Exhibit T-___ (TLS-15T)
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

REBUTTAL TESTIMONY OF

THOMAS L. SPINKS

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION STAFF

May 12, 2004

Q. Please state your name and business address.

A. My name is Thomas 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, supplemental direct, and response testimony earlier in this proceeding.

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

A. The purpose of my testimony is to rebut the response testimony Verizon filed in this proceeding. In particular, I will address Verizon's testimony regarding depreciation rates, cost of capital, and some of the criticisms it levels at the HAI 5.3 cost model.

DEPRECIATION

Q. What is Verizon's response to Staff testimony regarding depreciation rates?

A. Verizon witness Mr. Flesch rejects Staff's recommendation to use the currently prescribed depreciation rates for calculating TELRIC rates and continues Verizon's advocacy to use the depreciation lives used for financial reporting purposes (i.e. GAAP lives). Verizon believes that the currently prescribed depreciation rates authorized in Docket UT-992009 are inappropriate to use in UNE cost studies because, (1) "the purpose of the prior proceeding was to calculate retail rates for Verizon NW's customers under a rate-of-return regulatory regime whose requirements and underlying assumptions are far different than those under TELRIC." (Ex. ___ (AJF-1T), at 4, lines 13-16); and (2) "the depreciation inputs adopted in the prior proceeding are now nearly four years old and do not account for competitive and technological developments that have occurred since 2000, all of which have substantially shortened the use lives of Verizon NW's assets." (*Id.* at 4, lines 16-20).

Q. Does Staff agree with Verizon's first contention?

A. No. The purpose of Docket UT-992009 was to prescribe economic depreciation rates for Verizon. Nothing in that docket suggests the purpose of the represcription was to use the depreciation rates only for setting retail customer rates. In an earlier depreciation proceeding involving Verizon, the company challenged the then-currently prescribed depreciation rates by arguing that they did not represent economic depreciation rates. (*See* Docket UT-961632). In that docket, the Commission rejected Verizon's argument and found that the authorized depreciation rates were indeed economic depreciation rates. In an earlier generic cost case, the Commission affirmed the use of currently authorized depreciation rates for calculating TELRIC rates. (Docket No. UT-960369, Eighth Supplemental Order, ¶217). Nothing in the Triennial Review Order requires the Commission to use a different set of depreciation rates. Because the currently authorized depreciation rates are economic depreciation rates, the Commission should use them for all regulatory purposes, including the calculation of rates for unbundled network elements.

Q. Does Staff agree with Verizon's second contention?

A. Staff agrees with Verizon insofar as proper depreciation practices include restudying and represcription of depreciation rates every three to five years, and

that currently prescribed rates are now about four years old. Verizon's current depreciation rates are ready to be restudied, but Verizon has not put forth evidence in this case to show that the current rates are no longer appropriate. Indeed, as discussed in my response testimony, in March 2004, Verizon filed with the Commission a petition to represcribe depreciation rates, including a depreciation study.

However, Staff does not agree with Verizon's contention that competitive and technological developments that have occurred since 2000, have substantially shortened the use lives of Verizon NW's assets, for two reasons. First, Verizon refers to the testimony of Mr. West to support its contention. However, Staff could not find in Mr. West's testimony any evidence establishing a link between the competitive activity and technological changes described in that testimony, with the shorter asset lives for Verizon that the company advocates in the depreciation testimony. Second, Staff has seen mixed effects of technological and economic changes on asset lives over the last ten years. For instance, the development of Digital Subscriber Line (DSL) technology increased the expected life of copper cable plant because it was no longer necessary to replace the copper with fiber cable in order to provide high-speed data services to homes and businesses. Therefore, it is not necessarily true that if

technological changes are occurring, their effect is to shorten existing plant asset lives. The Commission should use the economic depreciation rates currently prescribed for Verizon until such time as Verizon's represcription has been completed. If there are substantive changes in depreciation rates as a result of the represcription, the Commission should permit Verizon to update its UNE rates accordingly.

COST OF CAPITAL

Q. Dr. Vander Weide states that the capital structure must be based on market value rather than book value because market value is necessarily forward-looking, while book values are necessarily based on historical costs. Please comment. (Ex. ___ (JHV-4T), at 5, lines 1-9).

A. TELRIC requires that the cost of capital be forward-looking, not the capital structure per se. There is nothing in the TRO that requires state commissions to use a market-based capital structure in determining the forward-looking cost of capital. Verizon remains a regulated public utility and therefore has a duty to maintain a sound capital structure that includes a prudent mix of debt and equity. To the extent that Verizon's actual capital structure may have changed

from the time the Commission last set Verizon's cost of capital, Staff does not object to an updated capital structure to reflect more current values.

HM 5.3 CRITIQUE

Q. Mr. Murphy states, "there is absolutely no merit to Staff witness Spinks' claim that HM 5.3 explicitly models high capacity loops in the network." (Ex. ___ (FJM-1T), at 96). Please comment.

A. It appears that Mr. Murphy disagrees with the way the HM 5.3 model sponsors have chosen to model high capacity loops. Because the high capacity loops have not yet been separately identified, Mr. Murphy appears to equate that lack of specific identification with the notion that HM 5.3 does not explicitly model high capacity loops. My statement that HM 5.3 now explicitly models high capacity loops refers to the fact that prior to the introduction of HM 5.3, high capacity loops were not included in the network design. The Commission has been critical of including all access lines in the network as individual copper loops when it was known that a significant number of the loops were being provisioned over DS-1 and above facilities. (*See* Docket No. UT-960369, Eighth Supplemental Order, at p.43). The HM 5.3 now explicitly accounts for circuits

carried over high capacity facilities, albeit not in a manner that Mr. Murphy would find acceptable.

Q. Mr. Murphy states that, "there is no merit to Staff witness Spinks' claim that it was unnecessary to make the Commission's adjustment for cable costs because the HAI cable costs reflect more current cable cost information." (Exhibit ___, (FJM-1T), at 124. Please comment.

A. Mr. Murphy is criticizing an apparent shift in costs between cable material, placement, and engineering costs that occurred between HM model versions 5.2 and 5.3. My earlier statement refers to a study of the cost of cable paid by ILECs to suppliers conducted by the Minnesota regulatory commission staff that concluded that ILECs were actually paying less for cable than the cable costs used in the HM 5.2 model. After reviewing the Minnesota study, I determined that cable prices would not need to be adjusted as they had been in prior proceedings. I did not make any recommendation regarding placement or engineering costs other than to note that the model documentation indicated that the hard rock/soft rock placement multipliers had been increased.

Q. Mr. Murphy is critical of the HM 5.3 because it fails to follow the outside plant planning process, ignores existing or planned cable routes and ignores man-made barriers. (Exhibit ___(FJM-1T), at 20, 38-44) Please comment.

A. Staff is perplexed by Mr. Murphy's criticisms given that cost models are simplifications of reality and the assumptions of long run incremental costing do not require cost models to rebuild the network as it exists today. The outside plant planning process is a short-run "subdivision at a time" procedure. The TELRIC assumption is a "what if you could rebuild the network in an economically efficient manner using the most current technology" exercise. The economics of re-creating the network within the TELRIC framework are different from the economics of adding a new subdivision to the existing network. Existing or planned cable routes are irrelevant or only marginally relevant to the TELRIC process. Mr. Murphy, moreover, provided no specific evidence showing that HM 5.3's failure to explicitly account for geographic or man-made barriers results in any understatement of required loop plant.

Q. Dr. Tardiff proposes that current investment be used as a benchmark to judge the reasonableness of the HM investment. (Exhibit ____ (TJT-1T) at 47-50). Please comment.

A. Staff believes that current investment levels do not make a good benchmark for judging the reasonableness of HM investment levels because current investment levels represent the embedded costs of the historic monopoly era network, and as such, may contain investments in excess plant and equipment that are remnants of the monopoly, regulated rate of return legacy in which there existed incentives to overbuild plant.[1]

Q. Dr. Tardiff is critical of the inability of the HM 5.3 to accurately model loop lengths and claims VzCost has much less error in its loop lengths. (Exhibit ___ (TJT-1T) at 97). Please comment.

A. The analysis I provided in response testimony, Ex.C-__ (TLS-14), showed that the VzCost model also produces some grossly inaccurate loop lengths for certain wirecenters. Dr. Tardiff also states that he found an average deviation of 15 percent in the VzCosts loop lengths, whereas I reported finding that VzCost produced loop lengths that were generally 54 percent longer than average. Staff is rechecking the information received from Verizon regarding the loop length data to see why the discrepancy exists between Dr. Tardiff's and my Verizon loop length analysis.

[1] *See, e.g.,* Alfred A, Kahn, The Economics of Regulation, Volume II, at. 49 (1971).

The point Staff would like to make here, however, is that an analyst can easily adjust the HM model investments for loop length differences using Staff's modified distribution module. The VzCost model has no known means to make such an adjustment.

Q. Mr. Dippon criticizes HM preprocessing methodology, which results in 1.166 million customer accounts being converted to 437,027 lots, and states "this method of modeling plant is absurd and leads to a significant understatement of costs." (Exhibit ___ (CMD-1), at 14-15). Please comment.

A. I read the 92 pages of Mr. Dippon's reply testimony and could not locate any evidence that supported his contention that conversion of 1.16 million records into 437,027 lots was inaccurate or unreasonable. Verizon did not produce evidence, such as the actual number of lots to which Verizon provides service, to refute the HM preprocessing method. Instead, Mr. Dippon provided a very one-sided analysis in which he identified a number of circumstances suggesting that costs may be lower than appropriate. As discussed later in this testimony, Mr. Dippon does not provide any quantifiable evidence that would lead the Commission to conclude that the model as a whole is unreasonable.

Q. Mr. Dippon states that he "will demonstrate, the cluster database, while certainly a major cost driver, is severely flawed, and thus renders HM 5.3's cost estimates useless." (Exhibit ____ (CMD-1), at 1). Please comment.

A. To begin with, Mr. Dippon's characterization of the cluster base inputs as "major cost drivers" is misleading. For the most part, the inputs consist of factual record data from the Census Bureau, city and state governments, and Verizon itself. The assumptions used in sizing the network and the like are integral to the type of model and network being developed, and would not represent an input like cost of capital or depreciation that can or should be adjusted at will. Therefore, calling them major cost drivers does not truly denote their nature. Second, and more importantly, Mr. Dippon does not substantiate his contention that "the cluster database is severely flawed."

Q. Why does Staff believe Mr. Dippon has not substantiated his allegations regarding the cluster database?

A. Mr. Dippon is critical of the use of rectilinear routing, yet despite the fact he has the GIS capability to map the cluster data and make measurements with which he could show where and how frequently the rectilinear method understates plant, he fails to do so. In another case, Mr. Dippon contends that the cluster

database preprocessing steps need to be completely explained or it's just a black box. (*See id.* at 10-11). While Staff does not condone or support models that are not open to inspection, we see no reason why Mr. Dippon could not compare for instance, the number of households and businesses within a given cluster with the information actually existing in the geographic area of the cluster to see how accurately the clusters portray reality in a given cluster area. Mr. Dippon has not substantiated his assertions because he fails to provide any quantitative analysis to support them.

Q. Mr. Dippon states that, "when HM's network is illustrated in map form, it becomes clear the model produces entirely unrealistic distribution areas, resulting in absurd outside plant estimates." (Exhibit ___ (CMD-1), at 58.) Please comment.

A. Staff reviewed a number of the maps Mr. Dippon produced and found that his projection of the cluster data produced results similar to Staff's analysis of the HM cluster data conducted earlier in this proceeding. Staff withdrew that analysis as part of the settlement agreement with Qwest. In performing that analysis, Staff found that two types of errors could occur with the cluster data. The cluster may be wrongly positioned, over a body of water for instance, but

can be moved to its correct location by rotating the cluster up or down without changing the radial distance. In that case, the error has no effect on cost. The other errors Staff found occurred in situations where the cluster was misplaced and could not be correctly positioned without changing the radial distance of the cluster. Mr. Dippon, in his analysis, makes no attempt to quantify, correct, or estimate cost if these corrections were made. He simply sees that clusters are misplaced, or in one case, produced insufficient coverage, and concludes the model produces incorrect and absurd results. Yet without any quantifiable analysis, the Commission is left to guess the extent, if any, of any cost impact caused by the misplacement of clusters. Generally, in the Qwest analysis Staff found many more rotational errors, which have no effect on cost, than radial distance errors, which do affect cost. Since the identification and correction of these errors can be easily accomplished, the Commission should look to correcting the errors rather than throwing out the model.

Q. Does this conclude your testimony?

A. Yes.