Exhibit ____ LLS-6T

Before the

WASHINGTON UTILITIES
AND TRANSPORTATION COMMISSION

AT&T Communications of the Pacific Northwest, Inc. v. Verizon Northwest, Inc.	**Docket No. UT-020406**

Rebuttal Testimony

of

LEE L. SELWYN

on behalf of

AT&T Communications of the
Pacific Northwest, Inc.

January 31, 2003

ALLEGEDLY PROPRIETARY DATA
HAS BEEN DELETED

TABLE OF CONTENTS

Tables

Exhibits

REBUTTAL TESTIMONY

Introduction

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

A. My name is Lee L. Selwyn. I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Boston, Massachusetts 02108.

Q. Have you previously submitted testimony in this docket?

A. Yes, I prepared an affidavit dated March 28, 2002, which was submitted by AT&T Communications of the Pacific Northwest, Inc. ("AT&T") in support of its petition in the current proceeding. I also submitted direct testimony on behalf of AT&T on September 30, 2002 in this proceeding.

Assignment and summary of testimony

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to address certain issues raised in reply testimony submitted on December 3, 2002 by Verizon Northwest. In particular, I address certain issues raised by Mr. Orville Fulp, Mr. David Tucek, Mr. Terry Dye, Dr. Carl Danner, and Ms. Nancy Heuring.

Q. Please summarize your rebuttal testimony.

A. In its reply filing, Verizon advances several theories to the Commission, none of which are supported by factual evidence. *First*, Verizon claims that its current intrastate switched access rates are "just, reasonable and compensatory" because the Commission found them to be so several years ago, and for that reason there is no basis for lowering them at this time.[1] On that basis, Verizon appears to advance the absurd theory that once determined, the "justness and reasonableness" of rates must hold in perpetuity. When Verizon's rates were last examined and its access charges were established as part of the settlement of the GTE/Bell Atlantic merger application proceeding,[2] the Commission committed not to revisit Verizon's rates sooner than July 1, 2002. That date having passed, the possibility that Verizon's pricing structure would be reexamined at this time was expressly contemplated in that settlement.

In fact, a thorough reexamination of Verizon Northwest's rates at this time is entirely appropriate. Telecommunications is a dynamic, declining-cost industry not characterized by a static business environment. In the years since Verizon Northwest's (then GTE-Northwest's) rates were last visited by this Commission as part of the then-pending merger proceeding between GTE and Bell Atlantic, the combination of the two carriers into what is now Verizon (the largest telecommunications company in the United States) had not yet been implemented. That of course is no longer the case. The Verizon BOCs are now in the

1. Fulp (Verizon), at 5.

2. WUTC Docket Nos. UT-981367, UT-990672, and UT-991164, consolidated.

interLATA long distance business in 11 of 14 legacy-Bell Atlantic states, and as recently as January 7, 2003 Verizon issued a press release announcing that it has now become the nation's third largest long distance company.[3] Perhaps Verizon Northwest wishes that time would stand still, at least when it comes to revisiting its pricing practices; that not being the case, it is entirely appropriate for the Commission to address the unique issues raised by AT&T that undermine the IXCs' ability to compete in the Washington intrastate long distance market.

Clearly, changes in the state's telecom marketplace affect what constitutes "just and reasonable" rates, and the movement away from implicit subsidies and towards cost-based rates for telecommunications services provides ample justification for the Commission to reexamine whether or not Verizon's intrastate access charges are just and reasonable today. Moreover, as I have demonstrated in my direct testimony, several of Verizon's intrastate toll plans fail the Commission's access charge imputation requirements, and Verizon's feeble criticisms of my imputation analysis do not withstand scrutiny. It is important to eliminate the anticompetitive price squeeze that currently exists for interexchange carriers seeking to compete with Verizon in the intrastate toll market, and the best method for doing so is to lower access rates — and not by some nominal amount, but at least to interstate levels and preferably to cost-based levels.

3. Verizon News Release, "Verizon Now Third Largest Long Distance Carrier," January 7, 2002, available at http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=78494, accessed on 1/27/03.

Second, Verizon claims that its earnings level is well below its current authorized rate of return of 9.76% and asserts that it has been for some time,[4] and for that reason if a reduction in switched access rates is pursued, Verizon argues that any reduction in access charges must be offset by a revenue-neutral rate increase for other retail services.[5] Verizon's claims as to its alleged failure to achieve its authorized rate of return ignore important additional "returns" that are not directly captured in the accounting "ROR," but which confer considerable value for the Company and its shareholders. By understating certain revenue categories and relying upon an inflated rate base, Verizon's rate of return calculations fail to properly quantify the Company's actual intrastate earnings. The Commission must fully explore the actual level of Verizon's earnings prior to reaching a determination that the Company should be "made whole" through a revenue-neutral rate rebalancing exercise following a reduction in intrastate access charges, but in no event should the debate over Verizon's earnings serve to delay the Commission's efforts at alleviating the current price squeeze through reductions in switched access rates.

Finally, Verizon insists that any offsetting rate increase must be assessed upon local residential rates.[6] As support for this position, Verizon asserts that its residential basic service is currently priced below cost.[7] Yet here, Verizon's analysis is fatally flawed: The Company examines only the costs and revenues associated with the basic residential local service rate

4. Heuring (Verizon), at 4.

5. Fulp (Verizon), at 7; Danner (Verizon), at 3-4.

6. Fulp (Verizon), at 20-21.

7. Dye (Verizon), at 9-10.

element, ignoring altogether the various other sources of residential revenue that are built on the basic residential service platform. In reality, when all of the appropriate costs and revenues are considered, Verizon's residential local exchange service is fully compensatory such that no residential-only rate adjustment is either warranted or justified.

REDUCING VERIZON'S INTRASTATE SWITCHED ACCESS RATES

The Commission should reduce Verizon's intrastate switched access rates to cost-based levels.

Q. Does Verizon believe its intrastate switched access rates should be reduced?

A. Verizon has advanced two contradictory opinions on the matter of whether the Company's intrastate switched access charges should be lowered. On the one hand, Verizon witness Orville Fulp claims that "Verizon's current access charges are just, reasonable, and compensatory and need not be changed."[8] On the other hand, Verizon witness Dr. Carl Danner, an independent economist, states that he "agree[s] with reducing Verizon's access charges because recovering the fixed costs of network access through access charges (as is now occurring in Washington) is economically inefficient, and causes economic losses to customers and the economy."[9] These two Verizon witnesses are thus at odds over whether Verizon's switched access rates are "just and reasonable."

Q. Do you agree with either of these positions?

A. I concur with Dr. Danner on this point. Mr. Fulp's claims regarding the "justness" and "reasonableness" of Verizon's intrastate access charges are illogical. He claims that since Verizon's intrastate access charges were considered by the Commission to be "just and

8. Fulp (Verizon), at 7.

9. Danner (Verizon), at 14.

reasonable" following the Bell Atlantic/GTE merger,[10] and since intrastate access rates have been reduced by $7-million since that time,[11] then rates in effect today must also be "just and reasonable."[12] But such a conclusion ignores the fact that changes in marketplace conditions can *and have* altered the perception of what meets the "just and reasonable" standard. As discussed in my direct testimony, the trend toward eliminating implicit subsidies and setting prices at levels closer to economic cost,[13] coupled with the fact that Verizon's intrastate switched access rates are currently set at many multiples of both the cost-based UNE rates[14] (adopted by the Commission in Docket No. UT-960369[15]) and the current negotiated rates for the termination of local exchange traffic between Verizon and other carriers,[16] there can be no doubt that the Company's intrastate switched access rates can no longer be considered "just and reasonable."

Apparently recognizing the weakness of his "just and reasonable" argument, Mr. Fulp is quick to offer up a back-up plan for the Commission's consideration, that being to "permit Verizon to make simultaneous increases to local residential rates on a revenue-neutral basis"

10. Fulp (Verizon), at 5, citing WUTC Docket No. UT-981367.

11. *Id*., at 6.

12. *Id*.

13. Selwyn Direct (AT&T), at 9-10 and 16-17.

14. *Id*., at 11-12.

15. *See generally*, *Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale*, WUTC Docket No. UT-960369.

16. Selwyn Direct (AT&T), at 12, and footnotes 12 and 14.

following any increase in intrastate switched access rates.[17] The testimony filed by the other five Verizon witnesses all seek to provide support for Verizon's revenue-neutral rate rebalancing proposal.

Q. In your direct testimony, you advocate that Verizon's intrastate switched access rates should be reduced to cost-based levels. Has Verizon addressed this recommendation?

A. No. My direct testimony not only recommends that Verizon's intrastate switched access rates be lowered to cost-based levels, but sets out the factual basis for doing so.[18] Verizon has, for unknown reasons, completely ignored AT&T's position on this matter. The Company's rebuttal testimony addresses only Staff witness Dr. Glenn Blackmon's recommendation. Staff would set Verizon's intrastate switched access rates at levels that are roughly equivalent to those of Qwest, which apparently equates to a $32-million reduction in switched access revenues.[19]

Although Verizon is critical of Staff's recommendation, the Company nonetheless has responded to Staff's proposal with its own similar $32-million switched access rate

17. Fulp (Verizon), at 7.

18. Selwyn Direct (AT&T), at 7-17.

19. Blackmon (Staff), at 7. The workpaper provided by Staff through discovery appears to indicate that Staff's proposed switched access revenue reduction is closer to $33-million. *See* Staff Response to AT&T Data Request No. 6.

reduction.[20] For whatever reason, a reduction of $32-million appears to be some sort of agreeable target for Staff and Verizon. But unless switched access rates are lowered to cost-based rates, some form of implicit subsidy will remain in place and Verizon will continue to have the opportunity to perpetrate a price squeeze on its rivals. It should be the goal of this Commission to eliminate these subsidies and promote fair and equal market opportunities for all types of carriers to compete for all types of traffic.

Q. What are Verizon's criticisms of Staff's recommendation?

A. Mr. Fulp asserts that there is no basis to comply with Staff's recommendation in light of the fact that Verizon and Qwest are different companies with different cost structures. Mr. Fulp postulates that because Verizon (1) serves fewer than one-third the number of switched lines as compared with Qwest; and (2) has a greater proportion of switched lines in less densely populated areas, the switched access rates for these two carriers should be different.[21]

Q. Do Verizon's criticisms of Staff's recommended approach also apply to your recommendation for setting switched access rates at cost-based levels?

20. It is important to note that Verizon and Staff rely upon different demand sets when calculating the revenue impact of their proposed switched access rate reductions. Staff uses 2001 units, while Verizon relies upon October 2001-September 2002 data.

21. Fulp (Verizon), at 11-16. I am skeptical of Mr. Fulp's comparison of the density characteristics between Qwest and Verizon in Washington. According to ARMIS data, Mr. Fulp appears to overstate the quantity of Qwest and Verizon 1998 switched access lines by 35% and 7%, respectively. *See* Federal Communications Commission, ARMIS Report 43-08 (Table III. Access Lines in Service by Customer), for year 1998, accessed 01/15/03.

A. No. In its rebuttal of Staff's recommendation, Verizon attempts to draw a distinction between the services provided by Qwest versus those being provided by Verizon based upon differences between the two companies, concluding that it is reasonable and appropriate for the two carriers to have different access rates. The same arguments cannot be used to rebut my position relative to the different rate structures applied by a *single company* (Verizon Northwest) for intrastate switched access, interstate switched access, unbundled switching elements and the termination of local exchange or wireless traffic, all of which are essentially the same service. As discussed at length in my affidavit and direct testimony, there is no economic justification for maintaining separate and grossly different rate structures for these services since the *functionality and underlying costs of each are in all material respects identical*. Staff witness Dr. Glenn Blackmon supports my position on this issue, noting that "[i]t raises issues of undue discrimination whenever a regulated company is charging different prices for the same service, and that is what Verizon is doing with access services."[22]

That is not to say that there are no *policy* reasons for maintaining rates at a particular level, even for different services whose functionality is the same. Switched access rates, for example, have historically been set at levels well above cost as a means of providing an implicit subsidy to basic local exchange service. That policy might have arguably been acceptable (if less than ideal) at a time when incumbent local exchange carriers were not themselves also in the long distance business, competing head-to-head with their non-affiliated access service "customers" — i.e., the IXCs. But that is no longer the case.

22. Blackmon (Staff), at 6. *See also id.*, at 10.

Verizon is both a long distance competitor as well as a provider of essential switched access services to rival long distance companies. By maintaining excessive prices for switched access provided to those rivals, Verizon can and does increase its competitors' costs and, by setting its own retail prices at levels that are not sufficient to recover the equivalent switched access charges, create a price squeeze that diminishes or eliminates altogether the potential profit margin that might otherwise be available to rival firms.

Q. Does Verizon in any way recognize the functional equivalency between intrastate switched access and other Verizon services?

A. Yes. As set forth in the testimony of Mr. Fulp, the Company proposes to undertake local transport rate restructuring, which would more closely align intrastate switched access rates with their interstate counterparts.[23] This appears to be based upon the Company's concession that "...state and interstate switched access services are typically jointly provisioned... ."[24] Verizon also proposes rates for the newly established intrastate rate elements (e.g., shared trunk ports, shared multiplexing, and dedicated trunk ports) that are *identical* to the current interstate rates for those very rate elements.[25] Verizon's actions not only confirm that the functionality of the intrastate and interstate switched access rates are identical, they demonstrate that the rate structures can be as well. Consequently, as an

23. Fulp (Verizon), at 17-20.

24. Verizon response to AT&T Data Request 38a.

25. Fulp (Verizon), at 17.

initial step in moving switched access rates towards cost-based levels, the Company would appear to agree that it is appropriate for intrastate and interstate access rates to be equal.

Q. Have you calculated the decrease in revenue from adopting intrastate switched access rates that are either cost-based or identical to Verizon's interstate switched access rates?

A. Yes. I have made two sets of calculations, one using the 2001 demand set relied upon by Staff in its proposal,[26] and the other using October 2001—September 2002 units as relied upon by Verizon in its proposal.[27] For each demand set, I have calculated the revenue effect of three separate adjustments to intrastate switched access rates: (1) lowering rates to cost-based levels; (2) lowering rates to interstate levels; and (3) lowering rates to interstate levels and implementing local transport rate restructuring ("LTR") as proposed by Verizon. I have provided the details encapsulated within these calculations in Exhibits LLS-7C (reflecting 2001 demand) and LLS-8C (reflecting Verizon's October 2001–September 2002 demand) in order to assist the Commission in understanding the revenue effect of each option for reducing rates.

Q. What are the results of your calculations?

A. The results of these calculations are summarized in Table 1. If the Commission were to approve the adoption of cost-based rates for intrastate switched access services, the reduc-

26. 2001 demand units were provided by Verizon in its response to Staff Data Request No. 28.

27. October 2001–September 2002 demand units appear in Fulp (Verizon), Exhibit ODF-2C.

tion in Verizon's switched access revenues would be $44.0-million using 2001 demand,[28] or $38.4-million using Verizon's October 2001—September 2002 data.[29] Alternatively, reducing intrastate switched access rates to interstate levels across-the-board would lower Verizon's switched access revenues by $39.9-million (2001 demand)[30] or $34.9-million (September 2001—October 2002 demand).[31]

Shifting rates to reflect interstate levels, while at the same time accomplishing the local transport rate restructuring proposed by Verizon, would lower Verizon's switched access revenues by $38.3-million (assuming 2001 demand)[32] and $33.4-million (assuming Verizon's October 2001–September 2002 demand).[33]

28. See Exhibit LLS-7C, p. 1.

29. See Exhibit LLS-8C, p. 1.

30. See Exhibit LLS-7C, p. 2.

31. See Exhibit LLS-8C, p. 2.

32. See Exhibit LLS-7C, p. 3.

33. See Exhibit LLS-8C, p. 3.

Table 1 Revenue Effect of Proposed Switched Access Rate Reductions (millions)		
	2001 Demand Units	10/01 – 9/02 Demand Units
Cost-based rates	($44.0)	($38.4)
Interstate rates	($39.9)	($34.9)
Interstate rates with LTR	($38.3)	($33.4)
Sources: *See* Exhibits LLS-7C and LLS-8C		

Verizon's feeble criticisms fail to invalidate the imputation analysis set forth in my direct testimony.

Q. Dr. Selwyn, has the Commission established a rule regarding a specific imputation standard with respect to intrastate toll service for Verizon?

A. The Commission has not established a statutory rule regarding imputation in general, or the imputation of costs into intrastate toll rates in particular. The Commission has addressed intrastate toll imputation in an earlier proceeding (Docket No. UT-970767),[34] and it is with guidance from the Commission's ruling that I developed the imputation test that I discussed in my direct testimony.

---

34. *In the Matter of the Investigation on the Commission's Own Motion Whether the Intra-LATA Toll Services of GTE Northwest Incorporated Should Be Classified as a Competitive Telecommunications Service*, WUTC Docket No. UT-970767, *First Supplemental Order*, September 29, 1997 ("*GTE-NW IntraLATA Toll Order*").

Q. Please describe the imputation analysis adopted by the Commission in Docket No. UT-970767.

A. In the *First Supplemental Order* in that docket, the Commission made the following statement:

> The Commission incorporates as the appropriate cost standard for determining whether GTE's prices for intraLATA toll service cover its costs the imputation analysis provided by GTE in Docket No. UT-970598, revisions to its Tariff WN U-12, IntraLATA Toll Services. The June 25, 1997 Staff Memorandum on this filing notes at page 2:
>
>> <u>Imputation</u>
>> GTE-NW is required to demonstrate that its rates do not create a "price squeeze" for its toll competitors, who must by access from GTE-NW. GTE-NW has provided its imputation analysis as a confidential cost support exhibit with the tariff filing. Staff believes the proposed toll rates do not result in a price squeeze, because the average rates under each toll plan are sufficiently high to cover the access charges that GTE-NW would incur and the incremental cost of toll service...[35]

The Commission's ruling is clear in that the proper imputation standard should include both access and non-access costs, consistent with my analysis.[36] Notably absent from the Commission's ruling is any language specifically identifying or limiting what the "incremental cost[s]" associated with toll service are.

Q. Why did you provide an imputation analysis for the Commission's review?

---

35. *GTE-NW IntraLATA Toll Order*, at 12.

36. Selwyn Direct (AT&T), at 28-40.

A. I provided the Commission with my imputation analysis[37] to support the notion that Verizon's intrastate switched access charges are currently set at economically inefficient levels, and are so much above cost as to perpetrate a price squeeze upon interexchange carriers seeking to compete with Verizon in the intrastate toll market.

Q. Does the Commission's Staff appear to agree with your imputation analysis?

A. Staff has not offered an official opinion regarding my imputation analysis, nor has Staff (yet) offered an imputation study of its own. Whereas my imputation study was submitted in support of the notion that Verizon's intrastate access rates are too high, Staff reached the same conclusion *even without demonstrable evidence that a price squeeze or imputation failure exists*.

Q. Does Staff opine as to what elements should comprise an imputation study?

A. Although he recognizes Commission precedent with respect to imputation calculations,[38] Staff witness Timothy Zawislak states that AT&T "raises some good points about

37. As discussed in my direct testimony, the amount to be imputed into Verizon's toll rates is found to be the sum of the access charges that Verizon would incur (for originating and terminating traffic on its own network as well as for terminating traffic on the networks operated by Qwest and other ILECs in Washington) and any non-access costs associated with providing toll service, which would include billing and collection, retailing/marketing and LNP database dips. As I mentioned in my direct testimony, the cost I derived to be associated with the LNP database is small enough that it does not have a material effect on the outcome of the calculation; the fact that it is also proprietary provides good reason to refrain from including it in the current discussion so as to preserve as much information on the public record as possible.

38. Zawislak (Staff), at 10.

Advertising, Marketing, and Retailing," and "encourage[s]" AT&T "to further develop the facts on those issues in this proceeding,"[39] even though these non-access costs were not included in prior Commission-approved imputation studies. Staff therefore appears open to the idea that the specific costs to be included in an imputation study are not at all precluded from review. Indeed, Finding of Fact No. 11 in the *GTE-NW IntraLATA Toll Order* states that "GTE's prices for intraLATA intrastate switched inter-exchange message toll service are subject to the imputation test described fully in the text of this Order until otherwise ordered by the Commission."[40] This statement clearly provides the Commission with the discretion to revise and/or clarify its toll imputation test.

Q. Does Verizon agree with your toll imputation study?

A. No. There are certain inputs to the study with which Verizon disagrees, and as a result Verizon does not concur with the outcome of my analysis — that being that a price squeeze exists for certain toll services. Verizon has supplied what it considers to be a current version of its own imputation study,[41] the results of which indicate that all of the Company's toll services pass imputation.[42] I shall address and refute each of Verizon's criticisms of my study below.

---

39. *Id.*, at 11.

40. *GTE-NW IntraLATA Toll Order*, Finding of Fact No. 11, p. 15.

41. Verizon response to Staff Data Request No. 26b.

42. See Dye (Verizon), Exhibit TRD-2C for a comparison of the ARPM for each individual toll service offering to the Company's price floor.

Verizon's erroneous use of direct trunked transport rate elements when calculating its own access costs causes two of Verizon's toll service offerings to fail the Company's own imputation standard.

Q. Does Verizon take issue with your calculation of the access costs attributable to Verizon for providing retail toll service?

A. Surprisingly, no. Verizon offered no criticism of my calculation of the access costs attributable to Verizon in the provision of toll service, despite the fact that the Company's calculation of these costs is different.

Q. How does Verizon's calculation of access costs differ from yours?

A. Although the imputation calculation is supposed to account for the "access charges that [the Company] would incur"[43] in the provision of toll service, Verizon's study weights the Company's originating and Verizon-terminating access rates across both tandem switched transport and direct trunked transport. However, Verizon acknowledges that it "utilizes tandem-switched transport when transporting its own intrastate toll call[s]" because "[n]o toll route exists whose traffic volume warrants establishment of dedicated interoffice trunks."[44] For that reason, it is improper to include any Verizon direct trunked transport rate elements in the calculation of the access charges to be imputed into Verizon's intrastate toll rates. Verizon's use of direct trunked transport in its access cost calculation serves to under-

---

43. *GTE-NW IntraLATA Toll Order*, at 12.

44. Verizon response to AT&T Data Request No. 38b.

state the actual costs to be imputed by the Company. When 100% of the Company's costs are attributed to tandem-switched transport, Residence Sensible Minute and Easy Savings Flat Plan for Business services fail Verizon's very own imputation threshold, *even without any other adjustments*.

Verizon's interpretation of the "incremental" cost of billing and collection unfairly attributes 100% of the economies of scope to the Company's competitive toll service.

Q. Dr. Selwyn, does Verizon concur with your methodology of quantifying the incremental cost of billing and collection?

A. No. Verizon witnesses Terry Dye and Dr. Carl Danner reject my use of a methodology that differs from established Commission precedent in calculating incremental non-access costs for toll imputation purposes.[45] Yet Verizon passes its own toll imputation analysis[46] by virtue of the self-serving manner in which the Company interprets how the incremental costs of billing and collection are to be calculated. The Commission's Order relating to imputation does not limit interpretation of "incremental cost" to only that applied by Verizon. It is Verizon's position that these incremental costs for toll service should "piggyback" on the costs already sunk by the Company to cover the billing and collection for local service, and that only the incremental cost above and beyond those costs already incurred to provide *regulated* services should be applied in the imputation study for Verizon's *unregulated* toll

45. Dye (Verizon), at 4-5; Danner (Verizon), at 8-9.

46. Ignoring for the moment the improper use of direct trunked transport rates when calculating the imputed access costs to Verizon, as discussed above.

service. Use of this form of incremental cost is akin to using UNE rates, rather than switched access rates, when imputing Verizon's access costs into its toll rates — and this is a position with which the Commission specifically does not concur.

The Company's interpretation of "incremental cost" unjustly assigns all joint costs of the Company's joint local and toll billing and collection operations to its regulated local services. This has the effect of capturing 100% of the *benefit* of the joint operation for the *nonregulated* competitive toll services.

This device allows Verizon to confer unto itself a benefit that is not offered or available to any of its rivals. Indeed, when providing billing and collection services to competing toll carriers, Verizon imposes charges that are intended to reflect not Verizon's costs, but the stand-alone billing and collection costs that nonaffiliated IXCs would be forced to incur if they did not purchase these services from Verizon. In fact, in the case of a rate of return-regulated company such as Verizon Northwest, the *correct* policy should be that 100% of the gains from joint production of a regulated and a nonregulated service (e.g., joint local and toll billing and collection) should inure to the *regulated* services and be used to offset the regulated services revenue requirement. The economic gains that are uniquely captured by Verizon from these and other joint operations are, from an economic perspective, no different than cash earnings when it comes to calculating the Company's realized rate of return. By flowing 100% of the gains from joint production over to its nonregulated operations, Verizon is simply shifting profit away from its regulated services and over to its competitive services. It is through tactics such as this that Verizon is able to report "deficient" rates of return on its regulated business while capturing the shifted profits on the nonregulated side. *At the very least, the Commission needs to consider and address this profit-shifting device when considering the validity of Verizon's claims of an earnings shortfall and its insistence upon "revenue-neutral" rate adjustments*.

The estimate of incremental retailing/marketing costs associated with interexchange carriers employed in my imputation study is not jurisdictional, and appropriately reflects the market realities of attracting and retaining customers for toll service.

Q. Verizon witnesses Terry Dye and Dr. Carl Danner reject your use of the $0.03 retailing/ marketing figure, claiming that it is neither Washington specific[47] nor reflective of the economies available to a provider of multiple services.[48] Do you agree with their criticisms?

A. Not at all. First, there is no basis for characterizing the $0.03 retailing/marketing incremental cost as being associated with any particular state. The fact that it was referenced in a piece of testimony submitted by frequent-Verizon witness Dr. William Taylor on behalf of Qwest in its Minnesota Section 272 proceeding is immaterial, as the subject discussed by Dr. Taylor in his testimony related to the incremental marketing costs for national IXCs, not Minnesota-specific costs. More recently, Dr. Taylor, along with "no less an authority than Professor Alfred Kahn,"[49] testified on the same issue in a declaration submitted to the FCC *on behalf of Verizon* and the other three RBOCs in which he made the identical claim with

47. Dye (Verizon), at 5.

48. Danner (Verizon), at 8.

49. *Id*., at 16.

respect to IXC marketing costs.[50] This should lay to rest any concern Verizon Northwest might have regarding whether or not these costs are specific to a particular state.

Second, Dr. Taylor's $0.03 incremental cost figure may well be understated, based upon the market realities regarding the costs associated with attracting and retaining toll customers. I am aware of at least one analysis that has put such cost at "up to $300 to $600 in sales support, marketing and commissions" per customer acquired.[51] Verizon's alleged retailing/ marketing cost of BEGIN PROPRIETARY << >> END PROPRIETARY multiplied by an estimate of average intrastate toll usage for those customers for whom Verizon Northwest provides intraLATA toll of BEGIN PROPRIETARY << >> END PROPRIETARY minutes per month[52] translates into an *annual* retailing/marketing cost to Verizon of just BEGIN PROPRIETARY << >> END PROPRIETARY for each such customer. Clearly, the only way in which such costs could be this low is if Verizon allocates all joint costs of local and toll service *to local*.

---

50. *In the Matter of AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, FCC RM No. 10593, Declaration of Alfred E. Kahn and William E. Talyor on behalf of BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and Verizon, December 2, 2002, at 11.

51. Borna, Claude, "Combating Customer Churn," in *Business and Management Practices,* Vol. 11, No. 3; Pg. 83-85; ISSN: 0278-4831, Horizon House Publications, Inc., Telecommunications Americas Edition (March, 2000).

52. Total intrastate billed toll minutes (193,283,000, as reported on Schedule S-4 of the Company's 2001 Annual Report filed with the Commission) divided by total retail intraLATA toll lines presubscribed to the Verizon ILEC of BEGIN PROPRIETARY << >> END PROPRIETARY (Verizon Supplemental Response to AT&T Data Request No. 17a) divided by 12.

Finally, use of Dr. Taylor's $0.03 retailing/marketing figure is generally supported by a recent article appearing in the *New York Times*, in which an investment analyst pegs the average cost for Verizon's long distance affiliate at $0.055 per minute for access and non-access costs.[53] Subtracting $0.011 for interstate access ($0.0055 per end, originating and terminating) puts non-access costs at $0.044 per minute. My estimate of non-access costs of $0.0455 is just 3% above this figure, whereas Verizon's estimate of BEGIN PROPRIETARY << >> END PROPRIETARY, is BEGIN PROPRIETARY << >> END PROPRIETARY below that amount.[54]

Verizon thus appears to be seriously understating the true incremental cost of marketing associated with providing toll service, and is therefore likely foisting a disproportionate share of the retailing/marketing costs upon regulated service. Moreover, the basic theory under which Verizon claims that only the incremental costs of the joint retailing/marketing operations should be "charged" to toll services is essentially the same — and just as invalid — as the manner in which this was done with respect to billing and collection costs, and for precisely the same reasons.

Verizon apparently believes that this Commission should accept what amounts to a "what's mine is mine and what's yours is mine" policy with respect to the treatment of joint costs

---

53. "Is Verizon Flying Too High Above Its Valuation?" *New York Times*, January 19, 2003, section 3, page 1. Notably, the analyst pegs Verizon's long distance revenues at just four and a half cents a minute, one full penny less than its average per minute costs.

54. Verizon's Billing and Collection Cost/MOU and Marketing Cost/MOU from Verizon response to Staff Data Request 26, Attachment 26b.

and joint benefits. Under Verizon's patently self-serving theory, it should be entitled to charge IXCs 100% of all joint costs of regulated and competitive services, while capturing 100% of all joint benefits for itself. This practice should be unacceptable for any public utility, but particularly for one such as Verizon Northwest that is still subject to rate of return regulation and which provides essential monopoly services (access services) to carriers with which Verizon itself competes. Verizon's device shifts profit out of regulation and over to its nonregulated businesses, causing the nominal "realized rate of return," which is calculated on the basis of accounting earnings captured on the books of its regulated operations, to be grossly understated. Verizon then appears before this Commission with the incredible claim that it is suffering an earnings shortfall, when in fact it has simply diverted earnings over to another component of the parent company. At the same time, Verizon's tactic raises its rivals' costs while simultaneously providing the mechanism for Verizon's price squeeze strategy.

Verizon's "opportunity cost" argument falls short of sufficiently guaranteeing against the existence of a price squeeze.

Q. Please describe Dr. Danner's criticism of your claim regarding the inappropriately high level of Verizon's intrastate switched access rates.

A. Dr. Danner claims that my analysis of the trade-off between Verizon self-provisioning switched access and providing switched access services to other IXCs ignores the opportunity cost associated with providing access to itself.[55] That is, he claims that any foregone revenue associated with switched access from an IXC is an actual out-of-pocket cost to Verizon that must be considered when assessing the competitiveness of Verizon's access charges.

If Dr. Danner's opportunity cost argument is correct, then there would be no need whatsoever for an imputation test. The fact that this Commission (as well as many public utility commissions in other states, the FCC, and the United States Congress in the *Telecommunications Act of 1996*) have all found it necessary to adopt imputation standards that go beyond access costs refutes Dr. Danner's conclusion that Verizon would not price toll at predatory levels due to the opportunity cost of switched access revenues.

Furthermore, unlike, say, the number of residential access lines, the number of switched access minutes is not a fixed (or nearly fixed) quantity. Due to price elasticity of demand, the retail price of toll service affects the quantity of toll minutes demanded by end users, which in turn affects the demand for switched access by IXCs. Verizon's ability to offer intrastate toll service at predatory levels (i.e., levels that on a service-specific basis fail imputation) serves to increase demand for toll minutes, which (assuming IXCs price at or near Verizon's levels) increases demand for Verizon switched access services.[56] Should

55. Danner (Verizon), at 6.

56. Citing 47 C.F.R. 64.1801, Staff witness Dr. Blackmon notes in his direct testimony that "federal statute and rule requires statewide averaging of intrastate long-distance rates;" therefore, IXCs may set prices that are competitive and above-cost in some areas of a state (e.g., in Qwest's region) but are below-cost in other areas of the state. Blackmon Direct (Staff), at 6.

IXCs remain in the market, they would lose money on every minute of toll service provided. Verizon, however, not only earns money from its retail toll service *but also* from its wholesale access services. If the IXC ultimately exits the market altogether, Verizon would then be in a position to remonopolize the intrastate toll market, increase retail toll rates, and thereby earn and sustain monopoly profits. Moreover, just the fact that Verizon has the ability to engage in such pricing tactics would be sufficient to discourage subsequent competitor reentry, even if Verizon has set its retail rates at supracompetitive levels.

Q. Please summarize your conclusions regarding imputation.

A. The conclusions from my direct testimony are still applicable here. Verizon's price floor remains at $0.1444.[57] In my direct testimony, I identified six Verizon Northwest toll plans that failed imputation.[58] At that time, I did not have access to any demand data that would have permitted me to calculate weighted-usage prices reflecting peak and off-peak usage. However, Exhibit TRD-2C to the testimony of Mr. Dye provides a total weighted price per MOU for each residence and business intrastate toll plan offered by Verizon, and a "Total Price Per MOU" that incorporates any monthly fee that might apply to these toll plans. I have compared each of these "Total Prices" to my price floor, and I now conclude that *all of Verizon's intrastate toll service plans fail imputation* — even Verizon's base MTS rates! In order for the price squeeze in the intrastate toll market to be eliminated, intrastate access

57. Selwyn Direct (AT&T), at 40.

58. *Id.*, at 42, Table 1.

rates must *at a minimum* be reduced so that the price floor is lower than the lowest "Total Price Per MOU" appearing in Mr. Dye's Exhibit TRD-2C.

VERIZON'S EARNINGS ANALYSIS

Verizon Northwest's claimed earnings level is grossly understated and does not support the Company's contention that any reduction in access charges should be offset by increases in local rates so as to produce a revenue-neutral result.

Q. Please describe Verizon's position with respect to the Company's rate of return on its intrastate regulated rate base since 2000.

A. In Verizon witness Nancy Heuring's testimony she calculated the rate of return for Verizon Northwest's Washington regulated intrastate operations for 2000 and 2001, and a *pro forma* annualized 2002 figure based upon data through September 2002.[59] According to Ms. Heuring, Verizon's rate base rate of return was 5.59% in 2000, 5.50% in 2001, and is projected to be 2.84% in 2002. Ms. Heuring calculates the "revenue deficiency" between her results and the level of revenues permitted by the Company's authorized return of 9.76% to be $60.9-million, $64.4-million and $105-million in years 2000, 2001 and *pro forma* 2002, respectively.[60] Based upon these results, Ms. Heuring concludes that any reduction in switched access rates (and thus revenues) "without commensurate offsets would make the deficiency significantly larger."[61] Verizon witness Orville Fulp references Ms. Heuring's rate of return analysis in his direct testimony, and he concludes that if the Commission were

59. Heuring (Verizon), Exhibit NWH-2, pp.1-3.

60. *Id*., at 7 and Exhibit NWH-3, p. 1.

61. *Id*., at 7.

to reduce Verizon's switched access charges, it "must permit Verizon to make simultaneous increases to local residential rates on a revenue-neutral basis."[62]

Q. Do Ms. Heuring's rate of return calculations support a revenue-neutral rate rebalancing following any Commission-approved reduction in switched access rates?

A. No. The earnings data presented by Ms. Heuring raise several issues that should be of concern to the Commission. I address each of these concerns below, and quantify the impact upon the rate of return calculation offered by the Company. I have recreated Ms. Heuring's Exhibit NWH-2, page 3 (reflecting *pro forma* annualized 2002 data) in my Exhibit LLS-9 to this testimony, which consists of 4 worksheets. Each individual adjustment set forth below is quantified separately in pages 1 through 3. Page 4 sets forth the cumulative effect of all adjustments.

First, the historical and *pro forma* returns set forth in Ms. Heuring's Exhibit NWH-2 do not properly account for revenues from directory yellow page advertising, as she readily admits.[63] Ms. Heuring seeks to justify the exclusion of directory yellow page advertising revenue from her analysis because "Verizon Northwest did not receive such revenue in any of those periods." Ms. Heuring's conclusion entirely ignores the purpose and regulatory precedent of imputation of yellow page directory revenue. As the Commission explained in

62. Fulp (Verizon), at 7.

63. Heuring (Verizon), at 6.

its July 2000 decision rejecting US West's attempt to end its imputations of yellow pages revenue:

> Imputation is the implementation of "Imputed Value," i.e., the logical or implicit value that is not recorded in any accounts. ATTORNEYS' DICTIONARY AND HANDBOOK OF ECONOMICS AND STATISTICS, by Les Seplaki, New York: Professional Horizons Press, 1991, p. 121. It is the ascription or attribution to another. Webster's II New Riverside University Dictionary, Boston, 1984. Here, imputation is the ascription or attribution of income, not recorded otherwise on any of USWC's accounts, implemented by an accounting adjustment. It revised USWC's earnings for regulatory purposes (that is, for setting rates), to reflect a portion of affiliate U S WEST Dex's earnings. It is a means by which the Commission may exercise the authority granted in Chapter 80.16 RCW to protect ratepayer interests affected by affiliated transactions.[64]

Ms. Heuring indicates that Commission Staff provided a "suggested calculation" to impute a portion of the earnings of Verizon Information Services to Verizon Northwest; although Ms. Heuring states that "Verizon Northwest does not support such a surrogate," she nonetheless indicates that such an imputation would increase the historic and *pro forma* return noted above by 226 basis points.[65] Ms. Heuring's outright dismissal of the imputation of yellow pages revenue diverts attention from the fact that the (appropriate) inclusion of directory yellow pages revenue to Verizon Northwest for ratemaking purposes increases the 2001 rate of return by approximately 42% (up to 7.80% from 5.50%).[66] If the same absolute change in

---

64. *In re the Petition of US West Communications, Inc. for an Accounting Order*, Docket No. UT-980948, *Fourteenth Supplemental Order*; Order Denying Petition, July 27, 2000, at 44-45.

65. Heuring (Verizon), at 6.

66. Verizon response to AT&T Data Request No. 50, Attachment 50, line 37, column (g).

net operating income were assumed for the *pro forma* 2002 calculation, the rate of return for that period would jump from 2.84% to 5.13%,[67] an increase of about 81%.

Q. What is the second concern you have relative to Verizon's earnings analysis?

A. Verizon's analysis does not account for the value attributable to the regulated asset base for the joint marketing of local and long distance services or for other joint activities the benefits of which inure "below-the-line" to Verizon's nonregulated operations. Where, as in Washington, the incumbent telephone company (Verizon Northwest) is engaged in the long distance business, there are extensive and uncompensated information flows going from the ILEC entity to the long distance affiliate, and yet the affiliate is not being required to pay the ILEC entity anything remotely close to the full and fair market value of such information and for the various other services that it receives from the ILEC. Verizon operating companies provide their long distance affiliate with unfettered access to the Verizon *local* customer base and to the *inbound* customer-initiated contacts that arise as a consequence of Verizon's dominance in the local residential service market in every in-region Verizon state. Indeed, Verizon's ability to gain market share in the long distance market appears to be a direct result of its joint marketing activities, since Verizon's long distance affiliates serve only BEGIN PROPRIETARY << >> END PROPRIETARY customers who are not presubscribed to Verizon for local exchange service,[68] which would indicate that the affiliates are expending minimal effort to capture market share in those Washington

67. See Exhibit LLS-9, p. 1.

68. Verizon Supplemental Response to AT&T Data Request No. 20.

geographic areas not served by Verizon Northwest.[69] Competing long distance providers must engage in extensive advertising, direct mail, cash promotions, and telemarketing to promote their service, and do not get anywhere near the quantity of inbound customer contacts as does Verizon, and those which IXCs do receive are primarily the result of the IXCs' advertising and other promotional efforts, undertaken at considerable cost to those IXCs.

Customer acquisition is among the most costly aspects of an interexchange carrier's operation. Without the benefit of the embedded ubiquitous customer base, which is uniquely available to Verizon's long distance affiliate, other IXCs must pursue active marketing strategies involving extensive media advertising, telemarketing, direct mail, and special promotions (cash, airline miles, etc.). When spread over the number of sales that are actually consummated, these costs can amount to hundreds of dollars per customer acquired. As referenced above, I am aware of at least one analysis that has put such cost at "up to $300 to $600 in sales support, marketing and commissions" per customer acquired.[70] The prevailing industry customer acquisition cost represents the fair market value of the customer acquisition services that Verizon is providing its long distance affiliate. The

69. It is entirely possible that *all* of these customers reside in Verizon Northwest's Washington service area. *Id*. Thus, even those customers who are not *currently* Verizon local service subscribers may have been customers of the Verizon LEC at the time they elected to take interLATA services from a Verizon affiliate, in which case the affiliate would still have benefitted from its ability to jointly market service with the Verizon LEC.

70. Borna, Claude, "Combating Customer Churn," in *Business and Management Practices,* Vol. 11, No. 3; Pg. 83-85; ISSN: 0278-4831, Horizon House Publications, Inc., Telecommunications Americas Edition (March, 2000).

regulated revenues of Verizon Northwest reported by Ms. Heuring do not include imputed compensation for the full market value of these services rendered — but they should.

In order to make this calculation, it is necessary to estimate the number of PIC changes Verizon Northwest captures in a given year through the use of its inbound marketing channel, which I have accomplished as follows: According to ARMIS data, Verizon served approximately 645,000 residential switched access lines in Washington in 2001.[71] In the interests of keeping the calculation "public," I am conservatively assuming that Verizon serves 98% of the residential local market, or about 632,000 customers, in its Washington service areas. According to the US Census Bureau, each year on average some 17% of all US households relocate to a new residence.[72] Thus, each year approximately 17% of the residential customers in Verizon's service area can be expected to initiate an order for new local telephone service. I have assumed that Verizon's share of these inward service orders will correspond with its share of the local exchange service market overall, i.e., 98%. Thus, Verizon Long Distance will have the opportunity to "address" 98% of the 17% of residential customers who relocate (i.e., 16.7%, or about 105,000) in Verizon's service area as a result of *customer-initiated* "inbound" contacts alone. I also assume that in approximately 82.3% of the customer-initiated contacts in which an order for new local service is placed, the customer selects Verizon as the Primary Interexchange Carrier ("PIC") following the

71. Federal Communications Commission, ARMIS Report 43-08 (Table III. Access Lines in Service by Customer), for year 2001, accessed 01/15/03.

72. U.S. Census Bureau, *American Housing Survey for the United States in 1999*, Table 2.9.

"recommendation" of the Verizon service representative.[73] By that count, nearly 87,000 lines will be PIC'd to Verizon Long Distance *annually* by virtue of the inbound marketing channel.[74]

Applying the most conservative estimate of $300 for customer acquisition costs means that about $26-million should be imputed to the Company's unseparated regulated operations,[75]

---

73. In order to estimate acquisition of customers using the inbound channel, it is helpful to model a market in which the BOC essentially "starts from scratch," rather than a market such as Verizon Washington's, in which Verizon has had the opportunity to offer long distance services for a number of years. For that reason, I have relied upon data relating to the entry of Verizon Long Distance into the interLATA market in New York. The 82.3% estimated "take rate" for "inbound" local service customers was developed as follows: Verizon Long Distance claims to have captured a 20% share of the New York market in the first year in which its entry was allowed. "Verizon Communications Posts Strong Results for Fourth Quarter and 2000," Verizon News Release, February 1, 2001. On average, about 30% of residence customers change their PIC in any given year. "J.D. Powers and Associates Reports: Sprint and SNET Top Performers in Residential Long Distance Customer Satisfaction," July 29, 1999. Thus, 6% (20% of 30%) out of Verizon's 20% total long distance market share is attributable to PIC changes made by existing customers. The remaining 14% would then be attributable to inbound local service customers selecting Verizon Long Distance at the time that they placed their orders for local service. Since the overall residential relocation rate is 17%, I have estimated the "take rate" at 14%/17%, or 82.3%.

74. These 87,000 customers would not represent the *net* gain to Verizon's long distance affiliates, because the relatively high churn rate for interLATA long distance customers means that in any given year the Verizon long distance affiliates would also lose some of their former customers to competitors. This concept is born out by the fact that in the 7 years since then GTE-Northwest was authorized to provide interLATA services to its local exchange customers in Washington state, Verizon's long distance affiliates have gained BEGIN PROPRIETARY << >> END PROPRIETARY of the market. Verizon Supplemental Response to AT&T Data Request No. 17. Nonetheless, it is the value of the joint marketing that leads to new customer additions that is relevant for the purposes of imputing revenue from the long distance affiliates to the regulated entity.

75. The amount imputed increases to $52-million if the actual customer acquisition cost is closer to $600.

all of which is properly attributed to the intrastate jurisdiction, and none of which has been accounted for by Verizon in its current earnings analysis. The result of this imputation serves to increase the Company's intrastate rate of return from 2.84% to 4.58%.[76]

Q. What is the third item of concern with respect to Verizon's earnings calculation?

A. The third area of concern lies with the apparent overstatement of the rate base level assumed in Ms. Heuring's earnings calculations, which would lead to an understatement of the Company's earnings. The Commission may recall that in February 1999, the Federal Communications Commission released the results of audits its staff had conducted of the Regional Bell Operating Companies' Continuing Property Records (CPRs) as these existed on June 30, 1997.[77] The audits revealed a pattern of systematic overstatements of capital

76. See Exhibit LLS-9, p. 2.

77. FCC Releases Audit Reports on RBOCs' Property Records, Report No. CC 99-3, Common Carrier Action, February 25, 1999. See also *Audit of The Continuing Property Records of Ameritech Corporation, as of July 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Ameritech CPR Audit"); *Audit of The Continuing Property Records of NYNEX Telephone Operating Companies also known as Bell Atlantic North, as of March 31, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Bell Atlantic North CPR Audit"); *Audit of The Continuing Property Records of Bell Atlantic Telephone Operating Companies, also known as Bell Atlantic South, as of March 31, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Bell Atlantic South CPR Audit"); *Audit of The Continuing Property Records of BellSouth Telecommunications, Inc., as of July 31, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("BellSouth CPR Audit"); *Audit of The Continuing Property Records of Pacific Bell and Nevada Bell Telephone Companies, as of June 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Pacific Bell CPR Audit"); *Audit of The Continuing Property Records of Southwestern Bell Telephone Company as of June 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("SWBT CPR Audit"); *Audit of The Continuing Property Records of US West Telephone Operating Companies, as of June 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("US West CPR Audit"); Sections

(continued...)

investments on the RBOCs' books relative to assets physically present in their networks. To the extent that an ILEC's rate levels — in both the state and federal jurisdictions — are linked to the net book value of plant in service, an overstatement of such book value would necessarily result in excessive prices for the ILEC's services. The FCC ultimately terminated its CPR audit investigation as part of the negotiated settlement of interstate access rate issues known as the "CALLS" plan.[78] However, that action did not actually resolve any of the specific issues raised by the CPR audit report, and has not foreclosed further investigation and action by *state* regulators to correct the problems with the booked capital assets that were revealed by those audits.

While the FCC's CPR audits focused on the BOCs, a joint state-FCC audit team undertook a similar investigation of the GTE Corporation's Telephone Operating Companies (GTOCs), which also found significant gaps between booked capital investments and those that could actually be verified. According the to auditors' final report issued in December 1997, the audit team's primary goal was to determine whether the GTOCs' maintained their basic property records (BPRs) in compliance with the FCC's Part 32 (USoA) rules.[79] The audit

77. (...continued)
VI. Collectively, the seven RBOC CPR audits ("The RBOC CPR Audits").

78. *In the Matter of Performance Review for Local Exchange Carriers*, FCC CC Docket No. 94-1; *Low-Volume Long Distance Users*, FCC CC Docket No. 99-249; *Federal-State Joint Board On Universal Service*, FCC CC Docket No. 96-45, *Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45*, Rel. May 31, 2000 ("CALLS Order"). See, *infra*, Statement of Commissioner Harold Furchtgott-Roth, Concurring in Part and Dissenting in Part, at 2.

79. Joint Audit Report on the Basic Property Records of GTE Corporation's Telephone Operating Companies, December 1997 ("GTE Joint Audit Report"), Executive Summary at 1.
(continued...)

team focused upon the three largest plant accounts, namely Digital Switching Equipment (Account 2212), Circuit Equipment (Account 2232), and Buried Cable (Account 2423). One aspect of the audit was a physical verification phase, meant to confirm the physical existence of selected assets included in the GTOCs' BPR. According to the auditors' report:

> In the physical verification phase of the audit, 2,286 items were reviewed. Based upon book values, 21.7% of the sampled items was missing and another 14.6% was unverifiable. Thus, 36.3% of the book value was questionable. Of the 2,286 line items included in the physical verification phase of the audit, 693 (30.3%) of the line items were out of compliance with the requirements of Part 32.[80]

The auditors also concluded that the GTOCs' procedures and internal controls would be adequate to ensure compliance with Part 32 if they were adhered to, but that in reality those procedures were not always followed.[81] While the auditors acknowledged that GTE was taking steps to might lead to better compliance with Part 32 requirements, at the time the report was issued — and more importantly, today — there is no assurance that these problems have been corrected.

Q. What would Verizon Northwest's Washington earnings look like if the Joint Auditor's findings were extrapolated to the Company's Washington assets?

---

79. (...continued)
The Executive Summary of this report was downloaded from http://www.fcc.gov/Bureaus/Common_Carrier/Reports/gteaudit.html, and is reproduced as Exhibit LLS-10 to my testimony. Note that 47 CFR Part 32 sets forth the rules for the Uniform System of Accounts for Telecommunications Companies ("USoA").

80. *Id*., at 2.

81. *Id*., at 3.

A. Exhibit LLS-9, p. 3 presents a restatement of Verizon Northwest's 2002 earnings that applies an adjustment to rate base, based upon the Joint Auditors' findings concerning the degree to which GTOCs' booked network assets were unaccounted for during the physical verification. My adjustment reduces Verizon Northwest's net plant for Accounts 2212, 2232, and 2423 by 36.3%, the same percentage of missing/unverified plant for those accounts that was found in the Joint Auditor's investigation. This adjustment produces a 20.6% decrease in the Company's rate base, and when applied separately from any other adjustments, it increases the Company's intrastate Washington earnings from 2.84% to 3.75%.

Q. What is the combined effect of all of the adjustments that you have proposed?

A. After making adjustments to (1) include the imputation of Yellow Pages earnings, (2) reflect the value of joint marketing of toll service, and (3) remove missing/unverified central office and cable assets from the Company's rate base based on the findings of the FCC-State Joint audit of Basic Property Records, I have found that the Company's *pro forma* 2002 earnings level increases from 2.84% to 9.09%. Page 4 of Exhibit LLS-9 presents the results of all of these adjustments.

Q. What is the dollar value of these three adjustments combined?

A. Exhibit LLS-11 recreates page 1 of Ms. Heuring's Exhibit NWH-3, which summarizes the impact of all of my adjustments. Imputation of yellow pages and joint marketing revenues has the effect of increasing Verizon Northwest's Washington net income by $39-million for *pro forma* 2002.[82] Additionally, recognition of the third adjustment — the elimination of overstated rate base value — has the effect of reducing the Company's Washington intrastate revenue requirement by $23-million for 2002.[83] The three adjustments combined work to eliminate some $97-million of the alleged earnings shortfall relative to the 9.76% authorized rate of return for *pro forma* 2002.[84] Significantly, this amount greatly exceeds the $44-million in access charge reductions that would be required if access charges were to be brought down to cost-based levels. Accordingly, even if the Commission determines that it should pursue a reexamination of Verizon Northwest's earnings, that effort should not work to delay the long overdue reductions in intrastate access charges that is being sought in this proceeding.

Individual regulatory actions or decisions are not *per se* confiscatory if the cumulative effect of the method of regulation provides the utility with an opportunity to recover its prudent investments and earn a fair return thereon.

Q. Dr. Selwyn, are you suggesting that in evaluating the reasonableness of Verizon Northwest's rates and earnings following an access charge rate reduction, the Commission should consider both the nominal accounting earnings that are recorded "above-the-line" on the Company's books as well as various benefits that the Company obtains by virtue of its status as the dominant incumbent local exchange carrier in its territory?

82. See LLS-11, line 15.

83. See *id*., line 17.

84. See *id*., line 19.

A. Yes, that is precisely what I'm suggesting.

Q. With that suggestion in mind, have you read or are you familiar with the United States Supreme Court case "*Duquesne Light Co. et al v. Barasch et al*"[85] and the Court's "takings" analysis, in particular?

A. Yes, I have read that case and I am familiar with the Court's analysis.

Q. Assume that a claim of confiscation requires a showing that the net effect of regulation on the business as an enterprise, after offsetting countervailing errors or allowances, precludes its successful operation. From an economic perspective, do you agree with Verizon's position that failing to allow for revenue-neutral rate reductions following a reduction of switched access rates is, in effect, confiscatory when considered in the context of the *Duquesne* ruling?

A. No. Verizon offers testimony that purports to show that its current intrastate earnings are below its authorized level, and on that basis seeks a revenue-neutral rebalancing of rates following any Commission action to lower intrastate switched access rates. According to Verizon witness Dr. Carl Danner, if the Commission were to "unilaterally slash earnings" through a decrease in access rates,[86] the Company's rate of return would fall to a level that is

85. 488 U.S. 299 (1989).

86. Danner (Verizon), at 4.

"obviously not compensatory."[87] Verizon believes, therefore, that the implementation of a non-compensatory rate of return would create stranded investment, and further suggests that "a significant 'risk premium'" would be required "with respect to additional investments in this state that may fall under Commission jurisdiction."[88]

Q. Does this argument have merit?

A. No, it does not. Even from the perspective of rate of return analyses, the Company's showing is inadequate. Its analysis focuses solely upon the carrier's intrastate accounting rate of return, but this constitutes only one piece of the Company's financial picture. The kind of one-dimensional approach being advanced here by Verizon is not sufficient to establish that the resulting rate or earnings level will be confiscatory, because it expressly ignores the various "offsetting countervailing errors or allowances" that I have been discussing, such as yellow pages earnings, the benefits of joint production and joint marketing, among others.

Q. Are these current earnings-based rate of return types of analyses germane to the ratemaking efforts that are before the Commission in this proceeding?

A. At best they provide one piece of data, but don't come close to offering a comprehensive picture of the impact of all of the Commission's (and the FCC's and Congress') policy

87. *Id*., at 3.

88. *Id*., at 4.

initiatives. Moreover, the specific merit of Verizon's claims with respect to earnings even on a current basis can themselves be challenged, as I discussed earlier. In any event, they represent only a single dimension of a highly complex financial and economic structure, and cannot serve as either the sole or even a dominant basis for evaluation of the impact of a reduction in intrastate access rates.

Q. Should the examination of the "net effect" of the combined state and federal process of regulation be confined to individual accounting periods, or should it also consider the net effect over time?

A. The effects and impacts of regulatory actions are often far-reaching and long-term in nature, and do not lend themselves to an evaluation that is confined to a single accounting period. To determine whether regulated firms are capable of operating successfully, the Commission must consider *inter-temporal* financial flows in evaluating the net effect of the recent state and federal actions, such that a temporary shortfall in one (or even in several) accounting period(s) could not be held to constitute a taking as long as it is or would likely be offset by higher earnings in other accounting periods that result from other aspects of the overall method of regulation.

When faced with a possible reduction in revenues, it is insufficient for a regulated entity to solely examine its intrastate earnings to either substantiate a "takings" claim or demand to be made whole through revenue-neutral rate rebalancing. The solvency of the carrier as a whole is determined not by its intrastate operations, but by the financial results of the entity as a whole. For that reason, an examination of a regulated telecommunications carrier must assess earnings not only at the intrastate level, but at the interstate level as well. In the instant case, Verizon asserts that its intrastate earnings level in Washington is sufficiently low as to require revenue-neutral rate rebalancing following a reduction in access charges. But the Company makes no effort to hide the fact that its *combined* regulated intrastate/interstate operations generates earnings in the 10–11% range even without any adjustments such as those I have identified above.[89] Even if the Commission were to reduce Verizon's intrastate access charges to cost — which it should do — Verizon Northwest's Washington operations would still be earning above the authorized level when all of the offsetting effects and profit-shifting devices are recognized.[90]

Q. Please summarize your comments with respect to Verizon's reported earnings level.

A. As I have shown, there is ample basis to conclude that Verizon Northwest's Washington intrastate earnings have been severely understated by the Company, perhaps by as much as $97-million. Accordingly, the Commission should proceed to reduce Verizon's intrastate access charges at this time and without further delay. It should also commence a thorough reexamination of Verizon Northwest's intrastate earnings, including the effects of inter-affiliate transfers and revenue shifts, in order to determine whether *additional* rate reductions are reasonable and appropriate. In any event, that process must not delay

89. Ms. Heuring calculated the restated total regulated rate of return to be 11.36% in 2000, 11.53% in 2001 and 9.74% in *pro forma* 2002. Heuring (Verizon), Exhibit NWH-2.

90. Taking into account all of my proposed adjustments *in addition to* the effect of reducing switched access revenue by $44-million produces a total regulated rate of return of 10.16% for Verizon Northwest's Washington operations. *See* Exhibit LLS-12.

implementation of the switched access rate reductions that will alleviate the current price squeeze being experienced by competitive toll carriers.

REVENUE-NEUTRAL RATE REBALANCING

If the Commission determines that revenue-neutral rate adjustments are necessary to offset the reductions to Verizon Northwest's intrastate switched rates, rate increases should be considered for other Verizon Northwest noncompetitive services, not just residential local exchange service.

Q. Please describe Verizon Northwest's position regarding any Commission decision to lower the Company's intrastate switched access rates.

A. Verizon witness Fulp clearly states the Company's "simple" proposal: "...if the Commission reduces Verizon's access charges, then it should increase Verizon's rates for residential service on a revenue-neutral basis."[91] As discussed in the direct testimony of Verizon witness Terry Dye, Verizon proposes to offset the $32-million reduction in intrastate switched access rates by increasing (1) the R-1 rate from $13.00 to $17.56 per month,[92] and (2) the R-1 Basic Measured service from $7.25 to $11.81.[93]

Q. How did Verizon determine that all offsets should be made to residential service rates?

91. Fulp (Verizon), at 20.

92. Dye (Verizon), at 9. "R-1" is Verizon's basic residential rate, and the service consists of basic access to the network plus unlimited local calling. *Id.*, at 8-9.

93. According to Mr. Dye, R-1 Basic Measured service "consists of basic access to the network plus measured usage rates for outgoing local calls to the home and EAS exchanges." *Id.*, at 9.

A. According to Mr. Dye, current R-1 prices ($13.00 for R-1 flat rate and $7.25 for R-1 measured) were compared to the total service long run incremental cost (TSLRIC) for R-1 service (BEGIN PROPRIETARY << >> END PROPRIETARY, as presented by Verizon witness David Tucek[94]), and the retail rates were found to be "significantly below TSLRIC."[95] He also determined that the TSLRIC for business local service (BEGIN PROPRIETARY << >> END PROPRIETARY) is less than the TSLRIC for residential service, and that B-1 retail prices ($29.70) are higher than those for R-1 service. Although Verizon witness Dr. Carl Danner "agree[s] with reducing Verizon's access charges because recovering the fixed costs of network access through access charges (as is now occurring in Washington) is economically inefficient, and causes economic losses to customers and the economy," he concludes that "[s]hifting cost recovery to basic local service is the appropriate response."[96]

Q. Do you agree?

A. No. In reaching this conclusion, Verizon focuses narrowly upon the cost and revenue associated with only one R-1 service rate element, claiming that R-1 service is not compensatory because the retail rate is lower than the TSLRIC. Although the relationship between the basic R-1 rate elements and costs may exist as Verizon has presented it, the comparison that Verizon seeks to draw omits major components of the price/cost relationship. In fact,

94. Tucek (Verizon), Exhibit DGT-4C, STUDY RESULTS/WA_Cost_Sum.pdf.

95. Dye (Verizon), at 9.

96. Danner (Verizon), at 14.

many other services are provided incrementally with respect to the R-1 "platform," and the costs and revenues associated with these additional rate elements must be included in any valid revenue/cost analysis.

Q. Have you analyzed the costs and revenues associated with all rate elements associated with the dial tone line for residential customers?

A. Yes I have. The results of my analysis appear in Table 2 below. When all sources of revenue and cost associated with residential local exchange service are considered, I find that residential service on the whole is compensatory. Verizon's recommendation to apply all revenue-neutral rate increases to basic residential service by virtue of the fact that it is priced below cost must therefore be rejected, and any revenue-neutral rate increase deemed appropriate by the Commission must be shared by services other than just R-1 flat and measured use.

Verizon's residence local exchange service is compensatory.

Q. Please describe the method you employed in assessing the relationship between Verizon's residential service revenues versus their costs.

A. From an economic standpoint, when assessing the relationship between revenues and costs for residential service, it is necessary to address *all* sources of revenues and costs associated with the local service platform. Verizon claims that TSLRIC for R-1 service (both flat and measured) exceed the retail rate for each service, yet the Company fails to consider other services that are being purchased by residential customers, and the other revenues that are attendant thereto, which would not exist if, for example, the customer were to take basic R-1 service from a CLEC. When Verizon serves a residential customer, it provides not only the dial tone line and local usage, but also offers vertical features and intrastate toll services. In addition, as the local service carrier, Verizon also realizes revenues from the federal Subscriber Line Charge ("SLC") paid by the end user and switched access revenues paid by interexchange carriers, as well as additional revenues from the highly lucrative Verizon Yellow Pages affiliate. It is the sum of these revenues that should be considered in the revenue/cost analysis.

On the other side of the analysis, one must aggregate all of the costs faced by Verizon in providing these services. In reporting these costs, I relied in large part upon the TSLRIC cost studies provided on the CD-ROM with the direct testimony of David G. Tucek.[97]

As shown in Table 2, when the costs and revenues associated with providing dial tone line and related services for residential consumers are viewed in the aggregate, these services are found to be compensatory.

97. For the purposes of this analysis, I have accepted Verizon's cost studies "as is." I have made no independent assessment as to the veracity of these costs, nor have I studied the inputs and assumptions relied upon by Verizon in setting these costs.

Table 2

Analysis of Verizon's Average Costs versus Average Revenues for Services Provided to Residential Customers

	Aggregate Costs	Aggregate Revenues
Residential Statewide Avg. Dial Tone Line	PROP<< >>	$13.00
Local Usage (flat rate)	PROP<< >>	0.00
Intrastate toll (average for residential and business lines) [NOTE 1]	PROP<< >>	2.45
Vertical Services [NOTE 2]	PROP<< >>	3.25
Subscriber Line Charge	0.00	PROP<< >>
Switched Access (average for residential and business lines) [NOTE 3]	PROP<< >>	PROP<< >>
Yellow Pages	0.00	2.84
Total	PROP<< >>	PROP<< >>
Net profit per residence line per month:		PROP<< >>
NOTE 1: Incremental cost, includes access charge payments to other ILECs but does not include imputation of Verizon access charges.		
NOTE 2: Estimate assumes that average customer subscribes for Call Waiting. Some customers take additional vertical features (e.g., Caller ID), whereas others take none		
NOTE 3: Incremental cost. Revenues shown at current access charge rate levels.		

>>END PROPRIETARY

Q. Please provide a breakdown of the individual revenue line items in Table 2.

A. The revenue associated with residential one-party service is the retail tariff rate of $13.00,[98] which is inclusive of flat rate local usage. To develop intrastate toll revenue per line of $2.45, I divided 2001 intrastate Network Toll revenue[99] by the quantity of Verizon switched access lines in place at that time, and again by 12 to present a monthly revenue figure. The vertical services revenue of $3.25 was derived by assuming that on average each residential customer subscribes to one vertical service feature. I have used the $3.25 Call Waiting rate as an estimate of the average per-customer vertical feature revenue.[100] My revenue calculation for the Subscriber Line Charge includes revenue for both initial and additional lines. ARMIS data indicates that there are about 645,000 residential switched access lines served by Verizon in Washington.[101] According to a report issued by the FCC, an average of 26.5% of US households subscribe to secondary lines,[102] which means that Verizon serves an estimated 510,000 "initial" lines (subject to a $6 SLC) and 135,000 "additional" lines

98. Verizon Northwest Inc., General and Local Exchange Tariff WN U-17, Section 4.E, 10th revised sheet 47, effective January 1, 2002.

99. Federal Communications Commission, ARMIS Report 43-01 (Table I. Cost and Revenue Table), for year 2001, accessed 01/15/03.

100. Verizon Northwest Inc., General and Local Exchange Tariff WN U-17, Section 6.D, 8th revised sheet 16, effective February 16, 2002. This is likely a conservative assumption, considering the popularity of other vertical services such as Caller ID that have a much higher ($7.95) monthly rate. A more accurate average revenue per line figure for vertical features may be available following receipt of Verizon's response to AT&T Data Request Nos. 59 and 61.

101. Federal Communications Commission, ARMIS Report 43-08 (Table III. Access Lines in Service by Customer), for year 2001, accessed 01/15/03.

102. FCC Industry Analysis Division, *Trends In Telephone Service*, May 2002, Table 8-4.

(subject to a $7 SLC).[103] Thus, the weighted average SLC revenue is $6.21 per residential line.[104]

In order to estimate revenues associated with switched access, I divided Verizon's reported total switched access revenues of BEGIN PROPRIETARY << >> END PROPRIETARY[105] by total residential and business switched access lines,[106] and divided again by 12 to arrive at a monthly figure of BEGIN PROPRIETARY << >> END PROPRIETARY. Finally, *net* revenue associated with Yellow Pages assigned to Washington state is just over $21.9 million,[107] or $2.84 per residential switched access line.[108]

Q. Why have you calculated revenues averaged over both residence and business access lines for intrastate toll and switched access?

---

103. Verizon Telephone Companies Tariff FCC No. 16, Section 4.7.1 (A), 10th revised page 4-8, effective October 26, 2002.

104. [(510,000 x $6) + (135,000 x $7)] ÷ 645,000 = $6.21.

105. Staff response to AT&T Data Request No. 6 (2001 data).

106. Verizon switched access lines from Federal Communications Commission, ARMIS Report 43-08 (Table III. Access Lines in Service by Customer), for year 2001, accessed 01/15/03.

107. Net Yellow Page Revenue from Verizon response to Staff Data Request No. 57a. By using a net figure for Yellow Pages revenues, I have eliminated the need for an associated cost.

108. Yellow pages contribution has traditionally been used to subsidize *residential* service, and so the amount is spread only across residential access lines.

A. Unfortunately I was not able to identify intrastate toll and switched access revenue data separately for business and residential customers. It was therefore necessary to calculate average revenues for these two services across all switched access lines. For consistency, the cost figures for toll and switched access, which are discussed in detail below, were also averaged across all switched access lines. In my experience, intraLATA toll use is typically greater on a per-line basis for residential customers than for business customers, since higher-volume business users would ordinarily combine their intraLATA and interLATA toll into a single package that would not be provided by the ILEC. Assuming this to be the case here, the use of aggregate business residential toll data would tend to *understate* residential toll revenues and profits.

Q. Why have you calculated the per-line revenue associated with Yellow Pages advertising solely with respect to residential access lines?

A. Yellow pages contribution has historically been associated with and earmarked for the purpose of subsidizing residential basic service. Accordingly, in assessing the relative profitability of residential service with respect to all relevant revenue sources, it is appropriate to limit the Yellow Pages contribution to residential access lines only.

Q. Are you able to provide a breakdown for the line-item costs you have reported in Table 2?

A. Yes. According to Verizon, the average TSLRIC for Residential Basic Calling Service is BEGIN PROPRIETARY << >> END PROPRIETARY.[109] Verizon did not provide any cost data associated with flat rate local usage, but did report average TSLRIC of BEGIN PROPRIETARY << >>END PROPRIETARY for providing local usage to Verizon Washington customers electing measured usage services.[110] According to Verizon, "...[l]ocal usage costs for flat-rated usage services are anticipated to be *significantly higher* than the costs shown in the referenced cost study."[111] Absent any specific quantification by Verizon, I have estimated costs for flat rate usage at twice the measured use level, or BEGIN PROPRIETARY << >> END PROPRIETARY.

As referenced above, I have assumed that the average residential customer subscribes to one vertical feature. Since I have utilized the Call Waiting rate as the estimate of per-line vertical feature revenue, I have similarly used the TSLRIC for Call Waiting of BEGIN PROPRIETARY < >> END PROPRIETARY[112] as the corresponding vertical feature cost for this analysis.

In order to determine the average costs associated with providing intrastate toll that correlates to the average intrastate toll revenues (as described earlier), it is necessary to calculate the average minutes of toll use per line. I accomplished this by dividing Verizon's total

---

109. Tucek (Verizon), Exhibit DGT-4C, STUDY RESULTS/WA_Cost_Sum.pdf

110. *Id.*

111. Verizon Response to Staff Data Request No. 45d, emphasis supplied.

112. Tucek (Verizon), Exhibit DGT-4C, STUDY RESULTS/WA_Cost_Sum.pdf.

intrastate billed toll minutes (193.3-million, as reported in the Company's 2001 Annual Report filed with the Commission[113]) by the total number of Verizon switched access lines in Washington (925,815[114]), and divided that result by 12 to arrive at 17.4 toll minutes of use per line per month. In my direct testimony, I calculated Verizon's actual cost per minute of intrastate toll use which relied upon, among other things, a tandem switching UNE rate for Qwest due to the fact that none existed for Verizon.[115] However, Verizon recently established a tariffed UNE rate for tandem switching;[116] incorporating this rate into my prior cost analysis results in a cost per intrastate toll minute of BEGIN PROPRIETARY << >> END PROPRIETARY exclusive of any imputation of Verizon's own access charges. Multiplying the cost per intrastate toll minute of use by the average of 17.4 minutes of toll use per month equals the average monthly cost to Verizon of BEGIN PROPRIETARY << >> END PROPRIETARY.

Q. What are the costs associated with Verizon's switched access service?

---

113. Verizon Northwest 2001 Annual Report, Schedule S-4, line 15, column c.

114. Federal Communications Commission, ARMIS Report 43-08 (Table III. Access Lines in Service by Customer), for year 2001, accessed 01/15/03.

115. Selwyn Direct (AT&T), at 46. Verizon's total toll cost is comprised of the cost to Verizon of the switched access functionality of originating and terminating traffic over its own lines (which is quantified by Verizon's TELRIC-based UNE rates), plus the access rates that must be paid to Qwest and other ILECs to terminate Verizon's traffic on their networks. Verizon also incurs *non-access* costs associated with providing toll to end user customers, including the incremental costs associated with billing and collection, retailing/marketing, and LNP database dips.

116. Verizon Northwest Inc., Unbundled Networks Elements Tariff WN U-21, Section 5, 3rd revised sheet 2, effective January 7, 2003.

A. Verizon’s cost for providing originating and terminating switched access are properly represented by the local switching, common transport/transport termination, and tandem switching UNE rates established by this Commission. The total monthly cost to Verizon for originating switched access is calculated by multiplying Verizon’s originating UNE rate of approximately $0.006 (including the new tandem switching rate referenced above) by the total annual originating access minutes of use (as reported by Verizon),[117] and dividing by 12, which equals about BEGIN PROPRIETARY << >> END PROPRIETARY. I then performed a similar calculation to arrive at the total monthly cost to Verizon for terminating switched access of BEGIN PROPRIETARY << >> END PROPRIETARY.[118] Adding the monthly costs for originating and terminating access together and dividing by total Verizon switched access lines (925,815)[119] results in an average monthly switched access cost per line of BEGIN PROPRIETARY << >> END PROPRIETARY.

Q. Please discuss the remaining line-item costs appearing in Table 2.

A. There are no costs associated with the revenues for the Subscriber Line Charge. Since the per-line revenue figure for Yellow Pages is net of costs, there is no need to calculate a per-line cost.

---

117. Fulp (Verizon), Exhibit ODF-2C.

118. *See id.*, for total Verizon terminating switched access minutes of use.

119. Federal Communications Commission, ARMIS Report 43-08 (Table III. Access Lines in Service by Customer), for year 2001, accessed 01/15/03.

Q. Please summarize the results of your analysis.

A. As discussed above, when comparing costs and revenues for local exchange service, it is appropriate to consider the costs and revenues of *all services* provided by a local exchange carrier. My conservative analysis shows that, using rates in effect today, residential service is more than compensatory: on average, Verizon exceeds its costs by about BEGIN PROPRIETARY << >> END PROPRIETARY per month per residential customer, which translates into at least BEGIN PROPRIETARY << >> END PROPRIETARY per year in profit.[120] Note that this profit figure does not include the additional profits being generated by Verizon's long distance affiliate through its "joint marketing" of interLATA toll services to Verizon residential subscribers. As I have previously noted, the annual value of this "joint marketing" to Verizon is of the order of some $26-million, bringing the total profit from the residential customer class to approximately BEGIN PROPRIETARY << >> END PROPRIETARY.

As I have previously noted, reducing switched access rates to cost-based levels serves to lower Verizon's revenues by $44-million. Thus, even if switched access rates were reduced to cost, profits generated in the residential sector would still be more than sufficient to offset this access revenue decrease, even if the entire decrease were ascribed to the residential sector, which of course it should not be.

120. Excess monthly revenue x residential access lines x 12.

In no case should Verizon's proposal to require residential basic service to shoulder 100% of any access rate rebalancing burden be approved by the Commission.

CONCLUSION

The Commission should continue its efforts regarding access reform by requiring Verizon to lower its switched access rates towards cost-based levels, as doing so will promote competition in the intrastate toll market and eliminate the price squeeze that currently exists.

Q. Dr. Selwyn, please summarize your conclusions.

A. Verizon's intrastate access charges are unreasonably high and must be lowered. Staff and Verizon's own economist concur. The Commission should adopt the current Verizon interstate switched access rate structure and lower Verizon Northwest's switched access rates to cost-based levels or, as an interim measure, to interstate levels, so that Verizon Northwest unequivocally satisfies imputation and the price squeeze on competitive toll providers is eliminated.

Based solely upon the adjustments I was able to quantify in my testimony, there is ample reason to believe that Verizon's earnings can absorb a sizable reduction in intrastate switched access rates without the need for any revenue-neutral rate reductions. The Commission should also commence a thorough reexamination of Verizon Northwest's intrastate earnings, including the effects of interaffiliate transfers and revenue shifts, in order to determine whether *additional* rate reductions are reasonable and appropriate. In any event, that process must not delay implementation of the switched access rate reductions that will alleviate the current price squeeze being experienced by competitive toll carriers.

Should some form of revenue-neutral rate rebalancing be deemed necessary, the Commission must spread the burden across all noncompetitive services. Verizon's proposal to solely raise residential basic service rates on the basis that local rates are set below TSLRIC fails to consider all costs and revenues associated with residential service. When all attendant costs and revenues are considered, residential service is found to be compensatory and is undeserving of discriminatory rate increases.

Q. Does this conclude your rebuttal testimony at this time?

A. Yes, it does.