BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

WUTC v. VERIZON

DOCKET NO. UT-040788

DIRECT TESTIMONY OF MICHAEL L. BROSCH (MLB-1T)

ON BEHALF OF

PUBLIC COUNSEL, AARP AND WEBTEC

THIS DOCUMENT IS THE NON-CONFIDENTIAL VERSION OF THIS TESTIMONY PURSUANT TO THE PROTECTIVE ORDER IN THIS DOCKET.

November 22, 2004

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MICHAEL L. BROSCH

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1 **I. INTRODUCTION AND QUALIFICATIONS**

2 **Q. Please state your name and business address.**
3 A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite
4 204, Lee's Summit, Missouri 64086.
5 **Q. By whom are you employed?**
6 A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in utility
7 rate and regulation work. The firm's business and my responsibilities are related to
8 special services work for utility regulatory clients. These services include rate case
9 reviews, cost of service analyses, jurisdictional and class cost allocations, financial
10 studies, rate design analyses and focused investigations related to utility operations and
11 ratemaking issues.
12 **Q. On whose behalf are you appearing in this proceeding?**
13 A. I am appearing on behalf of the Washington Attorney General – Public Counsel Section
14 ("Public Counsel"), AARP (formerly the American Association of Retired Persons), and
15 Washington Electronic Business & Telecommunications Coalition ("WeBTEC").
16 Utilitech entered into a contract with these parties, which I will collectively refer to as
17 "Consumers", to review and respond to certain issues raised by the Application of
18 Verizon Northwest Corporation ("Verizon" or "VZNW") for an increase in its intrastate
19 rates and revenues.
20 **Q. Will you summarize your educational background and professional experience in**
21 **the field of utility regulation?**
22 A. Exhibit MLB-2 is a summary of my education and professional qualifications. I have
23 testified before utility regulatory agencies in Arizona, Arkansas, California, Florida,

1 Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, New Mexico, Ohio,
2 Oklahoma, Utah, Washington and Wisconsin in regulatory proceedings involving
3 electric, gas, telephone, water, sewer, transit, and steam utilities. Exhibit MLB-3 is a
4 listing of the testimony I have submitted since 1981.

5 **Q. Have you previously participated in telecommunications regulatory proceedings?**

6 A. Yes. With respect to Verizon, Utilitech was involved in formal rate case proceedings in
7 Hawaii in 1995, and has advised clients in other Verizon matters in California, Oklahoma
8 and Indiana in connection with earnings reviews and/or alternative regulation analyses in
9 those states. Utilitech is presently assisting the Hawaii Consumer Advocate in the review
10 of the pending sale of Verizon Hawaii and related businesses, including Verizon's
11 Hawaii directory publishing business, to the Carlyle Group.

12 With regard to Qwest, my firm has represented various clients in a number of
13 prior Qwest/US West Communications ("USWC") proceedings in several states,
14 including Arizona, New Mexico, Utah and Washington. In Washington, I assisted the
15 Washington Attorney General's Office, Public Counsel Section, in negotiation and
16 subsequent review of this State's first Alternative Form of Regulation (AFOR) plan.[1] I
17 was also a witness in the two subsequent Washington general rate cases involving
18 USWC, the 1998 Dex proceeding dealing exclusively with directory imputation issues
19 and the 2003 proceeding involving the sale of Dex.[2] In Arizona, Utilitech has assisted
20 the Commission Staff in a total of five revenue requirement proceedings, including the
21 pending review of the Qwest Price Cap Plan in that State, as well as the recent Dex sale

1 WUTC Docket Nos. U-89-2698-F and U-89-3245-P.
2 WUTC Docket Nos. UT-950200, UT-970766, UT-980948 and UT-021120.

1 proceeding in that State.[3] In New Mexico, I served as a witness for the Commission Staff
2 in the most recent USWC rate case.[4] In Utah, I served as witness for the Utah Committee
3 of Consumer Services in USWC's last general rate case, Docket No. 97-049-08 and
4 sponsored the directory imputation amount approved by the Commission in that Docket.
5 I also assisted the Utah Committee in analysis of the Dex sale and negotiation of the Dex
6 settlement approved in Utah. I also represented consumer advocate clients in
7 Washington and two other states (Iowa and Utah) in the regulatory proceedings
8 associated with the acquisition of USWC by Qwest.[5]
9 I have also been involved in numerous regulatory proceedings involving
10 BellSouth, Sprint and SBC local exchange operating companies in several states, as
11 described in Exhibit MLB-3.
12 **Q. What is the purpose of your testimony in this Docket?**
13 A. My testimony is intended to describe and sponsor, on behalf of Consumers, certain
14 ratemaking adjustments that are necessary to properly quantify Verizon's Intrastate
15 Washington revenue requirement. My testimony explains the basis of and need for a
16 directory imputation adjustment and sponsors such an adjustment. In addition, I describe
17 the test period distortions introduced by Verizon's proposed pro-forma adjustments and
18 recommend alternative adjustments to rate base that remedy such distortions. My
19 testimony is complementary to that of Consumers' witness Mr. Steven Carver, who
20 sponsors testimony on certain expense issues and adjustments.
21 **Q. Please summarize the recommendations that are set forth in your testimony.**

3 Docket Nos. E-1051-88-146, E-1051-91-004, E-1051-93-183, E-1051B-99-105 and E-1051B-03-0454.
4 PRC Case No. 3008.
5 Utah Docket No. 99-049-41, Iowa Case No. SPU-99-27, Washington Docket No. UT-991358.

1 A. I recommend that the Commission impute a reasonable amount of directory publishing
2 income in determining Verizon's Washington intrastate revenue requirement, based upon
3 the estimated directory earnings of the Verizon Directories Company ("VDC") above the
4 regulated rate of return. This recommendation is based upon the regulatory asset status
5 of directory publishing and the many linkages between the incumbent local exchange
6 carrier ("ILEC") business and directory publishing business that create value for the
7 publisher and thereby justify ILEC ratepayer participation in publishing profits. This
8 recommendation is consistent with prior WUTC decisions involving ILEC ratemaking as
9 well as disposition of Qwest's directory publishing regulatory assets. My testimony is
10 responsive to Verizon witnesses Messrs. Trimble and Doane, who argue against the
11 Commission's longstanding policy of directory revenue imputation in determining
12 telephone utility revenue requirements.

13 My testimony also describes adjustments to Verizon's filing that are required to
14 remedy test period distortions caused by mismatched revenue, expense and rate base
15 measurement periods. Verizon has proposed adjustments that reach beyond the end of
16 the test year to capture estimated revenue losses and to include net plant in service
17 additions. If these piecemeal adjustments are not revised, or if offsetting adjustments for
18 changes in other costs and rate base reserve accounts are not considered, the Company's
19 approach will overstate revenue requirements, as explained more fully in my testimony.

20 **Q. How is the balance of your testimony organized?**

21 A. My testimony is arranged by major topical area. A Table of Contents appearing at the
22 beginning of the testimony sets forth this organization.

23

1 **II. DIRECTORY PUBLISHING IS A REGULATORY UTILITY ASSET**
2

3 **Q. How is the directory publishing business related to the local exchange telephone**
4 **business?**
5 A. Directory publishing is a profitable by-product income stream that is enjoyed by each of
6 the major incumbent telephone companies.[6] Directory publishing was developed by
7 telephone companies to add value to their public telephone networks, by providing
8 printed subscriber listing information in alphabetical and classified formats. The printed
9 telephone directory has evolved to include significant commercial advertising,
10 particularly within the classified directories where consumers seek information about
11 desired products and services at the time they are prepared to make purchasing decisions.
12 Advertising revenues were useful to the telephone companies for decades to defray the
13 costs of compiling and distributing the printed directories and have become so significant
14 as to also contribute to the overall costs of operating the business. However, telephone
15 holding companies have sought for years to redirect such revenues into their non-
16 regulated affiliates for retention for the sole benefit of shareholders. Verizon's filing
17 proposes such a redirection.
18 The telephone companies use their relationship with customers, their telephone
19 listings data, their brand name and business reputation, their billing and collection
20 systems, their financial resources and their shared corporate administrative and
21 management capabilities to dominate the directory publishing industry. Telephone

6 Qwest has liquidated its publishing business in a sale transaction that provided for long-term exclusive publisher status to the Buyer and other intangible asset grants in return for a one-time monetized value of $7.05 billion.

1 holding companies such as Verizon Communications participate in the directory
2 publishing business because of the significant opportunity to earn high profit margins and
3 strong cash flows by selling directory advertising to much of the same customer base to
4 which it sells telecommunications products, under a common brand and often on a
5 combined monthly billing. This business opportunity creates a substantial income
6 stream that is available to offset the substantial fixed costs associated with operating the
7 telephone business. It would be imprudent for a large ILEC to not avail itself of this
8 opportunity to lower the net cost of providing service and thus optimize earnings for
9 shareholders.

10 **Q. Have any of the large ILECs chosen to not engage in directory publishing?**

11 **A.** No. You will not find a large incumbent local exchange carrier ("ILEC") such as
12 Verizon <u>not</u> involved in a highly profitable directory publishing business in the areas
13 where they provide regulated telephone services. The large ILECs such as Verizon, SBC,
14 BellSouth and, until recently Qwest, have all historically participated in and dominated
15 the directory publishing business in this country for many years. This dominance has
16 occurred for many reasons, including the first mover advantage experienced when phone
17 books were first issued by telephone carriers, historical control over telephone listings,
18 shared branding of directories in the name of the carrier to convey "official" publisher
19 status, and through many other linkages between the telephone and directory operations.
20 Qwest only recently exited the directory publishing business and was able to realize an
21 extremely large gain on sale of the business by bundling a long term exclusive "official"

1 publishing contract and a long term non-competition agreement into the transaction, so as
2 to convey the full value of the official publisher status to the buyer of the business.[7]
3 As will be discussed later in my testimony, non-ILEC publishers have also
4 compiled and distributed telephone directories in competition with the incumbent
5 telephone companies for many years, but these competitors must compete with generally
6 lower pricing and reduced profit margins to attract business away from the incumbent
7 publishers, because they do not enjoy the benefits associated with affiliation with the
8 ILEC.

9 **Q. Is it reasonable to characterize the ILEC directory publishing business and the**
10 **extraordinary profits earned from directory publishing as a regulatory asset,**
11 **because a valuable directory publishing business opportunity arises from regulated**
12 **ILEC operations?**

13 A. Yes. Many regulatory and court decisions over the years have found directory publishing
14 operations and profits to be properly considered as a regulatory asset and used to offset
15 ILEC revenue requirements due to these linkages and advantages.[8] A large incumbent
16 local exchange carrier such as Verizon enjoys many advantages in directory publishing as
17 a direct result of affiliation with the regulated ILEC business. These advantages involve
18 public perceptions that the Verizon directories are the "official" directory product that is
19 the only book published by the telephone company, unlike competing directories that

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7 The cover of the current classified directory in Qwest territory continues to bear the Qwest name and logo, and the term "official directory."

8 See for example: Colorado PUC Decision No. C02-899 http://www.dora.state.co.us/puc/decisions/2002/C02-0899_36247.pdf; Utah Supreme Court Decision No. 980082 http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=ut&vol=supopin&invol=uswest3_lhr; Public Utility Commission of Oregon Order no. 97-171, http://www.puc.state.or.us/orders/1997ords/97-171.htm; New Hampshire PUC Order No. 24385, http://www.puc.state.nh.us/Regulatory/Orders/2004orders/24385t.pdf.

1 may not be valued as highly by advertisers. Such public perceptions are supported by
2 Verizon's branding of directory products with shared trade names and marks that are also
3 used by the telephone company. Verizon promotes its directories as having the broadest
4 distribution and usage rates among consumers so as to convey greater value and justify
5 higher pricing and profit margins that directory publishers that are not affiliated with an
6 ILEC. Verizon also includes yellow pages advertising charges for some of its customers
7 within the advertising customer's telephone bill, which also confirms the official status of
8 Verizon directory products.

9 **Q. Has the Washington Utilities and Transportation Commission ("WUTC" or**
10 **"Commission") concluded that directory publishing operations represent a**
11 **regulatory asset?**

12 A. Yes. In the Commission's Fifteenth Supplemental Order in Docket No. UT-950200, a
13 summary of prior Washington decisions associated with directory imputation is recited,
14 as follows:
15
16 > Before 1984, Pacific Northwest Bell, the predecessor in
17 > Washington State of US WEST Communications, Inc., published its own
18 > telephone directory, including Yellow Pages.[footnote omitted] Ex. 390-T,
19 > p.16. The publishing revenues and expenses were a part of the
20 > Company's results of operation for regulatory purposes and constituted a
21 > regulatory asset of the Company. Effective January 1, 1984, directory
22 > publishing was placed in Landmark Publishing Company. The publisher
23 > is now US WEST Direct (USWD), a division of US WEST Marketing
24 > Resources Group, Inc. (MRG). Between 1984 and 1988, the affiliated
25 > directory publisher paid annual publishing fees to USWC, ranging in
26 > amount from $14.9 million to $40.5 million. The payments ceased after
27 > 1988, according to USWC, " . . . because USWC recognized that there
28 > was no operational or business need for a cash payment to flow between
29 > the two US WEST companies." There is no indication that PNB or
30 > USWC received compensation other than the publishing fee for the
31 > transfer of the directory business or that it received compensation for the
32 > termination of the publishing fee. USWD is the exclusive publisher of
33 > directories for USWC, which provides billing and collection services
34 > exclusively to it.[footnote omitted]

> In the Second Supplemental Order, Cause No. U-86-156, **the Commission treated the Directory as a regulatory asset and determined that the public interest requires the full reasonable value of directory publishing be available to PNB for ratemaking purposes**. It found that the then-current publishing fee was not determined in an arms-length transaction with each party seeking to maximize return, but deferred adjusting the value until a later time. [footnote omitted]
>
> As a condition to the merger of PNB into USWC, all of the parties including USWC agreed in a signed stipulation, presented to the Commission and approved, that if the merger were approved, Yellow Page revenues would be considered as though the merger had not taken place.[footnote omitted] The order provided that the Commission could modify the arrangement by a future order. The Alternative Form of Regulation (AFOR) agreement between the Commission and the Company in 1990 contained an implicit directory imputation calculation. (emphasis added)

At page 34 of this Order, the Commission stated, "The Commission finds the directory publishing business to be a regulatory asset. Commissions have historically been authorized to impute revenues from interrelated operations that have been transferred to affiliates, to prevent utilities from taking profitable aspects and leaving captive utility customers with expenses of the operation but with reduced offsetting revenues from related services." The directory imputation ordered by the WUTC in Docket No. UT-950200 was appealed by U S West and the Commission's findings were ultimately upheld by the Washington Supreme Court, which held in pertinent part:

> We hold US West has not carried its burden of demonstrating the invalidity of the Commission's decision regarding the imputation of revenue. The yellow pages publication business is a lucrative revenue-producing asset which was developed as a result of the Company's long, de facto monopoly dominance of the telephone business in Washington. The transfer of an undervalued asset constitutes a payment of compensation prohibited by the affiliated interest statute, RCW 80.16. The commission acted within its discretion conferred by that statute and

1 within its authority to set just and reasonable rates pursuant to RCW
2 80.36.140 when it imputed yellow pages revenues to US West.[9]
3

4 A more exhaustive history of the Commission's treatment of directory publishing
5 operations within a telephone company affiliate can be found in the "HISTORY" section
6 of the Commission's Fourteenth Supplemental Order in Docket No. UT-980948 that
7 denied U S West Communications' request for an Accounting Order ending imputation.

8 **Q. Mr. Trimble's testimony, at page 22, suggests that the WUTC precedent regarding**
9 **U S West is not applicable to Verizon, where he argues "This "developed at**
10 **ratepayer expense" rationale is misplaced in the case of Verizon NW and VDC,**
11 **however. Neither VDC nor any of VDC's previous assets have ever been part of**
12 **Verizon NW's organizational structure, operations, or rate base. This distinct**
13 **separation of assets and operations has existed for more than 65 years" How do you**
14 **respond?**

15 A. The separation of assets and operations that Mr. Trimble seeks to emphasize does not
16 cause the Commission's imputation policy or the Supreme Court decision to be
17 inapplicable to Verizon Northwest. How Verizon's predecessors chose to hold assets or
18 conduct directory publishing operations does not change the key fact recognized by the
19 Supreme Court that, "The yellow pages publication business is a lucrative revenue-
20 producing asset which was developed as a result of the Company's long, de facto
21 monopoly dominance of the telephone business in Washington."[10] It is undisputed that
22 historically Verizon's predecessor operating telephone companies participated
23 operationally and financially in the directory publishing business, even though publishing

9 *U S West Communications, Inc., v. WUTC*, 134 Wn. 2d 74, 102, 949P.2d 1337 (1997).

responsibilities and revenues were shared between a publishing affiliate and the telephone company contractually and through imputation. While the specific historical facts are different for U S West versus Verizon, there should be no dispute regarding the official publisher status and strong operational linkages between the telephone business and the affiliate publishing business that have served as the basis for WUTC imputation policies.

Q. What are some of the linkages between the Verizon regulated telephone company and its directory publishing affiliate that support the characterization of directory publishing as a regulatory asset?

A. The linkages between the white and yellow page directories of Verizon Directories Corporation ("VDC") and the telephone services of Verizon Northwest Corporation ("VZNW") include:

1) Listings that represent the primary information content of the directories are created in operation of the local phone business. This causes the telephone company to be perceived as the best source for the most current and complete listings information. Verizon promotes its printed directories by stating, "Yellow page directories comprise the most complete source of business information available for businesses and consumers alike."[11]

2) Usage of the white and yellow pages is driven by telephone customers' desire to make more effective use of local telephone services to reach businesses they wish to communicate with.

3) The usefulness of local telephone service is enhanced by the availability of both alphabetical and classified directories.

4) In the case of Verizon directories, most of the revenues earned from yellow pages advertising are billed on local phone bills of VZNW telephone customers and are collected and processed by

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10 Id.

11 http://www.directorystore.com/product/productdetail.jsp?item_number=0778940001&type=us.

VZNW remittance centers.[12]

6) Directories of VDC are published with prominent placement of identifying Verizon trade names and trademarks linking them to the telephone company.[13]

7) The public is likely to perceive Verizon directories to be endorsed by the telephone company and thereby the "official" book that is accurate, current and comprehensive with respect to the phone number listings controlled and assigned by VZNW (see point 1). All Verizon Wireline subscribers are entitled to a free copy of their local SuperPages.[14]

8) Verizon's website and call center operators refer customer inquiries regarding directory advertising to VDC, where such referrals may lead to incremental sales of advertising.[15]

9) As a result of being first to market through directory publication over many prior decades, the telephone company directory affiliate enjoys a first mover advantage in the marketplace. This status is promoted by VDC with statements such as, "Verizon SuperPages is the world leading print yellow pages directory. With over a century of experience and a distribution of more than 112 million directories, Verizon can deliver advertising value like no one else."[16]

10) When a directory advertising customer **[CONFIDENTIAL BEGINS]**
****
**********************************[CONFIDENTIAL ENDS]** the customer is not made to pay remaining installments due for such advertising.[17]

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12 http://verizon.superpages.com/custsupp/faq.jsp#bp2 Verizon's confidential Attachment to Data Request PC-227 indicates that approximately **[CONFIDENTIAL BEGINS]************ **[CONFIDENTIAL ENDS]**of directory advertising revenue was billed and remitted by Verizon Northwest to its publishing affiliate. This represents more than **[CONFIDENTIAL BEGINS]**** **[CONFIDENTIAL ENDS]** percent of local advertising revenues earned by the publishing affiliate in Washington in 2003.

13 http://www.directorystore.com/product/productdetail.jsp?item_number=0778940001&type=us.

14 Id.

15 http://www22.verizon.com/ProductsAndServices/Anonymous/0%2C2356%2C%2C00.html See also Verizon's response to Data Request PC-254, "In the instance a Verizon Northwest call center employee receives a customer inquiry to purchase directory advertising from Verizon Directories, the customer is provided with the 1-800 number to contact Verizon Directories or the customer is cold transferred to Verizon Directories."

16 http://verizon.superpages.com/prodserv/dirprods/yellow_pages.jsp.

17 Verizon Confidential Attachment PC-238b, Terms and Conditions Applicable to Both Print Advertising and Internet Advertising. Page 3, Section 9.

> 11) After initial distribution of directories, the publishing affiliate will **[CONFIDENTIAL BEGINS] ***
> ***********************************[CONFIDENTIAL ENDS]**.[18]

Simply stated, Verizon Directories Corporation publishes the "official" phone books for VZNW, and these directories offer significant value to advertisers as well as supra-competitive profits to the publisher. For all of these reasons, the traditional regulatory practice, as codified in the FCC's Uniform System of Accounts and recognized by this Commission for many years, is to treat directory advertising and other directory publishing revenues as above-the-line for ratemaking purposes.

Q. Does Verizon promote its print directories by referring to its affiliation with the telephone company and its long term business history and reputation?

A. Yes. For example, one of the directory affiliate's promotional documents provided as part of a "Representative sample of advertising and collateral materials" produced in Confidential Attachment PC-239 part l contains the following message:

> **[CONFIDENTIAL BEGINS]**
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18 Id. Page 3 at Section 27.

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9 **
10 *********************************
11 **
12 ** **[CONFIDENTIAL**
13 **ENDS]**
14

15 This marketing document contains **[CONFIDENTIAL**
16 **BEGINS]**
17 ***
18 *****************************.**[CONFIDENTAL ENDS]**

19 Another VDC marketing document characterizes the Verizon directories as
20 having **[CONFIDENTIAL BEGINS]**
21 ***
22 ***
23 ***
24 **[19]**CONFIDENTIAL ENDS]**

25 In another marketing document provided by the Company one can find claims
26 such as, "Verizon is the world's leading yellow pages publisher. Verizon SuperPages
27 directories:
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[CONFIDENTIAL BEGINS]
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**************************************[CONFIDENTIAL ENDS]**[20]

Q. Has the Company previously recognized a regulatory claim upon directory publishing income, by including yellow pages advertising revenues within the telephone company's regulated accounts?

A. Yes. Prior to adoption of a new affiliated interest contract referred by Verizon as its "Fee for Services" arrangement, a significant share of directory publishing revenues were retained by the telephone company and recorded within regulated directory revenue accounts. Verizon's modification of affiliate publishing arrangements to move directory profits out of the telephone company and into its non-regulated publishing affiliate's income statement after 1999 is described in a subsequent section of my testimony.

19 Verizon Confidential Attachment PC-239d.
20 Verizon Confidential Attachment PC-239f.

1 **Q. Please elaborate upon the nature of the regulatory asset associated with directory**
2 **publishing.**
3 A. The directory publishing business primarily employs intangible assets to create value for
4 advertising customers. There are relatively few physical assets employed beyond the
5 facilities required to automate publishing, physically print and distribute the directories
6 and provide office space for employees. Much more important are the intangible benefits
7 associated with the Verizon directory's "official" status conveyed by the linkages
8 described above and the brand awareness created by telephone company operations.
9 These intangible assets position the VDC product as the incumbent telephone company
10 directory that is able to command higher advertising rates and thereby larger revenues
11 and profits than independent publishers.
12 Thus, the regulatory asset is the directory publishing opportunity arising from
13 Verizon Northwest's ILEC business and is not a physical or tangible asset residing on the
14 books that required any actual capital investment to develop. Instead, the directory
15 publishing asset arises from VZNW's status as a major ILEC, which creates the
16 opportunity and indeed a regulatory expectation that telephone directories be published
17 containing commercial advertising at prices designed to prudently exploit this income
18 opportunity, so as to offset the common overhead costs of operating the telephone
19 business.
20 **Q. How can Verizon directory profits be considered a regulatory asset associated with**
21 **operations of the telephone company if there are some independent directory**
22 **publishers who exist without such an affiliation and that compete with Verizon?**

A. The directory publishing industry is stratified between publishers who are affiliated with telephone companies and those which are "independent". This market stratification is described in one of the confidential reports attached as a workpaper supporting the testimony of Verizon witness Mr. Doane:

> **[CONFIDENTIAL BEGINS]******************
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> **[CONFIDENTIAL ENDS]**[21]

The directory operations of the telephone company affiliated publishers have been highly profitable for many years, because of the distinct advantages associated with incumbency and affiliation with the ILEC. These advantages contribute to higher pricing and profit margins for the ILEC-affiliated publishers than are experienced by the independent publishers. Operating profit margins for VDC and the other major telephone company publishers range from **[CONFIDENTIAL BEGINS] ** [CONFIDENTIAL ENDS]** percent to **[CONFIDENTIAL BEGINS]** ****[CONFIDENTIAL ENDS]** percent, while the operating margins for most independent publishers fall between **[CONFIDENTIAL BEGINS]** ** **[CONFIDENTIAL ENDS]** percent and **[CONFIDENTIAL BEGINS]** **

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21 Doane Workpapers, Tab 5: Simba Information Inc., Independent Yellow Pages Markets 2002: Navigating the Changing Landscape (2002), page 6.

1 **[CONFIDENTIAL ENDS]** percent.[22] The same confidential report included by Mr.
2 Doane in workpapers explains the role played by telephone publishing within the large
3 telephone companies as follows:

4 **[CONFIDENTAL BEGINS]**
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6 **
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11 **
12 ****************** **[CONFIDENTIAL ENDS]**
13

14 The consistently superior profitability of the telephone company publishers, relative to
15 independent publishers, is reasonably attributed to the many advantages associated with
16 affiliation with the regulated telephone business.

17 **Q. Do the incumbent telephone company publishers of directories control most of the**
18 **yellow pages advertising market as a result of their incumbent position and the**
19 **benefits of affiliation with the telephone companies?**

20 A. Yes. According to Simba Information, Inc., a directory publishing industry research
21 firm, "Utility publishers, including the RBOC and independent telcos, had an
22 **[CONFIDENTIAL BEGINS]** ***** **[CONFIDENTIAL ENDS]** share of the yellow
23 pages market in 2002. The RBOCs had **[CONFIDENTIAL BEGINS]** *****
24 **[CONFIDENTIAL ENDS]** of the market, while independent telcos had
25 **[CONFIDENTIAL BEGINS]** **** **[CONFIDENTIAL ENDS]**.[23]

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22 Id. Pages 17 and 45.

23 Doane Workpapers, Tab 7: Simba Information Inc., Yellow Pages Market Forecast 2003, page 46. Minor rounding errors appear to exist in these figures.

1 **Q. Is it necessary for independent publishers to charge lower prices for yellow pages**
2 **advertising because they do not enjoy the pricing power of the incumbent telephone**
3 **company publishers?**
4 A. Yes. Independent publishers have been able to successfully expand their share of the
5 directory publishing market at the expense of the incumbent telephone company
6 publisher only by offering significantly lower prices to enter new markets. This is
7 explained by Simba Information as follows:
8 **[CONFIDENTIAL BEGINS] ******************************
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10 ***
11 ***
12 ***
13 ***
14 ***
15 ***
16 ***
17 ***
18 .**[CONFIDENTIAL ENDS]** [24]
19
20 Competitive entry through reduced pricing is not limited to the
21 independent publishers. When a telephone company publisher seeks to move
22 outside its utility service territory, it too finds reduced pricing important to
23 success because the benefits of ILEC affiliation and incumbent status it enjoys in
24 the traditional market area are not valuable elsewhere. Simba describes Verizon's
25 out-of-franchise expansion efforts in 2002:
26
27 **[CONFIDENTIAL BEGINS]**
28 ***
29 ***

24 Doane Workpapers, Tab 5: Simba Information Inc., Independent Yellow Pages Markets 2002: Navigating the Changing Landscape (2002), page 75.

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************ **[CONFIDENTIAL ENDS]**[25]

In my opinion, the differential in pricing and profit margins between incumbent telephone company publishers and the independent publishers of directories is a strong indication of value associated with affiliation to the regulated telephone company business and the utilization of the regulatory asset described herein.

Q. Has the benefit associated with "official publisher" status been acknowledged by any entities that need not be concerned with regulatory issues associated with directory imputation?

A. Yes. Dex Media, Inc. was the buyer of Qwest's directory publishing business in a transaction approved by this Commission in August of 2003.[26] In its Amendment No. 1 to Form S-4 filed with the Securities and Exchange Commission on August 2, 2004, Dex Media describes its business as follows:

> We are the exclusive publisher of the "official" yellow pages and white pages directories for Qwest in the following states where Qwest is the primary incumbent local exchange carrier: Arizona,

25 Doane Workpapers, Tab 7: Simba Information Inc., Yellow Pages Market Forecast 2003, page 47.
26 See Tenth Supplemental Order, Docket No. UT-021120 dated August 1, 2003.

> Colorado, Idaho, Iowa, Minnesota, Montana, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, Utah, Washington and Wyoming, or collectively the "Dex States." Our contractual agreements with Qwest grant us the right to be the exclusive incumbent publisher of the "official" yellow pages and white pages directories for Qwest in the Dex States until November 2052 and prevent Qwest from competing with us in the directory products business in the Dex States until November 2042. (page 87 "Business")

Considerable additional detail regarding industry overview, industry outlook, competition and Dex Media strategies is described in this document. I have included excerpts from this Dex Media, Inc. SEC filing as Exhibit MLB-4.

Q. When Qwest sold its directory publishing regulatory asset to Dex Media, were ratepayers compensated for the transfer of the regulatory claim upon directory profits?

A. Yes. A Settlement Agreement was approved by the Commission that provided for up-front payments to customers of $67 million in bill credit form, as well as ongoing annual revenue credits in lieu of imputation starting at $110 million per year for four years and $103.4 million per year, thereafter, for an additional 10 years.[27]

III. VERIZON'S NEW DIRECTORY PUBLISHING AFFILIATE CONTRACTS ARE UNREASONABLE

Q. Earlier in your testimony, you referred to the previously effective Verizon affiliate Publishing Agreements between the telephone company and its directory publishing affiliate that provided for a sharing of yellow pages advertising revenues. Please describe these contracts.

27 Id. Pages 12 and 13 and Appendix B.

1 A. Prior to merging with Bell Atlantic to form Verizon, the GTE and Contel local exchange
2 operations in Washington had separate directory publishing affiliate contracts that
3 provided for a sharing of directory advertising revenues between the telephone operating
4 company and the publishing affiliate(s).

5 For the GTE Telephone Operating Companies, a Master Publishing Agreement
6 ("MPA") dated January 1, 1991 provided, "WHEREAS, the Directory Company and the
7 Telephone Company for their mutual benefit desire, on the terms set forth herein, to
8 jointly pursue, develop, maximize and share revenues from white and yellow page
9 directory adverting". An ADDENDUM to the MPA specified for GTE Northwest a
10 Franchise Revenue sharing percent of 63.09%.[28] The initial term of the MPA was through
11 December 31, 1995 with automatic annual renewals thereafter in the absence of written
12 notice of termination. By Amendment dated February 25, 1993, this initial term was
13 extended to December 31, 2001. However, the MPA was replaced by a new Publishing
14 Agreement effective January 1, 2000 that eliminated revenue sharing and implemented a
15 new "Fee for Services" approach to the affiliate company disposition of directory profits,
16 leaving much less directory revenue and income within the regulated telephone
17 company.[29]

18 For the Continental Telephone Company of the Northwest operations now within
19 VZNW, an affiliated interest Telephone Directory Publishing Agreement dated August 15,
20 1985 with Mast Advertising & Publishing, Inc. provided for retention by the telephone
21 company of 35% of the gross advertising revenues from directory advertising, which

28 Verizon response to Data Request PC-152, Attachment PC-152.c.
29 Verizon response to Data Request PC-152, Attachment PC-152.b.

1 revenue included foreign and national advertising accounts.[30] A First Amendment to this
2 contract dated October 10, 1995 referenced the merger of GTE and Contel and the
3 acquisition of Mast Advertising & Publishing by Associated Directory Services Inc.
4 ("ADS") and also increased the telephone company share of gross directory advertising
5 revenues to 46.37 percent in Washington. Then, a Second Amendment dated November
6 15, 1999 extended the term of this revenue sharing arrangement through December 31,
7 2001 on an automatic renewal basis thereafter, subject to termination by 120 days prior
8 notice. However, as in the case of the GTE properties, these arrangements for Contel were
9 also replaced by the new Publishing Agreement effective January 1, 2000 that eliminated
10 revenue sharing and implemented the new "Fee for Services" approach.

11 **Q. Did the affiliate publishing agreements that existed prior to 2000 provide some**
12 **compensation to the telephone company for use of the regulatory asset, the intangible**
13 **official publishing rights associated with the telephone business?**

14 A. Yes. While imputation may have still been required historically, due to the size of the
15 revenue retention percentage received by the telephone company, at least there was some
16 recognition of the value of the official publisher right prior to 2000.

17 **Q. What was the financial impact upon the telephone company of changes to the**
18 **directory publishing affiliate contracts?**

19 A. The regulated telephone business in Washington suffered major declines in revenues and
20 income as a result of the new Publishing Agreement. These impacts were quantified in
21 the Company's response to WUTC Staff Data Request No. 20 for the 1999 year, the last
22

30 Verizon response to Data Request PC-152, Attachment PC-152.d, paragraphs 10 and 11A.

1 year when the sharing arrangement was effective:

2 Intrastate Revenues on the Fee for Service Basis	$1,269,195
3 Directory Revenues – Gross	$52,119,140
4 Directory Settlement to Publisher	(16,608,863)
5 Net Telephone Revenues – Sharing Basis	$35,510,863

6

7 This comparison indicates an annual net revenue loss to the telephone company of more
8 than $34 million as of 1999. Given the affiliated interest relationship between the parties
9 to the old and new directory publishing agreements, the Company should be prepared to
10 demonstrate that it acted reasonably and prudently on behalf of the regulated business in
11 forfeiting such a large amount of revenue. Unfortunately, no showing has been attempted
12 by the Company to justify such changes.

13 **Q. Does adoption of the new Fee for Services affiliate Publishing Agreement tend to**
14 **reduce the regulated earnings reported by VZNW to the Commission?**

15 A. Yes. A seriously negative earnings impact was experienced starting in 2000, as a result of
16 Verizon's decision to move directory revenues out of the regulated business unit and into
17 the non-regulated publishing affiliate's books. This negative impact was the subject of
18 Staff witness Ms. Paula Strain's testimony in the interim phase of this Docket.[31]

19 **Q. What was the stated purpose for the GTE Operating Companies agreement to**
20 **forfeit their historical share of directory advertising revenues under the new**
21 **Publishing Agreement made effective among the affiliates in January of 2000?**

22 A. No clear explanation has been given for the major shift in directory revenue attribution
23 among affiliates that occurred in 2000. At page 21 of his testimony, Verizon witness Mr.
24 Trimble argues that "Verizon NW charges market-based rates for all the services it

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31 Testimony of Paula M. Strain Regarding Interim Relief, July 14, 2004, pages 14 and 21.

1 provide to VDC and to any other competitive directory provider." He then identifies only
2 "directory listing information" and "billing and collection" as such services provided to
3 VDC. Mr. Trimble completely ignores VZNW's grant of an extremely valuable
4 exclusive right to publish the official Verizon directories within the VZNW service
5 territory. While common ownership and control by Verizon Communications allows
6 Verizon to avoid contractually documenting this grant of official directory publisher
7 status or VZNW's intent to not compete with VDC in publishing directories, there can be
8 little doubt that VDC enjoys the benefits of all of the linkages to the regulated telephone
9 company that are identified herein.

10 **Q. How do you know that VDC is utilizing and enjoying the benefit of Verizon**
11 **Northwest's intangible assets, without compensation under the 2000 and subsequent**
12 **affiliate Publishing Agreements?**

13 A. One need look no further than the Verizon affiliate publishing agreements effective prior
14 to 2000 that compensated VZNW for its participation in and contribution of intangible
15 assets to the directory business by sharing more than $30 million annually in advertising
16 revenues. Another point of reference is the previously noted Qwest Dex sale in which a
17 non-affiliated buyer paid more than $7 billion to acquire Qwest's directory publishing
18 business and contractual official publisher designations with a long-term non-competition
19 agreement to secure the use of these intangible assets. Additionally, as noted above, the
20 persistently high profits earned by Verizon and the other incumbent telephone company
21 publishers is an indication that they enjoy competitive advantages by cost-free affiliation
22 with an incumbent telephone company.

1 **Q. At page 21 of his testimony, Mr. Trimble continues with the statement, "Both the**
2 **Publishing Agreement and the Billing and Collection Agreement between Verizon**
3 **NW and VDC are structured such that each party receives due compensation for**
4 **the activities and services that it provides to the other. By design, the contracts are**
5 **also competitively neutral; that is, the terms are equivalent to those provided to**
6 **other unaffiliated companies and each contract presents price sets that must be**
7 **considered market-based rates. As a consequence, the charges extended by Verizon**
8 **NW to VDC must be considered reasonable and prudent." How do you respond?**

9 A. The affiliate Publishing Agreement was restructured in 2000 to explicitly identify and
10 charge VDC for only the tangible goods and services that are provided, completely
11 ignoring the official publisher status and other intangible assets that are used in VDC's
12 business with no compensation to the telephone company. This is completely
13 unreasonable and imprudent from the perspective of VZNW business interests. In my
14 opinion, Verizon did not consider this VZNW perspective and adopted a new Publishing
15 Agreement that was not equitable to all parties.

16 This opinion is confirmed in the Company's documentation associated with the
17 analysis and "negotiation" of the Publishing Agreement among the affiliates, where the
18 only apparent consideration given the loss of directory revenue sharing on the telephone
19 company's books is referenced in a "DIRECTORY – FEE FOR SERVICE ADVOCACY
20 PLAN" that is apparently concerned more with defending the change before state
21 regulators than explaining and justifying the revenue shifts.[32] This document
22 acknowledges the drastic shift in compensation to the telephone companies, describing

32 Verizon Response to Staff Data Request 250 (Exhibit 70, UT-040788 Interim Rate Request Hearing).

1 the former arrangement as follows, "The MPA compensates the parties based on a
2 division of revenue in which the telephone companies retain approximately 61% of the
3 advertising revenue. The 39% remainder represents GTE Directories' share of the
4 revenue. Basically, the directory publisher pays a royalty payment to the Telephone
5 Company based on a publishing right which varies by state from a low of 56.89% in Iowa
6 to a high of 66.89% in Hawaii." However, no explanation is given for equitable
7 compensation in lieu of sharing, except for an apparently insincere statement under **Key**
8 **Messages** that, "The new Fee for Service contract will not impact the rates of the
9 subscriber. Customers will continue to be charged their current rates. *(In states where*
10 *we are required to impute, the imputation will continue to occur).*"

11 Notably, U S West Communications attempted to adopt a similar fee-based
12 affiliate publishing agreement in 1988 that terminated a "publishing fee" that was
13 previously paid to the telephone operating companies. The Commission consistently
14 required imputation of excessive directory publishing income on the books of the
15 publishing affiliate of U S West in all subsequent years within rate cases, so as to correct
16 for the misappropriation of the telephone company's intangible assets without due
17 compensation. Ultimately, upon sale of the Qwest Dex business, further compensation to
18 ratepayers was agreed upon for the transfer of valuable intangible assets used in directory
19 publishing, as noted in my prior testimony.[33]

20 **Q. Has the Commission ever reviewed or approved the Fee for Services style affiliate**
21 **Publishing Agreement that is being referenced in Mr. Trimble's testimony?**

33 See WUTC Second Supplemental Order in Docket No. U-86-156, Fifteenth Supplemental Order in Docket No. UT-950200 and the Commission's Fourteenth Supplemental Order in Docket No. UT-980948.

1 A. No. According to Verizon's response to Data Request PC-147, "beginning in 1998, pre-
2 approval of affiliate contracts went away when new legislation was passed. After that,
3 contracts were allowed to go into effect with no formal Commission approval required."

4 **Q. Was the January 2000 Publishing Agreement the last change to this affiliate**
5 **relationship that has occurred?**

6 A. No. Another new Directory Publishing Agreement was made effective on January 1,
7 2003 that references the telephone company as having "certain regulatory obligations to
8 publish and distribute telephone directories", in an apparent effort to show additional
9 value being received by the telephone company. Then, under the new Agreement at
10 paragraph 2.1, "The Publisher hereby agrees to fulfill, in accordance with the terms and
11 conditions of this Agreement, the Telephone Company's Regulatory Obligations".

12 One might wonder why there is no "fee" established for this service under the
13 new Agreement as the costs are clearly substantial to compile, print and distribute white
14 pages. However, the reality is that the affiliated publisher as well as many competing
15 publishers would quite willingly commit to publish the telephone company's directories
16 in fulfillment of this regulatory "obligation" in return for exclusive, official publisher
17 status and to meet the commercial interests in being able to promote a comprehensive
18 books to advertising customers. Indeed, Dex Media has committed to fulfill Qwest's
19 directory publishing operation in Washington and 13 other states through the year 2052 at
20 no charge to Qwest, in addition to paying $7.05 billion for the right to serve as official
21 publisher while fulfilling this obligation.

22 **Q. Has the WUTC historically found intangible assets used in directory publishing to**
23 **be regulatory assets?**

1 A. Yes. The intangible, going concern value of the directory publishing business that arises
2 from affiliation with the telephone business is what this Commission has recognized to be
3 a regulatory asset for many years. For example, in its Second Supplemental Order, in
4 Docket No. U-86-156 and in all subsequent U S West imputation decisions, the
5 Commission treated Directory publishing as a regulatory asset and determined that "the
6 public interest requires the full reasonable value of directory publishing be available to
7 PNB for ratemaking purposes."

8 Verizon's directory publishing intangible assets that exist today also arise from
9 ILEC operations. Unfortunately, the value associated with Verizon "official publisher"
10 status and the use of VZNW intangible assets have been imprudently granted to VDC by
11 the operating telephone company affiliates without reasonable consideration through non-
12 arm's length affiliate publishing arrangements. These intangible assets have already been
13 found by the WUTC and the Supreme Court to be an asset retained by the regulated
14 business until a showing has been made that the full, fair value has been transferred for
15 reasonable consideration to the telephone company.[34]

16 17 **IV. IMPUTATION OF VDC EXCESS PROFITS REMAINS NECESSARY AND APPROPRIATE**

18 **Q. Do the linkages between the telephone company and the publishing affiliate justify**
19 **the continued attribution of the value of the directory business to telephone**
20 **ratepayers, even though the directory publishing business no longer shares**
21 **advertising revenues pursuant to affiliate contract?**

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34 See in particular the Commission Fourteenth Supplemental Order Denying Petition in Docket No. UT-980948 at paragraphs 169 through 175.

1 A. Yes. Recognition of the excessive profits of the directory publishing affiliate has been
2 necessary historically when setting rates because these profits are created from the unique
3 benefits of affiliation with the regulated telephone business, benefits that arise from and
4 are integrally related to the provision of local telephone services. There has been no
5 recognition and accounting of (or compensation for) the value of intangible assets used in
6 publishing VZNW directories in Washington within the presently effective affiliate
7 publishing agreements. These intangible assets include the exclusive right to publish the
8 telephone company's directories, using telephone company trademarks, trade names,
9 business reputation and established customer relationships. Imputation is even more
10 important for the Verizon operating companies now that directory revenue sharing has
11 been eliminated through adoption of unreasonable and grossly imprudent Fee for
12 Services affiliate publishing agreements.

13 **Q. Has this Commission previously attributed virtually all the directory publishing**
14 **regulatory asset to customers, rather than to shareholders?**

15 A. Yes. All of the excess profits earned from directory publishing, above a regulated return
16 on investment, have been imputed into telephone company revenues in Washington rate
17 cases involving Verizon and U S West.[35] The effect of this imputation has been to
18 reverse the subsidy otherwise created by affiliate publishing contracts that would move
19 some or all of the benefits associated with official publisher status to the parent-holding
20 company in the form of an earnings windfall on the books of the publishing affiliate.

35 WUTC Second Supplemental Order, Cause No. U-82-45 (August 18, 1983) pages 21-23, WUTC Second Supplemental Order, Cause No. U-84-18 (January 15, 1985), page 14.

1 **Q. Has Verizon Northwest granted VDC, through existing affiliate contracts, the right**
2 **to use its valuable intangible assets without compensation, effectively shifting**
3 **directory publishing income to VDC?**
4 A. Yes. The affiliate company Publishing Agreements effective since January 2000 have
5 continuously granted usage of the official publishing right and related intangible assets to
6 VDC at no cost. This creates a subsidy to VDC and its parent, if the Commission fails to
7 properly impute for such value in determining VZNW's revenue requirement. A more
8 equitable publishing agreement would either contain a publishing fee as compensation for
9 the use of the intangible assets or would continue a revenue sharing arrangement as
10 provided for in the earlier agreements.
11 **Q. Would it be possible for the regulated telephone company to exploit the directory**
12 **publishing opportunity for its own account, if not for the parent company's decision**
13 **to separately organize the publishing business within an affiliate company?**
14 A. Yes. Prior to divestiture in 1984, the Bell operating companies provisioned the sales,
15 compilation, printing and distribution of white and yellow page directories within the
16 telephone operating companies or using non-affiliated contractors. Thus, history
17 indicates that directory self-provisioning or third party contracting with non-affiliates is a
18 viable solution that can be used to internalize the directory function and exploit the
19 opportunity to realize directory advertising profits. It would be possible for VZNW to
20 independently publish its own directories, particularly if VDC chose to cooperate in this
21 effort by not competing against VZNW. The official publisher status arises from
22 operating as the incumbent local exchange carrier and the attribution of the value
23 associated with this intangible asset to VDC is entirely a result of the non-arm's length

1 affiliate publishing agreements that have been installed under common corporate
2 ownership.

3 **V. QUANTIFICATION OF THE IMPUTATION ADJUSTMENT**
4
5 **Q. Have you prepared a ratemaking adjustment to quantify the directory imputation**
6 **amount that should be added back into VZNW's test period revenues, as a remedy**
7 **to the unreasonable affiliate company publishing agreement?**
8 A. Yes. I have actually prepared a matrix of possible adjustments, applying three different
9 imputation methodologies to financial data from two different years, calendar 2002 and
10 calendar 2003. I will discuss each methodology in testimony and then recommend a
11 single imputation value that is most appropriate for use in the rate case.
12 **Q. What are the three methodologies you have employed to quantify the appropriate**
13 **imputation amount?**
14 A. The first methodology I sponsor is based upon the work done by Verizon to "carve-out" a
15 Washington share of the VDC directory publishing business financial data that most
16 directly relates to the printed directory business in Washington. The Company's
17 response to Data Request PC-220 provided confidential spreadsheet analyses that isolated
18 the local directory advertising revenues and directly attributable printing and distribution
19 costs associated with Washington printed directories in each of two years, calendar 2002
20 and calendar 2003. Other indirect publishing costs, general administrative expenses and
21 certain balance sheet investment amounts for VDC's domestic operations are allocated to
22 Washington based upon relative revenue statistics to complete this analysis. After
23 making some further adjustments to the Company's carve-out analysis, my calculations

1 apply the Public Counsel's recommended pretax cost of capital to allocated Washington
2 VDC investment to calculate an excess earnings amount for imputation into telephone
3 company earnings.

4 The second methodology is based upon reversion to the prior "retention ratio"
5 form of affiliate publishing agreement. This method applies a telephone company share
6 of 63.09 percent to Washington net local directory advertising revenue in each of the two
7 years to determine an approximate amount that would have been on telephone company
8 books had this earlier form of affiliate contract remained in force. It is then necessary to
9 subtract the actual amounts recorded by VZNW in each year under the current "fee for
10 service" style affiliate contract for listings and billing & collection services, because such
11 revenues would not exist under the prior affiliate contract that compensated the telephone
12 company for use of intangible assets as well as listings and billing services via the
13 sharing of revenues approach.

14 The third methodology I present employs the WUTC Staff calculation that has
15 been applied to quantify imputation in prior U S West Communications ("USWC") rate
16 cases and in USWC/Qwest financial reporting to the Commission. Under this approach,
17 there is no carve-out of specific amounts of revenue and cost associated with VDC's
18 business in Washington, but instead the bottom line income of VDC is simply allocated
19 to Washington using a relative revenue ratio based upon Washington advertising
20 revenues divided by total advertising revenues. A return at Public Counsel's
21 recommended overall cost of capital is allowed on allocated VDC investment used to
22 support Washington operations using the same revenue based allocation ratio, with all
23 "excess" earnings used as the imputation value.

1 **Q. Why did you elect to calculate imputation amounts across two years, 2002 and 2003,**
2 **for consideration by the Commission?**
3 A. Accounting information in a single year can be influenced by unusual or non-recurring
4 transactions. Through examination of multiple years, the potential for distortion can be
5 mitigated somewhat. Additionally, VDC changed its method of revenue and income
6 recognition from the point of publication approach used in 2002, under which directory
7 revenue and direct expenses are recognized in the single month when the directory is
8 distributed, to an amortization approach in 2003 that spreads revenue and expense
9 recognition over the life of the directory. While the cumulative income effect of this
10 accounting methodology change is not included in either year's data, there are balance
11 sheet impacts that can be observed between the two years and that are captured in my
12 two-year analysis. Finally, the test year in this Docket spans both 2002 and 2003,
13 suggested that VDC financial results from both years are relevant.
14 **Q. Have you prepared an Exhibit to document the calculations associated with each**
15 **methodology in each of the two years?**
16 A. Yes. Confidential Exhibit MLB-5 sets forth each methodology separately on pages one
17 through three. Because Verizon has designated all of this information confidential, much
18 of the input data is redacted on the public version of these schedules, but the results can
19 be summarized as follows:

Summary of Intrastate Imputation Values $000	2002	2003
Income Carve-out Method	$ 35,865	$ 30,567
Retention Ratio Method	$ 41,735	$ 40,947
USWC Method	$ 34,042	$ 30,716

20

1 Several observations can be made from these results. First, the VDC financial results in
2 2002 are somewhat better than in 2003 under all three methods. This may be due in part
3 to an accounting change that was implemented by VDC in 2003 to commence accounting
4 for directory income on an amortized basis over the life of each printed books, rather than
5 recognizing income entirely within the first month each directory is issued. It is also
6 obvious that the previously employed revenue sharing approach at the 63 percent
7 telephone company percentage that was effective within affiliate contracts prior to 2000
8 produces an imputation result much higher than the other methods. Finally, in year 2003,
9 either the Income Carve-out or the USWC method yield similar results that are the most
10 conservative among all the methods in all the years.

11 **Q. What is your recommendation regarding the most appropriate directory imputation**
12 **adjustment amount?**

13 A. I recommend the Year 2003 Income Carve-out Method be used, as it most accurately
14 portrays the actual financial performance of the printed directory business in Washington
15 using the most detailed available cost assignments for directory printing and distribution
16 costs in Washington. This approach is based upon calculations performed by Verizon in
17 response to Public Counsel Data Request PC-156, as compelled by the Commission's
18 Order No. 10, and PC-220 to simulate the carve-out of directory business financial results
19 in Hawaii to prepare information made available to potential buyers interested in
20 acquiring that business.

21 **Q. Have you made any adjustments to the Company's VDC carve-out analysis in**
22 **preparing Exhibit MLB-5, page 1?**

1 A. Yes. I adjusted the Company's carve-out analysis to include the National Yellow Pages
2 Service or "NYPS" print advertising revenues, since these revenues from large business
3 customers purchased in multiple directories are an important part of the income stream
4 produced by publishing directories in Washington. A corresponding upward adjustment
5 in cost allocations was made as a result of including the NYPS revenues. If NYPS
6 revenues are not included, the carved-out Washington financial results would include all
7 of the costs of printing and distributing books in Washington, but not all of the revenues
8 derived from those directories.

9 Another adjustment made was to the rate of return allowed for VDC's fixed
10 investment in Plant, Property and Equipment and Inventories. I recommend this VDC
11 allocated investment be allowed to earn the higher common equity return recommended
12 by Public Counsel, rather than the lower weighted overall cost of capital. I applied this
13 100 percent equity capital structure and cost rate to explicitly eliminate all financial risk
14 from the VDC capitalization, so as to mitigate any incremental operating risk associated
15 with the directory publishing business relative to the regulated local exchange telephone
16 business in Washington. Both the ILEC and printed directory business enjoy the
17 benefits of incumbency and large economies of scale as part of Verizon, while
18 experiencing some exposure to competition. I believe the complete elimination of
19 financial leverage by adoption of the 100 percent equity capitalization in computing the
20 imputation amount serves to mitigate any alleged incremental operational risks associated
21 with competition in directory publishing.

22 **VI. REBUTTAL TO VERIZON DIRECTORY WITNESSES**
23

1 **Q.** **At page 6 of his testimony, Mr. Doane states, "However, as discussed below, there is**
2 **sufficient competition in the market in which VDC operates to alleviate any**
3 **concerns the Commission may have regarding 'excess' returns in the provision of**
4 **directory advertising" Have you calculated the rate of return earned by VDC in**
5 **2003?**
6 A. Yes. According to the Company's Confidential Attachment to Data Request PC-221,
7 VDC earned Income Before Special Items of **[CONFIDENTIAL BEGINS]** ****
8 **[CONFIDENTIAL ENDS]** million on year-end Stockholders' Equity of
9 **[CONFIDENTIAL BEGINS]** **** **[CONFIDENTIAL ENDS]** million, which
10 represent a return on equity of about **[CONFIDENTIAL BEGINS]** ************
11 **[CONFIDENTIAL ENDS]** Clearly, this level of achieved return on equity is reflective
12 of the unique advantages arising from VDC's affiliation with the Verizon ILECs that are
13 not sufficiently compensated under the non-arm's length affiliate publishing agreements
14 that eliminated equitable revenue sharing starting in the year 2000. Achieving such a
15 high return in advertising and directory publishing markets said to be competitive by Mr.
16 Doane suggests that VDC enjoys some unique competitive advantages.
17 **Q.** **At pages 9 through 46 of his testimony, Mr. Doane then addresses his understanding**
18 **of directory publishing and broader advertising market conditions. Has there been**
19 **competition in the markets for directory advertising for many years?**
20 A. Yes. Independent directory publishers have existed for many years and alternative
21 media, such as television, radio, newspapers, magazines, outdoor and direct mail are
22 similarly long-lived. Incumbent directory publishing companies that are affiliated with
23 telephone companies have prospered and dominated the industry in spite of significant

1 long-standing competition from these sources. My previous testimony describes how the
2 incumbent telephone company publishers dominate the directory publishing business
3 even in the presence of established competitors, and actually earn much higher profit
4 margins because of their incumbent status.

5 **Q. How is the competition that Mr. Doane describes throughout his testimony**
6 **addressed within the imputation calculations you describe in your testimony?**

7 A. Because the Commission's imputation methods use VDC's actual revenues or actual
8 earnings levels as the starting point, all competitive pressures faced by the company in
9 selling directory advertising are directly reflected in the resulting imputation
10 recommendation. If increased competition from independent publishers or alternative
11 media reduce the achieved sales and profits of VDC, the imputation amount will be
12 reduced proportionately. Alternatively, as incumbent telephone companies continue to
13 dominate directory publishing markets, they continue to earn supra-competitive returns.

14 **Q. At page 6, Mr. Doane states, "Even if some value of the directory business were**
15 **derived from its association with the ILEC, customers of Verizon NW do not own**
16 **the assets of the local exchange company or its unregulated affiliates, any more than**
17 **customers of AT&T or Sprint own their networks" How do you respond?**

18 A. Ownership of the intangible assets used by incumbent telephone company publishers is
19 not relevant to the discussion of whether some directory profits should be considered in
20 setting telephone rates. Ratepayers need not own utility assets for the Commission to
21 exercise jurisdiction over the disposition of the related costs and benefits. Consider, for
22 example, that customers of an electric utility need not own the utility's generation plant
23 for the Commission to find reasonable an offset to utility revenue requirements to

1 account for off-system sales profits derived from selling energy from such plant.
2 Similarly, customers need not own utility poles for rates for Commissions to set rates for
3 regulated services considering pole attachment rents paid by third parties as an offset to
4 cost of service. If a utility is able to rent unused space in a building or sell advertising in
5 bill stuffers, it would be considered prudent and quite appropriate to credit the revenue
6 earned from such activities to the revenue requirement otherwise recoverable from utility
7 customers.

8 Ownership is simply not the issue. In past imputation decisions the Commission
9 found directory publishing operations to be a regulatory asset, with no need to examine
10 the title to specific assets. When Qwest sold its Dex business, ratepayers participated in
11 the gain on sale even though they never owned the Dex intangible assets that caused the
12 gain to be realized. Finally, Verizon shared its directory advertising revenues between
13 the telephone company and the affiliate publisher on a retention ratio basis for many
14 years, without regard to ownership of assets.

15 **Q. Is directory imputation inconsistent with the requirements of the Universal Service**
16 **provisions of the Telecommunications Act of 1996, as asserted by Mr. Doane at**
17 **pages 8 and 9?**

18 A. No. As described in my previous testimony, there is no subsidy created when the official
19 directory publishing opportunity that arises from telephone service incumbency is
20 prudently exploited. There is a long and consistent regulatory policy established by the
21 WUTC in the Orders cited herein and by other regulatory commissions that base
22 regulated telephone service revenue requirements upon the net cost of service, reduced by
23 value received in connection with the directory publishing by-product revenue stream.

1 This Commission rejected this argument at page 36 of the 1995 U S West rate case
2 Order:

> 3 8. USWC argues that under the Telecom Act, universal service may
> 4 only be subsidized on an equitable and nondiscriminatory basis, and
> 5 imputing income to USWC is improper because there is no evidence
> 6 subsidies are needed by all customers including those who may be
> 7 millionaires.
> 8
> 9 The Commission rejects this argument. The proposal is not a
> 10 universal service subsidy. It is a ratemaking adjustment. Its purpose is
> 11 to reflect funds that would be available to the Company, but for
> 12 Company action. In any event, the Commission finds in this Order that
> 13 existing rates for local exchange service do cover incremental costs of
> 14 providing that service, which thus needs no "subsidy", and the
> 15 Commission does not attribute or "earmark" the directory imputation
> 16 directly to any class of customers. Therefore the subsidy argument is
> 17 inapposite.[36]
> 18

19 The Utah PSC also rejected the "subsidy" argument in its Order in a 1997 U S
20 West rate case:

> 21 A subsidy argument often times made in the context of the profit margin
> 22 or revenue contribution in excess of costs for specific services. This is
> 23 phrased as follows: Service A provides a return or profit of 5 percent,
> 24 service B provides a return or profit of 10 percent; therefore, service B is
> 25 subsidizing service A. In the telecommunications industry, like other
> 26 industries, few, if any, suppliers receive exactly the same contribution or
> 27 margin on each and every product or service they produce. We believe
> 28 that it is in this context of differing levels of contribution or profitability
> 29 that Judge Green made his comment. Consideration of margins and
> 30 levels of profitability have bearing in the rate design aspect of setting
> 31 rates. See discussion in Part III, below. But, in determining the revenue
> 32 requirement of USWC, we are concerned with the total revenue sources,
> 33 not the individualized profitability of separate products and services. To
> 34 ignore revenues from one area of a utility's operations in determining the
> 35 revenue requirement would result in unjust and unreasonable rates. *Cf.,*
> 36 *Stewart v. Public Service Commission,* 885 P.2d 759 (Utah 1994). This
> 37 aspect of utility regulation is end-result driven. See, e.g., *U.S. West*
> 38 *Communications v. Public Service Commission, 882 P.2d 141, 147*
> 39 *(Utah 1994)* (a utility may even be required to provide unprofitable
> 40 services, as long as the utility is allowed a reasonable opportunity to earn

36 WUTC Fourteenth Supplemental Order in Docket No. UT-950200, page 36.

1 its authorized rate of return on its overall investment). Adoption of
2 USWC's argument would carve out the directory operations' revenues,
3 which *Wexpro I* requires us to use. We cannot follow this 'subsidy'
4 argument if the means to the end is to leave out of the revenue
5 requirement calculations revenues which are required to be included.
6 The end result would not survive court review. *Stewart, supra*.
7 Removal of subsidies does not mean the elimination of revenues from a
8 product or service which exceeds its incremental costs. We cannot
9 construe U.C. A. 54-8b-2.4 to require a means that results I an unlawful
10 end.[37]
11

12 **Q. Turning to the testimony of Verizon witness Trimble at page 3, do you agree with**
13 **the statement, "…a straightforward review of the Verizon NW – VDC contractual**
14 **arrangements leads to only one conclusion: without any consideration of**
15 **imputation, these contractual arrangements are consistent with affiliated interest**
16 **guidelines and provide for reasonable and prudent revenues flows between the**
17 **affiliated companies"?**

18 A. No. The affiliate publishing agreement contractual arrangements that Mr. Trimble
19 references that have been effective between Verizon affiliates since 1999 are grossly
20 imprudent in failing to provide any compensation to the telephone affiliate in return for
21 the exclusive use of the official publisher status and other intangible assets that are
22 granted the publisher. Through non arm's length contracting, Verizon abruptly
23 terminated a $35 million revenue sharing arrangement that the same parties apparently
24 considered prudent the day before January 1, 2000. The affiliate contracts now in place
25 between the affiliates provide compensation for only tangible services that are provided
26 by the telephone company, such as listings information and billing and collection
27 services.

37 Utah Public Service Commission Docket No. 97-049-08, Commission Order dated December 4, 1997, pp.

1 This fee for services arrangement is essentially the same as the U S West open
2 directory architecture contracts that were in place during the 1995 Washington rate case,
3 which contracts were specifically found unreasonable by the Commission in its past
4 decisions requiring imputation, as outlined at page 12 of the U S West Accounting Order
5 (Fourteenth Supplemental Order in Docket No. UT-980948):

> 6 Near the end of 1988, after only five years of the "guaranteed" revenue
> 7 stream it had committed to the Commission, PNB agreed to the
> 8 termination of publishing fees without Commission approval and without
> 9 any further financial consideration from its affiliate. In a letter dated
> 10 December 12, 1988, U S WEST Direct's Vice President-Marketing, Max
> 11 G. Johnson, wrote Dennis Okamoto, then Vice President-Treasurer of
> 12 PNB, advising him that "the intercompany 'subsidy' payment
> 13 [publishing fee] will cease to be effective 12/31/88." Ex. 609. Mr.
> 14 Okamoto agreed to this action.
> 15
> 16 ***2. Further Revised Agreements, Cause No. U-86-156***
> 17
> 18 USWC subsequently applied for an order approving a newly revised,
> 19 extended publishing agreement. The Commission again partially and
> 20 conditionally approved the agreement, subject to a future review of the
> 21 appropriate level of publishing fees in a full rate case setting. *Third*
> 22 *Supplemental Order, In re Application of PNB, Cause No. U-86-156*
> 23 *(February 7, 1989).* Although it approved the publishing agreement, the
> 24 Commission expressly stated its disapproval of the Company's
> 25 "undisguised policy" of acting to "reduce and finally eliminate the
> 26 publishing fee in order to enhance U S WEST's results at the expense of
> 27 telephone subscribers."
> 28

29 As noted herein, full imputation of U S West Direct excess earnings to the credit of
30 telephone ratepayers was ordered by the Commission in 1995 to remedy the insufficiency
31 of compensation under the affiliate publishing agreements. This imputation decision was
32 affirmed by the Washington Supreme Court and later confirmed by the WUTC in its
33 Accounting Order in Docket No. UT-980948.

30-31.

1 The Verizon affiliate contracts Mr. Trimble describes at pages 17 and 18 for
2 listings and for billing and collection services may be reasonable for the specific services
3 they address, but the presently effective Directory Publishing Agreement is unreasonable
4 and inequitable in the crude bargain that is struck, essentially trading "free" services
5 associated with satisfaction of VZNW's so-called "directory obligation" in return for
6 uncompensated status as the official incumbent publisher. Verizon has followed in the
7 footsteps of U S West with an undisguised policy of acting, through revisions to the
8 publishing agreement, to eliminate any publishing fee or other compensation to the
9 telephone company for its role in directory publishing, in order to enhance Verizon's
10 overall financial results at the expense of telephone subscribers.

11 **Q. Mr. Trimble states at page 16, "VDC does not charge Verizon NW for satisfying**
12 **Verizon NW's regulatory requirements." Is this the good deal Mr. Trimble seems**
13 **to imply?**

14 A. No. VDC is quite interested in publishing comprehensive directories containing
15 complete listings information with broad distribution throughout the market areas served
16 by VZNW. The regulatory requirements Mr. Trimble refers to are not an economic
17 burden, but rather an extremely valuable intangible asset, the ability to engage in
18 directory publishing the "official directory" on behalf of the incumbent ILEC. Prior to
19 2000, the publishing affiliate satisfied this "obligation" and also paid $35 million for the
20 privilege of doing so pursuant to the then effective affiliate publishing agreement.

21 In similar circumstances, the buyers of the Dex business from Qwest readily
22 accepted responsibility for "satisfaction of regulatory requirements" for Qwest
23 Corporation and then paid an additional $7.05 billion to acquire the employees, customer

1 relationships, licensing of trademarks and long-term non-competition covenants to
2 prevent Qwest from re-entering the directory market.

3 **Q. At page 20 of his testimony, Mr. Trimble states, "As I discussed above, VDC does**
4 **not charge Verizon NW for the directory publication and distribution services VDC**
5 **provides to the carrier. It is my understanding that VDC considers this activity to**
6 **be an integral part of its overall directory business; as such, VDC must assume that**
7 **the incremental costs involved in the fulfillment of Verizon NW's regulatory**
8 **requirements are *de minimis*. A price of zero cannot possibly be considered to**
9 **represent an overpayment on the part of Verizon NW. Nor does a price of zero**
10 **enhance VDC's revenue flows vis-à-vis other competitive directory providers. Thus,**
11 **the "charges" paid to VDC by Verizon NW are reasonable and prudent." How do**
12 **you respond?**

13 A. I agree with Mr. Trimble that activities and costs associated with publishing
14 comprehensive directories with broad distribution represent "an integral part of [VDCs]
15 overall directory business". One should not assume the incremental costs involved in
16 fulfillment of regulatory requirements are "*de minimis*", but instead the better assumption
17 to be made is that official book status is well worth whatever costs are incurred by the
18 publisher because the benefits of affiliation with the Verizon ILEC far outweigh any
19 incremental costs to satisfy the "publishing obligation".

20 Rather than concluding that "A price of zero cannot possibly considered an
21 overpayment", I submit that VZNW receiving and accepting "zero" for the publishing
22 rights grant to VDC represents an underpayment. VZNW should continue to receive,
23 through either revenue sharing as previously practiced, or through imputation, full value

1 for the official publishing right and other telephone company intangible assets. There is
2 no reasonable basis for VZNW to have given away this regulatory asset starting in 2000
3 by consenting to affiliate publishing arrangements that are so clearly imprudent.

4 **Q. Do you agree with Mr. Trimble's statement at page 23, "The shareholders of**
5 **Verizon NW's parent company bear all the risk for VDC's performance. However,**
6 **under yellow pages imputation, Verizon NW ratepayers ultimately receive all the**
7 **benefits of any upside performance by VDC. This "one way street" is an absolute**
8 **indication that yellow pages imputation is bad public policy"?**

9 A. No. Ratepayers bear considerable risk under imputation, because the amount imputed
10 flows directly from VDC's actual financial results. If directory advertising revenues
11 decline, or if VDC costs increase, the imputation amount will decline and ratepayers will
12 bear corresponding rate increase exposure. Alternatively, if directory revenues grow or
13 costs are reduced, imputation amounts calculated in a rate proceeding will be revised
14 upward. Imputation is symmetrical, with both upside and downside shifts in performance
15 by VDC flowing directly to ratepayers through the imputation formula.

16 **Q. Does the symmetrical performance tracking under imputation have the effect of**
17 **eliminating all profit incentives to VDC management to expand revenues or**
18 **efficiently manage costs?**

19 A. No. Regulatory lag serves as a strong incentive to efficiently manage VDC directory
20 operations because all incremental revenue gains or cost savings are retained by
21 shareholders between rate case test years. Additionally, because VDC operations in
22 Washington represent a modest portion of VDC's overall national directory business, it is
23 unlikely that WUTC ratemaking policies would influence management decisionmaking.

1 **Q. At page 22 and 23, Mr. Trimble recites historical details regarding directory**
2 **publishing in Washington to support a view that "VDC was not developed at**
3 **ratepayer expense." Does this history support a conclusion that imputation should**
4 **be discontinued?**
5 A. No. There has been no showing that directory advertising ever added any risks or
6 financial burdens in Washington. The directory publishing business does not rely upon
7 large tangible asset investments, but is instead dependent mostly upon intangible assets
8 and human resources. Indeed, there are only modest capital investments required to enter
9 the business. The discretionary nature of selling and publishing directory advertising and
10 the minimal incremental capital investment required to enter the directory business makes
11 it highly unlikely that any significant costs or losses were ever incurred by VDC or its
12 predecessors in Washington. Absent any business requirement to publish directories at a
13 loss, prudent early telephone company management would have accepted only
14 advertising that could be profitably included within directories. Notably, Mr. Trimble
15 has not produced any evidence that VDC ever sustained material operating losses or
16 imposed any expenses in excess of advertising revenues.
17 **Q. Mr. Trimble argues at page 8 that, "There should be no question that, through the**
18 **use of yellow pages imputation, the Commission is effectively regulating the**
19 **earnings levels not only of Verizon NW, but of VDC as well. VDC is a competitive**
20 **entity, however, and not subject to regulation by the Commission; indeed, the only**
21 **regulation of its earnings levels should be that implied by the discipline of market**
22 **forces." How do you respond?**

1 A. Imputation simply causes the consolidated Verizon organization to not gift away the
2 directory publishing regulatory asset that arises from ILEC status in Washington, as
3 described in my prior testimony. Rather than "regulating the earnings level of VDC",
4 imputation simply reverses the imprudent transfer of publishing rights from VZNW to
5 VDC without compensation. In this sense, imputation merely requires VDC to pay for all
6 of its input resources, including the publishing rights for the official directories of VZNW
7 in Washington. A more accurate statement would be that the non-arm's length
8 publishing agreements that were changed from 1999 to 2000 sought to regulate the
9 earnings of Verizon Communications, by moving a large share of directory revenues
10 from the telephone company's income statement to the VDC income statement, in hope
11 that ratepayers would ultimately make up for the revenue loss.

12 **Q. Do you agree with Mr. Trimble's statement at page 8 that, "…yellow pages**
13 **imputation distorts rational investment decisions concerning the operations of both**
14 **Verizon NW and VDC in Washington"?**

15 A. No. Imputation simply attributes the market value of VZNW's publishing rights, as
16 realized through VDC's sale of directory adverting, back into the VZNW business entity
17 that is the origin of such value. Rational investment decisions can be made, recognizing
18 that VZNW is a regulated business subject to periodic review by the Commission if and
19 when a rate case if filed. In this sense, the Washington portion of VDC's business is
20 subject to the same form of regulatory lag incentive that influences investment decisions
21 for VZNW.

22 As a practical matter, since VDC does not maintain separate financial records in
23 Washington, imputation necessarily involves application of very small percentage values

1 to the consolidated nationwide business operations of VDC, making it extremely unlikely
2 that imputation would ever impact business investment decisions made for the entire
3 VDC business enterprise.

4 VII. TEST PERIOD MATCHING AND CUTOFFS

5

6 **Q. What test period was employed by Verizon Northwest in preparing its filing?**

7 A. The Company prepared its revenue requirement calculations based upon a basic test year
8 ending September 30, 2003, with numerous adjustments for pro-forma changes in
9 revenues and costs occurring or expected to in the full year beyond test year end.
10 Verizon has subjectively updated the basic test year on a piecemeal basis to a test period
11 ending September 30, 2004. The post test year changes Verizon has chosen to recognize
12 include adjustments for:

13
14
15
- Estimated declines in sales volumes and revenues that were projected to occur through September of 2004, a full year beyond test year-end (Adjustments P1, P2, P3 and P4).

16
17
18
19
- Increased expenses to recognize projected Other Post Employment Benefits cost increases projected through September of 2004 (Adjustment P11).

20
21
22
23
- Increased wage and benefit costs projected through September 2004 resulting primarily from anticipated increases in pension and other benefit costs (Adjustment P12).

24
25
26
- Increased rate base associated with projected Pension Asset balances through September of 2004 (Adjustment P14).

27
28
29
30
31
- Estimated additions to Plant in Service through September of 2004, with no corresponding recognition of depreciation expense accruals and the resulting depreciation reserve growth through the same date (Adjustment P17).

32

1 • Increased expenses to recognize a Management Voluntary Separation
2 Program ("MVSP") that occurred after the test year, ostensibly for the
3 purpose of reducing Verizon's overall cost of service (Adjustment P20).
4

5 The overall result of these piecemeal post-test year adjustments VZNW has proposed is
6 that test period revenue requirements are distorted. There is no consistency or balance in
7 adjustments selected by the Company when determining the changes in costs that should
8 be reflected in the rate filing. Some elements of the revenue requirement have been
9 chosen by Verizon for piecemeal updating, while other equally important elements are
10 retained at levels experienced during the 12 months ended September 30, 2003. If
11 Verizon's adjustments to an updated year ended September 30, 2004 are accepted to
12 produce something resembling a projected test year, certain additional adjustments are
13 required to achieve a more balanced result.

14 **Q. Are some of the specific Company adjustments where a test period consistency issue**
15 **exists discussed separately in testimony sponsored by Mr. Carver?**

16 A. Yes, they are. Mr. Carver will address the Company's expense adjustments, including
17 the incentive compensation, OPEBs and pension asset adjustments. However, this
18 section of my testimony is intended to discuss the concept of test period timing and the
19 matching of revenue requirement component elements, to provide a framework for
20 consideration of the individual issues in other sections of Consumers' testimony.

21 **Q. Why is it important to employ a reasonable balance and consistent cutoff date for**
22 **known and measurable changes in determining public utility revenue requirements?**

23 A. Each of the elements of rate base and operating income that must be measured to
24 determine revenue requirements tend to be dynamic. As time passes, most of the
25 elements of rate base will change in value, while sales volumes, revenues and operating

1 expenses will also fluctuate or, in the case of a typical incumbent local exchange
2 telephone companies, gradually trend downward. It is quite easy for a party to a rate case
3 to suggest reaching forward in time to quantify selected increasing costs or anticipated
4 declines in sales volumes, in an effort to increase the revenue requirement, while not also
5 recognizing headcount reductions, declining rate base trends and general productivity
6 gains that tend to reduce expenses. The challenge facing the Commission is to ensure
7 that a balanced treatment is afforded the measurement cutoffs for the various ratemaking
8 elements.

9 Consider the case of a typical ILEC. As retail customers are lost to competitors,
10 the Company is able to avoid certain billing and collection expenses and customer service
11 costs. More importantly, ILECs tend to systematically reduce their workforce size and
12 substitute new technologies to improve operational productivity, so as to maintain
13 acceptable earnings levels in the face of declining sales. This is why many alternative
14 regulation plans involve a price cap constraining revenues, subject to adjustment for
15 inflation less productivity. These plans have generally resulted in revenue reductions due
16 to productivity factors that have recently exceeded the modest inflation being
17 experienced in the economy.

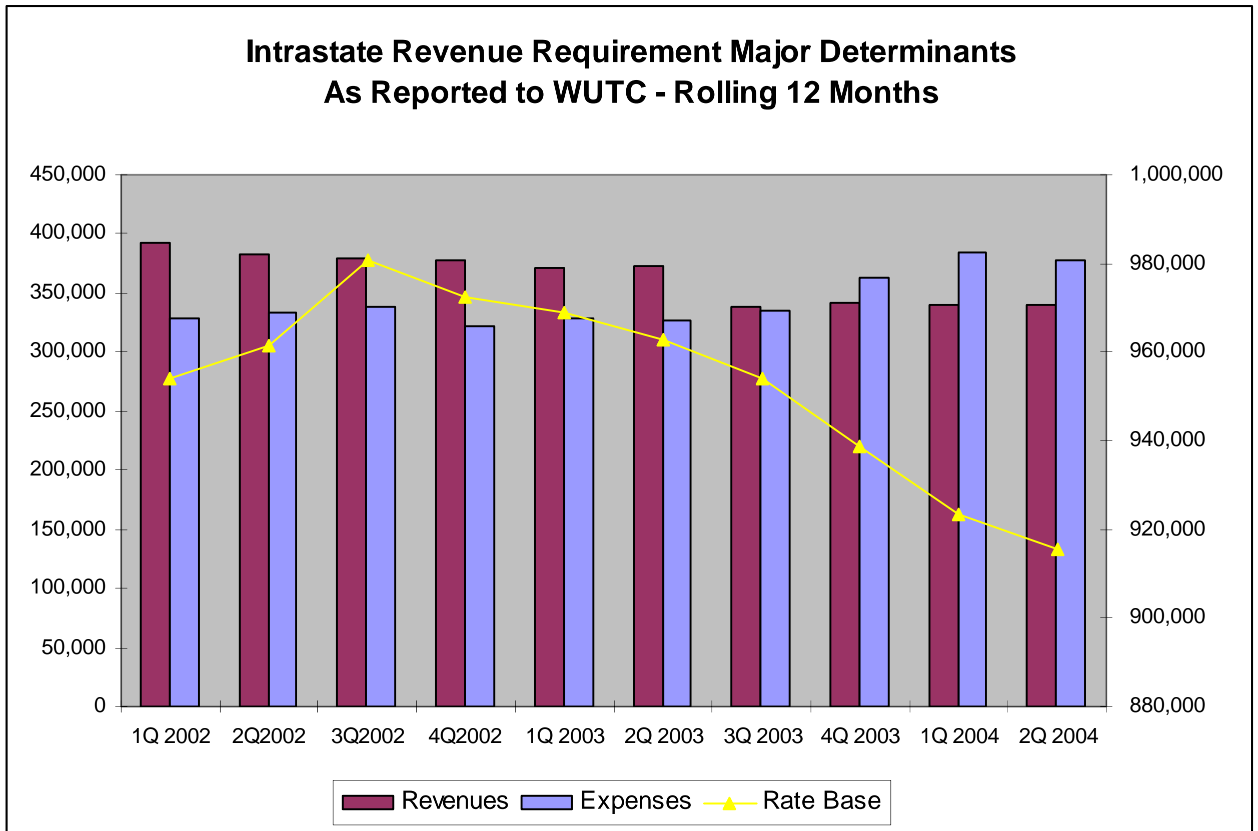
18 An additional important factor is steadily declining rate base investment as a
19 result of depreciation expense recoveries from customers more rapidly than new Plant is
20 Service is added. It would be improper to recognize declining sale volumes and not fully
21 capture these offsets. The existence of these dynamic influences upon revenue
22 requirement compel the regulator to seek a consistent and balanced test period cutoff for
23 ratemaking purposes. It is important to not ignore the displacement of labor costs when

1 new automated systems are deployed, the continuing growth in depreciation and deferred
2 tax reserves, inflation or deflation in materials and unit prices, changed actuarial
3 estimates of benefit plan costs, fluctuations in capital costs and general productivity
4 improvements.

5 **Q. Have you examined Verizon's Washington Intrastate revenue, expense and rate**
6 **base trends, so as to test whether your general observations are applicable in this**
7 **Docket?**

8 A. Yes. I reviewed the "Adjusted Basis" Quarterly Compliance Reports submitted by
9 VZNW to the Commission for all available periods starting in the first quarter of 2002.
10 The following graph summarizes this financial data on a rolling twelve months basis,
11 / /
12 / / /
13 / / / /
14 / / / / /
15 / / / / / /
16 / / / / / / /
17 / / / / / / / /
18 / / / / / / / / /
19 / / / / / / / / / /

1 indicating trends impacting the Company's business:



2

3 Several conclusions are suggested by this information. First, the "Rate Base" line and
4 rate base values shown on the right axis clearly indicates a declining trend since mid
5 2002 that has effectively reduced intrastate rate base by about five percent in the past
6 year. The Company's asserted rate base $949 million[38] is clearly at odds with historical
7 trends and is overstated, primarily because of the failure of Verizon to recognize the
8 continuing growth in the Reserve for Depreciation and Amortization caused by ongoing
9 depreciation expense accruals not properly recognized in the Company's adjustment P17.
10 Second, except for the significant step down in revenues since access charges
11 were reduced in 2003, total intrastate operating revenues have stabilized at about $340

38 Verizon Exhibit NWH-3, Revised September 2004.

1 million annually. Verizon has proposed annualized intrastate revenues of $337 million,
2 which results in a modest understatement of ongoing levels. However, the end result of
3 the Company's revenue adjustments appears reasonable in the context of a test period
4 fully projected through September 2004.

5 Finally, with respect to expense levels, it must be noted that Verizon recorded
6 very large one-time charges associated with workforce reduction programs during the test
7 year and in the fourth quarter of 2003 that distort the indicated trends in expenses in the
8 graph and cause total expenses to exceed total revenues on a rolling twelve month basis.
9 Annual expenses would be at least $60 million lower as of first quarter of 2004 and
10 thereafter if these costs had not been incurred.[39] When a force reduction program is
11 announced, large up-front costs are incurred for severance and benefit costs associated
12 with the program, followed by savings in wages and future benefits that represent
13 "payback" on the up-front costs. It would be inappropriate to draw any conclusions
14 regarding any trend in expenses because of these one-time costs recorded late in 2003
15 that are embedded in the graph. However, Verizon's pro-forma total operating expenses
16 of $378 million appear overstated, because this represents an expense level nearly equal
17 to the highest expense amounts shown in the graph – as if Verizon will continue to incur
18 expenses comparable to levels recorded including the up-front workforce reduction costs.
19 Mr. Carver will specifically address certain adjustments to pro-forma operating expenses
20 in his testimony.
21

39 Verizon Workpaper P20.1 indicates Washington expenses totaling $54 million were incurred in the fourth quarter of 2003, with another $34.8 million in the first quarter of 2004 in connection with the MVSP workforce reduction program. Approximately 67 percent of such amounts are allocable to Washington regulated intrastate expenses.

1 **Q. What approach do you recommend generally with regard to test period cutoff**
2 **issues, so as to minimize the distortion of revenue requirements?**
3 A. I recommend that the Commission seek balance in considering piecemeal adjustments for
4 events or changes occurring significantly beyond the test year end September 30, 2003.
5 Since Verizon has adjusted many revenue and cost elements through September 30, 2004
6 with a resulting apparent overstatement in rate base and ongoing expense levels, it is
7 necessary to critically review the Company's proposals to achieve appropriately matched
8 and balanced test year results.
9 **Q. How does the Company's revenue requirement witness explain her approach to the**
10 **test period and consistency among test year elements?**
11 A. Verizon witness Ms Heuring states the following, in explaining how the Company
12 understands test year ratemaking policies in Washington:

13 Q. ARE THE RESTATING AND PRO FORMA ADJUSTMENTS
14 INCLUDED IN THIS FILING CONSISTENT WITH THE
15 COMMISSION GUIDELINES FOR GENERAL RATE
16 PROCEEDINGS?
17
18 A. Yes. WAC 480-07-510(3)(b) requires a detailed portrayal of restating
19 actual adjustments, which it defines as "defects or infirmities in actual
20 recorded results that can distort test period earnings." In addition, this
21 rule describes pro forma adjustments as items that "give effect for the
22 test period to all known and measurable changes that are not offset by
23 other factors."[40]
24
25 **Q. Has the Company achieved compliance with the referenced Commission**
26 **Guidelines?**
27 A. No. Ms. Heuring's adjustments reach forward for many negative changes that tend to
28 increase revenue requirements, while failing to capture beneficial trends that are equally

40 Direct Testimony of Verizon witness Nancy Heuring, page 9.

1 known and measurable and that tend to offset the declining revenues and increasing costs
2 that are Verizon chooses to recognize.

3 **Q. What specific incremental adjustment is needed to correct the Company's**
4 **overstatement of Rate Base?**

5 A. Verizon's Adjustment P17 adds projected net Telecom Plant in Service additions for the
6 period ending September 30, 2004 into the average rate base, as shown on Line 1 of
7 Verizon's WP P17 (Revised September 2004). However, at Line 2 the adjustment to
8 Accumulated Depreciation Reserve has serious problems. This adjustment consists of
9 three separate elements, as set forth below:

10

Verizon Accumulated Depreciation Reserve Adjustment P-17

Line	Item	Amount
11–12	One half of Annual Depreciation Expense Impact of Proposed Accrual Rate Change	$ 32,258
13	Test Year Normalization Activity	(19,609)
14	Projected 2004 Retirement Activity	28,799
15	Total Adjustment to Depreciation Reserve	41,448
16	CAM Factor to Deregulated	3.7916%
17	Intrastate Allocation Factor	75.7228%
18	Total Intrastate Adjustment to Depreciation Reserve	**$ 30,196**

19 Unfortunately, two elements of this adjustment are in error. First, the addition of only
20 "One half of Annual Depreciation Expense" associated with the Company's proposed
21 increase in accrual rates dramatically understates the growth that will occur in the
22 depreciation reserve as the result of continuing depreciation expense accruals. Annual
23 depreciation expense is approximately $159.9 million per year at existing accrual rates
24 and would increase to $224.4 million per year at Verizon's proposed accrual rates.
25 Verizon has added only <u>one half of the increase</u> proposed in annual expense ($224.4 less

1 $159.9 = $64.5 million / 2 = $32.2 million). To reasonably project changes in the
2 depreciation reserve requires adding a full year's worth of expense accruals to the
3 reserve, prior to considering any projected retirement activity, because the mid-point of
4 the historical average test period (March 2003) must be "moved forward" by twelve full
5 months to simulate the mid-point of the annual period ending September 2004 (for which
6 the mid point is March 2004). Thus, one must substitute $159.9 million in place of
7 Verizon's $32.2 million for the first element of this adjustment.

8 Another error is contained in the posting of the "Projected 2004 Retirement
9 Activity" amount of $28.799 million for the year following the test period. Retirements
10 of the original cost of Telecom Plant in Service result in a debit or reduction to the
11 depreciation reserve account, not an increase as posted in Verizon's adjustment. The

Corrected Accumulated Depreciation Reserve Adjustment P-17

Full Year Annual Depreciation Expense (present accrual)	$ 159,904
Test Year Normalization Activity	(19,609)
Projected 2004 Retirement Activity	(28,799)
Total Adjustment to Depreciation Reserve	111,496
CAM Factor to Deregulated	3.7916%
Intrastate Allocation Factor	75.7228%
Intrastate Adjustment to Depreciation Reserve	**$ 81,227**

12 corrected P-17adjustment should appear as follows, assuming no change is ordered in
13 existing depreciation accrual rates that produce $159 million in annual expense:
14
15 In the event the Commission orders any change in present depreciation accrual rates, as
16 requested by the Company in Docket No. UT-040520, it would be necessary to revise

1 the $159,904 first line of this revised adjustment to comport with the annual expense
2 impact of such revisions.

3 **Q. Do the Company's pro-forma adjustments for workforce reduction programs**
4 **distort the balance and matching of the test year?**

5 A. Yes. Verizon witness Heuring actually includes two different workforce reduction
6 program adjustments in the determination of revenue requirements. In her pro-forma
7 adjustment P18, Ms. Heuring proposes to eliminate $17 million of severance expense
8 actually recorded in the test period and then she "adds back" one-third of this amount as a
9 proposed three-year amortization of such costs. In pro-forma adjustment P20, Ms.
10 Heuring proposes to increase test period expenses by $1 million for the net (apparently
11 negative) savings anticipated to arise from the Management Voluntary Separation
12 Program ("MVSP") that was implemented subsequent to the test year, in the fourth
13 quarter of 2003 and the first quarter of 2004.

14 **Q. What adjustments are required to the Company's filing to better match test period**
15 **expenses and benefits associated with the two workforce reduction programs?**

16 A. With regard to the first adjustment P18 eliminating severance costs incurred in the test
17 period, I agree that such costs should be eliminated to avoid inclusion of such unusual
18 costs within otherwise normal, ongoing annual expense levels used to set rates. What I
19 do not agree with is the proposed three-year amortization of such costs in determining
20 revenue requirements, effectively increasing annual expenses by $5.7 million. It is quite
21 possible that Verizon has achieved labor and benefit savings that have not yet been
22 recognized in any rate case that are cumulatively sufficient to fully offset or recover the
23 severance expenses incurred to achieve such savings. Verizon should not be allowed to

1 retroactively establish a regulatory asset for past severance costs and prospectively
2 amortize such costs into the revenue requirement without making some showing of
3 evidence that it has not already "recovered" this severance through labor and benefit
4 costs retained by shareholders between rate case test years.

5 With regard to the second adjustment P20 that addresses post test-year MVSP net
6 costs and savings, I urge the Commission to completely reject the Company's proposed
7 adjustment because it seeks to increase net expenses as the result of a cost reduction
8 initiative. A net expense **increase** adjustment as the result of a workforce reduction
9 program is absurd and would suggest that the program was ill-conceived and uneconomic
10 by design. Any force reduction program that involves total expenses significantly in
11 excess of anticipated cost savings benefits is either imprudent or at least poorly quantified
12 in the Company's pro-forma adjustment. In either event, customers should not be made
13 to pay higher rates because of Verizon work force reduction programs that are
14 uneconomic.

15 **Q. Are you aware of any information that suggest that Verizon has already realized**
16 **significant work force reduction savings that have been retained for shareholders as**
17 **an offset to severance and MVSP program costs?**

18 A. Yes. In its response to WUTC Staff Data Request No. 25, Verizon quantified estimated
19 annual savings of $17.1 million associated with the actual headcount reductions occurring
20 in the test year. This amount exceeds the total test year severance expense eliminated in
21 Verizon's P18 pro forma adjustment, implying that such severance costs have already
22 been fully recovered through retained labor cost savings in the absence of any general
23 rate adjustments based upon these values. With each passing month subsequent to

1 September 2003, Verizon shareholders retain more savings amounts as an offset to
2 incurred severance costs.

3 In the event the post test year MVSP program is actually designed to produce
4 more incremental savings than costs, it should not be incorporated into the revenue
5 requirement in a way that fails to properly offset such costs and savings. This is
6 particularly important if wage and benefit costs are not quantified in a manner that fully
7 annualized ongoing costs savings in the post-MVSP environment.

8 **Q. Have you prepared any Exhibits to quantify the adjustment you proposed to the**
9 **Company's filing to better synchronize and match the test year revenues, expenses**
10 **and rate base?**

11 A. Yes. Exhibit MLB-6 sets forth the incremental adjustment required to recognize known
12 and measurable growth in the depreciation reserve during the year following the basic
13 test year – an adjustment that is necessary if Verizon is allowed to project net Plant in
14 Service additions for rate base inclusion in its P17 pro-forma adjustment. Exhibits MLB-
15 7 and MLB-8 set forth the incremental adjustments to Verizon's asserted P18 and P20
16 work force reduction program expenses that are described herein.

17 **Q. Does this conclude your testimony at this time?**

18 A. Yes.