband-based telephony are widely available, and wireless penetration in Kentucky is nearly universal; (2) an increase in wireline prices due to access reform would be part of a holistic access reform policy that would be expected to result in lower wireline long distance prices, as I discussed earlier, which would tend to counterbalance increased prices for local exchange services; and (3) explicit policies have been implemented in Kentucky to protect low-income consumers from any negative effects of increases to regulated rates.

To put the numbers in perspective consider the fact that, according to the FCC's most recent report on wireless competition, the average monthly bill paid by wireless subscribers in 2008 in the U.S. was $51.54,[76] and the CTIA's most recent semi-annual wireless survey reports that the average local monthly bill for the six months ended December, 2009 was $48.16.[77] These rates have not discouraged 95 percent of the population over 15 in Kentucky from subscribing to wireless service. I understand from

[76] Fourteenth Report, *In the Matter of Implementation of section 6002(b) of the Omnibus Budget Reconciliation Act of 1993 and Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services,* before the Federal Communications Commission, FCC 10-81, (released May 20, 2010), (hereafter *FCC 2010 14th CMRS Report*), p. 20.

[77] CTIA December 2009 Semi-Annual Wireless Survey.

Dr. Oyefusi's testimony that the total amount of access revenues that would be forgone by Windstream if its intrastate access rates were reduced to interstate rates averages is less than [redacted] per line per month. Even if that entire amount were recovered by increasing Windstream's current retail prices (which I understand is not AT&T's proposal), Windstream's rates would not come close to the average prices customers pay for wireless service.

This suggests that at current price levels, there is significant tolerance for some increases in wireline prices. However, suppose for the sake of argument that allowing prices of basic regulated local service to rise, holding all other prices constant, would cause a significant share of customers to stop subscribing to regulated telephone service. In today's marketplace, this would not imply that these customers would be without telephone service. These customers might decide to rely instead on their wireless service, or, if they are among the few in Kentucky that do not have wireless service, begin subscribing to it; or they may decide to switch instead to VoIP services, assuming such services are available in their area.

Wireless service is certainly widely available in Kentucky. As of December 2008, there were 3.4 million mobile wireless subscribers in Kentucky, compared to 1.0 million in 2000, representing a growth of 236 percent,[78] and most of the state has wireless coverage, with a significant portion of it being served by three or more wireless providers.[79] Nationwide, 24.5 percent of households have no wireline service and rely on wireless

[78] "Local Telephone Competition: Status as of December 31, 2008," Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, June 2010 (hereafter *FCC Local Competition Report*), Table 14.

[79] *FCC 2010 14th CMRS Report* , Map D-13, p. 281.

service as their local telephone service.[80] Indeed, as of 2008, 95 percent of the population in Kentucky over the age of 15 had a wireless phone.[81] Studies have also found that lower income customers are more likely than are higher income customers to "cut the cord" and have wireless service only, rather than have wireline service and no wireless service.[82]

Broadband service is also widely available in Kentucky. According to the FCC's most recent report, as of December 2008, 114 out of 120 counties in Kentucky had at least 20 percent penetration.[83] The FCC also reports that in Kentucky, 86 percent of homes where ILECs offer local telephone service have xDSL available, and 93 percent of homes where cable providers offer service have broadband cable service available.[84]

If customers switch from wireline to wireless service (or simply drop their wireline service and retain the wireless service they already have); or switch to broadband-based telephony (as part of a broadband package, for example), this would not decrease overall telephone penetration and would therefore not damage universal service goals. It would be a reflection of consumer preferences, when consumers are able to face prices that

[80] Stephen J. Blumberg and Julian V. Luke, "Wireless Substitution: Early Release of Estimates from the National Health Interview Survey, July-December 2009," Centers for Disease Control and Education (CDC), May 12, 2010.

[81] The percentage of all residents in Kentucky with a wireless phone was 81 percent and is likely to be even higher today. *FCC Local Competition Report*, Table 17; "Local Telephone Competition: Status as of December 30, 2006," Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, December 2007, Table 14; and U.S. Census Bureau, "2008 American Community Survey, Selected Population Profile in the United States – Kentucky."

[82] See, for example, Charles S. Golvin *et al.*, "Cord-Cutting Reaches One In 20 Mobile Households," Forrester Research, May 5, 2005, p. 2; Keith Mallinson, "Personal Wireless Calling Surpasses Wireline Calling: A Wireless Substitution Update," Yankee Group Analyst Report, August 2005, p. 2; and Amy Cravens, "Cutting the Cord: Consumer Wireline Erosion," In-Stat Analyst Report, December 2005, p. 2.

[83] "High-Speed Services for Internet Access: Status as of December 31, 2008," Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, February 2010 (hereafter *FCC Broadband Report*), Table 22.

[84] *FCC Broadband Report*, Table 19.

more fully reflect actual costs. Of course, if, in some areas, no wireless, broadband, or other alternative services were available, and if the increase in wireline local service prices (all else equal) were enough to make a significant number of customers choose not to buy any telephone service at all, that might affect the goal of universal service.

The foregoing discussion, however, accounts for only half of the picture. If local service prices are increased to compensate for access rate reductions, the access rate reductions themselves would be expected to cause long distance prices to decline, as I have already explained. Lower wireline long distance prices would stimulate demand not only for wireline long distance service, but for access to the wireline network (i.e., basic local service), all else equal. The net effect of increased local exchange prices and reduced long distance prices could increase demand not only for long distance service but also for local exchange access—therefore leading to *increased* wireline telephone penetration.

Q: IS THERE EVIDENCE THAT ACCESS RATE REBALANCING—I.E., REDUCED ACCESS RATES AND COMPENSATING INCREASED LOCAL SERVICE RATES—CAN IN FACT CAUSE TELEPHONE PENETRATION TO INCREASE?

A: Yes. In a study published in the *American Economic Review* by economist Jerry Hausman and colleagues Timothy Tardiff and Alexander Belinfonte,[85] the authors analyze telephone penetration and prices from 1984 to 1990, and find that "an increase in

[85] *Hausman et al. 1993*, pp. 181-182. The *American Economic Review* is one of the leading peer-reviewed, academic journals in which economists publish their professional research. The authors estimate the effect on telephone penetration from changes in the price for local service and the prices for interstate and intrastate (intraLATA and interLATA) toll services. Employing a panel data set from 1984 to 1988 of up to 500 different geographic locations in the U.S., the authors estimate a binary logit model where the left-hand-side (dependent) variable is the proportion of households with telephone service and the right-hand-side (independent) variables are telephone prices and demographic variables of households. The authors find that at 1990 average U.S. prices and penetration levels, the own-price elasticity for local service is -0.005, whereas the cross-price elasticity of demand for local service is -0.0086 with respect to the price of intraLATA toll, -0.0019 with respect to the price of intrastate interLATA toll, and -0.0055 with respect to the price of interstate toll.

basic [retail local] access prices combined with a decrease in long-distance toll prices (via a decrease in long-distance access prices) could well lead to an *increase* in telephone penetration."[86] They conclude that "the evidence ... tends to show that increased penetration [that occurred during the time period studied] resulted in part from the combined effect of higher monthly basic [retail local] access charges and lower long-distance prices" during this period.[87]

Q: ARE THERE ANY SAFEGUARDS IN KENTUCKY FOR LOW-INCOME CUSTOMERS TO RECEIVE TELEPHONE SERVICE IF RETAIL PRICES FOR LOCAL EXCHANGE SERVICE WERE TO RISE?

A: Yes. Households with low income are also eligible for financial assistance through federal programs such as Lifeline Assistance, which provides discounts on basic monthly service, and Link-Up America, which assists households with the costs of setting up phone service (wireless or wireline).[88] AT&T Kentucky proposes that Lifeline and Linkup rates remain at their current levels.[89] Hence, these programs would continue to provide the same safeguard for low-income consumers as are available today in Kentucky.

[86] *Hausman et al. 1993*, p. 182.

[87] *Hausman et al. 1993*, p. 183.

[88] See, FCC website, "Lifeline and Link-Up: Affordable Telephone Service for Income-Eligible Customers," at http://www.fcc.gov/cgb/consumerfacts/lllu.html.

[89] See *Oyefusi Direct Testimony*.

Q: DR. ARON, CLEARLY SOME CONSUMERS WOULD BENEFIT FROM BEING ALLOWED TO PAY BELOW-COST PRICES THAT ARE SUBSIDIZED WITH UNIVERSAL SERVICE SUPPORT. ARE THERE DOWNSIDES TO THIS SYSTEM IN ADDITION TO THE PURELY ECONOMIC NEGATIVE EFFECTS ON OVERALL CONSUMER WELFARE AND COMPETITION THAT YOU HAVE EXPLAINED?

A: Yes. If some customers are allowed to pay below-cost prices, subsidized by universal service funds, it means that some other customers are providing the subsidy. For example, universal service support tends to flow to high cost areas, which tend to be more rural areas. Urban customers, then, tend to be net payers into the subsidy. There is no reason to believe that such a system of cross subsidies is "fair" given that urban customers may well face higher prices for housing, food, and other costs of living. Moreover, many urban customers (like many rural customers) live in households with low income, and there is no obvious social policy objective being served by requiring these urban households to subsidize rural households, including rural households with higher income levels. In addition, increased universal service funding imposes a greater cost on Kentucky businesses, who would also shoulder part of the subsidy burden as telephone customers. Imposing costs on businesses is detrimental to the business climate in Kentucky, and increases the prices paid by consumers for the goods and services produced by those businesses.

Q: HOW DOES A BENCHMARK PLAN SUCH AS THAT PROPOSED BY AT&T PROMOTE ECONOMIC EFFICIENCY WHILE PROTECTING UNIVERSAL SERVICE?

A: The idea of benchmarks is the following. Suppose that access reform would reduce access revenue for a given ILEC by $5 per line per month (using hypothetical numbers for purposes of exposition), and that the current retail price for basic local service were

$15 per line per month. One means of recovering that $5 in lost access revenue due to access reform would be to increase the retail price of service by $5 (to $20). Another would be to keep the retail price of service the same but provide a $5 subsidy via a universal service fund. The former would be the most efficient in the economic sense of encouraging efficient competition, investment, and resource allocation, as I have explained. The latter would be the least likely to cause a decline in wireline telephone penetration, because there would still be the expected decrease in long distance prices (due to the reduced access rates) but a much smaller increase in local service prices.[90] There is no free lunch, however. The larger is the draw from the universal service fund, the greater is the economic inefficiency and cost to society caused by distorted competition, distorted consumption decisions by consumer, and distorted incentives for investment by providers; and the greater is the cost burden to the customers providing the subsidy, as I have explained. Hence, it would generally be desirable to compensate the carriers for reduced access revenues by increasing retail prices to the greatest extent consistent with universal service policy, if not entirely. One way to achieve this would be to identify a price level for retail service that would recover some of the forgone access revenues at which customers would not be likely to defect from the network in significant numbers (i.e., a reasonably "tolerable" or "affordable" retail price level); and if that is not sufficient, to make up the rest of the access reduction with universal service funds. For example, suppose that there was reason to believe that if the price were to rise to $18 (again using hypothetical numbers), this would cause minimal decrease in

[90] Even if the entire decrease in access revenues were covered by increased universal service support, that support would have to come from somewhere. Assuming it comes from the industry and not general tax revenues, there would generally be some increased cost to consumers to fund the universal service system.

subscribership due to the higher local price. Then the benchmark could be set at $18, which would permit recovery of $3 of the $5 of forgone access revenues, and the remaining $2 could be recovered from universal service funds. This solution would be superior to a solution of recovering the entire decrease in access revenues from universal service funds because it would at least partially rationalize the retail price toward a more efficient level, it would impose less subsidy burden on the customers supplying the subsidy, and it would go further toward diminishing the wide range of retail rates across the state, bringing these rates closer together. It would be less efficient than a solution of fully recovering the forgone access revenues from retail prices, but may impose a lower potential risk to universal service goals (to the extent there is any material risk).

Q: COULD YOU PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING AT&T'S BENCHMARK PROPOSAL?

A: Yes. Economics is clear in teaching us that allowing retail prices to rise to a level that at least covers costs would generally advance overall consumer welfare by promoting an efficient allocation of resources, promoting efficient investment in alternative technologies, and promoting efficient competition. However, it is possible that such prices would impede social universal service objectives by discouraging some consumers from attaching to the telephone network at all. In such cases, there may be a conflict between advancing overall consumer welfare and advancing universal service policy objectives, and policy makers may choose to promote the latter at some expense of the former by permitting prices to remain below cost and subsidizing the difference via universal service funds. A benchmark plan such as that proposed by AT&T is designed to balance these goals by achieving the benefits of access reform that come from reduced

long distance prices, and achieving the efficiency benefits for competition and consumption decisions of increased retail prices, while protecting against any harm to universal service goals.

Q: BY ORDERING A REDUCTION IN INTRASTATE ACCESS CHARGES, WOULD THE COMMISSION BE ABDICATING ANY REGULATORY RESPONSIBILITY TO WINDSTREAM OR OTHER LOCAL EXCHANGE CARRIERS?

A: No. On the contrary, the current system of support is crumbling as long distance minutes fall, LEC lines decline, and the subsidy source erodes, as I have already described. It is imperative both to provide a sustainable policy for wireline local exchange companies that currently rely on access rates to support below-cost local exchange prices, and for the ability of wireline long distance providers to compete on a more level playing field with other technologies, to reduce the currently-excessive intrastate access rates of Windstream and other LECs in Kentucky, as it reduced AT&T Kentucky's intrastate access rates 15 years ago. Of course, it would neither be sustainable as a matter of economics nor advisable as a matter of policy credibility for regulators to rescind the subsidies embedded in access rates, but fail to alleviate regulatory restrictions that may have forced some local exchange rates below cost. It would be most efficient to allow local exchange carriers the opportunity to increase local exchange prices to recover the forgone access revenues, but if the social policy objective of maintaining local exchange rates below cost is still considered necessary, an explicit means to fund these prices, such as a universal service fund, must be implemented.

X. Concluding Comments

Q: CAN YOU PLEASE SUMMARIZE THE BENEFITS TO CONSUMERS AND THE ECONOMY FROM REFORMING INTRASTATE ACCESS RATES TO MIRROR INTERSTATE RATES?

A: Yes. Reforming the access regime by reducing intrastate access rates in Kentucky as part of a holistic regulatory approach that provides for offsetting revenues via retail rate relief and/or universal service support can be expected to benefit consumers in the following ways:

- Prices for wireline intrastate long distance services would be expected to fall, which would directly benefit consumers and in turn would stimulate more usage of the wireline long distance network and enhance opportunities for consumers to use the technology that best suits their needs at the time;

- Distortions in the competitive process between wireline, broadband, and wireless technologies would be reduced so that consumers could make decisions that reward providers more closely for their relative efficiencies, service characteristics, and value in the eyes of customers, rather than on the basis of artificially high wireline long distance services prices that distort consumer behavior;

- Investment incentives would be better aligned with the relative merits of different service providers and technologies;

- Arbitrary, implicit forms of subsidization from residents in some areas of Kentucky to residents in other areas would be reduced; and

- Wasteful arbitrage activities would be less attractive and would therefore likely be reduced.

Q: DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A: Yes, it does.

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EDUCATION

Ph.D., Economics, UNIVERSITY OF CHICAGO, Chicago, IL, 1985

A.B. (summa cum laude), Economics, UNIVERSITY OF CALIFORNIA AT LOS ANGELES, Los Angeles, CA, 1979

PRESENT POSITIONS

Navigant Economics, Evanston, IL, 2010-present
Principal and Managing Director

NORTHWESTERN UNIVERSITY, Communication Systems Strategy and Management Program, School of Communication, Evanston, IL, 2000 - present
Adjunct Associate Professor of Communication Studies

ACADEMIC AND PROFESSIONAL EXPERIENCE

LECG, LLC Evanston, IL, 1995-2010
Managing Director
Office Director, LECG Evanston

NORTHWESTERN UNIVERSITY, J. L. Kellogg Graduate School of Management, Evanston, IL, 1985–1995
Visiting Assistant Professor of Managerial Economics, 1993-1995
Assistant Professor of Managerial Economics, 1985-1992

HOOVER INSTITUTION, 1992-1993
National Fellow

UNIVERSITY OF CHICAGO, Department of Economics, Chicago, IL, 1983–1984
Instructor

CIVIL AERONAUTICS BOARD, Office of Economic Analysis, Washington, DC, Summers, 1979 and 1980
Staff Economist

HONORS & AWARDS

Guthman Research Chair, Kellogg Graduate School of Management, Northwestern University, Summer 1994.

Hoover National Fellowship, Hoover Institution, 1992-1993.

Faculty Research Fellow, National Bureau of Economic Research, 1987-1990.

Pepsico Research Chair, Northwestern University, 1990.

Kellogg Research Professorship, Northwestern University, 1989.

National Science Foundation Research Grant, 1987-1988.

Buchanan Chair, Kellogg Graduate School of Management, Northwestern University, 1987-1988.

IBM Chair, Kellogg Graduate School of Management, Northwestern University, 1986-1987.

RESEARCH INTERESTS

Industrial organization, antitrust economics, business strategy, pricing, information industries, network industries, telecommunications policy, theory of the firm, compensation and incentives.

TEACHING

Courses taught: Pricing Strategy; Information, Communication, and Competition (strategy and competition in communications industries); Intermediate Microeconomic Theory; Managerial Economics (microeconomic theory as applied to business strategy and decision making) at the M.B.A. level, The Economics of Information at the Ph.D. level.

Also qualified to teach: graduate Microeconomic Theory; Industrial Organization and Labor Economics; the Economics of Personnel; Public Finance; Applied Game Theory.

PUBLICATIONS AND WORKING PAPERS

"An Empirical Analysis of Regulator Mandates on the Pass Through of Switched Access Fees for In-State Long-Distance Telecommunications in the U.S.," with David E.

Burnstein, Ana Danies, and Gerry Keith, accepted for presentation at The 38th Research Conference on Communication, Information and Internet Policy (Telecommunications Policy Research Conference), October 1-3, 2010, George Mason University Law School, Arlington, Virginia.

"Regulatory Policy and the Reverse Cellophane Fallacy," with David E. Burnstein, *Journal of Competition Law and Economics* 2010; doi: 10.1093/joclec/nhp033.

"Investment in Next Generation Networks and Wholesale Telecommunications Regulation," with Robert W. Crandall, November 3, 2008, http://ssrn.com/abstract=1294910.

"Pricing Principles and Pricing Methodologies for Essential Facilities," May 2008.

Contributing author, *ABA Section of Antitrust Law, Telecom Antitrust Handbook, (2005)*, (Chicago: American Bar Association), 2005.

"The Proper Treatment of Spare Network Capacity in Regulatory Cost Models," with Ana Danies, May 2005.

"State Commissions Systematically Have Set UNE Prices Below Their Actual Costs," with Frank Pampush and E. Gerry Keith, 2004.

"Broadband Adoption in the United States: An Empirical Analysis," with David E. Burnstein, in *Down to the Wire: Studies in the Diffusion and Regulation of Telecommunications Technologies,* Allan Shampine, ed., (Nova Science Publishers, Hauppauge, NY, 2003).

"Developments in the Theory of Vertical Foreclosure as Applied to Regulated Telecommunications Markets" (March, 2002), Prepared for Presentation at The American Bar Association Section of Antitrust Law, 50th Annual Spring Meeting.

"Modifications at HHIs for Vertical Supply Relationships" with Wenqing Li and James Langenfeld, White Paper submitted to European Commission, February 2000.

"Economic Theories of Tying and Foreclosure Applied—And Not Applied—in *Microsoft,*" with Steven S. Wildman, *Antitrust*, vol. 14, no. 1, 1999, pp.48-52.

"Effecting a Price Squeeze Through Bundled Pricing," with Steven S. Wildman, in *Competition, Regulation, and Convergence: Current Trends in Telecommunications Policy Research*, Gillett and Vogelsang, eds. (New Jersey: Lawrence Erlbaum Associates, Inc.) 1999, pp. 1-17.

"Worldwide Wait? How the Telecom Act's Unbundling Requirements Slow the Development of the Network Infrastructure," with Ken Dunmore and Frank Pampush, *Industrial and Corporate Change*," vol.7, no. 4, 1998, pp. 615-621.

"The Pricing of Customer Access in Telecommunications," with Steven S. Wildman, *Industrial and Corporate Change*, vol. 5, no. 4, 1996, pp. 1029-1047.

"Bonus and Penalty Schemes as Equilibrium Incentive Devices, With Application to Manufacturing Systems," with Pau Olivella, *Journal of Law, Economics, and Organization*, 10, Spring 1994, pp. 1-34.

"Diversification as a Strategic Preemptive Weapon," *Journal of Economics and Management Strategy*, 2, Spring 1993, pp. 41-70.

"Using the Capital Market as a Monitor: Corporate Spin-offs in an Agency Framework," *RAND Journal of Economics*, 22, Winter 1991, pp. 505-518.

"Firm Organization and the Economic Approach to Personnel Management, *American Economic Review*, vol. 80, no. 2, May 1990, pp. 23-27.

"The Introduction of New Products," with Edward P. Lazear, *American Economic Review*, vol. 80, no. 2, May 1990, pp. 421-426.

"Ability, Moral Hazard, Firm Size, and Diversification," *RAND Journal of Economics*, 19, Spring 1988, pp. 72-87.

"Worker Reputation and Productivity Incentives," *Journal of Labor Economics*, vol. 5, no. 4, October 1987, part 2, pp. S87-S106.

"The Role of Managerial Ability and Moral Hazard in the Determination of Firm Size, Growth and Diversification," Ph.D. Dissertation, University of Chicago, August 1985.

REPRESENTATIVE PRESENTATIONS

"Pricing Principles and Pricing Methodologies for Essential Facilities," The 36th Research Conference on Communication, Information and Internet Policy (TPRC), September 27, 2008.

"Regulatory Policy and the Reverse Cellophane Fallacy," with David E. Burnstein, 17th Biennial International Telecommunications Society Conference, Montréal, Québec, Canada, June 24-27, 2008.

"The Use of Economic Analysis in 'Industry Expert' Testimony," CLE course, XPRT Forum, March 7, 2008.

Presentations to the New Jersey Board of Public Utilities and to the New Jersey Legislature's Telecommunications Utilities Committee regarding the economic principles for a forward-looking regulatory agenda in light of the facts of competition nationwide and in New Jersey, and the costs of regulation, October – November 2006.

"The Interaction of Regulation with Economics and Financial Analysis in Litigation, Policy, and Strategy Consulting," CLE course, XPRT Forum, October 7, 2006.

"Comments on 'Economic Analysis in FCC Merger Proceedings,'" Conference on Economic Analysis and FCC Decisionmaking, presented by the Federal Communications Bar Association (FCBA) and Stanford Institute for Economic Policy Research (SIEPR), Washington D.C., March 15, 2006.

"Economic Principles for Consumer Protection Rules," Pri Telecom / Tech Briefing, Santa Clara, California, October 11, 2005.

"The Proper Treatment of Spare Network Capacity in Regulatory Cost Models," Presentation at the Advanced Workshop in Regulation and Competition, Center for Research in Regulated Industries, Skytop, Pennsylvania, May 2005.

"Telecommunications Regulation: What's Obsolete? What Will Become Obsolete?" Presentation at the State and City Telecom Reform Conference, Heartland Institute, Chicago, Illinois, December 2004.

"Trends in Telecommunications Demand & Supply," Presentation at the 46th Annual NARUC Regulatory Studies Program, Michigan State University, August 2004.

"The Economic Costs of Proposed Wireless Regulations in California," Presentation to Commissioners Brown and Kennedy, California Public Utilities Commission, San Francisco, California, April 2004.

"The Economics of UNE Pricing: Presentation to Staff," Ex parte presentation to the staff of the FCC, in FCC WC Docket No. 03-173: Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, March 2004.

"The High Cost of Proposed New Wireless Regulations," Presentation to the Pacific Research Institute conference "Regulating Wireless in California: Bill of Rights... or Wrongs?," San Francisco, April 2003.

"The TELRIC Showdown," Panelist, NARUC Staff Subcommittee on Telecommunications, 2002 Annual Convention, Chicago, Illinois, November 2002.

"Economic Principles for Efficient Pricing of Municipal Rights-of-Way," National Association of Telecommunications Officers and Advisors (NATOA), Chicago, Illinois, September 2002.

"Trends in Voice and Broadband Competition in Telecommunications Markets: Markets, Strategies, and Regulation," 82nd Annual Convention of the Indiana Telecommunications Association, Lexington, Kentucky, June 2002.

"Broadband Deployment in the United States," Emerging Opportunities in Broadband Symposium, Northwestern University, Evanston, Illinois, December 2001.

"Local Competition in Illinois," Illinois Telecommunications Symposium, Northwestern University, Evanston, Illinois, December 2000.

"Licensing and Access to Innovations in Telecommunications and Information Services," Telecommunications Policy Research Conference, Alexandria, Virginia, September 2000.

"Effecting a Price Squeeze Through Bundled Pricing," Federal Communications Commission, Washington, D.C., May 1999.

"Competitive and Strategic Use of Optional Calling Plans and Volume Pricing Plans," The Institute for International Research Conference for Competitive Pricing of Telecommunications Services, Chicago, Illinois, July 1998.

"Effecting a Price Squeeze Through Bundled Pricing," Consortium for Research in Telecommunications Policy Conference, University of Michigan, Ann Arbor, Michigan, June 1998.

"The Pricing of Customer Access in Telecommunications," Conference on Public Policy and Corporate Strategy for the Information Economy, Evanston, Illinois, May 1996.

"Diversification as a Strategic Preemptive Weapon," University of Iowa, Iowa City, Iowa, February 1994.

"Diversification as a Strategic Preemptive Weapon, "University of Buffalo, Buffalo, New York, February 1994.

"Diversification as a Strategic Preemptive Weapon," University of Southern California, Los Angeles, California, December 1993.

"Strategic Pricing," Winter Meetings of the Econometric Society, Discussant, Anaheim, California, December 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Michigan State University, Lansing, Michigan, November 1993.

"Diversification as a Strategic Preemptive Weapon," Rutgers University, New Brunswick, New Jersey, November 1993.

"Diversification as a Strategic Preemptive Weapon," University of California at Santa Cruz, Santa Cruz, California, November 1993.

"Diversification as a Strategic Preemptive Weapon," Graduate School of Business, Stanford University, Stanford, California, November 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Purdue University, West Lafayette, Indiana, September 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Summer Meetings of the Econometric Society, Boston University, Boston, Massachusetts, June 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," University of California, Department of Economics, Berkeley, California, May 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Stanford University, Graduate School of Business, Stanford, California, May 1993.

"Diversification as a Strategic Preemptive Weapon," Stanford University, Graduate School of Business, Stanford, California, April 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Hoover Institution, Stanford, California, April 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," University of California, Graduate School of Business, Berkeley, California, February 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Stanford University, Department of Economics, Stanford, California, February 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Hoover Institution, Stanford, California, January 1993.

"Pricing Strategies," Session Discussant, 1992 North American Winter Meeting of The Econometric Society, Anaheim, California, January 1992.

"Diversification as a Strategic Preemptive Weapon," University of Toronto, Toronto, Canada, November 1991.

"Diversification as a Strategic Preemptive Weapon," Queen's University, Kingston, Ontario, Canada, November 1991.

"Bonuses and Penalties as Equilibrium Incentive Devices, with Application to Manufacturing Systems," University of Chicago, Chicago, Illinois, June 1991.

"The Timing of Entry into New Markets," Summer Meetings of the Econometric Society, University of Pennsylvania, Philadelphia, Pennsylvania, June 1991.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," University of Chicago, Chicago, Illinois, April 1991.

"Bonuses and Penalties as Equilibrium Incentive Devices, with Application to Manufacturing Systems," Winter Meetings of the Econometric Society, Washington, D.C., December 1990.

"Corporate Spin-offs in an Agency Framework," University of Washington, Seattle, Washington, October 1990.

"The Timing of Entry Into New Markets," University of British Columbia, Vancouver, British Columbia, October 1990.

"Corporate Spin-offs in an Agency Framework," Texas A&M University, College Station, Texas, April 1990.

"Firm Organization and the Economic Approach to Personnel Management," Winter Meetings of the American Economic Association, New York, New York, December 1989.

"Corporate Spin-offs in an Agency Framework," Western Finance Association Meetings, Seattle, Washington, June 1989.

"Corporate Spin-offs in an Agency Framework," University of Rochester, Rochester, New York, May 1989.

"Corporate Spin-offs in an Agency Framework," North American Summer Meetings of the Econometric Society, Minneapolis, Minnesota, June 1988.

"Competition, Relativism, and Market Choice," North American Summer Meetings of the Econometric Society, Berkeley, California, June 1987.

"Competition, Relativism, and Market Choice," University of Chicago, Chicago, Illinois, April 1987.

"Rate Reform and Competition in Electric Power," Discussant, Conference on Competitive Issues in Electric Power, Northwestern University, Evanston, Illinois, March 1987.

"Worker Reputation and Productivity Incentives," New Economics of Personnel Conference, Arizona State University, Tempe, Arizona, April 1986.

"Ability, Moral Hazard, and Firm Diversification," Various Universities, 1985, 1994, including Yale University, University of Rochester, Stanford University, University of Minnesota, California Institute of Technology, Duke University, Northwestern University, Brown University, Harvard University, University of California - Los Angeles, University of Pennsylvania.

ACADEMIC JOURNAL REFEREEING

Dr. Aron has served as a referee for *The Rand Journal of Economics, the Journal of Political Economy, the Journal of Finance, the American Economic Review, the Quarterly Journal of Economics, the Journal of Industrial Economics, the Journal of Economics and Business, the Journal of Economic Theory, the Journal of Labor Economics, the Review of Industrial Organization, the European Economic Review, the Journal of Economics and Management Strategy, the International Review of Economics and Business, the Quarterly Review of Economics and Business, Management Science, the Journal of Public Economics, the Journal of Institutional and Theoretical Economics*, and the National Science Foundation.

SELECTED TESTIMONY AND OTHER ENGAGEMENTS

Expert testimony before the Arizona Corporation Commission regarding the regulatory history of the US switched access regime and the effects on consumers and competition of modifying intrastate switched access prices, March 2010.

Deposition testimony on damages in a matter before the United States District Court, Western District of Texas, Austin Division, regarding intercarrier "access fees" for exchange of Internet Protocol telecommunications traffic, October 2009.

Expert testimony before the New Jersey Board of Public Utilities regarding intrastate switched access charges and retail rate rebalancing, September 2009.

Expert testimony before the Circuit Court for the Third Judicial Circuit, Madison County, Illinois in class action matter pertaining to allegations that a statutory refund required of defendant telephone company was improperly distributed, October 2009.

Advice and presentation to executives of a large Israeli telecommunications company regarding the Israeli regulatory regime, unbundling obligations, pricing, costing, and competitive reform, February 2009.

Deposition testimony in a matter before the Delaware Circuit Court regarding a contractual dispute between wireless telecommunications companies, on the issue of irreparable harm pertaining to alleged violation of exclusive territory provisions, November 2008.

Written expert evidence before the Canadian Radio-television and Telecommunications Commission in the matter of an application to expand the unbundling obligations of the ILECs for the provision of certain broadband services; regarding the effects of the requested unbundling obligations on competition, investment, and social welfare in Canada, July 2008.

Deposition and jury trial testimony in a matter before the Superior Court of the State of California, County of Los Angeles on the telecommunications business environment and viability of particular telecommunications business models in the late 1990s/early 2000s in a matter regarding an alleged breach of contract in the mobile satellite services industry, April/July 2008.

Written expert declarations before the California Public Utilities Commission in the matter of a rulemaking regarding whether to adopt, amend, or repeal regulations governing the retirement by incumbent local exchange carriers of copper loops and related facilities used to provide telecommunications services; regarding the effects of copper retirement regulation on investment incentives for next generation networks, January 2008.

Analysis of US and global subsea telecommunications fiber capacity investments and swap arrangements during the late 1990s and early 2000s, in a litigation matter alleging failure of defendant to disclose material information to plaintiffs (case settled before expert disclosure), 2008.

Written testimony before the Public Utility Commission of Texas regarding the regulatory philosophy of universal service policy, and competitive implications of proposed universal service distribution mechanisms, November 2007.

Expert evidence before the Canadian Radio-television and Telecommunications Commission regarding the economically appropriate methodology for pricing wholesale telecommunications services and essential facilities, October 2007.

Expert testimony before the Indiana Utility Regulatory Commission regarding the competitive effects on a new entrant in the video services marketplace of disclosure of highly detailed deployment data, August 2007.

Deposition testimony in a matter before the Oklahoma Court of Tax Review regarding the market factors affecting valuation of telecommunications assets during the relevant tax year of the dispute, June 2007.

Written evidence before the Canadian Radio-television and Telecommunications Commission regarding the proper economic principles that should govern determination of regulatory costs, and the effects of regulatory cost determination on economic efficiency and competition, May 2007.

Expert testimony before the New Jersey Board of Public Utilities regarding its review of telecommunications regulations and proposal to establish new regulations on incumbent and competitive wireline carriers, March 2007.

Analysis of competitive effects and effects on consumer welfare of deployment of IP video services in competition with incumbent video services providers, 2007.

Damages analysis as consulting expert in an international arbitration matter regarding disputed availability of and access to subsea and terrestrial telecommunications fiber capacity from mid 1990s through mid 2000s, with focus in Asia and Europe, 2007.

Expert testimony before the Michigan Public Service Commission regarding the competitive effects of total service resale of telecommunications services, and restrictions on resale pertaining to aggregation of demand for volume discounts, November 2006.

Preliminary Expert Report of Debra J. Aron, "The U.S. Long-haul Fiber Optic Network Industry: 1996-2001," in a matter in the Superior Court of the state of California involving disputed investment in long haul capacity in the U.S., June, 2006.

Expert testimony before the Kentucky Public Service Commission, Tennessee Regulatory Authority, and Mississippi Public Service Commission regarding the competitive effects of the proposed AT&T acquisition of BellSouth, June 2006.

Deposition testimony in a matter before the Oklahoma Court of Tax Review regarding the status of competition for wireline local exchange telephone service in Oklahoma and the likely economic effect of such competition on the forward looking value of company assets, March 2006.

Expert testimony before the California Public Utilities Commission regarding the competitive landscape in California and the desirability of establishing a Uniform Regulatory Framework for the telecommunications industry in the state of California, February 2006.

Deposition testimony and trial testimony in the Court of Chancery in the state of Delaware In and For New Castle County and in Circuit Court of Cook County, Illinois County Department, Chancery Division, regarding the possibility of "irreparable harm" to Sprint Nextel's wireless affiliates in connection with Sprint's acquisition of Nextel Corporation, November 2005 – July 2006.

Expert testimony before the California Public Utilities Commission and the Public Utilities Commission of Ohio evaluating the economic benefits and competitive impacts of the proposed acquisition of AT&T by SBC, June–August 2005.

Expert testimony before the Oklahoma Corporation Commission regarding the proper economic principles for reduced regulation of retail telecommunications services and regarding the determination of the amount of a supersedeas bond to quantify the economic

harm likely to result from the award of a stay of Commission order that would grant pricing flexibility and require broadband investment, June – August 2005.

Expert testimony before the Kansas Corporation Commission regarding the sustainability of competition in communications markets in Kansas, June 2005.

Cost and economic analysis for a large telecommunications firm regarding tariffed volume and term-discounted pricing plans for special access services based on regulatory requirements for consistency of prices with cost structure, March 2005.

Expert testimony before the Missouri Public Service Commission evaluating the potential competitive reclassification of local telephone service in Missouri, January 2005.

Expert testimony before the Public Utilities Commission of Ohio and the Public Service Commission of Wisconsin regarding the effects of UNE pricing on the competitive telecommunications markets, July 2004.

Expert testimony before the Florida Public Service Commission and the Georgia Public Service Commission, written expert testimony before the public utilities commissions in Mississippi, Alabama, North Carolina, South Carolina, Tennessee, and Kentucky, and deposition testimony, regarding the proper principles for determining which network elements should be provided to competitors on an unbundled basis at regulated rates; including testimony in support of a business case model of the viability of efficient competitive entry in specific geographic markets in each aforementioned state, January-March 2004.

Ex parte presentation "The Economics of UNE Pricing," to the Federal Communications Commission staff, with William Rogerson, March 2004.

White Papers, "The Economics of UNE Pricing," December 2003, and "A Further Analysis of the Economics of UNE Pricing," January 2004, with William Rogerson, submitted to the Federal Communications Commission in FCC WC Docket No. 03-173: Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers.

White Paper, "The Effects Of Below-Cost TELRIC-Based UNE Prices On CLEC And ILEC Investment," submitted to the Federal Communications Commission in FCC WC Docket No. 03-173: Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, January 2004.

Expert testimony before the Illinois Commerce Commission regarding the proper determination of Total Element Long Run Incremental Cost (TELRIC) for establishing prices for network elements, March 2004.

Expert testimony before the Illinois General Assembly regarding the effects of current regulated UNE pricing of telecommunications elements on competitive telecommunications markets in Illinois, May 2003.

Expert testimony before the Public Utilities Commission of Ohio on issues related to rights-of-way fees charged to electric, water, and telecommunications companies in the City of Toledo, Ohio, March 2003.

Reports evaluating the cost impacts and public policy implications of the proposed California Consumer Protection rules on wireless carriers and customers, February 2003 and September 2003.

Expert testimony before the state regulatory commissions in Ohio, Illinois, Indiana, and Kansas on the economic principles for evaluating anticompetitive claims regarding "winback" pricing by incumbent telecommunications carriers, 2002 - 2003.

Report pertaining to the economic and antitrust analysis of price squeezes, and the suitability of imputation rules as a protection against an anticompetitive price squeeze, for a carrier in a foreign market, 2002.

Expert testimony before the Michigan Public Service Commission pertaining to allegations of anticompetitive effects of long term contracts, 2002.

For a small manufacturer of telecommunications equipment, consulting support to evaluate the antitrust implications of a proposed acquisition, 2002.

White Paper submitted to the Texas Public Service Commission pertaining to the competitive effects of "winback" and "retention" pricing, 2002.

In Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the new Regulatory Framework for Pacific Bell and Verizon California Incorporated, written declaration submitted to the California Public Utilities Commission pertaining to the economic incentives created by modifications to the State's alternative regulation plan and competitive reclassification of services, 2002.

Statement to the Federal Communications Commission regarding the potential economic causes of sustained price increases for cable television services, 2002.

Expert testimony before the Kansas Corporation Commission regarding the antitrust principles relevant to establishing rules for competitive reclassification of services under governing state law, 2002.

For a national wireless telecommunications carrier, consulting support pertaining to litigation regarding access charges, 2001.

Expert testimony before the Missouri Public Service Commission pertaining to price squeeze allegations in the long-distance market, 2001.

Expert affidavit submitted to the Circuit Court in the state of Wisconsin, pertaining to irreparable harm caused if court declined to grant a stay of disputed performance remedy plan, 2001.

Expert testimony before the public utilities commissions of Illinois, Ohio, California, and Indiana, pertaining to the economic viability of constructing and provisioning ADSL services, including market definition and examination of competitive conditions, 2001.

Expert testimony before the Illinois Commerce Commission pertaining to the proper economic principles governing unbundling obligations, 2001.

In the matter of H & R Mason Contractor's et al. v. Motorola, Inc. et al., before the Circuit Court of Cook County, Illinois, expert affidavit examining the economic impediments to class certification, focusing on the determinants of price in the relevant equipment markets, April 2001.

For a competitive local exchange provider in a foreign market, consulting support regarding the proper determination of avoided costs for resale of incumbent services, April 2001.

For a major Japanese telecommunications equipment manufacturer, evaluated the revenue potential and desirability of entering several advanced services equipment markets worldwide, for the purposes of assisting the client to evaluate a proposed acquisition, February 2001.

Expert testimony in the Illinois Commerce Commission's Investigation Into Certain Payphone Issues, examined the economic and public policy issues pertaining to pricing of access lines for independent pay telephone providers, April 2001.

In the matter of the Illinois Public Utility Commission's Investigation Into Tariff Providing Unbundled Local Switching And Shared Transport, expert testimony regarding economic antitrust perspectives on obligations of firms to affirmatively help their competitors, and related public policy issues, April 2001.

In response to Request for Consultations by the U.S. Trade Representative (USTR) with the Government of Mexico before the World Trade Organization (WTO) regarding barriers to competition in Mexico's telecommunications market, analyzed regulated switched access rates in the U.S. in comparison with those charged by Telmex, November 2000.

Declaration submitted to the Texas Public Utility Commission, analyzed proposed regulation aimed at preventing incumbents from executing a price squeeze; developed a framework for evaluating claims of a price squeeze consistent with antitrust principles of predation, August 2000.

For a taxicab company, analysis of regulatory requirements in the City of Chicago pertaining to valuation of medallions and valuation of capital for purposes of regulatory ratemaking proceeding, 2000.

Written and oral testimony before the public utility commissions of Illinois and Michigan in various arbitration matters pertaining to the proper compensation for the use by competitors of client's facilities for foreign exchange services, 2000.

For a firm in the aluminum fabrication industry, in the matter of a potential merger between vertically integrated competitors, developed a methodology for adjusting the HHI measure of market concentration to account for the vertical control by the merging parties of downstream competitors, 2000.

For a large newspaper publisher, in the possible acquisition of the San Francisco Chronicle, analyzed the potential antitrust impediments to an acquisition by the client of the Chronicle, including issues of geographic and product market definition, the interplay between advertising markets and customer markets, and the relevant implications of the Newspaper Preservation Act, 1999.

Testimony before the Illinois Commerce Commission regarding the proper economic interpretation of the standards for declaring a service competitive under the Illinois Public Utilities Act, and quantification of the extent of competition in relevant Illinois markets, including discussion of market definition; the relevance of entry conditions; the relevance of resale competition and analysis of various resale entry strategies; the interdependence of resale and facilities-based entry strategies; and implementation of a technology-based method of measuring market participation, 1999-2000.

For a firm in the consumer mapmaking business, analyzed market definition, concentration, and efficiencies from a proposed merger, 1999.

Affidavit submitted jointly with Robert G. Harris to the Federal Communications Commission in the matter of "unbundled network elements" and commenting on the proper interpretation of the "Necessary and Impair" standard, including discussion of entry conditions and the business-case approach to valuation of an entry strategy, April 1999; reply affidavit May 1999.

Affidavit, "An Analysis of Market Power in the Provision of High-Capacity Access in the Chicago LATA," submitted to the Federal Communications Commission, including an analysis of the US DOJ merger guidelines and their applicability to regulatory relief in a regulated market, as well as extensive empirical modeling of the costs and business case for network buildout of high capacity facilities, February 1999.

White Paper, "Proper Recovery of Incremental Signaling System 7 (SS7) Costs for Local Number Portability," submitted to the Federal Communications Commission, April 1999.

PROFESSIONAL ORGANIZATIONS

Member, American Economic Association

Member, Econometric Society

Associate Member, American Bar Association

Past Member, Telecommunications Policy Research Conference Program Committee

COMMONWEALTH OF KENTUCKY

KENTUCKY PUBLIC SERVICE COMMISSION

COUNTY OF PRINCE GEORGE'S

STATE OF MARYLAND

BEFORE ME, the undersigned authority, duly commissioned and qualified in and for the State and County aforesaid, personally came and appeared Ola Oyefusi, who being by me first duly sworn deposed and said that he is appearing as a witness on behalf of BellSouth Telecommunications, Inc. d/b/a AT&T Kentucky and AT&T Communications of the South Central States, LLC before the Kentucky Public Service Commission in Docket Number 2007-00503, *In the Matter of: MCI Communications Services, Inc., Bell Atlantic Communications, Inc., NYNEX Long Distance Company, TTI National, Inc., Teleconnect Long Distance Services & Systems Company, and Verizon Select Services, Inc., Complainants v. Windstream Kentucky West, Inc., Windstream Kentucky East, Inc.–Lexington and Windstream Kentucky East, Inc.–London, Defendants*, and if present before the Commission and duly sworn, his statements would be set forth in the annexed direct testimony consisting of 55 pages and 7 exhibits.

Ola Oyefusi

SWORN TO AND SUBSCRIBED BEFORE ME
THIS 13TH DAY OF JULY, 2010

Notary Public

My Commission Expires: 9-5-2012

827372

9-5-2012

DIRECT TESTIMONY OF
DR. OLA A. OYEFUSI

On Behalf of

BellSouth Telecommunications, Inc., d/b/a AT&T Kentucky
and AT&T Communications of the South Central States, LLC

BEFORE THE KENTUCKY PUBLIC SERVICE COMMISSION

Docket No. 2007-00503

July 14, 2010

EDITED

I. INTRODUCTION, PURPOSE AND SUMMARY OF TESTIMONY.

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Ola A. Oyefusi, and my business address is 7125 Columbia Gateway Drive, Columbia, Maryland 21046.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am Lead Carrier Relations Manager in the National Access Management Organization of AT&T Operations, Inc. In that capacity, in 26 states, I am responsible for all matters affecting AT&T's costs to interconnect its network with those of all other carriers, regardless of class of service or technology.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

A. I hold a Ph.D. in Economics from George Mason University in Fairfax, Virginia. Additionally, I hold M.A. and B.S. degrees in Economics from Morgan State University in Baltimore, Maryland.

I began my career with AT&T in 1999 and have been responsible for matters related to AT&T's access and local interconnection expenses since then. Among other duties, I am responsible for reviewing and interpreting access tariffs and am involved in matters affecting AT&T's wholesale costs of providing long distance service.

Prior to joining AT&T in 1999, I served on the staff of the District of Columbia Public Service Commission ("DC PSC") between 1991 and 1999, where I provided economic advice in cost and ratemaking proceedings, reviewed and interpreted tariff applications, and made recommendations to the Commissioners. Before that, I taught economics and

held research positions, between 1985 through 1991, at George Mason University's Center for Study of Public Choice and at Morgan State University.

Q. DR. OYEFUSI, HAVE YOU TESTIFIED BEFORE IN ANY REGULATORY PROCEEDINGS INVOLVING ACCESS CHARGE REFORM?

A. Yes. I have testified or provided economic support in proceedings related to the reform of intrastate switched access charges in state commissions across the country. Most recently, I testified in Arizona regarding access reform in a generic proceeding that involves the investigation of the switched access charges of all incumbent local exchange carriers (ILECs) and competitive local exchange carriers (CLECs). I have also testified on AT&T's behalf in switched access charge proceedings in Virginia, Pennsylvania, New Jersey, Illinois, New Hampshire, and Massachusetts. I have generally provided economic support for AT&T in access charge proceedings in many other states. A list of the proceedings in which I have been a witness is attached as **Exhibit OAO-1**.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I am presenting testimony on behalf of the AT&T companies authorized to provide toll and interexchange service in Kentucky that use the switched access services provided by Windstream in Kentucky. Those AT&T companies have intervened in support of Verizon's complaint that Windstream's intrastate switched access rates are unjust and unreasonable. My testimony demonstrates why Windstream's rates are in fact unjust and unreasonable. More importantly, I propose a straightforward solution to reform those high access rates: that the Commission adopt in this proceeding the access reform plan AT&T filed with its petition in Case No. 2010-00162 ("AT&T Plan"). A copy of the AT&T Plan is attached hereto as **Exhibit OAO-2**. Although this proceeding addresses

only Windstream's intrastate access rates, the AT&T Plan is a general pricing policy that the Commission can and should apply to Windstream in this proceeding. In a generic proceeding, which AT&T has petitioned the Commission to initiate in Docket No. 2010-00162, the Commission can apply the same pricing policy to all Kentucky ICOs and the CLECs.

Q. PLEASE SUMMARIZE YOUR DIRECT TESTIMONY.

A. In my direct testimony, I recommend that the Commission adopt the AT&T Plan and (i) require Windstream - and subsequently all ICOs in Kentucky - to reduce its intrastate switched access rates to "parity" with its corresponding interstate rates, (ii) allow Windstream and other ICOs to recover reductions in access revenue through flexibility in retail rates and, in limited circumstances, through universal service support, and (iii) require the CLECs to cap their rates at the levels of the ILECs with which they compete, while granting them unlimited retail rates flexibility to recover their forgone revenue.

Verizon is right that Windstream's intrastate switched access rates are unjust, unreasonable, harmful to Kentucky consumers, and unsustainable in today's competitive environment. But I demonstrate that the problem of excessively priced intrastate switched access rates is not unique to Windstream. Rather, it is widely recognized that the current intrastate switched access regime is no longer sustainable for all carriers and that meaningful access reform is needed immediately. I will show that reducing intrastate switched access rates will benefit all Kentucky consumers in many ways, such as: reducing retail long-distance rates, allowing the competitive market to work with

fewer artificial regulatory distortions, reducing incentives for harmful arbitrage schemes like "call pumping," and reducing needless administrative costs. Reducing intrastate access rates for Windstream and other Kentucky LECs will also create greater incentives for broadband deployment and adoption, and will minimize instances where consumers across Kentucky are paying more than they should merely to subsidize telephone service prices that, for some LECs, are substantially below what the majority of Kentucky consumers is paying. There is nothing wrong with providing explicit subsidies to the high cost areas and low income consumers who need them, but there is no reason to continue providing large implicit access-driven subsidies just to maintain basic local telephone rates that, in some instances, are as low as $5.60 per month.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. In **Section II,** I provide a brief background and history of switched access charges and explain why the current switched access charges of Windstream and other ICOs are no longer just and reasonable given the dramatic changes in the telecommunications industry during the last decade. I show that excessive switched access rates distort competition in Kentucky's telecommunications markets, harming the Commonwealth's consumers and economy.

In **Section III**, I outline the benefits that Kentucky consumers will reap from reductions to the intrastate access rates of Windstream and other LECs. I will describe how reduced wholesale access charges will lead to lower prices for retail long distance service. I will show how access reform will also level the competitive playing field for long distance service and local service, and how that enhanced competition will drive further benefits to Kentucky consumers. I will also explain how parity with interstate rates will simplify

billing, reduce carrier costs, reduce incentives for arbitrage, and discourage or prevent illicit schemes some carriers have devised to take advantage of (or avoid) high intrastate access rates.

In **Section IV**, I will discuss in more detail the plan that AT&T recommends for implementing access reform in the most efficient and equitable fashion for Windstream and other ICOs in Kentucky. I show that the Commission should give ICOs the opportunity to recover their access revenue reductions from a combination of (i) flexibility to set retail rates for local service up to a reasonable benchmark and (ii) for ICOs that can demonstrate that the benchmark is not high enough to recover their costs, explicit transitional support from a Kentucky universal service fund ("KUSF"). I will also discuss the specific mechanics of implementing that plan for Windstream in light of Windstream's election into the alternative regulation plan pursuant to KRS 278.543.

II. BACKGROUND AND HISTORY OF LONG-DISTANCE CALLS AND SWITCHED ACCESS SERVICE.

Q. CAN YOU EXPLAIN WHAT SWITCHED ACCESS CHARGES ARE?

A. Switched access charges are the fees that a local exchange carrier assesses on wireline long distance providers when the LEC originates or terminates long distance calls made or received by the LEC's local service subscribers. The LEC owns the "loop" that connects those subscribers to the LEC's switch and the rest of the public switched telephone network. For example, when a Windstream local service subscriber in Lexington, Kentucky, wants to use AT&T's long distance service to call a Cincinnati Bell local service subscriber in Burlington, Kentucky, AT&T must pay (i) to Windstream an *originating* switched access charge for the delivery of the call from the local switch

serving the calling party's location in Lexington to AT&T's long distance network, and (ii) to Cincinnati Bell a *terminating* switched access charge for the delivery of the call from AT&T's long distance network to the local switch serving the called party in Burlington, Kentucky.

Q. WHAT FUNCTIONS DOES A LEC PERFORM WHEN IT PROVIDES *ORIGINATING* SWITCHED ACCESS SERVICE?

A. When a consumer places an intrastate or interstate call from a wireline phone, the call travels from the calling party's location over a local loop provided by the LEC that serves that caller, to that LEC's local serving office (sometimes called an "end office" or "central office"). There, the call is directed to the LEC's local switch, which electronically routes the call along a wired path known as a transport trunk to the interexchange carrier's point of presence ("POP") or the toll provider's switch at the serving wirecenter ("SWC"). At that point, the LEC hands the call off to the interexchange or intraLATA toll carrier and the originating access service ends.[1] Note that the LEC performs essentially the same service – taking the call from the end user to the long distance provider – no matter where the long distance provider takes the call, and no matter whether the call ultimately goes to an interstate or an intrastate destination.

Q. WHAT FUNCTIONS DOES THE LEC PERFORM WHEN IT PROVIDES *TERMINATING* ACCESS SERVICE?

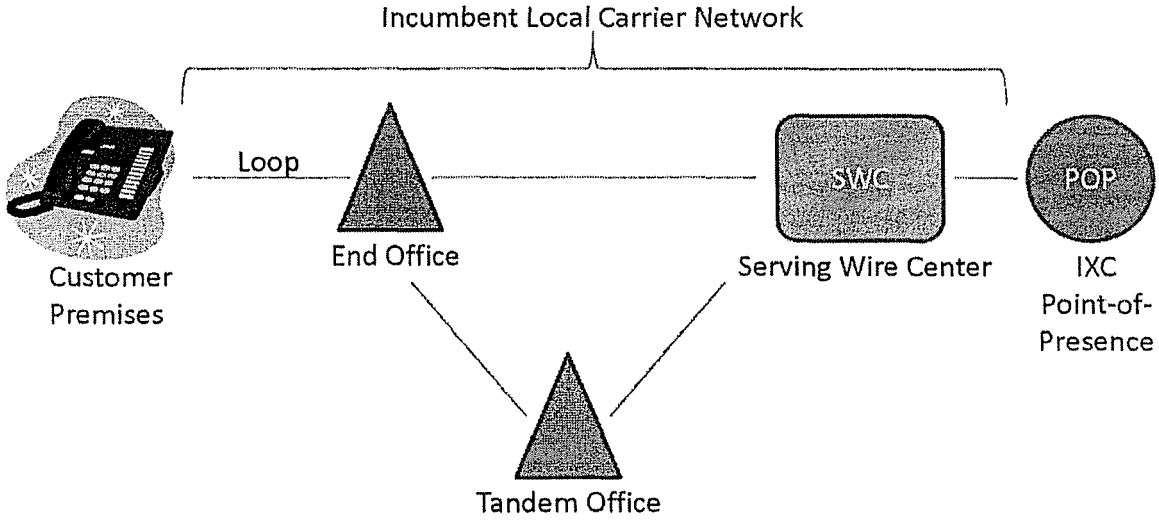
A. Essentially the same functions are performed in completing or "terminating" a call to a wireline phone as in originating the call, except it is in reverse. To complete the call discussed in the previous question, after the long distance carrier receives a call from the

[1] Depending upon the transport arrangements the access purchaser has made with the other carrier (ILEC or CLEC), the call may first be routed from an end office to an ILEC or CLEC intermediate "tandem" switch before being delivered to the purchaser's switch at either the SWC or POP.

originating LEC, the long distance carrier carries the call on its own network to its switch nearest the called party's location. From there, the long distance carrier hands off the call to the LEC that serves the called party on the receiving end of the call. The terminating LEC performs the same functions as an originating local carrier, just in reverse order: it uses its tandem switching (if necessary or if applicable) and local transport facilities to take the call from the long distance carrier's switch to the local switch in the end office that serves the called party, and that switch then routes the call over the terminating LEC's local loop to the called party's telephone based upon the called number. As with call origination, call termination is provided in materially the same manner, using the same equipment and facilities, regardless of the identity of the long distance carrier, the intercarrier compensation regime that applies to the call, and whether the call comes from an intrastate or interstate location. The diagram below illustrates originating and terminating access.[2]

[2] This diagram only shows the shared facilities option. The long distance carrier can choose to interconnect directly at either the End Office or the Tandem via switched dedicated facilities; in either case, the function performed by the LEC is the same.

Network Access Diagram



Q. IN GENERAL TERMS, PLEASE DESCRIBE THE RATE STRUCTURE OF WINDSTREAM'S INTRASTATE SWITCHED ACCESS CHARGES IN KENTUCKY.

A. As a general matter, each Windstream company has traffic sensitive rates for the switching and any transport functions it provides to long distance providers. In addition, Windstream has something called a "Non-Traffic Sensitive Revenue Requirement" (NTSRR), which is a flat rate per line charge. The NTSRR payment is calculated for toll carriers by allocating Windstream's aggregate revenue requirement based on each carrier's proportion of the total minutes of use. This NTSRR charge is not cost based, it does not exist on the interstate rate regime, and it is nothing more than a subsidy rate element providing an implicit subsidy for basic local telephone service. As I will explain

later in my testimony, the Commission should eliminate it in its reform of Windstream's access rates.

Q. HISTORICALLY, HOW DID THE INTRASTATE SWITCHED ACCESS RATES FOR WINDSTREAM AND OTHER LECS DEVELOP?

A. Historically, a single provider controlled both local and long distance phone service in its assigned territory, and the applicable state commission regulated its prices. At that time, Kentucky and other states set prices for some services (such as intrastate long-distance toll service, and local service for business customers) above cost, to subsidize below-cost prices for other services (such as residential local service in high-cost areas). Consumers had little choice but to pay those regulated prices if they wanted to make long-distance calls.

With the breakup of the Bell System in 1984, local and long-distance service were "split" and the system of interstate and intrastate switched access charges, assessed by local exchange carriers on long-distance carriers, was established. The IXCs and other toll providers carried long distance calls between their long distance switching facilities and paid switched access charges to the LECs to connect the call from the end-user locations to the long distance switches. Continuing the old practice of using long-distance prices to subsidize local service, switched access charges were set far in excess of the related switching and transport costs, to generate a subsidy for the LECs to keep local exchange service rates below cost. The long distance providers then recovered their switched access expense through the retail prices they assessed to their end-user long distance customers. Thus, for consumers, the implicit subsidy in access charges was in many ways like a hidden surcharge buried in their long distance rates.

Q. IS IT STILL POSSIBLE IN TODAY'S MARKET TO COUNT ON OVER-PRICED LONG-DISTANCE SERVICE IN ORDER TO SUBSIDIZE LOCAL PHONE SERVICE?

A. No. Economists recognize that this system sacrificed economic efficiency in pursuit of universal service, and that it could be sustained only as long as traditional wireline long distance calls were consumers' only real option for long distance voice communications. In that closed system, it was mechanically possible to overprice long distance in order to under-price basic local phone service as a way to promote "universal service," because consumers' options for escaping the high prices for long-distance service were far more limited and far less adequate substitutes (*e.g.*, mail, telegraph, or no communications at all). But those subsidies cannot be maintained in today's highly competitive and technologically diverse telecommunications market, simply because it is no longer a "closed" environment. New competitors, most of them substantially less regulated, have deployed new technologies (some not even contemplated when the access charge regime was established in 1984) to give consumers a broad range of options for long distance communications. Customers who want to communicate over long distances can now use wireless phones, Voice over Internet Protocol ("VoIP"), electronic mail, instant messaging, Skype, or other alternatives in place of wireline long-distance calling. These competitors do not pay the excessive intrastate access charges to the same extent – if they even pay them at all – that wireline long-distance carriers, like AT&T, must pay.

Q. DOESN'T THIS SIMPLY SHOW COMPETITION IS WORKING IN KENTUCKY?

A. No. The presence of alternative technologies is a welcomed development, and is good for competition, but an implicit subsidy disguised in the form of high access charges is not. Rather, it puts one group of competitors (wireline long distance carriers) at a huge,

artificial and unfair competitive disadvantage. AT&T and other wireline long distance carriers must pay excessive access charges to subsidize the local service of LECs like Windstream, while other communications services do not bear the same burden. Efficient competition - competition that maximizes consumer benefits - is advanced when consumers can pick among competitors based on real economic differences like quality, customer service, and real economic cost, not purely artificial differences. The Commission's policy should be to level the competitive playing field such that consumers decide the market's winners and losers.

Q. ARE IMPLICIT SUBSIDIES STILL NECESSARY TO PROMOTE UNIVERSAL SERVICE?

A. No. Competition has grown not only in the long distance market, but also in the market for local retail service. With competition this evident, the original purpose for which the implicit subsidies were established has diminished, if not disappeared. Universal service does not need the same subsidies, because consumers already have so many alternative options for their local retail service. Indeed, even a cursory review of Kentucky ICOs' basic local service prices and intrastate switched access rates shows that some ICOs have continued to charge very high intrastate access rates as a way to keep local exchange prices in the range of $5.60 per month (Brandenburg Telephone Company) to $14.00 per month (People's Rural Telephone Cooperative). For the most part, the consumers paying those artificially low local exchange prices have no idea that their local exchange carrier has been using the implicit subsidies in intrastate access charges to shift costs onto the backs of consumers across Kentucky. Put simply, consumers across Kentucky have been paying too much for long distance, just so some consumers could continue paying local

exchange rates less than half of what this Commission has deemed just and reasonable for other carriers. That is just not right.

That said, there is nothing wrong with providing support for truly high cost areas or for low income consumers. To the extent the Commission finds that some subsidies are still appropriate for some limited areas or customer groups, those subsidies should be *explicit* (as opposed to the hidden, implicit subsidies in access charges), and they should come from a universal service fund to which all providers contribute in a competitively neutral manner. I discuss AT&T's Plan to implement that policy in Section IV. Windstream's current, implicit access subsidies, which are assessed mostly on one group of competing providers, *i.e.*, wireline long distance providers, are simply unsustainable in today's competitive environment.

Q. HOW MUCH DOES WINDSTREAM CHARGE FOR INTRASTATE ORIGINATING AND TERMINATING SWITCHED ACCESS IN KENTUCKY?

A. As shown in the table below, the Windstream companies' intrastate switched access rates range anywhere from about [redacted] per minute to as high as [redacted] per minute for either originating or terminating access. So for an intrastate toll call that originates *and* terminates in any of Windstream's service territories, AT&T must pay the applicable Windstream company as much as [redacted] per minute for switched access.

Table 1

Windstream Charges Wireline Long Distance Providers in Kentucky Excessive Switched Access Rates

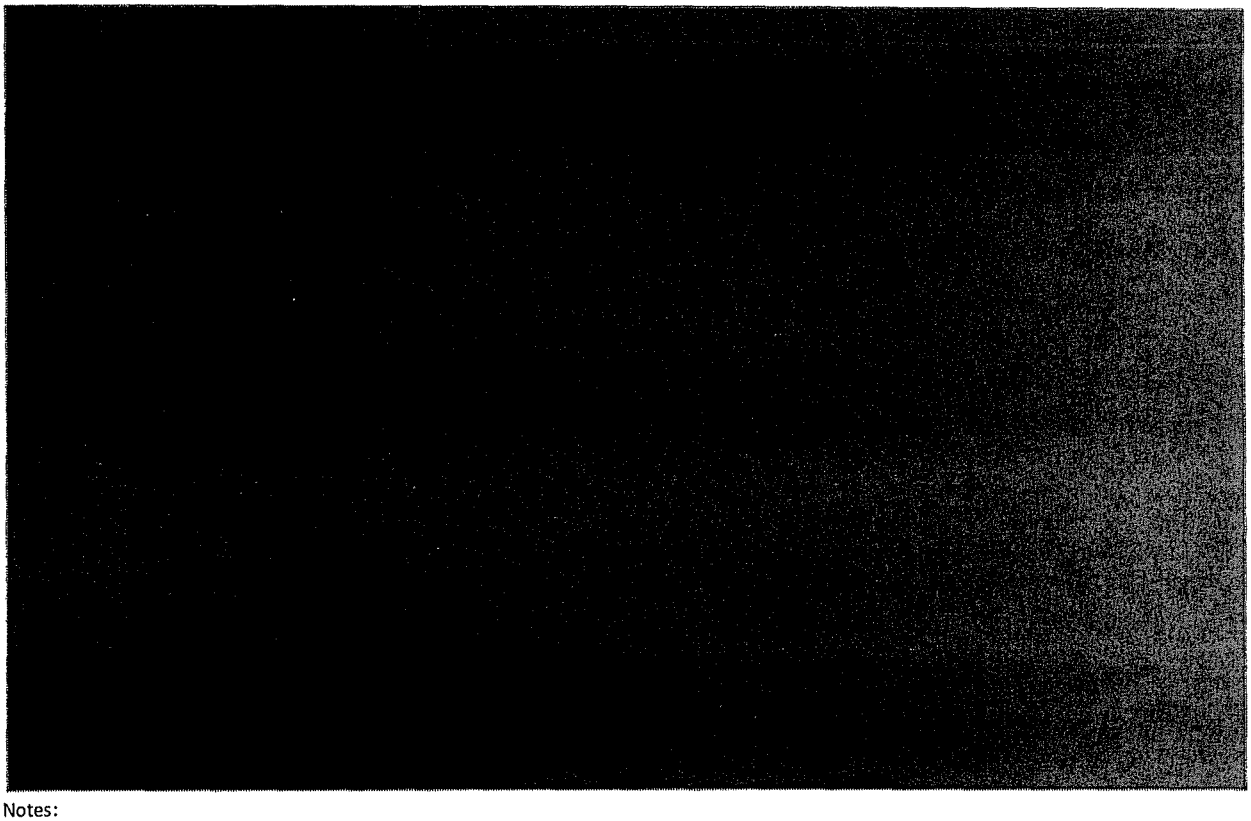
	Total Intrastate Charge per Minute (Termination or Origination Only)	Total Intrastate Charge per Minute (Both Termination & Origination)
Windstream East*		
Windstream West*		
Average Windstream		

* Computed as 2008 revenues divided by 2008 local switching minutes.

Source: Windstream's Responses to AT&T's First Set of Data Requests Nos. 8 and 9.

Q. DO WINDSTREAM'S ACCESS CHARGES EXCEED AT&T'S AVERAGE RETAIL LONG DISTANCE PRICE?

A. Unfortunately, yes. As I show in the chart below, Windstream assesses AT&T per-minute access charges in excess of the average price the competitive long distance market allows AT&T Communications to collect from its retail consumers for every access minute. Therefore, AT&T loses money on every minute of long distance calls originated and terminated in Windstream's service territories, even without taking AT&T's other costs into account:



Notes:
Sources: AT&T accounts payable and accounts receivable systems
Revenue and Access expense data are AT&T *Communications*; excludes AT&T ILEC.
Minutes are Local Switching

Q. HOW DO THE HIDDEN SUBSIDIES IMPOSED ON WIRELINE LONG DISTANCE PROVIDERS COMPARE TO SIMILAR CHARGES IMPOSED ON COMPETITIVE TECHNOLOGIES?

A. As things now stand, Windstream West imposes intrastate switched access charges as high as [redacted] per minute on each end of a wireline call (thus, nearly [redacted] per minute if the call originates and terminates on Windstream's network). Windstream East imposes intrastate switched access charges as high as [redacted] per minute on each end. They assess these charges almost exclusively on wireline long distance carriers such as AT&T and Verizon. Meanwhile, providers of new, alternative forms of communications,

such as internet, VoIP,[3] text messaging,[4] e-mail,[5] wireless,[6] social networking websites,[7] are generally able to complete the same calls for only 7/100ths of a cent per minute ($0.0007), or in the case of e-mail traffic (including social networking websites), and computer based VoIP services like Skype, essentially for free. This is because federal law has established very low call completion rates *for every other type of traffic except intrastate switched access traffic.* The difference between Windstream's access charges and the 7/100ths of a cent call termination rate for wireless calls within a Major Trading Area (MTA) is [redacted]. No one can seriously defend a regime where one type of carrier is charged so much more than another for the same functionality. The following table illustrates these massive disparities:

[3] VoIP includes "interconnected" services such as cable or Vonage service, which can make calls to and receive calls from the public switched telephone network. See *47 C.F.R. § 9.3.* Other services, such as Skype, are generally "non-interconnected" and operate computer-to-computer; consumers perceive calls made through these services as "free."

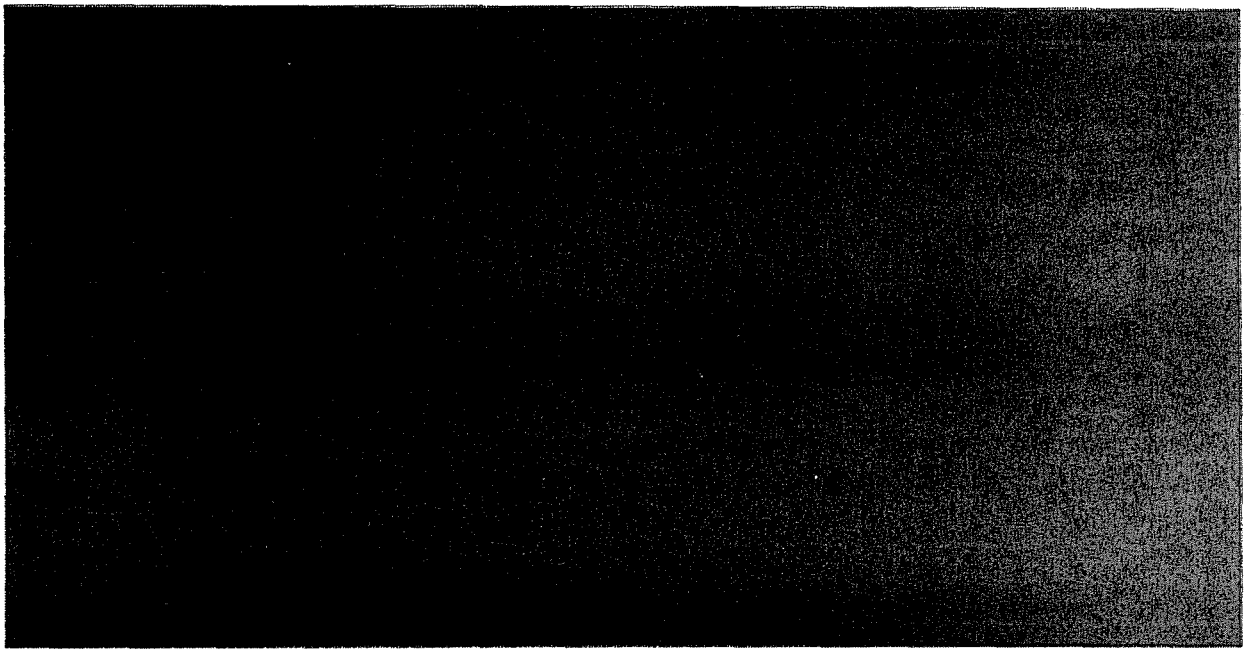
[4] Text messaging service includes wireless service, and a range of other texting options.

[5] E-mail providers include America On-Line (AOL), and Internet providers, as well as Yahoo, Hot Mail and a large number of other providers.

[6] Wireless carriers include Verizon Wireless, AT&T Mobility, Sprint/NexTel, T-Mobile, and others.

[7] Social Networking sites include Facebook, Twitter, MySpace, LinkedIn, and others.

Figure 1



Notes:
Sources: Windstream response to AT&T discovery

Q. WHAT IS THE EFFECT OF THESE COMPETITIVE DISPARITIES?

A. Not surprisingly, these rate disparities for competing services are driving customers *away* from traditional wireline long distance and *toward* alternative services not saddled with the access cost burden. Let's begin with wireless service: as of December 2008, Kentucky had over 3.4 million wireless subscribers, which means that at the end of 2008 some 81% of Kentucky *residents*, not households, had a wireless phone -- if you exclude children younger than 15 years of age, ***95%*** of the state's residents have a wireless phone.[8] At a national level, a growing number of consumers now rely *exclusively* on wireless services.

[8] See *FCC Local Competition Report*, Table 17 at http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-299052A1.pdf; and U.S. Census Bureau, "2008 American Community Survey, Selected Population Profile in the

Likewise, text messaging has literally exploded since the Commission last looked at LEC access rates. Less than five years ago, as of December 2005, monthly text message volumes were "just" 48.7 billion. By December 2009, the FCC reported those monthly volumes to be 740.3 billion – a growth of 1,420 percent from 2005. On an annual basis, by the end of 2008, the FCC reported volumes of over ***1 trillion*** messages – a growth of 177 percent from 2007.[9]

Technologies such as DSL, broadband cable and VoIP have also become more popular and providers of those services are challenging long distance carriers in the marketplace. The FCC reports that as of December 2008, there were 1,154,000 high speed connections in service in Kentucky. Also, the report shows that residential customers in Kentucky have access to high speed connections in 86% of areas served by ILECs and in 93% of areas served by cable companies.[10] Any customer with a high speed connection can use that connection for Internet access, e-mail, and social networking, as well as for free computer-to-computer service such as Skype, or a computer to PSTN, to make voice calls and avoid traditional subsidy-laden long distance prices. As of the end of second quarter 2009, Skype had over 480 million users worldwide; adding more than 37 million new users in the second quarter 2009 alone.[11]

Q. YOU POINTED OUT THAT THESE COMPETING SERVICE PROVIDERS DO NOT INCUR ACCESS CHARGES IN THE SAME WAY AS WIRELINE LONG

United States – Kentucky" at http://factfinder.census.gov/servlet/ADPTable?_bm=y&-geo_id=04000US21&-qr_name=ACS_2008_3YR_G00_DP3YR5&-ds_name=ACS_2008_3YR_G00_&-_lang=en&-_sse=on

[9] FCC Fourteenth Competition Report at p. 105, http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-10-81A1.pdf

[10] **High-Speed Services for Internet Access: Status as of December 31, 2008,** Industry Analysis and Technology Division Wireline Competition Bureau February 2010, Table 14 and Table 19 http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-296239A1.pdf

[11] http://ebayinkblog.com/2009/04/22/newsroom-april-2009/ and http://money.cnn.com/2009/09/01/technology/ebay_skype/index.htm?postversion=2009090111

DISTANCE PROVIDERS. HOW ARE OTHER PROVIDERS CHARGED DIFFERENTLY?

A. Only wireline long distance providers incur intrastate switched access charges on virtually all of their intrastate long distance calls. By contrast, other carriers incur access charges only on a small portion -- or even none -- of their traffic. It is beyond debate that the lion's share of the access charge burden falls squarely on the wireline long distance providers.

Wireless carriers, for example, pay access charges only on long distance calls that are routed outside the MTA where the call originated. All wireless calls *within* a MTA – also known as "intra-MTA calls" – are treated as "local." As a practical matter, that means most intrastate wireless calls are not subject to intrastate access charges because MTAs are very large – in fact a single MTA covers the majority of Kentucky (and parts of other states). The Louisville-Lexington-Evansville MTA (#26) covers most of Kentucky, and spans from the southern to northern border of the state and most of the width from east to west.[12] Most of Windstream's service territories fall within MTA #26[13] and all wireless calls in these areas are intra-MTA calls, treated as local calls subject only to FCC-established reciprocal compensation termination charges. For carriers in Kentucky that have opted into the FCC's ISP Remand Decision, that reciprocal compensation rate is $0.0007 per minute. If a LEC did not adopt this FCC's ruling for ISP traffic, that LEC will assess the Commission-approved local call termination charges for intra-MTA wireless call termination which is often less than the switched access rates.

Similarly, VoIP-originated calls are not subject to originating access charges and, in some instances, are terminated at reciprocal compensation rates instead of the much

[12] http://wireless.fcc.gov/auctions/data/maps/mta.pdf.

[13] *See* **Exhibit OAO-3** attached hereto.

higher switched access rates.[14] Text messaging, instant messaging and email providers *pay no terminating charges at all* – not even the much lower rates that wireless and VoIP providers pay.

In short, this patchwork of rates for the same call completion functionality is anti-competitive and unsustainable. AT&T and other wireline long distance carriers cannot be expected to compete effectively if they must pay intrastate access charges as high as [redacted] per minute for Windstream while their competitors can complete calls for a fraction of a penny or for nothing at all. This disparity in pricing has discouraged some consumers from using the traditional wireline network for their long distance calling, a fact underscored by the [redacted] drop in Windstream East's and Windstream West's intrastate access minutes, respectively, between 2007 and 2008.[15]

Q. DOES WINDSTREAM USE THE SAME FACILITIES TO TERMINATE WIRELINE, WIRELESS AND VOIP CALLS?

A. Yes. The process of call termination is generally the same for all LECs. Once the call has reached the LEC's network and is handed off to the LEC either at the end office switch or tandem switch, the process for terminating the call is materially the same whether it is a wireline, wireless or VoIP call.[16] It is simply unacceptable to require wireline long distance providers to pay high switched access charges, when competitors using different

[14] There have been disputes about the appropriate treatment of VoIP traffic caused by the arbitrage opportunities that some VoIP providers want to seize. They contend that the FCC's "ESP exemption" excuses them from paying access charges for interconnection with the PSTN. Some ILECs have opposed the VoIP providers' position. The issue of VoIP compensation remains ambiguous and unresolved, and as a practical matter VoIP calls are not consistently assessed the high access charges that are imposed on 100% of wireline long distance traffic. *See also Petition of Feature Group IP for Forbearance from Section 251(g) of the Communications Act and Sections 51.701(b)(1) and 69.5(b) of the Commission's Rules*, WC Docket No. 07-256 (filed October 23, 2007); *Petition of Embarq Local Operating Companies for Forbearance from Enforcement of Section 251(b) of the Communications Act and Commission Orders on ESP Exemption*, WC Docket No. 08-8 (filed January 11, 2008).

[15] *See* Windstream Response to AT&T Data Request No. 8.

[16] Wireless and VoIP calls originate on different networks and therefore undergo protocol conversion where they are translated to the LECs' network protocol. This is transparent to the LEC.

technologies pay much less -- or nothing at all – for the same functions of call origination and termination.

Q. DOES THE GROWTH OF ALTERNATIVE TECHNOLOGIES AFFECT ONLY LONG DISTANCE PROVIDERS?

A. No. As I have noted, the dramatic changes to the competitive market also put Windstream at risk if intrastate access rates remain at such high levels. The characteristics of today's communications marketplace are such that consumers are showing preference for getting all of their communications needs, including local service, from only one source. Therefore, high long distance rates not only drive consumers to different technologies for long distance communications, but can also lead consumers to discontinue Windstream's wireline local service as well, and to obtain voice service bundled packages from alternative technologies like cable, wireless, and VoIP. As that occurs, the Windstream companies have to recover their costs from a continually shrinking customer base. Ironically, then, high access charges will dry up the very stream of subsidies they were supposed to provide.

This concern is all too real in Kentucky, where Windstream has lost about [redacted] of its access lines between 2006 and 2008.[17] According to the May 12, 2010, report from the Center for Disease Control, nearly "one of every four American homes (24.5%) had only wireless telephones during the second half of 2009," and that trend is accelerating.[18] At least in part, consumers are deciding to forego wireline service in favor of other technologies (*e.g.*, wireless, VoIP, text messaging, social networking, etc.) because they

[17] *See* Windstream Response to AT&T First Data Request No. 1.
[18] Blumberg and Luke, *Wireless Substitution, Early Release Estimates from the Nation Health Interview Survey, July – December, 2009*, http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless201005.pdf

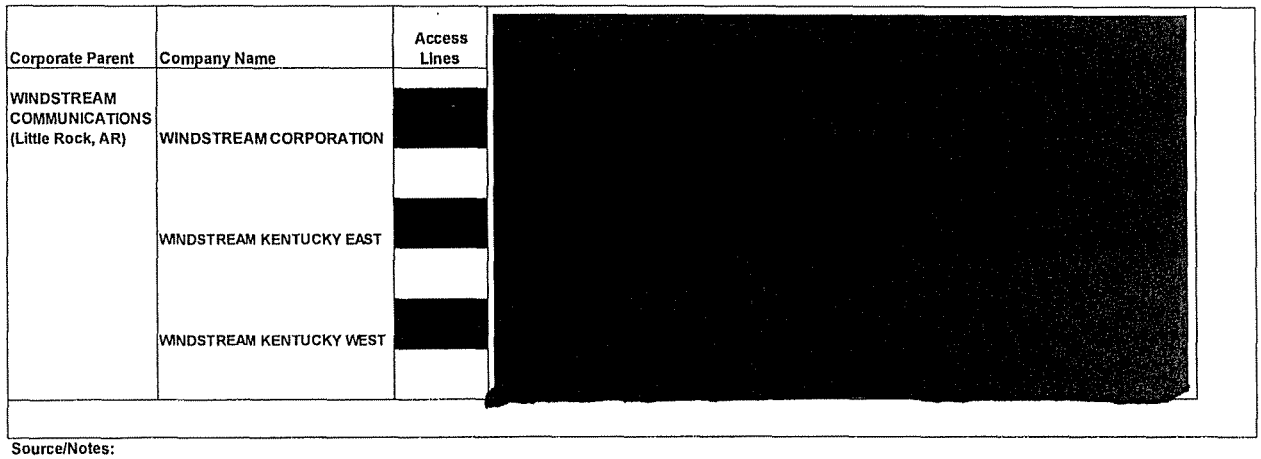
perceive traditional wireline long distance calls to be expensive relative to these alternative forms of communication that are sometimes available at no charge.

Q. IS THERE ALSO A DISPARITY BETWEEN WINDSTREAM'S SWITCHED ACCESS RATES FOR INTRASTATE VERSUS INTERSTATE CALLS?

A. Yes, the disparity is demonstrated by the next chart:

Figure 2

Windstream Intrastate Switched Access Rates are Multiples of Their Interstate Rate for the Same Functionality



Source/Notes:
Windstream response to AT&T discovery

The chart shows that Windstream's intrastate access rates are, on average, over ***500%*** more than its corresponding interstate rates, even though intrastate and interstate switched access services involve the same function and the same costs to Windstream.

Q. WHY IS THERE SUCH A DISPARITY BETWEEN INTRASTATE AND INTERSTATE SWITCHED ACCESS RATES WHEN THE UNDERLYING FUNCTION IS THE SAME?

A. The disparity is purely artificial, driven by legacy regulation. The FCC regulates interstate switched access rates while state commissions have authority over intrastate switched access rates. Originally, the system of embedding large subsidies in excessive access rates also existed at the federal level, but over several years the FCC has

implemented significant reforms to the federal regime. These federal reforms have significantly reduced - although not eliminated - the implicit subsidies that had been buried in interstate switched access rates. As I show below, it is past time for this Commission to adopt similar reforms at the state level, and the Commission can start in this proceeding by adopting AT&T's Plan to reform Windstream's rates.

Q. HOW DO THE SUBSIDIES IN INTRASTATE ACCESS RATES AFFECT CONSUMERS?

A. Those subsidies actually harm consumers in several ways. First, high access charges mean that consumers are paying more than they should for intrastate long distance. This harm affects consumers throughout Kentucky, not just those served by the LECs with the highest access charges. Long distance providers maintain statewide averaged long distance rates, so excessive LEC access charges drive up the price of all long-distance calls: they affect intrastate calls from Louisville and Owensboro (which incur AT&T Kentucky's low access charges) just as much as they affect calls from Lexington to Elizabethtown (where Windstream charges unreasonably high access rates).[19] In other words, Windstream's (and other LECs') excessive access rates adversely affect consumers throughout Kentucky, not just customers in its service territories.

A second and more insidious problem is that the access subsidy distorts and overstates the true cost of wireline long-distance service, and prevents wireline long distance providers from fully competing against providers of other communications services like wireless, e-mail, or social networking websites. Likewise, implicit subsidies distort the true price of wireline local services, because local carriers subsidize below-cost local rates through high access charges. This current system of implicit subsidies

[19] Section 254(g) of the Act requires that long distance prices must be geographically averaged such that carriers would spread high-cost access charges across all of their end users in a geographic area. *See* 47 U.S.C. § 254(g).

has been sustained on the backs of consumers in other parts of Kentucky by forcing them to pay higher prices only to enable consumers in the ICO territories to enjoy extraordinarily low rates. Whatever merit this system may have held in the era of monopoly telecommunications, it has long since outlived that usefulness in today's radically changed markets. Perversely, the mechanism that once was conceived as a means of protecting consumers instead harms them, forcing consumers across Kentucky - not just in the ICO territories - to pay more for their telecommunications services, exacerbating inefficient and unfair cross-subsidies, and impeding the Commission's efforts to foster full competitive choice for all of the Kentucky's telecommunications customers. Consumers are best served when prices reflect underlying cost and all competitors can compete on a level playing field.

Third, the present regime – in which Windstream and other LECs charge vastly different rates for the same access service, depending on whether the call is "interstate" or "intrastate" – creates incentives for carriers to mis-classify traffic, and results in the needless administrative costs of maintaining and enforcing two different rate structures for the same service.

Fourth, high access rates create other incentives for harmful arbitrage. In particular, high access charges have motivated some LECs to team up with chat line operators and other unsavory actors to game the system and engage in "traffic pumping" schemes – which ultimately harm all consumers. Typically, and as I discuss in more detail below, the chat line operators offer "free" conference calling and pornographic chat rooms, solely to generate large high volumes of long distance traffic terminating to the LEC. The LEC then shares its access revenues with the chat line provider.

Fifth, as the FCC has observed, and as Dr. Aron mentions in her testimony, high access rates can deter the growth of broadband. High access rates provide a disincentive for some companies to deploy or aggressively market broadband services because the subsidy-free broadband voice service cannot compete with the heavily subsidized LECs' PSTN voice service being offered at below cost prices in rural territories. LECs may be reluctant to invest in broadband when it gives their customers a means to avoid the traditional wireline long distance calling generating access subsidies for the LECs. Also, even where ICOs may have deployed broadband capabilities to 100 percent of their service territory, they may be reluctant to deploy more efficient subsidy-free VoIP services over those broadband facilities so long as high access charges are generating sizable subsidies from traditional wireline long distance calling.

Q. GIVEN THAT HIGH ACCESS CHARGES ARE HARMFUL TO KENTUCKY CONSUMERS, AND UNSUSTAINABLE IN TODAY'S COMPETITIVE MARKET, CAN WINDSTREAM'S EXISTING HIGH INTRASTATE ACCESS CHARGES STILL BE CONSIDERED JUST AND REASONABLE?

A. No. As I explain below, Windstream itself essentially has conceded that access reform is necessary. Even if Windstream's access charges were once thought to be just and reasonable, they can no longer be so considered as competition from multiple sources and multiple technologies has exploded. Rather, excessive access charges must be viewed for what they are – an impediment to competition and a harm to Kentucky consumers.

III. AT&T'S ACCESS REFORM PLAN WILL BENEFIT KENTUCKY CONSUMERS.

Q. WHAT DO YOU RECOMMEND THIS COMMISSION DO TO ADDRESS THESE HIGH ACCESS RATES?

A. I recommend the Commission adopt AT&T's Plan described in Exhibit OAO-2. Simply put, in this case, the Commission should order the Windstream companies to reduce their intrastate switched access rate levels and structures to parity with their corresponding interstate rate levels and structures, just as many other states have already done for other LECs. Thereafter, Windstream should be directed to update its intrastate tariff at the very same time it changes its interstate rates and/or rate structure, so that its intrastate rates continue to mirror its interstate access rates, both as to rate levels and rate structure.

Then, in Case No. 2010-00162, the Commission can and should adopt the same policy for other ICOs. As for CLECs (which are also parties to Case No. 2010-00162), AT&T will propose that the CLECs' intrastate rates be capped at the levels of the ILECs in whose territories the CLECs compete (just as has been done for the CLECs' interstate rates since 2001, pursuant to FCC order).[20] The AT&T Plan is designed to work not only for Windstream, but for all Kentucky LECs.

Q. WHAT BENEFITS WILL ADOPTION OF THE AT&T PLAN BRING TO KENTUCKY CONSUMERS?

A. The AT&T Plan will benefit Kentucky consumers in many ways. First, by reducing the wholesale cost of providing long distance service, it will drive down the retail price that consumers have to pay for retail long distance service. Second, the AT&T Plan will allow providers to compete on a more level playing field, which brings more of the benefits of competition (including advanced broadband services) to consumers. Third, the AT&T Plan will eliminate the artificial disparities between intrastate and interstate access charges (which involve essentially the same functions and cost) and therefore

[20] *See In the Matter of Access Charge Reform, Reform of Access Charges Imposed by Competitive Local Exchange Carriers,* CC Docket No. 96-262, Seventh Report and Order and Further Notice of Proposed Rulemaking, 16 FCC Rcd 9923 (2001) (*CLEC Access Reform Order*).

reduce harmful arbitrage and the administrative cost of maintaining different prices for the same access cost functions. Fourth, the AT&T Plan is straightforward to implement and administer. Also, adopting the AT&T Plan will eliminate implicit subsidies and foster an environment for full and fair competition, thereby bringing all of the benefits of competition to consumers, and promoting universal service policies. In addition, consumers throughout Kentucky will no longer be paying to keep rural local rates artificially low. Instead, the ICOs and the CLECs will have to compete on their own merits rather than rely on subsidies or excessive access revenues from their competitors. Just as substantial benefits were brought to customers by opening the local market to competition, requiring all companies to compete for customers based on their own efficiencies and offerings will bring measurable and continued benefits to all Kentucky customers.

Q. PLEASE EXPLAIN HOW THE AT&T PLAN WILL REDUCE LONG DISTANCE PRICES.

A. Intrastate switched access charges are a principal component of the wholesale cost that wireline long distance carriers incur when they provide retail long-distance service. In fact, today in certain instances AT&T must pay per-minute intrastate access charges that are *higher* than its per-minute retail prices for long-distance service. Obviously, high wholesale costs drive up retail prices; conversely, it is just as obvious that decreases in the wholesale cost of providing a service lead to a decrease in retail prices for that service. The FCC has reduced switched access rates for interstate calls, and over 20 states have tracked the FCC's reforms on the intrastate side. In her testimony, Dr. Aron presents a wealth of economic evidence showing that these access reforms have generated substantial benefits for consumers in the form of lower long-distance prices. In

addition, **Exhibit OAO-4** to my testimony provides data for AT&T Communications' access costs and long distance prices in 19 states that have reduced intrastate switched access rates to parity with interstate rates (as AT&T proposes for Kentucky). The data show that AT&T Communications has consistently reduced its average long distance prices in response to access cost reductions; in fact, long distance prices went down even *more* than the corresponding access costs.

These results are not surprising. It is an elementary economic principle that when the incremental cost of providing a service goes down, the provider will increase sales and maximize its profits by reducing its retail price. This principle applies even to a pure, unregulated monopolist; the competitive pressures of today's communications markets reinforce this economics concept. Since competition for long distance service is even more robust now than in the past, it is clear that decreases in intrastate access charges will lead to lower long-distance prices for Kentucky consumers.

Q. HOW WILL THE AT&T PLAN BENEFIT CONSUMERS THROUGH INCREASED COMPETITION?

A. The subsidies embedded in the intrastate switched access rates charged by Windstream and other LECs distort and overstate the true cost of wireline long-distance service. As I described above, these access subsidies prevent wireline long distance providers like AT&T from fully competing against providers of other communications services like wireless, e-mail, or social networking websites. Likewise, implicit subsidies distort competition for wireline local services, because LECs use them to subsidize below-cost local rates, which hinder competitive entry. Consumers are best served when prices reflect underlying cost and all competitors can compete on a level playing field. That

way, consumers can make their choice on the merits, rather than being influenced by artificial regulatory disparities. As a result, all competitors can (and will have to) improve their offerings on the merits, instead of being hindered by the artificial disadvantage of paying high access charges (as AT&T must do now) or relying on the crutch of some artificial advantage (as competing technologies do by avoiding access charges). Full and fair competition among all providers is the best way to get Kentucky consumers the services and prices they want.

Q. WILL IMPROVING THE COMPETITIVE BALANCE ALSO BENEFIT CONSUMER WELFARE AND ECONOMIC GROWTH, AND ENCOURAGE BROADBAND DEPLOYMENT AND ADOPTION IN KENTUCKY?

A. Yes. As Dr. Aron explains in her testimony, the best (*i.e.*, most valued) use of a society's scarce resources is when they are committed to uses that respond to consumer preferences. Consumers are beginning to change their preferences in favor of broadband and other technologies, and are moving away from the traditional Public Switched Telephone Network ("PSTN"). The Commission should act now to encourage an efficient transition to the broadband networks of today. Eliminating implicit subsidies and artificially low prices for wireline local service will better prepare consumers for the transition to broadband service, and may also encourage more consumers to choose broadband service. In turn, providers will have increased incentives to invest in and improve broadband deployment as the competition intensifies.[21]

[21] ILECs, including Windstream, have realized this trend and have already taken steps to deploy broadband capability in their networks. *See* statements by Windstream in its 12/31/2009 10-K report, at pp. 7, F-3. http://www.snl.com/Cache/9079836.pdf?O=3&IID=4121400&OSID=9&FID=9079836
This type of effort should be encouraged, not hampered or stalled by continuing the existing antiquated pricing system.

Q. HOW WILL PARITY BETWEEN INTRASTATE AND INTERSTATE SWITCHED ACCESS RATES SIMPLIFY ACCESS BILLING AND REDUCE ARBITRAGE AND ADMINISTRATIVE COSTS?

A. "Parity" is a straightforward approach. As I described earlier, the FCC has already implemented significant reforms to interstate switched access rates. The Commission can take advantage of those reforms (and future reforms) without having to reinvent the wheel, simply by requiring the ICOs to reduce their intrastate switched access rates to match the corresponding interstate rate structure and rate levels. Many other states have already taken the same "parity" approach that AT&T proposes here, as detailed in **Exhibit OAO-5** attached to my testimony.

Unified rates will also reduce Windstream's billing costs, if for no other reason than Windstream will only have one set of rates to bill instead of two. Each Windstream company – Kentucky East and West - already has in place interstate rates and rate structures that comply with the FCC's interstate access requirements. Likewise, the Windstream companies have mechanisms in place that enable them to track, rate and bill access customers for interstate switched access services. Once Windstream reduces its intrastate switched access rates to match its counterpart interstate rates - in both rate level and rate structure - it can simply use its existing rate structures and billing mechanisms to bill the matching intrastate rates. Indeed, once parity is implemented, Windstream will *eliminate* the costs associated with maintaining two different rate structures and billing mechanisms for the same switched access functions.

Q. WILL "PARITY" BETWEEN INTRASTATE AND INTERSTATE SWITCHED ACCESS RATES REDUCE OPPORTUNITIES FOR FRAUD AND ARBITRAGE?

A. Yes. The wide disparity between interstate and intrastate access rates creates opportunities and incentives for carriers to engage in "call pumping," "phantom traffic"

and similar arbitrage schemes. Adopting symmetrical rates and rate structures will help to reduce these problems.

With regard to "call pumping" schemes, some local providers, spurred on by the ability to benefit from high access prices, have developed processes that encourage the creation of "free" chat rooms, adult services and other questionable services that can generate high volumes of intrastate access traffic. The carriers often kick back a share of their access revenues to these providers. In reality, these schemes are not free for anyone: they drive up access costs for wireline long distance providers, which in turn drive up long distance prices for all Kentucky consumers. So all Kentucky consumers will end up footing the bill for call pumping – even the majority who never use the chat rooms and other adult services that the call pumpers peddle.

These schemes have generated a series of complaints and other litigation proceedings before the FCC and state commissions (*e.g.*, the Iowa Utility Board), and recently have drawn the interest of the chairmen of three separate U.S. Congressional Committees: Chairmen Waxman, Boucher, and Stupak.[22] These arbitrage schemes are quite serious and difficult to control under the current pricing system, as AT&T has expressed:

> AT&T and others are engaged in litigations with many current perpetrators for their violations of existing law, but given the ease with which these schemes are implemented and shifted rapidly to other locations, it is clear that after-the-fact, case-by-case litigation could never fully protect the public interest....[23]

[22] *See* AT&T Letter dated October 27, 2009 to Honorable Henry A. Waxman (Chairman, Committee on Energy and Commerce), Honorable Rick Boucher (Chairman, Sub-Committee on Communications, Technology, and the Internet), and Honorable Bart Stupak (Chairman, Committee on Oversight and Investigation), a copy of which is attached hereto as **Exhibit OAO-6.**

[23] *Id.* at 1.

"Phantom traffic" is the term used to describe schemes to disguise the jurisdictional nature of calls in an attempt to treat intrastate calls as interstate in order to take advantage of lower interstate switched access rates. These schemes may involve inefficient routing of calls, attempts to mislabel the originating points of calls, and attempts to deliver traffic without sufficient information for the LEC to determine the jurisdictional nature of the call.

Call pumping, phantom traffic, and similar schemes also harm consumers indirectly, by causing providers and regulators to incur the costs of detecting and eliminating these schemes. Disputes over "call pumping" and "phantom traffic" will be reduced once intrastate and interstate switched access rates are set at the same levels and share the same rate structure. Also, the Commission can avoid using its limited resources to settle complaints about traffic pumping or some other allegations that carriers have mischaracterized the jurisdiction of traffic.[24]

Q. HAS WINDSTREAM ITSELF SUPPORTED HAVING UNIFIED INTER- AND INTRASTATE ACCESS RATES?

A. Yes. In an *ex parte* filing with the FCC, Windstream expressed support for a multi-step process that would lead to a unified inter-carrier compensation rate, *i.e.*, where the FCC would "reduce terminating interstate, intrastate, and reciprocal compensation access rates for price cap carriers, phased in equal increments annually, to the lowest CALLS target pursuant to 47 C.F.R. § 61.3(qq)(1) (i.e., $0.0055) and unify any higher reciprocal

[24] *See, e.g.*, In the Matter of Complaint of Sprint Communications Company L.P. Against Bluegrass Telephone Company, Inc. d/b/a Kentucky Telephone Company for the Unlawful, Imposition of Access Charges, before the Public Service Commission of Kentucky, Case No 2010-00012, January 6, 2010.

compensation rates to that level."[25] In the same FCC proceeding, Windstream further recommended:

> The Commission's intercarrier compensation reforms should focus on areas where Federal Communications Commissioners have identified a "growing measure of consensus." Such areas, specifically, include the following: (1) moving intrastate access rates to interstate access levels over a reasonable period of time; (2) implementing an Alternative Recovery Mechanism in certain circumstances; (3) not unduly burdening consumers with increases in their rates untethered to reductions in access charges; and (4) addressing phantom traffic and traffic stimulation.
>
> ...
>
> Windstream supports moving all of a carrier's rates to its interstate CALLS target rates by study area and then to the lowest CALLS rate of $0.0055, so long as the Commission provides for a reasonable opportunity for an appropriate level of recovery of intercarrier compensation revenue reductions, as well as reasonable time for this transition to occur. [Footnotes omitted.]

Windstream's recommendations to the FCC are generally the same recommendations that AT&T proposes that the Commission adopt in Kentucky to reform Windstream's and other LECs' access charges.

Q. YOU TESTIFIED EARLIER THAT MANY OTHER STATES HAVE IMPLEMENTED ACCESS REFORM. CAN YOU ELABORATE ON WHAT THOSE STATES HAVE DONE?

A. Approximately 33 states have adopted some type of reform of intrastate switched access rates and some that have not attained a comprehensive parity status still want to implement additional reform. More than 20 states, including New Jersey, New Mexico, Massachusetts, Illinois, and Texas,[26] have taken steps similar to the straightforward

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[25] CC Docket No. 01-92, WC Docket No. 05-337, CC Docket No. 96-45, WC Docket No. 06-122, WC Docket No. 99-68, WC Docket No. 08-152, WC Docket No. 07-135, Windstream *ex parte* letter (Appendix) to FCC 10/27/2008 http://fjallfoss.fcc.gov/ecfs/document/view?id=7020244610

[26] The other states include Alabama, Georgia, Indiana, Iowa, Kansas, Kentucky, Maine, Mississippi, Nebraska, Nevada, North Carolina, Ohio, Oklahoma, Oregon, Tennessee and Wisconsin. Citations to the statutes or commission policies implementing such policy changes are listed in Exhibit OAO-5.

approach that AT&T recommends here to reduce intrastate switched access rates to levels at or below their interstate switched access rates.[27] Those states have recognized, as the Commission should here, that high access charges harm consumers by driving long-distance prices higher and by preventing wireline long distance providers from competing fully and fairly for their business. Exhibit OAO-5 summarizes the various state actions.

Q. HAS THE COMMISSION ALREADY ENDORSED ACCESS REFORM IN GENERAL AND THE PARITY APPROACH IN PARTICULAR?

A. Yes. In 1998, this Commission concurred with the FCC's statement "as competition develops, states may be compelled by market place forces to convert implicit support to explicit, sustainable mechanisms consistent with section 254(f).'"[28] The Commission further stated with regard to non-traffic sensitive ("NTS") rate elements that "[e]limination of NTS is a priority and will be considered along with the elimination of other implicit subsidies."[29] And in 1999, the Commission approved AT&T Kentucky's plan for alternative regulation,[30] which includes a condition that AT&T Kentucky reduce its intrastate switched access rates to parity with its interstate rates. AT&T Kentucky has already achieved parity; it is past time that Windstream and other ICOs do the same.

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[27] The commissions in 20 or more states have ordered at least some ILECs to reduce their intrastate switched access rates to the corresponding interstate level. When other types of access reform, other than ILEC parity, are considered (*e.g.*, with some other form of constraints on ILECs and CLECs) the number of states with reform increases to about 33.

[28] *In re An Inquiry into Universal Service and Funding Issues*, Adm. Case No. 360, Order (May 22, 1998) at 2-3, citing *In re Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report and Order (May 8, 1997) at ¶ 17.

[29] *Id.* at ¶ 35. The NTS rates are based on a fixed revenue requirement that the ICO is allowed to collect *regardless of the amount of long distance traffic delivered over its network*, so it is not surprising that the ICOs want to delay this proceeding as long as possible.

[30] *BellSouth Telecomm., Inc.'s Application to Restructure Rates*, Case No. 97-074, Order at 1 (Oct. 24, 1997), *citing Application of BellSouth Telecomm., Inc. d/b/a South Central Bell Tel. Co. to Modify Its Method of Regulation*, Case No. 94-121. *Tariff Filing of BellSouth Telecommunications, Inc. to Mirror Interstate Rates,* Case No. 98-065, Order (Mar. 31, 1999).

Q. WHAT ARE THE RISKS IN TAKING NO ACTION?

A. As I stated earlier, the present scheme (where some LECs charge extraordinarily low (below-cost) retail rates for local service while they collect implicit subsidies from extraordinarily high access rates) cannot be sustained. As consumers and the industry continue to migrate from the traditional PSTN towards alternative systems of delivering telecommunications (which includes broadband), the sources for these subsidies will shrink and eventually disappear. Ironically, the system that was initially designed to help consumers stay connected to the traditional network may be creating an unsustainable situation where consumers' ability to connect to the new networks is threatened. Without action the system that the access subsidies were intended to support appears to be headed for a collapse.

Moreover, it has been shown that high access rates can discourage companies from investing in or aggressively marketing various broadband services. According to a Phoenix Center study, high access rates create a disincentive for a local telephone company to deploy broadband facilities on its network. The study explains that access charges will not apply to voice calls carried over the broadband platform, and the potential loss of access revenues cannot be recovered by the price differences between traditional subsidized voice service and unsubsidized broadband voice service. Although this was a conceptual exercise, it has some pragmatic implication as follows. As I explained earlier, many consumers currently paying below cost (subsidized) rates for traditional local service may not find higher-priced (unsubsidized) broadband service attractive, and companies will be reluctant to invest in broadband so long as it competes with below-cost prices and curtails the subsidy revenues those companies receive from

high-priced access charges. The AT&T Plan addresses these problems. With the implicit subsidies removed from intrastate access rates, LECs will not only have increased incentives to become more efficient and innovative, they will also be encouraged to restructure retail prices so that prices more accurately reflect cost, which in turn will foster an environment where all companies can compete on their own relative merits. In that environment, consumers will be able to base their purchase decisions on appropriate pricing signals, free of the distortions caused by excessive intrastate access rates.[31]

Time is of the essence in correcting this problem. In 2008, long distance providers (or, more specifically, the long distance providers' customers in Kentucky) paid the Windstream companies approximately [redacted] more than they would have if intrastate switched access rates had been reduced to parity with interstate rates.[32] The Commission recognized over 10 years ago that intrastate switched access rates were too high, and it should not wait any longer to correct the problem.

IV. IMPLEMENTATION OF THE AT&T PLAN ACROSS KENTUCKY

Q. WHAT CARRIERS SHOULD BE COVERED BY THE AT&T PLAN FOR ACCESS REFORM?

A. Although this proceeding is formally limited to Windstream, all Kentucky local exchange companies who operate under the jurisdiction of the Commission (specifically Windstream, Cincinnati Bell Telephone, all RLECs regulated by the Commission, and the CLECs) should ultimately have their access charges reformed. (As I stated earlier, AT&T Kentucky's intrastate switched access rates have already been reformed and are

[31] It is easier for a consumer to perceive the relative or superior value of broadband service when the retail rates of the PSTN voice service reflect the true cost and the price differentials are not so drastic.
[32] *See* **Exhibit OAO-7.**

currently at parity with its interstate rates.) High access charges and implicit subsidies hurt consumers and competition across Kentucky no matter which LEC collects them. Conversely, the more LECs (and access volume) that the Commission covers through access reform, the greater the benefits will be to Kentucky consumers – and because long distance prices are averaged on a statewide basis, those greater benefits will be shared by all Kentucky consumers. In addition, it makes sense to apply access reforms generically to all LECs rather than on a piecemeal basis. The Commission currently has Windstream before it now in this proceeding, but should address all other LECs in a generic docket (which AT&T has petitioned the Commission to initiate).

Q. WILL WINDSTREAM'S INTRASTATE ACCESS RATES STILL BE ABOVE ACCESS COSTS WHEN THEY ARE REDUCED TO PARITY WITH INTERSTATE RATES?

A. Yes. This is readily confirmed by two separate tests. First, Windstream has been charging the interstate rates for interstate calls for years, and it has never shown that those rates are below cost. In discovery, AT&T asked Windstream to identify any instances where it has claimed its interstate rates are below incremental cost, and Windstream responded there was none.[33] I am not aware of a single instance in which the FCC or any court has ever found that Windstream's interstate switched access rates are below their relevant costs. Given that access for intrastate calls involves the same functions (and costs) as for interstate calls, interstate rates will also be more than sufficient to cover Windstream's costs for intrastate calls.

Second, long distance calls terminate in the same manner as local calls (using either end office or tandem office facilities) and the routing involved in termination of all

[33] *See* Windstream Response to AT&T First Data Request No. 10e.

types of calls is identical, so the cost of terminating a local call is the same in all material respects as the cost of originating or terminating a long-distance call. The FCC has set rates for local call termination at $0.0007 per minute.[34] In so doing, the FCC specifically found that the $0.0007 rate was sufficient to recover costs:

> These rates reflect the downward trend in intercarrier compensation rates contained in recently negotiated interconnection agreements, suggesting that they are sufficient to provide a reasonable transition from dependence on intercarrier payments ***while ensuring cost recovery***.[35]

As I illustrated in Figure 1, Windstream's interstate switched access rates are still well above the cost-based rate for call termination established by the FCC. So reducing Windstream's intrastate switched access rates to interstate levels will still leave those rates well above the $0.0007 rate the FCC found sufficient to cover cost.[36]

Q. WILL ADOPTING THE AT&T PLAN ENABLE WINDSTREAM AND OTHER ILECS TO RECOVER THE REDUCTION OF ACCESS REVENUES THAT WILL RESULT FROM ACCESS CHARGE REFORM?

A. Yes. The Commission should allow Windstream, and other ICOs, the opportunity to recover the reduction in access revenue in two steps. First, the Commission should give ICOs the flexibility to increase retail rates for basic local service up to a reasonable

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[34] All RBOCs and many ILECs have adopted the FCC's ISP-bound rate of $.0007 for their interconnection agreements. For these carriers that have adopted the FCC's ISP order, this same rate is the reciprocal compensation they will charge for intra-MTA wireless traffic, VoIP traffic and local wireline traffic.

[35] *See In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Intercarrier Compensation for ISP Traffic*, CC Docket No. 96-98, and No. 99-68, at 6 (April 27, 2001) (remanded on other grounds, *WorldCom, Inc. v. FCC*, 288 F.3d 429 (D.C. Cir. 2002), cert. den., *Core Communications, Inc. v. FCC*, 538 U.S. 1012 (2003), subsequent mandamus, *In Re: Core Communications, Inc.*, 531 F.3d 849 (2008); order on remand, *In the Matter of High Cost Universal Support, et al*, WC Docket No. 05-337 (released Nov. 5, 2008) (emphasis supplied).

[36] For termination of AT&T CLEC affiliate's local traffic, Windstream's ICA indicates Windstream Kentucky West charges $0.01 per MOU and Windstream Kentucky East charges $0.01334 per MOU. These comparisons demonstrate that there is no need to go through the lengthy and complex processes that would be involved in calculating the actual cost of intrastate switched access service to the last fraction of a penny, as long as no party is suggesting that intrastate rates should be reduced to cost.

"benchmark" to be established by the Commission. Note, however, that the Commission should not *require* Windstream to raise local service rates by any amount. Rather, the actual decision to raise its price, and the amount (within the constraints of the benchmark), should be left to Windstream, as that company is best positioned to make decisions about its own business.

For the second step, to the extent that the "benchmark" rate is not sufficient for any given ICO to recover all of its access reductions for all qualified basic service lines, the Commission could allow that ICO to receive support from the KUSF. The level of support will be determined as if the ICO had raised its retail local rate up to the benchmark level.

Q. WHY IS IT APPROPRIATE TO GIVE CARRIERS THE FLEXIBILITY TO INCREASE RETAIL RATES FOR LOCAL SERVICE?

A. The flexibility to restructure prices is part of effective access reform. As discussed earlier, under the monopoly regime high access rates were established to subsidize artificially low retail prices for local service. Thus, it makes perfect sense that as access charges are reduced, the Commission should also relax the restrictions on retail prices that were the other side of the access trade-off. That will allow local service prices to rise to more realistic levels and balance out the potential access revenue reduction. Moreover, giving carriers the flexibility to adjust retail prices creates the right consumer incentives because it gives consumers the correct price signal – one that better reflects the underlying cost of service. If retail prices for traditional switched local service continue to be held at artificially low, below-cost levels, consumers will demand more of that service than they otherwise should, and as I discussed above companies will have less incentives to invest in alternative advanced technologies like broadband when those

services appear less attractive to consumers because of the distorted prices. Rebalancing prices for PSTN basic local service will encourage consumers to use the right quantity of that service and the right quantities of alternative services like broadband. Companies will then have the incentive to invest in a manner that better reflects consumer preferences.

That said, I want to reiterate that I am not advocating that the Commission *mandate* any price increases. The Commission should simply relax the old artificial restrictions and give carriers more flexibility to adjust their retail price levels to the levels dictated by cost and competition. In addition, the Commission can still achieve universal service goals. As I stated earlier, under the AT&T Plan the Commission can elect to limit price increases to a reasonable "benchmark" and, to the extent any ICO (such as Windstream) needs additional support to make up for the reduction in the legacy access subsidies, AT&T is proposing that the ICO be eligible to receive transitional access replacement support from the KUSF.

Q. HOW SHOULD THE COMMISSION DETERMINE THE BENCHMARK?

A. The Commission should set a uniform statewide benchmark in the generic proceeding for all LECs (Docket No. 2010-00-162), applying the following guidelines:

(1) the Commission first should ensure that the benchmark allows as much recovery of the access reduction from end users as possible subject to any concern about the impact on consumers. This will encourage the right consumer incentives and at the same time limit the burden on the KUSF (which will ultimately be funded by all Kentucky consumers);

(2) narrow the gap between urban and rural retail rates to ensure that when urban consumers (who currently pay higher retail rates) are being asked to help pay the costs of serving rural consumers, the rural consumers' rates must first be reasonably comparable to similar services in urban areas. For example, consumers currently paying $18.95 in Lexington should not be overburdened with an oversized KUSF surcharge just so other consumers, for example, those in Brandenburg, could continue to pay heavily-subsidized retail basic rates as low as $5.60 per month. Such artificial disparity cannot be sustained going forward as the current system transforms into a subsidy-free broadband or multi-technology system; and

(3) the Commission should adopt implementation rules necessary to authorize KUSF support.

Q. COULD YOU ILLUSTRATE HOW THE BENCHMARK WOULD WORK?

A. The Commission would first determine the reduction in access revenue that will occur for each ICO once that ICO reduces its intrastate switched access rates to parity with interstate rates. Next, the Commission would give each ICO the flexibility (but not a requirement) to increase its rate for basic local service, up to a benchmark amount if the Commission determines that such a benchmark mechanism is appropriate for Kentucky. For the sake of illustration, let's consider a hypothetical whereby the Commission establishes an initial benchmark rate of $18.50 per month (which, if the Commission deemed it necessary, could be phased in over time). As I explain below, that hypothetical number is at the low end of a reasonable range of possible benchmarks, and it is important to caution the Commission of the importance of balancing the impact on some

consumers of the change in basic local service rates with the potential burden an extremely low benchmark would place on all consumers across Kentucky who will contribute to the KUSF. Put simply, the lower the benchmark, the higher the level of ICO costs being shifted to consumers all across the Commonwealth.

With that caveat, I will address how a hypothetical $18.50 benchmark would work. To the extent that raising basic local rates up to the hypothetical $18.50 benchmark level would not be enough to rebalance the reduction in access revenues for a particular ICO, that ICO would be eligible for transitional support from the KUSF. The Commission would determine the amount of KUSF support (if any) that the ICO could receive by identifying the ICO's total access reduction and subtracting the additional revenues the ICO would realize by increasing its local rates to the benchmark level. For example, if reducing an ICO's access rates to interstate parity would reduce its annual access revenues by $4 million, and increasing basic rates to the benchmark would generate $3 million, the ICO would be permitted to draw $1million from a Kentucky USF.[37]

Q. WHAT DATA SHOULD CARRIERS PROVIDE TO CALCULATE THE AMOUNT OF REVENUE REPLACEMENT TO BE DRAWN FROM A KUSF?

A. To recover any access replacement revenue from the KUSF, a carrier should be required to provide a report that identifies (1) the amount of its switched access reduction,[38] (2) the

[37] However, revenue reductions associated with line erosions from competition should not be included in the rebalancing process.

[38] Specifically, access reduction will be calculated as: the product of the difference of Intrastate Rate Less the Interstate Rate (Target Rate) Times the annual Intrastate Minutes of Use. That is,

Intrastate Rev. Loss = (Intrastate Rate – Interstate Rate) x (Annual Intrastate MOU)

amount of revenue it would recover if it raised its retail rates to the benchmark level,[39] and (3) the net funding for which it qualifies, *i.e.*, the amount of its switched access reduction in (1) above less the amount it would recover if it raised its rates to the benchmark level in (2) above.[40]

Q. SUPPOSE HYPOTHETICALLY THAT THE BENCHMARK WOULD GIVE A PARTICULAR LEC THE FLEXIBILITY TO INCREASE MONTHLY LOCAL SERVICE RATES BY $10.00 PER LINE. ARE YOU SUGGESTING THAT INCREASE SHOULD OCCUR IMMEDIATELY?

A. No. First, I note that Windstream would not have to face that type of increase since its access reduction is only [redacted] per line and its current weighted average residential retail rate is [redacted], so, under the hypothetical, it would only need to increase rates by [redacted] before it would reach the benchmark of $18.50. At any rate, the AT&T Plan includes a phase-in process for the rate rebalancing. Under that phase-in process, an ICO would only have the opportunity to increase its monthly retail rate by a maximum of $2.00 per line per month each year.[41] Using the hypothetical $10.00 retail rate increase as an example, the Commission would give the ICO flexibility to increase its monthly local retail rate by only $2.00 per line each year over five years, until it reaches the hypothetical $18.50 benchmark. During this phase-in period, the ICO could receive KUSF support to address any additional access reduction that the ICO is not able to recover because of the $2 limit on increases. Of course, the KUSF support would be

[39] To calculate this figure, a carrier would (i) collect the number of lines as of October 31 of the most recent calendar year prior to when the report is being prepared; and (ii) multiply the line count figure in (i) by the difference between current retail rate and the benchmark to derive the incremental retail revenue.

[40] For simplicity, the calculation should be on a per line basis such that if the access reduction per line was $3.00 and the ILEC could recover $2.00 per line from retail rate flexibility, that ILEC would potentially draw $1.00 per line for every qualified line in service.

[41] *See* **Exhibit OAO-2** (AT&T Plan at ¶ 3).

phased down each year as the ICO is able to increase its local rates by an additional $2.00 per line.

Although Windstream's current local rate is much closer to the $18.50 benchmark in my illustration, this phase-in process would also apply to Windstream. As I noted earlier, Windstream's access reduction is [redacted] per line and its current weighted average residential retail rate is [redacted], which is [redacted] below the hypothetical $18.50 benchmark. Under the AT&T Plan, Windstream would be allowed to increase its monthly basic local rate by $2.00 per line in the first year of the phase-in period (yielding a new monthly rate of $17.35), so it would draw [redacted] per line per month in transitional KUSF support for that year to be revenue neutral. In the second year, Windstream would be able to increase its local rate by the additional [redacted] to reach the $18.50 cap. Its draw from the KUSF would be reduced by an offsetting amount.[42]

Q. STICKING WITH THE $18.50 BENCHMARK FOR ILLUSTRATION, HOW MUCH KUSF SUPPORT WOULD BE AVAILABLE FOR ELIGIBLE CARRIERS?

A. Based on my preliminary analysis, rebalancing the basic local rates of Windstream and other ICOs to an $18.50 benchmark level will offset about $22 million of the estimated $51 million access revenue reductions that will occur when all ICOs reduce their intrastate access rates to parity with interstate rates.[43]

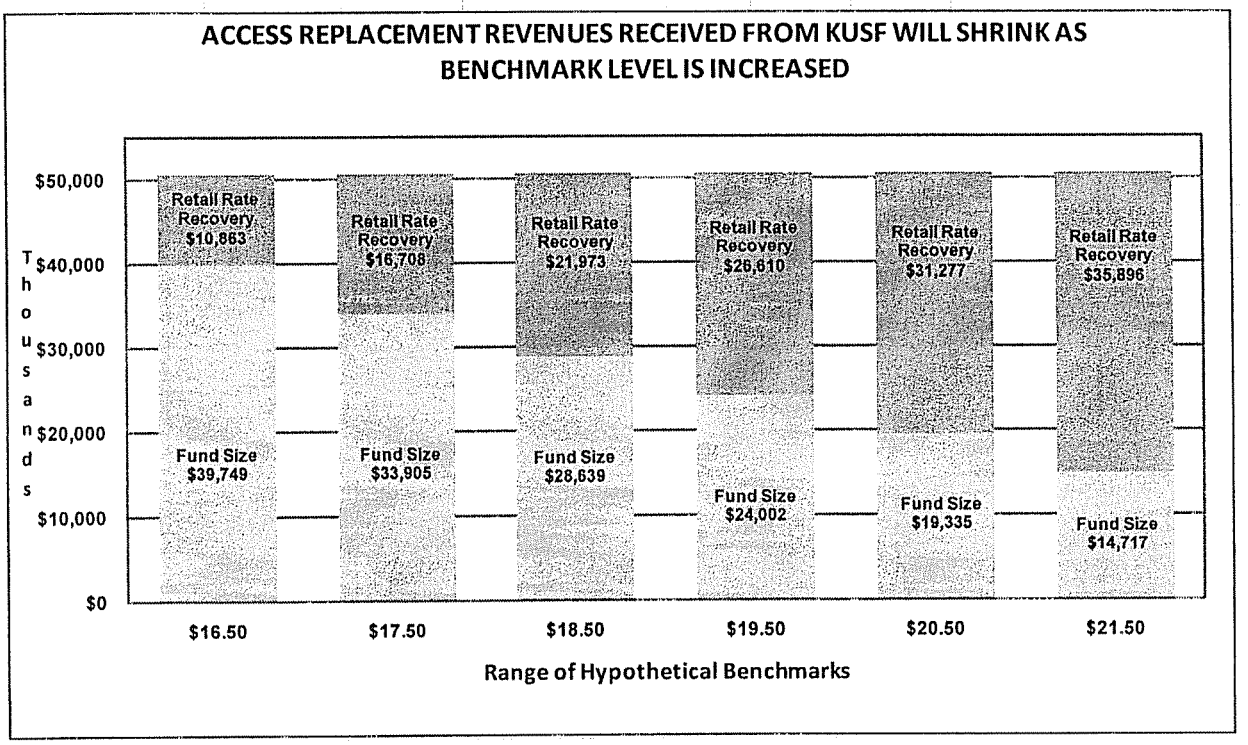
[42] After Windstream reaches the $18.50 benchmark in this example and the KUSF is offset by the second year retail rate increase, a sum of $2.11 per line per month will still be required from the KUSF for Windstream to be revenue neutral.

[43] Windstream provided its actual data in discovery, but the figures for the other ICOs are estimated, purely for the sake of illustration to give the Commission a total state view and impact. The actual data from these other ICOs will eventually replace these estimates once the Commission initiates their access reform proceeding.

Q. IS IT ACCURATE TO SAY THAT A HIGHER BENCHMARK WILL REDUCE THE SIZE OF THE KUSF, AND A LOWER BENCHMARK WOULD INCREASE IT?

A. Yes, absolutely. The policy question for the Commission will be to determine how high it is willing to set a basic service benchmark, recognizing that the lower the benchmark, the more ICO costs the Commission will be shifting onto consumers across all of Kentucky. The following chart illustrates how the KUSF would decrease or increase if the Commission adopts a benchmark higher or lower than the $18.50 hypothetical benchmark I use in my illustration.

Figure 3

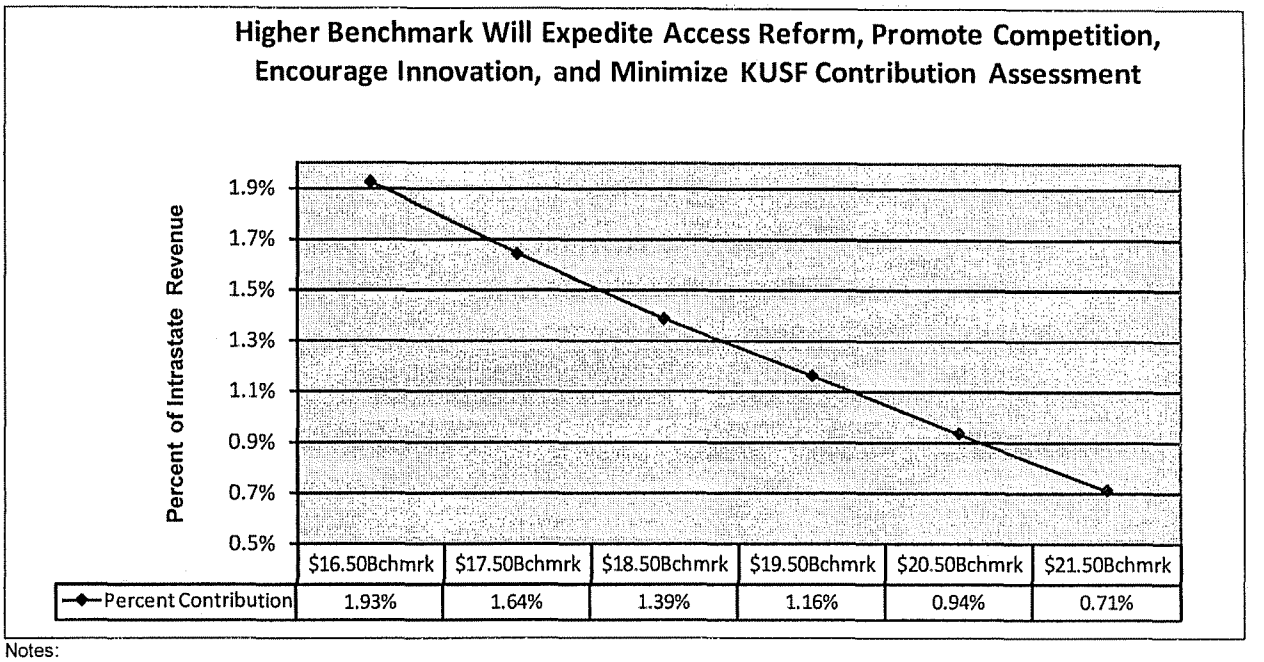


Notes:
- Total KUSF based on Windstream actual data, plus AT&T's estimate of other ILECs' access revenue reduction and support needs
- The range of Benchmarks is based on AT&T's analysis, for illustration purpose only, Commission will set final benchmark rate
- Retail Rate Recovery - means amount that could be recovered by increasing retail local exchange rates. ILECs are assumed to have flexibility to increase retail local rates up to benchmark, but are not mandated to do so. CLECs should have sufficient retail rate flexibiliy to allow full recovery from end-user retail rate increase.

Another way to look at this is to analyze the contribution all Kentucky consumers will be required to make to the KUSF at various benchmark levels. For purposes of this illustration, I assumed that the Commission would require (and has jurisdiction to require) all communications service providers to impose a USF assessment upon their subscribers, including, by way of example, cable telephony providers, other VoIP providers, and wireless carriers. Assessing the contribution obligation broadly, across all providers, accomplishes two goals; (1) it keeps the contribution percentage as small as possible, and (2) it minimizes unjust discrimination where only some market competitors must assess the charge.

Here again, as the size of the benchmark increases, the level of the contribution assessment on Kentucky communications services subscribers will decrease. This is illustrated by the next chart:

Figure 4



Notes:

1). Based in part on analysis of access revenue reduction and access replacement requirement as illustrated in Figure 4 above.

2). Benchmark Ranges based on AT&T's analysis for illustration purpose only. Commission will set final benchmark.

3). % Assessment (Contribution) = Total 12 month KUSF Fund Requirement ÷ Total 12 month Kentucky retail intrastate telecommunications service revenues from all providers, i.e. ILECs, CLECs, Toll, wireless, (and VOIP if state law or regulation permits).

4) Intrastate Revenue from FCC Monitoring Report, released December 2008, Table 1.15 Intrastate Telecommunications Revenues: 2006 End-User

Q. WHAT ARE THE LESSONS OF FIGURES 3 AND 4?

A. To minimize demands on the KUSF, the Commission should refrain from setting the benchmark too low. The KUSF is not "free money"; rather, contributions to the KUSF have to come from somewhere – specifically, from service providers and ultimately their end users. The explicit KUSF support is better than the current regime of high switched access charges (because the KUSF support will be spread over more providers, in a competitively neutral and explicit manner), but it is still a subsidy. In applying it, the Commission thus should protect the interests of the Kentucky consumers (some of which are already paying higher retail rates) who will contribute into the fund.

Q. WILL BASIC SERVICE REMAIN AFFORDABLE EVEN WHEN RETAIL RATES ARE ALLOWED TO INCREASE, SUCH AS TO THE $18.50 HYPOTHETICAL BENCHMARK IN YOUR ILLUSTRATION?

A. Absolutely. In fact, my illustration used a benchmark at the low end of a reasonable range. In most instances (*i.e.*, for most of Windstream's exchanges), even if Windstream were to raise its rates to the maximum extent allowed, those rates would still fall below what they would have been if they had just kept up with inflation since the last time those rates were changed. An AT&T analysis of the highest residential retail rates in Windstream's rate groups (based on publicly available data) reveals that the inflation adjusted retail rates for residential local service in most of the exchanges would range between $16.54 and $23.80 compared with the range of $13.20 to $18.99 paid today.[44] So as a practical matter, if the Commission decided to adopt a benchmark within this range, Windstream's price for basic local service in real terms (that is, adjusted for inflation) would not have changed for most customers. The results of AT&T's benchmark analysis are summarized in the table below:

[44] With inflation, the adjusted weighted average retail rates calculations for Windstream East is $19.59 (with 94 exchanges), and for Windstream West is $11.31 (with only two exchanges). The overall (blended) inflation adjusted residential weighted average retail rate for Windstream based on proportion of residential lines would be $19.22 compared to $15.35 that Windstream assesses today.

Table 2

SUMMARY OF AT&T BENCHMARK ANALYSIS		
	Current Rate	**Benchmark Result**
1. Based on Urban/Rural Comparability (Using 125% Factor)		
Highest Urban Rate	$18.95	$23.69
2. Based on Inflation/GDPPI Adjustment - Windstream Weighted Average		
Windstream West (Wt. Avg. 1FR)	$9.30	$11.31
Windstream East (Wt. Avg. 1FR	$15.63	$19.59
Total Windstream Blended (Wt. Avg. 1FR)^	$15.35	$19.22
3. Based on Inflation/GDPPI Adjustment - by Windstream Rate Groups		
Rate Group 1 (Highest Rate)	$13.20	$16.54
Rate Group 2 (Highest Rate)	$14.37	$18.01
Rate Group 3 (Highest Rate)	$15.64	$19.60
Rate Group 4 (Highest Rate)	$18.99	$23.80
Rate Group 5 (Highest Rate)	$18.95	$23.75
Rate Group 6 (Highest Rate)	$17.07	$21.39

Notes:

^ Blended Winstream Rate calculated using proportion of residential lines (Windstream East has [redacted] Res lines in 94 exchanges; Windstream West has [redacted] Res lines in (2 exchanges).

Only line count figures in this note are Confidential.

More to the point, AT&T is not asking the Kentucky Commission to plow new ground. My illustrative $18.50 benchmark is significantly lower than rates currently charged by ICOs (including Windstream) in other states. For example, in Georgia, Windstream charges retail rates as high as $30.90.[45] Likewise, Centurylink charges up to $22.64 in Wisconsin,[46] $25.10 in Ohio,[47] $20.20 in Louisiana,[48] and $21.50 in Michigan.[49]

[45] http://www.windstream.com/tariffs/GA/gamlcl_win.pdf
[46] http://about.centurylink.com/tariffs/

The hypothetical benchmark used in my illustration is also lower than some of the benchmarks that have been adopted in other states. For example, New York has a $23.00 rate cap.[50] For the 12-month period beginning July 1, 2010, the Wyoming benchmark is $32.09 for basic local exchange telephone service.[51] In Alaska, the Commission Staff has proposed a benchmark of $25.00.[52]

The Commission also needs to keep the benchmark in perspective. Today end users across the country readily pay $50.00 or more on bundled packages, wireless services and broadband connectivity.[53] Given the reality that most consumers pay more than $50 per month for their communications needs, an increase in basic local service rates that still leaves those rates in the range of $20 per month is hardly earth-shaking -- particularly when it comes hand in hand with the benefits of access reform.

Q. HOW SHOULD THE COMMISSION IMPLEMENT KUSF RULES TO AUTHORIZE THE REBALANCING OF ACCESS REDUCTIONS PROPOSED BY AT&T?

A. To the extent the Commission decides to give carriers the ability to use the KUSF for access revenue replacement as described above, the Commission should include

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[47] https://interapp.centurytel.com/resources/pdf/applications/tariffs/ohio/ohpuco11.pdf
[48] http://about.centurylink.com/tariffs/
[49] http://about.centurylink.com/tariffs/
[50] NY PSC Case 05-C-0616, Order issued April 11, 2006
[51] Specifically, according to the Wyoming Commission, "....[F]or the twelve-month period beginning July 1, 2010, the weighted statewide average local exchange service rate is established at $24.69. The associated 130% support benchmark is established at $32.09. Therefore, no Wyoming customer should pay more than $32.09 per month (excluding taxes, fees, surcharges, custom calling features and other optional services) for basic local exchange telephone service." See WY PSC Docket No. 90072-32-XO-10 (Record No. 12473), Order Issued May 14, 2010, at ¶ 36.
[52] Regulatory Commission of Alaska, Staff's Memorandum, July 13, 2009, page 22.
[53] According to a GAO report, bundled packages that contain television, High-Speed internet, and local telephone have been the preferred business strategy by Broadband Services Providers and these bundles can be offered at an average discounted price of $117.28, while the High-Speed internet portion alone (if purchased *a la carte*) could cost as much as $55.46 on average. *See* U.S. General Accounting Office Report to U.S. Senate Subcommittee on Antitrust, Competition Policy and Consumer Rights, Committee on the Judiciary, titled, "Wired-Based Competition Benefitted Consumers in Selected Markets," February 2004, page 12.

provisions that clearly authorize the use of KUSF support to recover reductions in access revenues. The provisions needed would include at least the following: (i) a provision that allows eligible ICOs to receive support for switched access revenues reduced as a result of Commission action, specifically describing how the amount to be drawn would be calculated, and identifying the supporting documentation tnat the eligible carrier must provide in order to qualify for a revenue replacement support; (ii) provisions describing the contribution methodology, the sources of contributions to the fund, and provision that provides carriers an option to recover their contribution assessment through a surcharge; and (iii) lastly a provision that specifies eligibility criteria for carriers to draw access replacement fund. The AT&T Plan attached as Exhibit OAO-2 to my testimony contains specific language that the Commission may adopt when drafting the KUSF rules.

Q. WHAT PROCEDURES SHOULD THE COMMISSION IMPLEMENT TO ACHIEVE THE REDUCTION IN WINDSTREAM'S INTRASTATE ACCESS RATES?

A. The relevant procedures are discussed in detail in the attached AT&T Plan at Exhibit OAO-2, but I will summarize them briefly here. AT&T recommends that the Commission require the Windstream companies, no later than 30 days after the effective date the Commission approves the KUSF, to reduce their intrastate switched access rates to their corresponding interstate rate structures and levels.[54] The Windstream companies should also be directed to update their intrastate tariffs any time they change their interstate rate level or rate structure in the future, so that Windstream's access rates will continue to be at parity.

[54] The timing of the implement a KUSF will depend on when the Commission concludes the subsequent generic proceeding involving other LECs, *i.e.*, Docket No. 2010-00162.

Q. SHOULD THE FACT THAT WINDSTREAM'S BASIC RETAIL RATES ARE CAPPED PURSUANT TO KRS 278-543 AFFECT HOW THE COMMISSION IMPLEMENTS REFORM FOR THAT COMPANY?

A. It certainly should not deter the Commission from undertaking reform as expeditiously as possible. On July 12, 2006, Windstream opted into a KRS 278.543 plan which effectively capped its basic service rates (but not its non-basic rates) for a period of 60 months (5 years) from the date the company adopted the statute-based plan. This means the basic service rate cap will expire July 12, 2011. Given the time it will take to complete this proceeding (and to adopt and implement KUSF rule changes), any Commission-ordered access rate reductions likely will not be effective until after the KRS 278.543 cap expires –and the Commission certainly can time such reductions in its order to be effective upon expiration of the basic service rate cap.

But if the Commission wants Windstream to begin reducing its intrastate access rates before its basic service rate cap expires, there is an easy means to do so. Specifically, the Commission can order Windstream to reduce (or eliminate) its NTSRR. Windstream already has pricing flexibility for the majority of its retail services (other than its small remaining number of basic service lines) that it can use to offset the interim reduction/elimination of the NTSRR.

Q. PLEASE EXPLAIN FURTHER HOW THE COMMISSION CAN ORDER REDUCTIONS TO WINDSTREAM'S NTSRR BEFORE THE BASIC SERVICE RATE CAP EXPIRES IN JULY 2011?

A. The NTSRR is the most egregious component of Windstream's intrastate switched access rates, and it should be eliminated as soon as possible, even if that means taking action before Windstream's basic local service rate cap expires. As I noted earlier, the NTSRR is a flat rate per line charge that is allocated and billed to carriers based on their

proportion of minutes of use. The Commission stated over a decade ago that the "[e]limination of NTS is a priority" and rightly so.[55] The NTSRR is not cost based; it is a pure and simple subsidy rate element. Worse, given the fixed nature of this rate element, Windstream continues to receive the same revenue from this element *even for lines that it has already lost to competition.* Windstream Kentucky West documentation shows that pursuant to Section 3.9.2 of PSC Tariff No. 3, "if the number of access lines decreases during subsequent years, the monthly NTS Revenue Requirement shall not decrease below the prior period revenue requirement." Likewise, Windstream explains that as for its Kentucky East – London and Lexington study areas - the number of access lines used to calculate its NTSRR was established in August 2002 "by regulatory body and this cannot be changed once set unless qualifying events occur."[56]

Windstream's data show that its line counts have decreased since the NTSRR was established. It is misguided policy to recover non-traffic sensitive costs from the NTSRR rate element that does not reflect any access function that Windstream performs, but this policy problem is compounded by the fact that Windstream will *continue to collect fixed revenues even if its access lines declined to zero.*

Thus, the NTSRR is, literally, "money for nothing." It requires long distance providers to pay Windstream an arbitrary sum of money from long distance providers for not performing any access function at all. Clearly, that is not consistent with the new competitive telecommunications environment where companies must operate on their own merits. And what makes the NTSRR even more insidious is that its very existence is

[55] *In re* An Inquiry into Universal Service and Funding Issues, Adm. Case No. 360, Order (May 22, 1998) at 2-3, citing In re Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Report and Order (May 8, 1997) at ¶35

[56] *See* Windstream Response to Verizon First Data Request No. 12.

hidden from the consumers who are asked to pay it. The Commission should not delay by one day the elimination of the NTSRR, which the Commission acknowledged to be a "priority" over 10 years ago.

Windstream will be able to offset the revenues it will lose from reduction or elimination of the NTSRR, even if the NTSRR is reduced or eliminated prior to the July 2011 lifting of Windstream's basis service rate cap. Windstream has a number of other retail services, other than its relatively small number of frozen basic local service lines, from which it can derive the replacement revenues in a revenue neutral manner until such time as its basic service rate cap ends.[57] Once Windstream's cap expires, the Commission can then implement further reductions to the other elements of Windstream's intrastate switched access charges.

V. CONCLUSION

Q. PLEASE SUMMARIZE YOUR POSITIONS IN THIS PROCEEDING.

A. The Commission has long recognized the problems created by the implicit subsidies embedded in the current intrastate switched access rates of Windstream and other ICOs. Taking meaningful action now will give consumers across Kentucky the benefits of lower long-distance prices and more aggressive competition in the long-distance and local communications markets. Doing nothing will leave Kentucky's implicit subsidy system on the verge of collapse, and will keep Kentucky out of step with the growing number of states addressing intrastate access reform.

[57] According to KRS 278.543, for nonbasic services, any telephone company can raise or lower the prices associated with such a service without any approval by the Commission; and this provision applies regardless of the type of regulation for the local exchange carrier. KRS 278.544(1). Nonbasic service includes basic local exchange service if the customer chooses to purchase a package that includes basic local exchange service as a component of the package. KRS 278.541(5).

Fortunately, the solution is literally right in front of the Commission. It is the same solution that the Commission approved years ago for AT&T Kentucky. It is the same solution that many other states have already implemented. The Commission should order Windstream – and ultimately, other Kentucky ICOs – to reduce their intrastate switched access rates to parity with the corresponding interstate access rates, which rates reflect significant reforms already implemented by the FCC. Also, the CLECs must be required to cap their rates at the levels of the ILECs with which they compete. In short, the Commission should adopt the AT&T Plan.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

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List of Testimonies by Dr. Ola Oyefusi

State	Docket No.	Subject	Date
Illinois	Docket No. 09-0315	In the Matter of Illinois Commerce Commission On its Own Motion vs. McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business Services. Investigation into whether Intrastate Access Charges of McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business Services are just and reasonable.	February 22, 2010
Pennsylvania	Docket No. I-00040105; Docket No. C-2009-2098380, et al.	Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund AT&T Communications of Pennsylvania, LLC, et. al. (Complainant) vs. Armstrong Telephone Company - Pennsylvania, et al. (Respondents)	July 2, 2009 (Direct), November 30, 2009 (Suppl. Direct), March 10, 2010 (Rebuttal), March 31, 2010 (Surrebuttal), & April 8, 2010 (Rejoinder)
Arizona	DOCKET NO. RT-00000H-97-0137; and T-00000D-00-0672	In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code; In the Matter of the Investigation of the Cost of Telecommunications Access.	December 1, 2009 (Direct Testimony), February 5, 2010 (Reply), and March 5, 2010 (Rejoinder)
New Jersey	Docket No. TX08090830	In the Matter of the Board's Investigation and Review of Local Exchange Carrier Intrastate Access Rates	February 13, 2009 (Initial Testimony), April 20, 2009 (Reply), June 22, 2009 (Rebuttal)
Pennsylvania	Docket No. I-	Investigation Regarding Intrastate	December 10,

	00040105	Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund	2008 (Direct), January 15, 2009 (Rebuttal), & February 10, 2009 (Surrebuttal)
Massachusetts	07-9	Petition for Investigation under Chapter 159, Section 14 of the Intrastate Switched Access Rates of Competitive Local Exchange Carriers	August 20, 2008 (Pre-filed)
Virginia	Case No. PUC-2007-00108	Petition of Sprint Nextel for reductions in the intrastate carrier access rates of Central Telephone Company of Virginia and United Telephone-Southeast, Inc.	August 1, 2008
New Hampshire	DT 06-067	Bayring Petition into investigation of Verizon New Hampshire's practice of imposing access charges, including carrier common line, on calls which originate from Bayring's network and terminate on wireless carriers' networks.	March 9, 2007 & April 20, 2007
New Jersey	TT 04060442	Application of Verizon New Jersey, Inc. for a Revision of Tariff B.P.U.-N.J. No. 2, providing for a Revenue Neutral Rate Restructure Including a Restructure of Residence and Business Basic Exchange Service and Elimination of 65¢ Monthly Credit	January 18, 2005 (Rebuttal)
New Jersey	TO 01020095	Application of Verizon New Jersey for approval (i) of a new alternative regulation plan, (ii) to reclassify multi-line regulated business as competitive services.	January 9, 2005 (Direct) & February 4, 2005 (Rebuttal)
Pennsylvania	C-20027195	Remand of Verizon access reduction proceeding	June 29, 2005
Pennsylvania	R-00049812	Verizon Pennsylvania Inc.'s Petition for Expedited Adoption of an Interim Rate Pending Determination of Final Rates for Time and Material	November 15, 2004 (Direct) & December 7, 2004 (Rebuttal)
Pennsylvania	C-20027195	Investigation into VZ access rates	July 18, 2003
Virginia	PUC-2002-00088	Petition of Cavalier Telephone LLC for injunction against Verizon Virginia Inc. for Violations of interconnection agreement and for	June 2, 2003

		expedited relief to order Verizon to provision Unbundled Network Elements in accordance with the Telecommunications Act of 1996	
Delaware	96-324, Phase II	In the matter of the application of Verizon Delaware Inc. for approval of its Statement of Terms and Conditions under section 252(f) of the Telecommunications Act of 1996 and code of conduct	September 14, 2001
District of Columbia	Formal Case No. 962	In the Matter of the Implementation of the District of Columbia Telecommunications Act of 1996 and Implementation of the Telecommunications Act of 1996	October 9, 2001
DC	Formal Case No. 814, Phase IV	rate design for telecommunications services, development of productivity measurements under a price cap plan, use of incremental cost as a price floor for competitive telecommunications services, criteria for determining competitive telecommunications services, critique of the alternative incentive regulation adopted in Phase III, and classification of telecommunications services	July 1, 1995
DC	Formal Case No. 920	telecommunications needs of residents, business community and government entities in the District of Columbia, introduction of new telecommunications services in the District of Columbia, and mechanisms for reviewing and monitoring Bell Atlantic's construction plans and budget	March 18, 1994
DC	Formal Case No. 926	rate design and determination of total factor productivity	July 30, 1993
DC	Formal Case No. 814, Phase III	market structure, determination of market share, pricing flexibility, and significance of economies of scale and economies of scope	October 13, 1992
DC	Formal Case No. 912	rate structure, pricing information and energy conservation	April 3, 1992

AT&T PLAN FOR KENTUCKY SWITCHED ACCESS REFORM

This five year Access Reform Plan ("Plan") ensures that each Kentucky Incumbent Local Exchange Carrier ("ILEC") that reforms its Kentucky intrastate switched access charges to match, in rate level and rate structure, its interstate switched access charges will have the opportunity to recoup for each billable line in service 100% of any reduction in switched access revenues through a combination of increased retail rates and amounts drawn from the Kentucky Universal Service Fund ("KUSF"). The Plan also requires each Competitive Local Exchange Carrier ("CLEC") to reduce its intrastate access rates so that on average they are no higher than the rates of the ILECs with which they compete. The Plan is as follows:

1. Thirty (30) days following a Commission Order adopting the Plan, each CLEC's overall weighted average intrastate switched access rates are capped at, and must be maintained at no greater than, the overall weighted average intrastate rates of the ILEC(s) with which the CLEC competes. CLECs currently have full retail rate pricing flexibility that can be used, in each CLEC's discretion, to recoup any resulting switched access revenue reductions.

2. One-hundred eighty (180) days[1] following the Commission Order, each ILEC shall implement intrastate switched access rates that are identical, in rate level and rate structure, to the ILEC's interstate switched access rates. Whenever changes occur to an ILEC's interstate switched access rates and/or rate structure, the ILEC shall implement identical changes to its provision of intrastate switched access services.

3. The Commission Order will establish a single statewide local exchange service rate benchmark ("Benchmark") applicable to all billable retail local exchange lines in service. To the extent allowed by law, each ILEC will have pricing flexibility to increase its price for any retail basic local exchange service line[2] to the Benchmark level, except that, unless otherwise ordered by the Commission, the increase implemented in each year of the Plan shall be limited to $2.00 per line per month (the "Transitional Cap"). To the extent allowed by law, the Commission Order will grant ILECs additional pricing flexibility to increase retail basic local exchange service rates up to $2.00 per line per month each year of the Plan until rates reach the Benchmark.

   3.1. To the extent any ILEC, that elected alternative rate regulation under KRS 278.543 prior to January 1, 2010, has its rates capped at the time this Plan is implemented, the difference between the capped rates and the Benchmark will be replaced with KUSF distributions until the rate cap expires, at which point the ILEC will continue to draw from the KUSF as set forth below.

   3.2. In the event an ILEC is allowed during the five years of the Plan to establish new rates for retail local exchange service above the Benchmark, the resulting revenue increase above the Benchmark will not be subtracted from the ILEC's KUSF distribution, if any.

4. Distributions from the KUSF will be determined as follows:

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[1] The additional 150 days (five months) provided to ILECs would be used to implement a Kentucky Universal Service Fund ("KUSF").

[2] The price of all billable local exchange lines of an ILEC, including those contained in a bundled offering, is assumed for purposes of the Plan to be the ILEC's basic local exchange rate in the exchange in which the line is being provided.

4.1. Each ILEC's Total Access Revenue Shift will be determined by calculating, for the calendar year prior to the Commission's order, the difference between the ILEC's total intrastate switched access revenues and the switched access revenues the ILEC would have collected had it applied its interstate switched access rates for the provision of intrastate switched access services.

4.2. Each ILEC's Per Line Access Shift will be determined by dividing the ILEC's Total Access Revenue Shift by the number of billable retail local exchange lines the ILEC had in service as of October 31 of the calendar year prior to the Commission's order. Administrative and official lines shall not be included in the calculation.

4.3. Each year of the Plan, each ILEC will recover from the KUSF its Annual Access Revenue Shift less its Additional Retail Revenue Opportunity, calculated prior to the beginning of the upcoming year ("the upcoming Plan year") as set forth below. If the calculations performed for an upcoming Plan year show that an ILEC's Annual Access Revenue Shift less its Additional Retail Revenue Opportunity produces a number at or less than zero, the ILEC will not be permitted to draw from the KUSF in the upcoming Plan year or in any subsequent year of the Plan. The specific calculations to be performed for each year of the Plan are set forth in Section 4.6, below, and are controlling.

4.4. The ILEC's Annual Access Revenue Shift for an upcoming Plan year is equal to the number of billable retail local exchange lines the ILEC had in service as of October 31 in the year prior to the upcoming Plan year times the ILEC's Per Line Access Shift as defined in Section 4.2, above.

4.5. The ILEC's Additional Retail Revenue Opportunity for each upcoming Plan year consists of two parts:

4.5.1. For each retail local exchange line which price (inclusive of any increases available, but not taken, under this Plan) is in a range from $0.01 to $2.00 below the Benchmark, as of October 31 of the year preceding the upcoming year of the Plan, the difference between the rate and the Benchmark, times 12, totaled for all such lines, plus

4.5.2. For each retail local exchange line which price (inclusive of any increases available, but not taken, under this Plan) is more than $2 below the Benchmark, as of October 31 of the year preceding the upcoming year of the Plan, $2 times 12, totaled for all such lines.

4.5.3. The specific calculations to be performed for each year of the Plan are set forth in Section 4.6, below, and are controlling.

4.6. Each ILEC will be entitled to recover from the KUSF for each year of the Plan as follows:

4.6.1. Year 1 – Each ILEC will be entitled to recover its Annual Access Revenue Shift less its Additional Retail Revenue Opportunity (as determined in the Commission Order and consistent with Sections 4.3, 4.4 and 4.5, above).

4.6.2. Year 2 – Each ILEC will be entitled to recover the amount it recovered in Year 1, with the following adjustments: (a) adjust for any change in the ILEC's number of

billable retail local exchange lines as of October 31 of Year 1,[3] then subtract the sum of (b) for each billable retail local exchange line in service priced below the Benchmark, but within $2.00 of the Benchmark, as of October 31 in Year 1,[4] the difference between the rate and the Benchmark, summed for all such lines, times 12, plus (c) for each billable retail local exchange line in service priced more than $2.00 below the Benchmark as of October 31 of Year 1 (see fn. 3), $2.00 times the number of such lines, times 12.

4.6.3. Year 3 - Each ILEC will be entitled to recover the amount it recovered in Year 2, with the following adjustments: (a) adjust for any change in the ILEC's number of billable retail local exchange lines as of October 31 of Year 2 (see fn.2), then subtract the sum of (b) for each billable retail local exchange line in service priced below the Benchmark, but within $2.00 of the Benchmark, as of October 31 in Year 2 (see fn. 3), the difference between the rate and the Benchmark, summed for all such lines, times 12, plus (c) for each billable retail local exchange line in service priced more than $2.00 below the Benchmark as of October 31 of Year 2 (see fn. 3), $2.00 times the number of such lines, times 12.

4.6.4. Year 4 - Each ILEC will be entitled to recover the amount it recovered in Year 3, with the following adjustments: (a) adjust for any change in the ILEC's number of billable retail local exchange lines as of October 31 of Year 3 (see fn.2), then subtract the sum of (b) for each billable retail local exchange line in service priced below the Benchmark, but within $2.00 of the Benchmark, as of October 31 in Year 3 (see fn. 3), the difference between the rate and the Benchmark, summed for all such lines, times 12, plus (c) for each billable retail local exchange line in service priced more than $2.00 below the Benchmark as of October 31 of Year 3 (see fn. 3), $2.00 times the number of such lines, times 12.

4.6.5. Year 5 - Each ILEC will be entitled to recover the amount it recovered in Year 4, with the following adjustments: (a) adjust for any change in the ILEC's number of billable retail local exchange lines as of October 31 of Year 4 (see fn.2), then subtract the sum of (b) for each billable retail local exchange line in service priced below the Benchmark, but within $2.00 of the Benchmark, as of October 31 in Year 4 (see fn. 3), the difference between the rate and the Benchmark, summed for all such lines, times 12, plus (c) for each billable local exchange line in service priced more than $2.00 below the Benchmark as of October 31 of Year 4 (see fn. 3), $2.00 times the number of such lines, times 12.

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[3] If the ILEC's number of billable lines in service increases from the prior October 31, add an amount equal to the increase in lines times the Per Line Access Shift times 12. If the ILEC's number of billable lines in service decreases from the prior October 31, subtract an amount equal to the decrease in lines times the Per Line Access Shift times 12.

[4] Nothing in the Plan precludes an ILEC from reducing any of its basic local service rates at any time, but any such reductions will be disregarded for purposes of calculating Kentucky USF distributions under the Plan so that an ILEC may not reduce its retail local exchange prices to increase its draw from the Kentucky USF. Likewise, an ILEC may not increase its distribution from the Kentucky USF by electing to forego available retail local exchange service price increases. The price used for this calculation shall be the highest price the ILEC had in effect during the preceding year, adjusted upward for any price increase the ILEC could have implemented under this Plan but elected to forego. *See* Sections 4.5.1 and 4.5.2.

5. No earnings test would be required of the ILECs to qualify for the Kentucky USF distributions.

6. Contributions to the KUSF will occur as follows.

   6.1. All providers having Kentucky retail intrastate telecommunications revenues would contribute to the KUSF, including wireline ILECs, CLECs, wireless carriers and IXCs.

   6.2. The KUSF contribution assessment will mirror the current Federal USF contribution methodology (*i.e.*, based on intrastate retail telecommunications revenues). If the Federal USF contribution methodology is changed in the future (*e.g.*, to be based upon telephone numbers and/or dedicated connections), then the Commission shall open a proceeding to evaluate the KUSF contribution methodology to consider whether the KUSF contribution methodology should be changed, and if so, how. If the KUSF contribution methodology is revised, the Commission shall allow a reasonable implementation period.

   6.3. By November 15 of each year of the Plan, the Commission or its designee will calculate a KUSF assessment for the upcoming Plan year, expressed as a percentage of intrastate retail telecommunications revenues, by dividing the expected KUSF distributions by the expected Kentucky intrastate retail telecommunications revenues, adjusting for a prior-year fund surplus or deficit, if any. Providers will be able to file their Kentucky intrastate retail telecommunications revenue data on a confidential basis.

   6.4. Providers are permitted, but not required, to recover their KUSF assessments from their end user customers, and may do so, e.g., through a separate line item for the KUSF assessment on retail customers' bills.

7. Not later than January 1 of Year 5 of the Plan, the Commission shall open a proceeding to review and reevaluate all aspects of the Plan, including the Benchmark and the necessity for continued KUSF distributions, which proceeding shall be completed by December 1 of Year 5 of the Plan. Interested parties shall be provided with notice and an opportunity to comment.

In the event the Federal Communications Commission (FCC) issues an order modifying its current methodology for establishing interstate switched access charges, the Kentucky Commission will open a proceeding to determine what changes, if any, are required to this Plan, such proceeding to be completed within 120 days of the effective date of any such FCC order.

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Kentucky

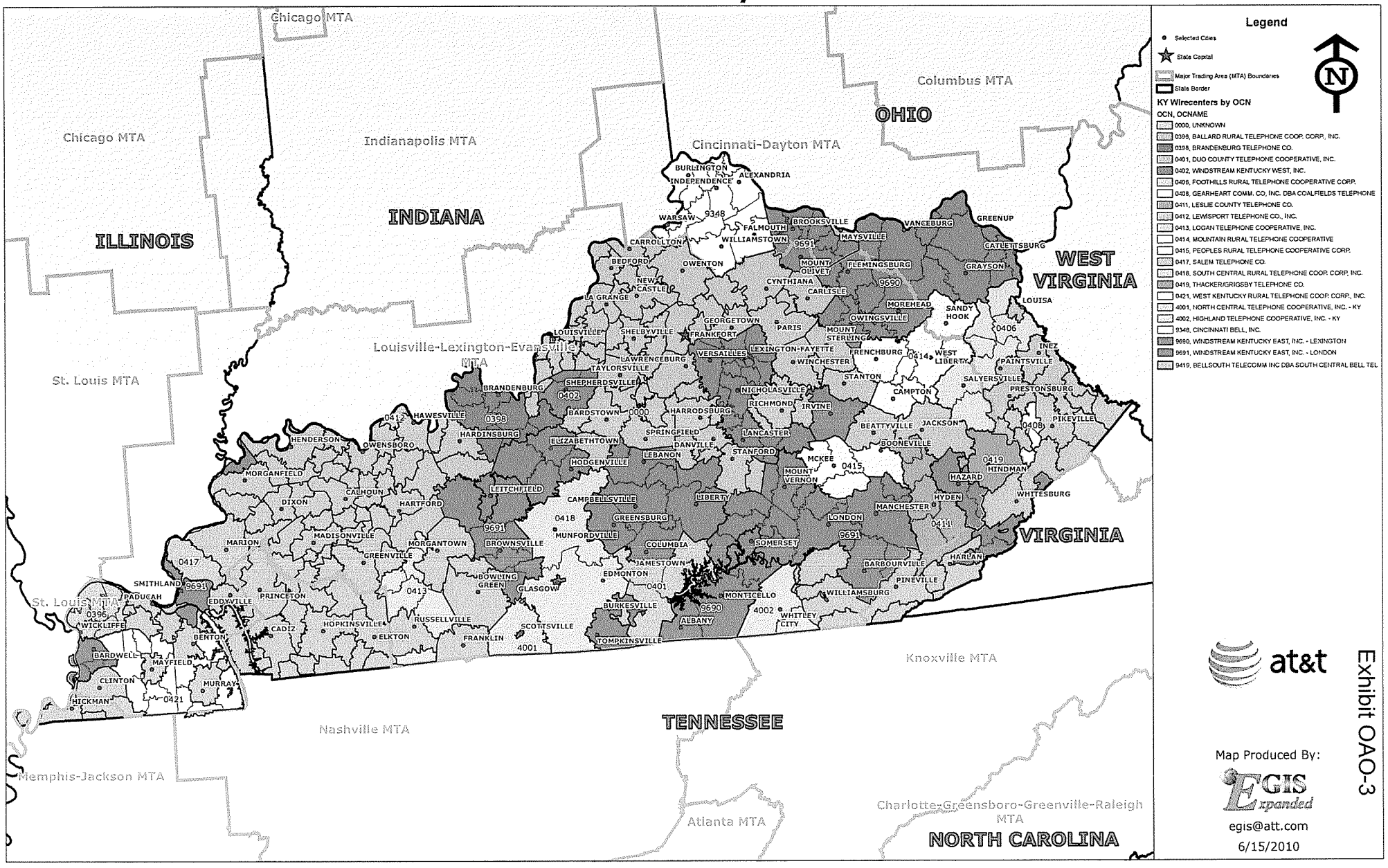

Exhibit OAO-3

Exhibit OAO-4

The entire document is proprietary.
There is no edited version.

STATES WITH INTRASTATE/INTERSTATE ACCESS PARITY

States that Mandate Intrastate/Interstate Parity by Statute for Certain Carriers

Ten states have mandated reduction of intrastate access rates to interstate rate levels by statute, and some have also directed the state utilities commission to ensure compliance through further proceedings and tariff oversight.

Michigan: Largest ILECs - The Michigan Telecommunications Act of 1991 ("MTA") required local carriers with more than 250,000 access lines to establish intrastate MOU access rates that did not exceed their interstate counterparts in order to be considered "just and reasonable.[1] AT&T Michigan and Verizon (soon to be Frontier) were the only local carriers that met this threshold, and were required to reduce their switched access rates immediately.

Smaller ILECs – The MTA was amended in 2009 to require rural LECs to mirror their interstate access rates by the end of September, 2010.[2] The Act also provided for a USF for certain eligible small carriers.

CLECs – The 2009 amendment to the MTA also required CLECs to establish parity in a five year stepped process (20% incremental reductions per year).[3]

Maine: Largest ILECs - In Maine, the legislature ordered the commission to ensure intrastate mirroring of interstate switched access rates: "By May 31, 2005, the commission shall insure that intrastate access rates are equal to interstate access established by the Federal Communications Commission as of January 1, 2003."[4] The Maine Public Utilities Commission implemented the statutory directive by adopting a rule requiring each local exchange carrier to implement access mirroring by June 1, 2003, and to refresh the mirrored rates on June 1 every two years thereafter.[5]

Smaller ILECs – The above requirement applies to all ILECs.

CLECs – The above requirement applies to all LECs in the state, including CLECs.

Illinois: LECs Electing Market Regulation - In June 2010, the Governor signed SB 107, which provides, in relevant part, that any LEC electing market regulation must reduce its intrastate switched access rates to levels that mirror the rates and rate

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[1] Michigan Compiled Laws, chap. 484.2310, sec. 310(2) (1991).

[2] *Id.* as amended Dec. 2009.

[3] *Id.*

[4] Maine Revised Statutes Annotated, Title 35-A, Chapter 71, sec. 7101-B Access Rates (effective May 2, 2003).

[5] Code of Maine Rules, 65-407 Ch. 280, section 8B (current through Aug. 2008).

structure of its interstate switched access rates in four installments by June 30, 2013.[6] The first installment requires reduction of 33% of the difference between intrastate and interstate rates within 30 days of the Electing Provider's complete application for Notice of Election for Market Regulation. The second reduction (equal to 41% of the difference between its then-current rates) must be made within one year of the initial reduction. The third reduction (equal to 50% of the difference in the carrier's then-current rates) must be made within one year of the second reduction, The fourth reduction must be made by July 1, 2013 and must reduce the Electing Carrier's intrastate switched access rates to mirror its rates and rate structure for its then-current interstate switched access rates. Thereafter, Electing Providers must continue to mirror their interstate switched access rates and rate structure.[7]

Smaller ILECs and CLECs - SB 107 Sec 13-900.2 requires (i) ILECs serving more than 35,000 access lines that do not elect Market Regulation and (ii) CLECs that do not elect Market Regulation to reduce their intrastate switched access rates to interstate levels within two years as follows: By January 1, 2011, such carriers must reduce their intrastate switched access rates by 50% of the difference between their then-current intrastate and interstate switched access rates. By January 1, 2012, they must reduce intrastate switched access rates by 50% of the then-current difference between their intrastate and interstate switched access rates. By July 1, 2012, they must reduce their intrastate access rates to mirror their then-current interstate switched access rates and rate structure. After July 1, 2012, these carriers must continue to mirror interstate access rates and rate structure.

Smallest ILECs – ILECs serving fewer than 35,000 access lines are not required to reduce intrastate access rates.

Kansas: Largest ILECs - Kansas statutes provide for reduction of switched access rates to interstate levels, with corresponding allowances for increases in retail local exchange rates: "Subject to the Commission's approval, all local exchange carriers shall reduce intrastate access charges to interstate revels as provided herein. Rates for intrastate switched access, and the imputed access portion of toll, shall be reduced over a three-year period with the objective of equalizing interstate and intrastate rates in a revenue neutral, specific and predictable manner. The Commission is authorized to rebalance local residential and business service rates to offset the intrastate access and toll charge reductions."[8] In March 2010, the Kansas Corporation Commission issued an order requiring Embarq (now CenturyLink) to reduce its intrastate access rates to

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[6] A LEC that elects market regulation must also offer, for three years, three residential services/service packages at capped rates.

[7] SB 107 Sec. 13-506.2(g).

[8] Kansas Code chap. 66. Sec. 66-2005(c)(1996).

parity with its interstate rates. Because the KCC ruled that Embarq/CenturyLink could recover reduced access revenues from the Kansas Universal Service Fund ("KUSF"), the KCC found that a phased-in reduction of access rates was not necessary. Carriers that contribute to the KUSF (including the AT&T ILEC) are allowed to pass on their USF contributions to their end users.

Smaller ILECs – The above requirements also apply to smaller ILECs, including rural ILECs, subject to a specific requirement that revenue reductions be recovered from the KUSF and that if the reductions exceed a specifically designated amount they may be deferred to odd-numbered years.

CLECs - There are no rules that limit CLECs' intrastate access rates.

Texas: Largest ILECs - The Texas legislature established interstate-intrastate access parity with a directive to incumbent local exchange companies to "reduce both the company's originating and terminating per minute of use switched access rates in each market to parity with the company's respective federal originating and terminating per minute of use switched access rates" on the date the last market of that incumbent carrier is deregulated.[9] The statute also requires a "transitioning ILEC" – an ILEC for which at least one, but not all, of its markets has been deregulated – that has greater than 3 million access lines, to reach parity after a phased reduction occurring over 2 years from the date of commencement.[10] The statute further requires incumbent carriers that have established parity to maintain parity on an ongoing basis for all switched access rates.[11]

Smaller ILECs - Other statutory provisions shield certain ILECs from the requirement to reduce intrastate access charges to parity with interstate rates. Specifically, "transitioning" ILECs with fewer than 3 million access lines and "newly designated transitioning" ILECs are governed by other rate reduction provisions that could lead to parity with interstate rates but do not mandate parity. Transitioning carriers are subject to phased rate reductions, but are not required to reach parity until 75% of their exchanges are deregulated by the Commission.[12] In addition, there are statutory provisions that permit certain ILECs (primarily small and rural companies) to elect incentive regulation under Chapter 59 of the Public Utility Regulation Act. ILECs

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[9] V.T.C.A., Utilities Code, sec. 65.201(a).

[10] V.T.C.A., Utilities Code, sec. 65.202(a). The initial 1/3 reduction occurred on 7/1/2006; the next 1/3 on 7/1/2007; the final 1/3 on 7/1/2008.

[11] *Id.* at sec. 65.201(b) & 65.202(b).

[12] V.T.C.A., Utilities Code, secs. 65.203 & 65.204.

electing such incentive regulation are not subject to the requirement that intrastate access rates be reduced to parity with interstate rates.[13]

CLECs - In order to prevent abusive CLEC access rate practices, the cited statute requires all telecommunications utilities to charge switched access rates no higher than (a) the prevailing rates charged by the incumbent carrier serving that area; or (b) a statewide average ILEC composite switched access rate as calculated by the state commission.[14]

Georgia: Largest ILEC - By statute enacted in 1995, Georgia required all Tier 1 and Tier 2 local exchange carriers to reduce their switched access rates to interstate levels. The statute mandated for Tier 1 carriers (only) that "The rates for switched access ... shall be no higher than the rates charged for interstate access by the same local exchange company."[15] Based on this requirement, AT&T (the only Tier 1 carrier in Georgia), has been required to maintain parity between its intrastate and interstate switched access charges.

Tier 2 ILECs - The 1995 statute required Tier 2 carriers to reduce, by July 1, 2000, their intrastate rates to parity with their July 1, 1995 interstate rates.[16] In June 2010, Georgia's governor signed HB 168, which amended the earlier statute and requires Tier 2 ILECs to reduce their intrastate access charges to interstate levels in equal annual increments over five years, beginning January 1, 2011 and ending December 31, 2015.

CLECs - HB 168 requires all certificated carriers other than Tier 2 ILECs to reduce their intrastate switched access rates to interstate levels in equal annual increments over a 10 year period, beginning January 1 2011 and ending December 31, 2020.

Indiana: Largest ILECs - By statute, Indiana provides that in any proceeding before the state commission, including any interconnection agreement or statement of generally available terms and conditions, "the commission shall consider the provider's rates and charges for intrastate access service to be just and reasonable if the intrastate rates and charges mirror the provider's interstate rates and charges."[17] Although the statute

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[13] V.T.C.A., Utilities Code, sec. 59.025 (Commission cannot reduce the switched access rates of carriers electing infrastructure commitment under Chapter 59).

[14] *Id.* at sec. 52.155 (and allows for higher rates only upon specific commission approval based upon a cost justification or other rationale for implementation of a higher rate for each rate element).

[15] Ga. Code Ann. sec. 46-5-166(f)(1)(1995).

[16] *Id.* at (f)(2). See also discussion regarding statutes awaiting adoption at p. 6 below.

[17] Indiana Code chap. 8-1 -2 .6. sec. 1.5 (c) (2) (2006).

does not specifically require rate parity, the Indiana commission, relying upon this provision, has approved parity arrangements over the years for large ILECs.[18]

Smaller ILECs – The Indiana commission has also approved parity arrangements for smaller ILECs.[19]

CLECs – Although the above statutory provision does not literally require rate parity, its "just and reasonable" standard also applies to CLECs.

Oklahoma: Largest ILECs - Oklahoma by statute requires each local telecommunications service provider serving 15% or more of the access lines in the state to maintain intrastate switched access tariffs "in parity with the *terms and conditions* of the interstate access tariffs of that company," and to ensure on an ongoing basis to "maintain the terms and conditions of the intrastate access tariffs of that company so that they are in parity with the terms and conditions of the interstate tariffs of that company."[20] There is no current parity requirement for Switched Access *rates* for Oklahoma. Oklahoma had previously required mirroring until certain revenue reduction targets had been met.[21] Oklahoma carriers are no longer required to flow through any access reductions, effective July 1, 2009.

Smaller ILECs - There are no specific rules applicable to LECs serving fewer than 15% of the state's access lines.

CLECs – There are no specific rules applicable to CLECs. However, the Oklahoma Corporation Commission typically requests CLECs to reduce their switched access rates to the level of the ILECs in whose territory they operate before approving a tariff, unless the CLEC can justify a higher rate by demonstrating higher costs.

Virginia:[22] Large ILECs - On April 13, 2010, the Governor of Virginia signed a revision to Section 56-235.5:1 of the Virginia Code that requires the State Corporation Commission (SCC) to establish a schedule for ILECs that serve over 15,000 lines in their incumbent territory to eliminate the Carrier Common Line Charge ("CCLC") for intrastate switched access service no later than July 1, 2013. Carriers that received funding prior to April 1, 2010 from the Department of Agriculture's Broadband Initiatives Program are subject to the schedule for small ILECs described below. Carriers that have not been the subject of an SCC proceeding to investigate their CCLC may petition

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[18] *See Re: Indiana Bell Telephone Company. Inc.*, Cause No. 42405, 2004 WL 2309824 at par.22 (continuing mirroring of Indiana Bell intrastate and interstate switched access rates).

[19] *See, e.g., Re: Universal Service Reform.* Cause No. 42144, 2004 W.L. 1170315 at par.38.

[20] 17 Oklahoma Statutes sec. 17-139.103.D.4 (1997).

[21] *Id.* at 3.

[22] See also discussion regarding state commission actions at p. 10 below.

the commission for an extension of time for the elimination of the charge until July 1, 2014. The SCC is required to permit ILECs "to recover a reasonable amount of carrier common line charge revenue lost."[23] The new statutory provision is scheduled to become effective July 1, 2010.

Small ILECs - For small ILECs serving under 15,000 lines and carriers that have received a grant under the Broadband Initiatives Program, the SCC is required to determine no later than July 11, 2011 a schedule for the elimination of the CCLC.

CLECs – CLEC intrastate switched access rates may not exceed the higher of the CLEC's comparable interstate switched access rates or the aggregate intrastate access rate of the ILEC in whose service territory the CLEC is providing service.[24]

Missouri: ILECs - Missouri enacted House Bill No. 1750, which adds Sec. 392.605 to the state's Revised Statutes. That section requires incumbent LECs that serve over 25,000 access lines to reduce their intrastate access rates by eighteen percent of the difference between their intrastate and interstate access rates in three equal installments. The first six percent reduction is to occur by March 1, 2011. The second and third reductions must occur by March 1 of the succeeding two years.

CLECs – As a condition of competitive classification, a CLEC is required to cap switched access rates at the level of the ILEC in whose territory it operates.[25]

States That Mandate Intrastate/Interstate Parity or Substantially Reduced Pricing by Commission Order, Rule or Tariff, Including Where Subsequently Modified

Ten state commissions have instituted or approved mirroring or near-mirroring of interstate switched access rates for local exchange carriers, although two have subsequently modified this approach. These states generally permit carriers to implement some form of alternative price regulation to ensure revenue neutrality.

Massachusetts: Large ILECs - The Massachusetts Department of Telecommunications and Energy established intrastate mirroring of interstate switched access rates for Verizon in 2002, while also allowing for retail rate rebalancing: "Currently, intrastate switched access charges are higher than interstate switched access charges. This creates a situation where it could cost more for Massachusetts customers to make a call across the state than it does to make a call across the country. The Department concludes that this is inefficient. .. [T]herefore, intrastate

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[23] Virginia Code Sec. 56-235-5:1.B.1 & 2.

[24] 20 VAC 5-417-50E (CLECs may use a blended or composite rate to reflect applicable price ceilings of more than one ILEC or to reflect an alternative rate structure of the ILEC).

[25] Missouri Statutes sec. 392.370.

switched access charges will be lowered to the more cost-based interstate levels."[26] In noting that the access revenues should be made up by retail rate increases, the Department also stated that "experience has shown that such rate-rebalancing enhances efficiency without negatively impacting universal service."[27]

CLECs - In an order issued June 22, 2009, the Department of Telecommunications and Cable directed that all CLEC intrastate switched access rates be established at or below Verizon's intrastate switched access rates, which, in turn, are required to be set at the levels of Verizon's interstate switched access rates. The Department required that CLEC rates would be capped at Verizon's rate effective one year from the date of its Order.[28]

New Jersey: ILECs – On February 1, 2010, the New Jersey Board of Public Utilities ("Board") issued an order implementing a 4-step, 3-year plan that requires all three of the state's ILECs to reduce their intrastate switched access rates to parity (both as to rates and rate structure) with their interstate access rates.[29] In several prior proceedings, the Board had granted significant (and in many cases complete) retail local pricing flexibility to the two largest ILECs,[30] without addressing access rates. The amount of rate flexibility the Board had previously granted those carriers far exceeded the access revenue reductions required by the Board's Access Order. In addition, consistent with those ILECs' commitment not to seek additional pricing flexibility until after the Board issued an order addressing intrastate access rates, the Board expressed its willingness to consider further retail pricing flexibility for the ILECs in a follow-on proceeding. LECs have appealed the Board's ruling to the state's Appellate Division.

CLECs – In the same order, the Board rejected the proffered CLEC cost studies, found that CLECs had not shown their costs of access exceed their interstate access rates, and required CLECs to mirror the rates of the ILECs in whose territory they operate. This means that when the phase-in plan is complete the CLECs' intrastate access rates will be the same as their interstate rates.

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[26] *Investigation by the Department of Telecommunications and Energy on its Own Motion into the Appropriate Regulatory Plan to Succeed Price Cap Regulation for Verizon New England, Inc. etc.*, 2002 Mass. PUC Lexis 10 (May 8, 2002), at 36.

[27] *Id.*

[28] *Petition of Verizon New England, Inc., et al for Investigation under Chapter 159, Section 14 of the Intrastate Access Rates of Competitive Local Exchange Carriers*, D.T.C. 07-9, Final Order, released June 22, 2009. One rural CLEC was permitted to charge a rate equal to the NECA tariff rate.

[29] *In the Matter of the Board's Investigation and Review of Local Exchange Carrier Intrastate Exchange Access Rates*, Docket No. TX08090830.

[30] The remaining New Jersey ILEC is a very small carrier that is subject to rate of return regulation.

Alabama: Largest ILECs - In 1995, the Alabama Public Service Commission allowed South Central Bell to elect price regulation with various conditions, including requiring South Central Bell to maintain intrastate access charges at a level not to exceed interstate access rates for a period of five years. The decrease to interstate parity was effective immediately. After expiration of the five year period, South Central Bell was required to continue to cap these rates at "the lower of the intrastate rates in effect on July 1, 1999, or the effective interstate prices and structures approved by the FCC."[31] In December 2004, the Commission adopted a Price Flexibility Plan for BellSouth that capped BellSouth's combination of the traffic sensitive per minute charge for originating and terminating switched access service at the then "effective intrastate level (including any non-traffic sensitive rate elements)."[32]

Smaller ILECs - The Price Flexibility Plan for other ILECs is the same as BellSouth's for intrastate switched access rates.

CLECs – There are no state limitations on CLECs' intrastate switched access rates.

Ohio: Largest ILECs - ILECs in Ohio have been required by the Ohio Public Utilities Commission ("PUCO") to mirror their federal access rate structure for intrastate switched access rates, a policy in place since 1987.[33] Large ILECs were required to reduce rates immediately. Smaller ILECs were transitioned to interstate rates over 3 years. In 2007, the Commission reiterated its support for earlier orders requiring the four largest incumbent local exchange carriers to mirror their then-current interstate switched access rates for intrastate access services.[34] However, the Commission has made an exception to the mirroring requirement with respect to the intrastate Carrier Common Line Charge ("CCLC"), which was capped at 1987 levels. Nonetheless, Ameritech, CBT and Verizon have taken steps to reduce or eliminate the intrastate CCLC due to merger conditions and alternative regulation plans.

Smaller ILECs - ILECs other than the four largest incumbents mirror interstate rates that were in effect a decade ago.

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[31] *In Re Petition of South Central Bell Telephone Company to Restructure its Form of Regulation, etc.,* Docket Nos. 24499, 24472, 24030, 24865, Report and Order, September, Ala. P.S.C. (1995) at par. 9.03.

[32] *In Re Proposed Revisions to the Price Regulation and Local Competition Plan*, Docket No. 28590, Order Approving Alabama Telecommunications Regulation Plan, December, Ala. P.S.C. (2004) at Appendix A, page 9, section 7.C.

[33] *In Re Modification of Intrastate Access Charges*, Case No. 00-127-TP-COI, Opinion and Order, (2001 WL 283031) at par. 2, citing *In the Matter of the Commission's Investigation Relative to Establishment of Intrastate Access Charges*, Case No. 83-464-TP-COI, Subfile C (May 21, 1982 and March 12, 1987).

[34] *In the Matter o/the Establishment of Carrier-to-Carrier Rules,* Case No. 06-1344-TP-ORD, Entry on Rehearing, Ohio P.U.C.(October 17, 2007) ("2007 Order") at par. 29, p. 18.

CLECs – The PUCO's 2007 order also required competitive local exchange carriers to mirror their respective interstate rates.[35]

New Mexico: All LECs - New Mexico administrative rules provide that effective January 1, 2008, "a local exchange carrier's intrastate switched access charges may not exceed the interstate switched access charges approved by the federal telecommunications commission as of January 1, 2006, and its intrastate switched access elements and structure shall conform to the interstate switched access elements and structure approved by [the FCC)]."[36] The rules also provide a mechanism to require carriers to continue to mirror updated interstate switched access rates.[37]

West Virginia: Largest ILECs - By order of the state commission in March of 2007 approving Verizon's Market Transition Plan ("MTP"), Verizon is eliminating the carrier common line charge from its intrastate switched access rates and mirroring its interstate traffic-sensitive switched access rates over a phase-in period through year-end 2010. Verizon is being granted pricing flexibility for basic local exchange services commensurate with the revenue reductions attributable to switched access decreases. At the conclusion of the phase-in period, all Verizon intrastate switched access rates are expected to mirror interstate rates.[38]

CLECs - By Commission Order dated November 23, 2009, CLECs are required to mirror Verizon's intrastate rate (which will soon mirror its interstate rate) over a phase-in period ending thirty months from the date of the Order.[39]

Virginia: ILECs – In May, 2009, the Virginia State Corporation Commission ("SCC") issued an order requiring the CenturyLink companies (i) to restructure their carrier common line charges ("CCLCs") to a per minute rate by January 1, 2010; (ii) to reduce their CCLCs by 25% on or before July 1, 2010 and (iii) to reduce their CCLCs by 25% of their January 1, 2010 per minute rates no later than July 1, 2011.[40] In addition, the parties to the CenturyLink proceeding have sought SCC approval of a settlement that requires CenturyLink companies to reduce their CCLCs by 25% of their January 1, 2010

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[35] *Id.*

[36] N.M. Admin. Code 17. 11.1 0.8(C) (2005). *See also* N.M.S.A. 63-9H-6I (requiring state commission to ensure intrastate access charges are equal to interstate access charges by May 1, 2008).

[37] *Id.* at 17. 11. 10.8(I).

[38] *Petition for Approval of Joint Stipulation and Agreement for Settlement and Joint Petition for Expedited Approval of a Joint Stipulation for a Market Transition Plan for Verizon West Virginia Inc.,* Case No. 06-1935- T-PC., W.V.P.S.C. (2007).

[39] *Petition of Verizon West Virginia Inc. et al.,* Commission Order, Case No. 08-0656-T-GI (November 23, 2009).

[40] *Petition of Sprint Nextel for Reductions in the Intrastate Carrier Access Rates of Central Telephone Company of Virginia and United Telephone-Southeast, Inc.*, Case No. PUC-2007-00108.

rates no later than July 1, 2012 and to eliminate their CCLCs entirely no later than July 1, 2013.

Kentucky: ILECs - In 1995, the Kentucky Commission approved a price regulation plan for BellSouth that required BellSouth to implement switched access rates that mirrored analogous interstate access rate elements.[41] The Commission later stated that its earlier Order "clearly and unequivocally required mirroring of interstate access rates as the FCC changed access rates," and required mirroring rates to be effective no later than 30 days after the FCC changed interstate rates.[42] The Commission subsequently approved further access reductions for BellSouth and Cincinnati Bell, citing public interest benefits associated with removing economically inefficient subsidies.[43]

In July 2006, statutory revisions effectively changed this regulatory scheme. Current statutory provisions permit telephone utilities the option to elect a price regulation plan as described within the statute.[44] Under price regulation, an electing utility's rates for intrastate switched-access service "shall not exceed its rates for this service that were in effect on the day prior to the date the utility filed its notice of election."[45] Accordingly, Kentucky's switched access rates are capped and no longer need to mirror interstate rates. AT&T-KY filed notice of its price regulation plan election on July 12, 2006.

CLECs – There are no state limitations on CLECs' intrastate switched access rates.

Tennessee: Largest ILECs - BellSouth Telecommunications Inc. ("BellSouth") agreed to reduce intrastate switched access charges to achieve parity between intrastate and interstate switched access rates that existed as of August 1, 1995 under agreement with certain interexchange carriers operating in Tennessee. This agreement was never filed with nor approved by the Tennessee Regulatory Authority ("TRA"). On January 31, 1997, BellSouth filed with the TRA a tariff to implement the first step of these reductions. The TRA initiated a docket to consider this tariff filing,[46] and issued an Order approving

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[41] *Application of BellSouth Telecommunication, Inc., d/b/a South Central Bell Telephone Company to Modify Its Method of Regulation,* Case No. 94-121 (1995), Order; 1995 WL 135116 Ky. 1628 (1999), 1999 WL 135116 (Neb. P .S.C.), at 7. The Commission initially exempted the PICC and TIC for originating access and capped terminating rates at the levels of originating rates. The Commission also gave guidelines for residential and business rate rebalancing initiatives. *Id.* at 5.

[42] *Telecomm, Inc.'s Application to Restructure Rates,* Case No. 97-074, Neb. P.S.C. (1997). *See also,* Tariff Filing of BellSouth Telecommunications, Inc. to Mirror Interstate Rates, Case No. 98-065 (1999).

[43] *See, e. g., Review of BellSouth Telecomm, Inc.'s Price Regulation Plan,* Case No. 99-434 Ky. P.S.C. (2000), at 5.

[44] Ky. Rev. Stat. 278.543.

[45] *Id.* at 278.543(4).

[46] *In Re: Tariff Filling by BellSouth Telecommunications. Inc. to Reduce Intrastate Access Charges.* Docket No. 9700185. Ten. R.A. (1997).

BellSouth's tariff as filed.[47] The TRA also approved all subsequent tariff filings made to reduce rates under the agreement with IXCs.

CLECs – There are no state limitations on CLECs' intrastate switched access rates.

Oregon: Largest ILECs - In 2001, the Commission approved a Qwest rate rebalancing plan that provided substantial access reform. The Commission required Qwest to reduce switched access rates by decreasing the local switching rate and eliminating the carrier common line charge, a move calculated to "bring Qwest's intrastate switched access rates closer to its currently lower interstate switched access rates ... an equitable development with respect to consumers . . ."[48]

CLECs – There are no state limitations on CLECs' switched access rates.

States That by Tariff Establish Intrastate Access Rates Near Parity with Interstate Rates

LECs in two states have established by tariff intrastate switched access rates that are virtually at parity with corresponding interstate rates.

Mississippi: BellSouth's terminating intrastate access charges "are currently at parity with the FCC interstate rates and will be adjusted annually subject to a cap at parity."[49] The intrastate rates in total for a two-ended call are marginally higher than interstate rates ($0.0095 intrastate vs. $0.0088 interstate).

North Carolina: In 1996 as part of a retail rate plan filing, BellSouth began a 3 year phase-down of intrastate access toward interstate rates, which was completed in 1999. By order dated July 21, 2009, the Commission froze switched access rates at current levels for all LECs that have elected retail rate deregulation, pending the Commission addressing access charges in a generic proceeding.[50] The current BellSouth per-minute, two-ended intrastate access rate is almost identical to interstate rates at $0.0092, compared with an interstate rate of $0.0088.[51]

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[47] *Id.* The TRA's Order also required "the long distance companies certified to provide service within Tennessee to file tariffs as described in (TRA) Rule 1220-4-.55(2)(d). That rule requires the long distance companies to flow- through this access reduction to ratepayers in the form of lower long distance rates."

[48] *Re: Qwest Corporation, UT 125/Phase II,* Order No. 01-810, 213 P.U.R. 4th 78 (2001).

[49] BellSouth Telecommunications, Inc. Mississippi, Access Services Tariff, effective January 1, 2008.

[50] NCUC Order, Docket No. P100, sub. 165 (July 21, 2009).

[51] *See generally,* BellSouth Access Services Tariff, sec. E.6, for Mississippi, North Carolina, Alabama, South Carolina and Florida.

Wisconsin Mandates Intrastate/Interstate Parity by Statute, but Ties Access Reform to a Carrier's Plan for Alternative Regulation/Price Regulation

Wisconsin establishes intrastate-interstate switched access parity by statute, but ties the reduction to parity to a participating local exchange carrier's plan for alternative regulation. This approach generally produces, at a minimum, a revenue-neutral event.

Wisconsin: ILECs - Wisconsin statutes establish a system for local exchange companies to elect price regulation, and for price-regulated local companies to reduce intrastate access rates to interstate levels.[52] Price-regulated local exchange carriers with more than 150,000 local lines are directed that "Intrastate access service rates ... may not exceed the utility's interstate rates for similar access services."[53] The directive includes eliminating half of all carrier common line charges within one year, a prohibition against reinstating these charges, and elimination of all carrier common line charges within the earlier of two years or receipt of authorization to provide interLATA services.[54] The statute provided a more graduated scale for access reductions for carriers with fewer than 150,000 lines.[55]

Wisconsin's statutes also establish a system to allow a telecommunications utility to file for approval of an alternative regulation plan ("ARP").[56] The statute lists factors that the Commission must assess in considering an ARP, but there is no specific requirement regarding intrastate switched access charge reductions. Carriers typically include such reductions in their plans, but the reductions are not required to establish parity with interstate rates. Typically, these rates are set with reference to benchmarks the Commission established in a 1993 proceeding.

Only Verizon and AT&T have elected price regulation. Therefore, they are the only ILECs subject to the state's mirroring requirement. All other independent companies are either regulated through the terms of their alternate regulation plan or have retained rate of return regulation.

CLECs – There are no state rules limiting CLECs' intrastate switched access rates.

Nevada Requires That Intrastate Switched Access Rates Be Consistent With Federal Law

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[52] *See generally*, Wis. Stat. Ann. 196.196.

[53] *Id* at 196.196(2)(b)1.

[54] *Id.* at 196.196(2)(b)1-3.

[55] *Id.* at 196.196(2)(b)3.(c).

[56] Wis. Stat. Ann. 196.195(12).

Nevada: Large ILECs - The rates, terms and conditions for switched access services are currently regulated in Nevada and must be consistent with federal law.[57] Carriers may reduce switched access charges to parity with the associated interstate switched access rates without a rate proceeding.

CLECs - The Public Utilities Commission of Nevada may deregulate switched access services provided by a CLEC upon its own motion or acting upon a carrier petition.[58]

Addendum

Additional States that Place Limits on CLEC Intrastate Switched Access Rates

The following states place limits upon CLEC switched access rates that are in most cases tied to the intrastate rates of incumbent LECs against which they compete.

Alaska: CLEC access rates are capped at the underlying ILEC's access rate.[59]

California: Effective January 1, 2009, CLEC access rates are capped at the higher of AT&T's or Verizon's intrastate access charges plus 10%. In addition, each intrastate rate charge element is capped at the level of AT&T or Verizon for the same element, plus 10%.[60]

Colorado: CLEC intrastate switched access rates must be cost based as determined by the Commission, and may not exceed the average price by rate element in effect on July 1, 1987.[61]

Connecticut: CLEC intrastate access rates are capped at $0.015 per minute, an amount equal to the principal ILEC's (AT&T's) access rate, which the Department of Public Utility Control ("DPUC") had reduced to cost based levels. Carriers seeking to charge a higher rate must provide a cost of service study to demonstrate a need for higher rates.[62]

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[57] Nevada Revised Statutes 704.68873.

[58] Nevada Revised Statutes 704.68879.

[59] Regulatory Commission of Alaska, Alaska Intrastate Interexchange Access Charge Manual, sec. 102.

[60] *In re Review Policies Concerning Intrastate Carrier Access Charges*, 2007 W.L. 5086757 (Ca PUC 2007).

[61] *I/M/O Emergency Rules Relating to Default Regulation of Competitive local Exchange Carriers*, 2006 WL 2135500 (Colo. P.U.C.) 2006 WL 2135500, Rule 2203 (a)(II).

[62] *Re Intrastate Carrier Access Charges – Court Ruling*, Docket No. 02-05-17, 2005 WL 1566747 (June 15, 2005).

Delaware: No CLEC may charge switched access rates under tariff that are higher than the tariffed switched access rates of the service provider serving the largest number of local exchange access lines in the state.[63]

Louisiana: CLECs may not charge switched access rates that exceed the rates of the competing ILEC in each of the CLEC's certificated territories.[64]

Maryland: CLEC switched access rates are capped at the level of the principal ILEC (Verizon). Proposed access rates at or below the level of Verizon are deemed just and reasonable. Rates exceeding Verizon's rates must be supported with adequate cost data.[65]

New Hampshire: CLECs may not charge access rates greater than those charged by the ILEC.[66]

New York: CLEC switched access rates may not exceed those of the largest carrier in the LATA without a showing that higher rates are cost-based and in the public interest.[67]

South Dakota: CLECs (as all other LECs) must either file a cost study justifying its access rates or file a waiver to charge the average rate of all South Dakota carriers.[68]

Washington:CLEC intrastate rates for terminating switched access must not exceed the rates charged by the ILEC for terminating access service in the comparable geographic area, including any applicable universal service rate.[69]

Wyoming: CLEC rates for switched access service are capped at $0.03/minute for originating and terminating access as of January 1, 2010.[70]

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[63] Del. Code sec. 707(e)

[64] Louisiana Public Service Commission Regulations for Competition in the Local Telecommunications Market, sec. 301-K-4.

[65] *Re Intelenet of Maryland, Inc., Re Policies Regarding Competitive Local Exchange Telephone Service*, Case 8584 Phase II, Order No. 72348 (December 28, 1995), 1995 WL 848272 (Md. P.S.C.).

[66] N. H. Public Utility Commission Rule 431.07.

[67] *Proceeding on Motion of Commission to Examine Issues relating to Continuing Provision of Universal Service*, N.Y.P.S.C. Case No. 94-C-0095, 28425, 1998 WL 518159 (Jure 02, 1998).

[68] S.D. PUC Rules, Chapter 20:10:27-29.

[69] Washington Administrative Code 480-120-540(2).

[70] Wyoming Statutes sec. 37-15-203(j).

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October 27, 2009

The Honorable Henry A. Waxman
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The Honorable Rick Boucher
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The Honorable Bart Stupak
Chairman
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Dear Chairmen Waxman, Boucher, and Stupak:

I am responding to your letter to our Chairman and CEO, Randall Stephenson, dated October 14, 2009. AT&T is pleased to assist the Committee in its review of traffic pumping abuses of the access charge regime that governs compensation for the termination of long distance calls to the local premises of actual end users.

Traffic pumping schemes involve unscrupulous incumbent local exchange carriers ("ILECs"), as well as "competitive" local exchange carriers ("CLECs"), many established for the sole purpose of engaging in scams, that: (i) establish grossly excessive access charges under false pretenses; (ii) offer kickbacks to operators of calling services that agree to advertise their services (typically for "free") to anyone who dials telephone numbers assigned by the LECs; and (iii) bill AT&T and other interexchange carriers ("IXCs") "terminating" access charges for millions of calls and billions of minutes of communications between non-residents of the small communities the LECs purport to serve. AT&T and others are engaged in litigation with many current perpetrators for their violations of existing law, but given the ease with which these schemes are implemented and shifted rapidly to other locations, it is clear that after-the-fact, case-by-case litigation could never fully protect the public interest. Accordingly, AT&T and others have also sought action from the FCC and state commissions to put an end to these

practices. Legitimate competitive LECs and conference service providers have likewise urged the FCC to put an end to traffic pumping abuses.[1]

The enormous public harms from these schemes are well-documented and indisputable. By significantly inflating long distance carriers' costs, traffic pumping forces ordinary long-distance customers throughout the nation to fund the schemers' windfall profits. The lure of those windfall profits has diverted the resources and focus of real LECs away from their proper role of providing high quality local services to actual residents. These schemes have depleted already strained universal service fund resources, as traffic pumping LECs ("TP LECs") seek and obtain millions of dollars in high-cost Universal Service Fund ("USF") support on the basis of "access lines" they claim to provide to their free calling service partners. Traffic pumping can degrade service to ordinary customers by clogging up transport and switching facilities. And, because these schemes use ordinary telephone numbers, they provide ungated access to "free" pornographic content, thus circumventing the laws designed to ensure that parents can prevent their children from accessing such content.[2]

One need only consider the case of Aventure Communications Technology, LLC to understand the nature and scope of the traffic pumping problem. To obtain its Certificate of Public Convenience and Necessity and its eligibility for universal service support, Aventure represented to the Iowa Utilities Board ("IUB") that it intended to provide local exchange service in numerous rural exchanges in Iowa and aggressively to market those services to the Iowa residents of those communities. Instead, Aventure set up chat and other traffic pumping schemes – which it did exclusively for more than two years, without constructing a local exchange network and without serving a single real Iowa resident Iowa residential service customer. To inflate its access revenues even further, Aventure concocted a truly absurd call routing scheme that had it billing for more than 200 miles of "local" transport through three states. Aventure has received further windfalls in the form of millions of dollars in USF high-cost support by representing that it would use moneys it received to provide USF-supported services and by misrepresenting the number of lines it served.

Traffic pumping schemes are unlawful in many respects, as the Iowa Utilities Board ("IUB") recently concluded after an exhaustive review of an extensive factual record developed in a two year proceeding involving eight incumbent and competitive LECs operating in rural

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1 *See, e.g.*, Ex parte letter from Counsel to the Rural Independent Competitive Alliance to FCC filed October 23, 2008 in FCC Docket No. 07-135 ("RICA agrees that the access stimulation issues may be addressed by establishing a requirement for CLECs to revise and reduce their tariff access rates in the event that traffic exceeds specified thresholds"); Ex Parte letter from David Frankel, CEO of ZipDX LLC to FCC, filed August 28, 2009 in FCC Docket No. 07-135 ("the abuse of rural access charges has been allowed to linger for far too long. . . . This undermines fragile funding mechanisms and will impede broadband enhancements. Rule clarifications proposed by ZipDX are non-controversial for any legitimate player not attempting to game the system").

2 *See* 47 U.S.C. § 228.

areas of Iowa that have been a hotbed of traffic pumping activity. The IUB found that these TP LECs violated their own tariffs, violated the law and, in a failed effort to hide their unlawful behavior, even fabricated and backdated documents in an attempt to transform their free calling partners into "end user customers" and their own switching facilities where the chat and conferencing equipment was located into "end user premises."

As described in more detail below, the IUB proceeding, which addresses Iowa *intra*state access charges, is one of many ongoing proceedings currently pending before federal courts and the FCC in which the lawfulness of the LECs' access charge billings in connection with traffic pumping schemes is being litigated. To be clear, AT&T is complying with the FCC's June 2007 declaratory ruling that prohibits call blocking.[3] Rather, AT&T continues to deliver calls associated with the traffic pumping schemes, and, in accordance with the TP LECs' own tariffs and established law, has followed accepted industry practices by disputing the charges and withholding payment pending resolution of those disputes.

Against this backdrop, we respond below to your specific questions.

1. **Is your company currently engaged in any disputes with rural ILECs or other rural carriers over the payment of terminating access charges?**

   a. **If so, please describe the nature and basis of such disputes and provide the Committee with the names of those companies and the total disputed dollar amount at issue in each dispute with each company.**

   b. **Please describe all steps your company has taken in these disputes. For example, is your company currently involved in litigation or regulatory proceedings related to the disputes?**

AT&T is currently involved in a number of access charge disputes with traffic pumping LECs. In 2006 the traffic volumes and corresponding billings of certain LECs located in very rural areas inexplicably began to skyrocket. These rural areas are sparsely populated (often only a few hundred people) and have typical call volumes of only a few thousand minutes per month. Yet, suddenly, and with no explanation, some LECs began billing AT&T for millions – even tens of millions – of minutes per month for calls to these rural areas. Even if every resident of these areas spent every waking minute of every day on long-distance calls, the resulting call volumes still would not even begin to approach the billed call volumes. As just one example, a "competitive" LEC that was supposedly serving customers in very sparsely populated areas on the border of Utah and Nevada suddenly began in April 2006 to bill AT&T terminating access for more than *ten million* minutes of calls in a single month.

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[3] *See* Declaratory Ruling and Order, Establishing Just and Reasonable Rates for Local Exchange Carriers, 22 FCC 2d. 11629, ¶ 5 (2007) ("carriers cannot engage in self help by blocking traffic to LECs allegedly engaged in the [traffic pumping] conduct described herein").

AT&T began investigating these unusual calling volumes and discovered that virtually all of these calls were placed to only a few telephone numbers. AT&T personnel called these numbers and determined that they were associated with so-called "free" chat and conference services, international calling, and other services. Several of the "chat lines" offered obscene and pornographic content and allowed as many as 270 out-of-state callers simultaneously to conduct conversations by calling a single telephone number, typically with the capability for callers to access a "back room" to conduct one-on-one conversations. Other telephone numbers provided "free" international calling by allowing callers to dial an Iowa (or Minnesota, Utah or South Dakota) telephone number and then enter an international telephone number to which the TP LEC would then route the call. At least one TP LEC appeared to be using autodialing equipment to place tens of thousands of calls to both wireless and wireline customers in an attempt to entice them (*e.g.*, by offering commercial credit cards, often *without* the knowledge of the credit card company) to call a telephone number in the TP LEC's local exchange, and when such customers placed those calls, the TP LEC billed terminating access service fees to the long distance carrier that delivered the call. None of the high volume telephone numbers AT&T investigated appeared to be associated with any actual residential or business customers of these LECs. And for each minute associated with these schemes, the TP LECs were billing extremely high access charges, typically 3 to 10 cents/minute (and in one case more than 23 cents/minute).

Upon discovering that these TP LECs were engaged in these traffic pumping schemes, AT&T informed them that it was disputing their charges, and, in early 2007, AT&T initiated litigation in Iowa against many of the TP LECs and calling service providers engaged in these schemes. This was the first of many lawsuits, some initiated by AT&T and/or other interexchange carriers and some initiated by TP LECs. Some of these disputes have since been settled under confidential terms, but others continue to be actively litigated.

In July 2007, the FCC suspended the tariff filings of a number of incumbent LECs suspected of engaging in (or preparing to engage in) traffic pumping, ordering them either to prove that their charges were lawful by providing cost justification or to return to the National Exchange Carriers Association ("NECA") tariff "pool," where they could no longer profitably engage in such schemes (because any earnings would then be shared with the hundreds of other LECs that participate in the NECA pool, making it impossible for the TP LEC to pay the necessary kickbacks to its free calling partners).[4] Although traffic pumping activity by incumbent LECs has fallen off dramatically in the wake of this FCC decision, supposed "competitive" LECs, which operate under different rules, have more than made up the difference – indeed, there are now individual "rural" CLECs that are generating more than 100 million minutes of traffic pumping calls *each month*.

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[4] *See* Order Designating Issues for Investigation, *Investigation of Certain 2007 Annual Access* Tariffs, 22 FCC Rcd. 16109 (2007). The FCC also provided the LECs with a third option under which they were required to add terms to their tariffs that they would immediately and significantly reduce their access rates if their traffic volumes increased significantly, thus significantly reducing incentives to engage in traffic pumping. *Id.*

Federal Court Litigation. Today AT&T is involved in the following federal court lawsuits against traffic pumping LECs: (i) in the Southern District of New York, AT&T is involved in litigation with All American Telephone Company, Chase.Com and E-Pinnacle (all Utah/Nevada CLECs); discovery is ongoing in this dispute that involves approximately $15 million in access billings to AT&T; (ii) in the Southern District of Iowa, AT&T is involved in litigation with Aventure Communications Technology, LLC (an Iowa CLEC); this case, which involves approximately $15 million in access billings to AT&T, is currently stayed pending action by the FCC; and (iii) in South Dakota District Court, AT&T is involved in litigation with Sancom Inc. and Northern Valley Communications, LLC (both South Dakota CLECs); discovery is ongoing in this dispute that involves approximately $25 million in access billings to AT&T.

State Public Utility Commission Proceedings. AT&T is also a party to ongoing proceedings related to the Iowa Utilities Board's September 21, 2009 Order.[5] In that order, the IUB – after more than two years of proceedings that included depositions and document discovery from traffic pumping LECs, thousands of pages of briefing and expert testimony, and live hearings – found that the traffic pumping LECs had "manufacture[d] evidence, after the fact" and "concealed truths from the Board and the FCC" to make it appear that their free calling service partners' ("FCSPs") bridging and other equipment were "end users" and that the LEC central offices where that equipment was located were "end user premises" that justified the billing of terminating access charges for calls to such equipment. *Id.* at 30, 34. The IUB found that, in truth, "none of the FCSCs associated with the [LECs] were end users for purposes of the [LECs'] intrastate exchange access tariffs, none of the intrastate toll traffic associated with the FCSCs terminated at the end user's premises, and much of the intrastate toll traffic associated with the FCSCs did not terminate in the Respondents' certificated local exchange area." *Id.* at 53-54. The IUB thus concluded that "intrastate access charges did not apply to calls to the FCSCs and should not have been billed to the IXCs for calls to nu.nbers assigned to the FCSCs." *Id.*[6]

AT&T is a participant in additional proceedings before the IUB that have been initiated in response to this IUB Order. First, the traffic pumping LECs have filed petitions for reconsideration of the order, and AT&T is opposing those petitions. Second, pursuant to the IUB

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5 *See, e.g., Qwest v. Superior Tel. Coop.*, Final Order, Docket No. FCU 07-2, at 61-62 (Iowa Utilities Board, Sep. 21, 2009) ("IUB Order").

6 The IUB was especially troubled by the fact that the LECs had "partnered with FCSCs that provided free calling services for indecent or pornographic content" and that "there were no technological measures in place to protect minors from making calls to access these pornographic services, such as a 1-900 number, which enables parents to place a block on the call." IUB Order At 61-62. The Board found this "lack of any mechanism for parents to regulate their minor children's access to pornographic or indecent services over the telephone is contrary to the public interest." *Id.* In addition, the IUB further found that these traffic pumping schemes led to "other schemes, such as the improper backdating of invoices and contracts, traffic laundering, telephone numbering abuses, and potentially misrepresented universal service fund (USF) certifications." *Id.* at 8.

Order, there are ongoing proceedings to determine the amount of refunds that the Iowa traffic pumping LECs owe to AT&T and other long-distance carriers. Third, the IUB has opened a rulemaking proceeding to adopt rules designed prospectively to discourage traffic pumping.

AT&T is also a participant in proceedings that the Public Service Commission of Utah has initiated to assess whether All American's state authorization should be rescinded. The certificate that Utah granted to All American in 2006 was expressly conditioned on All American's representation that it would not provide service in rural portions of the state. In fact, All American has operated *solely* in the areas it said it would not serve, has no real customers, and has done nothing but engage in traffic pumping.

FCC Proceedings. AT&T is also a party to three ongoing FCC proceedings involving traffic pumping. First, AT&T is opposing frivolous petitions filed by Iowa TP LECs seeking to have the FCC preempt the IUB Order. The IUB Order addressed *intra*state terminating access charges that Congress placed squarely within the jurisdiction of the IUB.

Second, AT&T is participating in a rulemaking proceeding initiated by the FCC in 2007 in response to allegations of traffic pumping to assess the need for rule changes to ensure that "rules governing the tariffing of traffic-sensitive switched access services by local exchange carriers (LECs) are ensuring that rates remain just and reasonable, as required by section 201(b) of the Communications Act of 1934, as amended (the Act)."[7]

Third, pursuant to a referral order by the United States District Court for the Southern District of New York, AT&T has filed a complaint with the FCC against All-American, Chase.Com, and e-Pinnacle for engaging in a scheme to create sham entities solely for the purpose inflating access charges. Under this scheme, an ILEC called Beehive Telephone Company and its traffic pumping partner Joy Enterprises – an adult chat line operator – devised a plan to avoid the FCC rules that would have required Beehive to reduce its access rates to reflect the enormous amount of Joy-related traffic volumes it was generating. The plan was to create "competitive" LECs to bill the access charges for the traffic pumping minutes, so that those additional volumes would not be attributed to Beehive. To accomplish the shift, Beehive and Joy made a few paper changes, such as reassignment of Beehive's telephone numbers and facilities to All American, Chase.Com and e-Pinnacle, so that these CLECs would then bill AT&T for the traffic associated with the Beehive/Joy traffic pumping schemes. As AT&T's complaint explains, it has long been settled that creating "a company that purport[s] to be a bona fide carrier but which instead [is] simply a sham creation, designed to facilitate an arrangement among several entities to capture access revenues that could not otherwise be obtained by lawful tariffs" is an unjust and unreasonable practice that violates the Communications Act.[8]

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[7] Notice of Proposed Rulemaking, *Establishing Just and Reasonable Rates for Local Exchange Carriers*, 22 FCC Rcd 17989, ¶ 1 (2007).

[8] *AT&T and Sprint Petitions for Declaratory Ruling on CLEC Access Charge Issues*, 16 FCC Rcd. 19158, ¶ 22, n.33 (2001) ("*CLEC Access Declaratory Ruling*"); *see Establishing Just and Reasonable Rates for Local Exchange Carriers*, 22 FCC Rcd. 11629, ¶ 6 n.20 (the

2. Has your company withheld payment of access charges relating to disagreements about the appropriate rate?

a. If so, when did your company begin withholding payments and how much was withheld or is being withheld from whom?

As permitted by established FCC precedent and the TP LECs' tariffs, AT&T has disputed and withheld payment of certain access charge billings associated with traffic pumping.[9] AT&T is currently withholding payment of terminating access charges from the following TP LECs: All American Telephone Company (as of April, 2006), Aventure Communications Technology (as of October, 2006), Chase.Com (as of April, 2006), E-Pinnacle (as of April, 2006), North County (as of September, 2008), Northern Valley Communications (as of January, 2008), Sancom (as of January, 2008), Spencer Municipal Communications Utility (as of January, 2008), and Capital Telephone Company (as of July 2007). The total amount of disputed charges that AT&T has withheld pending resolution of the disputes is approximately $60 million as of September 30, 2009.

3. What do you estimate the actual cost of terminating traffic to be on a per minute basis?

Although traffic pumping LECs have not disclosed their costs associated with their traffic pumping schemes, the public filings of NECA confirm that, to the extent they incur any costs at

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Commission has "found that an arrangement between a chat line service provider and competitive access provider (formed by an ILEC for purposes of the arrangement) that did not provide local exchange service and had no customers other than the chat line was a sham"); *AT&T Corp.* v. *FCC*, 317 F.3d 227, 233 (D.C.Cir. 2008) ("the entire arrangement was devised solely in order to circumvent regulation . . . [and] deserves to be treated as a sham").

[9] It is well established that the "responsibility for correct billings remains with the carriers" providing the service, *e.g., Tele-Valuation, Inc.* v. *AT&T Corp.*, 73 F.C.C.2d 450, ¶ 8 (1979), and that access customers are not obligated to pay for tariffed services that were not actually provided. *See, e.g., Iowa Network Servs., Inc.* v. *Qwest*, 385 F.Supp. 2d 850, 903-04 (S.D. Iowa 2005), *aff'd* 466 F.3d 1090 (8th Cir. 2006) (carrier under no obligation to pay where services were not provided under a "valid and applicable tariff"). Certain TP LECs have claimed that prior FCC decisions have held that it is illegal "self-help" to withhold payment for tariffed services, but those decisions arose in circumstances where, unlike here, it was undisputed that the tariffed services were actually provided and properly billed pursuant to an applicable tariff. *See, e.g., Business WATS, Inc.* v. *AT&T*, 7 FCC Rcd. 7942, ¶ 2 (1992). Indeed, the TP LECs' tariffs expressly contemplate that an access customer may withhold payment of terminating access charges pending the resolution of a dispute over whether service has been provided and charges have been properly assessed, *see, e.g.*, Northern Valley Commc'ns L.L.C., F.C.C. Tariff No. 2, § 2.4.1(D)(4) (effective Nov. 16, 2004), and the language in these tariffs is indistinguishable from the language in other tariffs that the FCC has authoritatively interpreted, concluding that "a customer may withhold payment of disputed charges pending resolution of the dispute." *See AT&T v. Beehive*, 17 FCC Rcd. 11641, ¶ 26 & n.91 (2002).

all, the per minute costs incurred by traffic pumping LECs (even accounting for a reasonable return) to deliver traffic to the bridging equipment of their free calling partners is exceedingly small (and certainly much less than one tenth of a penny per minute).

NECA represents rural ILECs subject to FCC cost of service regulation. Pursuant to the FCC's rules, NECA makes annual filings with the FCC that report the costs of its member ILECs. The highest cost annual report submitted by NECA ("Band 8") reports the costs and computes rates for the smallest rural ILECs. As of June 2009, there were 490 rural ILECs represented in the Band 8.[10] These ILECs have an average of 1,500 lines[11] serving widely dispersed residential and business customers that generate an average of less than 500 minutes of exchange access traffic per month per line.[12]

Based on this network cost structure – one designed to serve widely dispersed residential and business customers that make relatively few calls – NECA has developed a per minute access rate that allows Band 8 ILECs to recover these costs plus an 11.25 percent return. To compute these rates, NECA estimates the average cost of the switches, lines, and other infrastructure used by such LECs to serve their residential and business customers and spreads those costs over the total number of annual access minutes that Band 8 ILECs are expected to serve, which for 2009 is 3.5 million minutes.[13] Based on these calculations, NECA reported to the FCC in 2009 that Band 8 LECs must charge about 3.3 cents per minute to recover their

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[10] *See* National Exchange Carrier Association, Inc., Access Service Tariff F.C.C. No. 5, Transmittal NO. 1245, (filed with the FCC, June 15, 2009).

[11] The most recent publicly available report showing the number of lines for NECA band 8 ILECs is for 2007 from a report filed on Sep. 30, 2008 (*see* NECA's Overview of Universal Service Fund, USF08AF.ZIP, available at http://www.fcc.gov/wcb/iatd/neca.html). The 2009 report has not yet been submitted to the FCC. However, the line counts are not likely to change significantly because the number of lines served by band 8 ILECs has historically varied very little.

[12] To compute the average monthly minutes per line for Band 8 LECs, AT&T divided the total number of minutes generated by Band 8 ILECs in 2008 as reported by NECA (*see* Network Usage by Carrier, Annual submission by NECA of Access Minutes of Use, NETWU08.ZIP, available at http://www.fcc.gov/wcb/iatd/neca.html) by 12 (to obtain average monthly minutes) and then AT&T divided that amount by the number of lines for Band 8 LECs.

[13] To compute the average minutes per year for Band 8 LECs, AT&T divided the total number of minutes generated by Band 8 ILECs in 2008 as reported by NECA (*see* Network Usage by Carrier, Annual submission by NECA of Access Minutes of Use, NETWU08.ZIP, available at http://www.fcc.gov/wcb/iatd/neca.html) by the total number of NECA members reported by NECA as of June 2009 (*see* National Exchange Carrier Association, Inc., Access Service Tariff F.C.C. No. 5, Transmittal NO. 1245 (filed with the FCC, June 15, 2009)).

facilities costs and earn an 11.25 percent return.[14] This is the rate "mirrored" by many so-called rural CLECs that are engaged in traffic pumping.

Given these calculations, it is clear that, even if traffic pumping LECs had the same cost structure as the Band 8 NECA ILECs (in fact, as shown below traffic pumping LECs' incur much, much lower costs to the extent they incur any real costs at all), the per minute rates that traffic pumping LECs need to recover those costs would be a tiny fraction of the NECA rate. Whereas Band 8 LECs must spread their costs over an average of only about 3.5 million minutes per year, the pornographic chat and other services offered by traffic pumpers routinely generate that much traffic each *month* (and often much more). A traffic pumping LEC with typical NECA band 8 cost structure that generates monthly volume of 3.5 million minutes could recover its costs and a reasonable return by charging less than one third of a cent per minute.[15]

But even that greatly overstates the rate needed by TP LECs to recover their costs and earn a return, because the cost structure for TP LECs is not remotely similar to that of Band 8 ILECs. Whereas Band 8 ILECs have built out actual network infrastructure with lengthy wire "loops" buried or strung on poles to serve hundreds of widely dispersed residences and businesses located in their services areas, many TP LECs have built virtually nothing to serve their free calling partners. Rather, such LECs typically co-locate bridging and other equipment in the central office near the switch, so that connecting their partners' equipment requires only few feet of cables. Some traffic pumpers even avoid the cost of the switch by collocating their traffic pumping equipment in a central office of another LEC and by relying on that other LEC's switch to direct their traffic pumping calls to their equipment. Consequently, the costs that traffic pumping LECs must recover through their per minute rates are only a tiny fraction of the costs that must be recovered by Band 8 ILECs, which means that the actual per minute rates that traffic pumping LECs need to recover their costs are extremely small, and certainly well below a tenth of a penny per minute.

4. Do you charge other carriers to terminate traffic on your network? If so, how much do you charge for terminating access on a per minute basis? If you charge different rates in different areas, please provide a range of charges.

AT&T provides and charges others for both interstate and intrastate terminating access services, as follows:

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[14] *See* National Exchange Carrier Association, Inc., Access Service Tariff F.C.C. No. 5, Transmittal NO. 1245, Vol 5, Exhibit 12, Workpaper 1 of 12 (filed with the FCC, June 15, 2009).

[15] As the FCC has pointed out, the additional costs of serving more minutes are very low or zero. *See, e.g.,* Notice of Proposed Rulemaking, *Establishing Just and Reasonable Rates for Local Exchange Carriers,* WC Docket No. 07-136, ¶ 14 (released Oct. 2, 2007) ("It is well established that there is a large fixed cost to purchasing a local switch and that the marginal or incremental cost of increasing the capacity of a local switch is low (some contend that it is zero.").

Within AT&T's 22 state franchise service areas, AT&T operates both as an ILEC and, to a limited extent, as a CLEC. AT&T's interstate rates are governed by federal law. AT&T's ILEC per minute interstate terminating access rates, for example, are governed by the FCC's "CALLS Order."[16] AT&T's intrastate access charges are subject to applicable state laws. Some states require that AT&T's intrastate terminating access rates mirror its interstate rates, and other states provide for different intrastate access rates. Overall AT&T's statewide average per minute terminating access charges within AT&T's franchise service areas fall within the range of about a tenth of a penny up to about a half a penny per minute.

Outside of AT&T's franchise territory, AT&T operates only as a CLEC. Rates vary by and within states. Overall, AT&T's statewide average per minute terminating access charges outside of AT&T's franchise area range from about four tenths of a penny to about 1.3 cents per minute.

5. How much do you receive annually in terminating access charges?

The total amount of terminating access charges that AT&T ILECs and CLECs receive can depend upon many factors. For the calendar year 2008 the AT&T ILECs and CLECs provided, in total, between $700 million and $800 million in per minute terminating access services to their access customers to allow them to complete calls over AT&T's local telephone networks that provide wireline connections to tens of millions of residences and businesses.

6. How much do you pay to others in terminating access charges?

The total amount of terminating access charges that AT&T pays to others can depend upon many factors. For the calendar year 2008 AT&T paid to others between $700 million and $800 million in per minute terminating access charges.

* * * *

We trust that the foregoing information aids in your understanding of these issues. We respectfully suggest that, to ensure that you have a comprehensive view of the ways in which the legacy access charge regime suffers from and enables fraud and abuse, you not limit your inquiry by focusing on either the providers of end-user calling services, such as Google Voice, or the LECs that engage in traffic pumping schemes. Calling services like Google Voice, MagicJack and Speakeasy are enabled by wholesale transport providers partners like Bandwidth.com and YMax. These transport providers play an increasingly central role in the transiting of traffic, but the manner in which they assess and pay access charges is often unclear and potentially inconsistent with existing rules and limitations; therefore, they, too, deserve your thoughtful attention. For instance, it would be helpful to understand whether, in connection with Google Voice, Bandwidth.com or any other CLEC assesses originating or terminating switched access on calls in-bound to a Google Voice number or on 8YY toll-free calls placed by a Google Voice

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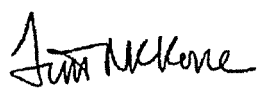
[16] Sixth Report and Order, Access Charge Reform, *Price Cap Performance Review for Local Exchange Carriers*, 15 FCC Rcd. 12962 (2000).

user and, if so, whether the assessment is for the entire duration of the calls, which network facilities are used in each circumstance, and what, if any, access functions are actually performed. This type of information would better inform you, the FCC and other stakeholders regarding the best way to guard against further abuses of the access charge framework. In this regard, it is important to understand the disproportional impact of traffic pumping on inter-exchange carriers such as AT&T given that providers such as Google Voice, MagicJack and Speakeasy take the position that they are not subject to the FCC order prohibiting the blocking of calls to high cost rural areas.

Please let me know if we can be of further assistance in connection with these matters.

Sincerely,



cc: The Honorable Joe Barton, Ranking Member
The Honorable Cliff Stearns, Ranking Member
Subcommittee on Communications,
Technology, and the Internet
The Honorable Greg Walden, Ranking Member
Subcommmittee on Oversight and
Investigations

Exhibit OAO-7

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