

Exhibit No. ___-T (GB-1T)
Docket No. UT-040788
Witness: Glenn Blackmon, Ph.D.

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Complainant,

v.

VERIZON NORTHWEST INC.,

Respondent.

DOCKET NO. UT-040788

DIRECT TESTIMONY OF

Glenn Blackmon, Ph.D.

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

POLICY AND COMPETITION ISSUES

November 22, 2004

1 **Q. Please state your name and business address.**

2 A. My name is Glenn Blackmon, Ph.D. My business address is 1300 South
3 Evergreen Park Drive Southwest, P.O. Box 47250, Olympia, Washington
4 98504. My e-mail address is blackmon@wutc.wa.gov.

5

6 **Q. By whom are you employed and in what capacity?**

7 A. I am employed by the Washington Utilities and Transportation Commission.
8 I am currently the Acting Director of the Regulatory Services Division. My
9 usual position is Assistant Director for Telecommunications.

10

11 **Q. What are your education and experience qualifications?**

12 A. I hold Ph.D. and master's degrees in public policy from Harvard University
13 and a bachelor's degree in economics from Louisiana State University. I
14 have been employed at the Commission since August 1995 and became
15 Assistant Director for Telecommunications in April 1996. I previously
16 served as the Commission's economics advisor in the interconnection case,
17 Docket No. UT-941464, and the U S WEST general rate case, Docket No. UT-
18 950200.

19 Prior to working at the Commission, I was a consultant in private
20 practice, where my clients included both regulated companies and consumer

1 advocates, and an analyst for the Washington State Senate Energy and
2 Utilities Committee. I have presented testimony as an expert witness before
3 this Commission, as well as the Illinois and Idaho commissions.

4 I am the author of a book, *Incentive Regulation and the Regulation of*
5 *Incentives* (Boston: Kluwer Academic Publishers, 1994). I have authored or
6 co-authored articles on utility regulation and economic theory published in
7 *American Economic Review*, *Journal of Regulatory Economics*, *Yale Journal on*
8 *Regulation*, *Journal of Risk and Uncertainty*, and *Public Utilities Fortnightly*.

9
10 **Q. What is your experience with the nature of Verizon’s telecommunications**
11 **operation in this state and the general telecommunications environment?**

12 A. I have been directly involved in the regulation of Verizon NW’s intrastate
13 operations since 1996. This work includes the merger of GTE and Bell
14 Atlantic, the competitive classification of the Company’s toll services,
15 implementation of the interconnection and unbundling requirements of the
16 federal Telecom Act of 1996, reduction of Verizon NW’s access charges,
17 implementation of universal service mechanisms affecting the Company, and
18 ongoing review of Verizon’s competitive and regulated practices. I have
19 been closely involved in the development of competition, the relaxation of

1 regulatory requirements, and the introduction of technological and market
2 structure changes in the telecom industry since 1996.

3
4 **I. PURPOSE OF THE TESTIMONY**

5
6 **Q. What is the purpose of your testimony?**

7 A. The purpose of my testimony is to provide the Commission an
8 understanding of the competitive and regulatory context within which
9 Verizon NW is pursuing this general rate case. In doing so, I will be
10 responding to the testimony of Mr. Banta, but my testimony goes well
11 beyond the cursory overview of the competitive situation that he offers.

12
13 **II. THE CONTEXT OF THIS CASE**

14
15 **Q. Please explain the role of Verizon NW and Verizon's other incumbent**
16 **local exchange companies within the overall operation of Verizon**
17 **Communications.**

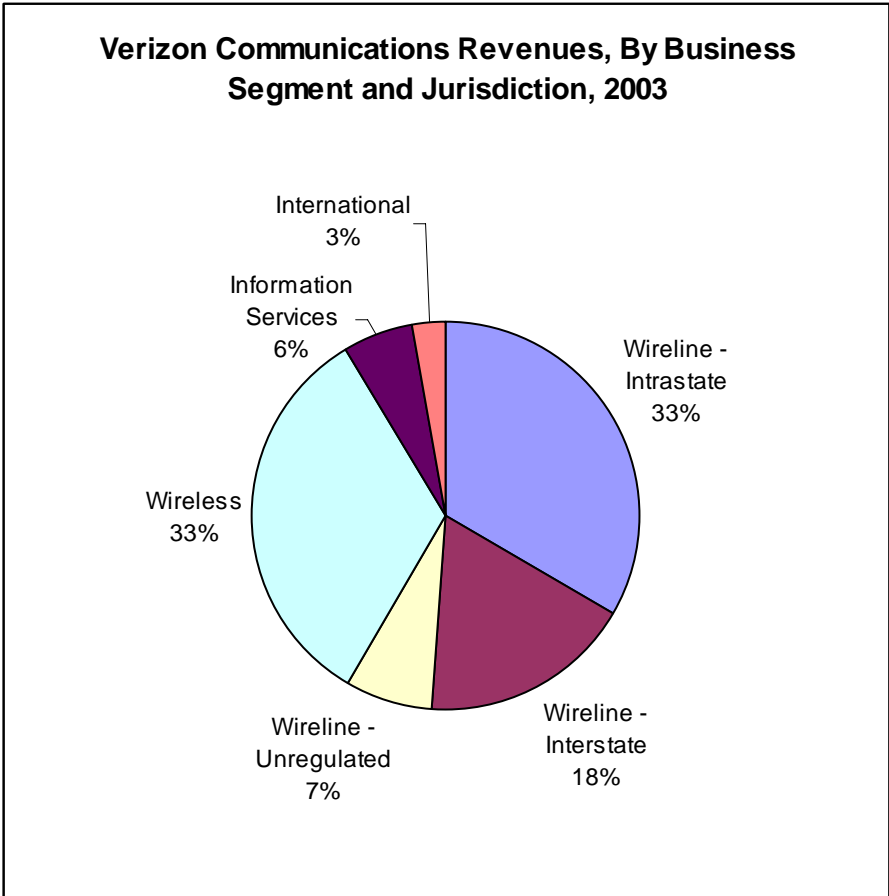
18 A. Verizon Communications (Verizon) is the largest provider of wireline and
19 wireless telecommunications services in the United States. It reported 2003
20 operating revenues of \$67.8 billion. Verizon reports financial results for four

1 reportable segments: Domestic Telecom, Domestic Wireless, Information
2 Services and International. In its financial reports, Verizon says that it
3 manages each segment as a strategic business unit, which I understand to
4 mean that all of the services and resources of a segment, such as Domestic
5 Telecom, are managed jointly.

6 In other words, Verizon does not seek to maximize revenues, profits,
7 or market share of individual services or products, such as local telephone
8 service, but rather focuses on the overall results of each sector. It follows
9 from this objective that if Verizon had the opportunity to take an action that
10 would decrease the profitability of its local telephone service, but would
11 increase profits of the overall sector, it would take that opportunity.

12 The contribution of the various business segments to Verizon's overall
13 revenues is shown in the chart below:¹

¹ Sources: Overall business segment data is published by Verizon at http://investor.verizon.com/financial/quarterly/xls/hist_financials_3Q04.xls. Jurisdictional breakdown of revenues is reported by Verizon in FCC Report 43-01, the ARMIS Annual Summary Report.



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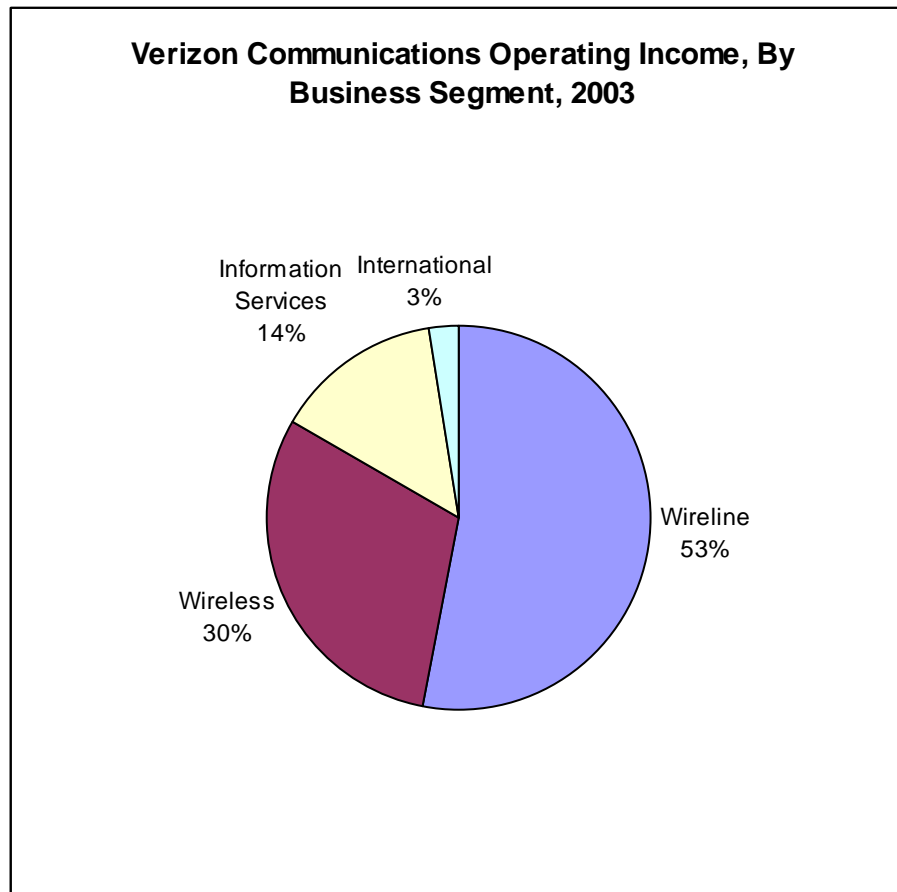
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8

The Domestic Wireline sector provides Verizon Communications with 58 percent of its overall revenue. Verizon says that about 14 percent of its overall revenue is in the “wireline growth” areas of long distance, data, and digital subscriber line (DSL) services.

Verizon does not report to investors the jurisdictional breakdown of these wireline revenues. However, data reported to the FCC show that one-third of Verizon’s overall revenues are in the intrastate jurisdiction.

1 The chart below shows the contribution to operating income of each
2 Verizon business segment. Verizon does not break down the operating
3 income within each business segment.



4

5 The operating margin (operating income relative to operating
6 revenues) is very similar for the Wireline and Wireless segments. Verizon
7 earns a substantially higher margin on its information services segment, i.e.,
8 its directory publishing business.

9

1 **Q. Is all of the business activity reported as the “Domestic Telecom” sector**
2 **conducted by Verizon within its incumbent local exchange companies,**
3 **such as Verizon NW?**

4 A. The incumbent local exchange companies (ILECs) conduct most, but not all,
5 of the business of the Domestic Telecom sector. Other affiliates within this
6 sector include Verizon Long Distance, Verizon Select Services, Inc., Verizon
7 Enterprise Solutions, and Verizon Online.

8

9 **Q. Does Verizon conduct all of its unregulated Domestic Telecom business**
10 **through these unregulated affiliates?**

11 A. No. The Verizon ILECs reported unregulated revenues of about \$2 billion in
12 2003. This is about 40 percent of all unregulated revenues of the Domestic
13 Telecom segment.

14

15 **Q. Do the “wireline growth” areas of long distance, data, and DSL also show**
16 **up in the revenues of both the ILECs and the unregulated affiliates?**

17 A. Yes. The ILECs sell long distance and data services and sell underlying
18 services used in the provision of DSL service.

19

1 **Q. Are the unregulated revenues of Verizon NW also growing?**

2 A. No. Verizon NW, the Verizon ILEC entity that provides service in
3 Washington, has actually seen a very large decline in unregulated revenues.
4 From 2000 to 2003, Verizon NW's Washington unregulated revenues
5 decreased by \$32 million, or 38%. Verizon NW's operating expenses
6 allocated to unregulated activities have also decreased, but by only \$9.5
7 million.

8

9 **Q. Please explain how this information about Verizon's corporate structure**
10 **and strategic approach is relevant to the issues in this rate case.**

11 A. The Verizon ILECs are a very large source of revenue to the parent company.
12 These subsidiaries, including Verizon NW, are strategically managed for the
13 overall benefit of the Domestic Telecom segment of Verizon
14 Communications. Strategic "growth areas" are pursued using the resources
15 of the entire segment, including Verizon NW.

16 In reviewing the financial results of Verizon NW – particularly the
17 subset of those results that are characterized as intrastate results – the
18 Commission should understand that Verizon does not manage this part of its
19 business as a separate, profit-maximizing unit. The resources that are
20 represented by the Washington intrastate rate base and expenses of Verizon

1 NW are not exclusively dedicated to producing Washington intrastate
2 revenues. Rather, they are simply the portion of the business' overall
3 resources that have, with considerable arbitrariness, been allocated to this
4 jurisdiction.

5

6 **Q. How does a regulatory proceeding such as this rate case fit in the overall**
7 **strategic efforts of the Domestic Telecom segment of Verizon?**

8 A. It does not fit well at all. Verizon's general approach for the Domestic
9 Telecom segment appears to be aimed at increasing the value that customers
10 place on its services. Verizon is offering broadband services to residential
11 customers who currently use dial-up Internet access. It is offering bundled
12 packages of features and toll calling that are similar to the offerings of
13 wireless companies. It is providing more data capacity to business
14 customers. In a few locations nationally, Verizon is even moving toward
15 head-to-head competition with cable operators via a fiber-based distribution
16 network.

17 In none of these strategic efforts does Verizon's response to
18 competition and technological change include compelling customers to pay
19 more for existing services. Yet that is just what Verizon seeks to do in this
20 proceeding. Verizon is attempting to use the monopoly-era mechanism of a

1 general rate case at a time when that mechanism is simply inadequate for the
2 circumstances. The Company would have the Commission focus on
3 revenue, expense, and investment figures that reflect a hopelessly distorted
4 combination of jurisdictional and non-jurisdictional activities.

5 The overall result tells the Commission virtually nothing about
6 whether the rates for local service in Washington state are fair, just,
7 reasonable, and sufficient, yet the Company is asking the Commission to
8 accept the Company's results and impose a massive rate increase, to be borne
9 primarily by those customers with the fewest alternatives, or no alternatives.

10

11 **Q. Are you referring to the argument that was made in the access charge case**
12 **about the mismatch of revenues and expenses in intrastate and interstate,**
13 **an issue that was also addressed by Staff witness Paula Strain in the**
14 **interim phase of this case, and the current phase of this case?**

15 A. That is just a part of the picture of how Verizon NW is using the rate case
16 process to compel captive customers of local services to bear costs that have
17 no relation to the provision of their services. Not only is Verizon NW
18 seeking to rely on separated results of operations that fail to match intrastate
19 revenues with intrastate expenses and investment, it is also strategically

1 using its “corporate cousins” – its affiliates – to understate the economic
2 profitability of the regulated entity.

3 Even within the Company’s regulated, intrastate operations, as
4 imperfectly defined as that is, Verizon NW is attempting in this proceeding
5 to shift its losses from competitive activities to the remaining captive
6 customers. For example, Verizon NW continues to allocate marketing
7 expenses to its intrastate results based on the proportion of intrastate and
8 interstate revenues that it received in 2000. Intrastate revenues increased by
9 \$33 million from 2000 to 2003, and intrastate revenues decreased by \$70
10 million. Using the 2000 revenue levels to allocate marketing expenses shifts
11 costs to captive customers. Verizon NW complains that it has incurred
12 significant loss of local and access revenue to its competitors, including both
13 competitive local exchange companies and wireless companies. Yet, rather
14 than respond in the marketplace, Verizon NW would have regulators make
15 up these losses by raising rates for basic service.

16
17 **Q. How has Staff attempted to respond to Verizon NW’s rate case filing,**
18 **given the circumstances that you have described?**

19 A. The Staff has attempted to present the Commission with as accurate a picture
20 of the jurisdictional results of operations as is possible. Staff has approached

1 this filing using the traditional regulatory tools. However, the tangle of
2 affiliated interest transactions, mismatched jurisdictional allocations and
3 assignments, and mal-classified intrastate services make it very difficult to
4 present a reliable, “clean” picture of the intrastate, non-competitive financial
5 results of Verizon NW.

6
7 **Q. Should the Commission look beyond the presentation of accounting**
8 **results and the various adjustments of Staff, the Company, and other**
9 **parties?**

10 A. Yes. Before raising local rates for captive business and residential customers,
11 the Commission should consider whether any changes in the demand and
12 use of services by those customers or any changes in the expenses or
13 investments of the Company justify an increase in local rates. The Company
14 would have the Commission take a completely different approach – treat the
15 local service as the price of last resort, shifting costs to this captive base as it
16 suffers competitive losses elsewhere – but this approach is neither fair to the
17 local service customers nor good competition policy.

1 **III. RESPONSE TO THE TESTIMONY OF MR. BANTA**

2

3 **Q. In the direct testimony of the Company’s policy witness Mr. Banta, in**
4 **Exhibit No. ___ (SMB-1T) at pages 5-10, Mr. Banta reviews several major**
5 **factors that he claims explain the changes in Verizon NW’s revenue**
6 **requirement over the past several years. Do you believe that this**
7 **retrospective view is helpful in understanding the context of the Verizon**
8 **NW’s current rate request?**

9 **A. Yes. I agree that this is a helpful approach to understanding the context of**
10 **this case. However, a proper understanding of the factors listed by Mr.**
11 **Banta shows his analysis is defective in many ways.**

12 In analyzing these issues, it is important to recall that in 1999, the
13 Company, then known as GTE Northwest, was in very sound financial
14 condition. Its intrastate earnings, as reported in the FCC ARMIS data base,
15 were as large as the Washington intrastate earnings of Qwest (then known as
16 U S WEST), even though Qwest had twice the revenues of Verizon. Indeed,
17 the Company appeared to be regularly earning excessive returns.

18 Accordingly, Staff was undertaking a financial review of the Company, with
19 the expectation that this review would lead to voluntary rate reductions by
20 Verizon NW, or a formal complaint by the Commission.

1 **Q. Mr. Banta identifies the merger-related rate reductions as one source of the**
2 **change in Verizon NW's financial condition. *Direct Testimony of Mr.***
3 ***Banta, Exhibit No. ___ (SMB-1T) at page 5, lines 6-7 and page 7, lines 12. Do***
4 ***you agree with his assessment?***

5 A. No. It is true that Verizon NW agreed in 1999 to reduce its rates by \$30
6 million per year, with the reductions phased in over a two-year period.
7 However, Mr. Banta neglects to mention the offsetting factors associated
8 with that revenue decrease. First, the merging companies claimed that the
9 result of the merger would be beneficial, through some combination of
10 expense reductions and revenue increases. Second, Staff's financial review
11 had shown that the Company was earning excessive returns immediately
12 prior to the merger. There is no reason to believe that the \$30 million in
13 revenue reductions would cause Verizon NW's earnings to fall below its cost
14 of capital.

15
16 **Q. Is it possible that the merging companies were counting on merger**
17 **"synergies" that never materialized?**

18 A. Yes, this is a possibility. As things turned out, Verizon NW's total operating
19 expenses did not decrease. Indeed, they increased dramatically after the
20 merger. Verizon NW's total operating expenses, other than depreciation and

1 amortization, (for all four states) were \$465 million in 1999 and \$674 million
2 in 2003. What is truly relevant about the merger is not the \$30 million of
3 agreed-to rate reductions discussed by Mr. Banta, but instead the \$209
4 million increase in operating expense that has occurred since the merger.
5 The Washington intrastate share of this increase, as allocated by the
6 Company, is \$88 million.

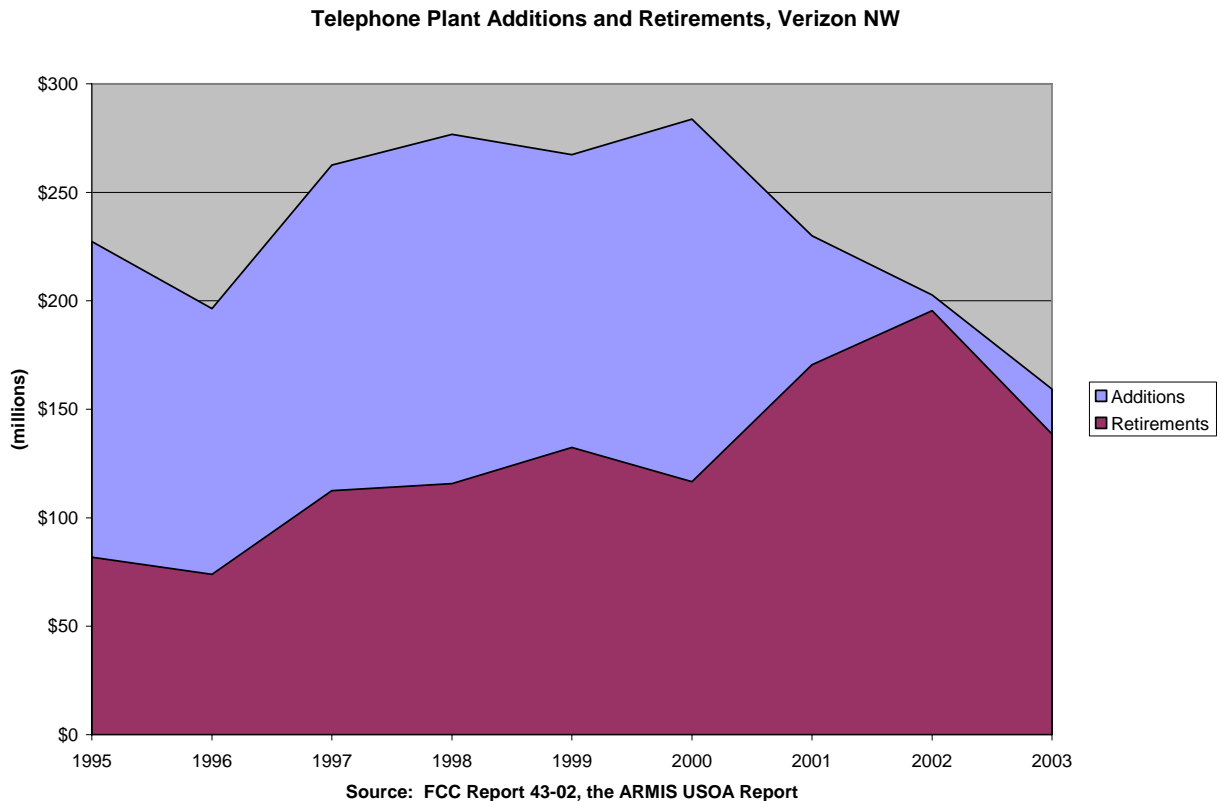
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8 **Q. Are you suggesting that the merger did not produce any synergies?**

9 A. No. I suspect that the merger of Bell Atlantic and GTE into Verizon did
10 allow the owners to increase revenues relative to costs. However, it would
11 appear that they did an excellent job of ensuring that synergies were realized
12 by the non-regulated entities within Verizon's web of affiliates.

13
14 **Q. Mr. Banta also discusses continued investment in the network as a reason**
15 **for the change in Verizon NW's circumstances. *Direct Testimony of Mr.***
16 ***Banta, Exhibit No. ___ (SMB-1T) at page 5, lines 8-11 and page 7, lines 14-15.***
17 **Do you agree with his analysis?**

18 A. No. In the first year after the merger, investment increased slightly. Since
19 2000, the annual investment by Verizon NW in telephone plant has dropped
20 by 44 percent. In the last three years, Verizon NW's investment in new plant

1 has barely kept pace with the retirement of old plant. Once plant retirements
2 are included in the analysis, it appears that Verizon NW's net plant
3 investment has a negligible effect on the company's financial circumstances.
4 This downturn in net investment is illustrated in the chart below:



5

6

7 **Q. Mr. Banta also identifies depreciation expenses as a reason for the change**
8 **in circumstances. *Direct Testimony of Mr. Banta, Exhibit No. ___ (SMB-1T)***
9 ***at page 5, line 12 and page 7, lines 8, line 1 to page 9, line 2. Please respond***
10 **to his analysis.**

1 A. I agree that the Commission increased Verizon NW's depreciation rates
2 effective January 1, 2000, in Docket No. UT-992009. This reprscription, like
3 the \$30 million of rate reductions discussed earlier, was associated with the
4 GTE-Bell Atlantic merger and came at a time of apparently excessive
5 earnings. I have no reason to believe that it creates an earnings problem
6 today.

7 The Company has recently proposed in a separate proceeding to
8 increase its depreciation rates further. That is Docket No. UT-040520. Mr.
9 Banta's comments regarding the merits of that proposal are best addressed in
10 the proceeding where the Commission is considering the matter.

11

12 **Q. Mr. Banta argues that the Commission's depreciation practices have**
13 **created an environment in which the Company has no incentive to invest.**
14 ***Direct Testimony of Mr. Banta, Exhibit No. ___ (SMB-1T) at page 7, line 17***
15 ***to page 10, line 8. Do you agree with his argument?***

16 A. No. The only factor he cites in support of this proposition is that Verizon
17 NW has an "extremely low percentage of past investment recovered." He
18 seems to define "low" as meaning less than other states. There is absolutely
19 no evidence to suggest that the depreciation or "capital recovery" practices
20 of the Washington Commission fail to result in full recovery by Verizon NW,

1 with a fair return to investors, of the investments that the Company makes in
2 this state.

3

4 **Q. Do you believe that Verizon NW is withholding investment in**
5 **Washington state because of the Commission's capital recovery practices?**

6 A. I cannot say whether Verizon NW's management actually makes investment
7 decisions on this basis, but it would be an irrational basis for allocating
8 capital. Rational investors make their decisions based on expected cash flow,
9 not on how fast they get their investment back or the annual level of a non-
10 cash item such as depreciation expense.

11 If Verizon NW's theory had any validity, investors would not put any
12 money into the telephone network at all. Instead, they would invest in
13 activities that would return the investment even more quickly than any
14 telephone plant ever could, such as retail inventory or accounts receivable.

15

16 **Q. Mr. Banta specifically mentions the Company's investment in a new fiber**
17 **optic network. Do you believe the regulatory environment in Washington**
18 **state is a significant factor in the Company's decision about whether to**
19 **deploy this network in Washington state?**

1 A. No, I do not. Verizon is attempting to use the prospect of fiber deployment
2 as an inducement to get more favorable regulatory treatment, but I believe
3 the regulatory changes that Verizon seeks would have no effect on its
4 ultimate decision about whether to use a fiber-optic distribution network
5 here. To the extent regulatory treatment matters in this decision, Verizon's
6 focus is on the Federal Communications Commission.

7 The Company has been quite successful in using the prospect of "fiber
8 to the premises" (FTTP) as an inducement to get more favorable regulation at
9 the federal level. Moreover, the Company is initially limiting its deployment
10 of the FTTP network to states where it is not a regional Bell operating
11 company (RBOC), thereby reducing or avoiding unbundling obligations that
12 might apply under federal law to RBOCs particularly. It does not follow that
13 states that tilt Verizon's way will get the FTTP investments ahead of other
14 states, because the nature of Verizon's federal approach has been to insulate
15 these investments from state regulatory oversight.

16

17 **Q. In your opinion, what will determine Verizon's decisions about where to**
18 **deploy FTTP?**

19 A. Verizon will go where the money is and where the competition is. Replacing
20 the existing copper-pair distribution network with an FTTP network is very

1 expensive proposition, and it provides more bandwidth than is necessary to
2 provide the existing level of residential voice and data services. Verizon will
3 choose communities where it has the best chance of gaining customers with
4 the ability and willingness to pay extra for the additional capabilities of the
5 fiber system.

6 For example, Verizon's much-publicized rollout of its fiber-based
7 Internet access service, FiOS, is in Keller, Texas. Keller is a community
8 within the Dallas-Fort Worth metropolitan area, and in Keller Verizon faces
9 competition from another national incumbent local exchange company, SBC,
10 and a cable company, OneSource Communications. OneSource, which is
11 owned by an electric cooperative, offers telephone service and broadband
12 Internet access.

13 Just as the competitive situation in Keller is not typical, the
14 community's demographics are also far from typical. Keller is substantially
15 richer, better educated, and younger than the typical United States
16 community. It also has a much higher percentage of owner-occupied homes,
17 and these homes are substantially more expensive than the national average.

18 Verizon has since named six other communities in California, Texas,
19 and Florida where it will offer FTTP-based services. The households in these
20 communities are all, like Keller, richer, better educated, and younger than

1 the nation as a whole. By comparison, the communities in this state that
 2 would seem to be the best candidates for Verizon to selling residential
 3 bandwidth – Kirkland and Redmond – are less affluent than the
 4 communities selected by Verizon for FiOS. This comparison is illustrated in
 5 the table below:

Demographic Characteristics of FiOS Cities, Compared to U.S. Average and Redmond/Kirkland		<u>U.S. Avg.</u>	<u>FiOS Cites</u>	<u>Redmond/ Kirkland</u>
Age	Population over age 65	12.4%	6.4%	9.8%
Housing	Owner occupied units	66.2%	78.5%	56.1%
Education	Bachelor's degree or higher	24.4%	45.7%	50.2%
Income	Median household income	\$41,994	\$85,532	\$63,534
Poverty	Families below poverty level	9.2%	2.5%	3.6%
Housing	Median monthly owner costs	\$1,088	\$1,867	\$1,641

Source: U.S. Census Bureau, Census 2000 American Fact Finder
<http://factfinder.census.gov/home/saff/main.html?lang=en>

6

7 **Q. If Verizon had deployed a fiber distribution network in Washington state,**
 8 **is it likely that the Company would be earning higher intrastate returns as**
 9 **a result?**

10 A. No. To the contrary, Verizon would in all likelihood have even lower
 11 intrastate earnings than it has filed in this case. Verizon has not disclosed
 12 expected financial results of the FTTP rollout, but it is far from certain that it
 13 will be profitable. Analysts have expressed skepticism about Verizon's

1 decision to spend so much money on this project. While Verizon and SBC
2 have announced FTTP plans, both Qwest and BellSouth have decided not to
3 make this investment at this time.

4 More importantly, even if the FTTP investment turns out to be
5 profitable, the financial returns will not be realized by the intrastate
6 jurisdiction. In Keller, Texas, Verizon is using the FTTP network to offer
7 high-speed Internet access, which is a combination of interstate and
8 unregulated services. Little if any of the incremental revenue received from
9 use of the FTTP network will be intrastate revenue. However, for every
10 \$1,000 that Verizon invests in the FTTP network, approximately \$750 will be
11 charged to the intrastate jurisdiction. With this mismatch between revenues
12 and costs, the effect of FTTP deployment on Washington intrastate results of
13 operations would likely be negative even if the strategy is profitable at the
14 Verizon corporate level.

15
16 **Q. Mr. Banta also cites the Commission's order reducing access charges as a**
17 **reason for the Company's change in circumstances. *Direct Testimony of***
18 ***Mr. Banta, Exhibit No. ___ (SMB-1T) at page 5, lines 4-5 and lines 21-23, and***
19 ***page 6, lines 1-9. Do you agree that this Commission decision contributed***
20 **to lower earnings by the Company?**

1 A. The Commission's access charge decision will, all other things being equal,
2 reduce the revenues and earnings of the Company. However, the
3 Company's access revenues could have been expected to decrease had the
4 Commission not issued that decision lowering access rates, because
5 customers would have continued to find ways to avoid paying the excessive
6 rates that Verizon NW was charging. Mr. Banta notes the loss of access
7 minutes that the Company has experienced; this would likely be even larger
8 had access rates not been reduced by the Commission.

9

10 **Q. Do you agree with Mr. Banta's assessment of the \$34 million per year**
11 **Verizon NW is no longer receiving from its directory affiliate? *Direct***
12 ***Testimony of Mr. Banta, Exhibit No. ___ (SMB-1T) at page 5, lines 12-15 and***
13 ***page 9, lines 4-9?***

14 A. No. Verizon has not suffered any loss in telephone directory revenues. As
15 Dr. Selwyn explains, the Company has simply shifted the revenues into an
16 unregulated affiliate.

17

18 **Q. Mr. Banta also identifies the cost of capital as a cause for Verizon NW to**
19 **increase its rates. *Direct Testimony of Mr. Banta, Exhibit No. ___ (SMB-1T)***
20 ***at page 5, lines 15-16, and page 9, lines 11-15. Please respond.***

1 A. As Mr. Rothschild explains in his testimony, Verizon NW's cost of capital has
2 not increased.

3

4 **Q. Mr. Banta also says that competitive pressure is causing Verizon NW's**
5 **revenues to decrease. Direct Testimony of Mr. Banta, Exhibit No. ____**
6 **(SMB-1T) at page 6, lines 11-20. Do you agree that Verizon NW is losing**
7 **revenues due to competition?**

8 A. I agree that the regulated revenues of a particular corporate entity, Verizon
9 NW, Inc., have decreased. Competition has probably contributed to this
10 decrease, but there are several other factors as well. Verizon NW has used its
11 corporate structure to shift some revenues from the regulated utility to
12 unregulated affiliates.

13 For example, Verizon NW toll revenues have been shifted to both
14 Verizon Long Distance and Verizon Wireless; two affiliates that are not
15 regulated by the Commission. The Company has also offered unregulated or
16 interstate services as substitutes for regulated services, such as digital
17 subscriber line service (DSL) as a replacement for dial-up service using voice-
18 grade telephone service. In addition, customers have cut back on telecom
19 services in response to the economic downturn. There were 51,000 fewer
20 people employed in our state in 2003 than there were in 2000.

1 **Q. If Verizon NW has lost customers due to an economic downturn, would it**
2 **be appropriate to raise rates on the remaining customers to restore those**
3 **revenues to Verizon NW?**

4 A. Generally speaking, it would not be appropriate to raise rates to offset an
5 economic downturn. Raising telephone rates when the economy is
6 depressed would hardly contribute to the economic vitality of the state.
7 Once the economy recovers, the Company would experience an increase in
8 revenues with little increase in its expenses or investment. The Commission
9 should set rates for the long run, especially since Verizon NW has
10 demonstrated that it can go for many years without submitting a general rate
11 case, regardless of whether it was over-earning or under-earning its
12 authorized rate of return.

13
14 **Q. If Verizon NW has lost customers or revenues due to competition, would it**
15 **be appropriate to raise rates to the remaining customers to restore those**
16 **revenues to Verizon NW?**

17 A. No, it would be inappropriate and possibly even contrary to law to raise
18 rates paid by captive customers to make up for revenues lost due to
19 competition. State law [RCW 80.36.330(6)] provides, "No losses incurred by
20 a telecommunications company in the provision of competitive services may

1 be recovered through rates for noncompetitive services.” Federal law [47
2 U.S.C. 254(k)] prohibits the subsidy of competitive services by services that
3 are not competitive and directs state commissions, with respect to intrastate
4 services, to “ensure that services included in the definition of universal
5 service bear no more than a reasonable share of the joint and common costs
6 of facilities used to provide those services.” (The basic residential and
7 business services for which Verizon proposes rate increases are services
8 “included in the definition of universal service.”)

9 The principles underlying these statutes require that Verizon, and not
10 its remaining captive customers, bear the costs relating to business that
11 Verizon has lost to competition. Those customers should pay rates that
12 cover the cost of providing their service, and no more.

13
14 **Q. What policy should the Commission adopt with respect to revenue losses**
15 **attributable to competition from local exchange companies using**
16 **unbundled network elements (UNEs) from Verizon’s own network?**

17 **A.** It is especially important that Verizon not be allowed to raise rates of captive
18 customers to offset revenue losses due to customers switching to UNE-based
19 services. Congress and the FCC established an entirely separate method for
20 establishing the prices for UNEs. Just as UNEs are not to be priced through

1 traditional regulatory approaches, the retail services that are still subject to
2 rate-of-return regulation must not be saddled with lost revenues attributable
3 to UNE-based competition.

4

5 **Q. Do you believe that a substantial portion of Verizon NW's intrastate**
6 **revenue loss is due to some combination of business downturn and**
7 **competitive effects?**

8 A. Yes. From 1999 to 2003, the number of business switched access lines served
9 by Verizon NW in Washington state decreased by 34,103. It is reasonable to
10 assume that Verizon NW received \$50 per line in revenue from business
11 customers. This loss of business lines therefore caused Verizon NW's annual
12 revenues to decrease by about \$20.5 million.

13

14 **Q. Mr. Banta has testified that Verizon NW has taken steps to retain or grow**
15 **its revenue. *Direct Testimony of Mr. Banta, Exhibit No. ___ (SMB-1T) at***
16 ***page 12, lines 1-8. Do you agree with his assessment?***

17 A. Verizon NW has made modest efforts to retain and grow revenue. However,
18 it is worth noting that Verizon NW is actually spending less – both in the
19 aggregate and in proportion to its revenues – on marketing than it was in
20 1999. Verizon NW was spending 6 cents per dollar of local and intrastate toll

1 revenue in 1999; by 2003 that figure had dropped to 4.8 cents per dollar of
2 revenue. Had Verizon not cut the marketing budget of its ILEC operation,
3 the revenue decline might have been smaller. As I discussed earlier, the
4 much greater focus of the company has been on increasing the revenues and
5 profits of the overall Domestic Telecom segment, even at the expense of ILEC
6 operations such as Verizon NW. For example, Mr. Banta offers, as an
7 example of Verizon NW's efforts to retain customers and revenues, the Local
8 Package and Local Package Extra. He does not mention the Verizon
9 "Freedom" packages that are more prominently marketed by Verizon, carry
10 higher charges, and provide revenues to an unregulated affiliate rather than
11 the regulated telephone company.

12

13 **Q. Does Verizon make full use of the tools that Washington state law**
14 **provides for regulated telephone companies to use in responding to**
15 **competition?**

16 A. No. Washington's Regulatory Flexibility Act (RCW 80.36.300 et seq.) allows
17 companies such as Verizon NW to obtain pricing flexibility when they face
18 effective competition for a particular service. Verizon has made very little
19 use of this provision. Indeed, it has sought competitive classification of a
20 service only once since the Telecom Act of 1996 was enacted, requesting in

1 2002 pricing flexibility for its directory assistance service (Docket No. UT-
2 020104).

3 The Commission itself has been more aggressive than Verizon in
4 providing the company with pricing flexibility, having twice initiated
5 competitive classification proceedings on its own motion. For example, the
6 Commission acted where Verizon would not regarding intrastate toll
7 services in 1997 and regarding out-of-area services in 2004 (Docket Nos. UT-
8 970767 and UT-040172).

9 Washington law also allows companies a reduced form of pricing
10 flexibility, in the form of banded rates, even when full effective competition
11 is not present. The banded rate mechanism allows a company to establish its
12 regulated price as its ceiling price. Verizon NW has made no use of this
13 mechanism.

14

15 **Q. Please compare this experience with Verizon to the use of these**
16 **mechanisms by Qwest Corporation.**

17 A. Qwest Corporation, the other major national incumbent local exchange
18 company doing business in Washington state, has been much more active in
19 using the pricing flexibility tools made available under our law. In addition
20 to directory assistance and intrastate toll services, Qwest sought and

1 obtained pricing flexibility for its high-capacity private line services in its
2 most urban markets and, most significantly, its basic business exchange
3 service throughout the state.

4

5 **Q. Please explain the significance of the competitive classification of Qwest’s**
6 **basic business exchange service?**

7 A. Business lines have been the most significant source of lost revenue and lost
8 customers for companies line Qwest and Verizon. As a result of its efforts,
9 Qwest has obtained more flexibility to lower and raise its prices in response
10 to competition – and to differentiate prices among customers – than has
11 Verizon.

12

13 **Q. Has Verizon attempted to use the alternative regulation mechanism**
14 **authorized by state law?**

15 A. No. The last serious discussion between Verizon and Staff of an alternative
16 regulation mechanism was during the GTE-Bell Atlantic merger process.
17 Verizon has shown little interest in this approach since then, and unlike
18 competitive classification, an alternative regulation mechanism cannot be
19 adopted by the Commission without the regulated company’s consent.

20

1 **Q. Has Verizon used informal rate adjustments or individual tariff filings to**
2 **adjust its rates to reflect changes in the level of local competition?**

3 A. Very little of this has occurred. As part of the final round of rate changes
4 arising from the merger, Verizon and Staff agreed to very minor increase in
5 residential rates – 25 cents per month – for customers in some rural
6 exchanges and to a very minor decrease in business rates – 30 cents per
7 month. In 2001, Verizon and Staff agreed to offsetting rate changes, in which
8 directory assistance rates were raised enough to cover cost and privacy
9 listings were lowered from \$2.25 per month to \$.55 per month.

10 Apart from these instances, Verizon has not used individual tariff
11 filings or informal process to adjust its rates to respond to competition. In
12 particular, the Company has not sought to change the relationship between
13 its urban and rural rates in a way that more closely reflects cost and the level
14 of competition.

15

16 **Q. Did Staff anticipate that Verizon would make more of an effort to adjust**
17 **its rates over time, or propose an alternative form of regulation?**

18 A. Yes. The merger settlement approved by the Commission in late 1999
19 specifically allowed for the Company to propose rate changes “if part of an
20 overall program of revenue neutral or revenue negative rate rebalancing.”

1 Even though Staff supported the concept of an overall rate freeze, as
2 embodied in that merger approval, Staff also believed that it was important
3 to preserve the ability to make rate changes in response to technology or
4 competition. The Company has not availed itself of these regulatory tools.

5

6 **Q. Do you believe that Verizon NW's revenues are lower than they would be**
7 **if the company had done a better job of responding to competition?**

8 A. This is an inherently difficult assessment to make, but it is my opinion that
9 Verizon NW's revenue decline is larger than it could have been had it done a
10 better job of responding to competition. Verizon's generally faces fewer
11 competitive pressures than does Qwest, because it has a less urban market
12 area and is not required to comply with the Sec. 271 competitive checklist
13 like Qwest. Nonetheless, it experienced as large a percentage reduction in
14 intrastate revenue as did Qwest. Qwest has managed to offset some of its
15 business access losses by increasing the per-line revenue amounts. Verizon's
16 per-line revenues have been essentially flat.

17

1 **Q. What is your understanding of the wireline business changes that Verizon**
2 **executives anticipate in 2005 and beyond?**

3 A. Verizon executives provide updates to the financial community about the
4 Company's plans and expectations. Based on Verizon Communications'
5 third quarter 2004 report, it is apparent that Verizon executives expect the
6 wireline business to change in the following ways:

- 7 • Business customers shift from basic telephone circuits to higher
8 capacity services.
- 9 • Customers generally shift from traditional telephone lines to
10 broadband service.
- 11 • Broadband customers use Verizon's voice over Internet
12 protocol telephone service.
- 13 • Fewer customers switch to competitors who use unbundled
14 network elements provided by Verizon.
- 15 • The Company retains customers and reduces customer
16 turnover by offering more bundled services.

17

18 **Q. How do you anticipate that the response of Verizon's executives to these**
19 **changes will affect the situation of Verizon NW, especially its regulated**
20 **intrastate business?**

1 A. If Verizon's executives are correct in their expectations and the anticipated
2 effect of the Company's actions, these developments generally will benefit
3 Verizon's financial situation. However, the overall positive effect at the
4 parent company level will in many instances actually have a negative effect
5 on that portion of Verizon's business that it conducts through its regulated
6 subsidiary, Verizon NW, and on the somewhat arbitrarily defined portion of
7 that entity's business that is know as the intrastate business. This is not
8 universally true: Verizon NW stands to improve its situation if Verizon
9 succeeds in restricting the use of unbundled network elements. However, in
10 general, the strategies being pursued by Verizon executives tend to benefit
11 the parent company at the expense of the regulated entity.

12

13 **Q. Please explain.**

14 A. Here are the changes that Verizon's executives anticipate and how they will
15 likely affect the intrastate results of Verizon NW:

- 16 • Consumers moving from traditional lines to broadband. This trend is
17 likely to increase Verizon's revenues overall, because broadband is priced
18 higher than traditional telephone service. However, the new revenue will
19 be recorded on the books of an unregulated affiliate or as interstate or
20 unregulated revenues of Verizon NW. The loss of revenue from

1 traditional lines will hurt the intrastate results of Verizon NW. Much of
2 the telephone plant used to provide traditional lines will still be allocated
3 to the intrastate jurisdiction. Moreover, as I discussed earlier,
4 approximately 75 percent of the FTTP investment will be charged to the
5 intrastate jurisdiction. There will be a smaller base of traditional
6 telephone service customers who will be asked to pay for a larger base of
7 investment in both the legacy network and the new FTTP network.

8 • Business customers moving to higher capacity circuits. As business
9 customers move from traditional switched access lines to dedicated DS-1
10 or higher circuits, Verizon will shift revenues from the intrastate
11 jurisdiction to the interstate jurisdiction. These circuits are classified as
12 “interstate” under the FCC’s mixed use policy, even though up to 90
13 percent of the traffic on them is intrastate. When the revenues move,
14 very little of the expense and investment follow. Verizon’s interstate
15 circuits are earning a 69 percent return on investment; for every dollar of
16 interstate special access revenue Verizon records only 25 cents of
17 operating expenses.

18 • Fewer customers moving to UNE-P competitors. As I discussed earlier, a
19 substantial portion of the change in Verizon NW’s financial condition can
20 be attributed to its loss of business lines. Some of this loss is due to

1 competition from UNE-P providers. Competition using UNE-P causes
2 Verizon NW's revenues to decrease with no appreciable effect on the
3 expenses and investment required to serve those customers. The
4 converse holds if Verizon in the near future succeeds in reversing the use
5 of UNE-P. A shift of customers from UNE-P to Verizon NW's retail
6 services will benefit the financial condition of Verizon NW, because
7 revenues will increase with no increase in expenses or investment. If the
8 Commission does not anticipate that shift in setting rates in this
9 proceeding, Verizon NW stands to realize a windfall.

- 10 • Aggressive winback campaigns underway. Verizon's "winback" strategy
11 is based on encouraging customers to subscribe to service packages and
12 bundles of services that are offered by unregulated affiliates, such as
13 Verizon LD. This strategy retains some revenue for the regulated entity,
14 but the net result is also that more of the customer's payments are
15 attributed to unregulated affiliates.
- 16 • Rollout VOIP. Verizon has introduced what may become a substitute for
17 local telephone service that uses voice over Internet protocol (VOIP).
18 This service, which Verizon calls "VoiceWing," is currently priced at
19 \$34.95 for a one-year contract. It has a superior feature set to the Local
20 Package Elite offering of Verizon NW, which is currently priced at \$46.45

1 (including the federal subscriber line charge), though admittedly it does
2 not include some characteristics that many customers desire, such as
3 reliable emergency calling and a directory listing. A customer would not
4 subscribe to both VoiceWing and Local Package Elite, so the successful
5 rollout of VoiceWing can be expected to hurt the financial circumstances
6 of the regulated telephone company, even if it benefits Verizon's overall
7 finances.

8
9 **Q. Are you suggesting that these business strategies represent a deliberate**
10 **effort by Verizon's executives to shift profits from the regulated telephone**
11 **company to its unregulated entities?**

12 A. No. The strategies that I have discussed are national strategies, and Verizon
13 appears to be pursuing them even in areas where its incumbent local
14 exchange company is not subject to rate of return regulation. However, there
15 is nobody at Verizon who is looking after the business interests of Verizon
16 NW, separate from and, if necessary, contrary to, the business interests of
17 other of Verizon Communications' business interests. I also believe that
18 Verizon's executives recognize that the regulated telephone company is not
19 the best entity to be the recipient of the enterprise's revenues and profits.

20 Verizon has significant discretion regarding which entities offer which

1 services, and the company can use that discretion to manage the operating
2 results and rate of return of Verizon NW.

3

4 **Q. Does this conclude your testimony?**

5 **A. Yes.**

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

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TRANSPORTATION COMMISSION

Complainant,

v.

VERIZON NORTHWEST INC.,

Respondent.

DOCKET NO. UT-040788

ERRATA TO DIRECT
TESTIMONY OF GLENN
BLACKMON

Changes to Exhibit No. ___ T (GB-1T) are in shaded text:

Page 11, line 8: ~~Intrastate~~ **Interstate** revenues increased