Exhibit No. ______ (MJD-3T)
Docket No. UT-040788

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

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

REBUTTAL TESTIMONY OF

MICHAEL J. DOANE

ON BEHALF OF

VERIZON NORTHWEST, INC.

February 2, 2005

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Michael J. Doane. My business address is 2000 Powell Street, Suite 500, Emeryville, California 94608.

Q. ARE YOU THE SAME MICHAEL J. DOANE WHO SUBMITTED 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") to review and comment on the Direct Testimony of Michael L. Brosch submitted on behalf of the Washington Attorney General – Public Counsel Section ("Public Counsel"), AARP, and Washington Electronic Business & Telecommunications Coalition.[1] I have also been asked to review and comment on the Direct Testimony of Dr. Lee L. Selwyn submitted on behalf of the Washington Utilities and Transportation Commission ("WUTC" or the "Commission") Staff.[2] In particular, I respond to the economic analysis collectively performed by Mr. Brosch and Dr. Selwyn that forms the basis of their opinions that the Commission should impute directory advertising income to Verizon NW in determining its Washington intrastate revenue requirement.

[1] Direct Testimony of Michael L. Brosch (MLB-1TC), *WUTC v. Verizon*, Dkt No. UT-040788 (Wash. U.T.C. Nov. 22, 2004) (hereinafter "Brosch").

Q. PLEASE SUMMARIZE YOUR MAIN FINDINGS.

A. Simply stated, in establishing an intrastate revenue requirement, imputation credits the regulated local phone company with revenues that come from an unregulated affiliate. Such imputation is undesirable as a matter of both economics and public policy. Neither Mr. Brosch nor Dr. Selwyn provide a valid economic basis for the Commission to adopt their proposals to impute revenues derived from the directory advertising business of Verizon Directories Corporation ("VDC") to Verizon NW's intrastate regulated operation.

From an economic perspective, it is bad public policy to use the revenues of a company that operates in a competitive, unregulated market to subsidize prices in a different market. Imputation takes revenues from a firm that competes with other forms of local advertising – not from a monopoly provider of yellow page advertising, as some witnesses have suggested. This is an economically inefficient way to subsidize the provision of local exchange services because it distorts the economic incentives of VDC in the long run to expand its business, reduce its costs, and develop new products and services. Moreover, imputation is not competitively neutral. No other local advertising company is asked to provide a similar contribution, and continuation of such a policy preserves distortions in the pricing of local exchange services and discourages competitive entry. Any arguments that may have supported such practices in the past were rendered obsolete by the Telecommunications Act of 1996.

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[2] Direct Testimony of Lee L. Selwyn, *Washington Utilities and Transportation Commission v. Verizon Northwest*, Dkt No. UT-040788 (Wash. U.T.C. Nov. 22, 2004) (hereinafter "Selwyn").

Mr. Brosch and Dr. Selywn do not respond to these basic economic criticisms and offer no meaningful rebuttal to the major findings of my Direct Testimony. Rather, they take the position that VDC derives value from its association with the regulated incumbent local exchange carrier ("ILEC") business and that use of the ILEC's intangible assets has been imprudently granted to VDC, without reasonable consideration to ratepayers and through affiliate agreements that have not been conducted at "arm's length." Their position regarding the value of affiliation is incorrect, and their proposed method of imputation is divorced from any notion of this alleged increase in value associated with ILEC affiliation. The proposal offered by Mr. Brosch and Dr. Selwyn is apparently predicated on the belief that third-party publishers would be willing to pay the sizeable dollar amount assigned to imputation for the rights conveyed by Verizon NW's existing agreement with VDC. As will be discussed below, there is no evidence to suggest that this would be a realistic outcome.

Finally, even if imputation were an appropriate public policy (which it is not), the approach to imputation proposed by Mr. Brosch and Dr. Selwyn is devoid of any notion of competitive returns in the market for local advertising. I find that applying their logic and methodology to other participants in the market in which VDC competes yields nonsensical results. For example, I demonstrate that applying their approach to the financial results of TransWestern Publishing, an independent publisher of directories, would lead one to conclude that over 70 percent of that firm's earnings were also "excessive" and presumably available for the taking.

Q. HOW HAVE YOU ORGANIZED YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony begins by examining issues related to competition in the market in which VDC competes. I then evaluate the claims made by Mr. Brosch and Dr. Selwyn that VDC's affiliation with Verizon NW justifies imputation.

II. COMPETITIVENESS IN THE MARKET IN WHICH VDC COMPETES

Q. DO MR. BROSCH AND DR. SELYWN PROVIDE OPINIONS REGARDING THE MARKET IN WHICH VDC COMPETES?

A. Yes. Mr. Brosch states that "ILECs such as Verizon, SBC, BellSouth, and until recently Qwest, have all historically participated in and dominated the directory publishing business in this country for many years." (Brosch, at 6.) Elsewhere, he describes what he considers to be the "market stratification" of the "directory publishing industry . . . between publishers who are affiliated with telephone companies and those which are 'independent.'" (Brosch, at 16.) Mr. Brosch later asserts that "incumbent telephone company publishers of directories control most of the yellow pages advertising market." (Brosch, at 18.)

Dr. Selwyn also refers to VDC's alleged "dominance in the directory publishing markets it serves in Washington." (Selwyn, at 5.) He presumes the existence of a "yellow pages market" and asserts that "yellow pages markets tend to support only a single primary directory at a time." (Selwyn, at 10, 63.) Elsewhere, Dr. Selwyn makes reference to "the printed directory advertising markets that VDC serves in Washington." (Selwyn, at 72.)

Q. DID MR. BROSCH OR DR. SELYWN UNDERTAKE ANY ECONOMIC ANALYSES TO DETERMINE THE RELEVANT PRODUCT AND GEOGRAPHIC MARKETS IN WHICH VDC COMPETES?

A. No. From their comments quoted above and similar others repeated throughout their testimonies and data responses, Mr. Brosch and Dr. Selwyn erroneously believe that VDC competes in a relevant market that is populated solely by publishers of printed yellow pages telephone directories serving Washington State. Neither witness, however, performed an economic analysis to determine the reasonableness of such a belief. In response to a Verizon NW data request, Dr. Selwyn confirms that he "has not undertaken any formal 'studies'" to determine whether or not yellow pages constitute a relevant product market.[3] (See Exhibit No. ___ (MJD-4).) Despite his comments presented above, Mr. Brosch could not identify in response to a Verizon NW data request any economic analyses he performed to determine the relevant market in which VDC competes; indeed, Mr. Brosch's response asserted that he "has formulated no 'contention' with respect to whether or not yellow pages are a 'relevant antitrust product market.'"[4] (See Exhibit No. ___ (MJD-5).)

As I discussed in my Direct Testimony, market definition properly focuses on demand substitution factors. This is not merely my opinion; rather, it is the guidance of the nation's leading antitrust authorities – the U.S. Department of Justice and the U.S. Federal Trade Commission. According to the agencies' *Horizontal Merger Guidelines*, "[m]arket definition focuses solely on demand substitution factors – i.e., possible

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[3] See Washington Utilities and Transportation Commission Staff Response to Data Request, *Washington UTC v. Verizon Northwest*, Dkt No. UT-040788 (Wash. U.T.C. Dec. 29, 2004), at VZ Data Request No. 124.

consumer responses."[5] Thus, in order to assess the appropriateness (or lack thereof) of their assumption regarding the relevant product market in which VDC competes, Mr. Brosch and Dr. Selwyn would have had to examine the degree of substitutability of alternative advertising media to the directory offerings of VDC. Again, neither witness presented such an analysis.

Nor has Mr. Brosch or Dr. Selwyn criticized the implementation of the substitutability analysis presented in my Direct Testimony. This is an important omission because, when such substitution patterns are considered, it is apparent that the relevant market is much broader than yellow pages alone and includes such advertising media as newspapers, radio, magazines, and direct mail, among others. As I concluded in my Direct Testimony, the relevant product market thus includes all forms of advertising media that meet the demands of local businesses and that are good substitutes for yellow pages ads.

Q DOES MR. BROSCH DISPUTE THE VIEW THAT VDC COMPETES WITH OTHER FORMS OF LOCAL ADVERTISING?

A. No. Despite the assertion in his Direct Testimony that incumbent telephone companies control most of the "yellow pages advertising market," Mr. Brosch concedes in response to a Verizon data request that the relevant product market is not limited to yellow pages directories. Specifically, the data request response confirms that "[i]t is not Mr. Brosch's

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[4] Response of Public Counsel, AARP and WeBTEC to Data Requests of Verizon Northwest, *Washington UTC v. Verizon*, Dkt No. UT-040788 (Wash. U.T.C. Dec. 30, 2004), at Data Request P.C. No. 116.

[5] U.S. Department of Justice and U.S. Federal Trade Commission, *Horizontal Merger Guidelines* (Rev. Apr. 8, 1997), at § 1.0 (hereinafter "*Horizontal Merger Guidelines*").

contention that directory publishers do not compete with other forms of local advertising."[6] (See Exhibit No. ___ (MJD-6).)

Q. WHAT ECONOMIC ANALYSES HAVE THE WITNESSES CONDUCTED THAT LEAD THEM TO CONCLUDE THAT VDC DOMINATES A MORE NARROWLY DEFINED "DIRECTORY PUBLISHING" OR "YELLOW PAGES" MARKET?

A. As stated above, neither of the witnesses conducted the required economic analysis to determine whether or to what extent "directory publishing" or "yellow pages" constitute a relevant product market. Working from the presumption that the relevant market is yellow pages, Mr. Brosch and Dr. Selwyn highlight certain price and financial data as evidence that VDC "dominates" this market. To begin with, Mr. Brosch examines certain financial and accounting data reported for VDC – e.g., the firm's return on equity ("ROE"), defined as income divided by stockholders' equity – and infers that the level of return is inconsistent with the view that the relevant market is competitive. Without explaining why any particular level of return is to be considered "excessive," Mr. Brosch simply concludes that the return on equity reported for VDC is "[c]learly . . . reflective of the unique advantages arising from VDC's affiliation with the Verizon ILECs." (Brosch, at 36.)

Mr. Brosch also states that ILEC-affiliated directory prices are higher than those of independent directories for comparable advertising and that the operating profit margins for VDC and other publishers affiliated with major telephone companies are

[6] Response of Public Counsel, AARP and WeBTEC to Data Requests of Verizon Northwest, *Washington UTC v. Verizon*, Dkt No. UT-040788 (Wash. U.T.C. Dec. 30, 2004), at Data Request P.C. No. 109.

higher as well. (Brosch, at 17-18.) Dr. Selwyn also relies upon price comparisons and financial data to determine if competition has constrained VDC's Washington earnings to non-monopoly levels. (Selwyn, at 72, 76.)

Q. PLEASE COMMENT ON THE USE OF FINANCIAL AND ACCOUNTING DATA BY MR. BROSCH AND DR. SELWYN TO INFER COMPETITIVENESS.

A. The "evidence" provided by Mr. Brosch and Dr. Selwyn, summarized above, is not an indication or proof that VDC is earning monopoly profits. It is well accepted in economics that high accounting profits can be consistent with competitive outcomes. Importantly, as I discuss in my Direct Testimony, even if one were to adopt Mr. Brosch's narrow market definition (which I do not), there are no significant barriers to entry in the alleged market for directory advertising. Examination of entry conditions is directly relevant because, as recognized by economists and the U.S. Department of Justice and U.S. Federal Trade Commission in the *Horizontal Merger Guidelines*, actual or potential entry vitiates any notion that VDC is realizing monopoly profits.[7] The lack of entry barriers in this industry is a point recognized by Mr. Brosch, who states that "[t]he directory publishing business does not rely upon large tangible assets investments, but is instead dependent mostly upon intangible assets and human resources. Indeed, there are only modest capital investments required to enter the business." (Brosch, at 45.) Mr. Brosch's own view on entry barriers runs counter to his claim that excessive profits are enjoyed by telephone company affiliated directory companies.

[7] See *Horizontal Merger Guidelines* at §§ 3.0 – 3.4.

Q. PLEASE COMMENT ON THE WITNESSES' RELIANCE ON PRICING DATA TO INFER LACK OF COMPETITIVENESS.

A. Mr. Brosch cites industry trade publications that indicate that independent directories, on average, offer advertising rates that are typically lower than those of publishers affiliated with an incumbent local exchange carrier. (Brosch, at 18.) As a preliminary point, I note that the publications relied upon by Dr. Brosch apparently provide no information regarding the source of the reported prices and do not state whether the prices are "list" prices or are inclusive of discounts. Thus, it is unclear whether or not the reported price data represent actual market transactions. Nevertheless, even if the prices reported in these publications do in fact represent market transactions, the studies simply report the average price of various ad types (e.g., double half column and full page ads) across a number of publishers and locations. Such price comparisons are misleading and suggest nothing about competitiveness.

To be useful as an element of comparison, the price of an advertisement must be adjusted to take into account a number of factors, including exposure – i.e., the number of "impressions" (or "looks") the advertiser purchases. A quarter-page advertisement circulated to 5,000 viewers once does not buy the same exposure as does a quarter-page advertisement circulated repeatedly to 100,000 viewers, and there is no reason to believe that they should be priced equally. Not controlling for such differences when comparing the prices in different directories would be similar to comparing the price of a television ad running for 30 seconds on local TV shown in off-hours to a similar ad running on network TV in prime time. The comparison would be apples-to-oranges.

To compare advertising rates across media accurately, it is necessary to control for the number of potential viewers (product reach) and the number of times each viewer sees the message (frequency). In the case of directories, for example, it would be necessary to take into account such factors as the number of books circulated in a given area, the exposed population, and the number of references to the directory by the exposed population expected in a given time period (e.g., references per month) when performing a comparison of ad prices. It is not surprising that a better (i.e., higher quality) directory is able to charge a higher price. The finding that such price differences exist is an outcome entirely consistent with the operation of a competitive advertising market. Yet as I explain elsewhere in my testimony, such price differentials do not justify imputation.

Dr. Selwyn also relies on directory price comparisons to substantiate his claim that VDC is able to charge higher prices than its competitors, but his comparisons are limited to the prices of just three ad types in two directories (i.e., those of VDC and Dex Media) distributed in Snohomish County, Washington. (Selwyn, at 76-77.) As an initial matter, I note that any conclusions drawn by Dr. Selwyn should be caveated as a result of his use of such limited pricing data. Next, I note that, unlike with Mr. Brosch, the source of Dr. Selwyn's data is known. That source, a database prepared by the Yellow Pages Integrated Media Association ("YPIMA"), reports list prices for various ad types by directory as well as other information regarding the characteristics of a directory (e.g., column format).[8] Thus, the price data relied upon by Dr. Selywn suffer from the same

[8] YPIMA has since changed its name to the Yellow Pages Association ("YPA"). See Yellow Pages Association News Release, "Yellow Pages Association Announces New Name, Logo and Ad Campaign," http://www.yppa.org/pdf/news_releases/YPANewName.pdf (Oct. 12, 2004).

criticisms mentioned above – namely, that they are not necessarily market transactions and that the extent to which they deviate from actual (i.e., discounted) prices is unknown. Dr. Selwyn recognizes the importance of controlling for other factors that might influence price comparisons, and he adjusts the rates of certain ad types to account for differences in the column format of the directory. However, like Mr. Brosch, Dr. Selwyn does not adjust his analysis to account for reach and frequency as described above. Thus, to the extent that advertising prices vary based on exposure, the price comparisons drawn by Dr. Selwyn can be entirely consistent with competitive outcomes and imply nothing about the value of any particular directory's affiliation with an ILEC.

Mr. Brosch attributes differences in directory advertising prices of ILEC-affiliated and independent directory publishers to the alleged "value associated with affiliation to the regulated telephone company business." (Brosch, at 19.) This is surprising, given Mr. Brosch's own recognition of the fact that independent directory publishers have been cutting price in an apparently successful attempt to compete as new entrants against the ILEC-affiliated publisher. As he observes in his Direct Testimony, independent directory publishers have been able to expand and take share from the directory publisher affiliated with the incumbent local exchange carrier, "by offering significantly lower prices to enter new markets." (Brosch, at 18.) I thus find Mr. Brosch's various arguments to be inconsistent with one another. In making one point, he essentially claims that price differentials are made possible by the privileged position of the ILEC-affiliated directory publisher, shielded from competition; in making another, he claims that price differentials can be explained by the aggressive entry of new suppliers, reducing price and taking share in what appears to be a highly competitive process.

Q. WHAT CONCLUSIONS DO YOU DRAW REGARDING THE ANALYSES OF COMPETITIVE MARKET CONDITIONS UNDERTAKEN BY MR. BROSCH AND DR. SELWYN?

A. I conclude that Mr. Brosch and Dr Selywn have not conducted the necessary economic analyses to render an informed opinion on this topic. Specifically, their analyses (1) do not consider the economic relevance of products that are reasonable substitutes for VDC's services from the perspective of consumers (i.e., advertisers), (2) fail to consider the economic relevance of the lack of entry barriers in the relevant market, (3) mischaracterize the value of financial data in rendering an opinion on competitiveness, and (4) misuse information on prices offered by VDC and competing suppliers of yellow pages advertising.

III. VDC'S AFFILIATION WITH VERIZON NORTHWEST DOES NOT PROVIDE AN ECONOMIC JUSTIFICATION FOR IMPUTATION

Q. DOES MR. BROSCH ASSERT THAT THERE ARE LINKAGES BETWEEN THE TELEPHONE COMPANY AND THE PUBLISHING AFFILIATE THAT JUSTIFY IMPUTATION?

A. Yes. Mr. Brosch identifies a number of linkages between VDC and the telephone services provided by Verizon NW that allegedly convey a competitive advantage to VDC and thus, in his opinion, justify imputation. (Brosch, at 6-7, 10-13.) Many of the linkages discussed by Mr. Brosch are related to VDC's *current* affiliation with the regulated ILEC business. According to him, these factors include (1) the public's perception that VDC's directories are endorsed by the local phone company and contain the most current and complete listing information controlled and assigned by Verizon NW and (2) actions taken to promote this perception, such as the use of trade names and trademarks linking VDC to the local phone company. In contrast, the first-mover advantage alleged by Mr. Brosch is related to VDC's *historical* affiliation with the local phone company.

Q. PLEASE COMMENT ON THOSE LINKAGES DISCUSSED BY MR. BROSCH THAT ARE RELATED TO VDC'S CURRENT AFFILIATION WITH THE REGULATED PHONE COMPANY.

A. Contrary to his assertions, the economic reality is that the Telecommunications Act of 1996, specifically Section 222(e), requires Verizon NW to make "subscriber list information" available on "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."[9] Thus, there is no specific benefit attributable to VDC's current relationship with Verizon NW. Independent publishers can (and do) obtain precisely the same subscriber list information available to VDC and can make their directories virtually indistinguishable from those affiliated with Verizon NW if they so desire, or they can choose to differentiate their product in an attempt to enhance its value to consumers. As noted in my Direct Testimony, new entrants are free to emulate the distinctive yellow copy of the cover and the widely recognized symbols, such as the familiar "Let your fingers do the walking" slogan and the "walking fingers" graphic. They can also combine white pages and yellow pages, if they perceive the combination of

[9] 47 U.S.C. § 222(e).

the two enhances value, and they can chose to distribute the book to the same target households and businesses.

One attribute of VDC's service that does differ from those of independents, as Mr. Brosch correctly recognizes, is the use of trademarks. Mr. Brosch is specifically concerned about the value of the Verizon trademark to VDC. He ignores the fact that this trademark does not belong to Verizon NW but covers instead a variety of business entities (e.g., Verizon Wireless), many of which have nothing to do with local exchange service. Furthermore, "Verizon" is a relatively new name, especially for a company that has been known by another name in Washington (i.e., GTE Northwest Incorporated) for a long time. It is my understanding that the first Washington directory using the Verizon name was distributed in 2000.

In addition, it must be recognized that the "Verizon" trade name and trademark is not owned by Verizon NW and was not developed by Verizon NW. It was developed by Verizon Communications and is used by its companies around the nation and the world. Verizon's decision to change its brand name during a period of emerging competition in the telephone industry signals the lack of value the company assigned to its longer-standing brand and trademarks. However, even if one were to conclude that there was value to the Verizon name, the value derived from that trademark properly flows to the shareholders of the company who put at risk the investment dollars required to develop the brand. Mr. Brosch produces no evidence to substantiate that the Verizon name carries with it the customer association he assumes.

The fallacy of Mr. Brosch's position, that some portion of this value should flow to ratepayers who may link VDC to the local phone company, is apparent when one considers that use of the very same logic would mean that ratepayers in Washington would also have a claim to the earnings of other Verizon companies (e.g., Verizon Wireless) to the extent that some customers perceive a link between those companies and the ILEC. Of course, extending this logic further implies that the losses incurred by such entities should also be borne by Washington ratepayers; however, discussion of the symmetrical treatment of gains and losses is absent from the witnesses' testimony.

Q. MR. BROSCH STATES THAT VDC'S PROMOTIONAL MATERIALS HIGHLIGHT THE ASSURANCE THAT THE DIRECTORY WILL CONTAIN A COMPLETE LISTING OF LOCAL BUSINESSES AND INVITE CONSUMERS TO QUERY POTENTIAL ADVERTISERS AS TO WHETHER COMPETING DIRECTORIES UNDER CONSIDERATION BY THEM WILL BE PUBLISHED IN A TIMELY MANNER AND HAVE ADEQUATE DISTRIBUTION, AMONG OTHER THINGS. DOES THE PRESENCE OF SUCH MARKETING INITIATIVES CHANGE YOUR VIEW THAT THE RELEVANT MARKET IS COMPETITIVE?

A. No. Such initiatives merely represent the attempt of marketing personnel to promote their product vis-à-vis an alternative source of supply. The fact that the marketing and promotional materials of one firm prompt potential customers to consider the relative merits of its directory to those of other, substitute sources of local advertising only reinforces the view that competition among directories and among other sources of local advertising content is present. Although Mr. Brosch did not present any information on the marketing material used by VDC's rivals, I would not be surprised to learn that competitive suppliers tout their product as having design features superior to those of existing providers or a more effective scope of distribution. For example, on its corporate website, TransWestern Publishing states that its "tailored approach to the markets, in addition to the attention to quality, excellence and pride in the product, sets TransWestern Publishing apart from the competition."[10] With regard to its Washington directories specifically, TransWestern highlights the following as some of the "benefits" of its products: "complete white and yellow pages in one book" and "targeted coverage at one low cost – delivering the best value for you advertising dollar."[11]

Q. PLEASE COMMENT ON THE CLAIM THAT VDC DERIVES VALUE FROM ITS FIRST-MOVER STATUS.

A. Mr. Brosch and Dr. Selywn both contend that VDC derives significant value from its first-mover status. (Brosch, at 12; Selwyn, at 60-64.) Dr. Selwyn observes that retailers value directories as a way to advertise to consumers and that they are willing to pay more for additional reach, all else constant. As he discusses in his testimony, more advertising leads to more consumer usage, which in turn leads to more advertising. (Selwyn, at 62.) In economics, this is referred to as a network externality.

Success in growing a directory is also attributable to the business acumen of the publisher – not the ILEC. However, Mr. Brosch and Dr. Selywn are silent on this point. This is particularly troublesome because the management of VDC has received numerous awards for achievements that demonstrate its business acumen. For example, GTE

[10] TransWestern Publishing Company, "TransWestern Publishing," http://www.twpsite.com/main/twpwebsite/Pages/twphome.html (visited January 22, 2005).

Directories Corporation ("GDC"), one of the predecessor firms to what is now known as VDC, received the Malcolm Baldrige National Quality Award for Service in 1994.[12] The Baldrige Award was established by Congress in 1987 "to recognize U.S. organizations for their achievements in quality and performance and to raise awareness about the importance of quality and performance excellence as a competitive edge."[13] The award is given by the President of the United States to business, educational, and health care organizations that are judged to be outstanding in seven areas: leadership; strategic planning; customer and market focus; measurement, analysis, and knowledge management; human resource focus; process management; and results. Highlighting the firm's focus on "anticipating and satisfying customer needs based on concrete, systematic customer input," the Baldrige National Quality Program observed that operations at GDC were "driven by a comprehensive, continuous focus on customer satisfaction that combines market research with clear-cut quality improvement processes and techniques."[14] In addition to this significant achievement, VDC has won numerous industry "APPY" awards (the industry equivalent to the motion picture industry "Oscar" award) for product design, marketing programs, and other elements of directory publishing. VDC was also a finalist for the Mercury Award for outstanding achievement

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[11] TransWestern Publishing Company, "Washington," http://www.twpsite.com/main/twpwebsite/Pages/states/WA/wastate.html (visited January 22, 2005) (main Washington directory menu).

[12] National Institute of Standards and Technology, Baldrige National Quality Program, "Malcolm Baldrige National Quality Award 1994 Winner: GTE Directories Corporation," http://www.quality.nist.gov/GTE_Directories_Corporation.htm (rev. Sept. 16, 2001).

[13] National Institute of Standards and Technology, Baldrige National Quality Program, "Frequently Asked Questions About the Malcolm Baldrige National Quality Award," http://www.nist.gov/public_affairs/factsheet/baldfaqs.htm (Nov. 23, 2004).

[14] National Institute of Standards and Technology, Baldrige National Quality Program, "Malcolm Baldrige National Quality Award 1994 Winner: GTE Directories Corporation," http://www.quality.nist.gov/GTE_Directories_Corporation.htm (rev. Sept. 16, 2001).

by the Industrial Academy of Communications Arts and Sciences and has won numerous awards presented by the Association of Direct Marketing, including an award for printing accuracy and an award for marketing and operations support, among others.

In light of the above, the remnant of a first-mover advantage, if any, is not relevant, and Mr. Brosch and Dr. Selywn have presented no evidence to the contrary. Given the other reasons for VDC's success unrelated to any ILEC affiliation, the first-mover advantage discussed by Mr. Brosch and Dr. Selwyn is not compelling, either as an explanation of VDC's performance or as a rationale for imputation.

Q. ASSUMING THAT VDC DERIVES SOME VALUE FROM ITS FIRST-MOVER STATUS, DO YOU AGREE THAT THE PRESENCE OF SUCH VALUE JUSTIFIES IMPUTATION?

A. No. Even if first-mover status were important, any value derived from it would still not justify imputation of directory advertising revenues to intrastate regulated accounts in this case. I do not agree that the value derived from first-mover status justifies imputation. As discussed in the testimony of Mr. Trimble, VDC was not developed at ratepayer expense. Since its creation in 1936, VDC (through its predecessor companies) has been separate from VERIZON NW and its predecessors. The assets and advertising expenses of VDC have never been part of Verizon NW's books. The shareholders of Verizon incurred the investment risk of VDC's performance, and they are the residual claimants to its income stream – not the customers that use the affiliate company's telephone services.

To understand this point, consider the Internet auction site known as eBay, the company used by Dr. Selwyn to describe the economic concept of network externalities. (Selwyn, at 61.) Dr. Selwyn observes that consumers are more likely to place an item for sale on eBay than on other Internet auction sites because eBay attracts more visitors than any other Internet auction site; simultaneously, the reason eBay attracts more visitors is because the site contains more auctions. This positive feedback loop has created significant value for eBay. Yet no one could credibly assert that the early users of eBay, who were essential to the company's successful growth, are entitled to some share of eBay's profits or market value. Only the initial investors in eBay have a legitimate claim to this income stream, as they incurred the investment risk. Yet Dr. Selywn takes the position (incorrectly in my view) that the ratepayers (i.e. the early users of directories) are entitled to essentially all the gains derived from VDC's first-mover advantage.

Q. BOTH MR. BROSCH AND DR. SELYWN ARGUE THAT THE EXISTENCE OF VALUE IN TELEPHONE COMPANY AFFILIATION OR "OFFICIAL PUBLISHER" STATUS IS CONFIRMED BY QWEST'S SALE OF ITS DIRECTORY PUBLISHING BUSINESS TO DEX MEDIA. DO YOU AGREE WITH THIS ASSERTION?

A. No, I do not agree. Mr. Brosch asserts that, by bundling a long-term exclusive "official" publishing contract and a long-term non-competition agreement into the transaction, Qwest was able to convey the "full value of the official publisher status to the buyer of the business." (Brosch, at 6-7.) (Both witnesses imply the dollar magnitude of this transaction, $7.2 billion, indicates that there are significant advantages to being perceived as the "official" directory product of the local phone company, although they do not attempt to quantify this value.) Contrary to Mr. Brosch's assertion, this transaction provides absolutely no information regarding the value of "official" directory status, precisely because the transaction *bundled* exclusive "official publisher status" and a non-compete agreement; thus, it is not possible to untangle their separate effects. That is, the value of the transaction to Dex Media includes the gains derived from "official" directory status (if any) and the gains derived from eliminating a competitor from the market. Mr. Brosch and Dr. Selwyn have not tried to determine the relative importance of these separate effects.

Q. MR. BROSCH AND DR. SELYWN CLAIM THAT THE FEE-FOR-SERVICES AGREEMENT BETWEEN VDC AND VERIZON NW IS INAPPROPRIATE BECAUSE IT CONFERS VALUABLE INTANGIBLE OFFICIAL PUBLISHING RIGHTS TO VDC WITHOUT COMPENSATION. DO YOU AGREE?

A. No, I do not. First, there is a significant flaw in their economic logic. To assess the reasonableness of compensation paid to Verizon NW by VDC, it is necessary to consider the value a third party would assign to the agreement. However, Mr. Brosch and Dr. Selwyn present no evidence that an independent directory company would be willing to pay Verizon NW for the right to perform the regulatory obligations now satisfied by VDC. Independent directory companies would likely not pay the large sum of money that Mr. Brosch and Dr. Selwyn recommend the Commission impute from the earnings of Verizon NW (i.e., 94-97 percent of VDC's actual earnings and 65-89 percent of VDC's annual revenue) since, in this hypothetical transaction, VDC would remain an effective competitor in the market for local advertising and there would be little (if any) change to the content of VDC's directories. If Dr. Selwyn is correct that network externalities are important, advertisers would still be willing to pay more for the additional reach of the VDC directory, and households would still prefer to use the VDC book because it would continue to be the largest yellow pages directory. Taking over the regulatory obligations of Verizon NW would not confer the benefits of the network externalities enjoyed by VDC to the independent directory company. I consider it unrealistic to assert that an independent directory would be willing to pay for value it is not receiving. Moreover, independent directory publishers are free to distribute their books to all Verizon NW customers (i.e., to duplicate the area served by VDC) and to combine yellow and white pages directories if they find it profitable to do so. The fact that some publishers choose not to do so indicates the lack of value they associate with these endeavors.

Q. DO MR. BROSCH AND DR. SELWYN PRESENT EVIDENCE THAT ANY PERCEPTIONS OF OFFICIAL PUBLISHING STATUS BY SOME CUSTOMERS ARE AN ADDED SOURCE OF VALUE TO VDC?

A. No. Mr. Brosch and Dr. Selwyn present no evidence to suggest that any perceptions of "official" publishing status that some customers may have are an added source of value to VDC (i.e., a source of value beyond that achieved by the quality of its directories). The reported differences in the prices do not represent evidence that customer perceptions of "official" publisher status are an added source of value. Inferences drawn from the sale of Qwest's directory business to Dex Media are also irrelevant because they are based on the premise that the incumbent competitor agrees to exit the market.

Q. PLEASE SUMMARIZE YOUR UNDERSTANDING OF THE PARTICULAR IMPUTATION APPROACH MR. BROSCH AND DR. SELWYN RECOMMEND THE COMMISSION APPLY IN THIS PROCEEDING.

A. Mr. Brosch recommends that the Commission essentially cap the earnings of VDC at the level that would be achieved had Verizon NW's regulated cost of capital been applied to VDC's fixed investment in Washington (defined as VDC's total capital investment multiplied by the ratio of advertising in the state divided by total advertising revenue). Dr. Selwyn recommends a similar approach advanced by Staff witness Paula Strain.

Q. IF ONE ASSUMED THAT IMPUTATION WERE AN APPROPRIATE RATEMAKING ADJUSTMENT, ARE MR. BROSCH'S AND DR. SELWYN'S APPROACHES FOR CALCULATING THE AMOUNT OF REVENUES CREDITED TO THE REGULATED TELEPHONE COMPANY VALID?

A. No, they are not. Both Mr. Brosch and Dr. Selwyn assert that the Fee-for-Service agreement is problematic because it grants valuable intangible assets to VDC at a zero price. As stated above, implicit in this line of reasoning is the notion that there exists another directory company willing to pay a higher price to perform the obligations borne by VDC. Only if a willing buyer were present could the price paid by Verizon NW be interpreted as too low. However, fulfilling Verizon NW's regulatory obligation would not eliminate VDC as a competitor, nor would it allow the independent directory publisher to provide services that it could not already offer today in the absence of an agreement with Verizon NW.

The imputation approach recommended by Mr. Brosch and Dr. Selwyn does not follow their own recommended logic because it is divorced from any notion of a directory company's willingness to pay for the rights conveyed under the arrangement. The calculation simply limits the earnings of the affiliated directory company to those that would have been achieved under cost-of-service regulation. In effect, the action regulates the profits of the unregulated directory affiliate. In imposing this constraint, it is further assumed that the appropriate cost of capital for the directory publisher is equivalent to the level authorized for the regulated telephone company. There is no reason to believe that such a calculation would be a reasonable representation of the willingness to pay for the rights granted to the third party under such the agreement.

Q. DO MR. BROSCH AND DR. SELWYN ATTEMPT TO DETERMINE WHETHER THE RATE OF RETURN ESTABLISHED BY THE COMMISSION FOR VERIZON NW IS APPROPRIATE FOR VDC GIVEN THE DIFFERENT RISKS INHERENT IN THE TWO LINES OF BUSINESS?

A. No, they do not. Even if their "excess profits" approach had merit (which it does not), Mr. Brosch and Dr. Selwyn would need to select a rate of return for VDC that represents the opportunity cost of capital specific to its line of business. Apparently, however, neither Mr. Brosch nor Dr. Selwyn has conducted the investigation necessary to determine whether or not the rate of return for VDC used in their calculations is specific to (or even appropriate to) the firm's line of business. Indeed, in response to a data request, Mr. Brosch concedes that he has not prepared any study to examine whether or to what extent the regulated rate of return for Verizon NW does or should differ from the competitive return for VDC.[15] Mr. Brosch admits that it is "[n]ot necessarily" his contention "that the regulated rate of return for Verizon NW rate represents a competitive rate of return for Verizon Directory Company. . ."[16] (See Exhibit No. ___ (MJD-7).) There exists no *a priori* economic reason to assume that the cost of capital would be the same for the two lines of business.

Q. PLEASE COMMENT ON THE RATE OF RETURN ADJUSTMENT MR. BROSCH EMPLOYS IN CONDUCTING HIS "CARVE-OUT" ANALYSIS OF VDC.

A. Instead of seeking to determine the appropriate cost of capital or rate of return for VDC, Mr. Brosch makes an arbitrary and *ad hoc* adjustment to the Verizon NW regulated rate of return, which he then applies to VDC. Specifically, Mr. Brosch recommends that "VDC's fixed investment in Plant, Property and Equipment and Inventories . . . be allowed to earn the higher common equity return recommended by Public Counsel, rather than the lower weighted overall cost of capital." (Brosch, at 35.) This was ostensibly done by Mr. Brosch "to explicitly eliminate all financial risk from the VDC capitalization, so as to mitigate any incremental operating risk associated with the directory publishing business relative to the regulated local exchange telephone business in Washington." (Brosch, at 35.) Mr. Brosch asserts that by allowing the "higher 100 percent equity" return on VDC's inventories and property, plant, and equipment ("PP&E"), he has made an allowance for differences in operating risks between the

[15] *See* Response of Public Counsel, AARP and WeBTEC to Data Requests of Verizon Northwest, *Washington UTC v. Verizon*, Dkt No. UT-040788 (Dec. 30, 2004), at Data Request P.C. No. 107.

directory publishing business and the ILEC business. While this *ad hoc* adjustment produces a higher rate of return than that employed by Commission Staff witness Paula Strain, its use does not ensure that the resulting calculation approximates a competitive return for VDC.

Mr. Brosch apparently "believes that the . . . elimination of all financial risk in the form of debt leverage is sufficient to offset any measurable differences in operational risk profiles between the two businesses."[17] (See Exhibit No. ___ (MJD-7).) There is no reason to believe this proposition. Independent of a firm's financing decisions, it faces certain risks as a result of operating in a particular industry or market. Mr. Brosch and Dr. Selwyn have undertaken no economic analysis in an attempt to determine the appropriate, "competitive" level of return for VDC, and neither have they attempted to quantify the gap between this level and the ILEC's regulated rate of return. Mr. Brosch does not seek to articulate the operational risks faced by VDC or to explain how these risks are mitigated, if at all, by his assumption regarding VDC's debt/equity structure. He furthermore provides no evidence to support his assertion that the reduction in VDC's financial risk implied by the adjustment (if it exists) is able – much less sufficient – to "offset any measurable differences in operational risk profiles" between two separate firms operating in different markets. As such, his adjustment and larger "carve-out" analysis are suspect.

[16] Response of Public Counsel, AARP and WeBTEC to Data Requests of Verizon Northwest, *Washington UTC v. Verizon*, Dkt No. UT-040788 (Dec. 30, 2004), at Data Request P.C. No. 107.

[17] Response of Public Counsel, AARP and WeBTEC to Data Requests of Verizon Northwest, *Washington UTC v. Verizon*, Dkt No. UT-040788 (Dec. 30, 2004), at Data Request P.C. No. 107.

Q. DOES MR. BROSCH'S RECOMMENDED IMPUTATION APPROACH PROVIDE UNREASONABLE RESULTS?

A. Yes. First, for the reasons articulated in my Direct Testimony, VDC operates in a competitive market, vying not only with other directories but with numerous forms of local advertising. That market is structurally unconcentrated, thus alleviating any concerns of lack of competitiveness. Moreover, actual or potential entry eliminates any concerns that yellow pages revenues include monopoly profits, even if the market were narrowly defined as directory advertising. Given this finding, imputation that removes 94 percent to 97 percent of earnings is clearly excessive.

Second, I have applied Mr. Brosch's imputation approach to a non-affiliated directory competitor in the market for local advertising, TransWestern Publishing. Using the most recent publicly available information for TransWestern (i.e., the company's 2002 10-K filed with the U.S. Securities and Exchange Commission), applying a 10.8 percent pre-tax return on investment to that company's directory investment ratebase yields a "required" income of approximately $15.8 million.[18] However, in that year, TransWestern's actual earnings before interest and taxes were approximately $58.9 million.[19] Thus, according to Mr. Brosch and Dr. Selwyn, TransWestern would have had "excess" earnings of approximately $43.1 million. A finding that approximately 73

[18] The last publicly reported financial statements for TransWestern are presented in the firm's SEC filings for 2002. In June of 2001, TransWestern acquired WorldPages.com, at which time the firm underwent a $900 million recapitalization funded by a group of private investors. As a result of the recapitalization plan, the newly combined firm was essentially taken private and is now primarily held by senior management, Thomas H. Lee Partners, and several other private investors. *See, e.g.*, TransWestern Publishing Company, "TransWestern Fact Sheet," http://www.twpsite.com/main/twpwebsite/Pages/faqsheet.htm (Feb. 20, 2003); WorldPages.com, "Acquisition Press Release: TransWestern Publishing Completes $900 Million Recapitalization Following Acquisition of WorldPages.com," http://admin.worldpages.com/financialPR/acqwpz01PR.htm (June 28, 2001).

[19] See TransWestern Publishing Company LLC, Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Year Ended December 31, 2002 (S.E.C. Mar. 27, 2003), at 11, 28.

percent of a non-affiliated directory publishing company's actual earnings would be deemed excessive if the imputation method proposed by Mr. Brosch and Dr. Selwyn were applied to that company demonstrates that their approach is misguided.

Q. IN THE BEGINNING OF YOUR REBUTTAL TESTIMONY, YOU INDICATED THAT MR. BROSCH AND DR. SELWYN DO NOT CONSIDER THE CONSEQUENCES OF THEIR PROPOSALS ON THE MARKET FOR LOCAL EXCHANGE SERVICES. PLEASE EXPLAIN THAT COMMENT IN MORE DETAIL.

A. In my Direct Testimony, I indicated that, from an economic perspective, imputation is bad public policy because it preserves distortion in the prices of local exchange services, setting them below economically efficient levels. Moreover, I indicated that imputation is not competitively neutral in that no other local advertising company is asked to provide a similar contribution and no other local exchange carrier seeking to serve customers with its own facilities receives a similar credit. Mr. Brosch and Dr. Selwyn do not respond to these basic economic criticisms. Mr. Brosch simply asserts that "there is no subsidy created when the official directory publishing opportunity that arises from telephone service incumbency is prudently exploited." (Brosch, at 38-39.)

As shown in Mr. Trimble's testimony, the results of imputation proposals offered by WUTC Staff and Mr. Brosch have the effect of artificially reducing residential monthly rates by $4.96 per line and $4.05 per line, respectively. The intent of Congress as expressed in the Telecommunications Act was to open markets to competition. Subsidies to regulated telecommunications services create competitive distortions that frustrate this goal. Mr. Brosch and Dr. Selwyn cannot credibly deny the fact that no other competitor seeking to enter local exchange markets with their own facilities has access to such a credit.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.