Exhibit ___-T (LLS-1T)

Before the

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. VERIZON NORTHWEST, INC., Respondent	**Docket No. UT-040788**

Direct Testimony

of

LEE L. SELWYN

on behalf of the

Washington Utilities and Transportation Commission Staff

November 22, 2004

REDACTED VERSION

TABLE OF CONTENTS

I. INTRODUCTION 1

A. Qualifications 1

B. Assignment 4

C. Summary of Testimony 6

II. RATEMAKING TREATMENT OF VERIZON NW'S AFFILIATE TRANSACTIONS 14

A. Economic transactions between a regulated ILEC such as Verizon NW and its unregulated affiliates create strong incentives and opportunities to improperly shift costs onto the regulated company and its ratepayers, and to confer uncompensated benefits from the regulated company to the unregulated affiliates. 14

B. The Commission should exercise its authority under Washington's Affiliated Interest statutes to investigate and correct certain improper affiliate transactions engaged in by Verizon NW that would otherwise cause harm to ratepayers. 25

C. The Commission should strictly interpret and enforce the FCC's affiliate transaction rules to ensure that the benefits of economies of scale and scope enure to regulated ratepayers. 29

III. IMPUTATION OF VERIZON DIRECTORIES CORP. EARNINGS 43

A. VDC's predecessor, the General Telephone Directory Company, developed its yellow pages directory business by virtue of its unique and longstanding position as exclusive publisher of directories for GTE-Northwest and the other GTE local telephone companies. 43

B. VDC's dominance in the Washington yellow pages markets it serves is a direct result of the "first mover" advantage that its predecessor GTDC gained from its historical status as exclusive publisher of GTE-Northwest's directories. 6

C. The going-concern value of VDC's Washington directory publishing operations is largely due to its continued use of Verizon NW intangible assets, including the right to publish directories on the Company's behalf. 80

D. Verizon's decision to have Verizon NW relinquish its directory publishing rights and associated publishing fees and accept a "fee for service" arrangement with VDC was an improper affiliate transaction under the Washington Affiliated Interest statutes, which the Commission can rectify by imputing VDC's excess Washington earnings to Verizon NW as a ratemaking adjustment. 87

IV. CONCLUSION AND RECOMMENDATIONS 99

Tables

1 Associated Telephone Company – Directory Revenues and Expenses 1937-1942 50

2 Southern California Telephone Company – Directory Revenues and Expenses 1937-1942 51

3 Pacific Telephone and Telegraph Company – Directory Revenues and Expenses 1937-1942 52

4 Comparison of VDC vs. Dex Directories for Snohomish County 76

Exhibits

Exhibit No. ___ (LLS-2) Statement of Qualifications

Exhibit No. ___ (LLS-3) Historical Directory Information, from California State Archives, Folder 3725:2855; *S-390, Review of Telephone Directory Practices of the Associates Telephone Company, 1943-1945*. (Source: *Public Utilities Commission Records, Part 1, 1979* Collection of the California State Archives Repository, Sacramento.)

Exhibit No. ___ (LLS-4) Master Directory Publishing Agreement (as provided in Verizon NW's Response to PC Data Request 152)

Exhibit No. ___ (LLS-5) Everett/Snohomish Directory Covers for Certain Years 1953 to 1999

Exhibit No. ___ (LLS-6) Customer Information Pages from Selected Everett/Snohomish Directories 1961 to 1999

Exhibit No. ___ (LLS-7) Current Snohomish County directory ("March 2005"), Cover and Customer Service Guide

Exhibit No. ___ (LLS-8)	Workpapers for Analysis of Snohomish Directories' Advertising Volume
Confidential Exhibit No. ___ (LLS-9C)	Workpapers for Analysis of YPIMA Advertising Rates Information
Exhibit No. ___ (LLS-10)	“Fee for Service” Implementation Documents (as provided in Verizon NW Response to WUTC Staff Data Request No. 250)
Exhibit No. ___ (LLS-11)	January 1, 2000 Publishing Agreement (as provided in Verizon NW’s Response to PC Data Request 152, Attachment PC-152b)
Exhibit No. ___ (LLS-12)	January 1, 2003 Publishing Agreement (as provided in Verizon NW’s Response to PC Data Request 152, Attachment PC-152a)
Confidential Exhibit No.__(LLS-13C)	VDC Accounting Separation Study for Washington – Income Statements and Balance Sheets for Years 2002 and 2003 (as provided in Verizon NW’s Response to PC Data Request 220, Confidential Attachment PC-220)
Exhibit No. ___ (LLS-14)	Mast Advertising & Publishing, Inc. Telephone Directory Publishing Agreement with Telephone Company Affiliates of Continental Telecom Inc., August 15, 1985 (as provided in Verizon NW’s Response to PC Data Request 152, Attachment PC-152d)
Exhibit No. ___ (LLS-15)	“AT&T Consumer: A Base Case Ahead of The Triennial Review,” issued by Credit Suisse First Boston (February 5, 2003)
Confidential Exhibit No. ___ (LLS-16C)	Verizon Information Services document, February 2002 (as provided in Verizon NW’s Response to PC Data Request 258, Confidential Attachment PC-258)
Confidential Exhibit No. ___ (LLS-17C)	Excerpt (pages 5 and 67) from confidential Hawaii sale transaction document dated May 21, 2004 (as provided in Verizon NW’s Response to WUTC Staff’s Data Request No. 277 and Commission Order No. 12)

I. INTRODUCTION

A. Qualifications

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

A. My name is Lee L. Selwyn. I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Boston, Massachusetts 02108. Economics and Technology, Inc. is a research and consulting firm specializing in telecommunications economics, regulation, management and public policy.

Q. Please summarize your educational background and previous experience in the field of telecommunications regulation and policy.

A. I have prepared a Statement of Qualifications, which is provided in Exhibit No. ___ (LLS-2).

Q. Dr. Selwyn, have you previously testified before the Washington Utilities and Transportation Commission ("WUTC" or "Commission")?

A. Yes. I have testified before the WUTC on a number of occasions dating back to the late 1970s. In April, 1978, I submitted testimony on behalf of the Boeing Company and Sears, Roebuck and Company in Cause Nos. U-77-50, U-77-51, and U-77-52. In November 1982, I submitted testimony before the Commission on behalf of the Tele-Communications

Association (TCA) in Cause No. U-82-19 concerning the transfer of Pacific Northwest Bell assets and personnel to AT&T as part of the Plan of Reorganization arising out of the break-up of the former Bell System, and appropriate pricing of terminal equipment. In September, 1988, I submitted two pieces of written testimony to the Commission in Docket No. U-88-2052-P regarding the competitive classification of certain of Pacific Northwest Bell's services. My testimony on behalf of Public Counsel in that case addressed competitive classification of Pacific Northwest Bell's intraLATA toll services, while my testimony on behalf of Telecommunications Ratepayers Association for Cost-based and Equitable Rates (TRACER) and the State of Washington Department of Information Services addressed competitive classification of Pacific Northwest Bell's private line services.

In January 1990, I submitted testimony on behalf of TRACER, Public Counsel, and the State of Washington Department of Information Services in Docket U-89-3031-P regarding GTE-Northwest's proposal for alternative regulation. I also submitted testimony on behalf of TRACER in June 1993, Dockets U-89-2698-F and U-89-3245-P proposing a "Modified Incentive Regulation Plan" for US West Communications (USWC).

On April 17, 1995, I submitted direct and supplemental testimony on behalf of the Staff of the Washington Utilities and Transportation Commission in Docket Nos. UT-941464, UT-941465, UT-950-0146 and UT-950265, regarding the cost studies filed by US West in support of its proposed local transport restructure and expanded interconnection tariffs. On August 11, 1995, I submitted testimony in Docket No. UT-950200 on behalf of the Staff of the Washington Utilities and Transportation Commission concerning US West's request for an increase in its rates and charges. On October 31, 1997, I offered testimony in Docket No.

UT-961638 on behalf of Public Counsel and TRACER in response to US West's request to be relieved of its obligation to serve.

On March 4 and June 28, 1999, I sponsored responsive and surrebuttal testimony, respectively, in Docket No. UT-980948 on behalf of WUTC Staff regarding US West's petition and accompanying testimony seeking to end the imputation of "yellow pages" directory advertising revenues to its Washington regulated telephone operations. In 2003, I appeared before the Commission as the WUTC Staff's expert witness in Docket No. UT-021120, the proceeding addressing the sale and transfer of Qwest's directory publishing affiliate, Qwest Dex. In that proceeding, I submitted Direct Testimony on March 18, 2003, and Supplemental Direct Testimony that addressed the proposed settlement in that case, on May 21, 2003.

Also in 2003, I prepared an affidavit and direct testimony on behalf of AT&T in Docket No UT-020406, a complaint proceeding addressing the level of Verizon Northwest's intrastate switched access charges, and I appeared before the Commission in its hearing in that case on March 7, 2003. Earlier this year, I submitted prefiled direct and surrebuttal testimony on behalf of AT&T in the Commission's unbundled network element ("UNE") review proceeding, Docket No. UT-023003, that addressed the cost of capital applicable to Verizon NW's UNEs, and defended that testimony at hearing on May 27, 2004.

In addition to the aforementioned appearances, ETI has served as a consultant to the Commission and has submitted other filings and reports to the Commission. In October, 1984, ETI prepared a comprehensive evaluation of Local Measured Service (LMS), *A Multi-*

Part Study of Local Measured Service, for the WUTC. In 1985, I was co-author, along with Patricia D. Kravtin and Nancy J. Wheatley of ETI, of Reply Comments of the U.S. Department of Energy, Richland Operations Office, regarding cost of service issues bearing on the regulation of telecommunications companies. These Reply Comments were submitted to the Commission in November of that year. In 1987, ETI was engaged by the Commission to undertake an examination of the outside plant construction and utilization practices of US West Communications and to present recommendations based on that investigation. The final report arising from that assignment, *An Analysis of the Outside Plant Provisioning and Utilization Practices of US West Communications in the State of Washington*, was submitted to the Commission in March 1990. I was co-author of that report, along with Patricia D. Kravtin and Paul S. Keller of ETI.

B. Assignment

Q. On whose behalf is this testimony being offered, and what was your assignment in this proceeding?

A. This testimony is submitted on behalf of the WUTC Staff. I have been asked by the Staff to review the economic, financial, and business relationships between Verizon Northwest Inc. ("Verizon NW") and its directory publishing affiliate, Verizon Directories Corporation ("VDC"), and the other Verizon entities involved in the publication of Verizon NW's printed directories in Washington. I have also been asked to address the economic and policy grounds for possible imputation of VDC's earnings from its Washington directory operations as a ratemaking adjustment to Verizon NW's test year revenue requirement. In addition, I have been asked to explain the general economic and policy principles that should guide the Commission in its review of this and other affiliate transactions engaged in by Verizon NW, and to consider whether any other affiliate transactions require additional ratemaking adjustments.

Q. How is your testimony organized?

A. Following this Introduction, the remainder of my testimony is organized in three principal sections:

The first section, Ratemaking Treatment of Verizon NW's Affiliate Transactions, explains why affiliated interest transactions, such as those between Verizon NW and unregulated Verizon affiliates, create strong economic incentives for the regulated utility to improperly shift costs and revenues in ways that can harm ratepayers. I then discuss how the Washington Affiliated Interest statutes (Chapter 80.16 RCW) and FCC's affiliate transaction rules provide tools for the Commission to identify and correct abuses in affiliate transactions. Finally, I review Verizon NW's charges for sales and marketing activities it performs on behalf of its long distance affiliate, Verizon Long Distance, and show that those charges are not in compliance with the Commission's affiliate transaction requirements.

The next section, Imputation of Verizon Directories Corp. Earnings, addresses Verizon NW's relationship with its unregulated directory publishing affiliate, Verizon Directories Corp. ("VDC"). I explain that VDC's dominance in the directory publishing markets it serves in Washington results from its longstanding historical and economic ties to the former monopoly local telephone operations of Verizon NW. I show that Verizon's elimination of the roughly $30-million in annual publishing fees formerly paid by VDC to Verizon NW, that began with the January 2000 directory publishing agreement and that has continued to this day, has resulted in significant uncompensated benefits flowing from Verizon NW to VDC, contrary to RCW 80.16. Finally, I demonstrate that imputation of VDC's earnings from its Washington directory operations is an appropriate means to rectify that improper transaction, so as to ensure that Washington ratepayers are not harmed by Verizon NW's transactions with VDC.

The final section of my testimony summarizes my recommendations to the Commission concerning ratemaking treatment of VDC's earnings, and other ratemaking adjustments that are necessary to correct improper affiliate transactions undertaken by Verizon NW.

C. Summary of Testimony

Q. Dr. Selwyn, please summarize your testimony.

A. My testimony begins with an overview of the economic and regulatory issues posed by transactions between a regulated utility such as Verizon NW and its unregulated affiliates. I explain how these affiliate relationships create strong incentives and opportunities to improperly shift costs onto the regulated company and its ratepayers, and to confer uncompensated benefits from the regulated company to the unregulated affiliates. I demonstrate that the potential for abuse of an ILEC's affiliate transactions is not merely a theoretical concern, as there are documented cases in which regulated telephone companies have engaged in affiliate transactions that have inappropriately inflated their costs of service.

To illustrate the harm that improper affiliate transactions can cause, I describe the case of NYNEX Materiel Enterprises Company ("MECO"), an unregulated affiliate of one of Verizon Communications' predecessors, NYNEX. After press reports describing allegations by ex-employees that MECO was overcharging NYNEX regulated companies for goods and services, the FCC conducted an audit that found "unreasonable markups and overcharges by MECO on sales of equipment, supplies, and services" to the NYNEX companies which, in turn, were "recording these artificially inflated costs on the regulated books of account, enabling the carriers to recover these costs from ratepayers through the ratemaking process." Thus, the effect of the affiliate transactions in that case was that ratepayers were grossly overcharged. As the MECO case demonstrates, the Commission should intensively scrutinize the transactions of regulated telephone companies, including Verizon NW, with their unregulated affiliates, because those interactions can lead to improper shifting of costs and/or revenues that ultimately harm Washington ratepayers.

Fortunately, the Washington legislature has recognized the potential for abuse of affiliate transactions by a regulated utility and has enacted the Affiliated Interests statutes set forth at RCW 80.16. Counsel advises me that the Affiliated Interest statutes give the Commission rather broad powers to review, revise and amend the terms and conditions of the arrangements under which affiliate transactions are conducted. As the Washington Supreme Court summarized the rationale for the Affiliated Interest statutes:

> The general rationale for the Commission's authority to review transactions between affiliated companies is fear of collusion in the absence of arm's-length dealings. It does not matter under these statutes whether the utility paid the affiliate too much money for too little service or property, or whether (as here) the utility gave the affiliate something of far greater value than the affiliate paid for in return. The effect in

> either situation is to give to the shareholders of the affiliate something of value at the expense of the ratepayers of the utility.[1]

These statutes also appear to place the burden of proof on the utility to demonstrate that its affiliated interest transactions are reasonable and thus suitable for inclusion in a Commission determination of the costs of regulated services. I conclude that the Commission should exercise its authority under Washington's Affiliated Interest statutes to investigate and correct certain improper affiliate transactions engaged in by Verizon NW that would otherwise cause harm to ratepayers.

My testimony discusses two main areas that the Commission should investigate: First, Verizon NW's compliance with the FCC's affiliate transactions rules, such as the charges that Verizon NW applies to its long distance services affiliate, Verizon Long Distance ("VLD"), for sales and marketing activities that Verizon NW performs on behalf of VLD; second, Verizon NW's arrangements with its directory publishing affiliate, Verizon Directories Corporation ("VDC"), to ensure that Verizon NW is properly compensated for the significant benefits VDC receives from its longstanding and ongoing relationship with Verizon NW.

Verizon NW's compliance with the FCC's affiliate transactions rules. As I explain in my testimony, Verizon NW and its affiliates currently apply the FCC's affiliate transaction rules with respect to transactions between Verizon NW and its unregulated affiliates. These rules are not strictly interpreted by Verizon, and are subject to little or no enforcement by the

1. *US West Communications, Inc. v. Utilities and Transp. Comm'n,* 134 Wn. 2d 74, 94, 949 P.2d 1337, 1997 Wash. LEXIS 824 (Citation omitted) (1997) ("*US West v. WUTC*").

FCC. Thus, this Commission must be prepared to strictly enforce these rules, as it has adopted them, when it reviews certain types of affiliate transactions engaged in by Verizon NW.

The basic thrust of those rules is that where an unregulated affiliate purchases non-tariffed services from a regulated entity, it must pay the *higher* of fully distributed cost ("FDC") or fair market value ("FMV"). For services provided by an unregulated affiliate to the regulated entity, the regulated entity pays the *lower* of fair market value or fully distributed cost. The purpose of these rules is to ensure that the regulated affiliate retains the benefit of any economies that result from the provision of assets or services to an unregulated affiliate, or receives the benefits of economies for assets and services it purchases from its affiliates.

I then explain that these rules are being violated in the case of Verizon NW's charges to its long distance affiliate, Bell Atlantic Communications, Inc. d/b/a/ Verizon Long Distance ("VLD"), for the consumer portion of sales and marketing activities that Verizon NW undertakes on behalf of VLD. I show that the Company's charge of $4.85 per contact for residential long distance sales, which is ostensibly compliant with the "higher of FDC or FMV" rule, is actually far below the fair market value of that sales and marketing activity. Instead, I present a highly conservative estimate of the FMV for residential long distance customer acquisition, $75.00 per successful sales contact, which was set forth by Credit Suisse First Boston in a February 2003 analyst's report and cited by Verizon NW's own expert witness in testimony last year in the Verizon NW access charges case, Docket No. UT-020406. I recommend that the Commission correct the inadequate compensation that Verizon NW has been receiving from VLD for those services, by adopting the $75.00 FMV value as the applicable charge for Verizon NW's test year billings to VLD for those services, and adopting the associated ratemaking adjustment presented by Staff witness Tim Zawislak.

In addition, it is my understanding that Mr. Zawislak has examined Verizon NW's affiliate transactions and has found several additional cases of improper affiliate transactions, including uncompensated use of the high frequency portion of the loop for provision of DSL service, and improper sales and marketing expenses for its Internet services affiliate (GTE.Net d/b/a Verizon Internet Solutions a/k/a Verizon Online ("VOL")). I recommend that the Commission also adopt those Staff adjustments as well, to ensure that Washington ratepayers are not harmed by Verizon NW's transactions with its affiliates.

Verizon NW's arrangements with its directory publishing affiliate, Verizon Directories Corp. For over 65 years, VDC and its predecessor GTDC have had a longstanding business relationship with Verizon NW and its predecessors under which the directory affiliate has published alphabetical ("white pages") and classified ("yellow pages") directories that are distributed within Verizon NW's local exchange service territory in Washington. Because of the economic characteristics of yellow pages markets and GTDC's substantial "first mover" incumbency advantage, the sale of the yellow pages advertising included in these directories has generated very sizable profits, profits that up until 2000 had been shared between the directory affiliate and the Company (as well as the other GTE operating companies ("GTOCs")) by a revenue-sharing formula that was revised from time to time and subject to Commission review. My testimony documents the extensive historical linkages between the VDC/GTDC directory affiliate and the Company and shows how VDC continues to dominate its Washington directory markets today as a direct results of its ties with Verizon NW.

My testimony demonstrates that, contrary to the portrayal by Verizon NW witness Dennis Trimble that VDC "remains wholly separate from Verizon NW," in reality, VDC's directory operations in Washington (and those of its predecessor, GTDC) have been and still are fundamentally dependent upon the Company's regulated telephone operations in the state, and are not a stand-alone business that could have been conducted absent those relationships. In essence, GTDC's operation represented an *outsourcing* of the GTOCs' directory publishing function, rather than pursuit of an entirely separate, unregulated business activity, as Mr. Trimble attempts to portray it. GTDC's primary line of business was to sell yellow pages advertising and publish directories *on behalf of the GTOCs*; it obtained the subscriber listing data necessary to do this *from the GTOCs*; and the GTOCs served as the billing and collection agents for GTDC. From the standpoint of a GTOC customer or a business advertising in GTDC's yellow pages, any corporate distinction between GTDC and the GTOC was practically invisible and essentially irrelevant: there was only the franchise monopoly "phone company" providing telephone service *and* its directories.

However, beginning with a new Publishing Agreement that took effect in January 2000, the Company entered into a so-called "Fee for Service" arrangement with its VDC/GTDC directory affiliate, which ended the traditional sharing of directory revenues and instead allowed the directory affiliate to retain all of the profits from yellow pages advertising. One financial effect of this change was to eliminate a revenue stream to Verizon NW that had exceeded $30-million per year on average during the 1990s, and thus had been making an important contribution to meeting the Company's intrastate revenue requirement. The loss of this revenue is implicit in the Company's test year revenue deficiency calculations, which do not include any revenues from yellow pages advertising.

Verizon internal memoranda and e-mails plainly show that the "Fee for Service" arrangement was not the product of independent, arms-length basis negotiations by the two classes of stakeholders (i.e., the operating companies, including Verizon NW, and the directory affiliate VDC), but that those parties worked to ensure that the adopted arrangements would be in the interests of the parent company, Verizon Communications Inc., as a whole, rather than serve the interests of the Company and other regulated operating companies and their ratepayers.

From these facts, I conclude that Verizon's decision to have the Company and other former GTOCs relinquish their directory publishing rights and associated publishing fees and replace them with the "Fee for Service" arrangement was an improper affiliate transaction under the Washington Affiliated Interest statutes (Chapter 80.16 RCW), because it has given the GTDC/VDC affiliate a substantial, ongoing benefit, without payment of any compensation. Consequently, I recommend that the Commission rectify this inappropriate transaction in Washington by imputing VDC's Washington earnings to the Company as a ratemaking adjustment, as proposed by Staff witness Paula Strain.

All of these ratemaking adjustments are essential to ensure that Washington ratepayers are not harmed by Verizon NW's transactions with its affiliates, and thus are necessary and appropriate to adopt in this proceeding.

II. RATEMAKING TREATMENT OF VERIZON'S AFFILIATE TRANSACTIONS

A. Economic transactions between a regulated ILEC such as Verizon NW and its unregulated affiliates create strong incentives and opportunities to improperly shift costs onto the regulated company and its ratepayers, and to confer uncompensated benefits from the regulated company to the unregulated affiliates.

Q. What is an "affiliate transaction," in the context of this proceeding?

A. An affiliate transaction refers to any number of economic interactions that may occur between a regulated utility (in this case, Verizon Northwest, referred to hereafter as "Verizon NW") and other corporate entities that are ultimately under the control of the same corporate parent (in this case, Verizon Communications, Inc.). For example, a utility may "purchase" capital equipment (cables, switches, motor vehicles, etc.) and supplies from an affiliated company that serves as a procurement and supply agent; as another example, a utility might outsource its billing and collection activities to an affiliated "service company" and "pay" the affiliate a fee for performing those functions. In other instances, the relationship may go in the opposite direction, i.e., the utility may provide goods, services, or other items of value, including such intangibles as licenses or assignable rights, to one or more nonregulated affiliates that "pay" the utility for these services.

Q. What issues are raised from a regulatory perspective when a utility engages in a significant level of economic transactions with one or more affiliates?

A. It is fairly commonplace in the telecommunications industry for a regulated utility to engage in some economic transactions with affiliates. In some cases, a utility and its ratepayers might benefit financially from such relationships. It would be possible, for example, for a parent corporation to create a subsidiary that specializes in providing billing and collection services for several relatively small local telephone company affiliates, so that the fixed costs of providing those services could be spread over more billing accounts than if each local telephone company performed these same functions on its own; such an arrangement could in theory lower the costs of billing and collection for each individual telephone company and (assuming it operates under rate of return regulation) the corresponding savings would be flowed through to end user customers.

However, a serious problem arises when a utility is regulated under a rate base/rate of return framework ("ROR"), and engages in a significant degree of economic transactions with affiliated companies. It is generally accepted by economists and regulators who have examined the issue that a firm regulated under an ROR framework faces incentives to increase and/or overstate its costs. In the case of transactions with nonregulated affiliates, this can be accomplished by establishing an excessive transfer price for "purchases" made by the utility from an affiliate or, in the case of "purchases" made by the affiliate from the utility, setting the transfer price below the utility's cost. In the latter situation, if what is being provided by the utility to the affiliate is an *intangible* that has no specific "cost" *per se*, such as access to the utility's customer database, there may be no "charge" to the affiliate at all.

These are not new concerns. For example, the FCC reviewed the incentives of rate of return regulation and their effects upon ILEC behavior in the *Further Notice of Proposed*

Rulemaking (FNPRM), FCC 88-172, in its price caps proceeding, CC Docket 87-313 (3 FCC Rcd 3195, 3216-3224). As stated therein:

> … rate-of-return regulation provides regulated firms with very strong incentives to pad their rates, for essentially two reasons. First, as a profit-maximizer, the firm is led to adopt the most costly, rather than the most efficient, investment strategies because its primary means of increasing dollar earnings under rate-of-return constraints is to enlarge its rate base. This is commonly known as the Averch-Johnson effect or "A-J" effect of rate-of-return. Second, since all operating expenses are included in a firm's revenue requirement under rate of return, management has little incentive to minimize operating costs. This is commonly known as "X-inefficiency." The firm's shareholders profit from the first phenomenon, and the benefits of the second redound to the firm's management. In both cases, however, consumers suffer because these distorted incentives increase the cost of doing business - and thus the rates consumers must pay for service. (3 FCC Rcd 3195, 3219, footnotes omitted)

The FCC's review noted several studies that found these effects to have significant impacts upon regulated firms' costs, including "one showing unit cost increases on the order of 6 to 12 percent" due to A-J type distortions (3 FCC Rcd 3195, 3220) and a unit cost differential of approximately 11 percent for monopoly electric utilities subject to rate-of-return regulation relative to such utilities in situations where some competitive forces exist (3 FCC Rcd 3195, 3222).

This tendency to overstatement of an ROR-regulated firm's costs is exacerbated when the firm relies upon nonregulated affiliates to perform a significant amount of its operations. The US Department of Justice ("DoJ") has expressed this issue concisely:

> If a firm produces nonregulated inputs needed to produce its regulated products, it has an incentive to cross-subsidize by selling itself those inputs at prices higher than the cost of producing them. This would increase the "cost" of the regulated product, but it would also increase the firm's total revenues because, under cost-based regulation, the regulators would permit a corresponding increase in the price of the regulated product. The carrier, therefore, would retain on the nonregulated side the higher profit resulting

> from the above-cost price paid by the regulated firm to its affiliate. Conversely, if assets or services of a regulated business are sold to a nonregulated affiliate at too low a price, profits on the nonregulated side will increase. The loss to the regulated business will increase the service's revenue requirement and be recovered from ratepayers.[2]

Q. Is the potential for abuse of an LEC's affiliate transactions merely a theoretical concern?

A. No, it is not. The need to closely scrutinize these types of transactions is very real. There are documented cases in which regulated telephone companies have engaged in affiliate transactions that have inappropriately inflated their costs of service. Consider, for example, the investigations pursued by the FCC and the New York Public Service Commission ("NY PSC") of the NYNEX Materiel Enterprises Company ("MECO"), which was an unregulated affiliate of one of Verizon Communications' predecessors, NYNEX. While I am not suggesting that Verizon NW has engaged in the same conduct that was at the heart of that case, an explanation of the MECO case may assist the Commission in understanding the nature of the problem and why it is particularly important in this proceeding to require Verizon NW to demonstrate the reasonableness of all of its affiliate transactions.

NYNEX established MECO in 1983 to provide support and procurement services for the various NYNEX companies.[3] By an *Order to Show Cause and Notice of Apparent Liability*

2. *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, CC Docket No. 86-111, Comments of the Department of Justice, pages 38-39; cited in *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities,* CC Docket No. 86-111, *Report and Order*, 2 FCC Rcd 1298, at para. 290.

3. *New York Telephone Co.; New England Telephone and Telegraph Co.; Apparent*
(continued...)

for Forfeitures adopted on February 6, 1990, the FCC opened an enforcement proceeding to investigate violations of its affiliate transaction rules by NYNEX and MECO.[4] The Common Carrier Bureau of the FCC had originally scheduled a routine audit of the NYNEX companies and their affiliate transactions for 1989, but "accelerated the schedule" and opened the audit proceeding in 1988 after press reports describing allegations by ex-employees that MECO was overcharging NYNEX regulated companies for goods and services.[5] The resulting audit found "unreasonable markups and overcharges by MECO on sales of equipment, supplies, and services" to the NYNEX companies which, in turn, were "recording these artificially inflated costs on the regulated books of account, enabling the carriers to recover these costs from ratepayers through the ratemaking process."[6] The FCC tentatively concluded that NYNEX paid MECO approximately $118.5-million in excess of the cost of goods and services based upon correct accounting rules.[7]

In the course of the MECO proceeding, the FCC found, in general, that regulators clearly confront a difficult task with respect to affiliate transactions. Specifically, the FCC noted that:

3. (...continued)
Violations of the Commission's Rules and Policies Governing Transactions with Affiliates, *Order to Show Cause and Notice of Apparent Liability for Forfeitures*, FCC 90-57, 5 FCC Rcd 866 (1990), ("*Order to Show Cause*"), at 869.

4. *Order to Show Cause*, at 867.

5. *Id.*, at 869; *Telecommunications Reports*, February 12, 1990, at 4.

6. *Order to Show Cause*, at 867.

7. *Id*.

> Transfers of goods and services between affiliates present the opportunity, through improper transfer pricing, to shift costs properly borne by the nonregulated company to the regulated enterprise for recovery from ratepayers through the ratemaking process. In such non-arm's length transactions, the prices charged for those goods and services may not bear a reasonable relation to costs. For example, the nonregulated affiliate may sell goods and services to the regulated company at artificially inflated prices; since such prices become part of the costs and rate base of the regulated carrier, they can lead to unreasonably high rates. The ultimate result of this abusive arrangement is supranormal profits flowing to the nonregulated affiliate at the expense of ratepayers.[8]

The FCC also found that the relationship developed between MECO and NYNEX, whereby New England Telephone ("NET") and New York Telephone ("NYT") were required to purchase certain goods and services through MECO, essentially rendered the regulated companies "captive customers" of MECO. This policy, in turn, guaranteed that MECO would receive a given level of demand for its products and services and essentially eliminated any business risk that a company would normally face in a competitive market.[9] In fact, only three percent of MECO's sales were to third parties outside of the affiliate relationship and MECO's return on investment had grown from 27.7% in 1984 to 80.7% in 1988.[10]

Q. What impact did these practices have upon ratepayers?

8. *Id.*, at 867-868.

9. *Id.*, at 870.

10. *Telecommunications Reports*, February 12, 1990, at 46.

A. The effect of the affiliate transactions in that case was that ratepayers were grossly overcharged. Following the audit, NYNEX directed MECO to rebate the operating companies in the amount of $42.2-million in overcharges found for the year of 1998 and ordered MECO to lower the prices charged to the regulated companies on a going-forward basis. The action did not address overcharges in previous years.[11] As a result of the *Order to Show Cause*, the FCC and NYNEX Telephone Companies entered into a Consent Decree, adopted by the FCC on October 3, 1990.[12] Without admitting any wrongdoing, the NYNEX Telephone Companies made a voluntary contribution to the United States Treasury of $1.42-million, reduced their capital account balances on their regulated books by $32.6-million; and filed revised access services tariffs that made a one-time reduction in their interstate revenue requirements of $35.5-million.[13] The FCC's adoption of the Consent Decree officially closed the investigation without a finding of wrongdoing.[14]

Q. You have described what the FCC did in connection with the MECO matter. Did the state regulatory commission in New York undertake any investigation of affiliate transactions in connection with the matter?

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11. *Order to Show Cause*, at 871.

12. *New York Telephone Co.; New England Telephone and Telegraph Co. Apparent Violations of the Commission's Rules and Policies Governing Transactions with Affiliates*, *Order*, FCC 90-328, 5 FCC Rcd 5892 (1990), ("*Order Adopting Consent Decree*").

13. *Order Adopting Consent Decree*, at Appendix.

14. *Id.*

A. Yes. The NYPSC opened its own investigation to study the relationship between NYT and its affiliates in order to “protect ratepayers from all of NYNEX’s excessive and improper charges” the day before the release of the FCC’s *Order Adopting Consent Decree.*[15] Allegations of improper affiliate transactions had begun to surface during a rate case proceeding. In a brief submitted in the NYT rate case, the New York State Attorney General maintained that NYT had overpaid for goods and services provided by its unregulated NYNEX affiliates, including MECO. The Attorney General specifically targeted the “Engineered Services Agreement” (“ESA”), an agreement describing the “markup,” or accounting, policy for the NYNEX regulated companies’ purchase of, and MECO’s installation of, new central office switching and related network equipment. The accounting policy, according to the Attorney General’s brief, would yield a markup on cost of 438% in 1985.[16] In addition, payment for services under the ESA in 1987 resulted in charges for goods and services from MECO to NYT and NET totaling $13.1-million while MECO’s cost to provide those services was just $2.76-million. The price differential, a 375% markup, was primarily paid for by NYT (i.e., two-thirds of the $13.1-million).[17]

The NYPSC Staff brief in the same NYT rate case stated, with respect to MECO’s recovery of costs from its parent company, that “[t]o the extent New York Tel purchased a product from MECO, it must be assumed that it did so because that was the lowest price available in the marketplace. MECO should not be allowed to augment returns on poorer performing product lines with a portion of the excessive returns generated on product lines where New

15. *Telecommunications Reports*, October 8, 1990, at 10.

16. *Telecommunications Reports*, September 17, 1990, at 30.

17. *Id*.

York Tel was a captive customer, e.g., central office removal and perhaps cable. MECO should not be permitted to increase its price to New York Tel after the fact on certain lines of business through a perverse application of the excess profits adjustments."[18]

Spurred by allegations arising out of the NYT rate case, the NYPSC voted on October 3, 1990 to pursue an investigation of allegations surrounding NYNEX companies' affiliated transactions and to direct the Attorney General to study the result of those transactions with regard to ratepayers.[19] An independent auditor was contracted to conduct an in-depth analysis into the transactions of NYT and its affiliates with particular attention paid to the subsequent effects of affiliate transactions on ratepayers. NYPSC Case No. 90-C-0912 was opened and included said audit "to discover and compile information to determine if the compensation paid by [New York Tel] for goods and services acquired from affiliates or in reliance upon affiliate recommendations or direction was reasonable and if the compensation received by [New York Tel] for the transfer of goods, services, trained personnel and other assets, including intellectual property, was reasonable; to ascertain the financial effects on [New York Tel's] ratepayers; and to propose remedies for those effects if warranted."[20]

18. *Id.*, at 32.

19. *Telecommunications Reports*, October 8, 1990 , at 11.

20. *Proceeding on Motion of Commission to Investigate Transactions Among New York Telephone Company and its Affiliates; Proceeding on Motion of the Commission to Investigate the Directory Publishing Operations of New York Telephone Company and its NYNEX Affiliates,* State of New York Public Service Commission Case Nos. 90-C-0912 and 92-C-0272, *Order Denying Petition for Rehearing*, Rel. October 7, 1997, at 2.

In June of 1997, nearly seven years after the inception of the proceeding to investigate the affiliated transactions of NYT, the NYPSC adopted a settlement agreement. This settlement provided for an $83-million refund to NYT ratepayers in exchange for an end to the investigation of "improper" affiliate transactions, $53-million of which was directly related to transactions with affiliates.[21]

Q. You are not suggesting, are you, that there are direct parallels between the specific types of transactions extant between MECO and the NYNEX telephone companies and those that exist as between Verizon NW and its affiliates?

A. Obviously, none of the specific facts that arose in the MECO case are necessarily operative here. Nevertheless, it is fair to conclude from the MECO case that the Commission should intensively scrutinize the transactions of regulated telephone companies, including Verizon NW, with their unregulated affiliates, because those interactions can lead to improper shifting of costs and/or revenues that ultimately harm Washington ratepayers. Moreover, if anything, the risks of improper affiliate transactions are actually greater today than they were in the 1980s when the MECO conduct was being addressed. At that time, virtually all of an ILEC's activities involved *regulated* services; that is no longer the case. In addition, activities that in the past were performed by the ILEC entity itself are now often performed by an affiliate. In some cases, the affiliate is marketing specific services to the ILEC's

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21. *Proceeding on Motion of Commission to Investigate Transactions Among New York Telephone Company and its Affiliates; Proceeding on Motion of the Commission to Investigate the Directory Publishing Operations of New York Telephone Company and its NYNEX Affiliates,* State of New York Public Service Commission Case Nos. 90-C-0912 and Case No. 92-C-0272, *Opinion and Order Approving Settlement with Modifications*, Opinion 97-9, Rel. June 5, 1997, at 1 and 4.

customers (e.g., long distance, Internet access) and in other cases the affiliate is performing services for the ILEC that in the past had been performed by the ILEC for itself (e.g., billing and collection, directory publishing, and a variety of corporate overhead functions). As the volume of transactions with affiliates escalates, so too must regulatory attention to these activities and their consequences for the ILEC's customers as well as for its competitors.

B. The Commission should exercise its authority under Washington's Affiliated Interest statutes to investigate and correct certain improper affiliate transactions engaged in by Verizon NW that would otherwise cause harm to ratepayers.

Q. Has the Washington legislature recognized the potential for abuse of affiliate transactions by a regulated utility such as Verizon NW?

A. Yes, I believe it has. While I am not an attorney and am not offering a legal opinion, I have reviewed the Washington Affiliated Interests statutes set forth in Chapter 80.16 RCW and find that they recognize and address the types of problems with affiliate transactions that I have just described. Some of the key terms of those statutes are as follows:

- RCW 80.16.020 **Dealings with affiliated interests -- Prior filing with commission required -- Commission may disapprove.** Every public service company shall file with the commission a verified copy, or a verified summary if unwritten, of a contract or arrangement providing for the furnishing of management, supervisory[,] construction, engineering, accounting, legal, financial, or similar services, or any contract or arrangement for the purchase, sale, lease, or exchange of any property, right, or thing, or for the furnishing of any service, property, right, or thing, other than those enumerated in this section, hereafter made or entered into between a public service company and any affiliated interest as defined in this chapter, including open account advances from or to the affiliated interests. [...] *Any time after receipt of the contract or arrangement, the commission may institute an investigation and disapprove the contract, arrangement, modification, or amendment thereto if the commission finds the public service company has failed to prove that it is reasonable and consistent with the public interest.* The commission may disapprove any such contract or arrangement if satisfactory proof is not submitted to the commission of the cost to the affiliated interest of rendering the services or of furnishing the property or service described in this section. [Emphasis supplied]

- RCW 80.16.030. **Payments to affiliated interest disallowed if not reasonable.** In any proceeding, whether upon the commission's own motion or upon complaint, involving the rates or practices of any public service company, *the commission may exclude from the accounts of the public service company any payment or compensation to an affiliated interest for any services rendered or property or service furnished, as described in this section, under existing contracts or arrangements with the affiliated interest unless the public service company establishes the reasonableness of the* *payment or compensation.* In the proceeding the commission shall disallow the payment or compensation, in whole or in part, in the absence of satisfactory proof that it is reasonable in amount. In such a proceeding, any payment or compensation may be disapproved or disallowed by the commission, in whole or in part, if satisfactory proof is not submitted to the commission of the cost to the affiliated interest of rendering the service or furnishing the property or service described in this section. [Emphasis supplied]

- RCW 80.16.050. **Commission's control is continuing.** The commission shall have continuing supervisory control over the terms and conditions of such contracts and arrangements as are herein described so far as necessary to protect and promote the public interest. The commission shall have the same jurisdiction over the modifications or amendment of contracts or arrangements as are herein described as it has over such original contracts or arrangements. *The fact that a contract or arrangement has been filed with, or the commission has approved entry into such contracts or arrangements as described herein shall not preclude disallowance or disapproval of payments made pursuant thereto, if upon actual experience under such contract or arrangement, it appears that the payments provided for or made were or are unreasonable.* Every order of the commission approving any such contract or arrangement shall be expressly conditioned upon *the reserved power of the commission to revise and amend the terms and conditions thereof, if, when, and as necessary to protect and promote the public interest.* [Emphasis supplied]

Q. Do these provisions appear to establish that the utility bears the burden of proof to demonstrate the reasonableness of its transactions with affiliated companies?

A. Yes. From an economic and policy perspective (and again, without offering a legal opinion), these provisions certainly appear to place the burden of proof on the utility to demonstrate that its affiliated interest transactions are reasonable and thus suitable for inclusion in a Commission determination of the costs of regulated services. First, under RCW 80.16.020, the Commission may disapprove an affiliated interest contract or arrangement if it finds the utility "*has failed to prove* that it is reasonable and consistent with the public interest." (Emphasis supplied.) Second, RCW 80.16.030 specifically addresses Commission action in the context of a utility rates proceeding, and states that "the commission may exclude from the accounts of the public service company any payment or compensation to an affiliated interest for any services rendered or property or service furnished, as described in this section, under existing contracts or arrangements with the affiliated interest *unless the public service company establishes* the reasonableness of the payment or compensation." (Emphasis supplied.)

Q. Is it your understanding that these statutes give the Commission broad authority to disallow or correct affiliated interest transactions that might otherwise cause harm to ratepayers?

A. Yes. While I am not offering a legal opinion, the Affiliated Interest statutes appear to give the Commission rather broad powers to review, revise and amend the terms and conditions of the arrangements under which affiliate transactions are conducted. Notably, when the Washington Supreme Court reviewed the Commission's final order in US West's general rate case (Docket No. UT-950200),[22] it found as follows:

> We conclude this language [RCW 80.16.050] is broad enough to cover imputation, since imputation of revenue is included in the power to revise and amend the contract between the two affiliates. Furthermore, RCW 80.16.030 authorizes the Commission to disallow unreasonable compensation to an affiliated company for purposes of ratemaking.[23]

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22. *US West Communications, Inc. v. Utilities and Transp. Comm'n,* 134 Wn. 2d 74, 949 P.2d 1337, 1997 Wash. LEXIS 824 (1997) ("*US West v. WUTC*").

23. *US West v. WUTC*, at 92-93. Counsel advises me that the language of RCW80.16.030 and 80.16.050 was amended subsequent to the Court's ruling, but not in ways that would materially impact these findings.

The Court also rejected US West's argument that the statute was limited to giving the Commission authority to examine affiliated interest contracts only when the utility was making purchases from the affiliate and proposed to include the affiliate's charges in its regulated results of operations, so that the Commission had no authority to correct situations where the affiliate was receiving something of value from the utility for inadequate or no compensation.[24]

Finally, as the Court summarized the rationale for the Affiliated Interest statutes:

> The general rationale for the Commission's authority to review transactions between affiliated companies is fear of collusion in the absence of arm's-length dealings. It does not matter under these statutes whether the utility paid the affiliate too much money for too little service or property, or whether (as here) the utility gave the affiliate something of far greater value than the affiliate paid for in return. The effect in either situation is to give to the shareholders of the affiliate something of value at the expense of the ratepayers of the utility.[25]

As I shall describe in the following sections of my testimony, it is essential that the Commission exercise that authority in the instant proceeding to ensure that Washington ratepayers' interests are protected from the adverse impacts of certain affiliate transactions engaged in by Verizon NW.

24. *Id.*, at 93-94.

25. *Id.*, at 94 (citation omitted).

C. This Commission should strictly interpret and enforce its affiliate transaction rules to ensure that the benefits of economies of scale and scope enure to regulated ratepayers.

Q. What affiliate transaction rules apply to Verizon NW's affiliate transactions?

A. Verizon NW and its affiliates currently claim to be applying the FCC affiliate transaction rules with respect to transactions between Verizon NW and its unregulated affiliates.[26] In fact, these rules are not being strictly interpreted and adhered to by Verizon, and are subject to little or no enforcement by the FCC. As a result, this Commission must be prepared to strictly enforce these rules as it reviews certain types of affiliate transactions engaged in by Verizon NW.

Q. Is Verizon subject to WUTC accounting rules different from those of the FCC?

A. In 1998 the WUTC adopted the FCC's affiliate transaction standards,[27] which have generally remained constant to the present day. Two significant changes have occurred that differentiate the WUTC rules as adopted in 1998 and the current FCC standards. The most substantial change in the FCC's affiliate transaction rules occurred with respect to prevailing company price requirements. Prevailing company price allows a company to charge an affiliate the same amount it charges unaffiliated purchasers of a good or service, as long as the company sells more than a certain threshold percentage of that good or service to unaffiliated purchasers. Since 1998, the FCC has changed the threshold percentage of

26. WUTC Docket No. 040788, Direct Testimony of Nancy W. Heuring on behalf of Verizon Northwest Inc., April 30, 2004, at 38.

27. WAC 480-120-302.

services applicable for prevailing company price from 50% to 25%. Second, the FCC has created a threshold valuation to begin applying its affiliate transaction rules. Assets and services provided by or to affiliate that are valued at less than $500,000 are not required to follow the FCC's standards.

Q. How should these discrepancies be reconciled?

A. Although a material change in the rules, the changes outlined above likely has little real effect on issues currently before the Commission. In the case of prevailing company price, any services (such as Billing and Collection) which typically qualify for prevailing company price would usually qualify under either the current FCC or WUTC standard. In the case of the value threshold, there is potential for cost shifting by disaggregating a transaction into smaller units (such as large numbers of affiliate transactions valued just below this $500,000 floor), but administratively this may be an inefficient means of shifting costs. The Washington Commission should be concerned not with these changes in details, but rather with the fundamental interpretation of basic affiliate transaction requirements, and their strict enforcement.

Q. What are the fundamentals of the affiliate transaction requirements?

A. The FCC's current affiliate transaction rules state that:

> Services provided between a carrier and its affiliate pursuant to a tariff, including a tariff filed with a state commission, shall be recorded in the appropriate revenue accounts at the tariffed rate. Non-tariffed services provided between a carrier and its affiliate pursuant to publicly-filed

> agreements submitted to a state commission pursuant to section 252(e) of the Communications Act of 1934 or statements of generally available terms pursuant to section 252(f) shall be recorded using the charges appearing in such publicly-filed agreements or statements. Non-tariffed services provided between a carrier and its affiliate that qualify for prevailing price valuation, as defined in paragraph (d) of this section, shall be recorded at the prevailing price. For all other services sold by or transferred from a carrier to its affiliate, the services shall be recorded at no less than the higher of fair market value and fully distributed cost. For all other services sold by or transferred to a carrier from its affiliate, the services shall be recorded at no more than the lower of fair market value and fully distributed cost.[28]

Put simply, where an unregulated affiliate purchases non-tariffed services from a regulated entity, it must pay the *higher* of fully distributed cost ("FDC") or fair market value ("FMV"). If the regulated entity sells the same service to a significant number (50%) of non-related entities, the amount it charges to non-related entities is assumed to be the fair market value and may be charged to the affiliate regardless of fully distributed cost. For services provided by an unregulated affiliate to the regulated entity, the regulated entity pays the *lower* of FMV or FDC.

Q. These rules appear to be asymmetric, with the regulated affiliate always receiving the higher price or lower revenue. Is there a reason for this asymmetry?

A. Absolutely. The purpose of this asymmetry is to ensure that the regulated affiliate retains the benefit of any economies that result from the provision of assets or services to an unregulated affiliate, or receives the benefits of economies for assets and services it purchases from its affiliates. Absent strict interpretation of these rules, Verizon is able to:

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28. 47 C.F.R. 32.27 (2003). Note that these standards only apply to services for which the aggregate annual billing exceeds $500,000.

- shift revenues out of the regulated entities, depressing regulated revenues;
- shift costs into regulated entities, depressing apparent profits;
- utilize the infrastructure of the regulated affiliate to *incrementally* provide service to unregulated affiliates, leaving the entire burden of fixed and/or joint costs with the regulated entity.

The purpose of requiring an affiliate to pay the ILEC the greater of fair market value or fully distributed cost was explained by the Accounting Safeguards Division in 2001, in response to a request by BellSouth to price affiliate transactions at incremental cost:

> This rule was intended to ensure that the captive telephony ratepayer receives the most reasonably advantageous result from the transaction and does not subsidize the LEC's affiliate activities.[29]

Thus, for a ILEC to justify to ratepayers a service provided to an unregulated affiliate, it must both be able to price the service so as to cover its costs *and* it must charge its affiliate the full fair market value of the service.

Q. If these are FCC rules, isn't the FCC enforcing Verizon Northwest's strict interpretation of them?

A. No, based upon Verizon's actions in other jurisdictions, it is not reasonable to assume that the FCC is enforcing these rules. The FCC has previously found that Verizon has failed to fully implement affiliate transaction rules with respect to its long distance affiliate. In the

29. *BellSouth Telecommunications, Inc. Permanent Cost Allocation Manual Petition for Waiver of Section 32.27 of the Commission's Rules*, ASD File No. 01-46, *Order*, 16 FCC Rcd 22120 (2001), 22120, at para. 2.

summer of 2003—i.e., more than three years after the grant of Section 271 authority is New York — the FCC released a Notice of Apparent Liability arising out of the "biennial" New York Audit proceeding required by Section 272 of the Telecommunications Act of 1996.[30] The FCC identified numerous apparent violations by Verizon of the requirements of Section 272 (which apply, among other affiliate requirements, the FCC's affiliate transaction requirements to the Verizon Long Distance affiliate). Among these violations were specific cost misallocations amounting to, at cost, some $16-million.[31] It is not possible to determine from the New York Audit documents and the FCC's Notice of Apparent Liability if accounting corrections for these violations were ever applied. However, in any event, the $283,800 fine imposed by the FCC for these infractions represents 2% of the benefit realized by Verizon from perpetrating these violations. Rather than operate to *deter* such conduct in the future, a fine of this almost inconsequential magnitude actually sends precisely the opposite message to Verizon, and works to reinforce the Company's strategy of largely — or even entirely — ignoring the FCC mandated limitations on inter-affiliate transactions. Indeed, Verizon's second New York biennial audit report continued to find affiliate transaction accounting irregularities[32], this time concluded with a Consent Decree.[33]

30. *Verizon Telephone Companies, Inc. Apparent Liability for Forfeiture*, File No. EB-03-IH-0245, NAL/Acct. No. 200332080014, FRN No. 00089884338, *Notice of Apparent Liability for Foreiture*, Rel. September 8, 2003, ("*Verizon Audit Order*").

31. *Id.*, at paras. 8-9.

32. *Section 272(b) Biennial Audit of Verizon Communications, Inc.,* EB Docket 03-200, *Report of Independent on Applying Agreed-Upon Procedures*, December 12, 2003.

33. *Verizon Telephone Companies*, File Nos. EB-03-IH-0245, EB-03-IH, 0550, Acct. No. 200332080014, FRN No. 0008988438, *Consent Decree*, FCC 04-180, July 27, 2004.

In Washington, Verizon NW is under no such audit requirement, and it is unlikely that the FCC would require such an undertaking. Given Verizon's disregard for accounting requirements when under such an audit requirement, it is highly likely that the violations found in New York, at a minimum, have also occurred in Washington.

Q. Have you identified any instances in which Verizon NW's transactions with an affiliate are not in compliance with the affiliate transaction requirements you have been discussing?

A. Yes. I have examined the cost support provided by the Company for its charges to its long distance affiliate, Bell Atlantic Communications, Inc. d/b/a/ Verizon Long Distance ("VLD"), for the consumer portion of sales and marketing activities that Verizon NW undertakes on behalf of VLD. Much of that selling activity occurs on the so-called "inbound channel" – that is, incoming calls placed by current or potential customers of Verizon-NW's *local* services. Most are calling to order new or additional local service, change their existing service, report a service problem, inquire about a billing issue, order optional features, or move their service to a new location. However, each of these inbound channel contacts provides Verizon-NW with an *opportunity* to *sell* its VLD affiliate's long distance service. Because Verizon-NW continues to provide the vast majority of retail local exchange lines within its Washington service territory, the ability to leverage the in-bound channel to sell VLD's long distance service is a powerful marketing tool that is unavailable to the other interexchange carriers ("IXCs") who are competing with VLD.

Indeed, customer acquisition is among the most costly aspects of a long distance carrier's operation. Without the benefit of the embedded ubiquitous customer base that is uniquely available to ILECs such as Verizon-NW, nonaffiliated long distance carriers must pursue active marketing strategies involving extensive media advertising, telemarketing, direct mail, and special promotions (cash, airline miles, etc.). When spread over the number of sales that are actually consummated, these costs can amount to hundreds of dollars per customer acquired. I am aware of at least one analysis that has put such cost at "up to $300 to $600 in sales support, marketing and commissions" per customer acquired.[34]

Q. What is the basis of the sales and marketing charges that Verizon NW collects from VLD?

A. According to page 2 of Verizon NW's Response to WUTC Staff Data Request No. 447, Verizon NW claims to apply the higher of FMV or FDC rule for those charges. For example, Verizon NW has supplied a cost study for "long distance sales made in the business sales office" that calculates an FDC for that activity of $48.97 per contact and an FMV per contact of $46.57 (*id.;* "per contact" in this context means per each customer contact that led to a sale of long distance service). Because the FDC value is higher than FMV value, Verizon NW is billing VLD at FDC (*id.*). Although Verizon NW has not provided cost support for its *Consumer* (residential) sales activity in that data response, it is reasonable to assume that Verizon NW uses a similar cost study to derive its higher of FMV/FDC charge of $4.85 per contact for residential long distance sales.

34. See Claude Borna, *Combating Customer Churn*, in Business and Management Practices, Vol. 11, No. 3, p. 83-85 March, 2000.

Q. Is the Company's charge of $4.85 per contact a reasonable estimate of the fair market value of the residential long distance sales made by Verizon NW on behalf of VLD?

A. No, it is not. As revealed in Confidential Attachment 447.16.4 provided with that data response, BEGIN VERIZON-NW CONFIDENTIAL <<

>> END VERIZON-NW CONFIDENTIAL Presumably, Verizon NW has developed its FMV for residential long distance sales in the same manner. Such a replacement, however, does nothing to capture the fair market value of the *preemptive* position of Verizon NW customer service agents to sell VLD services to customers at the moment they are already engaged in making decisions regarding their telecommunications services. The fair market value of *labor* services, therefore, bears no relation to the fair market value of *joint marketing* services provided by customer services agents. Rather, the proper fair market value of the marketing service provided by Verizon NW for VLD is the price that a competing IXC would have to pay to obtain that customer.

Q. Can you offer an alternative estimate of the FMV for Verizon NW's residential customer sales activity on behalf of VLD?

A. Yes. I believe that a highly conservative estimate of FMV for Verizon NW's Consumer Sales and Service Center ("CSSC") residential customer sales activity on behalf of VLD is $75.00 per successful sales contact.

Q. What is the basis of the $75.00 FMV estimate?

A. This value is derived from a February 5, 2003 equity research report entitled "AT&T Consumer: A Base Case Ahead of The Triennial Review," issued by Credit Suisse First Boston (hereafter referred to as the "CSFB Report"). At page 8 of that report, CSFB states that "[i]n 2002, we estimate AT&T's cost per gross LD customer addition at $75 with annual churn of approximately 30%." This value was cited by Verizon NW witness Carl Danner in the Company's recent access charges case, WUTC Docket No. UT-020406.[35] As I indicated at page 13 of my Surrebuttal Testimony in that proceeding (Exhibit No. T-___, LLS-13T), the CSFB estimate is lower than the $300-600 range noted above apparently because it does not include all of the costs that an IXC would incur in acquiring a new long distance customer, such as the costs associated with making the PIC change order or establishing a new customer record in the IXC's account and billing information systems. However, as I indicated at pages 17-18 of that testimony, the $75 value is consistent with a second estimate of IXC's marketing costs offered by two economists who frequently testify on behalf of Verizon and other ILECs, Dr. William E. Taylor and Dr. Alfred Kahn.

Q. Please explain how the Taylor/Kahn estimate of IXC marketing costs corroborates the CSFB $75 value.

A. In a December 2002 declaration submitted to the FCC *on behalf of Verizon* and the other

35. WUTC Docket No. 020406, Surrebuttal Testimony of Carl R. Danner on Behalf of Verizon Northwest Inc., February 24, 2003 (Exhibit No. T-200, CRD-3T), at page 26.

three RBOCs, Drs. Taylor and Kahn estimate that IXCs incur retail marketing expenses for long distance service that amount to $0.03 per minute.[36] Dr. Taylor had put forth the same $0.03 per minute value earlier in an affidavit he submitted on behalf of Qwest Communications, Inc., in the Minnesota Public Utility Commission's "Section 272 compliance" proceeding held in connection with Qwest's Section 271 Application for in-region interLATA authority in Minnesota.[37]

As I shall now demonstrate, the CSFB's $75 value can also be expressed on a per-minute basis by employing other data contained in the same CSFB report. The CSFB report estimates annual churn for long distance customers at 30%,[38] which suggests that, on average, the average customer will stay with the same LD carrier for approximately three years. The CSFB report also provides forecasts of average monthly minutes of use per customer by year for 2003, 2004 and 2005, at 73, 66 and 63 minutes of use per month, respectively. Multiplying each of these monthly figures by 12 and summing the results for all three years provides an estimate of the average total usage over the three-year life of each customer account at 2,424 minutes. Spreading the $75 acquisition cost over these 2,424 minutes works out to $0.0309 per minute, which corroborates the $0.03 per minute estimate

36. *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.

37. *In the Matter of a Commission Investigation into Qwest's Compliance with Section 272 of the Telecommunications Act of 1996's Separate Affiliate Requirement*, Minnesota PUC Docket No. P-421/CI-01-1372, OAH Docket No. 7-2500-24487-2; Surrebuttal Affidavit of Dr. William E. Taylor on behalf of Qwest Corporation, January 16, 2002, at para. 20.

38. *Id*., at 8.

set forth by Drs. Taylor and Kahn.

Q. What is your conclusion concerning appropriate treatment of Verizon NW's charges to VLD for its sales activities?

A. I recommend that the Commission adopt $75.00 as the FMV for each successful residential customer sale contact that Verizon NW's CSSC unit performed on behalf of VLD during the test year. Because that value is higher than Verizon NW's $4.85 FDC/FMV-based value, in accordance with the affiliate transaction requirements, the $75.00 FMV value should be applied to determine the value of those services provided to VLD during the test year.

It is my understanding that Staff witness Tim Zawislak has performed an adjustment to VLD's Affiliated Sales and Marketing Expense as presented by Verizon witness Ms. Heuring, that reflects application of the $75.00 FMV value to Verizon NW's test year billings to VLD for those services. I recommend that the Commission adopt that adjustment.

Q. Are you aware of any other areas in which Staff has determined that Verizon NW's affiliate transactions are not in compliance with the affiliate transaction requirements and the Commission's affiliated interest rules?

A. Yes. It is my understanding that Mr. Zawislak has examined Verizon NW's affiliate transactions and has found several additional cases of improper affiliate transactions, including uncompensated use of the high frequency portion of the loop for provision of DSL service, and improper sales and marketing expenses for its Internet services affiliate (GTE.Net d/b/a Verizon Internet Solutions a/k/a Verizon Online ("VOL")). I recommend that the Commission also adopt those Staff adjustments as well, to ensure that Washington ratepayers are not harmed by Verizon NW's transactions with its affiliates.

Q. Were Verizon to strictly implement the FCC's affiliate transaction standards, would such accounting necessarily prevent all improper cost and revenue shifting?

A. No. As I noted above, there are three primary ways that Verizon can utilize affiliate transactions to advantage its affiliate at the expense of regulated ratepayers: it can shift revenues, it can shift costs, or it can charge only incremental cost, without allocation of joint or common time, to its affiliate. Under the FCC's affiliate transaction standards, the third method does not appear to be foreclosed.

For those activities for which Verizon NW charges its affiliates fair market value or fully distributed cost in accordance with the affiliate transaction requirements, Verizon NW may still be bearing the full cost of joint expenses associated with this service. For example, if VOL contracts with Verizon NW for operations, installation, or maintenance ("OI&M") services based upon an hourly FDC/FMV rate, in theory, that may satisfy the FCC's accounting standards, but still allow VOL to avoid paying for joint costs borne entirely by Verizon NW. This loophole occurs because the FCC's standards are silent with respect to the allocation of a craft employee's time for a joint service call. To illustrate this possibility, consider the case when a craft employee travels to a customer premises to install both DSL and local telephone service. The travel time to and from the customer location is a joint cost, but depending on the specifics of Verizon NW's time allocation methodology, that joint cost may be allocated entirely to the local telephone service portion of the call. In this case, the benefits of the economies of scope that result from the joint call accrue entirely to VOL, in violation of the principles behind this Commission's and the FCC's affiliate transaction rules.

As I discussed above, applying the principles underlying the FCC's affiliate transaction standards, the ILEC, not its unregulated affiliate, should enure the benefits of economies related to affiliate transactions. As a result, time spent on functions that benefit both the affiliate and the regulated ILEC should be charged to the affiliate at the hourly rate determined using FCC fair market value/fully distributed cost standards. The Commission should consider requiring the Company to make further adjustment to its affiliate transaction-related charges to implement that principle.

III. IMPUTATION OF VERIZON DIRECTORIES CORPORATION ("VDC") EARNINGS

A. VDC's predecessor, the General Telephone Directory Company, developed its yellow pages directory business by virtue of its unique and longstanding position as exclusive publisher of directories for GTE-Northwest and the other GTE local telephone companies.

Q. Dr. Selwyn, why does the Commission need to examine the relationships between Verizon Directories Corp. and Verizon NW in the context of the Company's general rate case?

A. For several decades, VDC and its predecessor GTDC (hereafter referred to as the "directory affiliate") have had a longstanding business relationship with Verizon NW (and its predecessors) under which the directory affiliate has published alphabetical ("white pages") and classified ("yellow pages") directories that are distributed within Verizon NW's local exchange service territory in Washington. As I shall explain in detail later in my testimony, the sale of the yellow pages advertising included in these directories has generated very sizeable profits, which up until the year 2000 were shared between the directory affiliate and the Company by a revenue-sharing formula that was revised from time to time and subject to Commission review.

For example, in the Company's last general rate case back in 1982, Cause Nos. U-82-45 and U-82-48, the Commission determined that the available evidence on the record indicated that GTE-NW was in effect overpaying the directory affiliate in connection with the publication of the Company's directories.[39] The Commission thus adopted an affiliate transaction adjustment proposed by Staff that increased GTE-NW's retention of directory revenues from 54% to approximately 68%.[40]

Beginning in the year 2000, the Company entered into a so-called "Fee for Service" arrangement with the directory affiliate, which ended the traditional sharing of directory revenues and instead allowed the directory affiliate to retain all of the profits from yellow pages advertising. One financial effect of this change was to eliminate a revenue stream to Verizon NW that had exceeded $30-million per year on average during the 1990s, and thus had been making an important contribution to meeting the Company's intrastate revenue requirement. The loss of this revenue is implicit in the Company's test year revenue deficiency calculations, which I understand which do not include any revenues from yellow pages advertising.

In other cases involving the directory operations of US West and its predecessor Pacific Northwest Bell ("PNB"), the Commission has rectified improper transactions with the ILEC's directory affiliate by imputing part of the earnings of the directory affiliate to the regulated ILEC's Washington operations.[41]

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39. WUTC Cause Nos. U-82-45 and U-82-48, *Order* (August 18, 1983), 1983 Wash. UTC LEXIS 28, at 49-50.

40. *Id.*, 1983 Wash. UTC LEXIS 28, at 51 and 45.

41. See, e.g., *Petition of U S West Communications Inc., for an Accounting Order*, Docket No. UT-980948, *Fourteenth Supplemental Order; Order Denying Petition*, July 10, 2000 ("*Yellow Pages Imputation Accounting Order*"); *Request of US West Communications, Inc. for an Increase in its Rates and Charges*, Docket No. UT-950200, *Fifteenth Supplemental Order*,
(continued...)

In the instant case, the Commission needs to examine whether it is appropriate to apply an earnings imputation or other means as a ratemaking adjustment, to ensure that Verizon NW is being fairly compensated for the benefits that its directory affiliate VDC receives from its association with the Company's local telephone operations.

As I shall demonstrate in my testimony, contrary to the characterization by Verizon NW witness Dennis Trimble who alleges that VDC "remains wholly separate from Verizon NW (and its precursor local exchange carriers),"[42] in reality VDC's directory operations in Washington have been and still are fundamentally dependent upon the Company's regulated telephone operations in the state, so that an imputation of VDC's directory earnings to adjust Verizon NW's revenue requirement is entirely justified as an economic and policy matter.

Q. For how long has VDC and its predecessor GTDC served as the directory publisher for the Company's Washington local telephone operations?

A. This business relationship stretches back to at least 1936, when GTDC was created to assume responsibility for publishing all of the directories for the General Telephone system, which included the Company's local telephone operations in Washington.[43] GTDC and its

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41. (...continued)
April 11, 1996.

42. Direct Testimony of Dennis B. Trimble on Behalf of Verizon Northwest Inc., Exhibit No. ___ (DBT-1T) ("*Trimble (Verizon NW) Direct*"), at page 23.

43. *Trimble (Verizon NW) Direct*, at page 22; see also, Associated Telephone Company, Ltd. Memorandum Re: Telephone Directory Publishing Contract Between Associated Telephone Company, Ltd. and the General Telephone Directory Company, July 2, 1943 ("*1943 Directory*
(continued...)

successor VDC have continued to publish virtually all of the telephone directories associated with the Company's Washington local telephone operations since that time.[44]

Q. What were the historical arrangements between GTDC and the Company's predecessors that afforded GTDC the opportunity to publish yellow pages directories in Washington?

A. GTDC published yellow pages and white pages directories in Washington and elsewhere in the General Telephone system ("GTE") service territories pursuant to successive publishing agreements entered into with the Company's predecessors. Those publishing agreements were predicated upon the existence of a close working relationship between GTDC and the GTE telephone companies ("GTOCs"), that was uniquely available to GTDC as a result of its status as a GTE affiliate. Some of the key elements of their business relationship were as follows:

- GTDC would obtain an exclusive right to sell yellow pages directory advertising on behalf of the GTE telco;

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43. (...continued)
Memorandum"), at pages 11-12. A copy of the latter document is provided in my Exhibit No. ___ (LLS-3) As noted therein (page 11), GTDC's predecessor, the Tel-Ad Company, had published the telco directory for Wenatchee, Washington in 1934 as part of a feasibility test.

44. As I shall explain later in my testimony, when GTE acquired Contel, the directories associated with the former Contel exchanges in Washington continued to be published by a non-affiliated publisher, Mast Advertising & Publishing Inc., as they had been before Contel was acquired.

- GTDC would be responsible for the printing of both white and yellow pages directories; the design and appearance of the directories would reflect their association with the GTE telco;

- The GTOC would supply GTDC with the telephone subscriber name and address listings information that is basis of the white pages directories, but also essential for marketing yellow pages advertising to business customers;

- The GTOC would perform billing and collection for GTDC, with the billed amounts appearing on the advertisers' phone bills rendered by the GTOC;

- GTDC and the GTOC would share the revenues generated by GTDC, including the revenues from its yellow pages advertising, via a defined formula.

Q. Can you provide an example of an early directory publishing agreement that had these essential features?

A. Yes. Exhibit No. ___ (LLS-3) contains a collection of documents relating to GTDC's early operations, that was obtained from a California State Archives folder.[45] Pages 25-28 of that Exhibit are the 1940 directory publishing agreement between GTDC and the Associated

45. California State Archives, Folder 3725:2855; *S-390, Review of Telephone Directory Practices of the Associates Telephone Company, 1943-1945*. This folder is part of the *Public Utilities Commission Records, Part 1, 1979* Collection of the California State Archives Repository in Sacramento. Further information pertaining to the collection can be accessed via the California State Archives website, http://www.oac.cdlib.org/.

Telephone Company, another GTOC, that governed the publication of directories for that GTOC in California.[46] A review of that agreement confirms that it contains each of the elements that I have just identified. Specifically, note the following terms of that agreement:

1. "The Telephone Company grants and conveys to the Directory Company the *exclusive right* to publish, print, and sell advertising in the telephone directories of the Telephone Company under the covenants, terms, and conditions herein specified." (Para. 1, emphasis supplied)

2. "The Directory Company shall supervise the printing and publishing of telephone directories and shall pay all printing and publishing bills." (Para. 7) "The design and content of telephone directories shall be as mutually agreed upon from time to time by and between the parties." (Para. 4)

3. "The Telephone Company shall furnish the Directory Company with the alphabetical listings and classified listings, in a form as mutually agreed upon." (Para. 6) In addition, "The Telephone Company agrees to maintain a card file of all business accounts in each exchange for the use of the Directory Company." (Para. 6)

4. "Orders for Directory Advertising shall be entered into in the name of the Telephone Company. The Directory Company shall furnish the Telephone Company with billing information, in a form as agreed upon by and between the parties... " (Para. 9) "The Telephone Company is responsible and assumes all costs for the preparation and mailing of bills and the collection thereof, except for advertising which is sold on a system–wide basis." (Para. 9)

5. "The Directory Company shall receive seventy-two and one-half (72½%) of directory advertising billing applicable to each month, less one-half cent (½¢) per station per month for each company-owned and switched station in service...as full compensation for the services it is to perform hereunder."[47] (Para. 11)

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46. See *infra*, Exhibit A, Telephone Directory Publishing Contract between Associated Telephone Company Ltd. and General Telephone Directory Company, Dated August 19, 1940 ("*1940 Directory Publishing Agreement*").

47. These revenue-sharing terms may or may not have afforded a fair or reasonable division of directory revenues between GTDC and the telco, but in any event demonstrate that such revenue sharing did in fact occur.

In 1943, this agreement was superseded by another directory publishing agreement, that was very similar in most respects, but reduced the base revenue share paid to GTDC to 65% of the directory advertising billing applicable to each month.[48]

Q. Were these directory activities highly profitable during GTDC's first several years of operation?

A. Yes, they certainly appear to have been highly profitable. Table 1 presents data on the directory revenues and expenses reported by the Associated Telephone Company during each year 1937-1942, when its directories were first being published by GTDC. This data is drawn from the 1943 Directory Memorandum referenced earlier in my testimony (see footnote 43. As shown therein, net income (as a percent of total revenue) from directory publishing not only exceeded sixty-five percent (65%) of revenues in every year, but it also grew significantly, nearly doubling over those six years.

48. Telephone Directory Publishing Contract, November 1, 1943, between Associated Telephone Company Ltd. and General Telephone Directory Company ("*1943 Directory Publishing Agreement*"), at Para. 11. This contract is included in my Exhibit No. ___ (LLS-3). Note that this contract also prescribed that "[t]he design and content of telephone directories shall be determined by the Telephone Company." (Para. 4)

Table 1 Associated Telephone Company Ltd.				
Period	Directory Advertising and Sales Revenue	Directory Expense	Net Directory Income	Net Income as % of Total Directory Revenue
1937	$ 45,671.09	$ 15,238.27	$ 30,432.82	66.63%
1938	$ 52,903.12	$ 12,494.26	$ 40,408.86	76.38%
1939	$ 55,688.43	$ 15,535.07	$ 40,153.36	72.10%
1940	$ 70,349.53	$ 17,163.10	$ 53,186.43	75.60%
1941	$ 70,556.96	$ 18,038.59	$ 52,518.37	74.43%
1942	$ 74,568.96	$ 16,168.64	$ 58,400.32	78.32%
Source: 1943 Directory Memorandum (see Exhibit No. ___ (LLS-3) at page 50)				

While these figures only reflect the portion of directory revenues and expenses booked to the telco and not the entirety of the business, given that the publishing agreements granted GTDC roughly two-thirds of the directory revenues, this data suggests that GTDC also enjoyed healthy profits from that directory business.

The same data source also provides directory earnings results over the same 1937-1942 time frame for two other ILECs, which had published their directories directly. Tables 2 and 3 below present that data for the Southern California Telephone Company and the Pacific Telephone and Telegraph Company. Both of these ILECs clearly show strong profitability and sustained sales growth during those years. Over that six year period, the Southern California Telephone Company *more than tripled* its net income from directory operations, and net directory income as a percent of total revenue rose from 15% to more than 28%.

Table 2 Southern California Telephone Company				
Period	Directory Advertising and Sales Revenue	Directory Expense	Net Directory Income	Net Income as % of Total Directory Revenue
1937	$ 1,109,442.53	$ 939,205.19	$ 170,237.34	15.34%
1938	$ 1,330,913.59	$ 1,029,851.74	$ 301,061.85	22.62%
1939	$ 1,493,049.51	$ 1,109,725.13	$ 383,324.38	25.67%
1940	$ 1,656,787.77	$ 1,217,537.20	$ 438,250.57	26.45%
1941	$ 1,841,906.94	$ 1,358,295.07	$ 483,611.87	26.26%
1942	$ 1,893,729.67	$ 1,360,513.32	$ 533,216.35	28.16%
Source: 1943 Directory Memorandum (see Exhibit No. ___ (LLS-3), at page 50)				

Table 3 Pacific Telephone and Telegraph Company				
Period	Directory Advertising and Sales Revenue	Directory Expense	Net Directory Income	Net Income as % of Total Directory Revenue
1937	$ 912,340.57	$ 691,600.00	$ 220,740.57	24.20%
1938	$ 994,795.14	$ 698,000.00	$ 296,795.14	29.83%
1939	$ 1,079,601.07	$ 766,800.00	$ 312,801.07	28.97%
1940	$ 1,157,573.29	$ 832,500.00	$ 325,073.29	28.08%
1941	$ 1,220,869.38	$ 886,000.00	$ 334,869.38	27.43%
1942	$ 1,202,290.82	$ 910,900.00	$ 291,390.82	24.24%
Source: 1943 Directory Memorandum (see Exhibit No. ___ (LLS-3), at page 50)				

Accordingly, it appears that under either publishing approach, direct publication or contracting to an affiliate, ILECs' directory publishing operations earned substantial and sustained profits even more than sixty years ago.

Q. Did the directory publication arrangements that you have described between GTDC and the GTE telcos, including Verizon NW's predecessors, generally continue in similar fashion through the decades?

A. Yes, they did, up until the time of the merger of GTE with Bell Atlantic. Consider, for example, the "Master Directory Publishing Agreement" between GTDC and the GTOCs that was originally executed in January 1991 and remained in force (as subsequently amended) thereafter through December 31, 1999. (This agreement was provided in Verizon NW's Response to Public Counsel Data Request No. PC-152 c and is reproduced in my Exhibit No. ___ (LLS-4)). Similar to the 1943 Directory Publishing Agreement that I have just described, the Master Directory Publishing Agreement has the following key terms:

1. "This Agreement covers the exclusive sale of Advertising, publishing, printing and distribution of the Telephone Companies' Franchise Area directories." (Section II) "The Directory Company will ... market and promote the purchase of Advertising in the Directories; ... solicit and sell Advertising in the Directories..." (Section IV)

2. The directories will have a "standard design and content" with changes to the standard outside cover only if "agreed upon by the parties." (Section IX)

3. "The Telephone Company will timely provide the Directory Company with the necessary information required for accurately compiling the alphabetical listings sections of the Directories." (Section VII);

4. "The Telephone Company will bill and collect Franchise Advertising revenues from Customers and perform other related tasks." (Section XV)

5. "The Telephone Company shall receive the following percentage of the Franchise Revenues..." (Section XVI) – which for Washington was established at 63.09%

((Addendum A).[49]

Moreover, the agreement specifies that "[t]he Directories will be copyrighted by the Directory Company in the name of the Telephone Company" (Section XX).

Q. During the six decades that GTDC published directories on behalf of the Company and other GTOCs, did the design and appearance of the directories imply that they were the product of the GTOC, or the product of an entirely separate enterprise?

A. The design and appearance of the directories indicated that they were the product of the GTOC. First, consider the directories' covers. Exhibit No. ___ (LLS-5) contains a series of covers for the yellow pages directories published for the Everett vicinity and Snohomish County on behalf of the Company's predecessors, spanning the years 1953 to 1999. While the directory covers for other areas of Washington were not necessarily identical, the Everett region / Snohomish county directories are representative of the aspects of cover design that I am discussing.

As a review of those covers makes clear, while their appearance changed from time to time, they have for decades prominently displayed the name and logo of the GTOC and/or the GTE brand in a manner that implies that they are products of the telco entity. In addition, two more characteristics of those covers imply that it is the incumbent telephone company –

49. A subsequent Amendment signed February 25, 1993, allowed this revenue retention percentage to change after December 31, 1995, if the parties executed an amendment to do so, but no such amendment was supplied in the Company's Response to Public Counsel Data Request No. PC-152.

and decidedly not a publishing affiliate – that is responsible for the directory. First, many of the covers state that the copyrights for the directory belong to the GTE NW entity. Second, as I shall explain below, all but the most recent of those covers make no reference to any publishing affiliate, or to any other responsible party. These attributes would reinforce the impression of directory users and advertisers that the directories are "official" products of the incumbent telephone company. Following are some specific observations that can be confirmed by inspecting the covers included in my Exhibit No. ___ (LLS-5):

1. Exhibit page 2: The cover of the 1953 Everett region directory prominently displays the name and logo of the Company's predecessor ,West Coast Telephone Company ("West Coast"). The logo is flanked by "1928" and "1953" and placed above a banner proclaiming "25 Years of Service and Progress," an unambiguous reference to West Coast's provision of telephone services over that period. This directory also claims copyright for West Coast, and makes no mention of a publishing affiliate.

2. Exhibit pages 3 and 4: The covers of the 1959 and 1961 Everett region directories are similar, each sporting the West Coast logo and a West Coast copyright, and also making no reference to a publishing affiliate.

3. Exhibit page 5: The cover of the 1965 directory displays the West Coast Telephone Company name over the phrase "A Member of General Telephone and Electronics Corporation,"plus the contemporary GTE logo. No copyright is shown on the cover.

4. Exhibit page 6: The cover of the 1969 directory has similar branding, but reflects the

incumbent's name change to General Telephone Company of the Northwest. It also includes a promotion urging telephone subscribers to add an extension in their household.

5. Exhibit page 8: The 1985 directory displays two GTE logos on the cover, as well as the statement, "This directory is provided pursuant to the filed tariffs of General Telephone Company of the Northwest, Inc.," which also implies that the directory is an official product of the incumbent LEC.

6. Exhibit page 9: The 1995/96 Snohomish County directory cover displays an enormous GTE logo right in the center of the cover and the telco name (which had become "GTE Northwest") at the bottom. The cover also directs consumers to the back cover where they can find "additional GTE phonebooks." Again, there is no mention of the directory publishing affiliate so that users are left with the impression that GTE NW is the sole producer of the directory.

7. Exhibit pages 10-12: The 1996-1999 directories for Snohomish County all have similar covers, each including a prominent GTE logo, a more subtle reference to GTE Northwest, and a very small copyright mark attributed to the GTE Directories Corporation. This is the first, albeit very small, appearance of a reference to the directory publishing affiliate on the covers of these directories.

Q. Did certain content of those directories reinforce the impression that they were "official" products of the incumbent GTE telco?

A. Yes. The directories published on behalf of the Company and its predecessors traditionally have had a "customer information" section near the beginning of the book that contained instructions for use of the Company's monopoly telephone services, encompassing dialing procedures; telephone numbers to contact the Company's business offices to order/change service, make inquiries, or request repairs; information on how and where to pay telephone bills; and even (in the earliest directories) the Company's rates for long-distance calls. My Exhibit No. ___ (LLS-6) provides four representative examples of these customer information pages, from the Company's 1961, 1974, 1985/86, and 1999 Everett/Snohomish County directories.

Once again, while the precise content and organization of these pages has changed over time, they have consistently helped to solidify users' impressions that the book they are using is that of the incumbent telephone company. Perhaps the most notable of these four examples is the 1999 Snohomish County directory's "Customer Info Guide." Because that Guide in full spans 48 pages, to save space my Exhibit includes the first 26 pages only, and I briefly describe the remainder.

1. Exhibit pages 21-49: Out of the first 26 pages of the Customer Info Guide, 24 have a prominent display of the GTE logo, and address "How to reach GTE," "Doing Business with GTE," "Easy-to-use Products and Services from GTE," and "Special Services Available from GTE." The exception is two pages that address how to reach other local telephone services providers. Beyond those 26 pages, there is a fifteen-page middle section without GTE branding that provides "General Information" on dialing, area

codes, state ZIP codes, etc. That is followed by two pages labeled "The World of GTE Directories" that explains how to buy advertising in the white and yellow pages.

Taken as a whole, the Customer Info Guide reinforces the directories' linkage to the Company as the incumbent telephone company, and thus its status as an "official" product of the Company.

Q. Have these kinds of linkages been maintained in VDC's directories published in association with the Company on up to the present day?

A. Yes, they have. Although the appearance of the directory covers have continued to change from time to time, the combination of the directory covers and information pages section continue to reinforce users' and advertisers' impressions that the directories are "official" products of the Company, rather than an independent, unaffiliated publisher's product. In its most recently-published Washington directories, VDC employs a fairly standardized cover design and Customer Info Guide section. With the exception of the cover artwork, the essential features of the cover, as well as the Customer Info Guide, have not changed materially since 2001.

My Exhibit No. ___ (LLS-7) provides the current version of Customer Info Guide contained in the Snohomish County directory (marked as "use through March 2005") as an illustration. As one can see, the directory cover has a prominent Verizon logo at the top, along with the SuperPages trademark. The fine print along the bottom margin includes both "Verizon Northwest Inc." and a copyright to Verizon Directories Corp. The Customer Info

Guide section has been streamlined to 27 pages (which is nevertheless sizeable, esp. given its placement near the front of the directory), but still contains subsections similar to those found in the 1999 directory, on "How to reach Verizon," "Doing Business with Verizon," and "The World of Verizon Directories." Each of those sections continues to exhibit the Verizon logo.

Neither the Verizon or the SuperPages trademarks are "owned" by the individual Verizon operating companies, such as Verizon NW. While Verizon NW seems to ascribe some importance to this point, there can be no question but that the *value* of the marks derives from their extensive use by the individual Verizon units, including Verizon NW. The matter of which specific Verizon entity or entities "own" the marks is thus a matter of form over substance.

Q. Is there additional evidence from VDC's own operational decisions that it recognizes the value of its continued linkages to the local telephone operations of Verizon-NW and the other Verizon incumbent LECs?

A. Yes. VDC continues to rely upon Verizon-NW to perform billing and collection services for its local yellow pages advertising sold in Washington (as well as the rest of Verizon-NW's service territory).[50] Because both VDC and Verizon-NW use the common "Verizon" brand, having the charges for directory advertising appear on the Company's bills further cements users' impressions that the yellow pages are an integral part of Verizon-NW's operations as the longstanding incumbent telephone service provider. This powerful linkage

50. *Verizon-NW Response to Public Counsel Data Request No. 173.*

is simply unavailable to any unaffiliated directory publisher, even if they purchased billing and collection services from Verizon-NW at the same rates and terms. Thus, it is not surprising to learn that "Verizon NW does not have direct relationships with any non-affiliated customers to provide billing and collection services to telephone directories publishing companies in Washington or any other state."[51]

Furthermore, in response to certain data requests from Public Counsel, the Company has provided information concerning the scope of VDC's directory publishing activities nationwide. Nationwide, VDC publishes 1,063 printed directories, with a total circulation of over 64-million. Of that total circulation, nearly 95% of the directories are distributed primarily within the boundaries of Verizon wireline telephone exchange service areas, with only about 5% distributed outside of those boundaries.[52] Moreover, some 88% of VDC's directories are published on a co-bound basis, i.e. they include white pages listings as well as yellow pages listings and advertising. When one excludes the 54 directories that VDC publishes on a white pages-only basis, then the co-binding figure rises to 94.5%, i.e. only 5.5% of VDC's directories containing yellow pages advertising are published without any accompanying white pages listings.[53] This demonstrates that in the vast majority of cases, VDC has been limiting its entry into yellow pages markets where it can leverage the dominance of its affiliated ILEC, and use co-binding with the ILEC's white pages to

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51. *Id.*

52. Total in-boundary distribution is 60,513,578; total out-of-boundary distribution is 3,494,333; thus, on percentage basis, total in-boundary distribution is 60.513-M ÷ (60.513-M + 3.494-M) = 94.5%. (Source: *Verizon Response to Public Counsel Data Request No. 252*).

53. That is, 933 (co-bound) ÷ (933 + 54 (yellow pages only)) = 94.5%. *Id.*

reinforce users' impressions that they are getting the "genuine" ILEC directory. In fact, *all* of directories that VDC produces in Washington are published on a co-bound basis.

Q. At page 22 of his prefiled Direct Testimony,[54] Mr. Doane has pointed to Verizon's attempts in 2002-2003 to expand its directory operations into markets where it is not the ILEC as evidence that VDC is similarly vulnerable from competitive entry in the areas in which Verizon is the incumbent LEC. Do you agree with that conclusion?

A. No. The next section of my testimony will explain the economic basis for the continued dominance of ILECs' directory publishing businesses within their franchise service territory. However, the Commission should take notice that the same yellow pages market research report that Mr. Doane cites in support of his opinion expresses caution about Verizon's out-of-franchise expansion efforts:

> The industry will take a wait-and-see attitude on Verizon's expansion market strategy. While it will add revenues in the next few years, history is against Verizon's strategy. Other telcos have tried and failed, and Verizon's success will hinge upon how well it utilizes the knowledge of what felled its brethren in similar past endeavors.[55]

Q. At page 23 of his Direct Testimony, Mr. Trimble argues that "it strains credulity to allege that the ratepayers of Verizon NW ever subsidized the development or operation of VDC," because "at no time have the assets or the advertising operating expenses of the directory business been included on Verizon NW's books nor has Verizon NW had

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54. Direct Testimony of Michael J. Doane on Behalf of Verizon Northwest Inc., Exhibit No.(MJD-1T) ("*Doane (Verizon NW) Direct*").

55. Simba Information Inc., *Yellow Pages Market Forecast 2003* (2003), ("*Yellow Pages Forecast 2003*"), at 51-52. (Source: Doane Workpapers, Tab 7.)

any managerial control over VDC." How do you respond?

A. Mr. Trimble's argument ignores fundamental marketplace realities. The long-standing arrangements that I have just described clearly demonstrate that GTDC's directory business was from the outset heavily dependent upon GTDC's relationships with the GTOCs, and that it was not a stand-alone business that could have been conducted absent those relationships. In essence, GTDC's operation represented an *outsourcing* of the GTOCs' directory publishing function, rather than pursuit of an entirely separate, unregulated business activity, as Mr. Trimble attempts to portray it. GTDC's primary line of business was to sell yellow pages advertising and publish directories *on behalf of the GTOCs*; it obtained the subscriber listing data necessary to do this *from the GTOCs*; and the GTOCs served as the billing and collection agents for GTDC. From the standpoint of a GTOC customer or a business advertising in GTDC's yellow pages, any corporate distinction between GTDC and the GTOC was practically invisible and essentially irrelevant: there was only the franchise monopoly "phone company" providing telephone service *and* its directories.

As I shall explain in the next section of my testimony, it was this unique market position afforded to GTDC, relative to potential competitors in the yellow pages business, combined with certain fundamental economic characteristics of the yellow pages market, that allowed GTDC to achieve the dominant position in the market that its successor VDC continues to benefit from today.

B. VDC's dominance in the Washington yellow pages markets it serves is a direct result of the "first mover" advantage that its predecessor GTDC gained from its historical status as

exclusive publisher of GTE-Northwest's directories.

Q. Dr. Selwyn, you have just explained that GTDC's participation in the yellow pages business was focused for decades upon publishing directories on behalf of the GTOCs, including Verizon NW's predecessor in Washington, GTE-Northwest. Does the yellow pages business have any particular economic characteristics that affect the ability of alternative directory suppliers to attempt to compete against incumbent suppliers such as GTDC?

A. Yes, it does. As I explained in my testimony before the Commission in its investigation of the sale of Qwest Corporation's directory affiliate, Dex,[56] economists consider "network externalities" to exist where the demand exhibited by individual consumers for a given product or service is heavily influenced by the actions of other consumers with respect to the product. For example, I am more likely to place an item for sale on eBay than on other Internet auction sites because eBay attracts more visitors than any other Internet auction site. And the reason that eBay attracts more visitors is because eBay carries more auctions. Significantly, eBay's head start was just a few years earlier than other Internet auction sites, yet no rival has ever been able to penetrate its formidable market dominance. Even Amazon.com, which itself enjoys considerable market presence as the preeminent Internet "store" and which several years ago also started an Internet auction site, has nevertheless had very little impact upon eBay's dominance of the Internet auction business.

56. WUTC Docket No. UT-021120, Direct Testimony of Lee L. Selwyn on Behalf of WUTC Staff, March 18, 2003 (Exhibit 311T, LLS-1T) ("*Selwyn Dex Testimony*"), at pages 85-87.

The yellow pages directory advertising business is heavily impacted by these same types of network externalities. The reason for this phenomenon can best be explained by thinking of services like eBay, yellow pages directories, classified advertising sections of newspapers, and the like, as each performing a "switching" or an "exchange" function, bringing advertisers together with buyers and transferring information from the former to the latter. The demand exhibited by individual advertisers and consumers for a particular yellow pages directory, like that for many other products and services that perform switching or exchange functions, is heavily influenced by the actions of other advertisers and consumers with respect to the product.

In economic theory, such demand is said to be influenced by "externalities;" that is, one's demand for access to the "information exchange" function supported by a given yellow pages product is heavily influenced by the aggregate number of *other* advertisers and users who participate in the exchange. Advertisers are more willing to advertise in, and pay higher rates for, directories with large, perhaps ubiquitous circulation; consumers are more likely to select the directory that has the largest compilation of listings and advertisements. No competing directory publication comes even close to the level of user acceptance and penetration that can be found in the incumbent LECs' directory books. Moreover, each time a business decides to include its listing in the directory, it increases the value of the directory to all consumers and makes it all the less likely that consumers will elect to use a competing book. Indeed, ILECs are constantly promoting precisely this characteristic of their yellow pages directories.

Q. How did this characteristic of directories affect GTDC's position in the yellow pages

industry?

A. As I have described earlier in my testimony, GTDC entered the yellow pages market in a privileged position, as the exclusive publisher of yellow and white pages directories for the GTOCs, including Verizon NW's predecessors in Washington. Because of its early entry into the market, and the continuation of that exclusive publishing relationship over the following decades, GTDC gained what economists refer to as a "first mover" advantage in the market. The "first mover" advantage refers to the phenomenon in many markets that the first significant entrant into the market can gain a potentially insurmountable competitive advantage over later rivals by virtue of its ability to establish customer relationships, build goodwill and gain market share ahead of anyone else, all of which can discourage potential rivals from even contesting the market. In the yellow pages business, the "first mover" advantage is amplified by the network externalities that I have described, that greatly limit the prospects for more than one directory publisher from acquiring a significant share of the market.

Simply put, yellow pages markets tend to support only a single primary directory at a time. Thus, when the incumbent telephone company, which is a franchise monopoly in its own right, has developed its presence in the yellow pages market first (whether directly, or through an unregulated affiliate, as was the case with GTDC), then it will inevitably come to dominate that market – notwithstanding the relative skill of its management or sales team, the quality of its customer service, or its performance in other aspects of its operation relative to potential alternative suppliers. This is precisely the situation in which GTDC developed its yellow pages business in Washington, and that VDC inherited when it succeeded GTDC in the provision of the Company's directories.

Q. Is this the first time the Commission has confronted this situation relative to an ILEC's directory operations?

A. No, certainly not. Over the years, the Commission has examined the directory operations of Qwest and its predecessors US West and Pacific Northwest Bell ("PNB"), and found virtually the same situation, despite the fact that PNB originally published directories directly rather than through an affiliate like GTDC. In 1997, the Washington Supreme Court penned a particularly succinct statement summarizing the Commission's findings relative to US West and its directory operations (which by that time had been spun off into an affiliate known as US West Direct). In the Court's order reviewing US West's claims on appeal of the Commission's rate case order that required the continued imputation of yellow pages revenues, the Washington Supreme Court observed:

> The record shows that U S West did not develop this lucrative business by its initiative, skill, investment or risk-taking in a competitive market. Rather it did so because it was the sole provider of local telephone service, and as such owned the underlying customer databases and had established business relationships with virtually all of the potential advertisers in the yellow pages. Therefore, the Commission reasonably concluded that the yellow pages business is quite unlike businesses of other unregulated companies which were developed in, or derive their profitability from, the competitive marketplace. The record indicates that the billing and collection service provided to U.S. West Direct by U.S. West is a valuable business advantage to U.S. West Direct. The record also indicates that in contrast with potential publishing competitors, U.S. West Direct's publishing enjoys a unique and direct benefit by being associated with the Company's regulated telecommunications

services.[57]

As I have just demonstrated, these findings apply with equal force to the development of GTDC's directory business, including its Washington directory operations.

Q. Verizon NW's witness Michael Doane has suggested in his Direct Testimony (pages 14-27) that VDC's directory advertising sales in Washington, as well as ILEC directory activities elsewhere in the country, are facing increasing competition from independent directory publishers, making it is less appropriate to impute directory profits to Verizon NW. Is his assessment valid?

A. No. As a threshold matter, the degree of competition faced by VDC's directory operations in the state is essentially irrelevant to the basic question of whether those operations obtain significant uncompensated benefits from Verizon NW. Even if the Washington directory markets were fully competitive and price-constraining (which they are not, as I show below), that would have no impact upon the facts that I have set forth concerning the dependence of VDC's directory business upon the benefits it derives from its historical and ongoing economic ties to Verizon NW's local telephone business. Indeed, the Commission has previously reached this conclusion in the context of considering the same argument as advanced by US West in its rate case Docket No. UT-950200. As the Commission stated in its final order in that proceeding:

> 14. USWC contends that MRG [US West's Marketing Resources Group] does not have a monopoly and its return isn't inconsistent with competitive returns in the advertising

57. *US West v. WUTC*, at **36-37.

> business. It argues that there is no evidence that USWC's association with USWD leads people to advertise in the directory. ...
>
> The Commission rejects this argument. MRG's possession or lack of a monopoly in the directory market does not appear critical to the imputation decision. The Commission finds that USWC's association with MRG is a benefit to the directory, based on the testimony of Staff and Public Counsel/TRACER witnesses and its mention as a benefit by more than one "public" witness.[58]

Second, while I agree with Mr. Doane that there has been an increase in independent directory publishing activity in recent years, Mr. Doane is overstating the degree to which that activity has adversely impacted VDC and the other regional Bell operating company ("RBOC") directory operations. One of the market research reports that Mr. Doane relies upon notes that "despite a challenging year [2002], the U.S. Yellow Pages Industry remains enormously profitable"[59] and characterizes the major publishers' directory assets as "a cash cow."[60] Another one of Mr. Doane's source documents, the Simba Information Inc. *Yellow Pages Market Forecast* for 2004, states that "[i]nvestors looking for stable returns have continued to stash their cash in the yellow pages industry..." and notes that, despite having "continued their struggle against the economy and competition in 2003," the four RBOCs "combine to control more than BEGIN VERIZON-NW CONFIDENTIAL << >> END VERIZON-NW CONFIDENTIAL of the country's yellow pages market."[61] Simba also

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58. WUTC Docket No. UT-950200, *Fifteenth Supplemental Order*, April 11, 1996, at page **88.

59. Charles Laughlin and Neal Polachek, The Kelsey Group, *2002 U.S. Market Review and Outlook for 2003* (Dec. 23, 2002), at Executive Summary. This report was provided in Mr. Doane's Workpapers, Tab 4.

60. *Id.* at page 4.

61. Simba Information Inc., *Yellow Pages Market Forecast 2004* (2004), at pages 5 and 37.

(continued...)

reports that non-RBOC, independent ILECs accounted for another BEGIN VERIZON-NW CONFIDENTIAL << >> END VERIZON-NW CONFIDENTIAL of domestic yellow pages revenues in 2003, so that the independent publishers' overall revenue share was under BEGIN VERIZON-NW CONFIDENTIAL << >> END VERIZON-NW CONFIDENTIAL.[62]

Q. Mr. Doane observes that "several incumbent telcos other than Verizon have decided to exit the industry altogether" and concludes that those "sales would make little sense were it the case that incumbent local exchange carriers were extracting monopoly rents on directory advertising." Do you agree?

A. No. Mr. Doane neglects to point out that the most prominent of these sales were motivated by cash flow and liquidity problems of the associated ILEC or parent corporation, rather than a desire to exit the directory business. Most notably, as this Commission is quite aware, Qwest sold its Dex directory business at a time when the parent company, Qwest Communications Inc. ("QCI"), faced a heavy debt load and a serious and deteriorating financial position. Two witnesses from Qwest Corporation (the Qwest operating company) testified before the Commission that QCI decided to sell Dex in 2002 in order to raise sufficient cash in time to meet heavy debt payments, at a time when QCI faced falling

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61. (...continued)
(Source: Doane Workpapers, Tab 8.)

62. *Id.*, at pages 38 (Table 2.8), 51, and 53 (Table 2.11). The 2003 revenue data presented in those tables results in the following revenue shares by sector: BEGIN VERIZON-NW CONFIDENTIAL <<

>> END VERIZON-NW CONFIDENTIAL

revenues and earnings, and a debt load of over $25-billion;[63] and that after considering various options, by April 2002, QCI had no viable option other than the sale of Dex to avoid default on its debt and potential bankruptcy.[64] While not facing the same degree of financial distress as Qwest, Sprint Corp. also offered its directory unit, Sprint Publishing and Advertising, for sale to R.H. Donnelley in early 2002 "in a move to shore up the company's liquidity."[65]

The sale terms for both transactions confirm that the buyers were keenly aware that the going concern value of the directory business they were acquiring was intimately tied to the incumbent telco's operations. In each case, the sale terms included the grant of exclusive directory publishing rights to the buyer for fifty years.[66] In the Dex sale case, the buyer required a non-compete agreement by the ILEC under which it would refrain from re-entering the directory publishing business for forty years.[67] Indeed, as observed at pages 27-28 of the Opening Brief of Commission Staff (Non-Confidential Version) in the Dex sale case, "[t]hese first two agreements were so significant, in fact, that the Publishing Agreement provided, in section 6.4(a) (Bates No. 000729):

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63. WUTC Docket No. UT-021120, Direct Testimony of Peter C. Cummings on behalf of Qwest, January 17, 2003 (Exhibit 172, PCC-1T), at pages 8-9.

64. WUTC Docket No. UT-021120, Direct Testimony of Brian G. Johnson on behalf of Qwest, January 17, 2003 (adopted by Peter C. Cummings, Exhibit 171, BGJ -1T), at pages 4-6.

65. Simba Information Inc., *Yellow Pages Market Forecast 2003*, at pages 43-44.

66. RH Donnelley Inc., Third Quarter 10-Q Report, November 22, 2002, at Section 10; WUTC Docket No. UT-021120, Opening Brief of Commission Staff (Non-Confidential Version), July 3, 2003, at page 27.

67. *Id.*, at page 27 (referring to the "the 40-year Noncompetition Agreement").

> Publisher would not have entered into the LLC Purchase Agreement [Dexter] and the LLC II Purchase Agreement [Rodney], if QC had not simultaneously agreed to be bound by this Agreement and the Non-Competition Agreement and that QC's performance in this Agreement and the Non-Competition Agreement form a significant part of the benefit that Publisher intends to realize in entering into the LLC Purchase Agreement and the LLC II Purchase Agreement."

In addition, the Dex and Sprint directory sales transactions each included a Trademark License Agreement that granted the buyer a license to use certain key trademarks – i.e., the "Qwest Dex" name and several Sprint logos and trademarks – in connection with their publication and marketing of directories in the existing market territory.[68]

Q. Are you aware of any additional evidence that suggests Verizon itself recognizes the value of VDC's directory operations is closely tied to VDC's ongoing relationship to the Verizon operating companies?

A. Yes. In Verizon NW's Response to Public Counsel Data Request No. 258, Confidential Attachment PC-258 the Company provided a Verizon Information Services document dated February 2002. I have provided a copy of this document in my Confidential Exhibit No. ___ (LLS-9C). This document, BEGIN VERIZON-NW CONFIDENTIAL <<

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68. See WUTC Docket No. UT-021120, *Tenth Supplemental Order*, August 31, 2003, at page 34; and Sprint Corporation, Form 8K, September 27, 2002, Exhibit 1 - Stock Purchase Agreement, at page 11.

>> END VERIZON-NW CONFIDENTIAL

Q. Does the merger agreement for Verizon's sale of its local telephone and directory operations in Hawaii on a combined basis also confirm that the value of VDC's directory operations is closely tied to ongoing relationship to the Verizon operating companies?

A. Yes. One of the documents that Verizon NW has provided in response to WUTC Staff Data Request No. 277 and the Commission's Order No. 12 ("Order Granting Interlocutory Review and Compelling Production") is the sale transaction document titled "Agreement of Merger Among GTE Corporation / Verizon HoldCo LLC and Paradise HoldCo, Inc. / Paradise Mergersub, Inc.," dated May 21, 2004. In that agreement, BEGIN VERIZON NW CONFIDENTIAL <<

>> END VERIZON NW CONFIDENTIAL This term of the Hawaii sale transaction document thus provides additional evidence that the value of VDC's directory operations is closely tied to its ongoing relationship to the Verizon operating companies. An excerpt of this document that encompasses this term is provided in my Exhibit No. ___ (LLS-17C).

Q. Has Verizon NW presented data on VDC's market shares in the printed directory advertising markets that VDC serves in Washington?

A. No. In response to a Public Counsel data request seeking such information, the Company simply referred to Mr. Doane's testimony concerning VDC's share of revenues in the local advertising market nationwide.[69]

Q. Has actual and/or potential entry of other directory publishers into Washington markets constrained VDC's Washington earnings to non-monopoly levels?

A. No. In response to Public Counsel's Data Request No. PC-220, the Company has filed income statements for VDC's Washington operations for years 2002 and 2003, based upon an accounting separations or "carve-out" methodology that Verizon had followed when presenting its directory operations in Hawaii to prospective buyers (as part of its sale of its incumbent local telephone operation in Hawaii). Those income statements show gross margins of BEGIN VERIZON NW CONFIDENTIAL <<

>> END VERIZON NW CONFIDENTIAL.[70] When additional sales costs and general and administrative overheads are allocated to Washington in proportional to its share of VDC's domestic revenues, the resulting operating margins remain at an impressive BEGIN VERIZON NW

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69. *Verizon NW Response to Public Counsel Data Request No. 249*.

70. *Verizon NW Response to Public Counsel Data Request No. 220, Confidential Attachment 220*. This document is reproduced in my Confidential Exhibit No. ___ (LLS-13C).

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>> END VERIZON NW CONFIDENTIAL.[71] These high margins are not consistent with Mr. Doane's untested presumption that pricing pressure is constraining VDC's Washington earnings to competitive levels.

Q. Do you have any further evidence that demonstrates VDC's dominance in the Washington yellow pages markets that it serves?

A. Yes. I have examined VDC's yellow pages directory for Snohomish County and compared it to the Dex directory for the same area. Snohomish County arguably represents the most competitive area for directories in the state, as VDC competes against a former ILEC-affiliated directory that has published directories in Washington for many years. Even under these conditions, my analysis demonstrates that VDC continues to attract far more advertisers than does Dex.

71. *Id.* (percentages equal the reported Operating Income divided by Net Revenue for each year).

Table 4

Comparison of VDC vs. Dex Directories for Snohomish County

		VDC	Dex
Page count of white pages section (business + residential)	Unadjusted	706	941
	4-Column Equivalent[1]	706	705.75
Page count (Dex) and calculation (VDC) of pages in business white pages	Unadjusted	145.6	194
	4-Column Equivalent[1]	145.6	145.5
Page count of yellow pages section	Unadjusted	1083	514
	4-Column Equivalent[1]	1083	385.5
Page count of yellow pages section, net of basic business listings		937.4	320
Ratio of VDC advertising content to Dex		2.93	

[1] Adjusted page counts account for the difference in page formats – VDC uses a 4-column format, while Dex uses a 3-column format.

Source: 2004 VDC Superpages and Dex Snohomish County directories.

Table 4 presents the results of my analysis. I began my analysis by comparing the business and residential white pages section of each directory. VDC groups these sections together, while Dex uses separate sections for residential and business white pages listings. In order to make an apples-to-apples comparison, I have adjusted the Dex page counts by multiplying them by a factor of 0.75, to reflect the fact that VDC publishes its directory in a four column format, while Dex only prints three columns on a page (*i.e.*, their text capacity per page are in an approximate ratio of 4:3). Using the format-adjusted page counts, it is apparent that both VDC and Dex maintain approximately the same volume of business and residential listings, which makes sense given that both directories cover the greater Snohomish County area.

Using the Dex breakdown of business and residential white pages listings, I calculated an estimate of VDC's page count for business listings. These business white pages reflect comprehensive listings of all businesses in the area. Next, I compared the page counts of the two directories' yellow pages listing sections, which include the same comprehensive list of businesses as well as additional advertising content. (Some advertisers add bold text or highlighting to their listing, while others take out separate advertisements that accompany the regular business listing.) By subtracting out the actual count of white pages business listings from the total count of pages in the yellow pages section, I arrived at estimated page counts for the remaining yellow pages directly attributable to advertising, over and above any enhancements made to the basic business listings. On that basis, I estimate that VDC's Snohomish directory contains approximately 937 pages of such advertising, compared to approximately 320 pages contained in the Dex directory. Thus, I conclude that VDC has nearly triple the advertising content that Dex has in its directory. My Exhibit No. ___ (LLS-8) provides excerpted pages from the two directories that supports my analysis.

Thus, even in Snohomish County, the area where VDC faces the most direct competition from a former ILEC-affiliated directory publishing company, VDC is still able maintain an impressive command in the directory advertising market. From the same group of business listings, VDC is able to generate nearly three times the advertising content that Dex does. This is a clear indication that VDC remains the dominant provider of published directories in its Washington distribution territory.

Q. How do VDC's rates for directory advertising in the Snohomish County directory compare to the rates charged by Dex?

A. A comparison of directory advertising rates charged by VDC versus Dex in the Snohomish County market confirms that VDC is able to capitalize on its incumbency to charge substantial premiums, compared to the rates its competitors are able to charge. In Verizon NW's Response to WUTC Staff Data Request No. 445, the Company has provided year 2004 advertising rates data for VDC and other directory publishers active in Washington (see Confidential Attachment 445). This data shows that in Snohomish County, where VDC is arguably confronting the greatest competition, VDC's rates for display ads are priced BEGIN VERIZON NW CONFIDENTIAL <<
>> END VERIZON NW CONFIDENTIAL

For example, in Snohomish, Dex charges BEGIN VERIZON NW CONFIDENTIAL << >> END VERIZON NW CONFIDENTIAL for a full page display ad. Verizon charges nearly BEGIN VERIZON NW CONFIDENTIAL << >> END VERIZON NW CONFIDENTIAL , for the same ad space. For a 3HS (1 column, 1.5 inch) ad, Dex charges BEGIN VERIZON NW CONFIDENTIAL << >> END VERIZON NW CONFIDENTIAL while Verizon charges BEGIN VERIZON NW CONFIDENTIAL << >> END VERIZON NW CONFIDENTIAL .

The difference is even more striking for DQC (two columns, one quarter page) ads. Dex charges BEGIN VERIZON NW CONFIDENTIAL << >> END VERIZON NW CONFIDENTIAL, while Verizon charges BEGIN VERIZON NW CONFIDENTIAL

<< >> END VERIZON NW CONFIDENTIAL. Moreover, rates for Dex's 3HS and DQC ads should be adjusted by a factor of .75, to reflect the fact that its Greater Snohomish directory is published in a three-column format, whereas VDC's Snohomish County directory is published in a four-column format. When that adjustment factor is applied, the rates for 3HS and DQC become BEGIN VERIZON NW CONFIDENTIAL << >> END VERIZON NW CONFIDENTIAL respectively, showing that VDC is charging BEGIN VERIZON NW CONFIDENTIAL << >> END VERIZON NW CONFIDENTIAL and BEGIN VERIZON NW CONFIDENTIAL << >> END VERIZON NW CONFIDENTIAL respectively, more than its competitors for these display ads. The YPIMA rate information that I relied upon for this analysis is provided in my Confidential Exhibit No. ___ (LLS-9C).

C. The going-concern value of VDC's Washington directory publishing operations is largely due to its continued use of Verizon NW intangible assets, including the right to publish directories on the Company's behalf.

Q. At pages 21-22 of his Direct Testimony, Mr. Trimble attempts to distinguish the directory operations of the VDC/GTDC affiliate from those of US West, because in contrast to the US West case, no directory advertising-related expenses have ever appeared in Verizon NW's books and its ratepayers never bore those expenses. Is Mr. Trimble correct that this distinction means that it would be inappropriate for the Commission to impute the directory affiliate's yellow pages earnings to Verizon NW, as the Commission did in certain US West rate cases?

A. No, not at all. Mr. Trimble is placing form above substance. Since the structure of a corporation and its various affiliates is a matter that lies entirely within the corporation's own control, the Commission should not be influenced by such self-serving decisions on the part of Verizon NW and/or its parent or affiliates. Moreover, even if certain *tangible* assets of the Washington directory advertising business have been carried on the books of VDC/GTDC rather than on the Company's books, such tangible directory business assets are but a small fraction of the *going-concern value* of that line of business. In contrast, the *intangible* assets of the directory advertising business that are largely responsible for its value today have always resided with the Company's (and its predecessor's) regulated Washington operations, because of the longstanding outsourcing relationship to the monopoly telephone company that I have just described.

Q. How are "intangible"assets distinguished from "tangible" assets?

A. As I explained in my March 2003 testimony in the Dex case,[72] *tangible* and *intangible* assets — together with cash and other *financial* assets – by definition, collectively constitute the "going concern" value of an enterprise. Tangible assets are physical assets, such as plant and equipment, land and buildings, that are used by the company in the course of conducting its business.

In the case of VDC, the book value of the tangible assets for its domestic operations nationwide amounts to approximately BEGIN VERIZON NW CONFIDENTIAL << >>[73] END VERIZON NW CONFIDENTIAL The Company has not quantified the tangible assets associated with its Washington directory publishing activities, but has estimated the Washington share of VDC's total domestic assets by applying a general revenue-based allocation factor. Applying the same allocator to VDC's tangible assets results in an estimate of the book value of the tangible assets of VDC's Washington operations of approximately BEGIN VERIZON NW CONFIDENTIAL << >>[74] END VERIZON NW CONFIDENTIAL

Intangible assets are those other elements of a business enterprise that enable it to produce

72. *Selwyn Dex Testimony*, at page 72.

73. *Verizon NW Response to Public Counsel Data Request No. 220, Confidential Attachment 220*, at tab "WA Bal Sheet 12-03." This amount is VDC's Property, Plant and Equipment (account 21100), net of Accumulated Depreciation (account 21500), for its nationwide domestic operations for the year ending 12/31/03.

74. *Id.*, at tab "WA Bal Sheet 12-03."

revenues and profits, assets that exist in addition to the firm's financial and tangible assets.[75] Intangible assets include, *inter alia*, the firm's embedded customer base, accumulated customer loyalty, first mover advantages, brand name recognition, trademarks and rights thereto, patents, trade secrets, customer lists, databases, know-how, licenses, an experienced workforce, and the like.

Q. Can the economic value of particular intangible assets of the kinds that you have mentioned be separately identified and quantified?

A. Yes, at least for certain types of intangibles. The best way to think about intangible value is in terms of separability. If a certain asset can be separated from a business and sold on a stand-alone basis, that intangible qualifies as an either an identifiable intangible or "franchise value" and therefore is separate from "goodwill." There are several sources of separability, depending upon the specific asset in question.

We can look for specific guidance in this area to the Financial Accounting Standards Board ("FASB") as well as to the US Internal Revenue Service ("IRS"), both of which have promulgated standards and regulations pertaining to the treatment of intangible assets.[76]

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75. The Intangibles Research Center, Vincent C. Ross Institute of Accounting Research, New York University Stern School. Available at: http://www.stern.nyu.edu/ross/ProjectInt/.

76. Financial Accounting Standards Board, "*Statement of Financial Accounting Standards No 141 and 142*" ("*FASB 141*") June 2001; IRS Publication 535, "Business Expenses" 2003 Version, available at: http://www.irs.gov/pub/irs-pdf/p535.pdf (Accessed November 18, 2004). ("*IRS Publication 535*").

First, as the FASB explains, an "identifiable intangible asset" can arise from a legal right.[77] Trademarks, patents, licenses, and certain broadcasting and mineral rights are all common examples of assignable, separable, legal rights to intangible assets. An owner of these assets can either leverage the asset itself or sell the asset based upon the market valuation of the future economic benefit associated with the use of the asset to generate future revenues. For example, if a research pharmaceutical firm owned a patent on a new drug, the legal rights to that drug afford the firm several options. First, the company could utilize the patent itself and begin manufacturing the drug, thus realizing over time the patent's earning potential. Second, the company could sell all rights in the patent to a manufacturer, which would pay a price for the patent based upon the future earnings that it expects to realize from the sale of patented drug. Third, the company may license the patent to several manufacturers, each with the right to manufacture the drug, but retain ownership of the patent, with the price of such licenses also being driven by the potential earnings that each licensee can expect to generate therefrom. Conversely, a firm might license a patent, trademark or other intangible asset from its owner on terms that are either not (or no longer) available to other potential rivals and that enable it to generate profits over time. The possession of such rights to intangibles owned by others is itself an intangible asset that confers value upon an enterprise.

Significantly, separable intangible assets do not necessarily have to stand alone in order to be considered separable for valuation purposes. As the FASB notes, "an intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a

77. *FASB 141*, at 27-28.

related contract, asset, or liability."[78] Take the drug manufacturing example from above. Eli Lilly owns both the trademark and the right to manufacture "Prozac," the well-known anti-depression medication. By virtue of its legal rights, Eli Lilly can license to alternative manufacturers either the right to use the "Prozac" trademark, or the right to manufacture the patented formula for Prozac (released as a generic drug under a different name). In either case, the rights licensed would be valuable. Alternatively, Eli Lilly would be able to assign both the "Prozac" trademark and the patent to a buyer, while ceasing its own Prozac manufacturing activities, and thereby separate from itself its entire market share related to the sale of "Prozac." Such an assignment would effectively separate the entire value of the drug from Eli Lilly to the buyer without entailing the sale of the Lilly business itself, and represent what I have called the "franchise value" of the drug called Prozac, and would thus constitute additional value on top of the trademark or patent value.

These separable assets are clearly different from an intangible such as "satisfied customers." A company has no reliable or practical means to assign a customer's positive relationship with the company to a third party except through the sale of the entire enterprise. Similarly, where the additional value of a property exists because the property is an integral part of an established business, the relationship cannot be separated from the business as a whole. The value of non-separable intangibles is the goodwill and going concern value.

Q. Is this distinction between identifiable intangibles and goodwill a common one?

A. Yes. Both the IRS and FASB statement No. 141 require, for the purposes of amortization

78. *Id.,* at 12.

and depreciation, that a company separately account for identifiable intangible assets and goodwill. I previously explained some of the requirements applied by the FASB. The IRS defines a lengthy set of intangibles including, *inter alia*, Goodwill, Going concern value, computer software, patents, copyrights, a covenant not to compete entered into in connection with the acquisition of an interest in a trade or business, a franchise, trademark, or trade name.[79]

Q. What identifiable intangibles has the Company and its predecessors had that are responsible for the going-concern value of the Washington directory operation, historically and on up to the present day?

A. The most important identifiable intangible is the Company's ability to confer an exclusive right to develop and publish directories, including the sale of yellow pages advertising, on its behalf. As I have explained earlier in my testimony, this was an explicit term in earlier publishing agreements executed by the Company's predecessor GTE-Northwest and GTDC, as well as in similar publishing agreements entered into by GTDC dating back to the 1940s. Because this right to publish has been essential to VDC/GTDC's ability to sell yellow pages advertising at the high margins that came with "official" directory status, those agreements prescribed that a substantial share of the revenues generated by GTDC's directory business was retained by the GTOCs, including the Company's predecessors.

In addition to this right to be the "official" publisher of the Companies' directories, there are other identifiable intangibles that historically have contributed great value to the unregulated

79. *IRS Publication 535*, at 35.

affiliate's Washington directory operations. As I have discussed earlier in my testimony (pages 43-54), for many years GTDC used the Company's name, its billing and collection services, and obtained marketing referral information from the Company. These intangibles also derived their value directly from the Company's longstanding position of dominance as the incumbent provider of local telephone services.

As I shall explain in the next section of my testimony, subsequent to the Company's last rate case before the Commission, it had altered its directory publishing arrangements in a manner that, unless rectified by the Commission in this proceeding, would result in an improper affiliate transaction, namely the use of Verizon NW intangible assets by its unregulated affiliate, VDC, without compensation.

D. Verizon's decision to have Verizon NW relinquish its directory publishing rights and associated publishing fees and accept a "fee for service" arrangement with VDC was an improper affiliate transaction under the Washington Affiliated Interest statutes, which the Commission can rectify by imputing VDC's excess Washington earnings to Verizon NW as a ratemaking adjustment.

Q. Earlier in your testimony, you mentioned that GTDC's arrangements with the GTOCs, including the Company, changed at the time of the GTE-Bell Atlantic merger. What happened at that time?

A. According to documents obtained from the Company via discovery, as part of the GTE-Bell Atlantic merger implementation activity in 1998, a merger team was formed to examine the two companies' differing treatments of directory publishing activity. A memorandum prepared at that time by the President of the GTE Directories operation summarized the two approaches as "the publishing rights model followed by GTE, which contrasted with the fee for service orientation of BA [Bell Atlantic]."[80] (A copy of this memorandum is contained in my Exhibit No. ___ (LLS-10)).

Under the "publishing rights" model, the publishing agreement between GTDC and the GTOCs, including the Company, granted to GTDC the exclusive right to publish directories on behalf of the telco. As I have explained earlier in my testimony, in return for this very valuable right – which was the key precondition behind GTDC's ability to sell yellow pages advertising at the high margins that came with "official" directory status – a substantial

80. The memorandum is from Earl A. Goode, GTE Information Service to Dan O'Brien, September 1, 1999; provided in *Verizon NW's Response to WUTC Staff Data Request No. 250* (pages 70-71). According to *Verizon NW's Response to WUTC Staff Data Request Nos. 376d and 376c*, at that time, Mr. Goode was President of GTE Directories and Mr. O'Brien was Vice President-Finance, GTE Corp.

share of the revenues generated by GTDC's directory business was returned to the GTOCs. In contrast, the "fee for service" approach would entirely eliminate recognition of the economic value of that publishing right, and instead have GTDC and the GTOCs compensate each other only for the specific services supplied to the other, such as subscriber listings information, publication of white pages, etc. As part of the merger, the merger entity (referred to internally as "Newco" at that time) decided to adopt the "fee for service" approach uniformly, for GTDC and the GTOCs, including the Company. As I shall demonstrate, members of the merger team understood full well that this change would have an adverse financial impact on the regulated GTOCs, but nevertheless proceeded with it – apparently because, as stated by the GTE Directories President, "we certainly wish to do what is in total Newco's best interest"[81] – rather than what was in the best interest of the GTOCs and their ratepayers.

Q. What was the anticipated financial impact of adoption of the "fee for service" arrangement for GTDC and the GTOCs?

A. As admitted in a second GTE internal memorandum prepared at that time, the "fee for service" scheme would mean that "the majority of Directory Revenues would effectively be shifted from the telephone operating companies to the directory companies..."[82] (This

81. *Id.* (at page 71).

82. Letter from Gregory D. Jacobson, Assistant Vice President – Rating Agency & Support Administration, GTE Service Corporation, to Barry A. Johnson, December 13, 1999; provided in *Verizon NW Response to WUTC Staff Data Request No. 250* (pages 000072-000073). According to *Verizon NW's Response to WUTC Staff Data Request Nos. 374 and 376e*, Mr. Johnson was the "program manager" overseeing the transition to fee-for-service for the GTE

(continued...)

memorandum is reproduced in my Exhibit No. ___ (LLS-10), at pages 4-5 *infra*.)

In fact, a key member of the merger team, the Vice President of Finance for GTENS, i.e. the telco side of the transaction, wrote an e-mail that described the financial effects of the proposal in detail and vividly expressed his concerns that it would have a severe negative impact on GTOCs such as the Company (collectively referred to as "Network Services" or "NS" in the e-mail).[83] The e-mail stated, in part:

> Subject: re: Fee for Service
>
> Before we have this meeting, I would like some help. I have heard all the legal reasons and favorable comparisons to Bell Atlantic on the piece parts of the fee for services. Taken individually they may make sense, but I'm struggling with the big picture when I look at Network Services, after the change.
>
> If I'm not mistaken (please advise me if I am) – using round numbers, NS currently has about $600M of revenues – $525 from Directories and about $75M from third parties on listing sales, etc. With this goes $170M of expense for Info pages, enhancements, and something called MIPSs. So NS has $600M of revenues generating about $430M of operating income.
>
> After fee for services, NS is left with about $75M of revenues and $140m of expenses for an operating loss of $65M. Apparently, all of the $525M of revenues from Directories goes away and only about $30M of expenses. This is where I struggle. I can't understand how we can accept an operating loss on this, particularly when the revenues are from a third party and the expenses are intercompany. The operating loss is driven primarily because we are paying about $100M for Info pages.

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82. (...continued)
directories; his title was Assistant Vice President Special Projects, working in the GTENS operating unit.

83. E-mail from Doug Wilder to Barry Johnson et al, (January 25, 2000), supplied in *Verizon NW Response to WUTC Staff Data Request No. 250* (pages 000066-000067). Mr. Wilder was "responsible for the financial planning, budgeting and reporting of GTEN'S operations" (see *Verizon NW Response to WUTC Staff No. 376h*).

> Looked at another way, we are getting $75M for our listings from other parties and paying Directories about $40M to support this revenue stream and another $100M for Info pages. I know there is an argument that Info pages supports other revenue streams (local revenue), but $100M is more than all of our other promotion dollars.
>
> Bottom line. I know it is intercompany, but I have a hard time accepting an operating loss for NS and over a 2% reduction in NS operating margin. I had asked everybody I talked to in the beginning to look at Info pages for this very reason. What I'm hearing is minor changes and that is the way Bell Atlantic does it.

The full text of this e-mail as furnished in discovery is provided in my Exhibit No. ___ (LLS-10), at pages 8-10 *infra*.

The Chief Financial Officer of GTE Directories attempted to assuage his concerns in an e-mailed response,[84] but his response only confirms the problem that the GTENS Finance VP had identified. The full text of this e-mail as furnished in discovery is provided in my Exhibit No. ___ (LLS-10), at pages 6-8 *infra*. It states that "[u]nder the master publishing agreement, the 2000 budget numbers" showed "Pub Rights (net of uncollectibles)" of $515-million; but "[a]fter full implementation of the Fee for Service arrangement and other pricing adjustments" the 2000 budget would have Pub rights revenues of *zero*, i.e. entirely eliminated. As he proceeded to explain, "[u]nder the Master Publishing Agreement, Network Services shared in the Directory Advertising Product, which contributed the vast majority of the $509 M of "margin." Under the Fee for Service concept, from a Network

84. E-mail from Scott Hanle, to Doug Wilder et al (January 26, 2000), supplied in *Verizon NW Response to WUTC Staff Data Request No. 250* (pages 000064-000066). Mr. Hanle was the Vice President - Finance & Strategic Planning (CFO) for GTE Directories (see *Verizon NW Response to WUTC Staff Data Request No. 376g*).

Services perspective, this product line does not exist."[85]

Q. Was the "fee for service" arrangement ultimately adopted for the directories of the Company and other GTOCs?

A. Yes. Effective January 1, 2000, a new publishing agreement was executed between GTDC's parent GTE Information Systems and the GTOCs, that initiated those fee for service arrangements and eliminated the payment of any publishing fees to the telcos, including the Company.[86] The January 2000 Agreement supplanted the Master Directory Publishing Agreement that (as I'd noted earlier in my testimony) had been in effect, with certain amendments, since January 1, 1991. From a ratepayer perspective, the key revision from the terms of the Master Directory Publishing Agreement that I described earlier in my testimony (pages 49-50) was that the new agreement prescribed that:

> "Publisher may sell advertising in the telephone directories produced and distributed by Publisher, and *Carrier shall have no right or interest in any revenues received by Publisher in connection with such advertising sale*." (Section 1.6.1, emphasis added)

By consenting to this crucial term, the signatory GTOCs, including the Company, were agreeing to relinquish, without other compensation, the substantial share of directory advertising revenues that they had always received under the Master Directory Publishing Agreement and prior publishing agreements in return for granting the exclusive right to

85. *Id.* (at page 65).

86. This Publishing Agreement was provided in *Verizon NW's Response to Public Counsel Data Request No. 152b*, and is reproduced in my Exhibit No. ___ (LLS-11). Note that while it formally became effective on January 1, it was actually signed in April 2000, well after the dates of the two GTE internal e-mails I have just discussed.

publish their directories.[87]

In another uncompensated giveaway to the unregulated directory affiliate, the new agreement altered the copyright terms to "All telephone directories produced and distributed by Publisher under this Agreement will be copyrighted by and in the name of Publisher." (Section 1.7) In addition, the new agreement stated that "Carrier and Publisher shall cooperate in establishing an effective billing and collection system for activities conducted under this Agreement." (Section 2.3) While this language is clearly less prescriptive than the Master Directory Publishing Agreement in this area, it would have allowed continuation of the historical arrangements in which the telco performed billing and collection for the directory operation, and that is apparently what occurred.[88]

Q. Did the January 2000 Agreement change the terms for access to subscriber listings information by the directory publishing affiliate?

87. Of course, I am not an attorney and am not offering a legal opinion as to whether that action could be lawfully undertaken without Commission approval.

88. Verizon NW continues to perform billing and collection services for VDC. See *Verizon NW Response to Public Counsel Data Request Nos. 173 and 229*.

A. Yes. In September 1999, the FCC issued an order requiring ILECs to sell directory lists to competing publishers,[89] and in apparent response to the non-discrimination requirements of that order, the new publishing agreement included an explicit licensing for GTDC's use of subscriber listings supplied by the Company and other GTOCs.

Q. Have these arrangements, including the relinquishment of any directory advertising revenues by the Company and other former GTOCs, continued to the present day?

A. Yes, they have. The fee for service arrangements are now implemented via three separate agreements that became effective January 1, 2003: a Directory Publishing Agreement,[90] a Listings License Agreement, and a Billing and Collection Agreement.[91] The signatories to these agreements are, depending on the agreement, the Company or Verizon Corporate Services Group on its behalf (as well as other Verizon operating companies), and several

89. *In the Matters of the Implementation of the Telecommunications Act of 1996: Telecommunications Carriers' Use of Customer Proprietary Network Information and Other Customer Information; Implementation of the Local Competition Provisions of the of the Telecommunications Act of 1996; Provision of Directory Listing Information under the Telecommunications Act of 1934, As Amended,* CC Docket Nos. 96-115, 96-98, 99-273, *Third Report and Order in CC Docket No. 96-115, Second Order on Reconsideration of the Second Report and Order in CC Docket No. 96-98, and Notice of Proposed Rulemaking in CC Docket No. 99-279*, 14 FCC Rcd 15550 (1999).

90. See *Verizon NW Response to Public Counsel Data Request No. 152*, Attachment PC-152a; this agreement is reproduced in my Exhibit No. ___ (LLS-12).

91. See *Verizon NW Response to Public Counsel Data Request No. 173* (attached CD-ROM). I have not included this CD-ROM in my Exhibits.

unregulated Verizon affiliates involved in directory publication, including VDC, Verizon Directory Publishing Corp., and Verizon Yellow Pages Company (which are referred to in the agreement collectively as the "Publisher").

However, in striking contrast to *all* of the prior directory publishing agreements that I have discussed earlier in my testimony, these current agreements perpetuate the main terms of the fee for service arrangements first established in the January 2000 publishing agreement on a *tacit* basis, rather than through explicit terms. For example, the new Directory Publishing Agreement is entirely *silent* on the pursuit of directory advertising sales and disposition of the resulting revenues; it also makes no mention of directory publishing rights, and neither explicitly confers nor withholds an exclusive right to publish classified directory advertising; and it doesn't have an explicit non-compete agreement that prohibits the Company or other Verizon operating companies from developing and publishing their own yellow pages directories in competition with VDC's.

Q. How is it that these important terms no longer appear in the currently-effective directory publishing agreements?

A. The continuation of the fee for service arrangement, despite omission of those terms in the latest agreements formalizing those arrangements, is the plain result of the fact that those agreements, like the entire fee for service scheme itself, were not negotiated on an independent, arms-length basis by the two classes of stakeholders (i.e., the operating companies, including Verizon NW, and the directory affiliate VDC). Instead, as evident from the merger team memoranda and e-mails I described earlier, those parties worked to ensure that the adopted arrangements would be in the interests of the parent company, Verizon Communications Inc., as a whole, rather than serve the interests of the Company and other regulated operating companies and their ratepayers. Approximately four years have elapsed since the fee for service arrangement was initiated for the Company's directories in Washington, and the Company has neither launched its own classified directories in competition with VDC, nor has sought any compensation from VDC for the directory advertising line of business it effectively handed over to VDC. Thus, it is indisputable from the *conduct* of the Company and VDC that they are cooperating, tacitly or otherwise, to ensure that the franchise value of the historically-dominant directory operation in Washington is maintained, and is reaped by VDC, rather than the Company.

These facts reinforce the conclusion that Verizon's decision to have the Company and other former GTOCs relinquish their directory publishing rights and associated publishing fees and replace them with the "Fee for Service" arrangement was an improper affiliate transaction under the Washington Affiliated Interest statutes (Chapter 80.16 RCW) that I discussed earlier in my testimony, because it has given the GTDC/VDC affiliate a substantial, ongoing benefit, without payment of any compensation. Accordingly, I recommend that the Commission rectify this inappropriate transaction in Washington by imputing VDC's Washington earnings to the Company as a ratemaking adjustment, as proposed by Staff witness Paula Strain.

Q. In a directory publishing case before the New Hampshire Public Utilities Commission ("NH PUC"), the Company's sister operating company, Verizon New Hampshire ("VNH") argued that Section 222 (e) of the 1996 Telecommunications Act prohibited

the grant of "special rights" to its directory publishing affiliate, NIRC, such as the license and non-competition benefit provided in the former publishing agreements between VNH and NIRC.[92] Does that argument have any merit in the instant case?

A. No, it does not. In the first place, as the NH PUC concluded, "On its face, section 222(e) does not apply to directory publishing arrangements between a carrier and its affiliated directory publisher."[93] While I am not offering a legal opinion, the plain language of Section 222(e) appears to narrowly address only the terms under which LECs will offer subscriber list information, and makes no reference to LECs' directory publishing rights, sales agency issues, or non-competition agreements. Moreover, the Company's conduct in the years after Section 222(e) was enacted repudiates any potential claim by the Company that Section 222(e) prohibited it from entering into exclusive licensing and non-competition arrangements with particular directory publishers, because it did in fact do so in at least one case.

Q. Please explain.

A. Historically, the Continental Telephone Company ("Contel") operating companies had agreements with an unaffiliated directory publisher, Mast Advertising & Publishing, Inc. ("Mast") to publish white and yellow pages directories on their behalf.[94] In February 1993,

92. See *Investigation of Verizon New Hampshire's Treatment of Yellow Page Revenues*, NH PUC Docket No. DT 02-165, *Order Addressing Treatment of Yellow Page Revenues* Order No. 24,345, July 9, 2004, at page 130.

93. *Id.*, at page 131.

94. See, Mast Advertising & Publishing, Inc. Telephone Directory Publishing Agreement (continued...)

the Contel operating company serving portions of Washington, Contel of the Northwest, merged with GTE Northwest. Nevertheless, Mast continued to publish the directories for the former Contel areas in Washington for several more years, under a publishing agreement that ceased when the January 2000 Agreement that I described earlier was executed (see Verizon NW Response to WUTC Staff Data Request No. 440). By definition, the Company's agreement with Mast was the product of arms-length negotiations, because they were unaffiliated firms (in fact, Mast was a unit of Southwestern Bell).

The Company's publishing agreement with Mast is reproduced in my Exhibit No. ___ (LLS-14). What is striking about this agreement is that it is structured along the same "publishing rights" model that Verizon's merger team ultimately decided to abandon in favor of "Fee for Service" arrangements. Consequently, the Mast Publishing Agreement conferred to Mast (and its successor, Associated Directory Services, Inc.) precisely the types of "benefits" that VNH appeared to be claiming were prohibited by Section 222 (e), in return for the ability to share in the profits generated from directory advertising. Specifically, the Mast Publishing Agreement stated that:

- "Telephone Company hereby grants to Directory Company the exclusive right to compile, print and sell advertising in all of the directories for exchanges of Telephone Company (unless excluded by mutual agreement in writing)..." (Page 2)

- "Directory Company will have exclusive rights to the contract (advertising) database and Telephone Company will not sell the contract database or any part thereof and will not use such information for any purpose other than to fulfill its obligations under this

94. (...continued) with Telephone Company Affiliates of Continental Telecom Inc., August 15, 1985 ("*Mast Publishing Agreement*"), as provided in *Verizon NW Response to Public Counsel Data Request No. 152*, Attachment PC-152d.

Agreement." (Page 6)

- "Directory Company has the right to identify itself, and its affiliates, as the Telephone Company's sales agent, within the pages of each directory." (Page 11)

- "Except as otherwise provided in Section 2 hereof, for all amounts billed during the Initial Term of this agreement, Telephone Company will retain 35% of the gross advertising revenues from directory advertising," with varying percentage applying thereafter depending upon certain conditions. (Page 7)

The continued production of directories under the Mast Publishing Agreement demonstrates that the Company did not believe that Section 222(e) of the Act prohibited it from entering into agreements of the "publishing rights" type, and in fact did enter into that type of agreement when it was in its interest to do so.

IV. CONCLUSION AND RECOMMENDATIONS

Q. Dr. Selwyn, what are your overall recommendations to the Commission?

A. My testimony has explained why the Commission should give intensive scrutiny in this proceeding to Verizon NW's transactions with its affiliates, and that the Company has the burden of proof to demonstrate that those transactions are reasonable. As I have shown, Verizon NW has failed to comply with the Washington Affiliated Interests statutes set forth in Chapter 80.16 RCW and the FCC's affiliate transaction requirements (47 C.F.R. 32.27) as adopted by the Commission. Based on the evidence set forth in my testimony, I recommend the Commission should make the following findings in this proceeding:

- Verizon NW has been receiving from inadequate compensation from its long distance affiliate, Bell Atlantic Communications, Inc. d/b/a/ Verizon Long Distance ("VLD"), for the consumer portion of sales and marketing activities that Verizon NW undertakes on behalf of VLD. A reasonable estimate of the fair market value for those services is $75.00 per successful residential customer sale contact made by Verizon NW. The Commission should adopt that value as the applicable charge for Verizon NW's test year billings to VLD for those services, and adopt the associated ratemaking adjustment presented by Staff witness Tim Zawislak. The Commission should also adopt the other ratemaking adjustments presented by Mr. Zawislak that correct additional improper Verizon NW affiliate transactions identified by Staff.

- VDC's predecessor, the General Telephone Directory Company, developed its yellow pages directory business by virtue of its unique and longstanding position as exclusive publisher of directories for GTE-Northwest and the other GTE local telephone companies.

- VDC's dominance in the Washington yellow pages markets it serves is a direct result of the “first mover” advantage that its predecessor GTDC gained from its historical status as exclusive publisher of GTE-Northwest's directories.

- The going-concern value of VDC's Washington directory publishing operations is largely due to its continued use of Verizon NW intangible assets, including the right to publish directories on the Company's behalf.

- Verizon's decision to have Verizon NW relinquish its directory publishing rights and associated publishing fees and accept a “Fee for Service” arrangement with VDC was an improper affiliate transaction under the Washington Affiliated Interest statutes, Chapter 80.16 RCW, because it has given the GTDC/VDC affiliate a substantial, ongoing benefit, without payment of any compensation. Specifically, the Commission should find that the January 2000 and January 2003 Publishing Agreements entered into by Verizon NW were improper affiliate transactions under those statutes, and thus are subject to modification by Commission action in order to comply with those rules.

- The Commission can rectify Verizon NW’s improper affiliate transactions with VDC by imputing VDC's Washington earnings to Verizon NW as a ratemaking adjustment. Specifically, the Commission should find that the imputation of VDC’s Washington earnings proposed by Staff witness Ms. Strain is reasonable and appropriate for this purpose, and adopt that ratemaking adjustment so as to rectify the adverse effect of those improper transactions on Washington ratepayers.

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

A. Yes, it does.