BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Joint Petition of Verizon Communications, Inc. and MCI, Inc. For a Declaratory Order Disclaiming Jurisdiction Over or, in the Alternative a Joint Application for Approval of, Agreement and Plan of Merger	)))))))))))	Docket No. UT-050814

ERRATA
DIRECT TESTIMONY OF CHARLES W. KING

ON BEHALF OF

THE PUBLIC COUNSEL SECTION
OF THE
WASHINGTON ATTORNEY GENERAL

Corrected October 5, 2005

REDACTED

DIRECT TESTIMONY OF CHARLES W. KING (CWK-1HC)

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1 **I. INTRODUCTION**

2 **Q. Please state your name, position and business address.**

3 A. My name is Charles W. King. I am President of the economic consulting firm of
4 Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business
5 address is 1220 L Street, N.W., Suite 410, Washington, D.C. 20005.

6 **Q. Please describe Snavely King.**

7 A. Snavely King, formerly Snavely, King & Associates, Inc., was founded in 1970 to
8 conduct research on a consulting basis into the rates, revenues, costs and
9 economic performance of regulated firms and industries. The firm has a
10 professional staff of twelve economists, accountants, engineers and cost analysts.
11 Most of its work involves the development, preparation and presentation of expert
12 witness testimony before federal and state regulatory agencies. Over the course
13 of its 35-year history, members of the firm have participated in over 1000
14 proceedings before almost all of the state commissions and all federal
15 commissions that regulate utilities or transportation industries.

16 **Q. Have you prepared a summary of your qualifications and experience?**

17 A. Yes. Exhibit No. ___ (CWK-2) is a summary of my qualifications and
18 experience.

19 **Q. Have you previously submitted testimony in regulatory proceedings?**

20 A. Yes. Exhibit No. ___ (CWK-3) is a tabulation of my appearances as an expert
21 witness before state and federal regulatory agencies.

22 **Q. For whom are you appearing in this proceeding?**

23 A. I am appearing on behalf of the Public Counsel Section of the Washington Office
24 of the Attorney General ("Public Counsel").

25 **Q. What is the objective of your testimony?**

1 A. The objective of my testimony is to analyze the financial synergies that will flow
2 from the Verizon/MCI merger and to recommend an appropriate sharing of those
3 merger savings for the benefit of Washington ratepayers.

4 **Q. What are your recommendations?**

5 A. Verizon estimates that its merger with MCI will generate a present value of over
6 $7 billion in "synergies" in the form of increased revenue and reduced cost.
7 Washington ratepayers of both Verizon and MCI are entitled to share in these
8 synergies. Verizon ratepayers have hitherto borne the burden of the Company's
9 increased costs, and so it is appropriate that they should share in benefit of
10 reduced costs. Additionally, as described in Dr. Roycroft's testimony, the merger
11 will reduce the leverage of consumers to seek out the lowest prices and best
12 service among competing telecommunication providers. The effect of this loss of
13 competition cannot be quantified in dollar terms, but it represents a further
14 justification for the sharing of merger savings between the merged company and
15 its ratepayers.

16 For Verizon's ratepayers, I recommend that the preferred method of
17 sharing the merger synergies is to return them as rate reductions as a $1.00
18 monthly offset to the scheduled 2007 rate increase. For MCI customers, I
19 recommend an allocation of $1.00 per month per line synergy savings as imputed
20 revenue in any rate case.

21

22 **II. JUSTIFICATION FOR SHARING MERGER SYNERGIES**

23 **Q. What are the standards for judging the propriety of a merger between two**
24 **telecommunications providers?**

1 A. RCW 80.12.020 prohibits a public utility from merging or consolidating any of its
2 franchises, properties or facilities, by any means whatsoever, whether directly or
3 indirectly, without an order from the Commission authorizing the merger.

4 Under WAC 480-143-170, if the Commission finds after examination of
5 the application for merger that it is not in the public interest, it shall deny the
6 application.

7 In Docket UE-981627, the application of Scottish Power to acquire
8 PacifiCorp, the Commission set forth the standard for approval of a merger
9 transaction, as follows:
10
11 The standard in our rule does not require the Applicants to
12 show that customers, or the public generally, will be made
13 better off if the transaction is approved and goes forward.
14 In our view, Applicants' initial burden is satisfied if they at
15 least demonstrate no harm to the public interest.[1]

16 **Q. Does Verizon's application to acquire MCI result in "no harm to the public**
17 **interest?"**

18 A. In accompanying testimony, Dr. Trevor Roycroft discusses this issue extensively.
19 His conclusion is that as it stands the merger results in harm to the public interest
20 by reason of the reduction in competition for telecommunications services in
21 Washington.

22 **Q. What resolution does Dr. Roycroft recommend?**

23 A. Dr Roycroft recommends that a set of conditions be imposed on the merger in
24 order to alleviate harm to consumers. His recommendations focus primarily on
25 competition and service quality matters.

26 **Q. Is it appropriate for the Commission to impose financial and rate-related**
27 **conditions on the merger of Verizon and MCI?**
28

[1] Docket No. UE-981627, Third Supplemental Order on Prehearing Conference, April 2, 1999, at 2-3.

1 A. Yes. In addition to the conditions recommended by Dr. Roycroft, it is also
2 appropriate that there be monetary conditions in order for the merger to meet the
3 "no harm" standard enunciated by the Commission.

4 **Q. Is there Commission precedent for imposing financial and rate-related**
5 **conditions on mergers between utilities in Washington?**

6 A. Yes. On October 14, 1999, the Commission approved Scottish Power's
7 acquisition of PacifiCorp pursuant to a Settlement Agreement that called for a
8 merger credit of $3 million per year for four years. The approval was also
9 conditional on a commitment to fund an estimated $55 million in network
10 expenditures required to implement service standards outlined by Scottish Power.
11 The funds would be derived from efficiency savings and redirected internal
12 funding.[2]

13 In December 1999, the Commission approved Bell Atlantic Corporation's
14 acquisition of the GTE Corporation to form the company now called Verizon.
15 That approval was conditional on the terms of a Settlement Agreement among all
16 parties in the case. Among the conditions in the Settlement Agreement was the
17 commitment by GTE Northwest (now Verizon Northwest) to reduce rates for its
18 regulated services in Washington in four phases to achieve a $30 million annual
19 net revenue reduction.[3]

20 In June 2000, the Commission approved the merger of US WEST, Inc.,
21 and Qwest Communications International, Inc., conditioned on a number of
22 commitments by the merging companies. These included a multi-year rate freeze,
23 service quality performance program with financial penalties attached, and
24 investment commitments.[4]

[2] Docket No. UE-981627, Fifth Supplemental Order, October 14, 1999.
[3] Docket Nos. UT-981367, UT-990672 and UT-991164. Order Approving Merger, December 1999.
[4] Docket No. UT-991358, Order Approving Merger and Two Proposed Settlement Agreements, June 19, 2000.

1 **Q. What should be the basis of the monetary conditions?**

2 A. The basis should be a sharing of the synergies from the merger. Not to share
3 those synergies creates harm because it would deprive ratepayers of the benefit of
4 the lower revenue requirement resulting from the merger synergies. The effect is
5 the same as overcharging.

6 **Q. Is there Commission precedent for sharing the synergies from a merger**
7 **between ratepayers and the merging utilities' shareholders?**

8 A. Yes. The Commission ruled in the US West/Qwest merger that an important part
9 of the analysis of the public interest was an examination of merger synergies:
10

11 Applicants state that the merger will provide "substantial benefits"
12 to Washington consumers. They also claim "[t]he proposed merger
13 will produce economies of scope and scale." Application at 10. It
14 is appropriate to inquire into the nature and extent of the claimed
15 benefits. *As Public Counsel pointed out at the prehearing*
16 *conference, if the merger is approved, synergies may arise that*
17 *lead to cost savings and enhanced revenue. Conditions may be*
18 *required to ensure any such benefits are shared in a fashion that is*
19 *consistent with the public interest.* The transaction should strike a
20 balance among the interests of customers, shareholders, and the
21 broader public that is fair and that preserves affordable, efficient,
22 reliable, and available service.(emphasis supplied)[5]

23 **Q. In addition to these general principles, are there any reasons specific to this**
24 **merger why the Commission should consider the sharing of merger**
25 **synergies?**

26 A. Yes. In Docket Nos. UT-040788 and UT-040520, Verizon's ratepayers were
27 required to face an increase in rates because Verizon's costs had increased. The
28 Settlement Agreement of those cases, dated February 23, 2005, provided that
29 monthly rates would increase $2.43 per line for local service effective when the

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[5] *In Re Application of U S WEST, Inc. And QWEST COMMUNICATIONS INTERNATIONAL, INC.For An Order Disclaiming Jurisdiction, or in the Alternative, Approving the U S WEST, INC.--QWEST COMMUNICATIONS INTERNATIONAL, INC. Merger*, UT-991358, Third Supplemental Order Outlining Scope of Review, p. 5 (emphasis added).

1 Commission approves the settlement. Local service rates would increase by
2 another $1.47 on July 1, 2007. The total value of both increases was
3 $38,649,599.[6]

4 The Plan of Merger between Verizon and MCI was announced on
5 February 14, 2005, and subsequently amended on March 29 and May 1, 2005.
6 As a consequence, it was not possible to take the impact of the merger into
7 account in arriving at the February 23, 2005 rate case settlement. The rate case
8 Settlement Agreement, however, in acknowledgment of the possibility that a
9 merger would occur, preserved the Commission's ability to address financial
10 impact issues by providing, in Section D (Other Rate Changes or Proceedings)
11 that: "This Agreement does not affect the Commission's power on any issue in
12 merger, sales, or acquisition transactions that may require Commission
13 approval."[7]

14 Had the details of the $7 billion merger synergies been known at the time
15 of the rate case, the synergy savings could have been incorporated into the
16 calculation of Verizon's revenue requirement and would have been reflected in
17 marginally lower rates. Were a rate case to be initiated now, the synergy savings
18 would be captured in the revenue requirement calculation and in the consequent
19 rates. Since the savings were not captured, however, any merger synergies
20 realized by Verizon will accrue solely to its shareholders unless some adjustment
21 is made.

22 **Q. What should be the level of synergy sharing between ratepayers and**
23 **shareholders?**
24

[6] Docket Nos. UT-040788 and UT-040520, Settlement Agreement, February 25, 2005.¶¶ 23, 28, 35.
[7] *WUTC v. Verizon Northwest Inc.*, Docket Nos. UT- 040788, UT-040520, Settlement Agreement, ¶ 39. *See also*; Id. Narrative Supporting Settlement Agreement, ¶ 50 (re Commission retaining ability to address "merger benefits").

1 A. The minimum level of synergies that should be shared with ratepayers are the
2 reductions in costs and increases in revenues that would show up on a rate case
3 were one to be convened. The maximum level of synergies that should be shared
4 with ratepayers is an allocation of the total, global synergies achieved by the
5 merged companies. As I will discuss, many of these "non-jurisdictional"
6 synergies will flow to the benefit of the merged company's Washington intrastate
7 operations.
8
9 **III. OVERVIEW OF MERGER SAVINGS AND SYNERGIES**

10 **Q. Please describe the Verizon-MCI merger.**

11 A. Following a protracted competition with Qwest for the acquisition of MCI,
12 Verizon announced on February 14, 2005 that it would acquire MCI for $4.8
13 billion in equity and $488 million in cash. In addition, MCI would pay a special
14 dividend to its shareholders of $4.50 per share, worth $1.463 billion, bringing the
15 total value of the purchase to $6.7 billion. Verizon would be the surviving
16 company, although the MCI brand may survive for some applications.[8] This plan
17 of merger was amended on March 29 and May 1 to increase the benefit to MCI
18 shareholders.

19 **Q. What is the stated justification for the merger?**

20 A. The stated justification for the merger is the synergistic nature of the two
21 companies' strengths and weaknesses. Verizon is the stronger company
22 financially, but MCI has a powerful position in the Internet backbone network and
23 in the "enterprise" market, that is, the market for nationwide business
24 telecommunications networks. Verizon is the incumbent local exchange carrier
25 throughout much of the Northeast, and it has local exchange franchises scattered

[8] Verizon-MCI Press Release of February 14, 2005.

1 elsewhere across the nation, including the State of Washington. With the
2 impending demise of stand-alone long distance service and the weakening of local
3 exchange competition, Verizon will be able to absorb these declining components
4 of MCI to their mutual advantage and to the advantage of the merged company.[9]

5 **Q. Has Verizon quantified the value of synergies that would result from the**
6 **merger?**

7 A. Yes. Initially, the savings were estimated to be $7 billion in present value. That
8 number was subsequently increased to $7.3 billion, again in present value.[10]

9 **Q. What are the principal sources of synergy that Verizon expects to realize**
10 **from the merger?**

11 A. According to the merging parties, the synergies take a number of forms, classified
12 as follows:[11]

13 • Information Technology: **[Begin Highly Confidential]** ************* **[End**
14 **Highly Confidential]** MCI operates a large number of information technology
15 systems for various functions. MCI has a plan to develop a unified interface for a
16 number of these systems. The financial strength that Verizon brings to the merger
17 will allow this plan to be implemented

18 • Network: **[Begin Highly Confidential]** **********[End Highly Confidential]**
19 Verizon will move a large share of its long-distance traffic onto the under-
20 utilized portions of MCI's existing long-haul transport facilities, thereby
21 avoiding payments to third parties for transport services in the short run and
22 capital expenditures in the long run. Verizon will also be able to use MCI's
23 metropolitan area networks in areas outside its franchise territories, thereby

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[9] Id.

[10] Verizon Response to PC Data Request No. 131. "Present value" is calculated by estimating the net synergies each year and discounting them back to the present. Verizon has forecast synergies out to the year 2014.

[11] Verizon Response to Public Counsel Data Request No. 131.

1 avoiding capital expenditures. Greater volumes of interexchange and
2 international traffic will enable more efficient routing and terminating
3 arrangements. Finally, the combination of Verizon and MCI will provide
4 economies of scale in network equipment purchases.

5 • Canadian Divestiture: **[Begin Highly Confidential]** *********** **[End Highly**
6 **Confidential].** To comply with its noncompete agreement with Canada's
7 TELUS, Verizon will divest MCI's operations in Canada, saving the annual
8 support for these operations.

9 • Headcount Reductions: **[Begin Highly Confidential]** *********** **[End Highly**
10 **Confidential]**. The merger will permit the consolidation of numerous general
11 and administrative functions, such as network management, finance, human
12 resources, legal and information technology.

13 • Revenue: **[Begin Highly Confidential]** ********** **[End Highly Confidential]**
14 The merger will enhance MCI's ability to retain its existing enterprise customers,
15 and it will enable the merged company to sell additional services, particularly in
16 the enterprise and small-to-medium business markets.
17

18 **IV. WASHINGTON ALLOCATION OF SYNERGY SAVINGS**

19 **A. Verizon Calculation of Washington Savings**

20 **Q. Did Verizon or MCI provide testimony or exhibits in their WUTC filing**
21 **regarding Washington's share of merger savings?**

22 A. No. None of the three witnesses supporting the joint petition addressed the
23 savings or synergies attributable to Washington.

24 **Q. Did Verizon or MCI voluntarily provide Washington savings or synergies**
25 **information in this proceeding?**

1 A. No. In discovery, Public Counsel requested information regarding synergy
2 calculations at the national level, as well for California.[12] Verizon initially
3 objected and declined to provide any of the requested information. After Public
4 Counsel and Staff filed a Joint Motion to Compel, prior to a ruling on the motion,
5 Verizon agreed to provide the California information, and to provide a synergy
6 calculation for Washington state. On August 5, 2005, Verizon provided Public
7 Counsel and the Commission Staff with an allocation of synergy savings to
8 Washington.

9 **Q. What synergies did Verizon allocate to Washington?**

10 A. Verizon calculated present value synergies of **[Begin Highly Confidential]** ****
11 ****** **[End Highly Confidential]** [13] The first four years' undiscounted savings
12 are:

13 **[Begin Highly Confidential]**
14 **** ********
15 **** ********
16 **** ********
17 **** ******** **[End Highly Confidential]**

18 **Q. How did Verizon arrive at these savings?**

19 A. Verizon began with the total merger savings to both companies of $ 7.31 billion.
20 It then reduced this number three times. First, it divided the savings between
21 Verizon and MCI, and found that only **[Begin Highly Confidential]** **********
22 **[End Highly Confidential]** could be attributed to Verizon. Second, it found that
23 only **[Begin Highly Confidential]** ************ **[End Highly Confidential]** in
24 undiscounted dollars over the first four years of the merger related to regulated
25 operations in Washington. Finally, it applied intrastate jurisdictional factors to

[12] *See, e.g.,* Verizon Response to Public Counsel Data Request Nos. 134 and 135.
[13] Verizon Response to Public Counsel DR No. 131, Attachment 1, p. 13. HIGHLY CONFIDENTIAL

1 these savings to develop the **[Begin Highly Confidential]** ************ **[End**
2 **Highly Confidential]** present value estimate and the first four year savings noted
3 above in response to the previous question.[14]

4 **Q. Do you agree with Verizon's allocation between Verizon and MCI?**

5 A. No. The basis of this allocation is the presumption that the two companies will
6 continue to operate independently and that MCI's synergies will not affect
7 Washington. Thus, the savings attributable to Verizon are those that would be
8 experienced by Verizon were it to maintain books separately from MCI, and the
9 savings to MCI are those incurred by the remaining shell of that company.

10 This view does not reflect the reality of the post-merger company. In
11 order to achieve most of the savings from the merger, the operations of the two
12 companies will have to be combined, so that the benefits realized by operations
13 previously part of MCI will flow to Verizon's operations and vice versa. Any
14 attribution of merger benefits must recognize this fact.

15 Additionally, it is incorrect to exclude MCI synergies from the allocation
16 to Washington. Apparently, this exclusion is based on the fallacious assumption
17 that MCI is unregulated. That is not the case. MCI has hitherto been classified as
18 Competitive Local Exchange Carrier ("CLEC").[15] The Commission has assumed
19 that CLECs have no market power and therefore need not be subject to price
20 regulation. They are, however, within the Commission's jurisdiction, and the
21 Commission could re-impose price regulation or remove the competitive
22 classification if it would protect the public interest.

23 **Q. Can you identify any merger synergies that have been attributed to MCI but**
24 **which would directly benefit Washington ratepayers of both MCI and**
25 **Verizon?**

---

[14] Id., Attachment 1
[15] Joint Petition, ¶ 28.

1 A. Yes. As I shall discuss, a strong case can be made that all of MCI's merger
2 benefits will flow to all of the merged company. There are two specific forms of
3 benefit that the Washington study has attributed to MCI but which will
4 unquestionably flow to the Washington intrastate operations of both Verizon and
5 MCI. The first is the headcount reductions that have been attributed to MCI. The
6 second is the "go to market" revenue enhancements that have been allocated to
7 MCI in both the enterprise and small business markets.

8 **B. Cost Savings Due to Headcount Reductions**

9 **Q. Please describe Verizon's allocation of cost savings due to headcount**
10 **reductions.**

11 A. **[Begin Highly Confidential]** **
12 **
13 ***
14 ***
15 ***
16 ***
17 ************************************.[16] ************************
18 ***
19 ***
20 ***
21 ***************************************[17] **[End Highly Confidential]**

22 **Q. Is it appropriate to allocate headcount savings according to the company**
23 **from which the downsizing will occur?**
24

[16] Response to P.C. Data Request No. 131, Attachment 2, p. 1
[17] Id.

1 A. No. This allocation ignores the high probability that most of the functions for
2 which there will be headcount reductions are redundant between the two
3 companies. For example, the synergy study predicts that there will be a reduction
4 of **[Begin Highly Confidential]** *** **[End Highly Confidential]** employees from
5 the CFO's office, **[Begin Highly Confidential]** *** **[End Highly Confidential]**
6 from legal/business conduct and **[Begin Highly Confidential]** *** **[End Highly**
7 **Confidential]** from human resources, all from MCI.[18] These reductions come
8 from MCI only because the functions performed by the redundant personnel will
9 be consolidated into Verizon's operations. After the merger, the Verizon CFO,
10 legal and human resources personnel will no longer serve just Verizon, but both
11 companies. Their efforts will then be spread over a much larger base, and they
12 will be that much more efficient. The consequent savings will accrue to the
13 operations of both merging companies, not just to those of MCI.
14 Moreover, as noted earlier, there is no justification in supposing that
15 savings attributable to MCI are irrelevant to regulated Washington intrastate
16 operations. If the companies merge as expected, then MCI's intrastate operations
17 will be regulated to the same degree as Verizon's.
18 **Q. Have you estimated the headcount savings that could be allocated to**
19 **intrastate operations?**
20 A. Yes. Exhibit No. _____ (CWK-4HC) provides my estimate of the headcount
21 savings that would be allocated to Washington intrastate operations by a merged
22 Verizon/MCI in the years 2007, 2008 and 2009. The exhibit identifies the
23 national and Washington intrastate savings.
24 I have assumed that all headcount savings would accrue to all services,
25 with one exception. In response to Staff Data Request No.78, Verizon identified

[18] Id.

1 the annual savings that relate solely to long distance services. Since only a small
2 portion of the merged company's long distance services would be classified as
3 intrastate, I have removed these savings from my calculation.

4 **Q. Why does your exhibit cover only 2007, 2008 and 2009?**

5 A. I have excluded 2006 for two reasons. First, Verizon's 2006 data include many
6 costs that are transitional in nature. That is, they relate to the effort to merge the
7 two companies, not to the final condition of the merged company. Second, there
8 is no opportunity for Verizon to recover the merger costs or for ratepayers to
9 recover the merger benefits during the year 2006. That is because the Settlement
10 Agreement in Docket Nos. UT-040788 and UT-040520 does not permit any party
11 to initiate a proceeding that would change Verizon's tariff rates until after July 1,
12 2007. Effectively, Verizon's rates are frozen until mid-year 2007.

13 **Q. How did you allocate the national headcount savings to Washington**
14 **operations?**

15 A. Exhibit No. _____ (CWK-5HC) shows the development of my allocators. In this
16 case, I have used as a Washington allocator for Verizon the relationship of total
17 Washington revenues, $631.6 million as reported in Verizon's 2004 annual report
18 to the WUTC to the Company's national domestic telecom revenues, $38,551
19 million as reported in Verizon's 2004 10K report to the SEC That relationship is
20 1.64 percent.

21 In developing an intrastate allocator, however, I have not accepted the
22 revenues as reported by Verizon to the WUTC. That is because of the disconnect
23 between the FCC's revenue allocations and its frozen 25/75 percent
24 interstate/intrastate allocation of subscriber line costs. The FCC has classified all
25 broadband services as interstate, but it has not changed the frozen 25/75
26 interstate/intrastate allocation of subscriber line plant. Since we are allocating

cost savings, not revenue gains in this case, we must adjust the intrastate allocator to reflect the 75 percent subscriber line factor.

To do this, I have identified from Verizon's 2004 Annual Report the total revenues that are allocable to subscriber lines (column C). They include local service revenues and subscriber line charges for interstate and intrastate access. I have redistributed these revenues on a 25/75 basis (column D) and then added the intrastate portion to the non-subscriber line component of intrastate revenue. The restated intrastate revenues are ~~$449.02~~ $479.53 million, which when compared with total state revenues of $631.6 million, yield a restated intrastate allocator of ~~71.1~~ 75.9 percent.

Q. How did you develop the allocation factor for MCI?

A. My allocator for MCI is developed in the lower portion of Exhibit No. _____ (CWK-5HC). In response to Public Counsel Data Request Nos. 164 and 174, MCI identified its revenues from residential and small businesses in the Verizon service area. In his testimony, MCI witness Beach identified the number of residential lines in 2004 and small business lines in April 2005. From these data I was able to develop the average revenue per line in the Verizon service area, which I then multiplied by Mr. Beach's counts of total Washington state lines to derive an estimate of MCI's total residential and small business local service revenues.

The only source for the MCI's enterprise market is a one-month figure for May, 2005 described in Public Counsel Data Request No. 166 as "commercial facilities based revenue." I multiplied this number by 12 to estimate the annual revenue which I assumed to cover enterprise services. I then summed these Washington numbers to an estimate of total MCI Washington intrastate revenue. When these numbers are divided by MCI's 2004 national revenue, the result is the

1 very small allocator shown in column H of line 14 of Exhibit No. ____(CWK-
2 5HC).

3 **Q. How did you develop a composite allocator for both companies?**

4 A In the final columns of Exhibit No. _____ (CWK-5HC), I weight Verizon and
5 MCI allocators by the Washington intrastate revenue of the two companies shown
6 in column E. The composite Verizon and MCI allocator of national to
7 Washington intrastate services for all costs is **[Begin Highly Confidential]**
8 ************** **[End Highly Confidential]**.

9 **Q. What is your estimate of the Washington allocation of headcount savings?**

10 A. My estimates of headcount savings allocable to the Washington intrastate services
11 of both Verizon and MCI are presented in the last three columns of Exhibit No.
12 _____(CWK-4HC) on line 8. The Washington allocation of the headcount
13 synergies of the merged company are **[Begin Highly Confidential]** **********
14 **[End Highly Confidential]** in 2007, **[Begin Highly Confidential]** *****
15 ******* **[End Highly Confidential]** in 2008 **and [Begin Highly Confidential]**
16 ************* **[End Highly Confidential]** in 2009.

17 **C. "Go-To-Market" Revenue Synergies**

18 **Q. What is meant by "go to market" revenue benefits?**

19 A. The term "go-to-market" applies to the expected increases in sales that the
20 combined companies will experience by reason of their greater presence in their
21 respective markets. Specifically, by incorporating Verizon's sales operations into
22 MCI's already established presence in the enterprise market, the combined
23 companies will penetrate this market in a manner that would have been
24 impossible had the two remained separate. The reverse applies to the small
25 business market, where Verizon has the dominant presence, at least within its own
26 service territory. By combining with MCI, the two companies expect that Verizon

1 will be able to increase its sales in both Verizon's territory and in that of Qwest.
2 Verizon has identified no corresponding synergies in the residential market,
3 apparently because the merged company intends to withdraw from serving
4 residential customers outside of Verizon's franchise territory.

5 **Q. Why do you believe that MCI's "go to market" benefits will show up in**
6 **Verizon's revenue requirements?**

7 A. I do not know the organization that Verizon, the surviving company, will adopt
8 for its Washington intrastate operations. Nor, apparently, does Verizon because
9 its response to questions on this topic has been that no post-merger plans have
10 been formed.[19] However, it would be highly inefficient for Verizon to maintain
11 two separate operating companies in Washington, Verizon and MCI. To do so
12 would negate most of the synergistic savings from the merger.

13 If, as appears likely, the Washington operations of the two companies are
14 merged, then the result would be a company (or companies) subject to the
15 Commission's rate base, rate-of-return regulation. This regulation would apply to
16 the incremental intrastate revenues of <u>both</u> MCI and Verizon. For this reason, it is
17 improper to assume that MCI's "go to market" revenue gains would not be
18 captured in any future calculation of Verizon's intrastate revenue requirements.

19 **Q. Can you estimate the "go to market" revenue benefits that Verizon and MCI**
20 **expect in the Washington intrastate business market?**

21 A. Yes. My Exhibit No. _____ (CWK-6HC) provides my estimate of these benefits.
22 In response to Staff Data Request No. 45, Verizon provided a national estimate of
23 the annual revenue benefits it expects in both the enterprise and small to medium
24 business ("SMB") segments of the market. My exhibit provides a separate
25 calculation for each of these segments.

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[19] *See* Verizon Response to Staff Data Request No. 17.

1 The first task is to identify the Washington share of these benefits. Verizon
2 provides allocators for its Washington operations, but because it erroneously
3 supposes that MCI is irrelevant to this calculation, it has provided no MCI
4 allocators. I have nonetheless used Verizon's Washington allocators for all of the
5 merged company's business operations.[20] Verizon's **[Begin Highly**
6 **Confidential]** ***[**End Highly Confidential]** percent enterprise allocation
7 probably understates the Washington portion of MCI's national services.
8 Verizon's **[Begin Highly Confidential]** *** **[End Highly Confidential]** percent
9 allocation of SMB services to Washington matches almost exactly Washington's
10 proportion of the population of the continental 48 states. If MCI's SMB services
11 are evenly distributed by population, then the **[Begin Highly Confidential]** ***
12 **[End Highly Confidential]** percent factor would be appropriate for MCI's as
13 well as Verizon's services.

14 In lines 6 and 13 of Exhibit No. ____ (CWK-6HC), I apply intrastate
15 regulated allocators to the total state revenue benefits. Verizon claims that the
16 intrastate allocator for its enterprise market will decline from **[Begin Highly**
17 **Confidential]** ***** **[End Highly Confidential]** percent in 2006 to **[Begin**
18 **Highly Confidential]** ***** **[End Highly Confidential]** percent in 2009.[21] For
19 this radical reduction to occur, virtually all additional enterprise sales after 2006
20 would have to be for interstate or non-regulated services. That seems highly
21 unlikely. Accordingly, I have reduced by half the rate at which the intrastate
22 allocator will decline each year, 2007 through 2009, from the previous year. I
23 have accepted Verizon's SMB allocators, even though they also show a
24 remarkable – and unlikely -- decline from **[Begin Highly Confidential]** *****

[20] Verizon Response to Public Counsel Data Request No. 131, Att. 2, p.3, ll. 7H and 10H.
[21] Id., Att. 2, p. 6, l. 31.

1 **[End Highly Confidential]** in 2007 and 2008 to **[Begin Highly Confidential]**
2 ***** **[End Highly Confidential]** percent in 2009.[22]
3 As shown in line 15 of Exhibit No. ____ (CWK-6HC) I calculate
4 Washington intrastate net go-to-market revenue benefits to be **[Begin Highly**
5 **Confidential]** *********** **[End Highly Confidential]** in 2007, **[Begin Highly**
6 **Confidential]** ************* **[End Highly Confidential]** in 2008, and **[Begin**
7 **Highly Confidential]** ************* **[End Highly Confidential]** in 2009.
8 Q. **Is your revenue requirement reduction total simply the sum of head count**
9 **and go to market savings?**
10 A. No. To arrive at the revenue requirement reductions I must add back in the
11 network savings that Verizon has allocated to Washington intrastate services.
12 These are very small amounts, less than **[Begin Highly Confidential]** ********
13 **[End Highly Confidential]** annually. Exhibit No. ____ (CWK-7HC), ll. 5, 6.
14 **Q. Have you calculated the total synergies that would show up in a revenue**
15 **requirement calculation for the merged company?**
16 A. Yes. My Exhibit No. ____ (CWK-7HC) summarizes the synergies that are
17 allocable to Washington intrastate operations during the years 2007, 2008 and
18 2009. Lines 1 and 2 show present the revenue benefits that were calculated in
19 Exhibit No. _____ (CWK-6HC) based on "go-to-market" revenues. Line 7 shows
20 the headcount savings that were calculated in Exhibit No. _____ (CWK-4HC).
21 The remaining lines are taken from Verizon's Washington intrastate synergy
22 calculations.
23 The following table compares my estimate of the Washington intrastate
24 synergies with those estimated by Verizon for the three years 2007, 2008 and
25 2009:

[22] Id., Att. 2, p. 6, l. 32.

1 **[Begin Highly Confidential]**

2 Table 1: WA Intrastate Synergies Comparison

	Verizon Estimate	Public Counsel Estimate
****	********	**********
****	********	***********
****	*********	**********

3 **[End Highly Confidential]**

4 **D. Systemic Synergies --- The Broader View**

5 **Q. Do you believe that the savings analyzed above are the maximum allowable**
6 **synergies that would show up in a rate case?**

7 A. No. I question whether many of the exclusions, aside from headcounts and go-to-
8 market benefits, should be disallowed as synergies allocable to Washington
9 intrastate operations.

10 For example, Verizon has assumed that none of the procurement cost
11 savings achievable from the economies of scale in procurement should be applied
12 to Washington. This exclusion was based on the assumption that the benefits
13 flowed exclusively to MCI because Verizon is already a very large buyer of
14 telecommunications equipment. First of all, MCI's savings are not irrelevant to
15 Washington intrastate services, as I have discussed. Second, it is by no means
16 certain that these benefits are a one-way street, that is, from Verizon to MCI. In
17 2004, Verizon's gross revenues were $ 71.3 billion, but only about half of this
18 amount, $38.5 billion, related to domestic telecommunications services.[23] Most
19 of the remainder involved wireless and international operations. By comparison,
20 MCI had domestic revenues of $13.9 billion, over a third of Verizon's domestic
21 telecom revenues. If there are scale economies from combining the purchases of

[23] Verizon 10-K Report to the Securities & Exchange Commission, 2004.

1 these two companies, it is reasonable to expect that they will benefit both of them,
2 not just MCI.

3 **Q. Are there synergies from the merger that might benefit Washington**
4 **intrastate operations, yet never turn up in a revenue requirement?**

5 A. Yes. For example, the so-called "network" synergies principally affect the merged
6 company's interexchange services, most of which are jurisdictionally interstate.
7 But the benefit of these synergies flow back to local service if they result in more
8 attractively priced local and long-distance packages. Even the sale of MCI's
9 money-losing Canadian operations benefits local service if it frees up capital for
10 investment in fiber optic local loops. Under this view, merger synergies are
11 fungible.

12 **Q. Is there any other basis for allocating synergies to Washington ratepayers**
13 **that would recognize the fungibility of system merger synergies?**

14 A. Yes. The discussion up to now has assumed that the only synergies that apply to
15 Washington intrastate operations are those that would turn up as reductions in the
16 intrastate revenue requirement in a conventional rate case. This is the narrowest
17 possible definition of the synergies that are allocable to Washington ratepayers.

18 However, it should be recognized that merger synergies are systemic, that
19 is, that synergies affecting one component of the merged company's operations
20 benefit all other components. They cannot be limited to specific services or
21 classes of customers.

22 **Q. What is the Washington allocation of synergies under this broader view of**
23 **merger benefits?**

24 A. Verizon's latest estimate of the present value of the national merger synergies is
25 $7.31 billion, computed from 2006 extending to perpetuity.[24] In Exhibit No. ____

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[24] Verizon Response to PC Data Request No. 131, p. 1. See also, Att. 4, page 1.

(CWK-5HC), I developed a composite Verizon/MCI intrastate regulated allocator to Washington of **[Begin Highly Confidential]** ****** **[End Highly Confidential]** percent. As I explained earlier, this represents Washington's share of the composite of Verizon's and MCI's national revenues. Using this number as the allocator, the present value of the synergies applicable to Washington's intrastate services is **[Begin Highly Confidential]** ************** **[End Highly Confidential]**.

In Exhibit No. ____ ~~(CWK-7HC)~~ (CWK-8HC) I show the year-by-year revenue, expense and capital synergies from 2007 through 2014. Column G shows the amounts that are allocable to Washington intrastate services using the **[Begin Highly Confidential]** ****** **[End Highly Confidential]** percent allocator. The exhibit demonstrates that once the transition expense and capital costs have been expended, the Washington allocation of the total system synergies is in the range of **[Begin Highly Confidential]** *************** **[End Highly Confidential]** annually.

In columns H and I, I convert the Washington intrastate allocated synergies to present value starting in mid-year 2007. The total at the bottom of that column indicates a present value through 2014 of ~~$80.57~~ $86.25 million. This number differs only slightly from the **[Begin Highly Confidential]** ****** ******* **[End Highly Confidential]** mentioned earlier because it uses a different initial date and because it considers synergies only through 2014.

V. SHARING THE SYNERGIES

Q. How should synergies be shared with ratepayers?

A. The form of sharing depends upon whether we are speaking of Verizon or MCI customers because very different problems face these two groups. Verizon's

1 customers have recently experienced one rate increase and are scheduled to face
2 another increase in July 2007. MCI's customers, at least in the residential sector,
3 are confronted with a provider that apparently wants to abandon them.

4 **Q. How should Verizon's customers share in the savings?**

5 A. In view of the fact that the merger synergies are expected to be permanent
6 (indeed, increasing over time), the compensation to Verizon's ratepayers should
7 be permanent as well. This consideration suggests that the compensation should
8 take the form of reductions in monthly line charges. This approach has
9 significant advantages because it is tangible and easy to quantify and track

10 **Q. Do you have any specific suggestions as to how Verizon's retail ratepayers**
11 **should receive their share of merger savings?**

12 A. Using conventional ratemaking procedures, the line rate reductions should come
13 in stepped decreases matching the annual increase in the net synergies that the
14 merged company will experience. This arrangement is complicated, however, by
15 the Settlement Agreement in Docket Nos. UT-040788 and UT-040520 which
16 freezes rates until July 1, 2007, at which time monthly line charges are to increase
17 by $1.47. If ratepayers are to receive merger synergy compensation, then it would
18 initially have to take the form of some sort of reduction in the July 1, 2007
19 increase.

20 Assuming the Commission agreed to flow back synergies allocable to
21 Washington, then it would reduce the $1.47 increase by some amount on July 1,
22 2007, then a greater amount on January 2008, with further reductions each year as
23 the synergies increase. While these stepped reductions could be implemented, it
24 seems counter-productive to increase Verizon's line charges in July 2007 by the
25 net of $1.47 per line against the small synergies in that year, and then reduce them

1 again the next January and each year thereafter. A much simpler procedure would
2 be to make a single reduction in the July 1, 2007 rate increase.

3 I recommend that the July 1, 2007, rate increase be reduced by $1.00 per
4 line monthly. Rather than $1.47, local service line rates would increase by $0.47
5 monthly. This adjustment represents a revenue reduction to Verizon of $8.69
6 million annually, as developed at the bottom of Exhibit No. ____(CWK-8HC),
7 Note 1.

8 **Q. Why is a rate reduction of $8.69 million a reasonable sharing of merger**
9 **synergies?**

10 A. Unlike the revenue requirements reduction developed in my Exhibit No. ____
11 (CWK-7HC), ratepayers are not entitled to the entire amount of the identified
12 synergy benefits. It is appropriate that the system merger synergies be shared
13 between ratepayers and the companies' shareholders. In the final two columns of
14 Exhibit No. ____ (CWK-8HC), I compute the present value of a $8.69 million
15 contraction in Verizon's revenue from mid-year 2007 through the end of 2014. It
16 reveals that the present value of this reduction is $46.57 million, or ~~58~~ 54 percent
17 of the present value of the merger synergies allocable to Washington intrastate
18 operations through 2014. This leaves ~~42~~ 46 percent of the synergy benefits to the
19 companies' shareholders. I believe this is a reasonable balance between the
20 interests of ratepayers and shareholders, and it provides an appropriate offset to
21 the harm to the public interest that will result from the merger.

22 **Q. How should merger synergies be shared with MCI's ratepayers?**

23 A. The status of MCI's rates following the merger is unclear. Nor is it clear whether
24 the merged company will attempt to retain MCI residential customers outside of
25 Verizon's service territory. For this reason, I recommend that MCI rates be
26 tariffed and that any increase in those rates be subject to a full evidentiary

1 proceeding. In any such proceeding, the merged company would have the burden
2 of proving that the increase is necessary. If a rate case involving MCI residential
3 and small business rates is initiated, then a $1.00 imputation of synergy savings
4 should be applied to each MCI line.

5 **Q. Does this complete your testimony?**

6 A. Yes. It does.