Exhibit T-___ (GB-RT)
Docket No. UT-020406
Witness: Glenn Blackmon, Ph.D.

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

AT&T COMMUNICATIONS OF THE PACIFIC NORTHWEST, INC.,	)	**DOCKET NO. UT-020406**
Complainant,	)	
v.	)	
VERIZON NORTHWEST, INC.	)	
Respondent.	)	

REBUTTAL TESTIMONY OF

Glenn Blackmon, Ph.D.

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

February 7, 2002

Q. Please state your name and business address.

A. My name is Glenn Blackmon, Ph.D., and my business address is 1300 South Evergreen Park Drive Southwest, P.O. Box 47250, Olympia, Washington 98504. My business e-mail address is blackmon@wutc.wa.gov

Q. Have you previously submitted direct testimony in this proceeding?

A. Yes.

Q. What is the scope of your rebuttal testimony?

A. My testimony explains why the direct testimony of Verizon witnesses Danner, Fulp, and Tucek is either incorrect or irrelevant to the Commission's decision in this proceeding. Verizon has not successfully challenged Staff's contentions that its access charges should be reduced, that there is no demonstrated need to offset this decrease with an increase in local rates, that a retail access charge is a reasonable alternative should the Commission choose not to reduce Verizon's overall revenues, and that Verizon should be ordered to comply with the rate design requirements embodied in former WAC 480-120-540.

<u>Terminating Access Charge Rate Design</u>

Q. Please begin with the issue of terminating access charge rate design. Has Verizon offered any evidence challenging Staff's recommendation?

A. No. Verizon appears not to challenge this recommendation. The evidence in my direct testimony demonstrates why the Commission should require Verizon to use an access charge rate design in which, with the exception of any explicit rate element for the recovery of authorized universal service costs, the overall charge for terminating access does not exceed what Verizon charges its local exchange competitors for termination of local exchange traffic.

<u>Commission's Prior Approval of Verizon Access Charges</u>

Q. Verizon's witnesses claim that the Commission already rejected Staff's arguments when it approved the Bell Atlantic/GTE merger in 1999. Please respond.

A. Verizon is greatly overstating the seal of approval that the Commission gave to Verizon's access charges more than three years ago. According to Mr. Fulp, the Commission "rejected" the current position of Staff and AT&T in 1999. This supposed rejection occurred because the arguments Staff makes in this case "could have been made (and applied with equal force)" at the time of the merger proceeding. That is a very inaccurate characterization of the merger proceeding, in which I participated as the Staff witness supporting the settlement. In reality the Commission approved a settlement, and it determined that the settlement was consistent with the public interest. No party asked the Commission to consider the claims that Staff makes in this case, and the Commission cannot reject that which it has not considered.

Q. Is Staff being inconsistent in supporting Verizon's access charge levels in 1999 and advocating lower levels in 2003?

A. No. Staff's position in this case represents our on-going concern over access charges. Staff supported a settlement in 1999 that made some progress toward a long-term objective of lower access charges. Verizon had no reason to believe that Staff's support of those access charges would extend beyond the terms of the settlement agreement itself, which allowed this complaint proceeding in July 2002.

Q. Why is Staff making claims, such as the need for parity with Qwest's access charges, in this proceeding that it did not make in 1999?

A. Circumstances have changed, and our own understanding of the dynamics of the toll and access markets has improved. In 1999, the Commission recently had enacted its access charge reform rule, which called for a shift in access charges from terminating to originating but did not require an overall decrease. The Commission hoped to "allow competition and customer choices (i.e., the 'Market') to determine the sustainability of originating access charges." Adoption Order, Docket UT-970325, page 18. In other words, the Commission wanted to give competition from new local exchange companies a chance to reduce originating access charges. The merger settlement reduced terminating access charges significantly, but it did not reduce originating access charges.

I believe that originating access charges have not proven to be as effective a catalyst to competition as we hoped in 1997. Competitors appear to charge the incumbents' prevailing access rates and do not compete based on the price of switched access services. Probably one reason for this lack of progress is that access charges are paid by carriers, rather than being assessed directly on retail customers. This experience suggests that achieving lower access charges, which has clearly been the Commission's objective all along, will require more overt pressure in the form of proceedings such as this one. In addition to our experience with local competition and its effect on access rates, we better understand the cross-subsidy problem that comes when toll prices must be uniform across the state and smaller carriers are permitted to charge high access charges. We now better understand that the "access charge problem" is not just high access charges but also markedly different access charges within the state.

Comparison of Verizon and Qwest

Q. Mr. Fulp disputes your testimony that Verizon and Qwest should have similar costs because they are similar companies. Please respond.

A. Both Mr. Fulp and Dr. Danner go to great length to challenge a simple observation about two large telecommunications companies. I did not contend that the companies' costs are the same or should be, because I recognized that they differ in the extent of their service to customers in high-cost locations. However, once this universal service difference is accounted for, the question remains as to why Verizon should find it is so much more expensive to provide local service and access service than does Qwest. Mr. Fulp offers various statistics comparing switch sizes and customer density levels, but his statistics fail to support his criticism.

His reliance on forward-looking cost results of the WUTC is particularly puzzling. As Verizon is quick to point out in other forums, those forward-looking studies at best measure what the cost of service should be. If a company actually is operating less efficiently than it should be, the extra cost will not necessarily be captured in a forward-looking study. Moreover, the specific amounts that he cites do not generally support his point. He notes that, at the high end of the range, Verizon's cost is $445 per customer per month, while Qwest's costs top out at $181. He quotes costs at the low end of $15.74 for Qwest in Seattle and $18.36 for Verizon in Mount Vernon. Mr. Fulp's comparisons actually support my point. There are indeed large differences at the high end of the range – Verizon's most expensive exchange is more than twice as expensive as Qwest's most expensive exchange – but the federal and state universal service mechanisms compensate for the differences at this end of the spectrum. At the other end, the difference in cost between the two companies is much smaller. Qwest's lowest cost exchange is cheaper than Verizon's lowest cost exchange by less than $3 per month. Even that modest differential is offset in part by the higher local rates that Verizon charges, compared to Qwest. Thus the comparison does not support the proposition that Verizon needs higher access charges because it has higher costs.

Mr. Fulp also would make much of the fact that Qwest has more loops on large switches in high-density exchanges. He invites the Commission to assume that large switches and high-density exchanges lead to lower costs, but he provides no evidence in support of that proposition. Indeed, the only evidence he presents shows that Seattle and Mount Vernon – areas with very different switch sizes and line densities – do not differ greatly in cost.

Q. Mr. Fulp suggests that you are advocating that the WUTC set rates using cost models. Is this accurate?

A. No. I am not suggesting that rates be based on cost models. Rather, I am suggesting that the Commission consider the reasonableness of Verizon's claims about its results of operations in light of the rates of a similar large local exchange company operating in this state. Verizon would have the Commission ignore this sort of reality check and focus exclusively on its financial statements, which are produced using complex and potentially self-serving allocations of cost among intrastate, interstate, and unregulated activities. I believe the Commission should not ignore this extrinsic evidence, which suggests that the problem may not lie with Verizon's local rates but instead with the way it keeps its intrastate and interstate books.

Verizon's Claim That Any Change Must be Revenue-Neutral

Q. Do you agree with Dr. Danner that, as a matter of policy, the Commission should not reduce access charges without first proving that the company's

earnings are excessive?

A. No. I agree that the regulated company must be given the opportunity to show that its earnings are low and to raise rates if it makes this showing. However, I disagree that every rate adjustment must pass an earnings test. Verizon would have the Commission focus on a single factor – the sufficiency of its rates – when the statutes and good public policy call for consideration of multiple factors. Even if Verizon's overall revenues are reasonable and sufficient, a particular rate could be unfair, unjust, or unreasonably discriminatory. In this particular case, there is substantial evidence that Verizon's access charges are excessive and should be reduced. Verizon does not even seriously challenge that proposition. Staff has recognized that Verizon should have the opportunity to make its case for an offsetting increase, and the Commission has provided that opportunity to Verizon.

However, Dr. Danner goes too far in contending that the Commission should not reduce access charges "unless and until it proves the company is overearning." Danner Direct, p. 3, l. 12. He equates this "prove-it" standard with a company's opportunity to earn a reasonable return and recover its costs. If that logic held, then the Commission also should allow Verizon to increase its rates whenever any of its costs increased, unless the Commission could prove that the company's earnings were excessive. Every bonus paid to the corporate officers, every shift in expenses from unregulated books to regulated books, and every loss of market share to competitors would get virtually automatic pass-through to captive customers, limited only by proof that the company would still earn a fair return without the pass-through. That's not how regulation works or should work. Companies should be able to – and in reality, can – change individual rates without a full earnings review. The Commission should – and in reality, does – include earnings levels as a factor in deciding whether an individual rate change is warranted.

In this case, Staff recommends that the Commission consider all the evidence about Verizon's earnings levels but that it not let that evidence control its decision. As Ms. Erdahl shows, Verizon has not demonstrated that its earnings are insufficient now or that they would be with a decrease in access charges.

<u>Cross-Subsidy of Verizon Through Access Charges</u>

Q. Please respond to Dr. Danner's testimony regarding your claim that Verizon is "exporting costs" to the customers of other local companies.

A. Dr. Danner does not really take issue with my contention that the combination of statewide average toll rates and variable access rates allows Verizon to export its costs. Rather than deny it, he attempts to justify it. He testifies that "many" of these cross-subsidies are the explicit objective of policy, and he cites the interim universal service charge as an example of a public purpose cross-subsidy. Dr. Danner never actually claims that the exporting of Verizon's costs to the toll market is backed up by an "explicit objective of policy," so perhaps we really have no disagreement about the need for Verizon to charge its own customers rather than rely on cross-subsidies through access charges.

Q. Why is it good policy to allow companies to spread their universal service costs but not other costs?

A. The universal service charge is a cross-subsidy with a public purpose, as Dr. Danner notes. However, there is an important difference between the universal service rate element and other access charges. The Commission has decided that universal service costs should be spread as broadly as possible, i.e., "exported" in the form of toll rates charged statewide. Doing so advances the national and state public policy goal of reasonably affordable and comparable basic service in urban and rural areas of the state. There is no corresponding public purpose in having Verizon export its other costs to the customers of Qwest.

<u>Retail Access Charge Alternative</u>

Q. Dr. Danner responds to your testimony regarding an access charge assessed on Verizon's retail customers. Has he accurately characterized your testimony?

A. No, he has not. He describes it as a proposal when my testimony is quite clear in proposing that Verizon's access charges be reduced. I am not proposing that Verizon be allowed to establish a retail access charge. However, I offered this as an alternative for the Commission's consideration, should it decide to limit its options to revenue-neutral alternatives.

Q. Do you agree with Dr. Danner that you are being inconsistent to argue that access charges are too high and then suggest a retail access charge?

A. I agree that these are inconsistent, which is why my recommendation is that the Commission simply lower Verizon's access charges to a reasonable level. However, it is not inconsistent to say that, if the Commission is going to permit Verizon to continue its current access charge levels, it should find a way to assess those on Verizon's own customers. As Mr. Zawislak testifies, either option –

reducing the access charge or shifting part of it to retail customers –would improve Verizon's ability to pass imputation and therefore would eliminate the price squeeze that AT&T alleges. In essence there are two problems with Verizon’s access charges: (1) They are too high, and (2) They are higher than Qwest’s and therefore create a cross-subsidy. The retail alternative suggestion simply offers a way to address the second problem without addressing the first problem. Staff’s actual proposal addresses both problems together.

Q. Do you agree with Dr. Danner’s claim that a retail access charge would be anti-competitive?

A. No. It is not anti-competitive to require a company to get its revenues from those customers who actually use the company’s services. The retail access charge alternative simply shifts the excess portion of the access charge from interexchange companies to retail customers. Dr. Danner speaks of an “artificial incentive” to use other carriers who might be “less efficient” than Verizon. This claim cannot be squared with his earlier testimony that Verizon’s costs are high and the company needs the access revenues to earn a fair return. Indeed, it is the current situation – in which, as Dr. Danner agrees, Verizon is obtaining a cross-subsidy through the export of its costs to the statewide toll market – that is anti-competitive. Through this cross-subsidy, Verizon is able to charge lower rates to its own retail customers and thereby discourage other companies from offering service. This would include even those companies that do not have the same high costs that Dr. Danner ascribes to Verizon.

Q. Do you agree with Dr. Danner's claim that a retail access charge is economically inefficient, because a per-minute rate is used to recover fixed costs?

A. Yes, I do. However, this criticism is equally applicable to Verizon's existing access charges. There is a general pricing problem in telecommunications in that much of the cost of the network is fixed. Using per-minute charges to recover those costs is not the theoretical ideal. That is true whether the per-minute rate is assessed on the interexchange carrier or on the retail customer. Moreover, it also is economically inefficient to recover fixed costs of the network using per-line charges. Thus, while I agree with Dr. Danner's specific point, I do not believe it matters in the final analysis because every proposal is susceptible to this criticism.

<u>Rate Design of any Increase in Local Rates</u>

Q. Verizon contends that any increase in local rates should be limited to residential service because residential service is priced below cost. Please respond.

A. This is the key point in Verizon's case, as evidenced by the fact that four different witnesses attempt to make the case that local rates are below cost and thus should bear any increase. At its core, Verizon's argument is that the Commission has been wrong in its decisions that loop costs are not part of the incremental cost of local service. Dr. Danner makes the theoretical argument that the loop is an incremental cost of local service. Mr. Tucek submits a cost study that purports to show the total service long-run incremental cost with the loop cost included (indeed, there is virtually no cost other than loop cost, since the study excludes usage costs). Mr. Dye testifies that he compared this cost to the residential rate, though he neglects to present the actual comparison. Mr. Fulp also says that residential rates but not business rates should increase.

My testimony that residential rates cover cost is consistent with the Commission's past decisions as to how cost should be measured. A loop is used to provide multiple services, including dial-up Internet access, interexchange toll services, digital subscriber line service, and local service. There is no reason to attribute the loop cost to any single one of those services. Doing so is not only inaccurate and theoretically unsound, but it also misses the point. Verizon has provided absolutely no evidence that residential customers do not cover the costs that Verizon incurs as a result of the use of the network by the residential class. At best, Verizon's evidence demonstrates that a single service – basic local service – is not priced high enough to cover the total cost of the loop. If Verizon's approach to pricing were used in the restaurant business, the main dinner course would be required to bear the full cost of the entire restaurant. Even though the restaurant used its kitchen and dining room to provide and sell many other items, such as appetizers, a lunch menu, drinks, desserts, and banquets, Verizon would say that these should all be ignored in deciding whether the dinner price covers its cost.

Residential customers subscribe to digital subscriber line services, make toll calls that generate access charges, purchase high-priced bundled packages, subscribe to expensive vertical services such as Caller ID and voice messaging, pay optional line maintenance charges, and, yes, subscribe to local service for which it receives both intrastate and interstate monthly service charges. The intrastate service charge is the monthly rate for local service, and the interstate service charge is the federal subscriber line charge. Verizon would have the

Commission ignore every source of revenue save the local rate; only this distorted comparison produces the result that Verizon seeks.

Q. Mr. Fulp contends that your prior testimony supports limiting any increase to residential service. Do you agree with this reading of your testimony?

A. No. Mr. Fulp uses an excerpt of my testimony in the 1997 U S WEST case to support his argument for a residential-only increase, but he would mislead the Commission in doing so. The 1997 excerpt would support the proposition that "basic service" –i.e., both residential and business local service – rates should be increased. Should the Commission decide to increase local rates, Staff recommends that the increase be applied to business and residential rates. Both classes of customers make interexchange toll calls that are subject to access charges. If some access revenue is to be shifted to local rates, the shift should apply to all customer classes that use toll services.

CONCLUSION

Q. Does this conclude your testimony at this time?

A. Yes, it does.