

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

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

**DIRECT TESTIMONY OF
MICHAEL J. DOANE
ON BEHALF OF
VERIZON NORTHWEST INC.**

APRIL 30, 2004

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1 (“DOJ”) and to the U.S. Federal Trade Commission (“FTC”) on several matters
2 involving competitive issues in the context of horizontal and vertical mergers and in the
3 assessment of such business practices as tying and bundling. I have also served as a
4 consultant to the DOJ in the *Microsoft* antitrust case, both in the antitrust liability phase
5 and in the Tunney Act Proceeding, during which the public interest aspects of the
6 proposed antitrust remedy were considered.

7
8 Prior to joining KeyPoint Consulting, I was Vice President and Principal of Analysis
9 Group/Economics, where I managed the firm’s San Francisco office and directed the
10 firm’s energy and telecommunications practice areas. I received a M.A. degree in
11 applied economics from the University of California at Santa Barbara, and my B.A. in
12 economics is from the University of Connecticut. A copy of my *curriculum vitae* is
13 attached as Exhibit One.

14
15 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE STATE OR FEDERAL**
16 **REGULATORY COMMISSIONS?**

17 A. Yes. I have presented testimony on telecommunications pricing issues in sixteen states. I
18 have also submitted prepared testimony on regulatory issues associated with the gas pipeline
19 and electric power industries before the Federal Energy Regulatory Commission.

20
21 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

22 A. I have been asked to comment on the economic issues raised by the past practice of the
23 Washington Utilities and Transportation Commission (“WUTC” or the “Commission”)

1 of imputing revenues generated by the unregulated directory publishing business of
2 Verizon Directories Corp. (“VDC”) to Verizon Northwest Inc. (“Verizon NW”) for the
3 purpose of calculating rates that Verizon NW charges for local exchange
4 telecommunications services in Washington State. As part of this undertaking, I have
5 been asked to evaluate the competitiveness of the yellow pages directory services
6 provided by VDC in the Verizon NW operating area. My testimony takes into account
7 recent market developments – such as the passage and implementation of the
8 Telecommunications Act of 1996 and the growth of independent yellow page publishers.
9 Based on this analysis, I subject to public policy scrutiny the issue of whether VDC
10 earnings in excess of Verizon NW’s regulated rate of return should continue to be
11 imputed in the calculation of Verizon NW’s revenue requirement.

12
13 **Q. PLEASE SUMMARIZE YOUR PRIMARY CONCLUSIONS.**

14 A. I have concluded the following based on my review of relevant data and other evidence:

- 15
16
- From an economic perspective, it is bad public policy to use the revenues of a
17 company that operates in a competitive deregulated market to subsidize prices in a
18 different market.
 - Imputation distorts the economic incentives of VDC to expand its business, reduce its
19 costs, and develop innovative products and services. At the same time, imputation
20 preserves distortions in the prices of local exchange services, setting them below
21 economically efficient levels.
22

- 1 • The above conclusions hold regardless of the level of competition in the market in
2 which VDC operates. However, the more competitive the market in which VDC
3 operates, the greater the harm resulting from imputation. I find that VDC operates in
4 a competitive market, vying not only with other directories, but also with numerous
5 other local advertising media. Thus, the properly defined market includes all forms of
6 local advertising. I find that market to be structurally unconcentrated, thus alleviating
7 any concern regarding lack of competitiveness.
- 8 • Moreover, even if the relevant market were narrowly defined as “directory
9 advertising,” there are no significant barriers to new entry. Therefore, actual or
10 potential entry would prevent VDC from profitably increasing prices above
11 competitive levels.
- 12 • Given that VDC lacks the ability to raise price above competitive levels for a
13 sustained period, its yellow pages revenues do not include monopoly profits. Thus, in
14 addition to the reasons described above, there is no economic basis for imputing
15 “excess” directory earnings in ratemaking proceedings to offset the cost of Verizon
16 NW’s local telephone service. Simply put, there are no “excess” earnings to share.

17

18 **Q. HOW HAVE YOU ORGANIZED YOUR TESTIMONY?**

19 A. The remainder of my testimony is organized as follows. Section II addresses from an
20 economic and public policy perspective whether or not directory publishing revenues
21 should be imputed from VDC when determining the revenue requirement of Verizon
22 NW. I then present in Section III a detailed evaluation of the competitiveness of the
23 yellow pages directory services provided by VDC in the Verizon NW operating area,

1 beginning first with an analysis of the product and geographic markets relevant to the
2 evaluation. As will be discussed below, the conclusions reached in Section II regarding
3 the merits of imputation are not contingent upon any particular definition of the relevant
4 market in which VDC competes, nor are they sensitive to the specific level of
5 competition exhibited within that market. Nevertheless, the findings on competitiveness
6 presented in Section III reinforce the economic and policy arguments against imputing
7 VDC revenues to Verizon NW for the purpose of establishing Verizon NW's revenue
8 requirement in Washington.

9
10 **II. IMPUTATION OF DIRECTORY REVENUES TO THE LOCAL EXCHANGE**
11 **CARRIER**
12

13 **Q. SHOULD REVENUE FROM DIRECTORY OPERATIONS BE IMPUTED TO**
14 **THE LOCAL EXCHANGE CARRIER WHEN DETERMINING THAT**
15 **CARRIER'S LOCAL REVENUE REQUIREMENT?**

16 A. No. Whatever the justifications for imputation that may have existed in the past, it would
17 not be good economic and public policy today.

18
19 **Q. WHAT HAVE BEEN THE HISTORICAL JUSTIFICATIONS FOR**
20 **IMPUTATION IN WASHINGTON?**

21 A. As explained more fully in the direct testimony of Mr. Dennis Trimble, it appears that the
22 stated purpose of imputation has been to "substitute the processes of a competitive

1 marketplace for the less than arm's length's transactions which actually occur.”¹
2 However, as documented by Mr. Trimble, there is no evidence to suggest that the
3 affiliated transactions between VDC and Verizon NW result in any cross subsidy, from
4 Verizon NW to VDC. That is, Verizon NW is not shifting profits to its unregulated
5 affiliate by paying “too much” for the directory services provided by VDC. Nor is VDC
6 paying “too little” for the services it acquires from Verizon NW.

7
8 Other justifications for the subsidy of local rates with revenues from VDC have included
9 (1) a belief that an incumbent local exchange carrier's (“ILEC's”) directory advertising
10 affiliate derives “excess” returns from its association with the ILEC and that the ILEC's
11 customers should therefore be compensated for those alleged benefits and (2) a belief that
12 the development of the directory advertising business occurred within the ILEC and,
13 consequently, that the ILEC's customers paid for that development activity and must be
14 fully compensated for it. However, as discussed below, there is sufficient competition in
15 the market in which VDC operates to alleviate any concerns the Commission may have
16 regarding “excess” returns in the provision of directory advertising. Moreover, there is
17 no reason to believe *a priori* that the rate of return established for the ILEC is appropriate
18 for VDC given the different risks inherent in the two lines of business. Even if some
19 value of the directory business were derived from its association with the ILEC,
20 customers of Verizon NW do not own the assets of the local exchange company or its
21 unregulated affiliates, any more than customers of AT&T or Sprint own their networks.

¹ See Direct Testimony of Dennis B. Trimble, at 10-13. See also *Second Supplemental Order*, Cause No. U-84-18 (January 15, 1985), at 4-16.

1 Customers pay for the use of Verizon's assets over the years, but possess no property
2 rights in them.

3
4 **Q. ARE THERE OTHER REASONS WHY IS IT INAPPROPRIATE TO IMPUTE**
5 **DIRECTORY PUBLISHING OR ADVERTISING REVENUES TO THE LOCAL**
6 **EXCHANGE CARRIER?**

7 A. Yes. Without at this stage defining the relevant market in which the directory publishing
8 affiliate competes (as this will be discussed in Section III below), it is nonetheless clear
9 as a general matter that transferring revenues from VDC to Verizon NW, either literally
10 or only through adjustments on the firms' books of account, has an adverse impact on
11 competition in the markets in which VDC competes. Let me explain why. First, to
12 understand the negative consequences of imputation on investment incentives in the
13 directory business, it is necessary to recognize that imputation works in the long run to
14 lower the aggregate revenues of Verizon Communications and to reduce the parent
15 company's returns on investments made in the activities of VDC. The effect of the
16 imputation scheme on VDC earnings necessarily reduces the contribution made to the
17 parent company by this business unit and some investments that would have been
18 profitable in the absence of imputation will be unprofitable in the presence of imputation.
19 That is, the imputation of revenues from directory operations to local exchange
20 operations will, at the margin, tend to reduce the incentive to investment in VDC. In
21 effect, a cap on earnings diminishes the incentives of VDC to compete, expand its
22 business, reduce its costs, and develop innovative product and services.

1 **Q. ARE THERE OTHER DISTORTIONS RESULTING FROM THE PRACTICE OF**
2 **IMPUTATION?**

3 A. Yes. Directory revenue imputation contributes to a rate structure that prices the local
4 exchange service of the incumbent carrier below economically efficient levels. In
5 addition to placing competitive local exchange carriers (“CLECs”) at a disadvantage,
6 consumers are encouraged to subscribe to a service whose costs exceed the value the
7 customer places on it. The preservation of such an implicit subsidy encourages
8 economically inefficient and wasteful consumption decisions.

9
10 **Q. IS IMPUTATION OF DIRECTORY REVENUE CONSISTENT WITH THE**
11 **UNIVERSAL SERVICE PROVISIONS OF THE TELECOMMUNICATIONS**
12 **ACT OF 1996 (“ACT”)?**

13 A. No. As discussed, imputation of directory revenues to support rates for basic
14 telecommunication services, would constitute a pure subsidy flow. According to the Act,
15 such subsidies must be both explicit and competitively neutral. The imputation of
16 directory revenues to the ILEC as currently practiced by the Commission is neither
17 explicit nor competitively neutral. Thus, it is inconsistent with the provisions of the
18 Telecommunications Act and the associated rules developed by the Federal
19 Communications Commission.

20
21 **Q. PLEASE EXPLAIN WHY THE IMPUTATION OF DIRECTORY REVENUE**
22 **WOULD NOT CONSTITUTE A COMPETITIVELY NEUTRAL MECHANISM**
23 **FOR OBTAINING SUPPORT FLOWS?**

1 A. Requiring VDC's directory revenues to support the intrastate rates of Verizon NW would
2 force VDC (or its parent company) to make a unique contribution to universal service,
3 one not required of any other competitive local carrier, directory publisher, or provider of
4 directory advertising in Washington.

5

6 **Q. DOES IMPUTATION OF VDC REVENUES CONFLICT WITH FEDERAL**
7 **COMMUNICATION COMMISSION DIRECTIVES REGARDING UNIVERSAL**
8 **SERVICE?**

9 A. Yes. The FCC has directed that universal service support should come exclusively from
10 end user telecommunications revenues on a carrier-neutral and non-discriminatory basis.²
11 VDC's advertising revenues, however, are not end user telecommunications revenues.
12 Again, including the non-telecommunications advertising revenues of VDC in Verizon
13 NW's intrastate rates would result in the subsidization of universal service from a
14 category of revenues other than those specified as appropriate by the FCC.

15

16 **III. COMPETITIVENESS OF YELLOW PAGES DIRECTORY ADVERTISING**

17

18 **A. *Yellow Pages Directory Business***

19 **Q. HOW DID YOU BEGIN THE PROCESS OF DEFINING THE MARKET IN WHICH**
20 **VDC COMPETES?**

21 A. At the outset, it is necessary to recognize that a business purchases an advertisement in a
22 yellow pages directory for one reason: to attract more customers, hence increasing sales and

1 profits. By purchasing a yellow pages display ad, a business may reach two types of potential
2 customers: (1) buyers who seek information regarding a particular establishment and (2)
3 buyers who seek information upon which to base a choice regarding which business to
4 patronize.

5
6 The first customer type uses the directory as a source for the address, telephone number, and
7 other information associated with the establishment being sought. However, the same
8 information can be conveyed through a variety of other sources, including but not limited to a
9 white pages listing, a yellow pages listing, a listing with telephone directory assistance, and a
10 company website. Given that these alternatives are available to businesses either free or at a
11 very low price, it is unlikely that a yellow pages directory provider could derive significant
12 market power in its role of informing customers who are seeking to reach pre-selected
13 businesses.

14
15 The second customer type uses a directory listing or advertisement as a source of information
16 upon which to base a choice of business to patronize. Businesses purchase a yellow pages
17 listing or display advertisement to attract customers who have not definitively chosen a
18 business to patronize. There are a wide variety of marketing techniques and advertising
19 media through which a business can attract customers. Thus, in principle, directory
20 advertising may compete against any of the various forms of advertising that inform
21 consumers as part of their decision-making process regarding which business to patronize.

22 This is known as *local advertising*, and it differs from national advertising in that national

²*In the Matter of Federal-State Joint Board on Universal Service*, CC Docket 96-45 (Released May 8, 1997) at 47,
Verizon NW Direct
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1 advertising is generally associated with the promotion of products or services (e.g., Shell
2 gasoline or Diet Pepsi) rather than particular businesses (e.g., a local gasoline service station
3 or grocery store).

4
5 **Q. PLEASE DESCRIBE THE ROLE OF THE TELECOMMUNICATIONS ACT OF**
6 **1996 AS IT PERTAINS TO THE ENTRY OF INDEPENDENT DIRECTORIES.**

7 A. While the term “yellow pages” is not specifically mentioned in the Act, Section 222(e) of
8 the Act requires telecommunications carriers providing telephone exchange service to
9 make “subscriber list information”³ gathered in its role as a provider of the service
10 available “on a timely and unbundled basis, under nondiscriminatory and reasonable
11 rates, terms, and conditions, to any person upon request for the purpose of publishing
12 directories in any format.”⁴

13
14 **Q. IS THERE EVIDENCE THAT THE ACT HAS FACILITATED ENTRY BY**
15 **YELLOW PAGES DIRECTORY PROVIDERS?**

16 A. Yes. According to a 2002 report by Simba Information, Inc (“Simba”), the Act has
17 provided the catalyst for rapid and significant entry:

48, and 854.

³ “Subscriber list information” is any information “identifying the listed names of subscribers of a carrier and such subscribers’ telephone numbers, addresses or primary advertising classifications (as such classifications are assigned at the time of the establishment of such service), or any combination of such listed names, numbers, addresses, or classifications; and . . . that the carrier or an affiliate has published, caused to be published, or accepted for publication in any directory format.” Communications Act as Amended, at § 222(f)(3).

⁴ Communications Act as Amended, at § 222(e). By contrast, “[e]xcept as required by law or with the approval of the customer,” a telecommunications carrier that obtains CPNI by virtue of its provision of a service to the customer may only use, disclose, or permit access to “individually identifiable” CPNI in the provision of the particular service from which the information is derived or in the provision of “services necessary to, or used in, the provision of such telecommunications service, including the publishing of directories.” *Id.*, at § 222(c)(1).

Verizon NW Direct

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1 The Telecom Act and the FCC's decision on rates opened the floodgates
2 to independent expansion. . . . Guaranteed access to listings at affordable
3 rates, independents began launching a slew of new directories.
4 Independents also began attracting interest from investors, who were
5 previously wary that telephone companies would yank listings away from
6 independents and topple their businesses.⁵
7

8 **Q. GIVEN THAT THE ACT ENSURES ACCESS TO SUBSCRIBER LIST**
9 **INFORMATION AT "REASONABLE" RATES, ARE YOU AWARE OF ANY**
10 **OTHER ENTRY BARRIERS THAT SERVE TO PREVENT ENTRY?**

11 A. No. I have seen no evidence to suggest that activities required for the physical
12 production and distribution of yellow pages directories entail any significant barriers to
13 entry. Indeed, to the contrary, it appears that these tasks represent decidedly low barriers
14 to entry. For example, printing and distribution efforts can be contracted out to firms
15 specializing in these activities. Even small firms and start-up firms, therefore, generally
16 appear to be able to enter markets profitably, as has been noted recently in one report on
17 the industry:

18 Small independent publishers can have operating margins as high as 20%
19 to 30% because they can operate with very low overhead. They don't
20 require expensive production equipment, a large office, or layers of
21 employees, which drive up costs. All they need is a small office furnished
22 with a few computers and telephones, and they can farm out printing and
23 production.⁶
24

25 Even for those independent publishers performing their own printing, however, this task
26 does not appear to be very costly. Indeed, according to an estimate recently published by

⁵ Simba Information Inc., INDEPENDENT YELLOW PAGES MARKETS 2002: NAVIGATING THE CHANGING LANDSCAPE (2002), at 17.

⁶ Simba Information Inc., INDEPENDENT YELLOW PAGES MARKETS 2002: NAVIGATING THE CHANGING LANDSCAPE (2002), at 71.

1 Simba, printing costs for independent yellow pages publishers are only about 16 percent
2 of revenues, on average.⁷

3
4 As noted above, the Act ensured that the collection of subscriber list information poses
5 no barrier to entry for firms seeking to provide directory publications. Similarly, the
6 physical production and delivery of directory books appear to present no substantial
7 barriers to entry. The only major task remaining in the production of a yellow pages
8 directory – i.e., the solicitation of advertising from customers listed in the directory –
9 likewise does not erect any great barrier to entry. As implied by the quotation above, a
10 marketing staff equipped with telephones and computers is sufficient to perform this task,
11 although larger operations will need to make greater investments in infrastructure,
12 equipment, and sales and management personnel.⁸ I note also that the incumbent’s
13 yellow pages directory provides a ready-made catalogue, complete with telephone
14 numbers and other contact information, of potential customers for an independent
15 publisher seeking to enter the market.

⁷ Simba Information Inc., INDEPENDENT YELLOW PAGES MARKETS 2002: NAVIGATING THE CHANGING LANDSCAPE (2002), at 71.

⁸ “Once an independent starts expanding and surpasses the \$15 million to \$20 million mark, they typically need to invest in larger office space, remote sales offices, management personnel and more equipment. To expand, an independent also needs to hire additional sales reps.” Simba Information Inc., INDEPENDENT YELLOW PAGES MARKETS 2002: NAVIGATING THE CHANGING LANDSCAPE (2002), at 71-73.

1 **Q. ARE THERE ANY INTANGIBLE BARRIERS TO THE ENTRY OF AN**
2 **INDEPENDENT PUBLISHER?**

3 A. No. Independent publishers have great leeway in making their directories virtually
4 indistinguishable from those of incumbent providers, even to the degree that they are
5 freely allowed to copy the distinctive yellow color of the cover and widely recognized
6 symbols employed by the incumbent (e.g., the familiar “Let your fingers do the walking”
7 slogan and “walking fingers” graphic).⁹ At the same time, however, independent and
8 incumbent publishers can and do differentiate the content of their products through the
9 inclusion of such things as maps, coupons, community information, and the like. This
10 suggests that selection of a particular directory for use is driven less by customer loyalty
11 to the incumbent’s brand name, for example, and more by the nature and
12 comprehensiveness of information presented in the book.

13

14 **Q. WHAT EVIDENCE HAVE YOU REVIEWED THAT DOCUMENTS ENTRY BY**
15 **INDEPENDENT PUBLISHERS?**

16 A. As a threshold matter, the yellow page industry in Washington has never been regulated
17 and no firm in this industry has ever been found by a court or an antitrust agency to hold
18 monopoly power, and therefore independent evidence of yellow page competition is not
19 necessary. Nonetheless, I have reviewed a variety of industry, analyst, and trade press
20 reports as well as data collected by Verizon NW and others that document market entry

⁹In 1991, the U.S. Supreme Court even ruled that white pages listings were not copyrightable, essentially guaranteeing that independent white pages publishers could legally copy listings from incumbent telephone company directories. *See Feist Publications, Inc. v. Rural Telephone Service Co., Inc.*, 499 U.S. 340 (1991). *See also* Simba Information Inc., *INDEPENDENT YELLOW PAGES MARKETS 2002: NAVIGATING THE CHANGING LANDSCAPE* (2002), at 14.

1 by independent publishers of yellow pages directories. Below, I discuss certain pertinent
2 evidence discovered as a result of this review. First, I discuss the evidence of
3 competition on a national level, which clearly shows there are no barriers to entry.
4 Second, I discuss the independent publishers in Washington.

5
6 **Q. PLEASE DISCUSS THE ENTRY BY INDEPENDENT PUBLISHERS ON A**
7 **NATIONAL BASIS.**

8 A. According to Simba, there were some 265 publishers of yellow pages directories in the
9 United States as of 2003.¹⁰ Of these, Table One below presents summary information
10 regarding a selected few of the leading independent publishers.

11

¹⁰ Simba Information Inc., YELLOW PAGES MARKET FORECAST 2004 (2004), at 6.

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TABLE ONE
SELECTED LEADING INDEPENDENT YELLOW PAGES PUBLISHERS
(2001)

Company	Estimated Revenues (\$ million)	Titles	Circulation (000s)
<i>Large Publishers:</i>			
Yellow Book	415	306	28,000
Transwestern	242	311	17,800
<i>Mid-Size Publishers:</i>			
White Directory Publishers	92	37	6,000
Valley Yellow Pages	82	29	4,900
DataNational	60	125	13,000
Feist Publications	55	19	4,300
<i>Small Publishers:</i>			
Phone Directories	20	61	1,900
Associated Publishing	18	10	950
Names and Numbers	17	42	1,100
Clarke Directory	15	4	888
Hometown Directories	11	24	1,400
Hagadone Directories	10	7	610
MacGregor Publishing	6	6	335
Tahoe Publishing	4	2	155
Champion Directories	3	4	340
Source: Simba Information, Inc., <i>Independent Yellow Pages Markets 2002</i> (2002), p. 25.			

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Generally speaking, independent publishers as a whole have been experiencing a period of increased growth since passage of the Act in 1996. According to one source, the share of independent yellow pages publishers increased from 4.7 percent to 6.1 percent between 1990 and 1995 – an increase of 1.4 percentage points. In contrast, between 1995 and 2000, the share of independent yellow pages publishers increased from 6.1 percent to

1 10 percent – an increase of 3.9 percentage points. By 2002, the share of independent
2 yellow pages publishers increased to 11.7 percent.¹¹ Independent yellow pages
3 publishers continue to grow at a fast pace. Thus, independent yellow pages publishers
4 grew by approximately 17.9 percent in 2003.¹² Contributing to this growth is what one
5 analysis firm has characterized as a “growing competitive frenzy in Yellow Pages, fueled
6 by strong demand for growth being placed on this industry by parent telecoms and
7 private equity buyers.”¹³

8
9 As a whole, independent directory publishers have increasingly become more formidable
10 competitors in recent years. Following the passage of the Act, there has been significant
11 merger and acquisition activity among such firms. Indeed, consolidation in the industry
12 has continued through at least 2003, “with the large independent publishers becoming
13 much larger, and several mid-sized and small publishers leaving the industry.”¹⁴ Such
14 consolidation has created formidable entrants, many backed by substantial private equity
15 sources. Citing the acquisitions of such major incumbent publishers as “QwestDex,
16 Cincinnati Bell Directory and, in Canada, Bell ActiMedia,” one industry research group
17 has underscored the “big impact” and “monumental changes” that private equity
18 investors have wrought on the U.S. yellow pages industry.¹⁵ As noted by Simba,

¹¹ Simba Information Inc., INDEPENDENT YELLOW PAGES MARKETS 2002: NAVIGATING THE CHANGING LANDSCAPE (2002), at 21.

¹² Simba Information Inc., YELLOW PAGES MARKET FORECAST 2004 (2004), at 6.

¹³ Charles Laughlin and Neal Polachek, The Kelsey Group, *2002 U.S. Market Review and Outlook for 2003* (Dec. 23, 2002), at 9.

¹⁴ Simba Information Inc., YELLOW PAGES MARKET FORECAST 2002 (2002), at 6. *See also* Simba Information Inc., YELLOW PAGES MARKET FORECAST 2003 (2003), at 5, Simba Information Inc., YELLOW PAGES MARKET FORECAST 2004 (2004), at 5.

¹⁵ Charles Laughlin and Neal Polachek, The Kelsey Group, *2002 U.S. Market Review and Outlook for 2003* (Dec. 23, 2002), at Executive Summary.

1 “competition is intensifying from independent publishers, which are growing larger and
2 more powerful.”¹⁶ One such independent publisher is Yellow Book, which acquired
3 McLeodUSA Publishing in early 2002, thereby “creating a 40-state footprint and making
4 it a nearly national independent force.”¹⁷

5
6 **Q. HAVE THE FIRMS EMERGING FROM THE RECENT WAVE OF**
7 **ACQUISITION AND INVESTMENT BEEN AGGRESSIVELY EXPANDING**
8 **INTO INCUMBENT LOCAL CARRIERS’ TERRITORIES?**

9 A. Yes. Increasingly, this expansion has been taking the form of head-to-head competition
10 against the incumbent rather than the provision of a specialty or niche directory. As one
11 analysis firm recently observed, “[i]n the past, most independents competed by offering
12 users and advertisers differently scoped directories – such as an area-wide book
13 overlaying several telco books or several community books slicing up a big telco book.”
14 In recent years, however, “independents have amassed the resources and know-how to go
15 after major metro markets, challenging telcos head-to-head.”¹⁸ Table Two below
16 documents selected instances of this finding.

¹⁶ Simba Information Inc., INDEPENDENT YELLOW PAGES MARKETS 2002: NAVIGATING THE CHANGING LANDSCAPE (2002), at 17-18.

¹⁷ Simba Information Inc., YELLOW PAGES MARKET FORECAST 2002 (2002), at 6.

¹⁸ Simba Information Inc., INDEPENDENT YELLOW PAGES MARKETS 2002: NAVIGATING THE CHANGING LANDSCAPE (2002), at 44.

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TABLE TWO
SELECTED MAJOR MARKETS IN WHICH INDEPENDENT DIRECTORIES
COMPETE AGAINST THAT OF THE INCUMBENT LOCAL CARRIER

Area	Company	Circulation (000s)	Publication Date
Manhattan	Yellow Book	1,000	03-02
	Verizon	1,324	08-02
Boston	Yellow Book	1,000	07-02
	Verizon	1,263	02-02
Seattle	Transwestern	612	12-01
	QwestDex	960	05-02
Buffalo	White Directory	649	09-02
	Verizon	640	10-02
Raleigh	White Directory	440	02-02
	BellSouth	556	03-02
San Francisco	Valley Yellow Pages	604	03-03
	Pacific Bell	870	11-02
Sacramento	Valley Yellow Pages	585	06-02
	Pacific Bell	764	02-02
Kansas City	Feist Publications	1,170	06-02
	Southwestern Bell	72	05-02
Wichita	Feist Publications	392	11-01
	Southwestern	461	08-01
Salt Lake City	Phone Directories	350	01-02
	Transwestern	365	09-01
	QwestDex	591	06-02
Source: Simba Information, Inc., <i>Independent Yellow Pages Markets 2002</i> (2002), pp. 76.			

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As the table shows, independent yellow pages publishers are now competing head-to-head against the local incumbent in major markets throughout the country. These include both locations in California (i.e., San Francisco and Sacramento) and locations in which

1 Verizon is the incumbent local carrier (i.e., Manhattan, Buffalo, and Boston). In each
2 case of competitive entry listed on Table Two, furthermore, the independent publishers
3 distribute their book to a body of customers equal to some large fraction of the size of the
4 incumbent's circulation. (In the case of White Directory competing against Verizon in
5 Buffalo, NY, and Feist Publications competing against Southwestern Bell in Kansas City,
6 KS, the independent's circulation even *exceeds* that of the established local carrier.)

7
8 Many independent directory publishers reportedly "have aggressive plans to launch new
9 books in the next few years," with some planning "to launch as many as five to 10 new
10 directories within the next two years."¹⁹ The fact that many such independent firms are
11 keeping "an eye on contiguous markets," furthermore, suggests that benefits of
12 competitive entry will accrue to markets other than the major ones highlighted in Table
13 Two above.²⁰ Indeed, successful entry has by no means been limited to major
14 metropolitan areas or to the largest and most sophisticated independent publishers. Table
15 Three below presents a list of fifteen selected independent directories that have been
16 launched since 2000. As the table shows, such start-up activity has taken place in
17 locations, large and small, throughout the United States.

¹⁹ Simba Information Inc., YELLOW PAGES MARKET FORECAST 2002 (2002), at 25-26.

²⁰ Simba Information Inc., YELLOW PAGES MARKET FORECAST 2002 (2002), at 25-26.

TABLE THREE
SELECTED INDEPENDENT DIRECTORY START-UPS

Company	Title	Launch Date	Circulation (000s)
Yellow Book	Boston, MA	2000	1,000
White Directory	Raleigh, NC	2000	440
Feist Publications	Kansas City, KS	2001	1,170
DataNational	Atlanta N., GA	2001	450
TransWestern	Sand Diego Coastal, CA	2001	220
TransWestern	San Diego S. Bay, CA	2001	140
Valley Yellow Pages	Contra Costa Co., E., CA	2001	112
Phone Directories	Mt. Ogden, UT	2001	72
Valley Yellow Pages	San Francisco, CA	2002	604
Valley Yellow Pages	Palo Alto – Redwood City – Menlo Park, CA	2002	150
Valley Yellow Pages	Butte Co., CA	2002	126
Hometown Directories	Western Hills, OH	2002	112
Phone Directories	Cache Valley, UT	2002	40
Phone Directories	Laguna Beach, CA	2002	20
Names and Numbers	Teluride, CO	2002	20
White Directory	Camden, SC	2002	38
TransWestern	Gateway, FL	2002	91
TransWestern	Connecticut River Valley, CT	2002	66
TransWestern	Bennington, VT	2002	22
National Directory Co.	Los Angeles Metro, CA	2002	350
Sources: Simba Information, Inc., <i>Independent Yellow Pages Markets 2002</i> (2002), p. 11 and Simba Information, Inc., <i>Yellow Pages Market Forecast 2003</i> (2003), p. 25.			

Industry observers note that competitive entry such as that documented in Tables Two and Three is expected to continue for the foreseeable future. For instance, The Kelsey Group (“TKG”) has summarized events occurring in 2002 and predicted for 2003 thus:

Independent publishers, or challengers, launched new directories in a number of large markets in 2002, including the first competitive directory

1 covering the city of San Francisco (Valley Yellow Pages). In addition,
2 challengers released second or third editions of books in top markets,
3 including Manhattan, Chicago, Boston and Kansas City. . . . TKG expects
4 that 2003, if anything, will be a busier year on the competitive front, as
5 Verizon Information Services accelerates its independent strategy and
6 enters markets that include Miami and Atlanta, which have to date been
7 strongholds of BellSouth. Add to this the possibility that other
8 incumbents are considering similar out-of-territory launches, and the year
9 could shape up to become one of the most competitive in the industry's
10 history. . . . In addition, several leading independent Yellow Pages
11 publishers have told The Kelsey Group that they plan to accelerate their
12 expansion efforts in 2003.²¹
13

14 TKG concludes, therefore, that “[m]ost growth in 2003 will be driven by the expansion
15 into new markets, largely by independent publishers, but also by incumbents expanding
16 out of territory.”²² Furthermore, as these quotations make clear, market entry has not
17 been limited to large independent publishers’ expansion into the local territories of
18 incumbent carrier publishers. As noted by Simba, “[a] blurring of the lines between
19 incumbent and independent publishers reappeared in 2002 with Verizon Information
20 Services’ entry into 15 expansion markets. Undercutting the rates of its fellow RBOC
21 publishers with similarly-scoped directories in large metro markets, Verizon continued its
22 strategy in early 2003 with a handful more expansion directory launches.”²³ That VDC
23 has been able to enter another incumbent’s markets successfully underscores the fact that
24 VDC is similarly vulnerable to competitive entry within its own local service areas.
25

²¹ Charles Laughlin and Neal Polachek, *The Kelsey Group, 2002 U.S. Market Review and Outlook for 2003* (Dec. 23, 2002), at 3.

²² Charles Laughlin and Neal Polachek, *The Kelsey Group, 2002 U.S. Market Review and Outlook for 2003* (Dec. 23, 2002), at Executive Summary.

²³ Simba Information Inc., *YELLOW PAGES MARKET FORECAST 2003* (2003), at 5–6.

1 **Q. DO INDEPENDENT PUBLISHERS COMPETE IN WASHINGTON?**

2 **A.** Yes. A review of the locations in Washington in which VDC provides yellow pages
3 directories demonstrates that VDC does in fact confront competitors in the large majority
4 of these areas. As shown in Table Four below, VDC provides directories in ***
5 **(Confidential)** zip codes throughout Washington. Of these, only *** **(Confidential)** zip
6 codes (approximately ** **(Confidential)** percent of Verizon NW’s locales) are served by
7 a single directory. In other words, nearly ** **(Confidential)** percent of the zip codes in
8 which a Verizon NW yellow pages directory is distributed also have distributed to it one
9 or more other directories. ***** **(Confidential)** of VDC zip codes in Washington
10 (approximately ** **(Confidential)** percent) are served by at least five directories.

11
12 **TABLE FOUR**
13 **NUMBER OF DIRECTORIES SERVING WASHINGTON ZIP CODES**
14 **IN WHICH VDC PROVIDES A YELLOW PAGES DIRECTORY**
15

Number of Directories	Number of Zip Codes	Percentage of Zip Codes
1	** (Confidential)	** (Confidential)
2	** (Confidential)	** (Confidential)
3	** (Confidential)	** (Confidential)
4	** (Confidential)	** (Confidential)
5	** (Confidential)	** (Confidential)
6	** (Confidential)	** (Confidential)
7	** (Confidential)	** (Confidential)
8	** (Confidential)	** (Confidential)
9	** (Confidential)	** (Confidential)
Total	** (Confidential)	** (Confidential)

Source: Yellow Pages Integrated Media Association, *IRIS Database*.

Note: Totals may not sum due to rounding.

1 Some publishers, of course, distribute more than one directory. If one were to examine
 2 the number of publishers appearing in the same Washington zip code as Verizon NW,
 3 rather than by the number of directories, the result is similar. As Table Five shows, VDC
 4 is the sole publisher in just *** (**Confidential**) (approximately ** (**Confidential**)
 5 percent) of the Washington zip codes to which it distributes a directory. Thus, in nearly
 6 ** (**Confidential**) percent of the locations in Washington in which VDC provides yellow
 7 pages, at least one other publisher is also distributing a directory. Three or more
 8 publishers are present in approximately ** (**Confidential**) percent of Verizon NW zip
 9 codes in Washington, and approximately ** (**Confidential**) percent of areas are served
 10 by at least four publishers. A list of the publishers that provide directories in Washington
 11 zip codes served also by Verizon NW is presented in Table Six.

12
 13 TABLE FIVE
 14 NUMBER OF INDEPENDENT DIRECTORY PUBLISHERS
 15 SERVING WASHINGTON ZIP CODES IN WHICH VDC
 16 PROVIDES A YELLOW PAGES DIRECTORY
 17

Number of Publishers	Number of Zip Codes	Percentage of Zip Codes
1	** (Confidential)	** (Confidential)
2	** (Confidential)	** (Confidential)
3	** (Confidential)	** (Confidential)
4	** (Confidential)	** (Confidential)
5	** (Confidential)	** (Confidential)
Total	** (Confidential)	** (Confidential)

Source: Yellow Pages Integrated Media Association, *IRIS Database*.
 Note: Totals may not sum due to rounding.

18
 19

TABLE SIX
LIST OF PUBLISHERS SERVING WASHINGTON ZIP CODES
IN WHICH VDC PROVIDES A YELLOW PAGES DIRECTORY

** (Confidential)	** (Confidential)
** (Confidential)	** (Confidential)
** (Confidential)	** (Confidential)
** (Confidential)	** (Confidential)
** (Confidential)	** (Confidential)
** (Confidential)	** (Confidential)
Source: Yellow Pages Integrated Media Association, <i>IRIS Database</i> .	

Entry – whether by start-up directories, independents moving into new markets, or established local carriers competing outside their home region – has had, and is continuing to have, a noticeable effect on incumbent publishers. Indeed, according to Simba, revenues of yellow pages publishers associated with incumbent local carriers grew by only about 4.2 percent from 2000 to 2001, declined by about 0.6 percent from 2001 to 2002, declined by 1.2 percent from 2002 to 2003, and are expected to grow by only about 2.0 percent from 2003 to 2004. At the same time, revenues of independent yellow pages publishers grew by 28.8 percent from 2000 to 2001, by 26.5 percent from 2001 to 2002, by 17.9 percent from 2002 to 2003, and are expected to grow by about 14.3 percent from 2003 to 2004.²⁴ Total yellow pages revenues are estimated to have grown from approximately \$13.5 billion in 2000 to approximately \$14.9 billion in 2003 and are

²⁴ See Simba Information Inc., *YELLOW PAGES MARKET FORECAST 2002* (2002), at 45; Simba Information Inc., *YELLOW PAGES MARKET FORECAST 2003* (2003), at 48, Simba Information Inc., *YELLOW PAGES MARKET FORECAST 2004* (2004), at 53.

1 expected to grow to approximately \$15.5 billion in 2004.²⁵ Over the same time period,
2 independents' share of total revenues increased from 8.9 percent in 2000 to 15.4 percent
3 in 2003 and are expected to increase further to 17.0 percent in 2004, despite growth in
4 telco publisher revenues.²⁶

5
6 **Q. WHAT DO YOU INFER FROM RECENT DIVESTITURES OF MAJOR**
7 **INCUMBENT DIRECTORY PUBLISHING BUSINESSES?**

8 A. While firms such as VDC have been successful in entering directory areas outside of
9 their incumbent service areas, several incumbent telcos other than Verizon have decided
10 to exit the industry altogether. Far from exercising monopoly control over directory
11 advertising, several incumbent local carriers have divested their publishing ventures in an
12 attempt to shore up their core businesses. Such sales would make little sense were it the
13 case that incumbent local exchange carriers were extracting monopoly rents on directory
14 advertising. They do make sense when the directory publishing operations of the
15 incumbent local exchange carriers are seen to be what they are – i.e., currently profitable
16 businesses that face increasing and credible threats of competition from other firms.

17

²⁵ See Simba Information Inc., *YELLOW PAGES MARKET FORECAST 2002* (2002), at 45; Simba Information Inc., *YELLOW PAGES MARKET FORECAST 2004* (2004), at 53. Analysts at the Kelsey Group have also estimated that, “in 2002, the five ‘incumbent’ Yellow Pages publishers – SBC Directory Operations, Verizon Information Services, BellSouth Advertising & Publishing Corp., QwestDex Yellow Pages and Sprint Publishing & Advertising – saw their combined domestic revenues decline by 0.5 percent to US \$12.1 billion. . . . All other Yellow Pages publishers, including independent or competitive directory publishers, saw their revenues grow by 14 percent to US\$1.97 billion” Charles Laughlin and Neal Polachek, *The Kelsey Group, 2002 U.S. Market Review and Outlook for 2003* (Dec. 23, 2002), at 1.

²⁶ See Simba Information Inc., *YELLOW PAGES MARKET FORECAST 2002* (2002), at 45 and Simba Information Inc., *YELLOW PAGES MARKET FORECAST 2004* (2004), at 53.

1 **Q. WHAT DO YOU CONCLUDE FROM YOUR REVIEW OF THE DOCUMENTED**
2 **ENTRY OF INDEPENDENT DIRECTORIES?**

3 A. As the above discussion has demonstrated, competitive entry by out-of-area telcos, start-
4 up independent directories, and independent directory publishers expanding into
5 territories already served by an incumbent local carrier is not only possible, it is in fact
6 happening throughout the nation. More specific to the present inquiry, VDC does in fact
7 face competition in a large majority of the Washington locations in which it provides
8 yellow pages directories, and there exist no significant barriers to the entry of competitors
9 in those few locations in which VDC is still the only publisher present. The threat of
10 competitive entry is thus credible, which disciplines attempts to raise price above
11 competitive levels. Thus, even if one were to assume, *arguendo*, that the relevant market
12 includes only yellow pages directories, the demonstrated lack of entry barriers prevents
13 yellow pages providers from exercising market power.

14

15 **B. Analysis of Relevant Product and Geographic Market**

16 **Q. DOES VDC COMPETE AGAINST OTHER ADVERTISERS?**

17 A. Yes, VDC competes against many different advertisers and products, not just independent
18 publishers of yellow pages. To identify these other competitors, it is necessary to identify the
19 relevant market.

20

1 **Q. WHAT ROLE DOES MARKET DEFINITION HAVE IN A MARKET POWER**
2 **STUDY?**

3 A. Market definition is a tool for identifying which products compete against one another, which
4 firms supply those products and thus compete against one another, and the geographic area
5 over which such competition takes place. These concerns must be examined collectively in
6 order to analyze the ability of a firm or firms to charge supra-competitive prices. Definition of
7 the relevant market is generally the first step in understanding competitiveness. One method
8 often employed to achieve the goal of market definition is to define a product market and an
9 associated geographic area in such a way that a hypothetical monopolist in that market would
10 profitably exercise market power. Since market power is the ability to maintain prices above
11 a competitive level profitably for a significant period of time, analysis of the relevant market
12 focuses on consumer responses to price changes.

13

14 **Q. HOW IS THE RELEVANT “PRODUCT MARKET” DETERMINED?**

15 A. A relevant product market is determined by identifying the alternative products, if any, to
16 which consumers would switch in response to a price increase associated with a given
17 product. Thus, products that are reasonably interchangeable in use from the perspective of
18 consumers compete in the same product market. Conversely, products that are not reasonably
19 interchangeable in use from the perspective of consumers do not compete in the same product
20 market.

21

22 The importance of consumer substitution to a discussion of competitiveness can be illustrated
23 by the situation of a hypothetical firm that produces a good for which a perfect substitute

1 exists in abundant supply from many suppliers. If the firm were to raise its price, it would
2 lose all sales as customers shift their patronage to the now lower-priced sources of otherwise
3 identical substitutes. In this hypothetical, the firm totally lacks market power.

4
5 There are numerous, more important cases in which substitutes are not perfect (i.e., identical).
6 A supplier attempting to increase price when available substitutes differ to some extent – as
7 could be the case because of brand names or trademarks – still can face severe limits on its
8 ability to achieve or exercise market power, however; sufficient numbers of buyers
9 substituting away from the higher-priced product will make increasing the price unprofitable.
10 Thus, the properly defined product market includes *non-identical* products if they are viewed
11 by consumers as effective substitutes. For example, while mid-sized Fords and Chevrolets are
12 not “identical,” all mid-sized automobiles are sufficiently similar such that a significant price
13 increase by Chevrolet could induce potential buyers to select instead a Ford, Toyota, Chrysler,
14 or some other model. Products that are identical in technical content, such as branded and
15 generic gasoline, may sell for different prices because of the attractiveness of the brand, but
16 they are nevertheless effective substitutes. An attempt by one supplier to increase its price
17 could be rendered unprofitable by a shift of buyers to the technically identical alternative.

18
19 **Q. HOW IS A RELEVANT “GEOGRAPHIC MARKET” DETERMINED?**

20 A. A relevant geographic market is determined by identifying the area encompassing firms that
21 supply products that are reasonably interchangeable in use from the perspective of consumers.

1 **Q. IS YOUR DESCRIPTION OF MARKET DEFINITION CONSISTENT WITH THE**
2 **APPROACH TAKEN IN THE *HORIZONTAL MERGER GUIDELINES* OF THE U.S.**
3 **DEPARTMENT OF JUSTICE AND THE U.S. FEDERAL TRADE COMMISSION?**

4 A. Yes. The *Horizontal Merger Guidelines* state that “[m]arket definition focuses solely on
5 demand substitution factors – i.e., possible consumer responses.”²⁷ Thus, the Guidelines
6 define an antitrust market as:

7 a product or group of products and a geographic area in which it is
8 produced or sold such that a hypothetical profit-maximizing firm,
9 not subject to price regulation, that was the only present and future
10 producer or seller of those products in that area likely would
11 impose at least a “small but significant and nontransitory” increase
12 in price, assuming the terms of sale of all other products are held
13 constant. A relevant market is a group of products and geographic
14 area that is no bigger than necessary to satisfy this test.²⁸

15
16 The approach to market definition in my analysis is consistent with this standard.

17

18 **Q. IN YOUR OPINION, WHAT IS THE RELEVANT MARKET IN WHICH YELLOW**
19 **PAGES COMPETE?**

20 A. Since market definition focuses on demand substitution factors, the relevant product market is
21 defined from the perspective of firms that purchase the advertising. As such, the relevant
22 product market includes all forms of advertising media that meet the demands of local
23 businesses and that are good substitutes for yellow pages ads. The relevant geographic
24 market in which advertising in a given directory competes is defined in terms of the area the
25 directory serves. In order for local advertising presented via two different media (e.g.
26 newspaper and radio) to compete, it is simply necessary for both media to be capable of

²⁷ U.S. Department of Justice and U.S. Federal Trade Commission, *1992 Horizontal Merger Guidelines* (revised Apr. 8, 1997), at § 1.0 (hereinafter “Merger Guidelines”).

1 promoting the business of the same establishment. The location of the plant at which a
2 newspaper is produced or the radio station from which the signal is transmitted is relevant
3 only to the extent that it affects coverage area (and thus the geographic scope the
4 advertisement).

5
6 The reasoning and examples provided above demonstrate that defining the relevant market to
7 include both local and national advertising is too broad an approach. Generally speaking, a
8 commercial on network television displayed in New York, NY, is not a good substitute for a
9 display ad in a local yellow pages directory in Seattle, WA, for the purposes of local
10 advertising. At the same time, however, a market definition that included only yellow pages
11 directory advertisements would be considerably too narrow. A variety of other media can and
12 do effectively function to promote the business of local firms.

13
14 **Q. WHAT EVIDENCE DID YOU EVALUATE TO INFORM YOUR CONSIDERATION**
15 **REGARDING THE DEGREE OF SUBSTITUTABILITY AMONG ALTERNATIVE**
16 **MEDIA?**

17 A. First, I examined data and documentation that discussed the extent to which purchasers of
18 advertising view the alternative media as substitutable. Second, I reviewed sources discussing
19 the extent to which media providers view their products as substitutes for other media. The
20 specific data sources and documentation I considered are discussed below.

1 **Q. PLEASE DESCRIBE THE EMPIRICAL EVIDENCE YOU CONSIDERED**
2 **REGARDING THE EXTENT TO WHICH PURCHASERS OF ADVERTISING**
3 **VIEW ALTERNATIVE LOCAL MEDIA AS SUBSTITUTABLE.**

4 A. For internal purposes unrelated to this regulatory proceeding, VDC previously performed two
5 market research studies to better understand its customers' choices of advertising media. Both
6 of these surveys shed light on the extent to which buyers of yellow pages advertisements view
7 other forms of local advertising as effective substitutes. I will discuss the research findings of
8 each of these studies in turn.

9
10 During the months of August through November in 2001, VDC commissioned a market
11 research study to investigate the factors influencing advertisers' decisions to reduce (or
12 cancel) advertising expenditures in their yellow pages directories. (I refer to this study
13 hereinafter as the "2001 VDC Decreaser and Cancellor Research.") This research, performed
14 by Travis Research Associates, Inc, consisted of **** **(Confidential)** interviews with VDC
15 advertisers. Characteristics of the survey sample are summarized in Table Seven below. As
16 shown in the table, approximately ** **(Confidential)** percent of those surveyed had canceled
17 or reduced their expenditures on Verizon yellow pages advertising during the prior year, **
18 **(Confidential)** percent had renewed their Verizon yellow pages advertising, and **
19 **(Confidential)** percent had initiated Verizon yellow pages advertising. (The survey design
20 was focused on understanding the needs of those choosing to reduce or cancel Verizon's
21 service and therefore is heavily weighted to this customer segment.)

22

TABLE SEVEN
2001 VDC DECREASER AND CANCELLER RESEARCH:
CHARACTERISTICS OF SURVEY SAMPLE

Respondent Category	No. of Respondents
Discontinued Spending on Verizon Yellow Pages ("Canceller")	** (Confidential)
Reduced Spending on Verizon Yellow Pages ("Reducer")	** (Confidential)
Renewed Verizon Yellow Pages ("Retainer")	** (Confidential)
Began Verizon Yellow Pages With Past Year ("New Buyer")	** (Confidential)
Source: VDC and Travis Research Associates, Inc. Note: Parenthetical numbers represent percentage of survey population within each respondent category.	

Of direct relevance to the issue of substitutability, each survey respondent was asked to identify the type of advertising other than Verizon yellow pages advertising that its business uses. (See Table Eight.) This information is relevant because a direct test of whether alternative media satisfy the advertising needs of businesses is the extent to which such firms make expenditures on these media. It is logical to infer that a business seeking to convince customers to patronize it will spend money on media advertising considered to perform well relative to cost.

As shown in Table Eight, among those reducing or canceling expenditures on Verizon yellow pages advertising, approximately ** (Confidential) advertised their business using the Internet, ** (Confidential) advertised in newspapers, ** (Confidential) percent advertised via direct mail, and ** (Confidential) percent advertised at community activities. Each of

1 these forms of advertising were used ***** **(Confidential)** was advertising in non-
2 Verizon yellow pages (** **(Confidential)** percent). The same respondent group also
3 advertised using hand-delivered ads (** **(Confidential)** percent), coupons (** **(Confidential)**
4 percent), magazines (** **(Confidential)** percent), radio (** **(Confidential)** percent), television
5 (* **(Confidential)** percent), and outdoor ads (** **(Confidential)** percent). Similar usage
6 patterns were reported among those renewing or buying new Verizon yellow pages ads.
7 Thus, the fact that a large percentage of Verizon yellow pages advertisers use a wide variety
8 of local media is evidence that these other forms of media are effective substitutes.

9
10

TABLE EIGHT
VDC DECREASER AND CANCELLER RESEARCH:
USAGE OF ALTERNATIVE LOCAL ADVERTISING MEDIA

Types of Advertising Business Currently Uses (Other Than Verizon Yellow Pages)		
Advertising Media	Canceller/Reducers (%)	Retainers/New Buyers (%)
Internet	** (Confidential)	** (Confidential)
Newspapers	** (Confidential)	** (Confidential)
Direct mail	** (Confidential)	** (Confidential)
Advertising at community activities, festivals, etc.	** (Confidential)	** (Confidential)
Flyers, door-hangers, and other hand-delivered advertising	** (Confidential)	** (Confidential)
Magazines	** (Confidential)	** (Confidential)
Coupons	** (Confidential)	** (Confidential)
Radio	** (Confidential)	** (Confidential)
Billboards or other outside advertising	** (Confidential)	** (Confidential)
Television	** (Confidential)	** (Confidential)
Non-Verizon yellow pages	** (Confidential)	** (Confidential)
None	** (Confidential)	** (Confidential)
Source: VDC and Travis Research Associates, Inc.		

Further evidence that buyers of yellow pages advertisements view other local media as reasonable substitutes is derived from this research. Specifically, of the ** (Confidential) survey respondents that cancelled or reduced their expenditures on Verizon yellow pages advertising in the prior year, approximately ** (Confidential) percent indicated that they simultaneously increased their use of other local advertising. Of those that increased their use of other advertising, approximately ** (Confidential) percent increased their usage of non-Verizon yellow pages and ** (Confidential) percent increased their usage of the Internet as

1 an advertising vehicle. Increased usage of other media was observed in **** (Confidential)**
 2 categories. (See Table Nine.)

3
 4 **TABLE NINE**
 5 **2001 VDC DECREASER AND CANCELLER RESEARCH:**
 6 **USAGE OF ALTERNATIVE LOCAL ADVERTISING MEDIA**
 7 **AMONG RESPONDENTS CANCELING OR REDUCING VERIZON YELLOW PAGES ADVERTISING**
 8

Did Company Increase Use of Other Advertising Media as a Direct Result of Canceling or Reducing Verizon Yellow Pages Advertising?	
Response	No. of Respondents (%)
Yes	** (Confidential)
No	** (Confidential)
Don't Know	** (Confidential)
Type of Other Advertising Media Increased by Those Answering "Yes" to Above	
Other Media	No. of Respondents (%)
Non-Verizon yellow pages	** (Confidential)
Internet	** (Confidential)
Direct mail	** (Confidential)
Newspapers	** (Confidential)
Magazines	** (Confidential)
Radio	** (Confidential)
Flyers, door hangers, and other hand-delivered advertising	** (Confidential)
Television	** (Confidential)
Coupons	** (Confidential)
Advertising at community activities, festivals, etc.	** (Confidential)
Billboards and other outdoor advertising	** (Confidential)
Other	** (Confidential)
Source: 2001 VDC Survey, Travis Research Associates, Inc.	

9
 10 Similar information was obtained from the **** (Confidential)** survey respondents that had
 11 renewed or begun their use of Verizon yellow pages advertising in the prior year.

1 Approximately ** (**Confidential**) percent of this group indicated that they reduced their usage
2 of other advertising media as a direct result of renewing or beginning advertising in Verizon
3 yellow pages. Reduced usage of newspapers (reported by ** (**Confidential**) percent of this
4 group), non-Verizon yellow pages (** (**Confidential**) percent), hand-delivered ads (**
5 (**Confidential**) percent), and direct mail (** (**Confidential**) percent) was *****
6 (**Confidential**), although reductions in usage occurred in ** (**Confidential**) categories. (See
7 Table Ten.)

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TABLE TEN
2001 VDC DECREASER AND CANCELLER RESEARCH:
USAGE OF ALTERNATIVE LOCAL ADVERTISING MEDIA
AMONG RESPONDENTS RENEWING OR BUYING VERIZON YELLOW PAGES ADVERTISING

Did Company Decrease Use of Other Advertising Media as a Direct Result of Renewing or Buying Verizon Yellow Pages Advertising?	
Response	No. of Respondents (%)
Yes	** (Confidential)
No	** (Confidential)
Don't Know	** (Confidential)
Type of Other Advertising Media Reduced by Those Answering "Yes" to Above	
Other Media	No. of Respondents (%)
Newspapers	** (Confidential)
Flyers, door hangers, and other hand-delivered advertising	** (Confidential)
Direct mail	** (Confidential)
Non-Verizon yellow pages	** (Confidential)
Magazines	** (Confidential)
Radio	** (Confidential)
Advertising at community activities, festivals, etc.	** (Confidential)
Television	** (Confidential)
Internet	** (Confidential)
Coupons	** (Confidential)
Billboards and other outdoor advertising	** (Confidential)
Other	** (Confidential)
Source: 2001 VDC Survey, Travis Research Associates, Inc.	

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Additional information regarding the value of alternative advertising media from the perspective of those purchasing yellow pages ads is contained in the survey respondents' value ratings of alternative media. Each survey respondent was asked to rate, using a ten-point scale (with 1 equaling "poor" and 10 equaling "excellent") the value of the advertising it

1 uses. Among those interviewed, the average value rating of yellow pages advertising (**
2 **(Confidential)** on a ten-point scale) was *** **(Confidential)** the average value of **
3 **(Confidential)** other advertising media considered. (See Table Eleven.)

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TABLE ELEVEN
2001 VDC DECREASER AND CANCELLER RESEARCH:
VALUE OF OTHER ADVERTISING MEDIA

Advertising Media	Rating (1 = poor, 10 = excellent)		
	Mean	Std. Deviation	Median
Verizon yellow pages	** (Confidential)	** (Confidential)	** (Confidential)
Non-Verizon yellow pages	** (Confidential)	** (Confidential)	** (Confidential)
Billboards and other outdoor advertising	** (Confidential)	** (Confidential)	** (Confidential)
Advertising at community activities, festivals, etc.	** (Confidential)	** (Confidential)	** (Confidential)
Internet	** (Confidential)	** (Confidential)	** (Confidential)
Coupons	** (Confidential)	** (Confidential)	** (Confidential)
Newspapers	** (Confidential)	** (Confidential)	** (Confidential)
Magazines	** (Confidential)	** (Confidential)	** (Confidential)
Radio	** (Confidential)	** (Confidential)	** (Confidential)
Flyers, door hangers, and other hand-delivered advertising	** (Confidential)	** (Confidential)	** (Confidential)
Direct mail	** (Confidential)	** (Confidential)	** (Confidential)
Television	** (Confidential)	** (Confidential)	** (Confidential)

Source: 2001 VDC Survey, Travis Research Associates, Inc.

6

Thus, not only do the customers of Verizon yellow pages advertise in a wide variety of other media, many customers apparently view these other forms of advertising as having a greater value than the use of Verizon yellow pages when price is taken into account.

8

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This suggests that yellow pages advertising is particularly vulnerable to cut-back or cancellation in favor of other media.

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For those survey respondents that gave Verizon a relatively high value rating (i.e., a rating of 6 or higher), approximately ** (Confidential) percent indicated that a major

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reason for the rating was that the same spending on other advertising would not be as

1 effective as advertising in the Verizon yellow pages. In contrast, of those survey
2 respondents giving Verizon a relatively low rating (i.e., a rating of 1 through 5),
3 approximately ** (**Confidential**) percent indicated that a major reason for the rating was
4 that the same spending on other advertising would be more effective than would
5 advertising in the Verizon yellow pages. (See Table Twelve.)

6

TABLE TWELVE
2001 VDC DECREASER AND CANCELLER RESEARCH:
REASONS FOR HIGH/LOW VALUE RATING FOR VERIZON YELLOW PAGES

For Those Giving Verizon a Relatively High Value Rating (i.e., 6-10) (N=388)				
Response	Major Reason	Minor Reason	Not a Reason	Don't Know
Same Spending on Other Advertising Would Not be as Effective as Verizon Yellow Pages	** (Confidential)	** (Confidential)	** (Confidential)	** (Confidential)

For Those Giving Verizon a Relatively Low Value Rating (i.e., 1-5) (N=781)				
Response	Major Reason	Minor Reason	Not a Reason	Don't Know
Same Spending on Other Advertising is More Effective Than Verizon Yellow Pages	** (Confidential)	** (Confidential)	** (Confidential)	** (Confidential)

Source: 2001 VDC Survey, Travis Research Associates, Inc.

Q. PLEASE SUMMARIZE THE RESULTS OF THE SECOND MARKET RESEARCH STUDY THAT YOU REVIEWED.

A. Verizon commissioned another, large-scale market research study over the months of April through June 2002, with the goal of better understanding the needs of its advertisers and the types of products and services they prefer. In this study, *** (Confidential) interviews were conducted among current VDC yellow pages advertisers across ** (Confidential) directory areas nationwide. The market research study was performed by ResearchLink. (I will refer to this study hereinafter as the “2002 VDC Survey.”)

1 As shown in Table Thirteen, this study also investigated the advertising media used by
 2 customers advertising in Verizon yellow pages, and it likewise confirms that buyers of yellow
 3 pages ads also purchase advertising in numerous other media. For example, approximately **
 4 **(Confidential)** percent of those surveyed indicated that they advertise their businesses using a
 5 company website and direct mail. According to the survey responses, usage rates for all other
 6 forms of advertising are in excess of ** **(Confidential)** percent with the exception of *****
 7 ***** **(Confidential)**.

8
 9 TABLE THIRTEEN
 10 2002 VDC SURVEY:
 11 USAGE OF ALTERNATIVE ADVERTISING MEDIA
 12

Advertising Media	Percentage of Respondents Using Medium
Online yellow pages	** (Confidential)
Newspapers	** (Confidential)
Sunday supplement to newspaper	** (Confidential)
Magazine	** (Confidential)
Network TV	** (Confidential)
Cable TV	** (Confidential)
Radio	** (Confidential)
Direct mail	** (Confidential)
Outdoor/Billboards	** (Confidential)
Specialty item	** (Confidential)
Company website separate From on-line yellow pages	** (Confidential)
Other on-line media	** (Confidential)
Community programs	** (Confidential)
Penny-saver/greensheets	** (Confidential)
Other forms of advertising	** (Confidential)
Source: 2002 VDC Survey, ResearchLink.	

13

1 This research study also investigated the plans of those surveyed with respect to advertising in
2 the upcoming year. (See Table Fourteen.) Of those surveyed, approximately **
3 **(Confidential)** percent indicated that they intended to cancel or spend less on Verizon printed
4 yellow pages advertising in the upcoming year. Approximately ** **(Confidential)** percent of
5 those with the intent to cancel indicated that other forms of advertising were more effective
6 than Verizon printed yellow pages, and ** **(Confidential)** percent indicated another yellow
7 pages provider was less expensive or more effective. These results confirm those of the 2001
8 VDC Decreaser and Canceller Research previously discussed: Buyers find alternative media
9 acceptable for advertising their businesses, and they substitute away from yellow pages for
10 other more attractive alternatives.

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TABLE FOURTEEN
2002 VDC SURVEY:
EXPECTED FUTURE USAGE OF ALTERNATIVE ADVERTISING MEDIA

Plans for Use of Verizon Printed Yellow Pages Advertising Next Year (N=3109)	
Response	Percentage of Respondents
Spend More	** (Confidential)
Spend Less	** (Confidential)
Spend the Same	** (Confidential)
Cancel	** (Confidential)
Of those Canceling, Reasons for Canceling (N=107)	
Another Yellow Pages Provider is Cheaper or More Effective	** (Confidential)
Other Type of Advertising is More Effective	** (Confidential)
Source: 2002 VDC Survey, ResearchLink.	

16

1 **Q. PLEASE DESCRIBE THE EVIDENCE YOU CONSIDERED REGARDING THE**
2 **EXTENT TO WHICH THE MEDIA PROVIDERS VIEW THEIR PRODUCTS TO**
3 **BE SUBSTITUTES.**

4 A. First, many aspects of VDC's operations provide evidence that, from both the company's and
5 its customers' perspective, directory advertising competes against all other forms of local
6 advertising. For example, the company routinely performs market research that focuses on
7 understanding the competitive interaction between directory and other local advertising. The
8 company's market research does not focus solely on customers' perceptions of rival
9 directories, but rather the research focuses on understanding customers' perceptions of a wide
10 variety of local media. I would expect that if these other media were not reasonable
11 substitutes for yellow-page advertising, VDC would not routinely perform such research.

12
13 In addition, sales force material describing the relative strengths of yellow-page advertising
14 relative to other media (such as newspapers, magazines, direct-mail advertising, television,
15 and radio) is relied upon to more effectively market yellow-page advertising in response to
16 competitive threats from these different media.²⁹

17
18 Directory yellow page providers would not commit resources to understanding the tactics
19 other media sales representatives use to promote their products over yellow pages and in
20 developing responses to overcome these tactics, unless they perceived these other forms of
21 advertising to be reasonable substitutes to yellow pages ads.

²⁹ See, e.g., Fromholzer, D.R., Yellow Page Publishers Association, *Yellow Pages and Intermedia Competition: Yellow Pages vs. Newspapers* (August 1998).

1 **C. The Strength of Competition Facing VDC in the Relevant Markets**

2 **Q. HAVE YOU ATTEMPTED TO CALCULATE THE MARKET SHARE OF VDC**
3 **DIRECTORY ADVERTISING IN THE PROPERLY DEFINED MARKET?**

4 A. Yes. Ideally, such a calculation would be performed using advertising revenues for each
5 substitute media taking the area served by a particular directory as a starting point.
6 Revenues are the most appropriate measure of the relative importance of competing
7 media because they provide a measure of value of alternative forms of advertising from
8 the perspective of buyers.

9
10 Unfortunately data regarding expenditures on local advertising are not available for the
11 area served by a particular directory. Therefore, I found it necessary to the estimate
12 VDC's share of the relevant market at a more aggregate level. National data on local
13 advertising and national advertising are separately reported by a prominent advertising
14 research firm, Universal McCann. According to Universal McCann, the outlook for
15 advertising in 2004 involved approximately \$166 billion in expenditures. Of this
16 amount, national advertising in all yellow page directories totaled \$2.2 billion, or
17 approximately 1.3 percent of total national advertising.³⁰ As shown in Table Fifteen
18 below, the outlook for local advertising placed by retailers and local entrepreneurs
19 involved expenditures of approximately \$94 billion, of which advertising on local yellow
20 page advertising equaled approximately \$11.8 billion, or 12.5 percent of total local
21 advertising.

22

³⁰ See Universal McCann, "Insider's Report, Robert Coen Presentation on Advertising Expenditures,"
<http://www.universalmccann.com/InsidersReport1203.pdf> (December 2003).

TABLE FIFTEEN
YELLOW PAGES' SHARE OF LOCAL ADVERTISING REVENUE
UNITED STATES, 2004

	Revenues (\$ million)	Share (%)
Local Newspapers	38,156	40.5
Local TV	13,586	14.4
Local Radio	15,131	16.1
Local Yellow Pages	11,806	12.5
Other Local Media	15,595	16.5
Total	94,274	100.0
Source: Universal McCann, "Insider's Report, Robert Coen Presentation on Advertising Expenditures" December 2003, http://www.universalmccann.com/InsidersReport1203.pdf (visited on Jan. 27, 2004).		

If Verizon's directory advertising market shares are similar across the various areas served by VDC, then the aggregate figure should provide an accurate though conservative estimate of a single directory's market share. Having examined national data on local advertising expenditures, I find that local yellow pages advertising revenue represents less than *thirteen percent* of all local advertising revenues. This estimate establishes a conservative upper bound on VDC's likely share because such revenues include the directory revenues of all yellow pages suppliers. For example, according to Simba Information, in 2004 VDC's domestic revenues are expected to be approximately \$3.8 billion, inclusive of print and on-line directory revenues.³¹ Using this figure, VDC's share of local advertising revenues nationwide would be approximately four percent.

³¹ Simba Information Inc., YELLOW PAGES MARKET FORECAST 2004 (2004), at 38.
Verizon NW Direct
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1 **Q. WHAT CONCLUSION DO YOU DRAW FROM VDC'S SHARE OF LOCAL**
2 **ADVERTISING REVENUES?**

3 A. Even using this conservative estimate, VDC's share of local advertising is substantially
4 less than any reasonable market share threshold related to the unilateral ability to control
5 price.

6
7 **Q. ASSUMING, ARGUENDO, THAT VDC'S SHARE OF THE PROPERLY**
8 **DEFINED MARKET WAS HIGHER THAN THRESHOLD LEVELS FOR**
9 **COMPETITIVE CONCERN, WOULD THAT INFORMATION ALONE BE**
10 **SUFFICIENT TO CONCLUDE THAT VDC HAD THE ABILITY TO CONTROL**
11 **PRICE?**

12 A. No. Modern theoretical and empirical research in economics demonstrates that a high
13 market share alone is not sufficient to enable a firm to control price. In a market with no
14 significant barriers to entry, a firm cannot exercise market power, regardless of its market
15 share. As one modern textbook summarizes: "Though not sufficient for a finding of
16 market power, high market shares are likely necessary for such a finding. Whether
17 market shares are reflective of market power depends on barriers to entry."³² Thus, a
18 high market share can be indicative of market power only if barriers to entry exist.

19

³² Jeffrey Church and Roger Ware (2000), *INDUSTRIAL ORGANIZATION*, McGraw-Hill, p. 604.

1 **Q. HAVE YOU EXAMINED BARRIERS TO ENTRY IN THE MARKET FOR**
2 **LOCAL ADVERTISING?**

3 A. Yes. There appear to be no barriers to expansion of capacity by providers of local
4 advertising. For example, in response to profit opportunities, the number of pages
5 dedicated to advertising in newspapers and magazines could easily expand. Similarly,
6 television and radio stations could devote more airtime minutes to advertisements if it
7 were profitable to do so. Barriers to entry also appear to be quite low for direct mail and
8 community newspapers, as well. The large number of community newspapers is strong
9 evidence that entry into the newspaper business can occur at a small scale, with low sunk
10 costs. The technology for printing direct mail and other hand-delivered advertising is
11 widely available at relatively low cost. Thus, both actual and potential competition from
12 these sources imposes a strong competitive check on the price of advertisements placed
13 in yellow page directories.

14
15 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

16 A. Yes.