Exhibit T-___ (TLS-12T)
Docket No. UT-023003
Witness: Thomas L. Spinks

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Review of Unbundled Loop and Switching Rates and Review of the Deaveraged Zone Rate Structure	)))))	DOCKET NO. UT-023003

RESPONSE TESTIMONY OF

THOMAS L. SPINKS

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION STAFF

April 20, 2004

Q. Please state your name and business address.

A. My name is Thomas L. Spinks, my business address is 1300 South Evergreen Park Drive Southwest, P.O. Box 47250, Olympia, Washington 98504. My e-mail address is tspinks@wutc.wa.gov.

Q. By whom are you employed and in what capacity?

A. I am employed by the Washington Utilities and Transportation Commission as a Regulatory Consultant.

Q. Have you previously filed testimony in this proceeding?

A. Yes. I submitted direct and supplemental direct testimony earlier in this docket.

Q. What is the purpose of your testimony at this time?

A. The purpose of my testimony is to respond to the direct and supplemental direct testimony filed by Verizon Northwest, Inc. (Verizon). In particular, I will address Verizon's proposal to use the VzCost model for estimating the Total Element Long Run Incremental Cost (TELRIC) for unbundled network elements (UNEs) in Washington and respond to the Company's proposals to use

depreciation rates and cost of capital that are different from what this Commission previously has authorized for use in TELRIC studies.

Q. Please summarize your testimony.

A. The VzCost model raises a number of concerns including how the model constructs the network and the inability of analysts to alter key model assumptions. As a result, Staff recommends that the Commission decline to use cost estimates produced by VzCost for setting UNE rates in Washington.

Q. What are Staff's concerns regarding the VzCost model?

A. Staff has several concerns with Verizon's new VzCost model. Staff has a number of operational concerns with the model. Staff also is concerned about how VzCost builds out the network. In addition, Staff has concerns with a number of the proposed inputs used in the model.

Q. What are the operational concerns with the VzCost model?

A. Staff's operational concerns are: 1) the Internet-only access; 2) the time requirements and complexity involved in using the model; and 3) the lack of

interfaces that allow Staff to make changes in global inputs such as common costs or structure sharing.

Q. Why is Staff concerned with the Internet-only access to the VzCost model?

A. Staff is concerned about the limited access to the model because of the uncertainty that it introduces into the model evaluation. In order for an analyst to optimally control outside or external influences and conduct a real-time physical evaluation of a cost model, the model should be in the analyst's physical possession and control. If the analyst does not have physical possession and control of the model, the analyst must make a very important and critical assumption at the very beginning of any evaluation. That is, the analyst must assume that what is sent and received through the remote access is not in any way different from what would occur if the analysis were conducted at the analyst's own computer. If the analyst cannot maintain physical control over the model, the analyst cannot know whether the data received resulted entirely from changes made by the analyst, or whether the data received were also changed because of changes in the model programming, or data errors in the transmission and reception of information. Staff notes that Verizon has in place processes and procedures designed to address these concerns, but the point to be made here is

that the uncertainty created by remote-only access could be avoided entirely if Verizon were willing to provide the model on a stand alone basis as has been done with prior models, such as the ICM.

In addition, the fact that Verizon retains centralized control over the model means that Verizon can change the model whenever Verizon deems it necessary to do so. Verizon has updated the model twice during the course of this proceeding. This makes it difficult for the analyst to produce consistent results. For instance, when an analyst is evaluating a series of progressive input changes, if the underlying formulae of the model changes during the analysis, the analyst cannot ascertain what changes in output were due to the input changes versus model formulae changes without rerunning the entire analysis. In the past, Staff has been critical of Verizon's cost models even when they were physically available because they contained compiled programming. In this case, the model algorithms are purported to be viewable over the Internet but the analyst does not have any direct physical connection to the model. In reality, instead of being more accessible and usable as Verizon claims, the VzCost model is less open than the old ICM model.

Q. Why does Staff believe the model is overly complex?

A. After receiving training on how to run the model through the Internet connection, Staff examined some aspects of Verizon's proposed cost study. In Data Request No. 35, Staff asked Verizon to provide the results of Verizon's cost studies as presented in Exhibit No. ___ (RP-2) with the effects of the FLC (forward looking calibration) removed. Notwithstanding its objection to this request, Verizon provided 33 pages of instructions in response. Over the course of two days and eight hours of Internet model calculation time, Staff was able to recalculate loop cost results without the FLC adjustment. These results are shown in Exhibit C- ___ (TLS-13). Staff believes that the model could have been designed in a more user-friendly way that would not require the expenditure of so much time and resources to obtain what should have been the simplest of answers.

Q. Does Staff have other operational concerns with the model?

A. Yes. The model lacks the interfaces that allow an analyst to change inputs that commonly have been subject to change in prior proceedings, such as common cost percentages, structure sharing, and loop length adjustments. Unlike the HAI model, there is no inputs menu that allows the analyst to simply input a

different common cost percentage or structure sharing percentage assumption. I discuss these issues in more detail later in my testimony.

Q. What is Staff's concern regarding the way VzCost models the network?

A. A major concern with the VzCost model is how the loop module replicates the existing network. Verizon's panel testimony describes the model as using the actual locations of distribution terminals, existing serving area interfaces, existing digital loop carrier locations, and existing cable routes to model the necessary investment for determining loop cost. (Ex. ___ RP-1T, p. 35 line 12 through p. 39 line 18.) Staff disagrees with this approach because the existing Verizon network was constructed incrementally over the last fifty to one hundred years as population increased and Washington State developed geographically. The process of incremental growth over a long period of time necessarily would result in network design and equipment locations that are different from the network design and equipment locations that a company would choose if it were to rebuild the network today to serve existing total demand. A cost model (like VzCost) that replicates the existing physical network creates a backward-looking network containing all the inefficiencies that could be avoided in a forward-looking network designed to serve total demand as it

exists today. For this reason, Staff believes the VzCost model is fatally flawed in its design.

Q. Are all of the VzCost algorithms viewable?

A. No. In response to Staff Data Request No. 18, Verizon indicated that certain information, such as engineering and construction standards, is not accessible in the model.

Q. On page 6 of its panel testimony, Verizon states that the Commission "should adopt Verizon NW's cost studies and the resulting costs and rates because (1) Verizon NW's costs are the product of a cost model and cost studies that fully comply with the Commission's previous orders . . . " Does Staff agree?

A. No, the Verizon cost model and cost studies do not comply with prior Commission orders. The Commission first directed the use of loop length adjustments and certain structure sharing assumptions in its 8th Supplemental Order in Docket Nos. UT-960369 et al., which was issued April 16, 1998. In its November 18, 1998 Final Order in Docket No. UT-980311, the Commission reaffirmed its determination to use the structure sharing values and loop length adjustments it had found appropriate in Docket Nos. UT-960369 et al. Finally, in

the June 21, 2002, 32nd Supplemental Order in Docket No. UT-003013, the Commission stated that the Verizon ICM model did not provide for either structure sharing or loop length adjustments and ordered Verizon to make such changes to the ICM cost model. (*See id.* ¶¶ 345-47, 354-55). Despite these prior Commission orders, including prior directives aimed directly at Verizon's cost model, Verizon has failed to include in VzCost the ability to adjust costs based on loop length differences or to alter structure sharing assumptions. The VzCost model does not comply with prior Commission orders because it fails to accommodate input choices for calculating UNE TELRIC costs that this Commission repeatedly has ordered.

Q. How do the loop lengths produced by VzCost compare with the updated actual loop length data submitted by Verizon?

A. Exhibit C- ___ (TLS-13) shows a comparison between the actual and modeled loop lengths. The comparison shows that the loop lengths produced by VzCost vary widely from the updated actual loop lengths and are on average 54 percent longer than the updated actual loop lengths for Verizon's wire centers. The longer loop lengths mean that the VzCost model significantly overstates Verizon's loop cost in Washington.

Q. Please summarize Staff's concerns with the VzCost model.

A. The VzCost model operates in an environment that cannot be controlled by the analyst, is difficult and time consuming to use, and lacks input menus that are necessary in order to adjust key model variables such as common cost and structure sharing values. The model is backward-looking in its replication of existing loop plant locations, which leads to the model producing approximately 54 percent more loop plant than exists today. Finally, the model cannot be used to calculate costs in compliance with prior Commission orders because it either contains hardwired programming for assumptions such as structure sharing and contains no way to adjust for factors like loop length differences. As a result, Staff believes the model is not suitable for use in estimating UNE costs in Washington.

Q. What does Verizon propose for depreciation rates in this proceeding?

A. In his testimony, Verizon witness Mr. Sovereign asks the Commission to adopt the depreciation lives and rates used for financial reporting purposes. Mr. Sovereign acknowledges that the Commission has adopted longer depreciation lives in previous cases, but nevertheless states that "the considerations and

circumstances that led the Commission to adopt those lives no longer apply." (Ex.___ (AES-1T), p. 6, lines 4 –5.)

Q. Should the Commission use the depreciation rates proposed by Verizon for calculating costs in this proceeding?

A. No. Staff asked Verizon in Data Request No. 43 to provide any studies of its Washington plant and equipment it had performed to support its statement regarding changes in considerations and circumstances. Verizon had no studies to support its request and simply points to the evidence of competition presented by other witnesses in the case as support for the proposition that the Commission should now adopt Verizon financial reporting depreciation rates. Staff also notes that on March 29, 2004, Verizon filed a depreciation study with the Commission in Docket No. UT-040520. The Commission should await the outcome of that docket before considering any revision to depreciation rates in this proceeding.

Q. Has staff reviewed the testimony of Verizon witness Mr. West regarding the extent of competition in Washington?

A. Yes, the testimony of Mr. West contains an extensive discussion of CLEC market entry in the state of Washington but provides very little factual information

regarding the state of competition in Verizon Northwest–Washington service areas. Based on the Verizon-specific information presented by Mr. West and responses to several Staff data requests, Staff concludes that Verizon has no effective competition in its service area. Based on the response to Staff Data Request No. 42 and total line information from the cost model, Staff estimates that Verizon still retains over 97 percent of its total access lines. Verizon relies heavily on competitive risk as the reason why this Commission should use both higher depreciation rates and a higher cost of capital, yet the actual amount of competition experienced by Verizon in Washington State does not appear to substantiate the high level of competitive risk posited by Verizon.

Q. What does Verizon propose for a cost of capital in this proceeding?

A. The testimony of Dr. Vander Weide proposes that the Commission adopt a 15.98 percent weighted cost of capital for use in calculating UNE TELRIC rates in Washington. The return assumes a 12.03 percent Weighted Average Cost of Capital (WACC) and a 3.95 percent additive for what Verizon describes as its additional risk for offering UNEs to competitors.

Q. Does Staff agree with Verizon's proposed 15.98 percent cost of capital?

A. No. Staff disagrees with Verizon's proposed capital structure used in calculating the 12.03 percent WACC and the additional risk premium proposed by Verizon. Staff opposes the risk additive in part because the comparable group used for estimating the 12.03 percent WACC overestimates the competitive risk faced by Verizon Northwest in Washington and therefore already contains an additional risk premium that the FCC has stated should be used in calculating UNE rates. The comparable group used by Dr. Vander Weide, (Ex. ___ (JHV-2)), is not an appropriate selection of comparable companies because those companies do not operate in the relevant industry (i.e. telecommunications) and are not of similar size or similar revenue bases. In addition, the lease theory relied on by Verizon for proposing the risk additive falls flat on a practical perspective because Verizon does not even offer UNE loops on a lease basis. Staff has reviewed the UNE cost of capital decisions for Verizon from Virginia (August 29, 2003), Pennsylvania (November 13, 2003), and New Hampshire (January 16, 2004) and all three of the decisions uniformly reject the risk premium Verizon proposed.

Q. Does Staff believe that Verizon's existing 9.76 percent overall cost of capital is still appropriate to use in this proceeding?

A. In prior Washington cost dockets the Commission determined that the ILEC's currently authorized rate of return was appropriate to use in calculating UNE rates. However, Staff believes the Commission should reevaluate whether to use Verizon's authorized cost of capital for calculating UNE rates in light of the FCC's decision regarding the cost of capital for TELRIC rate calculation, which was set forth in the Triennial Review Order (TRO). As discussed in my supplemental direct testimony, the FCC clarified that the cost of capital used in calculating UNE TELRIC rates should reflect the overall risks of a competitive market as well as any unique risks associated with new services that might be provided over certain types of facilities. Verizon's current cost of capital was last determined by this Commission in the early 1990s, well before the federal Telecommunications Act became law, and therefore could not have considered the sort of competitive risk that the FCC now states needs to be accounted for in calculating UNE rates under the TELRIC standard.

Q. What is Verizon's currently authorized cost of capital and capital structure?

A. In Docket No. UT-931591, the Commission authorized the following capital structure and costs for Verizon:

Type of Capital	Ratios	Cost Rates	Weighted Cost
Long Term Debt	37.224%	8.505%	3.166%
Short Term Debt	7.165%	4.740%	0.340%
Preferred Equity	0.090%	8.302%	0.007%
Common Equity	55.521%	11.25%	6.246%
Total	100.000%		9.759%

Q. What is Staff's proposal for cost of capital?

A. If the Commission determines that cost of capital should be adjusted pursuant to the TELRIC changes in the TRO, Staff believes an upper bound for the overall cost of capital can be estimated by substituting Dr. Vander Weide's costs of debt and equity into Verizon's currently authorized capital structure. The result of that exercise would increase the weighted cost of capital from 9.76 percent to 10.54 percent. Staff considers this an upper limit because the firms shown in Ex.___ (JHV-2) used to develop the cost of equity are not an appropriate comparable group to use for determining Verizon's cost of equity.

Q. Why should the Commission use the existing capital structure for determining Verizon's WACC?

A. An appropriate capital structure balances economy with financial flexibility. Because the cost of debt is generally lower than the cost of equity, it is clear that Verizon's proposal to use 25 percent debt and 75 percent equity is not a balance that considers economy in the capital structure. In addition, the business risk Verizon Northwest faces in Washington State cannot justify such a capital structure given the de minimis line losses Verizon has experienced to date. Finally, the bond rating process considers a wide variety of financial and non-financial factors that evaluate the overall riskiness of a firm. Currently, Verizon Northwest's Standard and Poors bond rating is A+, the same rating it had when the Commission last approved an authorized return for Verizon in 1994.

Q. Does this conclude your testimony?

A. Yes.