Exhibit No. ______(CRD-3T)
Docket No. UT-011439

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

IN THE MATTER OF THE PETITION OF VERIZON NORTHWEST INC. FOR WAIVER OF WAC 480-120-071(2)(a)	**)))**	**DOCKET NO. UT-011439**

REPLY TESTIMONY OF

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ON BEHALF OF

VERIZON NORTHWEST INC.

May 15, 2002

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I. INTRODUCTION

Q. WHAT IS THE PURPOSE OF YOUR REPLY TESTIMONY?

A. I am responding to the testimony of Mr. Robert B. Shirley of the Commission staff, and Professor Kenneth D. Duft, who is also appearing on behalf of the Commission staff.

Q. WHAT FUNDAMENTAL QUESTION DOES THE COMMISSION FACE IN THIS PROCEEDING?

A. A review of the Commission staff testimony makes the question clear: Will the Commission serve as a gatekeeper to protect other customers (and the economy) from unduly costly line extension requests, or not? This important consumer protection issue is one to which the staff testimony gives short shrift. No one else can play this consumer protection role if the Commission declines it.

For example, the idea that other customers should be forced to pay nearly a million dollars to give wired phone service to a handful of people on their 7,000 acre cattle ranch does not seem at all fair or reasonable. It sounds more like the kind of governmental action that could be criticized as a misuse of the public's money.

Q. WHAT SUMMARY OBSERVATIONS WOULD YOU OFFER WITH RESPECT TO MR. SHIRLEY'S TESTIMONY?

A. Mr. Shirley seems to want to come to grips with everything except the central issue of this case – the very high cost it would take to provide wired telephone service to a handful of people, at the expense of the other consumers of Washington. In exchange for this high cost would be created phone service whose value would be only a small fraction of the resources consumed to create it. This is a serious issue that should not be overlooked, as Mr. Shirley's testimony effectively proposes.

Indeed, I do not see anything in Mr. Shirley's testimony that concedes any limits to the proposition that other customers (and telephone companies) should be compelled to pay to provide service to any location, no matter how remote or costly to serve. To attempt to support his position, Mr. Shirley cites from a number of statutes and rules that do not, in fact, compel any such absolutist position. He also offers some numerical comparisons that do more to obscure the issue than shed light on it.

Mr. Shirley also appears to miss the point of my direct testimony in attributing to me an absolutist position in the opposite direction – a position that I do not actually take. It is obvious that some subsidy of customers in higher-cost locations has been a part of telecommunications public policy for decades, and is intended by the Commission's line extension rule. At the same time, it is also obvious that such subsidies can exceed reasonable limits, thereby creating considerable economic waste and becoming plainly unfair to those who are compelled to pay the expense. The fact that there is a waiver provision in the Commission's line extension rule demonstrates the Commission's recognition of this common-sense proposition, and in itself rebuts Mr. Shirley's absolutist position.

Q. WHAT SUMMARY OBSERVATIONS WOULD YOU OFFER WITH RESPECT TO PROFESSOR DUFT'S TESTIMONY?

A. Professor Duft certainly seems knowledgeable about the farm economy of Washington. At the same time, this is not a case about agriculture, and there is no evidence that the Commission will harm agriculture by making reasonable use of the waiver provision it wrote into the line extension policy. By comparison to his elaborations about farming and ranching in Washington, the specific opinions Professor Duft offers about these proposed line extensions are vague, somewhat contradictory and not on point. Indeed, Professor Duft praises Timm Ranch as a fine example of an efficient cattle operation – a status it has achieved while using the communications options it already has. This testimony does not justify the expense of nearly a million dollars to give wired residential phone service to a few households on the Timm Ranch.

II. RESPONSE TO MR. SHIRLEY

Q. DO THE CITATIONS OF PAST WASHINGTON LEGISLATION SUPPORT MR. SHIRLEY'S ARGUMENT AGAINST WAIVERS, OR UNDERMINE IT (SHIRLEY, PAGES 2-3)?

A. By their language, they neither compel nor foreclose waivers. All of the quotations he offers are couched in the familiar terms of legislative intent directed towards regulatory agencies, with qualifying terms such as "reasonable," "reasonably entitled to," and so on. There is nothing absolute in this language, which is hardly surprising. Legislatures understand that circumstances vary and that the goals they articulate for regulated industries are not always practical in every instance.

By their dates of enactment, the legislative language Mr. Shirley cites undermines his argument. The 1911 and 1985 statutes he quotes were in force when prior line extension tariffs – about which Mr. Shirley complains repeatedly – were in effect for decades. The obvious implication is that the law is broad enough to permit line extension policies other than the one the Commission recently adopted, or outcomes different from those Mr. Shirley might favor personally. The fact that the lawful prior tariff made these particular proposed extensions impractical is evidence that the statutes Mr. Shirley cites certainly do not stand in the way of waivers in this case.

Q. WOULD A POLICY REQUIRING CUSTOMERS TO PAY ALMOST THE ENTIRE COST OF A LINE EXTENSION BE PERMISSIBLE UNDER THE REQUIREMENTS MR. SHIRLEY CITES?

A. It appears that it would, because the Commission enforced such a policy under these very statutes in prior years. In other words, the Commission appears to have broad latitude with respect to how much customers can be asked to pay for line extensions, or in setting reasonable limits on the size of a subsidy that may be provided to a particular customer at the expense of the general body of ratepayers. When the prior GTE line extension tariff was approved by the Commission in 1983, it provided for a charge of $440 per one-tenth mile for line extensions beyond the one-half mile free allowance. Based on Commission staff testimony filed in that case and a General Telephone cost study to which it referred (which determined a cost of 83 cents/foot, or $438.24 per one-tenth mile), it appears that this charge was intended to recover the entire cost of the added distance beyond the free allowance. Indeed, in addressing a proposal to reduce the free allowance, the staff testimony stated the following concern about who pays the cost of line extensions:

> *"Q. Philosophically, do you oppose the proposed reduction of the free allowance to 1/10th mile?*
>
> *A. No, I favor it. It's only 'free' because other ratepayers are subsidizing it. Had the company been able to provide accurate data, the full line extension package would have been acceptable."*

The data accuracy concern referred to General Telephone's record keeping for shorter line extensions (those of over 1/10th mile but less than ½ mile), which the staff witness found insufficient. The full line extension "package" would have included a reduction to only a 1/10th mile free allowance.[1]

I understand that this tariff stayed in effect after the enactment of the 1985 legislation to which Mr. Shirley referred, at which time it presumably still required customers to pay the greater part of the costs of line extensions.

[1] "Testimony of David Richardson re Rate Design and Rate Spread," Cause No. U-82-45, pages 6-9 & Sheet 1; line extension cost study provided to the Commission in Cause No. U-82-45 under cover of April 11, 1983 and signature of W. E. Stern, Vice President, General Telephone of the Northwest. Copies are provided as exhibits to Ms. Ruosch's Reply Testimony.

Q. MR. SHIRLEY CLAIMS THAT PRIOR LINE EXTENSION TARIFFS "WERE NOT DESIGNED TO RECOVER THEIR COSTS BUT TO DISCOURAGE CUSTOMERS FORM [SIC] SEEKING EXTENSIONS BECAUSE THE QUOTED CHARGES WOULD RUN QUICKLY INTO THE TENS OF THOUSAND OF DOLLARS." CAN YOU COMMENT?

A. The documents I noted above contain no reference to efforts to discourage customers from seeking line extensions, but instead suggest that the tariff was designed to recover the costs of line extensions. It is true that being asked to pay a price for something does tend to discourage some people from buying it, if they don't find enough value in the purchase to justify the expense. But if that price reflects cost, it is generally understood to be economically appropriate. A price that reflects cost is also frequently recognized as fair.

Q. DOES THE COMMISSION'S LANGUAGE IN ADOPTING THE NEW RULE COMPEL THE OUTCOME MR. SHIRLEY FAVORS (SHIRLEY, PAGES 4-5)?

A. No. Again, in discussing the intended effect of the rule, the Commission speaks of intent to "maintain and advance the efficiency and availability" of service, to ensure that charges are "reasonable," to provide "incentives to include as many customers as is reasonable on new extensions," and so on. There is again no mention of an absolute right to a service extension regardless of the expense, or the burden on other customers that would be created.

The absolute language Mr. Shirley seems to want is simply absent from the Commission statements he quotes, which is hardly surprising in light of the practical concerns and limitations with which regulatory commissions must cope.

Q. IN THE PROCESS OF ADOPTING THE RULE, WERE CONCERNS EXPRESSED ABOUT THE POSSIBILITY THAT SOME LINE EXTENSIONS MIGHT BE TOO COSTLY FOR THE GENERAL BODY OF CUSTOMERS TO SUBSIDIZE?

A. Yes, Commission Chairwoman Showalter stated the following during the April 12, 2000 Open Meeting during which the rule was discussed:

> *"I just don't know …to what extent an individual choosing to live very far away should be able to impose a very high price on others. It's the issue. And I recognize the phone is very important…but most people choose to live where such a thing is cheaper and doesn't impose costs on other people."*[2]

By these observations, Chairwoman Showalter aptly described the concern that is squarely posed by these line extension requests.

Q. WHAT PERSPECTIVE IS HIGHLIGHTED BY MR. SHIRLEY'S SUMMARY OF THE EFFECTS OF THE RULE THUS FAR (SHIRLEY, PAGE 10)?

A. Mr. Shirley denotes the rule a success because it has ended complaints from customers who want service extensions, and because the companies involved have not complained of

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[2] Transcript of April 12. 2000 Open Meeting, UT-991737, Washington Utilities and Transportation Commission, page 16.

a burden due to their ability to readily recover the costs from other customers. Although these are significant concerns, at the same time Mr. Shirley does not seem concerned about whether the customers who are paying the bill are getting corresponding value for what they are compelled to contribute.

Q. MR. SHIRLEY STATES THAT $1,212,541 IS AN "OVERSTATED" COST FOR THE EXTENSIONS BECAUSE IT INCLUDES REINFORCEMENT COSTS (SHIRLEY PAGES 13-14). IS THIS CORRECT?

A. From the standpoint of economics, no. The costs of the extensions are what it will take to build them, whether the construction takes place beyond the limits of existing facilities, or not. Whether or how the funds may have been accounted for in ratemaking is also irrelevant to the economics of the decision. If $1.2 million in resources are consumed in creating these line extensions, then $1.2 million is the cost. Mr. Shirley's suggested discounts to the actual costs (at page 14) are thus inappropriate.

Q. IN DESCRIBING "TYPICAL" LINE EXTENSION COSTS, MR. SHIRLEY COMPARES THE TAYLOR EXTENSION TO TWO OTHER PROJECTS THAT COST $84,381, AND $95,340. DOES THIS COMPARISON APPEAR MEANINGFUL?

A. It does not. To begin with, as Ms. Ruosch notes, Mr. Shirley appears to have chosen selectively from the list of completed projects (contained in a confidential data request response) by picking only the two most expensive – which cost more than three times the average. Next, Mr. Shirley excludes reinforcement costs, which as I noted above are appropriately considered economic costs of the projects. Finally, Mr. Shirley does not divide by the number of customers served in order to obtain a per-customer cost, but simply cites a total project expense. On a per-customer basis, the cost of the two most expensive projects selected by Mr. Shirley are each less than one-fifth the cost of the Taylor proposed extension, and a smaller fraction of the Timm Ranch proposal.

Q. MR. SHIRLEY ASSERTS THAT THERE ARE "THOUSANDS" OF LOOPS OF 20-40 MILES IN LENGTH SERVING CUSTOMERS IN WASHINGTON, SO THAT THESE PROJECTS "DO NOT REPRESENT ANY SORT OF 'UNUSUAL' SITUATION." (SHIRLEY, PAGE 15). ACCORDINGLY, MR. SHIRLEY ASSERTS, "BECAUSE THE LENGTHS ARE NOT EXTRAORDINARY, THE 'TOTAL DIRECT COST' IS NOT EXTRAORDINARY." CAN YOU COMMENT?

A. Yes. As Ms. Ruosch explains, the Timm Ranch extension (for example) would involve placing 27 miles of facilities with Verizon on one end, a few customers on the other, and nothing in between. With respect to Mr. Shirley's leap of logic from "not extraordinary" lengths to "not extraordinary" costs, what matters is that the costs in this instance will be dedicated to serving only a handful of customers at a per-customer expense that is extraordinary. Similar lengths imply similar unit costs only if similar use is to be made of the facilities, which will not be the case here.

Q. WITH RESPECT TO THE COST OF THE PROPOSED EXTENSIONS, MR. SHIRLEY SUGGESTS THAT "THE NUMBERS ALWAYS APPEAR QUITE HIGH" BECAUSE "TELECOMMUNICATIONS IS A CAPITAL-INTENSIVE BUSINESS,"

WHILE POINTING OUT THAT NEW FACILITIES SUCH AS THESE SHOULD WORK "WITHOUT FAIL FOR DECADES." HE ALSO NOTES MR. SPINK'S STATEMENT THAT "THE AVERAGE COST OF CONSTRUCTION FOR THE EXTENSIONS IS BELOW AVERAGE ON A PER-MILE BASIS" (SHIRLEY, PAGE 16). DO THESE STATEMENTS OFFER ANYTHING MEANINGFUL OR RELEVANT TO THE COMMISSION'S DECISION?

A. No, they do not. The high costs of these proposed extensions are not just an appearance, they are a reality. Regardless of how much maintenance the facilities may require (a subject Ms. Ruosch addresses), it is a significant and costly act to sink $1.2 million into the ground; my recommendation is that the Commission should expect a corresponding benefit that has some reasonable relationship to that amount, which is not the case here. Highlighting the per-mile costs of the facilities does not tell us anything without some reference to what use they will be put, i.e. in this case serving only a small number of customers.

Q. MR. SHIRLEY CLAIMS THAT THE TAYLOR EXTENSION IS LIKELY TO PRODUCE ANOTHER THREE CUSTOMER ORDERS (FOR A TOTAL OF SIX), AND THAT ONE MORE ORDER MAY COME FROM THE TIMM RANCH (FOR A TOTAL OF SIX)(SHIRLEY, PAGES 17-18). IS THIS RELEVANT?

A. As a general statement, at some point, if enough customers place orders a given extension may fall within the bounds of reasonableness in terms of per-customer cost, but even with Mr. Shirley's proposed additions, that is not the case here. However, I would caution against building highly costly extensions "on spec" (i.e., speculation), as Mr. Shirley is apparently recommending. Also, the "'Pontiac Ridge' effect" he proposes apparently works both ways; some customers who say they want service later do not take it. As Ms. Ruosch points out, 44 people said they would take service there but only 41 actually did, and the current count is 37.

By comparison to the expense of the line extensions at issue, the actual financial commitment a customer has to make in ordering service is quite small. Given Mr. Shirley's apparent outreach efforts, it seems likely that a lack of customer interest in committing to service is probably not due to any lack of information. I don't see how one can justify spending tens or hundreds of thousands of dollars on facilities to reach customers who aren't interested enough to commit to a few hundred dollars in line extension charges to get basic service at a subsidized price. The Commission should count orders when they are actually placed.

Q. MR. SHIRLEY STATES THAT THESE EXTENSIONS WOULD INCREASE THE AVERAGE COST PER-CUSTOMER IN THE RELEVANT EXCHANGES BY ONLY 10 TO 20 PERCENT (SHIRLEY, PAGE 18). CAN YOU COMMENT?

A. By this comparison Mr. Shirley jumps from the per-mile costs of the facilities to the average customer costs in the area without stopping in between to consider the costs per customer to be served by the extensions – which are the relevant figures. This is simply an example of how averages can conceal more than they reveal.

Even so, the Bridgeport and Brewster exchanges have about 1200 and 2000 access lines, respectively. Contrary to Mr. Shirley, I find it striking that the addition of a handful of telephone lines could increase per-customer costs by 10-20 percent in exchanges of that size. To me, that suggests the added costs would be large.

Q. MR. SHIRLEY ASSERTS THAT MOVING FROM 95 PERCENT PENETRATION TO "NEARLY ONE HUNDRED PERCENT PARTICIPATION" FOR CUSTOMERS IN "RURAL AMERICA" CAN BE ACHIEVED "WITHOUT ASKING ANY SINGLE PARTICIPANT TO PAY MORE THAN A FRACTION OF A DOLLAR PER YEAR." (SHIRLEY, PAGES 33-34). CAN YOU COMMENT?

A. The $1.2 million at issue in this case alone already approaches $1.50 per Verizon switched access line. For Verizon's Washington customers, this case alone would seem to exhaust Mr. Shirley's suggested budget for a number of years.

Given the tens of millions of dollars in lifeline and high-cost support funding in place for Washington, substantial amounts are already at stake for those who must pay the bill for such programs even before adding the impacts of the new rule. Aside from being self-evidently incorrect, I do not think Mr. Shirley's assertion shows enough regard for the customers who would be required to pay not only for these extensions, but also for others of similar expense that may come later.

Q. MR. SHIRLEY OBSERVES, "ONE CANNOT HAVE MUCH OF A TELEPHONE SYSTEM BY ONESELF. WHOM WOULD YOU CALL?" CAN YOU COMMENT?

A. If the only way to have other people to call was to spend $150,000 to give each of them a telephone, then I would agree that there wouldn't be much of a telephone network. Because most customers are willing to pay the (much lower) cost of telephone service for themselves, this isn't a genuine issue. Mr. Shirley offers nothing more than rhetoric to attempt to rebut the analysis in my opening testimony that the expense of these proposed extensions cannot possibly be justified by the externality value of telephone service.

Q. MR. SHIRLEY SUGGESTS THAT YOUR OPENING TESTIMONY AMOUNTS TO A CASE FOR DISCONNECTING ALL CUSTOMERS FROM TELEPHONE EXCHANGES WHOSE MONTHLY SUPPORT PAYMENTS EXCEED THE EXTERNALITY VALUE OF TELEPHONE SERVICE (SHIRLEY, PAGE 34). CAN YOU RESPOND?

A. It seems that Mr. Shirley wants to believe that the externality value of adding just one more subscriber is of tremendous value even at the point where one can already call 190 million wired telephones and 135 million wireless phones in a nation of less than 300 million people. But he is mistaken. Neither is Mr. Shirley correct in characterizing my argument as calling for the removal of all subscribers from all exchanges where subsidies are more than the externality value. I said no such thing, even though such subsidies often cannot be justified on that basis.

Q. DID YOU CONDEMN THE COMMISSION'S RULE IN YOUR DIRECT TESTIMONY, AS MR. SHIRLEY ASSERTS (SHIRLEY, PAGE 35)?

A. Not at all. To the contrary, I noted that most extensions under the rule would probably fail a cost-benefit test as a way to acknowledge that the Commission intended to go beyond what was economically justified in encouraging new line extensions. As a practical matter, regulatory policy is not always limited by the bounds of sound economics, and I would not advocate that it should be strictly limited in that sense. Some actions that don't pay for themselves can be seen as reasonable on other grounds. But by the time someone is proposing to turn over a million dollars (in cost) into something like the same number of nickels (in value), it is time to draw a line unless there is some kind of compelling justification that is not present in this case.

Q. MR. SHIRLEY CHALLENGES YOUR DIRECT TESTIMONY FOR FAILING TO PROVIDE A "SPECIFIC COST-BENEFIT THRESHOLD" (SHIRLEY, PAGE 36). WHAT IS YOUR RESPONSE?

A. The threshold comes down to two questions the Commission must answer for itself. First, how much should the other customers of Washington – who include a variety of people who are not all wealthy, by any means – be compelled to spend to provide telephone service to people who may not be needy in any sense, who in this case already have access to communications that seems to fulfill at least their basic requirements, but choose to live remotely for whatever reasons or benefits they perceive?

Second, to what extent does the Commission want to destroy valuable economic resources in pursuit of this policy? Is it worth burning a $10 bill (or what it can buy) to give a $1 bill to a remote resident? Is it worth burning a $20 bill? Mr. Shirley pooh-poohs such comparisons by complaining that "Verizon does not offer to purchase nice houses" for the customers involved. But I think the customers who would be forced to pay for these extensions would appreciate the point of such comparisons, even if Mr. Shirley does not.

Personally, I think it is difficult enough to justify a subsidy of $15,000 to $20,000 per customer to provide telephone service, especially under these circumstances. To reach the six figure range, as would occur here, is clearly going too far. By doing so, I think the Commission would breach its fundamental obligation to those who are forced to pay the bill for the expense. The Commission should also be concerned that denying waivers in this case could encourage other, highly costly requests to be filed.

Q. MR. SHIRLEY ASSERTS THAT THE SERVICE ALTERNATIVES ALREADY AVAILABLE TO AND BEING USED BY SOME OF THE APPLICANTS DO NOT QUALIFY AS "REASONABLY COMPARABLE" TO WIRELINE SERVICE UNDER SUBSECTION (2)(C) OF THE COMMISSION'S LINE EXTENSION RULE. HOW SHOULD THE COMMISSION USE THIS INFORMATION IN REACHING A DECISION ON THE WAIVER PETITION?

A. Verizon is applying for a waiver in this case, not proposing that these alternatives qualify under the part of the rule Mr. Shirley references.

However, the Commission should recognize that the existing radio phone and cellular services used by some of the applicants provide useful and significant communications service to resourceful people who have chosen – for reasons they find important – to live in remote places where they understood wired telephone service was not available. For instance, the amount of use that the Taylor household appears to make of wireless service suggests that its quality is at least acceptable. These proposed line extensions would upgrade the communications capabilities that are already in use at these locations, rather than create new service where none exists.

Q. MR. SHIRLEY NOTES THAT UNDER SUBSECTION (2)(C) OF THE LINE EXTENSION RULE, THE PRICE OF A WIRELESS SERVICE SHOULD BE COMPARABLE TO THE PRICE OF A WIRELINE SERVICE, IF THAT WIRELESS SERVICE IS TO BE RECOGNIZED AS A MEANS TO ACCOMPLISH A LINE EXTENSION UNDER THE RULE. (SHIRLEY, PAGE 37). CAN YOU COMMENT?

A. As I noted above, Verizon seeks waivers, not a finding that the wireless service constitutes the equivalent of wired service in these instances. Nor would it be worth building these extensions just to reduce the applicants’ existing wireless telephone bills. However, the fact that wireless service is available and already in use at these locations is relevant to waivers under Section 7(b)(ii)(C) of the rule.

Q. MR. SHIRLEY CONCLUDES HIS TESTIMONY BY ASSERTING THAT HIS RECOMMENDATION TO DENY THE COMPANY’S WAIVER REQUEST FOR THE

TIMM RANCH PROJECT "IS NOT IN THE LEAST SENTIMENTAL" BECAUSE "TELECOMMUNICATIONS THAT SUPPORT AGRICULTURE IS GOOD POLICY." CAN YOU COMMENT?

A. As I note below in discussing Professor Duft's testimony, it appears that Staff wants to have it both ways by describing the Timm Ranch extension as residential in nature, while at the same time emphasizing business uses that might be made of the service to support the Timm Ranch commercial operation. As Mr. Shirley acknowledges (Shirley, page 29), the Commission has already made a policy decision not to subsidize line extensions to commercial and industrial customers, and to land developers. The fact that the Timm Ranch is a substantial, apparently successful commercial operation is relevant to the fairness of the situation. Other customers should not be required to subsidize such commercial operations through their phone bills.

Q. IN SEVERAL PLACES MR. SHIRLEY DIRECTLY AND INDIRECTLY REFERS TO THE COMMISSION'S DECISION IN DOCKET UT-980311(a) (PP. 9-10, 14, 23) AND SEEMS TO ASSERT THAT THE COMPANY HAS ALREADY BEEN PAID, IN WHOLE OR IN PART, FOR THE COST OF THESE PROPOSED LINE EXTENSIONS. IS THIS AN ACCURATE CHARACTERIZATION OF THE COMMISSION'S ACTION IN DOCKET UT-980311(a)?

A. It is understandable why this subject is confusing, but I believe Mr. Shirley's assertion is incorrect. The key is to recognize that in UT-980311(a) the Commission only relabeled existing revenues, and in its subsequent access charge rule moved those existing revenues to a new rate element. Those existing revenues did not include funding for line extensions under the Commission's new rule.

Let's start with the revenues. In 1999 the Commission issued an order that approved a settlement in Verizon's (then GTE) last earnings review.[3] Under the rate-of-return regulation that the Commission applied in that order, Verizon was provided the revenues it needed to fund its operations and investments at the time. Of course, in 1999 the prior line extension tariff was still in effect, and so there was no expectation that Taylor and Timm Ranch line extensions would be built. Therefore, although the earnings review decision was the result of a settlement (and did not address this question specifically), the 1999 order would only have provided funding for line extensions expected under the old tariff.

Understanding that starting point for Verizon's revenues helps make clear what the Commission did later in its new access charge rule. In Docket UT-980311(a), the Commission started with the (correct) understanding that implicit support (i.e. cross-subsidies) existed in Verizon's rate structure by which revenues from some customers or services were being used to support below-cost local service rates. To try to identify the size of those cross-subsidies, the Commission examined TELRIC-type computer models that attempt to estimate the costs of reconstructing a telephone network from scratch, using forward-looking technology and a host of idealized assumptions whose realism has been debated for years across the country in regulatory proceedings.

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[3] In the Matter of the Application of GTE Corporation and Bell Atlantic Corporation, Docket Nos. UT-981367, UT-990672, UT-991164, Order Approving Settlement (Dec. 16, 1999).

Based on the results of that modeling exercise, the Commission decided that $33 million of the revenues Verizon was already receiving should be collected through terminating access charges in order to protect universal service. In that way the Commission provided some insulation for that revenue flow from the impacts of competition, and thereby made Verizon's existing retail rate structure more sustainable in a competitive environment.

Mr. Shirley's point of view seems to be that the TELRIC-type computer models the Commission used in this process included an assumption that certain investment costs (the ones Mr. Shirley identifies as "reinforcement") would be incurred. In other words, in the process of making its calculations, it may be that one of the things the imaginary network model "built" was those facilities. Since Verizon's existing revenues were reallocated based on these computer model results, Mr. Shirley believes that the "reinforcement" costs were already paid for in some fashion.

The key part of this discussion is keeping straight the difference between the real network and Verizon's real revenues, versus the imaginary network that the computer model "built" through the process of its calculations. As I discussed, the money the Commission previously authorized (in 1999) to fund Verizon's real network and operations would not have included funds for these line extensions. According to Mr. Shirley, in the imaginary network built by the computer model, some of the line extension costs were covered. The problem is that the *imaginary* computer model never gave Verizon the *real* additional money it will need to build line extensions stimulated by the new rule. Instead, what happened as a result of the computer model was just a shifting around of the same revenues Verizon was already receiving from the prior earnings review order.

Thus, contrary to Mr. Shirley's view, Verizon has not already been paid for the "reinforcement" costs of these proposed extensions.

III. RESPONSE TO PROFESSOR DUFT

Q. IS THIS A CASE ABOUT AGRICULTURE?

A. No, although Professor Duft's testimony seems to try to make it one. Professor Duft's line of reasoning seems to be that agriculture is good, that the residents of the Timm Ranch are engaged in agriculture, and thus that extending them wired residential telephone service without any regard for the expense is also good.

Q. IS THERE A TENSION BETWEEN PROFESSOR DUFT'S TESTIMONY AND MR. SHIRLEY'S TESTIMONY WITH RESPECT TO THE PURPOSE OF THESE LINE EXTENSIONS?

A. Yes, there is. In the few comments he offers about the Timm Ranch's use of communications, Professor Duft seems to be speaking exclusively about business purposes, while Mr. Shirley attempts to portray these requests as residential in character in keeping with the requirements of the Commission's rule (Shirley, page 29).

Q. DO YOU HAVE ANY REASON TO DOUBT PROFESSOR DUFT'S REPRESENTATIONS THAT THE TIMM RANCH IS A SUBSTANTIAL, EFFICIENT OPERATION THAT SUPPLIES BEEF THAT CONSUMERS VALUE?

A. Not in the least. I recognize that my family and I enjoy beef because of the hard work of people like the Nelsons and the Timms, and their counterparts who work other ranches and farming operations. I also have no reason to dispute Professor Duft's characterization that "..the Timm Ranch is indicative of our state's agricultural future and fulfills a vital role in our state's continued need to produce foodstuffs efficiently, while making best use of available productive resources." (Duft, page 17).

Q. DOES PROFESSOR DUFT CITE ANY SPECIFIC EVIDENCE OF ANY IMPAIRMENT TO THE TIMM RANCH'S OPERATIONS AS A RESULT OF USING ITS CURRENT COMMUNICATIONS CAPABILITIES, WHICH DO NOT INCLUDE WIRED TELEPHONE SERVICE?

A. No, he does not. There are two places in his testimony that offer some vague statements in this regard (pages 7-8, and page 17) – concerns that communications using services now available to the ranch become "a critical and costly matter," causing the coordination of movement of cattle between pastures and to market to become a "major and complex undertaking" that is "difficult and inefficient," causing time and resources to be "wasted." These statements make the situation at the Timm Ranch sound dire. At the same time, there are no specific operational problems described, there are no calculations of actual expenses or losses associated with these suggested problems, and there is no explanation as to how the Timm Ranch could have become a model for the state's agricultural future while (supposedly) being seriously hampered by reliance on the communications capabilities the ranch now enjoys. For example, one might suspect that the ability those at the ranch apparently have to view satellite video transmissions of their cattle being sold at auction could be considered helpful in the process of bringing cattle to market.

Indeed, Professor Duft's description of Timm Ranch seems to make the intuitively more reasonable point that a major cattle ranch that is efficient and has been in operation for decades could hardly be suffering from a fundamental lack of something necessary for it to conduct business.

Q. ARE LINE EXTENSIONS FOR BUSINESS PURPOSES SUPPOSED TO BE SUBSIDIZED IN THE SAME MANNER AS RESIDENTIAL LINE EXTENSIONS UNDER THE COMMISSION'S RULE?

A. According to the rule, they are not. Thus, even if Professor Duft had identified a substantial business benefit to Timm Ranch from these line extensions, the appropriate response to such a justification would be to extend business service to the ranch under the governing rule and tariff provisions for such construction.

Q. DOES PROFESSOR DUFT PRESENT ANY EVIDENCE THAT THE COMMISSION'S USE OF THE WAIVER PROVISION OF ITS LINE EXTENSION RULE IN THE MANNER YOU RECOMMEND WILL PRESENT A GENERAL THREAT TO THE AGRICULTURAL ECONOMY OF WASHINGTON?

A. No, he does not. To do so, he would presumably have to discuss factors such as how many ranches now lack wired telephone service, what specific problems their operations now suffer due to lack of wired telephone service, and how many of those operations might be subject to waivers similar to those requested in this case. However, beyond the general observations that large cattle ranches tend to be located in remote places and that agricultural operations benefit from access to reliable communications, he presents no such specific information. And as I noted above, his characterization of the strength of the agricultural economy suggests that the farms and ranches of Washington are functioning reasonably well with the communications options they current have available.

It is also important to remember that I am not recommending that waivers be granted in all cases that are uneconomic, just in particularly high cost circumstances such as the line extensions at issue. Applied in this manner, the policy will presumably still lead to an increase in rural service connections above what would have occurred under the prior telephone company line extension tariffs.

Q. PROFESSOR DUFT DESCRIBES AGRICULTURE AS THE "BACKBONE" OF THE WASHINGTON ECONOMY. HOW SIGNIFICANT IS AGRICULTURE TO THE ECONOMY OF WASHINGTON STATE?

A. According to the U.S. Census Bureau, agriculture represents something less than 2.7 percent of the economic output of Washington (1998 gross state product). In terms of employment, the Washington State Office of Financial Management reported that approximately 93 percent of jobs in Washington were non-agricultural in 2000. Clearly, while agriculture is still significant, the economy of Washington is like that of most states in having developed other sectors as its primary drivers of growth and output

Q. DOES AGRICULTURE RECEIVE A WIDE ARRAY OF PUBLIC POLICY PREFERENCES AND SUBSIDIES?

A. In general, agricultural interests have long succeeded in exerting considerable political influence. Therefore, the catalog of special benefits that Professor Duft categorizes is hardly surprising. However, there is a significant hole in Professor Duft's argument. His testimony seems to suggest that since agriculture *as an industry* already receives so many benefits, extending telephone service *to these particular customers* on a large, remote ranch constitutes one more benefit to *the industry* that won't hurt anything. But of course, the residents of Timm Ranch are hardly the entire agricultural sector of the state, and such a suggestion would ignore the actual costs and benefits of this particular proposed line extension.

Q. WITH RESPECT TO ECONOMIC ANALYSIS, WHAT SIGNIFICANCE DOES PROFESSOR DUFT ATTACH TO THE FACT THAT THE TIMM RANCH CUSTOMERS ARE ENGAGED IN AGRICULTURE?

A. The fact that Timm Ranch is a large cattle operation leads Professor Duft to suggest that the ordinary principles of economic analysis (i.e., comparing marginal costs and benefits) should not be applied to considering whether residential telephone service should be extended to that location.

Q. PROFESSOR DUFT STATES THAT CERTAIN SERVICES AND BENEFITS "ARE RECOGNIZED AS CRITICAL ISSUES THAT ARE BEST ADMINISTERED WHEN NOT SUBJECTED TO MARGINAL COST PRICING PRESSURES." CAN YOU COMMENT ON THIS ASSERTION FROM THE STANDPOINT OF ECONOMIC PRINCIPLES?

A. Yes. In this discussion, Professor Duft is primarily making a statement about politics, not about appropriate principles of economics. The idea of considering decisions on the margin – i.e., that the best way to consider economic decisions is from the standpoint of their specific impacts, not how they might change an overall average – is a fundamental building block of modern economic analysis. As I am certain Professor Duft would agree, teaching students to appreciate the difference between marginal and average costs (and benefits) is one of the principal tasks of any introductory economics course. Getting one's marginal and average costs confused is an almost-certain prescription for making poor (and wasteful) economic decisions. Note also that a proper marginal analysis can take into account genuine externality or network effects that occur when service is extended to more people. As I described in my direct testimony, this perspective also fails to justify the proposed line extensions, a point that was unrebutted in staff testimony except by some rhetoric from Mr. Shirley.

As a matter of politics, on the other hand, it is more convenient for those who support subsidies to argue that they are imposing only a slight additional cost on everyone else, on average. Mr. Shirley makes precisely this argument in favor of these proposed line extensions by calculating by how much they will change the average cost of service in the exchanges in question. There is also an administrative or political convenience for some providers of service in ignoring variations in the individual cost of reaching various customers, so long as the variations in those costs are not too great. But administrative ease is clearly not the issue here.

Indeed, there is room to hide a great deal of expense in any average that includes a significant number of people. For example, I doubt the average taxpayer would notice any increased tax burden if I were granted a special exemption from paying all taxes. A focus only on averages would suggest ignoring the impact (and fairness) of such a proposal, since it wouldn't cost the average person very much if it were granted. The same is true for a given extension of telephone service to a highly remote place, while averaging the cost over all of Verizon's customers in Washington in a way that few may notice in a single instance.

IV. THE ONGOING ROLE OF THE COMMISSION

Q. DOES THE COMMISSION STAFF TESTIMONY SEEM TO ANTICIPATE ANY ROLE FOR THE WAIVER PROVISION IN THE LINE EXTENSION RULE?

A. No. As I described, Mr. Shirley seems to admit nothing that would suggest that a waiver should ever occur, while Professor Duft's testimony effectively suggests that no cost is too great for others to bear where agriculture may be concerned.

Q. WOULD IT BE HARMFUL TO OTHER CUSTOMERS AND THE WASHINGTON ECONOMY FOR THE WAIVER PROVISION TO BE RENDERED INOPERATIVE?

A. Yes, because the economy would suffer the economic losses associated with line extensions in particularly-high-cost instances such as the ones at issue here, while customers (and telephone companies, to the extent they may be precluded from recovering all related costs) would be sent the bill for service that is worth a mere fraction of what it costs to provide. To keep the costs of line extensions within reasonable and fair bounds, someone has to serve as a gatekeeper over this process to safeguard consumers and the economy of the state.

Q. IS ANYONE OTHER THAN THE COMMISSION POSITIONED TO ACT AS A GATEKEEPER OVER THIS PROCESS TO PROTECT THE INTERESTS OF OTHER CUSTOMERS AND THE ECONOMY?

A. As I read the rule and understand the Commission's process, the answer is no. If the Commission will not stand up and perform this function, then no one else will be able to, either.

Q. WOULD THE COMMISSION CREATE A PROBLEMATIC PRECEDENT FOR ITSELF BY DENYING A WAIVERS IN THIS CASE?

A. Yes. It may become difficult for the Commission to go back towards any reasonable economic bounds if it decides not to enforce any limits in these circumstances. I do not believe it would be wise for the Commission to put itself in that position, especially since the line extension rule is relatively new and it may not yet be clear what the ultimate costs of such a posture would be to the economy and customers of Washington. For example, making very high cost line extensions available to potential subscribers on a nearly free basis can be expected to increase the value and attractiveness of real estate in remote areas, thereby encouraging development that would increase the line extension burdens on other customers, and waste more resources in the process. While I am not in a position to try to quantify this potential impact, it would not take very many additional line extensions like the ones in this proceeding for the costs to add up quickly. If waivers are not granted in this case, the ready willingness of the Staff to argue for extensions for commercial purposes in this proceeding also suggests that the rule's requirement for developers to pay their own costs of extensions may prove less than iron-clad when it comes down to actual cases in the future. In this case, the Staff is not just overlooking an apparent intended commercial purpose for a line extension, it is making that purpose a centerpiece of its argument for going ahead.

Q. IS THERE AN OBLIGATION ON THE PART OF THE COMMISSION TO INFORM THE PUBLIC ABOUT THE IMPACTS OF ITS LINE EXTENSION POLICY?

A. Recovering costs through a terminating access charge is perhaps the epitome of a hidden tax. Customers who are footing the bill are entitled to know what they are being required to pay for. Practically speaking, such notification may not make sense with respect to minor amounts. However, if waivers are not granted in this case I believe the Commission would cross the threshold, and the public should be advised as to what this policy is costing and what it is purchasing in return. As I have discussed, this policy cannot be justified as a matter of economics; rather, its justifications arise from political or policy preferences the Commission has found important. Such policies – and their expense -- should be subject to informed expressions of support or opposition from the public.

V. SUMMARY

Q. PLEASE SUMMARIZE THE MAIN POINTS OF YOUR DIRECT AND REPLY TESTIMONY AND YOUR RECOMMENDATION TO THE COMMISSION.

A. The Commission should grant Verizon's waiver petition as to both the Taylor and the Timm Ranch locations. Their extraordinarily high costs should not be subsidized by other ratepayers and/or the company. Forcing the company to go ahead with them would be wasteful and unfair.

While the Commission's new line extension rule resolved a number of problems with the previous tariff approach for both applicants and the companies, it left to the waiver petition process the question of limits on the subsidies to be provided under the rule. It is important to the public and the industry that the Commission set such limits and do so in a manner that provides guidance for the future. This case gives the Commission that opportunity either to discuss limits in general, or at least to set some bounds by granting waivers in this case.

Only the Commission can act as a gatekeeper to protect customers from the costs of excessively expensive line extensions, and the waiver process is the means the Commission provided for doing so.