Exhibit No. ______ (DBT-1T)
Docket No. UT-

**BEFORE THE**

**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

| | | |
|---|---|---|
| **In the Matter of the Petition of Verizon Northwest Inc. for an Order Approving Commencement of Bifurcated General Rate Case and Waiver of WAC 480-07-510(2)** | **)<br>)<br>)<br>)** | **DOCKET NO. UT-** |

**DIRECT TESTIMONY OF**

**DENNIS B. TRIMBLE**

**ON BEHALF OF**
**VERIZON NORTHWEST INC.**

**APRIL 30, 2004**

Exhibit No. ______ (DBT-1T)
Docket No. UT-

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# I. INTRODUCTION

**Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND TITLE.**

A. My name is Dennis B. Trimble. My business address is 6803 India Court, Colleyville, Texas 76034. I am a telecommunications consultant and have been engaged by Verizon Northwest Inc. ("Verizon NW" or the "Company") to provide testimony in this proceeding.

**Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE.**

A. I received an undergraduate degree in business and an MBA from Washington State University in the early 1970s. I then served as an Assistant Professor at the University of Idaho, where I taught undergraduate courses in statistics, operations research, and decision theory. From 1973 to 1976, I completed course work towards a Ph.D. degree in business at the University of Washington, majoring in quantitative methods with minors in computer science, research methods, and economics.

I joined GTE Corporation in 1976 as an Administrator of Pricing Research for General Telephone Company of the Northwest. From 1976 until 1985, I held various positions within GTE Northwest and GTE Service Corporation in the areas of demand analysis, market research, and strategic planning. In 1985, I was named Director of Market Planning for GTE Florida Incorporated ("GTE-FL"), and, in 1987, I became GTE-FL's Director of Network Services Management. In 1988, I became Acting Vice President – Marketing for GTE-FL. From 1989 to 1994, I was the Director of Demand Analysis and Forecasting for

GTE Telephone Operations. In October 1994, I became Director of Pricing and Tariffs for GTE Telephone Operations, and, in 1996, I was named Assistant Vice President of Marketing Services. In February 1998, I assumed the position of Assistant Vice President - Pricing Strategy for GTE Service Corporation. Following the merger of GTE and Bell Atlantic to form Verizon, I became Executive Director - Regulatory in the Verizon Corporate Services Group Inc. organization in September 2000. In this capacity I was responsible for the development of various regulatory policies and for supporting those policies in regulatory arenas. In December 2003, I separated from Verizon Corporate Services Group Inc. and became a consultant.

**Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE STATE REGULATORY COMMISSIONS?**

A. Yes. I have presented testimony on issues related to pricing, customer demand, and general policy on behalf of various Verizon operating telephone companies before state commissions in Alabama, California, Florida, Hawaii, Illinois, Indiana, Missouri, Oregon, Pennsylvania, South Carolina, Texas, Virginia, and Washington.

**Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

A. Verizon NW is seeking to establish a new revenue requirement with the Washington Utilities and Transportation Commission ("WUTC" or "Commission"). During its deliberations in this proceeding, the WUTC may consider imputing into Verizon NW's regulated revenue requirement some portion of "yellow pages advertising" directory earnings generated by an unregulated affiliate, Verizon Directories Corp. ("VDC"). In this manner, the Commission would effectively deduct the imputed earnings from the revenue requirement Verizon NW is allowed to recover through rates. The purpose of my testimony is to explain that VDC earnings should not be imputed to Verizon NW. The Commission's use of VDC's profits to reduce the regulated revenue requirement is not supported by any appropriate business or public policy rationale, and such an action would also not be consistent with Washington's affiliated interest guidelines.

**Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

A. The Commission should not impute any VDC revenues to Verizon NW in calculating Verizon NW's revenue requirement. My testimony first explains that a straightforward review of the Verizon NW – VDC contractual arrangements leads to only one conclusion: without any consideration of imputation, these contractual arrangements are consistent with affiliated interest guidelines and provide for reasonable and prudent revenue flows between the affiliated companies. There is no reasonable basis to ignore these contractual arrangements. Second, I explain why the Commission would be mistaken to impute VDC revenues on the assumption that ratepayers funded the development of VDC and thus should receive ongoing compensation for that development. The facts are that ratepayers have never supported the development of VDC and that VDC has never been considered a regulatory asset on the accounting books of Verizon NW. For that same reason, it is also apparent that the rationale supporting recent adjustments to US WEST's revenues due to yellow pages imputation are inappropriate for Verizon NW.

**Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?**

A. Section II provides background information relevant to a discussion of the imputation of yellow pages earnings to a regulated local carrier. Specifically, I will provide a description of the yellow pages imputation process. In this section, I will also describe various policy implications that result from yellow pages imputation, any one of which proves that this form of imputation is bad public policy. In Section III, I discuss the Commission's historical rationale for implementing yellow pages imputation. Section IV describes Verizon NW's directory-related regulatory obligations and how the relationship between VDC and Verizon NW fulfills the satisfaction of those obligations. In Section V, I demonstrate that the contractual agreements currently in place between Verizon NW and VDC are consistent with the affiliate transaction rules and guidelines observed in Washington State. This is true whether one considers the directory-related services Verizon NW purchases from VDC or the directory-related services VDC purchases from Verizon NW. This section also discusses why Verizon NW has no opportunity to shift profits to its unregulated affiliate (i.e., VDC). Section VI reviews the historic relationships between Verizon NW and VDC with the goal of showing beyond doubt that VDC was not developed at ratepayer expense. Section VII describes why recent adjustments (based on yellow pages revenues) to US WEST's revenues are not applicable or appropriate for Verizon NW. Finally, my concluding remarks are presented in Section VIII.

## II. IMPUTATION OF YELLOW PAGES EARNINGS

### *A. Description of Imputation*

**Q. HOW HAS THE COMMISSION PREVIOUSLY HANDLED YELLOW PAGES REVENUES OR EARNINGS IN DETERMINING VERIZON NW'S RATE LEVELS?**

A. Historically, the WUTC included two sources of yellow pages revenues during ratemaking proceedings associated with a regulated incumbent local exchange carrier ("ILEC"): (1) revenues paid to the ILEC under contract by an affiliated directory publisher for the provision of goods or services and, (2) additional earnings of the directory publisher imputed to the local carrier. In the specific case of Verizon NW, the two sources of yellow pages revenues considered by the Commission in the setting of the local carrier's rates thus included (1) revenues received from VDC as a result of contractual agreements in effect between VDC and Verizon NW and (2) additional, allegedly "excess," earnings of VDC.[1]

The first of these, revenues received by Verizon NW from VDC, are accounted for in the Company's regulated books, and there is no dispute that they are properly included in the rate making process. The second source of revenues historically used by the Commission in determining Verizon NW's earnings levels – allegedly "excess" VDC earnings – is in reality a forced subsidy flow provided from the earnings of a competitive business entity (i.e., VDC) to support Verizon NW's provision of regulated telecommunication services.

[1] For example, see *Second Supplemental Order*, Cause No. U-82-45/48 (August 18, 1983), ("U-82-45/48 Order") at p. 21 and *Second Supplemental Order,* Cause No. U-84-18 (January 15, 1985) ("U-84-18 Order"), at pp. 14-16.

**Q. PLEASE GIVE AN OVERVIEW OF THE HISTORIC YELLOW PAGES IMPUTATION PROCESS.**

A. The mathematics historically associated with the imputation of yellow pages earnings involve a fairly complex calculation of the ILEC's financial position, but the overall process can be summarized as consisting of three general steps:

(1) An "authorized" revenue requirement is computed for the ILEC based on an authorized rate of return ("ROR");

(2) Working from the assumption that the directory affiliate's earnings should be constrained to the ILEC's authorized ROR, the Commission Staff then computes the amount by which the directory affiliate's earnings (or revenues) within the state exceed this presumed limit; and

(3) This amount – the alleged "excess" – is then subtracted from the ILEC's authorized revenue requirement to create an "approved" revenue requirement for ratemaking purposes.

A simplified example of this process, using hypothetical numbers for the purpose of illustration, is presented in Table One.[2]

[2] The imputation adjustment procedure presented in Table One follows the general steps presented by WUTC Staff witness Betty A. Erdahl in Docket No. UT-020406. See Ms. Erdahl's Rebuttal Testimony, Confidential Exhibit BAE-2C.

**TABLE ONE**
**ILLUSTRATION OF THE YELLOW PAGES IMPUTATION PROCESS**

| | **Verizon NW** (Rate of Return Regulated) | | **Verizon Directories Corp.** (Nonregulated, Competitive Entity) | |
|---|---|---|---|---|
| [a] | “Authorized” Rate of Return | 10% | | |
| [b] | “Authorized” Revenue Requirement | $600 M | | |
| [c] | | | Total Directory Operating Revenues | $2,000 M |
| [d] | | | Total Directory Operating Revenues, Constrained to Verizon NW’s Authorized 10% ROR (a Staff computation) | $400 M |
| [e] = [c] – [d] | | | Allegedly “Excess” VDC Directory Operating Revenue | $1,600 M |
| [f] | | | Percentage of Total Directory Revenues Generated in Washington | 2.5% |
| [g] = [e] * [f] | | | Alleged “Excess” VDC Directory Operating Revenue in Washington | $40 M |
| [h] = [g] * 0.65 | | | Alleged Net Operating Income Adjustment (after Taxes) | $26 M |
| [i] = [g] | Imputation of Allegedly “Excess” Yellow Pages Revenues from VDC to Support Verizon NW | $40 M | **← IMPUTATION (Alleged Excess Revenue)** | ($40 M) |
| [j] = [b] – [i] | “Approved” Revenue Requirement for Ratemaking Purposes | $560 M | | |
| [k] | Resulting “Approved” ROR | < 10% | Staff Estimated ROR in Washington (See Row [h]) | > 10% |
| Note: Figures are illustrative only. The effective “Approved” ROR for the combination of Verizon NW’s operations and VDC’s directory operations in Washington is constrained to be equal to Verizon NW’s “authorized” ROR for the test year (e.g., 10 percent in this illustration). | | | | |

***B.***

***Economic and Regulatory Implications of Imputation***

**Q. WHAT ARE THE ECONOMIC AND REGULATORY IMPLICATIONS OF YELLOW PAGES IMPUTATION?**

A. First, and most disturbing, yellow pages imputation effectively creates a regulatory-mandated earnings cap on a mythical company – that is, on an entity comprised of the combination of Verizon NW's operations and VDC's local directory advertising operations in Washington. This cap on the hypothetical "combined" company's earnings has results identical to a situation in which the Commission regulated each of the entities individually and ascribed the same authorized ROR to each entity. There should be no question that, through the use of yellow pages imputation, the Commission is effectively regulating the earnings levels not only of Verizon NW, but of VDC as well. VDC is a competitive entity, however, and not subject to regulation by the Commission; indeed, the only regulation of its earnings levels should be that implied by the discipline of market forces.

Second, yellow pages imputation distorts rational investment decisions concerning the operations of both Verizon NW and VDC in Washington. To illustrate, assume that VDC could enhance its earnings capabilities in Washington if given additional investment resources. In light of imputation, however, the question that faces Verizon's management is: "Why should I invest additional dollars in VDC's competitive local directory advertising business in Washington if any enhancement to earnings will ultimately be appropriated by the Commission in ratemaking proceedings?" This question is not one that Verizon's management should have to address when determining a rational level of investment in a competitive business entity. Likewise, Verizon's management faces a similar issue when considering investments in Verizon NW. Investment dollars are scarce resources, rationally targeted to projects that provide the best expected financial returns relative to other opportunities for investment, and yellow pages imputation lowers the actual rate of return exhibited by Verizon NW. By reducing the total revenue that Verizon NW can generate through service rates, imputation of yellow pages earnings effectively constrains the actual return achieved by Verizon NW to a level that is below its authorized return. Such a constraint, all else equal, creates a disincentive against the allocation of scarce investment dollars to the operations of Verizon NW in Washington.

Third, yellow pages imputation harms the development of an efficient and competitive telecommunications marketplace by lowering various service rates of Verizon NW to levels that are below what even the Commission considers to be economically efficient. When the Commission determines an authorized ROR for an incumbent local carrier, it is establishing what it believes the total revenues (i.e., allowed revenue requirement) should be for an efficient firm providing competitive telecommunications services. Yellow pages imputation effectively forces the actual ROR generated by Verizon NW from its telecommunications offerings to be below the rate of return otherwise authorized for it by the Commission. It can be demonstrated mathematically that imputation forces a variety of Verizon NW's rates to be set at levels less than what the Commission must assume to be efficient, competitive market levels. Such a practice can only distort the development of an efficient, competitive marketplace for local telecommunications in Washington.

Finally, and as is discussed in the testimony of Michael J. Doane, the competitive distortions created by yellow pages imputation appear to violate many of the efficient-market principles advanced in the Telecommunications Act of 1996. Specifically, the practice of yellow pages imputation is neither competitively neutral nor non-discriminatory.

**Q. HAS THE COMMISSION EVER EXPRESSLY RECOGNIZED THAT YELLOW PAGES IMPUTATION EFFECTIVELY REGULATES THE EARNINGS OF DIRECTORY AFFILIATES?**

A. Yes, in Cause No. U-82-45/48, the WUTC succinctly recognized that '[T]he "cost plus fair return" theory [the theory for yellow pages imputation] attempts to set prices [for GTE Directories Corporation – the then directory affiliate] that are sufficient to cover the operating expenses and taxes of GTE Directories Corporation, plus a reasonable return on [the] capital [of GTE Directories Corporation].'[3] The Commission's recognition in this order is absolutely correct – through the imputation process, the Commission is regulating (constraining) the earnings of the directory affiliate to a level that the Commission believes represents a reasonable return on the directory affiliate's capital. But again, VDC is a competitive affiliate over which the Commission has no regulatory powers beyond determining whether affiliated interest guidelines are followed.

[3] See U-82-45/48 Order, at p. 21.

## III. THE RATIONALE HISTORICALLY GIVEN FOR IMPUTATION

**Q. WHAT RATIONALE HAS THE COMMISSION HISTORICALLY RELIED UPON TO SUPPORT THE IMPUTATION OF DIRECTORY ADVERTISING REVENUES TO THE INCUMBENT LOCAL EXCHANGE CARRIER?**

A. Based on my review of previous orders of the WUTC, it is apparent that the Commission has relied upon the following to support its imputation of yellow pages earnings:

(1) A presumption that a directory affiliate's revenues may and should be considered when determining the appropriate compensation due the affiliated ILEC;[4]

(2) A belief that affiliated interest guidelines support the imputation of directory affiliate earnings into the ILEC's regulated revenue requirement;[5] and

(3) A belief that the development of the directory advertising business occurred within the ILEC and should be considered a "regulatory asset" and, consequently, that the ILEC's customers paid for that development activity and must be fully compensated for it (I will refer to this rationale as "developed at ratepayer expense").[6]

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[4] See *Fourteenth Supplemental Order, Order Denying Petition*, Docket No. UT-980948 (July 27, 2000) (UT-980948 Order"), at para. 39 (citing Second Supplemental Order in Docket No. U-89-3524-AT).

[5] See U-84-18 Order at pp. 14-15 and UT-980948 Order at paras. 10, 17, and 39.

[6] See UT-980948 Order at footnote 7 and paras. 80-81; and also see *Fifteenth Supplemental Order, Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling*, Docket No. UT-950200 ("UT-950200 Order"), at p. 32.

Apparently relying on the beliefs and presumptions described above, the Commission has historically determined that an ILEC's directory affiliate should not be allowed a greater return on business than that authorized for the ILEC itself, with the effect that any return in excess of this rate generated by the directory affiliate has instead been imputed to the ILEC's earnings. Thus, the Commission would impute "excess" directory advertising earnings in ratemaking proceedings to offset the cost of providing regulated telecommunication services.

**Q. WHAT DID THE COMMISSION CITE AS THE RATIONALE FOR ITS APPARENT ASSUMPTION THAT DIRECTORY ADVERTISING AFFILIATES WERE GENERATING EXCESS EARNINGS?**

A. The only stated rationale for this assumption that I could find involved Commission Staff arguments to the effect that the "best measure of the reasonableness of payments by an operating company to affiliates is the rate of return on the affiliates' investment." [7] As the WUTC expressed in its Second Supplemental Order in Docket U-84-18:

> The Commission staff, therefore, uses the "cost plus fair return" theory to calculate adjustments to transactions with Mast [a directory affiliate] and Telecom. The purpose of the Commission staff adjustment is to <u>substitute the processes of the competitive marketplace</u> for the less than arm's-length transactions which actually occur.[8]

This rationale makes the implicit presumption that yellow pages advertising should be considered part of the regulated telecommunications business of the incumbent local carrier (e.g., part of Verizon NW). Under this reasoning, the level of return appropriate for that business (i.e., implicitly authorized) should be constrained to the level of return that the

[7] U-84-18 Order at p. 15 (emphasis added).

Commission authorizes for the ILEC.[9] I observe that by employing this rationale, the Commission must necessarily be asserting that the directory advertising affiliate is not operating in a competitive marketplace and thus market forces are not sufficient to discipline the directory affiliates' earnings. In other words, implementation of the Commission's historic yellow pages imputation process is equivalent to stating that: (1) the competitive rate of return for the directory advertising affiliate is the regulated ILEC's authorized rate of return; (2) the directory advertising affiliate is earning supranormal (i.e., monopoly) profits if its returns are higher than those authorized by the Commission for the affiliated ILEC and (3) the Commission has the right to use some portion of those alleged excess profits to reduce the ILEC's allowed revenue requirement.

As Mr. Doane's testimony demonstrates, the presumption that VDC is not operating in a competitive market and thus can generate excess profits is belied by the actual conditions of today's competitive market place for local advertising. Nevertheless, even if the Commission decides (erroneously) to view VDC as operating as a near monopoly, it must still recognize that it has no basis for assuming that the competitive level of earnings for VDC is the same as the ROR the Commission authorizes for Verizon NW.

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[8] Id.
[9] For example, see UT-980948 Order at para. 80 and U-82-45/48 Order at pp. 21-22.

**Q. HOW DO YOU RESPOND TO THE ARGUMENTS HISTORICALLY GIVEN BY THE COMMISSION THAT YELLOW PAGES IMPUTATION IS CONSISTENT WITH AFFILIATE TRANSACTION GUIDELINES OR THAT ILECS' DIRECTORY AFFILIATES WERE DEVELOPED AT RATEPAYER EXPENSE?**

A. The remainder of my testimony will directly address these issues. First, however, I will as background describe the current relationship that exists between Verizon NW and VDC.

## IV. THE RELATIONSHIP BETWEEN VERIZON NW AND VDC

### *A. Verizon NW's Directory-Related Regulatory Requirements*

**Q. WHAT ARE THE DIRECTORY-RELATED PRODUCTS AND SERVICES THAT VERIZON NW IS RESPONSIBLE FOR PROVIDING WITHIN ITS OPERATING TERRITORY?**

A. As a local exchange company, Verizon NW is required by Commission rule to "ensure" that all its customers receive (at least every fifteen months) a directory containing an alphabetic listing of all subscribers (except those that wish to be excluded) in the local calling area.[10] As part of its tariffed services for business customers, Verizon NW must also provide one listing in the classified (i.e., yellow pages) section of the directory.[11] In addition, the Commission mandates that local exchange companies arrange for various public interest information to be included in the white pages directories; the section of the directory allocated to this purpose is commonly referred to as the "information pages."[12]

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[10] See WAC 480-120-251.
[11] See Verizon Northwest Inc. Tariff WN U-17, Section 9, 3rd Revised Sheet 12, DIRECTORY LISTINGS A.1.
[12] See, for example, WAC 480-120-254, and WAC 480-120-255.

**Q. DOES VERIZON NW HAVE ANY LEGAL RESPONSIBILITY TO BE A DIRECTORY PUBLISHER?**

A. No. Verizon NW's regulatory responsibility is to ensure that at least "a" directory containing white pages listings be "distributed" to its various subscribers.

**Q. DOES VERIZON NW HAVE ANY STATE-MANDATED LEGAL RESPONSIBILITY TO PRODUCE AND DISTRIBUTE A YELLOW PAGES DIRECTORY?**

A. No. I know of no Commission mandates requiring the local exchange companies to be in the directory advertising business.

**Q. HAS THE FEDERAL COMMUNICATIONS COMMISSION ESTABLISHED ANY REQUIREMENT FOR ILECS TO PRODUCE A YELLOW PAGES DIRECTORY?**

A. No. Rather, the Federal Communications Commission ("FCC") has explicitly stated that it "does not require a carrier to publish a yellow pages directory."[13]

***B. Verizon NW's Contractual Arrangements with VDC***

**Q. HOW DOES VERIZON NW ENSURE THAT ITS DIRECTORY-RELATED REGULATORY REQUIREMENTS ARE ADEQUATELY SATISFIED?**

A. Verizon NW has entered into contractual arrangements with VDC to assure that Verizon NW's directory-related regulatory obligations are satisfied. These include contracts for (1)

[13] Local Exchange Carriers' Permanent Cost Allocation Manuals for the Separation of Regulated and Unregulated Costs, AAD Nos. 92-22 through 92-35, 9 FCC Rcd 4457, p. 2 (released Aug. 29, 1994) ("FCC's Cost Allocation Memorandum and Order"), paragraph 6.

ensuring that VDC's directories satisfy the regulatory mandates imposed on Verizon NW and (2) directory-related services that VDC purchases from Verizon NW.

### 1. <u>DIRECTORY-RELATED SERVICES VERIZON NW RECEIVES FROM VDC</u>

**Q. WHAT DIRECTORY-RELATED SERVICES DOES VERIZON NW RECEIVE FROM VDC?**

A. Under a publishing contract, VDC agrees that the directories it publishes and distributes in Verizon NW's service area will fulfill the requirements that local exchange companies are mandated to perform under that Commission's rules – specifically, the development and distribution of a printed white pages alphabetic directory (including the requisite information pages). VDC also ensures that Verizon NW's business customers receive one free classified listing per telephone number in VDC's directory.

**Q. WHAT RATES, IF ANY, DOES VDC CHARGE VERIZON NW FOR ITS PUBLISHING SERVICES?**

A. VDC does not charge Verizon NW for satisfying Verizon NW's regulatory requirements.

### 2. <u>DIRECTORY-RELATED SERVICES VDC PURCHASES FROM VERIZON NW</u>

**Q. IN GENERAL, WHAT DIRECTORY-RELATED SERVICES DOES VDC PURCHASE FROM VERIZON NW?**

A. To facilitate VDC's production of the directories, Verizon NW sells to VDC a list of its end users' telephone numbers and other directory listing information. In addition, Verizon NW provides to VDC classified yellow pages headings for businesses. Verizon NW may also perform billing and payment collection activities associated with the placement of ads in the yellow pages directory by various local businesses.

**Q. WHAT CONTRACTUAL ARRANGEMENTS DOES VERIZON NW HAVE WITH VDC FOR THE SALE OF THESE SERVICES?**

A. Verizon NW has two contractual agreements with VDC for the directory-related services VDC purchases from Verizon NW: (1) a Publishing Agreement and (2) a Billing and Collection Agreement.

**Q. PLEASE DESCRIBE THE PUBLISHING AGREEMENT.**

A. The Publishing Agreement sets forth the terms and conditions under which Verizon NW will provide subscriber listing information ("SLI"). SLI is the primary source of information used by directory publishers to produce directories, as it includes listed subscribers' names, addresses, and telephone numbers, as well as assigned classified yellow pages headings for businesses.

**Q. WHAT IS THE BASIS FOR THE SLI RATES CHARGED BY VERIZON NW?**

A. The charges listed in the Publishing Agreement for SLI provisioning services are the rates ordered by the FCC as being presumptively reasonable.[14]

[14] *In the matter of Implementation of the Telecommunications Act of 1996, Third Report and Order in CC Docket No. 96-115. Second Order on Reconsideration of the Second report and Order in CC Docket No. 96-98, and Notice of Proposed Rulemaking in CC Docket No. 99-273*, FCC 99-227, (Released September 9, 1999) ("Third Report"), paragraph 103.

**Q. ARE THE SLI RATES CHARGED BY VERIZON NW TO VDC ALSO THE RATES VERIZON NW APPLIES TO OTHER, COMPETITIVE DIRECTORY PUBLISHERS?**

A. Yes.

**Q. PLEASE DESCRIBE THE BILLING AND COLLECTION AGREEMENT.**

A. The Billing and Collection Agreement sets forth the terms and conditions under which in-franchise billing activities for VDC will be performed by Verizon NW. Under the contract, Verizon NW bills VDC directory advertising charges to VDC customers who are also Verizon NW telephone service customers, and Verizon NW then remits payments to VDC. The terms and conditions of the agreement follow Verizon NW's standard billing and collection contracts, similar examples of which are in effect with many non-affiliated businesses (e.g., interexchange carriers). The rates contained in the Billing and Collection Agreements are non-discriminatory and competitive market-based rates.

## V. VERIZON NW IS NOT SHIFTING PROFITS TO VDC

**Q. ARE THE CONTRACTUAL ARRANGEMENTS BETWEEN VERIZON NW AND VDC CONSISTENT WITH AFFILIATE TRANSACTION GUIDELINES?**

A. Yes. In order to ensure that regulated ILECs do not shift profits to nonregulated affiliated companies, state regulatory commissions commonly follow established affiliate transaction rules in order to determine if transactions are inappropriate. In my opinion, the contractual arrangements existing between Verizon NW and VDC are consistent with affiliate transaction guidelines as commonly employed in Washington State.

**Q. PLEASE SUMMARIZE YOUR UNDERSTANDING OF THE OBJECTIVE OF AFFILIATE TRANSACTION RULES.**

A. Affiliate transaction rules such as the ones presented in 80.16 RCW are intended to ensure that regulated entities do not shift profits to any nonregulated affiliates. Historically, the regulatory concern prompting such rules has been that, without them, regulated firms might be able to transfer profits by (1) charging too low a price for services provided to the nonregulated affiliate or (2) paying too high a price for services received from the nonregulated affiliate. Thus, disputes regarding affiliate interest generally revolve around whether the expenses and revenues derived from business transactions with a nonregulated affiliate company are "prudent and reasonable."

In the case of services purchased *by* the ILEC, the standard commonly used for a determination that an affiliate transaction is prudent and reasonable is whether the price of the service is set at the *lower* of either market rate or cost.[15] In the case of services purchased *from* the ILEC, a standard commonly used for a determination that an affiliate transaction is prudent and reasonable is whether the price of the service is set at the *higher* of either market rate or cost. As I will present below, Verizon NW's contractual agreements with VDC are

[15] See, for example, UT-950200 Order at p. 55.

consistent with both of these guidelines established for "prudent and reasonable" transactions.

***A. <u>Verizon NW Does Not Overpay VDC for Services Received by Verizon NW</u>***

**Q. COULD THE COMMISSION REASONABLY CONTEND THAT VERIZON NW IS TRANSFERRING PROFITS TO VDC BY OVERPAYING FOR SERVICES PROVIDED TO IT BY VDC?**

A. No. As I discussed above, VDC does not charge Verizon NW for the directory publication and distribution services VDC provides to the carrier. It is my understanding that VDC considers this activity to be an integral part of its overall directory business; as such, VDC must assume that the incremental costs involved in the fulfillment of Verizon NW's regulatory requirements are *de minimis*. A price of zero cannot possibly be considered to represent an overpayment on the part of Verizon NW. Nor does a price of zero enhance VDC's revenue flows vis-à-vis other competitive directory providers. Thus, the "charges" paid to VDC by Verizon NW are reasonable and prudent.

***B. <u>Verizon NW Does Not Undercharge VDC for Services Purchased by VDC</u>***

**Q. DOES VERIZON NW UNDERCHARGE VDC FOR THE SERVICES IT PROVIDES TO VDC?**

A. No. Verizon NW charges market-based rates for all the services it provides to VDC and to any other competitive directory provider. As I previously stated, for directory listing information, Verizon NW charges all directory providers the same FCC-established rates.

These rates must be deemed to be reasonable and prudent by the Commission. Similarly, for the other major services provided to VDC by Verizon NW (e.g., billing and collection), Verizon NW charges non-discriminatory and market-based rates.

**Q. IS VERIZON NW FULLY COMPENSATED UNDER THE VARIOUS CONTRACTUAL ARRANGEMENTS FOR THE COSTS THAT VERIZON NW INCURS IN PROVIDING THESE SERVICES TO VDC?**

A. Yes. Both the Publishing Agreement and the Billing and Collection Agreement between Verizon NW and VDC are structured such that each party receives due compensation for the activities and services that it provides to the other. By design, the contracts are also competitively neutral; that is, the terms are equivalent to those provided to other unaffiliated companies and each contract presents price sets that must be considered market-based rates. As a consequence, the charges extended by Verizon NW to VDC must be considered reasonable and prudent.

## VI. <u>VDC WAS NOT DEVELOPED AT RATEPAYER EXPENSE</u>

**Q. IS THE "DEVELOPED AT RATEPAYER EXPENSE" RATIONALE APPROPRIATE IN THE CASE OF VERIZON NW AND VDC?**

A. No. In the US WEST case, the Commission supported yellow pages imputation on the basis of the directory operation having been part of the local telephone company before it was purportedly spun off to an affiliate.[16] Since, the Commission reasoned, the US WEST

[16] See UT-950200 Order and UT-980948 Order.

directory business had been developed at ratepayer expense, the ratepayers were entitled to enjoy that profits from the business – even the otherwise unregulated yellow page advertising part of the business. This "developed at ratepayer expense" rationale is misplaced in the case of Verizon NW and VDC, however. Neither VDC nor any of VDC's previous assets have ever been part of Verizon NW's organizational structure, operations, or rate base. This distinct separation of assets and operations has existed for more than 65 years.

**Q. PLEASE GIVE A BRIEF OVERVIEW OF THE ORGANIZATIONAL HISTORY OF VDC'S OPERATIONS IN WASHINGTON.**

A. VDC is a nonregulated, competitive company that can trace its history back to 1926, when a company named Tel-Ad Publishing ("Tel-Ad") was created to compete with other companies in the directory publishing business. Shortly thereafter, Tel-Ad was purchased by Associated Telephone Utilities, a firm providing telecommunications services in the Santa Monica and Redondo Beach areas of California. In 1935, Associated Telephone Utilities was reorganized as the General Telephone Company, with Tel-Ad preserved as one of its business units. In the following year, and with a view towards expanding Tel-Ad's presence beyond California, the General Telephone Company dissolved Tel-Ad through a sale of its assets to the newly created General Telephone Directory Company, a direct subsidiary of the parent organization. Beginning with the creation of this organization in 1936, VDC (through its precursor companies and operations in Washington) has been totally distinct and separate from any affiliated company providing telephone service.

VDC (and its precursor companies) remains wholly separate from Verizon NW (and its precursor local exchange carriers) and at no time have the assets or the advertising operating expenses of the directory business been included on Verizon NW's books nor has Verizon NW had any managerial control over VDC. It strains credulity to allege that the ratepayers of Verizon NW ever subsidized the development or operation of VDC. In fact, through the imputation of VDC revenues in setting local rates, quite the opposite is true – VDC has historically subsidized Verizon NW and Verizon NW's customers.

**Q. DO VERIZON NW RATEPAYERS BEAR ANY OF THE DOWNSIDE RISK ASSOCIATED WITH THE BUSINESS OPERATIONS OF VDC?**

A. No, nor should they. The shareholders of Verizon NW's parent company bear all the risk for VDC's performance. However, under yellow pages imputation, Verizon NW ratepayers ultimately receive all the benefits of any upside performance by VDC. This "one way street" is an absolute indication that yellow pages imputation is bad public policy. The only function of such imputation is to siphon profit away from VDC to support the revenue requirement of Verizon NW, thus allowing the Commission to establish local telecommunications rates at levels lower than efficient market rates.

**Q. IS THERE ANY WAY THE COMMISSION CAN REASONABLY CONSIDER VDC TO BE A REGULATED SUBSIDIARY OF VERIZON NW?**

A. No. VDC is a totally separate and nonregulated entity. To argue otherwise is to ignore not only the particular makeup of VDC but also the role of directory publication affiliates in general. As the FCC has emphatically stated, for example, "the publication of yellow pages directories is a nonregulated activity."[17]

## VII. <u>THE COMMISSION'S US WEST REVENUE ADJUSTMENTS</u>

**Q. ARE YOU FAMILIAR WITH THE MECHANISM FOR THE IMPUTATION OF YELLOW PAGES REVENUES ADVOCATED BY THE COMMISSION STAFF IN *AT&T v. VERIZON NW*, DOCKET NO. UT-020406?**

A. Yes. In particular, I have read the testimony filed by Betty A. Erdahl on behalf of the Commission Staff, dated February 7, 2003. In that filing, Ms. Erdahl advocated that the Commission should reduce Verizon NW's intrastate regulated revenue requirement by the

[17] FCC's Cost Allocation Memorandum and Order, paragraph 1.

"imputation of directory revenue." The amount of her proposed adjustment was calculated using a formula previously applied by the Commission to US WEST (now Qwest).

**Q. IS THE FORMULA THAT THE COMMISSION USED TO ADJUST US WEST'S REVENUE REQUIREMENT THROUGH THE IMPUTATION OF YELLOW PAGES ADVERTISING REVENUES APPLICABLE TO VERIZON NW?**

A. No, it is not. The formula, which had been used by the Commission as part of US WEST's 1995 general rate case, resulted in the reduction of the carrier's revenue requirement through the imputation of yellow pages advertising revenues from its directory publishing affiliate.[18] US WEST subsequently appealed this and other elements of the Commission's decision regarding the 1995 general rate case. The Washington Supreme Court upheld the inclusion of yellow page revenues in US WEST's revenue requirement calculation on the grounds that the directory operation had been a part of the regulated telephone operation – i.e., that it had been included in the rate base – and that US WEST had never received fair value for the sale of its yellow pages business.

A different situation exists with regard to Verizon NW and VDC. The arguments set forth for preserving yellow pages imputation in the case of US WEST are not applicable to Verizon NW, because, quite unlike the directory operations affiliated with US WEST, VDC was not developed at ratepayer expense. As I discussed above, Verizon NW has always obtained directory services from separate companies. It has never had a directory operation

[18] See UT-950200 Order.

"regulatory asset." The relationship that currently exists (and that has historically existed) between Verizon NW and VDC satisfies the threshold requirement for ending yellow pages imputation established by the Washington Supreme Court in its discussions regarding US WEST. Verizon NW need not demonstrate "that it has received fair value for the asset," since it was never in possession of the alleged regulatory asset. By the Court's standard, any imputation activities concerning Verizon NW and yellow pages earnings should be eliminated.

## VIII. <u>CONCLUDING REMARKS</u>

**Q. TO SUMMARIZE, SHOULD THE EARNINGS OF VDC BE USED TO REDUCE VERIZON NW'S REVENUE REQUIREMENT DURING ANY INTRASTATE RATEMAKING ACTIVITIES?**

A. No. VDC is a nonregulated, competitive affiliate of Verizon NW. As a competitive affiliate, it is inappropriate, either directly or indirectly, to include any revenues of VDC in the development of intrastate rates for Verizon NW. Verizon NW is not shifting profits to VDC; all contractual arrangements between VDC and Verizon NW are absolutely in concert with affiliated interest guidelines. No argument asserting that VDC was developed at ratepayer expense withstands even cursory scrutiny. The Commission has left to it no rational economic or regulatory support for continuing what would be bad public policy – the imputation of yellow pages revenues to support Verizon NW.

**Q. WHAT ACTIONS DO YOU RECOMMEND THE COMMISSION TAKE IN THIS PROCEEDING?**

A. The Commission should find that imputation of VDC's earnings is not warranted and is inappropriate from legal, regulatory, economic, and public policy perspectives. Accordingly, the WUTC should find that the actual revenues received by Verizon NW from all directory publishers are the only directory revenues appropriate for consideration in the ratemaking process. In other words, the appropriate regulatory treatment of any of VDC's earnings is to exclude them from the determination of the intrastate rates of Verizon NW. To do otherwise is to remain focused on the inefficiencies and subsidies of the past and to ignore the legal and competitive conditions presently exhibited in the telecommunications and local advertising markets. In the telecommunications and local advertising business arenas, a policy requiring the imputation of VDC revenues to Verizon NW for the purpose of establishing the carrier's local revenue requirement would be patently unfair and discriminatory. It would require VDC (or, by extension, Verizon-Parent) to provide these types of revenue flows to support Verizon NW's revenue requirements.

**Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

A. Yes.