

Before the
**WASHINGTON UTILITIES
AND TRANSPORTATION COMMISSION**

AT&T Communications of the Pacific
Northwest, Inc. v. Verizon Northwest, Inc.

Docket No. UT-020406

Rebuttal Testimony

of

LEE L. SELWYN

on behalf of

AT&T Communications of the
Pacific Northwest, Inc.

January 31, 2003
Revisions dated May 1, 2003

ALLEGEDLY PROPRIETARY DATA
HAS BEEN DELETED

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Individual regulatory actions or decisions are not *per se* confiscatory if the cumulative effect of the method of regulation provides the utility with an opportunity to recover its prudent investments and earn a fair return thereon. 39

~~REVENUE-NEUTRAL RATE REBALANCING~~ 45

~~If the Commission determines that revenue-neutral rate adjustments are necessary to offset the reductions to Verizon Northwest's intrastate switched rates, rate increases should be considered for other Verizon Northwest noncompetitive services, not just residential local exchange service.~~ 45

~~Verizon's residence local exchange service is compensatory.~~ 47

CONCLUSION 58

The Commission should continue its efforts regarding access reform by requiring Verizon to lower its switched access rates towards cost-based levels, as doing so will promote competition in the intrastate toll market and eliminate the price squeeze that currently exists. 58

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1 REBUTTAL TESTIMONY

2

3 **Introduction**

4

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

6

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

9

10 Q. Have you previously submitted testimony in this docket?

11

12 A. Yes, I prepared an affidavit dated March 28, 2002, which was submitted by AT&T
13 Communications of the Pacific Northwest, Inc. (“AT&T”) in support of its petition in the
14 current proceeding. I also submitted direct testimony on behalf of AT&T on September 30,
15 2002 in this proceeding.

16

17 **Assignment and summary of testimony**

18

19 Q. What is the purpose of your rebuttal testimony?

20

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

1 Q. Please summarize your rebuttal testimony.

2

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

14

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

1. Fulp (Verizon), at 5.

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

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

8
9 Clearly, changes in the state's telecom marketplace affect what constitutes "just and
10 reasonable" rates, and the movement away from implicit subsidies and towards cost-based
11 rates for telecommunications services provides ample justification for the Commission to
12 reexamine whether or not Verizon's intrastate access charges are just and reasonable today.
13 Moreover, as I have demonstrated in my direct testimony, several of Verizon's intrastate toll
14 plans fail the Commission's access charge imputation requirements, and Verizon's feeble
15 criticisms of my imputation analysis do not withstand scrutiny. It is important to eliminate
16 the anticompetitive price squeeze that currently exists for interexchange carriers seeking to
17 compete with Verizon in the intrastate toll market, and the best method for doing so is to
18 lower access rates — and not by some nominal amount, but at least to interstate levels and
19 preferably to cost-based levels.

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

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

15
16 ~~*Finally*, Verizon insists that any offsetting rate increase must be assessed upon local resi-~~
17 ~~dential rates.~~⁶ ~~As support for this position, Verizon asserts that its residential basic service~~
18 ~~is currently priced below cost.~~⁷ ~~Yet here, Verizon's analysis is fatally flawed: The Company~~
19 ~~examines only the costs and revenues associated with the basic residential local service rate~~

4. Heuring (Verizon), at 4.

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

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

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

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

1 REDUCING VERIZON'S INTRASTATE SWITCHED ACCESS RATES

2

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

5

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

7

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

17

18 Q. Do you agree with either of these positions?

19

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

8. Fulp (Verizon), at 7.

9. Danner (Verizon), at 14.

1 reasonable” following the Bell Atlantic/GTE merger,¹⁰ and since intrastate access rates have
2 been reduced by \$7-million since that time,¹¹ then rates in effect today must also be “just
3 and reasonable.”¹² But such a conclusion ignores the fact that changes in marketplace
4 conditions can *and have* altered the perception of what meets the “just and reasonable”
5 standard. As discussed in my direct testimony, the trend toward eliminating implicit
6 subsidies and setting prices at levels closer to economic cost,¹³ coupled with the fact that
7 Verizon’s intrastate switched access rates are currently set at many multiples of both the
8 cost-based UNE rates¹⁴ (adopted by the Commission in Docket No. UT-960369¹⁵) and the
9 current negotiated rates for the termination of local exchange traffic between Verizon and
10 other carriers,¹⁶ there can be no doubt that the Company’s intrastate switched access rates
11 can no longer be considered “just and reasonable.”

12
13 Apparently recognizing the weakness of his “just and reasonable” argument, Mr. Fulp is
14 quick to offer up a back-up plan for the Commission’s consideration, that being to “permit
15 Verizon to make simultaneous increases to local residential rates on a revenue-neutral basis”

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

11. *Id.*, at 6.

12. *Id.*

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

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

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

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

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

4
5 Q. In your direct testimony, you advocate that Verizon's intrastate switched access rates should
6 be reduced to cost-based levels. Has Verizon addressed this recommendation?

7
8 A. No. My direct testimony not only recommends that Verizon's intrastate switched access
9 rates be lowered to cost-based levels, but sets out the factual basis for doing so.¹⁸ Verizon
10 has, for unknown reasons, completely ignored AT&T's position on this matter. The
11 Company's rebuttal testimony addresses only Staff witness Dr. Glenn Blackmon's recom-
12 mendation. Staff would set Verizon's intrastate switched access rates at levels that are
13 roughly equivalent to those of Qwest, which apparently equates to a \$32-million reduction
14 in switched access revenues.¹⁹

15
16 Although Verizon is critical of Staff's recommendation, the Company nonetheless has
17 responded to Staff's proposal with its own similar \$32-million switched access rate

17. Fulp (Verizon), at 7.

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

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

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

7
8 Q. What are Verizon's criticisms of Staff's recommendation?

9
10 A. Mr. Fulp asserts that there is no basis to comply with Staff's recommendation in light of the
11 fact that Verizon and Qwest are different companies with different cost structures. Mr. Fulp
12 postulates that because Verizon (1) serves fewer than one-third the number of switched lines
13 as compared with Qwest; and (2) has a greater proportion of switched lines in less densely
14 populated areas, the switched access rates for these two carriers should be different.²¹

15
16 Q. Do Verizon's criticisms of Staff's recommended approach also apply to your recommenda-
17 tion for setting switched access rates at cost-based levels?

18

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

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

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

15

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

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

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

7
8 Q. Does Verizon in any way recognize the functional equivalency between intrastate switched
9 access and other Verizon services?

10
11 A. Yes. As set forth in the testimony of Mr. Fulp, the Company proposes to undertake local
12 transport rate restructuring, which would more closely align intrastate switched access rates
13 with their interstate counterparts.²³ This appears to be based upon the Company's con-
14 cession that "...state and interstate switched access services are typically jointly
15 provisioned...".²⁴ Verizon also proposes rates for the newly established intrastate rate
16 elements (e.g., shared trunk ports, shared multiplexing, and dedicated trunk ports) that are
17 *identical* to the current interstate rates for those very rate elements.²⁵ Verizon's actions not
18 only confirm that the functionality of the intrastate and interstate switched access rates are
19 identical, they demonstrate that the rate structures can be as well. Consequently, as an

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

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

25. Fulp (Verizon), at 17.

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

3

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

6

7 A. Yes. I have made two sets of calculations, one using the 2001 demand set relied upon by
8 Staff in its proposal,²⁶ and the other using October 2001—September 2002 units as relied
9 upon by Verizon in its proposal.²⁷ For each demand set, I have calculated the revenue effect
10 of three separate adjustments to intrastate switched access rates: (1) lowering rates to cost-
11 based levels; (2) lowering rates to interstate levels; and (3) lowering rates to interstate levels
12 and implementing local transport rate restructuring (“LTR”) as proposed by Verizon. I have
13 provided the details encapsulated within these calculations in Exhibits LLS-7C (reflecting
14 2001 demand) and LLS-8C (reflecting Verizon's October 2001–September 2002 demand) in
15 order to assist the Commission in understanding the revenue effect of each option for
16 reducing rates.

17

18 Q. What are the results of your calculations?

19

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

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

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

1 tion in Verizon's switched access revenues would be \$44.0-million using 2001 demand,²⁸ or
2 \$38.4-million using Verizon's October 2001—September 2002 data.²⁹ Alternatively,
3 reducing intrastate switched access rates to interstate levels across-the-board would lower
4 Verizon's switched access revenues by \$39.9-million (2001 demand)³⁰ or \$34.9-million
5 (September 2001—October 2002 demand).³¹

6
7 Shifting rates to reflect interstate levels, while at the same time accomplishing the local
8 transport rate restructuring proposed by Verizon, would lower Verizon's switched access
9 revenues by \$38.3-million (assuming 2001 demand)³² and \$33.4-million (assuming
10 Verizon's October 2001–September 2002 demand).³³

11

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

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

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

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

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

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

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

12 **Verizon’s feeble criticisms fail to invalidate the imputation analysis set forth in my direct**
13 **testimony.**

14
15 Q. Dr. Selwyn, has the Commission established a rule regarding a specific imputation standard
16 with respect to intrastate toll service for Verizon?

17
18 A. The Commission has not established a statutory rule regarding imputation in general, or the
19 imputation of costs into intrastate toll rates in particular. The Commission has addressed
20 intrastate toll imputation in an earlier proceeding (Docket No. UT-970767),³⁴ and it is with
21 guidance from the Commission’s ruling that I developed the imputation test that I discussed
22 in my direct testimony.

23

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

1 Q. Please describe the imputation analysis adopted by the Commission in Docket No. UT-
2 970767.

3

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

6

7 The Commission incorporates as the appropriate cost standard for determining
8 whether GTE's prices for intraLATA toll service cover its costs the imputation
9 analysis provided by GTE in Docket No. UT-970598, revisions to its Tariff
10 WN U-12, IntraLATA Toll Services. The June 25, 1997 Staff Memorandum
11 on this filing notes at page 2:

12

13

Imputation

14

15

16

17

18

19

20

21

22

GTE-NW is required to demonstrate that its rates do not create a
"price squeeze" for its toll competitors, who must by access from
GTE-NW. GTE-NW has provided its imputation analysis as a
confidential cost support exhibit with the tariff filing. Staff believes
the proposed toll rates do not result in a price squeeze, because the
average rates under each toll plan are sufficiently high to cover the
access charges that GTE-NW would incur and the incremental cost of
toll service...³⁵

23 The Commission's ruling is clear in that the proper imputation standard should include both

24 access and non-access costs, consistent with my analysis.³⁶ Notably absent from the

25 Commission's ruling is any language specifically identifying or limiting what the

26 "incremental cost[s]" associated with toll service are.

27

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

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

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

1 A. I provided the Commission with my imputation analysis³⁷ to support the notion that
2 Verizon's intrastate switched access charges are currently set at economically inefficient
3 levels, and are so much above cost as to perpetrate a price squeeze upon interexchange
4 carriers seeking to compete with Verizon in the intrastate toll market.

5
6 Q. Does the Commission's Staff appear to agree with your imputation analysis?

7

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

13

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

15

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

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

38. Zawislak (Staff), at 10.

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

10
11 Q. Does Verizon agree with your toll imputation study?

12
13 A. No. There are certain inputs to the study with which Verizon disagrees, and as a result
14 Verizon does not concur with the outcome of my analysis — that being that a price squeeze
15 exists for certain toll services. Verizon has supplied what it considers to be a current
16 version of its own imputation study,⁴¹ the results of which indicate that all of the Company’s
17 toll services pass imputation.⁴² I shall address and refute each of Verizon’s criticisms of my
18 study below.

39. *Id.*, at 11.

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

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

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

1 **Verizon’s erroneous use of direct trunked transport rate elements when calculating its own**
2 **access costs causes two of Verizon’s toll service offerings to fail the Company’s own**
3 **imputation standard.**
4

5 Q. Does Verizon take issue with your calculation of the access costs attributable to Verizon for
6 providing retail toll service?
7

8 A. Surprisingly, no. Verizon offered no criticism of my calculation of the access costs
9 attributable to Verizon in the provision of toll service, despite the fact that the Company’s
10 calculation of these costs is different.
11

12 Q. How does Verizon’s calculation of access costs differ from yours?
13

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

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

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

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

5

6 **Verizon's interpretation of the "incremental" cost of billing and collection unfairly**
7 **attributes 100% of the economies of scope to the Company's competitive toll service.**
8

9 Q. Dr. Selwyn, does Verizon concur with your methodology of quantifying the incremental
10 cost of billing and collection?
11

12 A. No. Verizon witnesses Terry Dye and Dr. Carl Danner reject my use of a methodology that
13 differs from established Commission precedent in calculating incremental non-access costs
14 for toll imputation purposes.⁴⁵ Yet Verizon passes its own toll imputation analysis⁴⁶ by
15 virtue of the self-serving manner in which the Company interprets how the incremental costs
16 of billing and collection are to be calculated. The Commission's Order relating to imputa-
17 tion does not limit interpretation of "incremental cost" to only that applied by Verizon. It is
18 Verizon's position that these incremental costs for toll service should "piggyback" on the
19 costs already sunk by the Company to cover the billing and collection for local service, and
20 that only the incremental cost above and beyond those costs already incurred to provide
21 *regulated* services should be applied in the imputation study for Verizon's *unregulated* toll

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

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

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

4
5 The Company's interpretation of "incremental cost" unjustly assigns all joint costs of the
6 Company's joint local and toll billing and collection operations to its regulated local
7 services. This has the effect of capturing 100% of the *benefit* of the joint operation for the
8 *nonregulated* competitive toll services.

9
10 This device allows Verizon to confer unto itself a benefit that is not offered or available to
11 any of its rivals. Indeed, when providing billing and collection services to competing toll
12 carriers, Verizon imposes charges that are intended to reflect not Verizon's costs, but the
13 stand-alone billing and collection costs that nonaffiliated IXCs would be forced to incur if
14 they did not purchase these services from Verizon. In fact, in the case of a rate of return-
15 regulated company such as Verizon Northwest, the *correct* policy should be that 100% of
16 the gains from joint production of a regulated and a nonregulated service (e.g., joint local
17 and toll billing and collection) should inure to the *regulated* services and be used to offset
18 the regulated services revenue requirement. The economic gains that are uniquely captured
19 by Verizon from these and other joint operations are, from an economic perspective, no
20 different than cash earnings when it comes to calculating the Company's realized rate of
21 return. By flowing 100% of the gains from joint production over to its nonregulated opera-
22 tions, Verizon is simply shifting profit away from its regulated services and over to its
23 competitive services. It is through tactics such as this that Verizon is able to report
24 "deficient" rates of return on its regulated business while capturing the shifted profits on the

1 nonregulated side. *At the very least, the Commission needs to consider and address this*
2 *profit-shifting device when considering the validity of Verizon's claims of an earnings*
3 *shortfall and its insistence upon "revenue-neutral" rate adjustments.*

4
5 **The estimate of incremental retailing/marketing costs associated with interexchange**
6 **carriers employed in my imputation study is not jurisdictional, and appropriately reflects**
7 **the market realities of attracting and retaining customers for toll service.**
8

9 Q. Verizon witnesses Terry Dye and Dr. Carl Danner reject your use of the \$0.03 retailing/
10 marketing figure, claiming that it is neither Washington specific⁴⁷ nor reflective of the
11 economies available to a provider of multiple services.⁴⁸ Do you agree with their criticisms?
12

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

47. Dye (Verizon), at 5.

48. Danner (Verizon), at 8.

49. *Id.*, at 16.

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

3
4 Second, Dr. Taylor's \$0.03 incremental cost figure may well be understated, based upon the
5 market realities regarding the costs associated with attracting and retaining toll customers. I
6 am aware of at least one analysis that has put such cost at "up to \$300 to \$600 in sales
7 support, marketing and commissions" per customer acquired.⁵¹ Verizon's alleged retailing/
8 marketing cost of BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY
9 multiplied by an estimate of average intrastate toll usage for those customers for whom
10 Verizon Northwest provides intraLATA toll of BEGIN PROPRIETARY << [REDACTED] >> END
11 PROPRIETARY minutes per month⁵² translates into an *annual* retailing/marketing cost to
12 Verizon of just BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY for each such
13 customer. Clearly, the only way in which such costs could be this low is if Verizon allo-
14 cates all joint costs of local and toll service *to local*.

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

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

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

1 Finally, use of Dr. Taylor’s \$0.03 retailing/marketing figure is generally supported by a
2 recent article appearing in the *New York Times*, in which an investment analyst pegs the
3 average cost for Verizon’s long distance affiliate at \$0.055 per minute for access and non-
4 access costs.⁵³ Subtracting \$0.011 for interstate access (\$0.0055 per end, originating and
5 terminating) puts non-access costs at \$0.044 per minute. My estimate of non-access costs of
6 \$0.0455 is just 3% above this figure, whereas Verizon’s estimate of BEGIN
7 PROPRIETARY << [REDACTED] >> END PROPRIETARY, is BEGIN PROPRIETARY << [REDACTED]
8 >> END PROPRIETARY below that amount.⁵⁴

9
10 Verizon thus appears to be seriously understating the true incremental cost of marketing
11 associated with providing toll service, and is therefore likely foisting a disproportionate
12 share of the retailing/marketing costs upon regulated service. Moreover, the basic theory
13 under which Verizon claims that only the incremental costs of the joint retailing/marketing
14 operations should be “charged” to toll services is essentially the same — and just as invalid
15 — as the manner in which this was done with respect to billing and collection costs, and for
16 precisely the same reasons.

17
18 Verizon apparently believes that this Commission should accept what amounts to a “what’s
19 mine is mine and what’s yours is mine” policy with respect to the treatment of joint costs

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

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

1 and joint benefits. Under Verizon's patently self-serving theory, it should be entitled to
2 charge IXCs 100% of all joint costs of regulated and competitive services, while capturing
3 100% of all joint benefits for itself. This practice should be unacceptable for any public
4 utility, but particularly for one such as Verizon Northwest that is still subject to rate of
5 return regulation and which provides essential monopoly services (access services) to
6 carriers with which Verizon itself competes. Verizon's device shifts profit out of regulation
7 and over to its nonregulated businesses, causing the nominal "realized rate of return," which
8 is calculated on the basis of accounting earnings captured on the books of its regulated
9 operations, to be grossly understated. Verizon then appears before this Commission with
10 the incredible claim that it is suffering an earnings shortfall, when in fact it has simply
11 diverted earnings over to another component of the parent company. At the same time,
12 Verizon's tactic raises its rivals' costs while simultaneously providing the mechanism for
13 Verizon's price squeeze strategy.

14
15 **Verizon's "opportunity cost" argument falls short of sufficiently guaranteeing against the**
16 **existence of a price squeeze.**
17

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

20
21 A. Dr. Danner claims that my analysis of the trade-off between Verizon self-provisioning
22 switched access and providing switched access services to other IXCs ignores the oppor-

1 tunity cost associated with providing access to itself.⁵⁵ That is, he claims that any foregone
2 revenue associated with switched access from an IXC is an actual out-of-pocket cost to
3 Verizon that must be considered when assessing the competitiveness of Verizon's access
4 charges.

5
6 If Dr. Danner's opportunity cost argument is correct, then there would be no need whatso-
7 ever for an imputation test. The fact that this Commission (as well as many public utility
8 commissions in other states, the FCC, and the United States Congress in the *Telecommuni-*
9 *cations Act of 1996*) have all found it necessary to adopt imputation standards that go
10 beyond access costs refutes Dr. Danner's conclusion that Verizon would not price toll at
11 predatory levels due to the opportunity cost of switched access revenues.

12
13 Furthermore, unlike, say, the number of residential access lines, the number of switched
14 access minutes is not a fixed (or nearly fixed) quantity. Due to price elasticity of demand,
15 the retail price of toll service affects the quantity of toll minutes demanded by end users,
16 which in turn affects the demand for switched access by IXCs. Verizon's ability to offer
17 intrastate toll service at predatory levels (i.e., levels that on a service-specific basis fail
18 imputation) serves to increase demand for toll minutes, which (assuming IXCs price at or
19 near Verizon's levels) increases demand for Verizon switched access services.⁵⁶ Should

55. Danner (Verizon), at 6.

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

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

8
9 Q. Please summarize your conclusions regarding imputation.

10
11 A. The conclusions from my direct testimony are still applicable here. Verizon's price floor
12 remains at \$0.1444.⁵⁷ In my direct testimony, I identified six Verizon Northwest toll plans
13 that failed imputation.⁵⁸ At that time, I did not have access to any demand data that would
14 have permitted me to calculate weighted-usage prices reflecting peak and off-peak usage.
15 However, Exhibit TRD-2C to the testimony of Mr. Dye provides a total weighted price per
16 MOU for each residence and business intrastate toll plan offered by Verizon, and a "Total
17 Price Per MOU" that incorporates any monthly fee that might apply to these toll plans. I
18 have compared each of these "Total Prices" to my price floor, and I now conclude that *all of*
19 *Verizon's intrastate toll service plans fail imputation* — even Verizon's base MTS rates! In
20 order for the price squeeze in the intrastate toll market to be eliminated, intrastate access

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

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

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

1 VERIZON'S EARNINGS ANALYSIS

2

3 **Verizon Northwest's claimed earnings level is grossly understated and does not support the**
4 **Company's contention that any reduction in access charges should be offset by increases in**
5 **local rates so as to produce a revenue-neutral result.**
6

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

9

10 A. In Verizon witness Nancy Heuring's testimony she calculated the rate of return for Verizon
11 Northwest's Washington regulated intrastate operations for 2000 and 2001, and a *pro forma*
12 annualized 2002 figure based upon data through September 2002.⁵⁹ According to Ms.
13 Heuring, Verizon's rate base rate of return was 5.59% in 2000, 5.50% in 2001, and is pro-
14 jected to be 2.84% in 2002. Ms. Heuring calculates the "revenue deficiency" between her
15 results and the level of revenues permitted by the Company's authorized return of 9.76% to
16 be \$60.9-million, \$64.4-million and \$105-million in years 2000, 2001 and *pro forma* 2002,
17 respectively.⁶⁰ Based upon these results, Ms. Heuring concludes that any reduction in
18 switched access rates (and thus revenues) "without commensurate offsets would make the
19 deficiency significantly larger."⁶¹ Verizon witness Orville Fulp references Ms. Heuring's
20 rate of return analysis in his direct testimony, and he concludes that if the Commission were

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

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

61. *Id.*, at 7.

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

3
4 Q. Do Ms. Heuring's rate of return calculations support a revenue-neutral rate rebalancing
5 following any Commission-approved reduction in switched access rates?

6
7 A. No. The earnings data presented by Ms. Heuring raise several issues that should be of
8 concern to the Commission. I address each of these concerns below, and quantify the
9 impact upon the rate of return calculation offered by the Company. I have recreated Ms.
10 Heuring's Exhibit NWH-2, page 3 (reflecting *pro forma* annualized 2002 data) in my
11 Exhibit LLS-9 to this testimony, which consists of 4 worksheets. Each individual adjust-
12 ment set forth below is quantified separately in pages 1 through 3. Page 4 sets forth the
13 cumulative effect of all adjustments.

14
15 First, the historical and *pro forma* returns set forth in Ms. Heuring's Exhibit NWH-2 do not
16 properly account for revenues from directory yellow page advertising, as she readily
17 admits.⁶³ Ms. Heuring seeks to justify the exclusion of directory yellow page advertising
18 revenue from her analysis because "Verizon Northwest did not receive such revenue in any
19 of those periods." Ms. Heuring's conclusion entirely ignores the purpose and regulatory
20 precedent of imputation of yellow page directory revenue. As the Commission explained in

62. Fulp (Verizon), at 7.

63. Heuring (Verizon), at 6.

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

3
4 Imputation is the implementation of "Imputed Value," i.e., the logical or
5 implicit value that is not recorded in any accounts. ATTORNEYS'
6 DICTIONARY AND HANDBOOK OF ECONOMICS AND STATISTICS,
7 by Les Seplaki, New York: Professional Horizons Press, 1991, p. 121. It is the
8 ascription or attribution to another. Webster's II New Riverside University
9 Dictionary, Boston, 1984. Here, imputation is the ascription or attribution of
10 income, not recorded otherwise on any of USWC's accounts, implemented by
11 an accounting adjustment. It revised USWC's earnings for regulatory purposes
12 (that is, for setting rates), to reflect a portion of affiliate U S WEST Dex's
13 earnings. It is a means by which the Commission may exercise the authority
14 granted in Chapter 80.16 RCW to protect ratepayer interests affected by
15 affiliated transactions.⁶⁴
16

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

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

65. Heuring (Verizon), at 6.

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

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

3
4 Q. What is the second concern you have relative to Verizon's earnings analysis?

5
6 A. Verizon's analysis does not account for the value attributable to the regulated asset base for
7 the joint marketing of local and long distance services or for other joint activities the bene-
8 fits of which inure "below-the-line" to Verizon's nonregulated operations. Where, as in
9 Washington, the incumbent telephone company (Verizon Northwest) is engaged in the long
10 distance business, there are extensive and uncompensated information flows going from the
11 ILEC entity to the long distance affiliate, and yet the affiliate is not being required to pay the
12 ILEC entity anything remotely close to the full and fair market value of such information
13 and for the various other services that it receives from the ILEC. Verizon operating
14 companies provide their long distance affiliate with unfettered access to the Verizon *local*
15 customer base and to the *inbound* customer-initiated contacts that arise as a consequence of
16 Verizon's dominance in the local residential service market in every in-region Verizon state.
17 Indeed, Verizon's ability to gain market share in the long distance market appears to be a
18 direct result of its joint marketing activities, since Verizon's long distance affiliates serve
19 only BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY customers who are not
20 presubscribed to Verizon for local exchange service,⁶⁸ which would indicate that the
21 affiliates are expending minimal effort to capture market share in those Washington

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

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

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

7
8 Customer acquisition is among the most costly aspects of an interexchange carrier's opera-
9 tion. Without the benefit of the embedded ubiquitous customer base, which is uniquely
10 available to Verizon's long distance affiliate, other IXCs must pursue active marketing
11 strategies involving extensive media advertising, telemarketing, direct mail, and special
12 promotions (cash, airline miles, etc.). When spread over the number of sales that are
13 actually consummated, these costs can amount to hundreds of dollars per customer acquired.
14 As referenced above, I am aware of at least one analysis that has put such cost at "up to
15 \$300 to \$600 in sales support, marketing and commissions" per customer acquired.⁷⁰ The
16 prevailing industry customer acquisition cost represents the fair market value of the
17 customer acquisition services that Verizon is providing its long distance affiliate. The

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

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

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

3
4 In order to make this calculation, it is necessary to estimate the number of PIC changes
5 Verizon Northwest captures in a given year through the use of its inbound marketing
6 channel, which I have accomplished as follows: According to ARMIS data, Verizon served
7 approximately 645,000 residential switched access lines in Washington in 2001.⁷¹ In the
8 interests of keeping the calculation “public,” I am conservatively assuming that Verizon
9 serves 98% of the residential local market, or about 632,000 customers, in its Washington
10 service areas. According to the US Census Bureau, each year on average some 17% of all
11 US households relocate to a new residence.⁷² Thus, each year approximately 17% of the
12 residential customers in Verizon’s service area can be expected to initiate an order for new
13 local telephone service. I have assumed that Verizon’s share of these inward service orders
14 will correspond with its share of the local exchange service market overall, i.e., 98%. Thus,
15 Verizon Long Distance will have the opportunity to “address” 98% of the 17% of residential
16 customers who relocate (i.e., 16.7%, or about 105,000) in Verizon’s service area as a result
17 of *customer-initiated* “inbound” contacts alone. I also assume that in approximately 82.3%
18 of the customer-initiated contacts in which an order for new local service is placed, the
19 customer selects Verizon as the Primary Interexchange Carrier (“PIC”) following the

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

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

1 “recommendation” of the Verizon service representative.⁷³ By that count, nearly 87,000
2 lines will be PIC’d to Verizon Long Distance *annually* by virtue of the inbound marketing
3 channel.⁷⁴

4
5 Applying the most conservative estimate of \$300 for customer acquisition costs means that
6 about \$26-million should be imputed to the Company’s unseparated regulated operations,⁷⁵

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

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

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

1 all of which is properly attributed to the intrastate jurisdiction, and none of which has been
2 accounted for by Verizon in its current earnings analysis. The result of this imputation
3 serves to increase the Company's intrastate rate of return from 2.84% to 4.58%.⁷⁶
4

5 Q. What is the third item of concern with respect to Verizon's earnings calculation?
6

7 A. The third area of concern lies with the apparent overstatement of the rate base level assumed
8 in Ms. Heuring's earnings calculations, which would lead to an understatement of the
9 Company's earnings. The Commission may recall that in February 1999, the Federal
10 Communications Commission released the results of audits its staff had conducted of the
11 Regional Bell Operating Companies' Continuing Property Records (CPRs) as these existed
12 on June 30, 1997.⁷⁷ The audits revealed a pattern of systematic overstatements of capital

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

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

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

10
11 While the FCC's CPR audits focused on the BOCs, a joint state-FCC audit team undertook a
12 similar investigation of the GTE Corporation's Telephone Operating Companies (GTOCs),
13 which also found significant gaps between booked capital investments and those that could
14 actually be verified. According to the auditors' final report issued in December 1997, the
15 audit team's primary goal was to determine whether the GTOCs' maintained their basic
16 property records (BPRs) in compliance with the FCC's Part 32 (USoA) rules.⁷⁹ The audit

77. (...continued)

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

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

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

(continued...)

1 team focused upon the three largest plant accounts, namely Digital Switching Equipment
2 (Account 2212), Circuit Equipment (Account 2232), and Buried Cable (Account 2423).

3 One aspect of the audit was a physical verification phase, meant to confirm the physical
4 existence of selected assets included in the GTOCs' BPR. According to the auditors' report:

5
6 In the physical verification phase of the audit, 2,286 items were reviewed.
7 Based upon book values, 21.7% of the sampled items was missing and another
8 14.6% was unverifiable. Thus, 36.3% of the book value was questionable. Of
9 the 2,286 line items included in the physical verification phase of the audit,
10 693 (30.3%) of the line items were out of compliance with the requirements of
11 Part 32.⁸⁰
12

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

19
20 Q. What would Verizon Northwest's Washington earnings look like if the Joint Auditor's
21 findings were extrapolated to the Company's Washington assets?

79. (...continued)

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

80. *Id.*, at 2.

81. *Id.*, at 3.

1 A. Exhibit LLS-9, p. 3 presents a restatement of Verizon Northwest's 2002 earnings that
2 applies an adjustment to rate base, based upon the Joint Auditors' findings concerning the
3 degree to which GTOCs' booked network assets were unaccounted for during the physical
4 verification. My adjustment reduces Verizon Northwest's net plant for Accounts 2212,
5 2232, and 2423 by 36.3%, the same percentage of missing/unverified plant for those
6 accounts that was found in the Joint Auditor's investigation. This adjustment produces a
7 20.6% decrease in the Company's rate base, and when applied separately from any other
8 adjustments, it increases the Company's intrastate Washington earnings from 2.84% to
9 3.75%.

10

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

12

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

19

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

21

22 A. Exhibit LLS-11 recreates page 1 of Ms. Heuring's Exhibit NWH-3, which summarizes the
23 impact of all of my adjustments. Imputation of yellow pages and joint marketing revenues
24 has the effect of increasing Verizon Northwest's Washington net income by \$39-million for

1 *pro forma* 2002.⁸² Additionally, recognition of the third adjustment — the elimination of
2 overstated rate base value — has the effect of reducing the Company’s Washington intra-
3 state revenue requirement by \$23-million for 2002.⁸³ The three adjustments combined work
4 to eliminate some \$97-million of the alleged earnings shortfall relative to the 9.76%
5 authorized rate of return for *pro forma* 2002.⁸⁴ Significantly, this amount greatly exceeds
6 the \$44-million in access charge reductions that would be required if access charges were to
7 be brought down to cost-based levels. Accordingly, even if the Commission determines that
8 it should pursue a reexamination of Verizon Northwest’s earnings, that effort should not
9 work to delay the long overdue reductions in intrastate access charges that is being sought in
10 this proceeding.

11
12 **Individual regulatory actions or decisions are not *per se* confiscatory if the cumulative**
13 **effect of the method of regulation provides the utility with an opportunity to recover its**
14 **prudent investments and earn a fair return thereon.**
15

16 Q. Dr. Selwyn, are you suggesting that in evaluating the reasonableness of Verizon
17 Northwest’s rates and earnings following an access charge rate reduction, the Commission
18 should consider both the nominal accounting earnings that are recorded “above-the-line” on
19 the Company’s books as well as various benefits that the Company obtains by virtue of its
20 status as the dominant incumbent local exchange carrier in its territory?
21

82. See LLS-11, line 15.

83. See *id.*, line 17.

84. See *id.*, line 19.

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

2

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

6

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

8

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

15

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

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

86. Danner (Verizon), at 4.

1 “obviously not compensatory.”⁸⁷ Verizon believes, therefore, that the implementation of a
2 non-compensatory rate of return would create stranded investment, and further suggests that
3 “a significant ‘risk premium’” would be required “with respect to additional investments in
4 this state that may fall under Commission jurisdiction.”⁸⁸

5
6 Q. Does this argument have merit?

7
8 A. No, it does not. Even from the perspective of rate of return analyses, the Company’s
9 showing is inadequate. Its analysis focuses solely upon the carrier’s intrastate accounting
10 rate of return, but this constitutes only one piece of the Company’s financial picture. The
11 kind of one-dimensional approach being advanced here by Verizon is not sufficient to
12 establish that the resulting rate or earnings level will be confiscatory, because it expressly
13 ignores the various “offsetting countervailing errors or allowances” that I have been
14 discussing, such as yellow pages earnings, the benefits of joint production and joint
15 marketing, among others.

16
17 Q. Are these current earnings-based rate of return types of analyses germane to the ratemaking
18 efforts that are before the Commission in this proceeding?

19
20 A. At best they provide one piece of data, but don’t come close to offering a comprehensive
21 picture of the impact of all of the Commission’s (and the FCC’s and Congress’) policy

87. *Id.*, at 3.

88. *Id.*, at 4.

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

6
7 Q. Should the examination of the “net effect” of the combined state and federal process of
8 regulation be confined to individual accounting periods, or should it also consider the net
9 effect over time?

10
11 A. The effects and impacts of regulatory actions are often far-reaching and long-term in nature,
12 and do not lend themselves to an evaluation that is confined to a single accounting period.
13 To determine whether regulated firms are capable of operating successfully, the Commis-
14 sion must consider *inter-temporal* financial flows in evaluating the net effect of the recent
15 state and federal actions, such that a temporary shortfall in one (or even in several)
16 accounting period(s) could not be held to constitute a taking as long as it is or would likely
17 be offset by higher earnings in other accounting periods that result from other aspects of the
18 overall method of regulation.

19
20 When faced with a possible reduction in revenues, it is insufficient for a regulated entity to
21 solely examine its intrastate earnings to either substantiate a “takings” claim or demand to
22 be made whole through revenue-neutral rate rebalancing. The solvency of the carrier as a
23 whole is determined not by its intrastate operations, but by the financial results of the entity
24 as a whole. For that reason, an examination of a regulated telecommunications carrier must

1 assess earnings not only at the intrastate level, but at the interstate level as well. In the
2 instant case, Verizon asserts that its intrastate earnings level in Washington is sufficiently
3 low as to require revenue-neutral rate rebalancing following a reduction in access charges.
4 But the Company makes no effort to hide the fact that its *combined* regulated intrastate/
5 interstate operations generates earnings in the 10–11% range even without any adjustments
6 such as those I have identified above.⁸⁹ Even if the Commission were to reduce Verizon’s
7 intrastate access charges to cost — which it should do — Verizon Northwest’s Washington
8 operations would still be earning above the authorized level when all of the offsetting effects
9 and profit-shifting devices are recognized.⁹⁰

10
11 Q. Please summarize your comments with respect to Verizon’s reported earnings level.

12
13 A. As I have shown, there is ample basis to conclude that Verizon Northwest’s Washington
14 intrastate earnings have been severely understated by the Company, perhaps by as much as
15 \$97-million. Accordingly, the Commission should proceed to reduce Verizon’s intrastate
16 access charges at this time and without further delay. It should also commence a thorough
17 reexamination of Verizon Northwest’s intrastate earnings, including the effects of inter-
18 affiliate transfers and revenue shifts, in order to determine whether *additional* rate reduc-
19 tions are reasonable and appropriate. In any event, that process must not delay

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

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

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

1 REVENUE-NEUTRAL RATE REBALANCING

2

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

7

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

10

11 ~~A. Verizon witness Fulp clearly states the Company's "simple" proposal: "...if the Commission~~
12 ~~reduces Verizon's access charges, then it should increase Verizon's rates for residential~~
13 ~~service on a revenue-neutral basis."⁹¹ ~~As discussed in the direct testimony of Verizon wit-~~
14 ~~ness Terry Dye, Verizon proposes to offset the \$32-million reduction in intrastate switched~~
15 ~~access rates by increasing (1) the R-1 rate from \$13.00 to \$17.56 per month,⁹² and (2) the~~
16 ~~R-1 Basic Measured service from \$7.25 to \$11.81.⁹³~~~~

17

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

19

91. ~~Fulp (Verizon), at 20.~~

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

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

1 ~~A. According to Mr. Dye, current R-1 prices (\$13.00 for R-1 flat rate and \$7.25 for R-1~~
2 ~~measured) were compared to the total service long run incremental cost (TSLRIC) for R-1~~
3 ~~service (BEGIN PROPRIETARY << [REDACTED] >> END~~
4 ~~PROPRIETARY, as presented by Verizon witness David Tucek⁹⁴), and the retail rates were~~
5 ~~found to be “significantly below TSLRIC.”⁹⁵ He also determined that the TSLRIC for~~
6 ~~business local service (BEGIN PROPRIETARY << [REDACTED] >>~~
7 ~~END PROPRIETARY) is less than the TSLRIC for residential service, and that B-1 retail~~
8 ~~prices (\$29.70) are higher than those for R-1 service. Although Verizon witness Dr. Carl~~
9 ~~Danner “agree[s] with reducing Verizon’s access charges because recovering the fixed costs~~
10 ~~of network access through access charges (as is now occurring in Washington) is economi-~~
11 ~~cally inefficient, and causes economic losses to customers and the economy,” he concludes~~
12 ~~that “[s]hifting cost recovery to basic local service is the appropriate response.”⁹⁶~~

13

14 ~~Q. Do you agree?~~

15

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

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

95. Dye (Verizon), at 9.

96. Danner (Verizon), at 14.

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

4
5 ~~Q. Have you analyzed the costs and revenues associated with all rate elements associated with~~
6 ~~the dial tone line for residential customers?~~

7
8 ~~A. Yes I have. The results of my analysis appear in Table 2 below. When all sources of~~
9 ~~revenue and cost associated with residential local exchange service are considered, I find~~
10 ~~that residential service on the whole is compensatory. Verizon’s recommendation to apply~~
11 ~~all revenue-neutral rate increases to basic residential service by virtue of the fact that it is~~
12 ~~priced below cost must therefore be rejected, and any revenue-neutral rate increase deemed~~
13 ~~appropriate by the Commission must be shared by services other than just R-1 flat and~~
14 ~~measured use.~~

15
16 ~~**Verizon’s residence local exchange service is compensatory.**~~
17

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

20
21 ~~A. From an economic standpoint, when assessing the relationship between revenues and costs~~
22 ~~for residential service, it is necessary to address *all* sources of revenues and costs associated~~
23 ~~with the local service platform. Verizon claims that TSLRIC for R-1 service (both flat and~~
24 ~~measured) exceed the retail rate for each service, yet the Company fails to consider other~~

1 ~~services that are being purchased by residential customers, and the other revenues that are~~
2 ~~attendant thereto, which would not exist if, for example, the customer were to take basic R-1~~
3 ~~service from a CLEC. When Verizon serves a residential customer, it provides not only the~~
4 ~~dial tone line and local usage, but also offers vertical features and intrastate toll services. In~~
5 ~~addition, as the local service carrier, Verizon also realizes revenues from the federal~~
6 ~~Subscriber Line Charge (“SLC”) paid by the end user and switched access revenues paid by~~
7 ~~interexchange carriers, as well as additional revenues from the highly lucrative Verizon~~
8 ~~Yellow Pages affiliate. It is the sum of these revenues that should be considered in the~~
9 ~~revenue/cost analysis.~~

10
11 ~~— On the other side of the analysis, one must aggregate all of the costs faced by Verizon in~~
12 ~~providing these services. In reporting these costs, I relied in large part upon the TSLRIC~~
13 ~~cost studies provided on the CD-ROM with the direct testimony of David G. Tucek.⁹⁷~~

14
15 ~~— As shown in Table 2, when the costs and revenues associated with providing dial tone line~~
16 ~~and related services for residential consumers are viewed in the aggregate, these services are~~
17 ~~found to be compensatory.~~

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

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

>>END PROPRIETARY

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

1 ~~A. The revenue associated with residential one-party service is the retail tariff rate of \$13.00,⁹⁸~~
2 ~~which is inclusive of flat rate local usage. To develop intrastate toll revenue per line of~~
3 ~~\$2.45, I divided 2001 intrastate Network Toll revenue⁹⁹ by the quantity of Verizon switched~~
4 ~~access lines in place at that time, and again by 12 to present a monthly revenue figure. The~~
5 ~~vertical services revenue of \$3.25 was derived by assuming that on average each residential~~
6 ~~customer subscribes to one vertical service feature. I have used the \$3.25 Call Waiting rate~~
7 ~~as an estimate of the average per-customer vertical feature revenue.¹⁰⁰ My revenue calcula-~~
8 ~~tion for the Subscriber Line Charge includes revenue for both initial and additional lines.~~
9 ~~ARMIS data indicates that there are about 645,000 residential switched access lines served~~
10 ~~by Verizon in Washington.¹⁰¹ According to a report issued by the FCC, an average of 26.5%~~
11 ~~of US households subscribe to secondary lines,¹⁰² which means that Verizon serves an~~
12 ~~estimated 510,000 “initial” lines (subject to a \$6 SLC) and 135,000 “additional” lines~~

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

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

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

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

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

1 (subject to a \$7 SLC).¹⁰³ Thus, the weighted average SLC revenue is \$6.21 per residential
2 line.¹⁰⁴—

3
4 — In order to estimate revenues associated with switched access, I divided Verizon's reported
5 total switched access revenues of BEGIN PROPRIETARY << [REDACTED] >> END
6 PROPRIETARY¹⁰⁵ by total residential and business switched access lines,¹⁰⁶ and divided
7 again by 12 to arrive at a monthly figure of BEGIN PROPRIETARY << [REDACTED] >> END
8 PROPRIETARY. Finally, *net* revenue associated with Yellow Pages assigned to
9 Washington state is just over \$21.9 million,¹⁰⁷ or \$2.84 per residential switched access
10 line.¹⁰⁸—

11
12 Q. Why have you calculated revenues averaged over both residence and business access lines
13 for intrastate toll and switched access?
14

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

104. $[(510,000 \times \$6) + (135,000 \times \$7)] \div 645,000 = \$6.21$.

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

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

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

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

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

11

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

14

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

19

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

21

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

10

11 ~~As referenced above, I have assumed that the average residential customer subscribes to one~~
 12 ~~vertical feature. Since I have utilized the Call Waiting rate as the estimate of per-line~~
 13 ~~vertical feature revenue, I have similarly used the TSLRIC for Call Waiting of BEGIN~~
 14 ~~PROPRIETARY << [REDACTED] >> END PROPRIETARY¹¹² as the corresponding vertical feature~~
 15 ~~cost for this analysis.~~

16

17 ~~In order to determine the average costs associated with providing intrastate toll that corre-~~
 18 ~~lates to the average intrastate toll revenues (as described earlier), it is necessary to calculate~~
 19 ~~the average minutes of toll use per line. I accomplished this by dividing Verizon’s total~~

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

110. *Id.*

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

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

1 intrastate billed toll minutes (193.3 million, as reported in the Company's 2001 Annual
2 Report filed with the Commission¹¹³) by the total number of Verizon switched access lines
3 in Washington (925,815¹¹⁴), and divided that result by 12 to arrive at 17.4 toll minutes of use
4 per line per month. In my direct testimony, I calculated Verizon's actual cost per minute of
5 intrastate toll use which relied upon, among other things, a tandem switching UNE rate for
6 Qwest due to the fact that none existed for Verizon.¹¹⁵ However, Verizon recently esta-
7 blished a tariffed UNE rate for tandem switching,¹¹⁶ incorporating this rate into my prior
8 cost analysis results in a cost per intrastate toll minute of BEGIN PROPRIETARY << [REDACTED]
9 >> END PROPRIETARY exclusive of any imputation of Verizon's own access charges.
10 Multiplying the cost per intrastate toll minute of use by the average of 17.4 minutes of toll
11 use per month equals the average monthly cost to Verizon of BEGIN PROPRIETARY << [REDACTED]
12 >> END PROPRIETARY.

13
14 Q. What are the costs associated with Verizon's switched access service?
15

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

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

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

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

1 ~~A. Verizon's cost for providing originating and terminating switched access are properly~~
2 ~~represented by the local switching, common transport/transport termination, and tandem~~
3 ~~switching UNE rates established by this Commission. The total monthly cost to Verizon for~~
4 ~~originating switched access is calculated by multiplying Verizon's originating UNE rate of~~
5 ~~approximately \$0.006 (including the new tandem switching rate referenced above) by the~~
6 ~~total annual originating access minutes of use (as reported by Verizon),¹¹⁷ and dividing by~~
7 ~~12, which equals about BEGIN PROPRIETARY << [REDACTED] >> END PROPRIETARY. I~~
8 ~~then performed a similar calculation to arrive at the total monthly cost to Verizon for~~
9 ~~terminating switched access of BEGIN PROPRIETARY << [REDACTED] >> END~~
10 ~~PROPRIETARY.¹¹⁸ Adding the monthly costs for originating and terminating access~~
11 ~~together and dividing by total Verizon switched access lines (925,815)¹¹⁹ results in an~~
12 ~~average monthly switched access cost per line of BEGIN PROPRIETARY << [REDACTED] >> END~~
13 ~~PROPRIETARY.~~

14

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

16

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

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

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

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

1 ~~Q. Please summarize the results of your analysis.~~

2

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

15

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

21

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

- 1 ~~— In no case should Verizon’s proposal to require residential basic service to shoulder 100%~~
- 2 ~~of any access rate rebalancing burden be approved by the Commission.~~

1
2
3 CONCLUSION

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

8 Q. Dr. Selwyn, please summarize your conclusions.

9
10 A. Verizon's intrastate access charges are unreasonably high and must be lowered. Staff and
11 Verizon's own economist concur. The Commission should adopt the current Verizon
12 interstate switched access rate structure and lower Verizon Northwest's switched access
13 rates to cost-based levels or, as an interim measure, to interstate levels, so that Verizon
14 Northwest unequivocally satisfies imputation and the price squeeze on competitive toll
15 providers is eliminated.

16
17 Based solely upon the adjustments I was able to quantify in my testimony, there is ample
18 reason to believe that Verizon's earnings can absorb a sizable reduction in intrastate
19 switched access rates without the need for any revenue-neutral rate reductions. The
20 Commission should also commence a thorough reexamination of Verizon Northwest's
21 intrastate earnings, including the effects of interaffiliate transfers and revenue shifts, in order
22 to determine whether *additional* rate reductions are reasonable and appropriate. In any
23 event, that process must not delay implementation of the switched access rate reductions
24 that will alleviate the current price squeeze being experienced by competitive toll carriers.

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

7

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

9

10 A. Yes, it does.

Exhibit LLS-7

**Switched Access Revenue Reductions
2001 Demand**

**CONFIDENTIAL PER PROTECTIVE ORDER
IN WUTC DOCKET UT-020406**

Exhibit LLS-8

**Switched Access Revenue Reductions
October 2001 — September 2002 Demand**

**CONFIDENTIAL PER PROTECTIVE ORDER
IN WUTC DOCKET UT-020406**

Exhibit LLS-9

**Adjusted Verizon Northwest
Washington Earnings Analysis**

VERIZON NORTHWEST INC
RESULTS OF OPERATIONS
STATE OF WASHINGTON
(Dollars in Thousands)

Adjusted Verizon Northwest Washington Earnings Analysis
Including Yellow Pages Revenue Imputation
September 2002 YTD Annualized

(a)	(b)	(c1)	(c2)	(c3)	(c)	(d)	(e)	(f)	(g)
Description	Total Regulated Adjusted (NOTE 1)	Out-of-Periods	Restatements	ETI Adjustments	Total	Total Regulated Restated	ETI Intrastate Allocation	ETI Revised Intrastate Restated	Verizon Total Intrastate Restated
OPERATING REVENUES									
Local Network Service	258,776	0	0		0	258,776	100%	258,776	258,776
Network Access Revenues	331,029	0	1,411		1,411	332,440	27%	88,672	88,672
Long Dist Netwk Revenues	24,517	0	0		0	24,517	98%	23,905	23,905
Miscellaneous Revenues	32,031	(466)	0		(466)	31,565	63%	19,987	19,987
Yellow Pages Imputation	0	0	0	34,223	34,223	34,223	100%	34,223	
Uncollectibles	24,424	0	0		0	24,424	45%	11,000	11,000
Total Operating Revenues	621,929	(466)	1,411	34,223	35,168	657,097		414,563	380,340
OPERATING EXPENSES									
Plant Specific Operations	68,425	(2,355)	0		(2,355)	66,070	78%	51,211	51,211
Plant Non-Spec Operations	48,231	(1,906)	0		(1,906)	46,325	75%	34,562	34,562
Customer Operations	64,317	(2,475)	0		(2,475)	61,842	81%	50,182	50,182
Corporate Operations	71,863	8,196	(10,236)		(2,040)	69,823	79%	55,048	55,048
Depreciation & Amort	168,164	0	0		0	168,164	77%	129,324	129,324
Other Income & Expenses	(3)	0	0		0	(3)	0%	-	0
Juris Diff - Depr/IDC	0	0	0		0	0			0
Total Operating Expenses	420,997	1,460	(10,236)	0	(8,776)	412,221		320,326	320,326
Operating Taxes Other than Inc	33,835	0	0	0	0	33,835	71%	24,176	24,176
Earnings Before Income Taxes	167,097	(1,926)	11,647	34,223	43,944	211,041		70,061	35,838
INCOME TAXES									
State Income Tax	0	0	0	0	0	0		0	0
Net Federal Income Tax	50,164	(674)	4,076	11,978	15,380	65,544		20,317	8,339
Total Income Taxes	50,164	(674)	4,076	11,978	15,380	65,544		20,317	8,339
NET OPERATING INCOME	116,933	(1,252)	7,571	22,245	28,564	145,497		49,744	27,499
INVESTMENT (AVG)									
Telecomm Plant in Service	2,453,923	(2,099)	0		(2,099)	2,451,824	77%	1,887,608	1,887,608
Other Assets (SFAS 87)	158,810	0	0		0	158,810	79%	125,307	125,307
Juris Assets-TPIS	0	0	0		0	0		-	0
Depr & Amort Reserve	965,467	0	0		0	965,467	77%	744,987	744,987
Deferred Income Taxes	347,162	0	0		0	347,162	78%	272,485	272,485
Other LT Liab - SFAS 106,112	36,011	(2,785)	0		(2,785)	33,226	79%	26,252	26,252
RATE BASE	1,264,093	686	0	0	686	1,264,779		969,191	969,191
Rate Base ROR	9.25%					11.50%		5.13%	2.84%

VERIZON NORTHWEST INC
RESULTS OF OPERATIONS
STATE OF WASHINGTON
(Dollars in Thousands)

Adjusted Verizon Northwest Washington Earnings Analysis
Including Value of Toll Services Joint Marketing
September 2002 YTD Annualized

(a)	(b)	(c1)	(c2)	(c3)	(c)	(d)	(e)	(f)	(g)
Description	Total Regulated Adjusted (NOTE 1)	Out-of-Periods	Restatements	ETI Adjustments	Total	Total Regulated Restated	ETI Intrastate Allocation	ETI Revised Intrastate Restated	Verizon Total Intrastate Restated
OPERATING REVENUES									
Local Network Service	258,776	0	0		0	258,776	100%	258,776	258,776
Network Access Revenues	331,029	0	1,411		1,411	332,440	27%	88,672	88,672
Long Dist Netwk Revenues	24,517	0	0		0	24,517	98%	23,905	23,905
Miscellaneous Revenues	32,031	(466)	0	26,017	25,551	57,582	80%	46,004	19,987
Yellow Pages Imputation	0	0	0					-	
Uncollectibles	24,424	0	0		0	24,424	45%	11,000	11,000
Total Operating Revenues	621,929	(466)	1,411	26,017	26,962	648,891		406,357	380,340
OPERATING EXPENSES									
Plant Specific Operations	68,425	(2,355)	0		(2,355)	66,070	78%	51,211	51,211
Plant Non-Spec Operations	48,231	(1,906)	0		(1,906)	46,325	75%	34,562	34,562
Customer Operations	64,317	(2,475)	0		(2,475)	61,842	81%	50,182	50,182
Corporate Operations	71,863	8,196	(10,236)		(2,040)	69,823	79%	55,048	55,048
Depreciation & Amort	168,164	0	0		0	168,164	77%	129,324	129,324
Other Income & Expenses	(3)	0	0		0	(3)	0%	-	0
Juris Diff - Depr/IDC	0	0	0		0	0		-	0
Total Operating Expenses	420,997	1,460	(10,236)	0	(8,776)	412,221		320,326	320,326
Operating Taxes Other than Inc	33,835	0	0		0	33,835	71%	24,176	24,176
Earnings Before Income Taxes	167,097	(1,926)	11,647	26,017	35,738	202,835		61,855	35,838
INCOME TAXES									
State Income Tax	0	0	0	0	0	0		0	0
Net Federal Income Tax	50,164	(674)	4,076	9,106	12,508	62,672		17,445	8,339
Total Income Taxes	50,164	(674)	4,076	9,106	12,508	62,672		17,445	8,339
NET OPERATING INCOME	116,933	(1,252)	7,571	16,911	23,230	140,163		44,410	27,499
INVESTMENT (AVG)									
Telecomm Plant in Service	2,453,923	(2,099)	0		(2,099)	2,451,824	77%	1,887,608	1,887,608
Other Assets (SFAS 87)	158,810	0	0		0	158,810	79%	125,307	125,307
Juris Assets-TPIS	0	0	0		0	0		-	0
Depr & Amort Reserve	965,467	0	0		0	965,467	77%	744,987	744,987
Deferred Income Taxes	347,162	0	0		0	347,162	78%	272,485	272,485
Other LT Liab - SFAS 106,112	36,011	(2,785)	0		(2,785)	33,226	79%	26,252	26,252
RATE BASE	1,264,093	686	0	0	686	1,264,779		969,191	969,191
Rate Base ROR	9.25%					11.08%		4.58%	2.84%

VERIZON NORTHWEST INC
RESULTS OF OPERATIONS
STATE OF WASHINGTON
(Dollars in Thousands)

Adjusted Verizon Northwest Washington Earnings Analysis
Including Rate Base Adjustment per BPR Audit Findings
September 2002 YTD Annualized

(a)	(b)	(c1)	(c2)	(c3)	(c)	(d)	(e)	(f)	(g)
Description	Total Regulated Adjusted (NOTE 1)	Out-of-Periods	Restatements	ETI Adjustments	Total	Total Regulated Restated	ETI Intrastate Allocation	ETI Revised Intrastate Restated	Verizon Total Intrastate Restated
OPERATING REVENUES									
Local Network Service	258,776	0	0		0	258,776	100%	258,776	258,776
Network Access Revenues	331,029	0	1,411		1,411	332,440	27%	88,672	88,672
Long Dist Netwk Revenues	24,517	0	0		0	24,517	98%	23,905	23,905
Miscellaneous Revenues	32,031	(466)	0		(466)	31,565	63%	19,987	19,987
Yellow Pages Imputation	0	0	0		0			-	
Uncollectibles	24,424	0	0		0	24,424	45%	11,000	11,000
Total Operating Revenues	621,929	(466)	1,411	0	945	622,874		380,340	380,340
OPERATING EXPENSES									
Plant Specific Operations	68,425	(2,355)	0		(2,355)	66,070	78%	51,211	51,211
Plant Non-Spec Operations	48,231	(1,906)	0		(1,906)	46,325	75%	34,562	34,562
Customer Operations	64,317	(2,475)	0		(2,475)	61,842	81%	50,182	50,182
Corporate Operations	71,863	8,196	(10,236)		(2,040)	69,823	79%	55,048	55,048
Depreciation & Amort	168,164	0	0		0	168,164	77%	129,324	129,324
Other Income & Expenses	(3)	0	0		0	(3)	0%	-	0
Juris Diff - Depr/IDC	0	0	0		0	0		-	0
Total Operating Expenses	420,997	1,460	(10,236)	0	(8,776)	412,221		320,326	320,326
Operating Taxes Other than Inc	33,835	0	0		0	33,835	71%	24,176	24,176
Earnings Before Income Taxes	167,097	(1,926)	11,647	0	9,721	176,818		35,838	35,838
INCOME TAXES									
State Income Tax	0	0	0	0	0	0		0	0
Net Federal Income Tax	50,164	(674)	4,076	0	3,402	53,566		8,339	8,339
Total Income Taxes	50,164	(674)	4,076	0	3,402	53,566		8,339	8,339
NET OPERATING INCOME	116,933	(1,252)	7,571	0	6,319	123,252		27,499	27,499
INVESTMENT (AVG)									
Telecomm Plant in Service	2,453,923	(2,099)	0	(505,427)	(507,526)	1,946,397	77%	1,498,490	1,887,608
Other Assets (SFAS 87)	158,810	0	0		0	158,810	79%	125,307	125,307
Juris Assets-TPIS	0	0	0		0	0		-	0
Depr & Amort Reserve	965,467	0	0	(198,854)	(198,854)	766,613	77%	591,544	744,987
Deferred Income Taxes	347,162	0	0		0	347,162	78%	272,485	272,485
Other LT Liab - SFAS 106,112	36,011	(2,785)	0		(2,785)	33,226	79%	26,252	26,252
RATE BASE	1,264,093	686	0	(306,573)	(305,887)	958,206		733,516	969,191
Rate Base ROR	9.25%					12.86%		3.75%	2.84%

VERIZON NORTHWEST INC
RESULTS OF OPERATIONS
STATE OF WASHINGTON
(Dollars in Thousands)

Adjusted Verizon Northwest Washington Earnings Analysis
September 2002 YTD Annualized

(a)	(b)	(c1)	(c2)	(c3)	(c)	(d)	(e)	(f)	(g)
Description	Total Regulated Adjusted (NOTE 1)	Out-of-Periods	Restatements	ETI Adjustments	Total	Total Regulated Restated	ETI Intrastate Allocation	ETI Revised Intrastate Restated	Verizon Total Intrastate Restated
OPERATING REVENUES									
Local Network Service	258,776	0	0		0	258,776	100%	258,776	258,776
Network Access Revenues	331,029	0	1,411		1,411	332,440	27%	88,672	88,672
Long Dist Netwk Revenues	24,517	0	0		0	24,517	98%	23,905	23,905
Miscellaneous Revenues	32,031	(466)	0	26,017	25,551	57,582	80%	46,004	19,987
Yellow Pages Imputation	0	0	0	34,223	34,223	34,223	100%	34,223	
Uncollectibles	24,424	0	0		0	24,424	45%	11,000	11,000
Total Operating Revenues	621,929	(466)	1,411	60,240	61,185	683,114		440,580	380,340
OPERATING EXPENSES									
Plant Specific Operations	68,425	(2,355)	0		(2,355)	66,070	78%	51,211	51,211
Plant Non-Spec Operations	48,231	(1,906)	0		(1,906)	46,325	75%	34,562	34,562
Customer Operations	64,317	(2,475)	0		(2,475)	61,842	81%	50,182	50,182
Corporate Operations	71,863	8,196	(10,236)		(2,040)	69,823	79%	55,048	55,048
Depreciation & Amort	168,164	0	0		0	168,164	77%	129,324	129,324
Other Income & Expenses	(3)	0	0		0	(3)	0%	-	0
Juris Diff - Depr/IDC	0	0	0		0	0			0
Total Operating Expenses	420,997	1,460	(10,236)	0	(8,776)	412,221		320,326	320,326
Operating Taxes Other than Inc	33,835	0	0		0	33,835	71%	24,176	24,176
Earnings Before Income Taxes	167,097	(1,926)	11,647	60,240	69,961	237,058		96,078	35,838
INCOME TAXES									
State Income Tax	0	0	0	0	0	0		0	0
Net Federal Income Tax	50,164	(674)	4,076	21,084	24,486	74,650		29,423	8,339
Total Income Taxes	50,164	(674)	4,076	21,084	24,486	74,650		29,423	8,339
NET OPERATING INCOME	116,933	(1,252)	7,571	39,156	45,475	162,408		66,655	27,499
INVESTMENT (AVG)									
Telecomm Plant in Service	2,453,923	(2,099)	0	(505,427)	(507,526)	1,946,397	77%	1,498,490	1,887,608
Other Assets (SFAS 87)	158,810	0	0		0	158,810	79%	125,307	125,307
Juris Assets-TPIS	0	0	0		0	0		-	0
Depr & Amort Reserve	965,467	0	0	(198,854)	(198,854)	766,613	77%	591,544	744,987
Deferred Income Taxes	347,162	0	0		0	347,162	78%	272,485	272,485
Other LT Liab - SFAS 106,112	36,011	(2,785)	0		(2,785)	33,226	79%	26,252	26,252
RATE BASE	1,264,093	686	0	(306,573)	(305,887)	958,206		733,516	969,191
Rate Base ROR	9.25%					16.95%		9.09%	2.84%

Exhibit LLS-10

**Executive Summary of the Joint Audit Report on
The Basic Property Records of
GTE Corporations' Telephone Operating Companies
December 1997**

ARKANSAS PUBLIC SERVICE COMMISSION GENERAL STAFF
FEDERAL COMMUNICATIONS COMMISSION
MISSOURI PUBLIC SERVICE COMMISSION GENERAL STAFF
NEBRASKA PUBLIC SERVICE COMMISSION
OHIO PUBLIC UTILITY COMMISSION
PENNSYLVANIA PUBLIC UTILITY COMMISSION

EXECUTIVE SUMMARY

OF THE

JOINT AUDIT REPORT ON
THE BASIC PROPERTY RECORDS OF
GTE CORPORATION'S
TELEPHONE OPERATING COMPANIES

DECEMBER 1997

EXECUTIVE SUMMARY

Report Responsibility

This report is the product of a joint audit team comprised of auditors from regulatory commissions of the States of Arkansas, Missouri, Nebraska, Ohio, and Pennsylvania, and auditors from the FCC. The opinions, conclusions, and recommendations stated in this report are those of either the audit team or individuals who comprise the audit team. The statements contained herein are not necessarily the opinions, conclusions, and recommendations of the individual regulatory commissions whose auditors participated in the audit. This report has not been presented to the individual regulatory commissions for adoption of content. Authorization for the auditors to participate in the joint audit and authorization for publication of this report do not constitute an express or implied decision by the individual regulatory commissions on any of the matters or issues addressed by the audit or raised by this report. Among other things, this report does not constitute a regulatory commission ratemaking determination or a regulatory commission finding of non-compliance with statute or rules and regulations. However, a regulatory commission may choose to use this report to evaluate the GTOCs' compliance with the requirements of Part 32 and to identify areas where additional audit work and further action may be needed.

Introduction

In November 1994 the National Association of Regulatory Utility Commissioners (NARUC) passed a resolution calling for joint Federal-State audits of the GTE Corporation's Telephone Operating Companies (GTOCs). The FCC invited the 28 state regulatory commissions in which the GTOCs operate to join its audit of the basic property records (BPR) of GTE California, GTE Hawaii and GTE Texas. Five state regulatory commissions agreed to join in the audit: Arkansas, Missouri, Nebraska, Ohio, and Pennsylvania.

The primary objective of this joint Federal-State audit was to determine whether the GTOCs maintained their BPR in compliance with Part 32.¹ To evaluate the GTOCs' conformity to the requirements of Part 32, the audit involved two phases: (1) physical verification of the plant investment recorded in the BPR, and (2) evaluation of the accuracy of the 1994 plant investment additions, retirements, and transfers.

The audit consisted of reviewing, documenting, and testing accounting information and procedures utilized by the GTOCs to maintain their BPR. The audit team limited its review to the three plant accounts that contained the largest investment in the GTOCs' telephone plant in 1994. They were Account 2212, Digital Switching Equipment; Account 2232, Circuit Equipment; and Account 2423, Buried Cable.²

The joint audit team performed a physical verification of selected telephone plant in eight states. The auditors also compared financial and property records to determine whether they were equal in the aggregate. Finally, the team reviewed the GTOCs' BPR procedures for recording additions, retirements, and transfers for accuracy and internal controls contained therein.

¹ 47 C.F.R. Part 32, Uniform System of Accounts for Telecommunications Companies

² Account 2422, underground cable, was reviewed in California instead of Account 2423 because underground cable contained more investment in California than buried cable. All future references to Account 2423 will encompass this difference.

GTE is in the process of bar coding its central office assets. The process consists of two major steps. First, a physical inventory is performed, and a bar code is affixed to each asset. Second, the BPR are reconciled to the physical inventory, the bar codes are recorded on the BPR, and any necessary adjustments are made to the BPR. For example, according to GTE, the GTE California Inc. BPR were reduced by \$289.5 million as a result of the bar coding process.

During the period the audit field work was performed, the bar coding project was in the early stages. Only twenty-two of the fifty-two central offices reviewed by the auditors had bar codes affixed to each asset. Moreover, only five of the fifty-two BPR listings provided by GTE for physical verification of the central office assets listed bar codes for the assets.

Verification of Physical Assets

The objective of the physical verification phase of the audit was to confirm the physical existence of selected assets listed in the GTOCs' BPR. To verify selected assets, the auditors chose assets listed in the BPR and reviewed all data concerning these assets to determine whether the BPR contained sufficient information to comply with Part 32 which requires a specific description and location for each asset, so it can be readily spot-checked for proof of physical existence.³ GTE recorded the location of its central office assets in its BPR by assigning each asset a bay, shelf and position address within each central office. GTE's method of identifying asset location was used by the auditors to evaluate GTE's BPR procedures. To be designated as verifiable, the BPR had to contain an accurate description, location, placement date, and cost of the asset. If any of these elements necessary to locate a specific asset were inaccurate or missing, the asset was designated as non-compliant and unverifiable. If the asset could not be located in the field, it was designated as missing.

The audit team could not verify assets that did not have an accurate description and location. For example, if a central office asset was located in the correct bay, shelf, and position but bore an incorrect part number, it was designated as non-compliant and unverifiable. This designation was given because the team did not have the ability to verify whether a former part had been retired and replaced with a new part or simply relocated within the central office. Likewise, if an asset was not located in the bay, shelf, and position designated in the BPR, it was noted as non-compliant and unverifiable because the asset could not be located with certainty.

The audit team defined "description" as (1) an accurate part number in the column headed "part number" and (2) a brief, accurate, and readily understandable description of the asset. For central office assets, the audit team's standard for location was an accurate bay, shelf, and position number for each selected asset within a specific central office. For outside plant (OSP) assets, the audit team defined location as an accurate map depicting the actual location and type of facilities within a specific exchange area. Details of construction were not tested in this sample. The year of placement and original cost could not be confirmed directly through physical inspection. Records with a placement year designation and accompanying cost were deemed to be compliant.

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

³ 47 C.F.R. § 32.2000(f)(5)

Evaluation of BPR Procedures

The audit team performed a review of the GTOCs' BPR procedures, as well as a review of the internal controls embedded in those procedures, to determine whether they were adequate to ensure conformance with Part 32. We concluded that the procedures were written to adequately ensure conformance with Part 32. However, these procedures were not always followed. For instance, 43 of the sample items, valued at \$363,637, that were designated as missing had been retired from service but were still listed in the BPR and, presumably, were still on the books of account.

Verification of Plant Additions, Retirements, and Transfers

The joint audit team sampled plant additions, retirements, and transfers reported in the GTOCs' December, 1994 ARMIS⁴ 43-02 Reports to determine whether the 1994 transactions were accurately booked. The audit team attempted to trace a sample of each type of transaction from open work orders to source documents that supported the costs reported in the BPR.

The auditors selected plant addition work order line items representing direct labor, labor overheads, direct materials issued from inventory, materials purchased from outside vendors, and material overheads. Audit team members also reviewed retirement work order line items and transfer work order line items. Supporting documents reviewed by the audit team included time sheets, hourly wage schedules, purchase orders, payment authorization forms, invoices, vouchers, canceled checks, retirement detail listings, and other accounting records.

The joint audit team reviewed 124 plant additions, 44 retirements, and 67 transfers valued at \$2,765,554, \$1,471,406, and \$3,179,825, respectively.

Summary of Findings

The joint Federal-State audit of the GTOCs' BPR produced two major findings. First, the review of sample items from the three accounts showed that 21.7 percent of the investment was missing and another 14.6 percent of the investment was unverifiable. Second, the auditors were unable to trace the costs of retirements from the open work order detail to placing work order costs. If the problems identified in the sample persist throughout the GTOCs' BPR, significant action should be taken by GTE to bring its BPR into compliance with Part 32.

We acknowledge that GTE is taking steps that may lead to a more full compliance with the regulatory commissions' recordkeeping requirements.

⁴ Automated Reporting Management Information System (ARMIS)

Exhibit LLS-11

**Effect of Adjustments
Verizon Northwest Washington Earnings**

Effect of Adjustments Verizon Northwest Washington Earnings (Dollars in Thousands)				
(a)	(b)	(c)	(d)	(e)
Description	2000 Intrastate Restated	2001 Intrastate Restated	Verizon Sept. 2002 YTD Annualized Intrastate	ETI Adjusted 2002 Annualized Intrastate
Rate Base	933,733	965,116	969,191	733,516
Authorized Rate of Return	9.760%	9.760%	9.760%	9.760%
Required Net Operating Income	91,132	94,195	94,593	71,591
Net Operating Income	52,214	53,038	27,500	66,655
Net Operating Deficiency	(38,919)	(41,157)	(67,093)	(4,936)
Net-To Gross Multiplier	1.564568	1.564568	1.564568	1.564568
Revenue (Requirement)/Excess	(60,891)	(64,393)	(104,972)	(7,723)
Increase in Net Income (col. e line 7 minus col. d line 7)				39,155
Reduction in revenue reqm't (col. d line 5 minus col. e line 5)				23,002
Reduction in alleged earnings shortfall (col. d line 13 minus col. e line 13)				(97,249)

Exhibit LLS-12

**Adjusted Verizon-Northwest
Washington Earnings
Reflecting \$44-Million Reduction in
Switched Access Rates**

VERIZON NORTHWEST INC
RESULTS OF OPERATIONS
STATE OF WASHINGTON
(Dollars in Thousands)

Adjusted Verizon-Northwest Washington Earnings
Reflecting \$44-million Reduction in Switched Access Rates
September 2002 YTD Annualized

(a)	(b)	(c1)	(c2)	(c3)	(c)	(d)	(e)	(f)	(g)
Description	Total Regulated Adjusted (NOTE 1)	Out-of-Periods	Restatements	ETI Adjustments	Total	Total Regulated Restated	ETI Intrastate Allocation	ETI Revised Intrastate Restated	Verizon Total Intrastate Restated
OPERATING REVENUES									
Local Network Service	258,776	0	0		0	258,776	100%	258,776	258,776
Network Access Revenues	287,029	0	1,411		1,411	288,440	27%	76,936	88,672
Long Dist Netwk Revenues	24,517	0	0		0	24,517	98%	23,905	23,905
Miscellaneous Revenues	32,031	(466)	0	26,017	25,551	57,582	80%	46,004	19,987
Yellow Pages Imputation	0	0	0	34,223				34,223	
Uncollectibles	24,424	0	0		0	24,424	45%	11,000	11,000
Total Operating Revenues	577,929	(466)	1,411	60,240	26,962	604,891		428,844	380,340
OPERATING EXPENSES									
Plant Specific Operations	68,425	(2,355)	0		(2,355)	66,070	78%	51,211	51,211
Plant Non-Spec Operations	48,231	(1,906)	0		(1,906)	46,325	75%	34,562	34,562
Customer Operations	64,317	(2,475)	0		(2,475)	61,842	81%	50,182	50,182
Corporate Operations	71,863	8,196	(10,236)		(2,040)	69,823	79%	55,048	55,048
Depreciation & Amort	168,164	0	0		0	168,164	77%	129,324	129,324
Other Income & Expenses	(3)	0	0		0	(3)	0%	-	0
Juris Diff - Depr/IDC	0	0	0		0	0		-	0
Total Operating Expenses	420,997	1,460	(10,236)	0	(8,776)	412,221		320,326	320,326
Operating Taxes Other than Inc	33,835	0	0		0	33,835	71%	24,176	24,176
Earnings Before Income Taxes	123,097	(1,926)	11,647	60,240	35,738	158,835		84,342	35,838
INCOME TAXES									
State Income Tax	0	0	0	0	0	0		0	0
Net Federal Income Tax	36,955	(674)	4,076	21,084	24,486	61,441		29,423	8,339
Total Income Taxes	36,955	(674)	4,076	21,084	24,486	61,441		29,423	8,339
NET OPERATING INCOME	86,142	(1,252)	7,571	39,156	11,252	97,394		54,919	27,499
INVESTMENT (AVG)									
Telecomm Plant in Service	2,453,923	(2,099)	0	(505,427)	(507,526)	1,946,397	77%	1,498,490	1,887,608
Other Assets (SFAS 87)	158,810	0	0		0	158,810	79%	125,307	125,307
Juris Assets-TPIS	0	0	0		0	0		-	0
Depr & Amort Reserve	965,467	0	0	(198,854)	(198,854)	766,613	77%	591,544	744,987
Deferred Income Taxes	347,162	0	0		0	347,162	78%	272,485	272,485
Other LT Liab - SFAS 106,112	36,011	(2,785)	0		(2,785)	33,226	79%	26,252	26,252
RATE BASE	1,264,093	686	0	(306,573)	(305,887)	958,206		733,516	969,191
Rate Base ROR	6.81%					10.16%		7.49%	2.84%