Exhibit No. __________ (DBT-2CT)
Docket No. UT-040788
(Redacted Version)

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	
Complainant,	)	
v.	)	**DOCKET NO. UT-040788**
VERIZON NORTHWEST INC.,	)	
Respondent.	)	
. . . .	)	

REBUTTAL TESTIMONY OF

DENNIS B. TRIMBLE

ON BEHALF OF
VERIZON NORTHWEST INC.

FEBRUARY 2, 2005

CONFIDENTIAL PER PROTECTIVE ORDER

IN WUTC DOCKET NO. UT-040788

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Dennis B. Trimble. My business address is 6803 India Court, Colleyville, Texas 76034.

Q. DID YOU FILE DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I have been asked by Verizon Northwest Inc. ("Verizon NW" or the "Company") to respond to the direct testimony of (1) Michael L. Brosch, submitted on behalf of the Washington Attorney General – Public Counsel Section ("Public Counsel"), AARP, and Washington Electronic Business & Telecommunications Coalition; and (2) Dr. Lee L. Selwyn, submitted on behalf of the Commission Staff. Specifically, I respond to their proposals to impute directory advertising revenues for state rate-making purposes, and I explain why the Commission must reject these proposals.

Q. PLEASE SUMMARIZE MR. BROSCH'S AND DR. SELWYN'S TESTIMONY REGARDING IMPUTATION OF DIRECTORY ADVERTISING REVENUES.

A. Both Mr. Brosch and Dr. Selwyn propose that the Commission reduce Verizon NW's intrastate revenue requirement by imputing revenues from its directory publishing affiliate, Verizon Directories Corporation ("VDC"). Mr. Brosch proposes a reduction of

1 $30.6 million per year (Brosch at 34), and Dr. Selwyn supports a reduction of $37.5
2 million per year.[1]
3
4 They claim imputation is appropriate because the Verizon NW-VDC Publishing
5 Agreement confers "intangible benefits" to VDC, most specifically, the right to be
6 "perceived" as the "official publisher" of Verizon NW directories. (Brosch at 15-16;
7 Selwyn at 83-84). Their adjustments purport to reflect the fair market value ("FMV") of
8 these intangible benefits. (Brosch at 46; Selwyn at 84).
9
10 **Q. ARE THESE PROPOSED ADJUSTMENTS SIMPLY "BOOKKEEPING"**
11 **ADJUSTMENTS WITH NO TANGIBLE EFFECT ON VERIZON NW, VDC, OR**
12 **THEIR PARENT CORPORATION?**
13 A. Absolutely not. These adjustments have a direct and significant effect upon all the
14 Verizon companies – they take millions of dollars per year from an unregulated business
15 (*i.e.*, VDC) to artificially reduce the earnings requirement of a regulated business (*i.e.*,
16 Verizon NW). There should be do doubt that imputation lowers the aggregate revenues
17 achieved by the parent corporation. Contrary to Mr. Brosch (Brosch at 47), there can be
18 no doubt that this is a significant taking of property.
19
20 **Q. PLEASE ELABORATE ON THE FINANCIAL IMPACTS THAT WOULD**
21 **RESULT IF THE COMMISSION FOLLOWED THE RECOMMENDATIONS OF**
22 **MR. BROSCH AND DR. SELWYN?**

[1] Dr. Selwyn's reduction is sponsored by Staff witness Paula Strain. *See* Exhibit No. ____ -C (PMS-11-C), at 5.

1 A. Bluntly stated, Verizon NW would be deprived of its right to sufficient rates because its
2 revenue requirement would be artificially reduced by drastic levels. As depicted in Table
3 One, these imputations significantly reduce the allowed revenues and earnings of VDC's
4 operations in Washington. The table shows that Verizon NW would be credited with
5 millions of dollars of phantom revenue, which it will never receive in real dollars to cover
6 Verizon NW's real costs of service. It must be stressed that this phantom revenue is
7 revenue earned by an unregulated affiliate that operates in a competitive market for local
8 advertising.
9
10 **TABLE ONE *****CONFIDENTIAL*******
11 RESULTS OF WUTC STAFF AND MR. BROSCH'S IMPUTATION PROPOSALS

	WUTC Staff[2]	Mr. Brosch[3]
Revenues:		
(a) VDC's Est. WA Director Rev.	** **	** **
(b) Proposed Imputation	37.5 M	30.6 M
(c) Net Allowed Rev = (a) – (b)	** **	** **
(d) Alleged Excess Rev as a % of Allowed Rev = (b) / (c)	****	****
Pretax Earnings:		
(e) VDC's Est. WA Earnings	** **	** **
(f) Proposed Imputation	37.5 M	30.6 M
(g) Net Allowed Pretax Earnings = (e) – (f)	** **	** **
(h) Alleged Excess Earnings as a % of Est. Actual Earnings = (f) / (e)	****	****
Monthly Imputation per Residential Line:		
(i) Test Year Avg, Residential Lines Inservice	630 K	630 K
(j) Monthly Imputation per Line = (g)/(i)/(12)	$ 4.96	$ 4.05

12
13 The Staff's imputation proposal implies that VDC's estimated Washington revenues are
14 _89 percent_ higher than the "fair" return recommended by the Staff. Thus the Staff

[2] WUTC Staff witness Paula M. Strain's Exhibit No. ____ -C (PMS-11-C), at 5, Staff Test Year column.
[3] Brosch, Exhibit No. _____, MLB-5C, page 1 of 3, Year 2003 column.

1 recommends that the Commission impute _94 percent_ of VDC's estimated pre-tax
2 earnings as an offset to Verizon NW's allowed revenue requirement. Under the Staff
3 recommendation, rate-design related revenues for Verizon NW equivalent to $4.96 per
4 month for each residential line in service will be taken from VDC but actually never seen
5 by Verizon NW. The impacts are significant.
6
7 **Q. PLEASE SUMMARIZE THE CURRENT AGREEMENTS BETWEEN VERIZON**
8 **NW AND VDC.**
9 A. There are three separate contracts: (1) a Subscriber Listings License Agreement, under
10 which Verizon NW provides subscriber listings to VDC in accordance with the Federal
11 Communications Commission's ("FCC") requirements; (2) a Billing and Collection
12 ("B&C") Agreement, under which Verizon NW provides certain B&C services to VDC;
13 and (3) a Directory Publishing Agreement ("DPA"), under which VDC agrees to publish
14 and distribute directories at no charge that fulfill Verizon NW's regulatory obligations.[4]
15
16 Mr. Brosch and Dr. Selwyn do not address the first two agreements; instead, they claim
17 that the DPA is inappropriate because it does not reflect the FMV of the "intangible
18 benefits" VDC allegedly receives by agreeing to fulfill Verizon NW's directory-related
19 regulatory requirements.
20

[4] In my Direct Testimony (at p. 17) I only listed two agreements: (1) a Publishing Agreement (which included sales of SLI) and (2) a Billing and Collection Agreement. Since that testimony was written, the 2000 Publishing Agreement has been split into two separate agreements: a Directory Publishing Agreement and a Listings License Agreement. The new Directory Publishing Agreement is currently undergoing Commission review.

Q. WHAT STANDARD SHOULD THE COMMISSION APPLY IN EVALUATING THE REASONABLENESS OF THE DIRECTORY PUBLISHING AGREEMENT?

A. The Commission should apply its well-settled affiliate interest standard to measure the reasonableness of the compensation: when Verizon NW is the purchaser, the transaction should be priced at the lower of fully distributed cost ("FDC") or FMV; when Verizon NW is the provider, the transaction should be priced at the higher of FDC or FMV. Dr. Selwyn agrees (Selwyn at 31).

Under the DPA, Verizon NW is the purchaser – it is purchasing directory publishing and distribution services from VDC. Therefore, the transaction should be priced at the lower of FDC or FMV. Verizon NW clearly meets this standard – it pays zero. Brosch and Selwyn, however, make the remarkable claim that VDC is the purchaser and should pay Verizon NW for the "right" to satisfy Verizon NW's directory-related regulatory obligations, and therefore a price of zero is "too little" for VDC to pay. In short, their proposed adjustments simply do not meet the standard test for examining affiliate transactions, and they should be rejected for this reason alone. Nevertheless, the following section of my rebuttal testimony addresses their claims that the "right" to publish directories that satisfy Verizon NW's regulatory requirements has a positive value equal to the imputation amounts they propose.

1 **II. VERIZON NW DOES NOT CONVEY ANY "BENEFIT" TO VDC**

2

3 **Q. DOES THE EXISTING PUBLISHING AGREEMENT CONFER ANY BENEFITS**
4 **– TANGIBLE OR INTANGIBLE – TO VDC?**

5 A. No. VDC receives no economic value from entering into the existing DPA. *In fact, VDC*
6 *could publish the same directory it publishes today without any publishing agreement*
7 *with Verizon NW*. All VDC needs from Verizon NW to publish its directories in Verizon
8 NW's territory is subscriber listings information ("SLI"), and VDC already receives this
9 information under its stand-alone Subscriber Listings License Agreement. This
10 undisputed fact completely refutes Brosch and Selwyn's theory that the "right to publish
11 and distribute" directories that fulfill Verizon NW's regulatory obligations "is an
12 extremely valuable intangible asset." (Brosch at 42; *see also* Selwyn at 85-86.)

13

14 **Q. WHAT ABOUT THE VERIZON NAME? DOES THE DIRECTORY**
15 **PUBLISHING AGREEMENT GIVE VDC THE RIGHT TO USE THIS NAME?**

16 A. No. Verizon NW does not own the Verizon name; therefore VDC does not need Verizon
17 NW's "permission" to use it. Indeed part of VDC's own legal name is "Verizon" and it
18 can use that name and related logos on its products. Likewise, other entities in
19 Washington, such as Verizon Wireless (a cellular provider), Verizon Online (an internet
20 provider), and Verizon Avenue (a provider of telecommunications services to multiple
21 dwelling unit complexes) also have the right to use the "Verizon" name.

22

1 **Q. IS VDC THE "OFFICAL" PUBLISHER OF THE VERIZON NW DIRECTORY?**

2 A. No. Although Selwyn and Brosch make this claim, they offer no evidentiary support.
3 Factually, the DPA grants no such status. VDC is not the "official" publisher, nor is
4 there any evidence that consumers perceive VDC as the "official" publisher.

5

6 **Q. MR. BROSCH AND DR. SELWYN CONTEND THAT VDC'S OPERATIONS IN**
7 **WASHINGTON ARE "FUNDAMENTALLY DEPENDENT" UPON VERIZON**
8 **NW'S REGULATED TELEPHONE OPERATIONS. (BROSCH AT 45; SELWYN**
9 **AT 11). DO YOU AGREE?**

10 A. No. As explained, the only thing VDC needs from Verizon NW to publish directories is
11 SLI. Every other directory publisher needs this same information. Thus, VDC's
12 operations are only "dependent" on the receipt of SLI, just like any other publisher.[5] This
13 is no different when VDC publishes and distributes directories outside of Verizon NW's
14 territory – *e.g.*, when VDC publishes its SuperPages in Qwest's area, it is dependent on
15 Qwest's provision of SLI. (*See* Exhibit No. _____ (DBT-3) for sample directory cover
16 pages used by VDC in Qwest's territory).

17

18 **Q. BROSCH AND SELWYN CLAIM THAT THE DIRECTORY PUBLISHING**
19 **AGREEMENT IS A VALUABLE "REGULATORY ASSET" THAT VERIZON**
20 **NW HAS CONVEYED TO VDC WITHOUT DUE COMPENSATION. (BROSCH**
21 **AT 46; SELWYN AT 84). PLEASE COMMENT.**

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[5] VDC does also employ some of Verizon NW's B&C services for customers within Verizon NW's franchise area. But it should be noted that VDC is not dependent upon Verizon NW for these services.

1 A. They are wrong. A "regulatory asset" is an accounting term used to describe assets that
2 can be recorded on the regulatory books of a company because the regulator provides
3 reasonable assurance that the utility can earn a return on the investment in the form of
4 rates from ratepayers.[6] Thus, properly used in the ratemaking context, the "regulatory
5 asset" concept is the proposition that certain assets on the books of regulated companies
6 are treated as part of the rate base, as are their related expenses.
7
8 First, as I previously pointed out, VDC does not need the DPA in order to successfully
9 operate in Verizon NW's territory. Thus, from VDC's standpoint, it receives no added
10 benefit from the agreement; *i.e.*, for VDC, the alleged asset lacks value.
11
12 In addition, contrary to Dr. Selwyn's assertions, Verizon NW did not give its directory
13 advertising line of business to VDC. (Selwyn at 93). Factually, Verizon NW has never
14 had anything to give - *VDC's operations were never assets on Verizon NW's regulated*
15 *books*, a point that neither Brosch nor Selwyn dispute. For this reason alone their
16 regulatory asset argument must be rejected. It is for this reason, too, that their reliance on
17 the US West/US West Direct case is misplaced.[7] In that matter, the US West directory
18 business was developed within the incumbent local exchange carrier ("ILEC") and then
19 transferred to an affiliate. When the business was within the ILEC, its assets were fully

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[6] Statement of Financial Accounting Standards No. 71, paragraphs 5 and 9.
[7] *U S West Communications, Inc., v. WUTC*, 134 Wn. 2d 74, 102, 949P.2d 1337 (1997).

1 recorded on the regulated books – it was a "regulatory asset." The WUTC never fully
2 authorized the ILEC to transfer this asset to its affiliate, and for this reason the
3 Washington Supreme Court concluded that the ILEC – US West – could be required to
4 impute revenues until it could show that it had received fair value for the assets it
5 transferred to its affiliate, US West Direct.

6

7 **Q. VERIZON NW AND VDC HAD PRIOR "REVENUE SHARING"**
8 **ARRANGEMENTS UNDER WHICH VERIZON NW RECEIVED MORE**
9 **REVENUE THAN THE CURRENT FEE FOR SERVICES ARRANGEMENT.**
10 **PLEASE EXPLAIN THIS CHANGE.**

11 A. Quite simply, any prior arrangements have been trumped by the Telecommunications Act
12 of 1996 ("96 Act") and associated FCC orders. As I explained in my Direct Testimony,
13 the FCC, acting under its authority from the 96 Act, established a market rate for SLI
14 which, given the FCC's non-discriminatory mandate, Verizon NW charges to all
15 directory providers (including VDC).[8] What Verizon NW could have charged or did
16 charge in historical arrangements is irrelevant.

17

18 **Q. BROSCH AND SELWYN HYPOTHESIZE THAT AN UNAFFILIATED**
19 **DIRECTORY PUBLISHER WOULD PAY VERIZON NW BETWEEN $30-$38**
20 **MILLION PER YEAR FOR THE "RIGHT" TO SATISFY VERIZON NW'S**

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[8] *In the matter of Implementation of the Telecommunications Act of 1996*, Third Report and Order in CC Docket No. 96-115. Second Order on Reconsideration of the Second report and Order in CC Docket No. 96-98, and Notice of Proposed Rulemaking in CC Docket No. 99-273, FCC 99-227, (Released September 9, 1999) ("Third Report and Order"), paragraph 103.

1 **DIRECTORY-RELATED REGULATORY REQUIREMENTS. PLEASE**
2 **COMMENT.**
3 A. This position makes no economic sense and is not based upon any evidence. Today, an
4 unaffiliated provider can purchase SLI from Verizon NW at FCC-based rates on a non-
5 discriminatory basis. This is all such a provider needs to publish a Verizon NW
6 directory. The thought that a competitive directory publisher would agree to pay an
7 additional $30-$38 million per year for the right to use Verizon NW's name and logos is
8 beyond comprehension.
9
10 Put differently, the FMV of a transaction is the price a purchaser would be willing to pay
11 in the open market for a particular good or service. In my opinion, a rational buyer
12 would not be willing to pay anything for the "official" "right" to publish a directory,
13 because it does not need this "right" to be in business nor do I believe the "right" has any
14 material economic value.
15
16 Moreover, Brosch and Selwyn appear to believe that if Verizon NW entered into a DPA
17 with a non-affiliated publisher, VDC would exit the market (thus, conferring potential
18 competitive value to the buyer). But there is no evidence to support this claim. As noted
19 above, VDC can publish a directory in Verizon NW's territory without having a DPA
20 with Verizon NW.
21

1 **Q. BROSCH AND SELWYN CLAIM THAT RATEPAYERS DO NOT**
2 **APPROPRIATELY BENEFIT FROM THE CURRENT VERIZON NW-VDC**
3 **DPA. PLEASE COMMENT.**

4 A. They are wrong – Verizon NW's ratepayers receive appropriate benefits because, as
5 noted earlier, VDC does not charge Verizon NW for satisfying Verizon NW's regulatory
6 requirements. This benefit is worth at least $4 million per year. (Using fully-distributed
7 cost methods, VDC estimated that for 2003 it incurred about $4 million for that activity.[9])
8 If Verizon NW were to try to satisfy this regulatory obligation itself, I believe its cost
9 would be higher than $4 million per year, since Verizon NW (or its designated
10 contractors) would not likely have the same efficiencies or expertise as VDC.
11
12 In short, VDC receives no economic value from entering into the existing DPA; indeed,
13 VDC could publish the same directory it publishes today without entering into a DPA
14 with Verizon NW. Likewise, there is no evidence that a non-affiliated publisher would
15 rationally pay Verizon NW for the right to satisfy Verizon NW's regulatory
16 requirements. As such, the existing DPA satisfies the WUTC's affiliate transaction rules
17 and also conveys the correct benefit upon Verizon NW's ratepayers.
18

[9] *See* Verizon NW's response to Public Counsel's Data Request PC-260(a).

III. BROSCH'S AND SELWYN'S FMV CALCULATIONS ARE INVALID

Q. PLEASE EXPLAIN HOW BROSCH AND SELWYN CALCULATE THEIR ALLEGED FMV THAT THEY IMPUTE TO VERIZON NW.

A. They purport to quantify the FMV of the DPA by (1) assuming VDC is a regulated company, (2) applying Verizon NW's regulated rate-of-return to VDC, and then (3) imputing VDC's alleged "excess profits" to Verizon NW. (Brosch at 4; Selwyn at 85) They ignore the true test for determining FMV, which depends upon a willing buyer.

This methodology is fundamentally flawed – VDC's directories business has absolutely nothing in common with Verizon NW's regulated, intrastate telecommunications business, and nowhere do Brosch and Selwyn explain why these different businesses should have the same rate of return. Such differences in return levels cannot possibly be ascribed solely to the alleged right to publish and distribute directories that satisfy Verizon NW's regulatory requirements. In short, neither Brosch nor Selwyn provide any credible evidence of their alleged FMV.

Brosch and Selwyn attempt to bolster their theory by comparing VDC's directory advertising rates to rates of other publishers. They argue that VDC's rates are higher, and these higher rates can only be attributable to VDC's affiliation with Verizon NW. This argument also is baseless – the fact that different publishers charge different rates is irrelevant. Pricing differences exist between all competitive firms for various reasons. For example, differences in price levels can reflect the perceived value of superior

1 customer service, superior customer support, or superior product attributes, to name a
2 few. Price differences can also reflect differing market strategies (*e.g.*, maintenance of
3 market share, growth of market share, market exit, and market entry). In short, these
4 price comparisons are meaningless. Mr. Doane addresses this point further in his rebuttal
5 testimony.
6
7 **Q. PLEASE DISCUSS MR. BROSCH'S THREE ALTERNATIVE CALCULATIONS**
8 **FOR IMPUTATION OF DIRECTORY REVENUES.**
9 A. Mr. Brosch presents three ways to calculate an imputation amount: an income "carve-
10 out" method, a retention ratio ("revenue sharing") method, and the "US West" method.
11 According to Mr. Brosch, these methods produce imputation amounts of $30.6 million,
12 $40.9 million, and $30.7 million, respectively, and he proposes the Commission adopt the
13 carve-out method's $30.6 million. (Brosch at 34)
14
15 Obviously, Verizon NW disagrees with any imputation method. I'd like to point out,
16 however, that he made a mistake in applying the retention ratio method. This method
17 was supposedly based on the Verizon NW/VDC Master Publishing Agreement ("MPA"),
18 which was in effect prior to the year 2000. But Mr. Brosch's calculation does not
19 represent the correct estimate of the payments VDC would have made in 2003 assuming
20 the MPA was still in effect. Under the MPA, only "Franchise Revenues" (i.e., revenues
21 generated from Verizon NW's in-franchise customers) would be shared, but Mr. Brosch
22 erroneously assumed all revenues were subject to sharing. I have fixed his mistake in my
23 confidential Exhibit No. DBT-4C. This correction reduces his $40.9 million figure to

$21.1 million. Again, Verizon NW does not agree that any imputation is proper, but if one assumes (incorrectly) that Verizon NW should impute the revenues it would have received from VDC under the old revenue-sharing agreement, that figure is $21.1 million.

IV. THE BROSCH/SELWYN PROPOSAL IS CONTRARY TO PUBLIC POLICY

Q. PLEASE EXPLAIN WHY THE BROSCH/SELWYN IMPUTATION PROPOSAL IS CONTRARY TO PUBLIC POLICY.

A. First, it directly conflicts with Section 222(e) of the 96 Act and the FCC's regulations. As explained in my direct testimony, the FCC, pursuant to its authority under the 96 Act, established a rate for SLI that all carriers must charge on a non-discriminatory basis. Since SLI is the only information VDC needs from Verizon NW to publish a directory, the Brosch/Selwyn proposal would require Verizon NW to effectively charge VDC between $30 million and $38 million more per year for SLI. This directly conflicts with Verizon NW's obligations under federal law.

Q. PLEASE EXPLAIN WHY YOU THINK SECTION 222(e) CONTROLS THE EFFECTIVE PRICE FOR SLI BASED UPON HISTORY AND THE FCC'S IMPLEMENTATION OF THIS SECTION.

A. Prior to the 96 Act, ILECs could potentially exercise substantial control over their customer listings. ILECs maintained discretion to control access to their directory listings, as well as the terms and conditions surrounding access. When developing

Section 222(e), Congress found that some ILECs refused to sell subscriber-listing information to potential directory competitors or were charging excessive and discriminatory prices for their (the ILEC's) listing information.[10] Section 222 (e) of the 96 Act eliminated these types of requirements and any potential barriers to directory competition that could be associated with those requirements.

Specifically, Section 222 (e) mandates that:

> … a telecommunications carrier that provides telephone exchange service shall provide subscriber list information gathered in its capacity as a provider of such service on a timely and unbundled basis, under *nondiscriminatory* and reasonable rates, *terms and conditions*, to any person upon request for the purpose of publishing directories in any format. (Emphases added)

Under Section 222(e), Verizon NW and other local exchange carriers are required to make their directory listings available to all directory publishers under the same rates, terms and conditions. Thus, Section 222(e) eliminates any control over customer listings that an ILEC may possess by making the listings a commodity available under the same rates, terms and conditions to any directory publisher. More important, Section 222(e) preempts any state commission's ability to force an ILEC to charge more. This does not exclude the rates paid by an affiliated directory publisher. In my opinion, directory advertising imputation forces Verizon NW to extract a higher price from VDC for directory listings and the right to do business in Verizon NW's serving areas (a right no other competitive provider must pay to receive). VDC need only pay FCC-authorized

[10] *Id.*, paragraph 3.

rates for the primary input it needs to be in the directory advertising business - subscriber listings information. Therefore, directory advertising imputation creates a discriminatory price charged only to VDC for the right to publish directories in Verizon NW's territory (because the right and capability to publish is conferred by the receipt of directory listing information from Verizon NW) contrary to Section 222(e) of the 96 Act.

Q. DID THE FCC CONSIDER THE VALUE OF THE DIRECTORY AFFILIATE/ILEC RELATIONSHIP WHEN IT IMPLEMENTED SECTION 222(e)?

A. A review of the order leads to this conclusion. If LEC affiliates had all of the advantages that Dr. Selwyn and Mr. Brosch claim they have, the FCC would have had to take those alleged advantages into account in order to satisfy its obligation under the 96 Act. The FCC noted that it was charged with "preventing unfair LEC practices and encouraging the development of competition in directory publishing."[11] In fact, the FCC expressly rejected any sort of discriminatory methodology for setting SLI rates. Instead, the FCC opted for equal treatment noting

> We conclude that the nondiscrimination requirement in section 222(e) obligates a carrier subject to that section to provide subscriber list information to requesting directory publishers at the same *rates, terms, and conditions* that the carrier provides the information to itself, its directory publishing affiliate, or another directory publisher.[12]

[11] *Id.*
[12] *Id.,* paragraph 8 (Emphasis added).

1 Mr. Brosch fails to discuss Section 222(e) or the Third Report and Order in his testimony.
2 Dr. Selwyn did so but only in a superficial manner.[13] The lack of consideration of the 96
3 Act and its impact in this case should undermine the validity of those witnesses'
4 testimonies.
5
6 **Q. WHAT OTHER PUBLIC POLICY CONCERNS DO THE BROSCH/SELWYN**
7 **PROPOSAL RAISE?**
8 A. Their proposals ignore the fact that imputation is inefficient and not competitively-
9 neutral, because it requires Verizon to subsidize local telephone service. Mr. Brosch
10 claims that directory imputation does not create a subsidy,[14] but Dr. Selwyn himself
11 contradicts this claim. In a recent Qwest proceeding, the Commission summarized
12 Dr. Selwyn's testimony concerning yellow page revenues as:
13
14 Dr. Selwyn for Commission Staff recommends that yellow pages
15 revenues be allocated at $4.27 per residential line per month to
16 lower residential rates. He also argues that, because *Yellow Page*
17 *imputations are intended to subsidize residential services*, not
18 USWC's competitive advantage ...[15]
19
20 In short, there can be no doubt that the imputation of directory advertising revenues
21 results in a subsidy to regulated telecommunication services. This implicit subsidy is not
22 competitively neutral – Verizon NW's prices for telecommunications services are
23 artificially suppressed because of directories subsidy. Moreover, VDC is placed at a

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[13] Selwyn at p. 93.
[14] Brosch at 38:19-39:1.
[15] *See* Docket No. UT-950200, Fifteenth Supplemental Order, Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling, at 33 (Emphasis added).

competitive disadvantage because none of its competitors are required to contribute this subsidy. Again, *real dollars are being transferred as a result of imputation* – this is not merely a bookkeeping exercise.

Q. MR. BROSCH ASSERTS THAT IMPUTATION DOES NOT REGULATE THE EARNINGS OF VDC, AS VERIZON CLAIMS. PLEASE RESPOND.

A. Mr. Brosch states that instead of regulating VDC, "[i]mputation simply causes the *consolidated Verizon organization* to not gift away the directory publishing regulatory asset that arises from ILEC status in Washington."[16] As a threshold matter, this statement concedes that no directory publishing asset belongs (or ever belonged) to Verizon NW. In any event, it is clear that his imputation proposal is nothing more than treating VDC as a fully regulated ILEC because the size of the alleged "gift" he is trying to capture equals precisely the difference between VDC's actual earnings and the earnings it would derive if it were limited to a Commission-authorized rate of return. This value has no basis in rational economics – it's simply an earnings constraint on VDC. In fact, his assertion proves my contention – through imputation, the Commission would be regulating the overall earnings of a hypothetical, combined VDC/Verizon NW company, without regard to the true unregulated nature of VDC's operations.

Finally, the fact that Mr. Brosch is proposing to regulate VDC is made clear in his discussion of "regulatory lag"; specifically, he contends that "regulatory lag" will provide

[16] Brosch at 46:5-7 (Emphasis added).

1 VDC with a strong incentive to effectively manage its operations.[17] He cites no evidence
2 of another unregulated, competitive business whose net earnings would be affected by
3 regulatory lag; nor am I aware of any. I'm familiar with product, market, management,
4 or competitive considerations (to name a few) that can affect an unregulated firm's
5 operational tactics and ultimately rate of return, but not regulatory lag. Again,
6 Mr. Brosch erroneously assumes VDC's entire domestic publishing operations constitute
7 a regulatory asset (even though the assets for which he is seeking compensation are
8 alleged intangible assets) over which the Commission may enforce earnings control in
9 order to support lower intrastate rates.
10
11 **Q. DO THE IMPUTATION METHODOLOGIES PROPOSED BY DR. SELWYN OR**
12 **MR. BROSCH INCORPORATE ANY ATTRIBUTES OF THE UNREGULATED**
13 **COMPETITIVE MARKET IN WHICH VDC OPERATES?**
14 A. No. For Verizon NW's rate making purposes, both make the assumption that VDC is a
15 regulated asset owned by Verizon NW and, as such, both recommend using imputation
16 methodologies that effectively constrain the fair rate of return VDC is allowed to earn to
17 the regulatory-authorized rate of return for Verizon NW.[18] No real attempt was made on
18 their part to determine whether VDC is or was earning monopoly profits in the local
19 advertising market in which it operates (which it is not).[19]
20

[17] *Id.* at 45:1-3.
[18] Mr. Brosch's recommended imputation methodology does attempt to adjust for some risk by recommending a return level based on common equity only versus a weighted overall cost of capital (Brosch at 35:14-20).
[19] *See* the Direct Testimony of Michael J. Doane at 4.

1 **Q. WHAT ABOUT MR. BROSCH'S ASSERTION THAT HIS IMPUTATION**
2 **METHODOLOGY ADJUSTS FOR COMPETITIVE PRESSURES?**[20]
3 A. Once again, his statement merely reinforces the observation that imputation is nothing
4 but improper, unilateral earnings regulation of VDC. Assume VDC's earnings decrease
5 by 30% but Verizon NW's earnings levels are constant. Under the Brosch/Selwyn
6 theory, the Verizon-parent supposedly has a remedy for this reduction in earnings that is
7 outside of the market in which VDC operates – have Verizon NW file for a rate case with
8 a proposal to increase intrastate regulated rates to offset VDC's losses. This outcome is
9 unlikely and demonstrates the "heads I win, "tails you lose" nature of imputation.
10 Allowing the performance of an unregulated entity to impact ratepayers is not likely to be
11 one of the objectives envisioned by the authors of the 96 Act.
12
13 **Q. IN WHAT WAY WOULD THE COMMISSION BE TREATING THE VERIZON**
14 **NW-VDC SITUATION DIFFERENTLY THAN IT TREATS OTHER**
15 **UNREGULATED VZNW ACTIVITIES?**
16 A. Verizon NW itself conducts a number of activities that are not regulated by the
17 Commission. It provides interstate telecommunications service, sells and maintains
18 customer premise equipment, provides pay telephone services, and installs and maintains
19 inside wire, for example. None of these activities are treated as "regulatory assets" for
20 intrastate ratemaking purposes, and the Commission could not do so. They are all
21 accounted for as nonregulated activities on the Company's books, according to long
22 established procedures.

[20] Brosch at 37:11-14.

1 **Q. IN LIEU OF IMPUTATION, MR. BROSCH SUGGESTS, THEORETICALLY,**
2 **THAT VERIZON NW COULD CREATE A DIRECTORY ADVERTISING**
3 **ASSET TO PUBLISH AND DISTRIBUTE ITS OWN WHITE PAGES WITH**
4 **CLASSIFIED DIRECTORIES.**[21] **PLEASE COMMENT.**
5 A. The prudence of such a venture is doubtful because after all, Verizon NW's expertise is
6 in telecommunications not advertising and publishing. Even if Verizon NW did so, so
7 long as it treated this activity the same way it treats the other unregulated parts of its
8 business (*i.e.*, booking assets, expenses and revenues in the non-regulated accounts), the
9 Commission could not use the Company's directory advertising revenues to cover the
10 costs of regulated services. Brosch has not demonstrated any ratepayer benefit from such
11 an arrangement. In fact, it is far more likely that Verizon NW would incur more costs
12 than VDC; given that Verizon NW would not likely be able to achieve the economies
13 enjoyed by VDC.
14
15 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**
16 A. Staff's and Mr. Brosch's rationales for their recommendations are wrong. They are
17 rooted in a long-past, regulatory paradigm that was rendered obsolete by the pro-
18 competitive aspects of the 96 Act. First, they presume that this Commission has the
19 authority to explicitly or implicitly re-write the underlying Fee-for-Service agreements to
20 extract a price Verizon NW cannot otherwise charge given the provisions of the 96 Act.
21 Second, they incorrectly assume (without support) that their imputation amounts are
22 representative of the "fair market value" of official publisher status (and any other

[21] Brosch at 30:15 – 31:7.

1 alleged intangible assets). Third, they misapply Washington's affiliate interest rules in
2 the determination of their proposed imputation amounts. Fourth, their recommendations
3 are provided without any consideration of whether VDC is earning excess (i.e.,
4 monopoly) profits in the specific market in which it operates (i.e., the local advertising
5 market), which it is not. Finally, they erroneously assume that the VDC/Verizon NW
6 relationship will result in no real financial loss to VDC, Verizon NW, or the parent
7 corporation. As I explained in my direct testimony (at pp. 8-9) imputation necessarily
8 yields lower aggregate revenues to the parent by the amount of imputation. This action
9 harms Verizon NW, VDC, and the parent company.
10
11 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**
12 A. Yes.