

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Verizon North Inc. (f/k/a GTE North)
Incorporated) And Verizon South Inc.)
(formerly known as GTE South)
Incorporated)) Docket No. 00-0812
Petition Seeking Approval Of Cost Studies For)
Unbundled Network Elements, Avoided Costs)
And Intrastate Switched Access Services.)

Direct Testimony o

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On Behalf of

VERIZON NORTH INC.
VERISON SOUTH INC.
(Formerly GTE North Incorporated and GTE South Incorporated)

JANUARY 21, 2005

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EXHIBITS

Exhibit JW-1: Microsoft Excel File (Proprietary)

Exhibit JW-1a: Microsoft Excel File (Proprietary)

Exhibit JW-2: Microsoft Word File

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND POSITION WITH VERIZON.

A. My name is Joseph Williams and my position is Specialist, Financial Planning & Analysis-Service Costs in the Verizon Finance Department. In that position, I am responsible for analyzing approximately \$33 billion in expenses to support Verizon's regulatory cost studies.

Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?

A. I am a graduate of the University of Kansas where I received a Bachelor of Science degree in Accounting and Business Administration. In addition, I am a Certified Public Accountant licensed in the state of Kansas.

I have been employed by Verizon for 15 years in various accounting, budgeting, and finance roles in both regulated and non-regulated business units. I began my career as a cost accountant with GTE Directories, now Verizon Information Services. I worked in the Budgets and Analysis departments of three business units where I performed annual budgets, monthly and quarterly forecasts, and analyzed variances between actuals and forecasts. I also worked in New Business Development, where I prepared business cases and new business proposals. Prior to joining Verizon, I worked for a short time in public accounting as an auditor and in industry as a staff accountant.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to present the methodology that Verizon North Inc. and Verizon South Inc. (hereafter collectively “Verizon” or “the Company”) used to update the wholesale discounts that apply when Verizon’s retail telecommunications services are resold in Illinois by carriers pursuant to section 251(c)(4) of the Telecommunications Act of 1996 (“The Act”).

The Act established several methods of market entry designed to open the telecommunications industry to full competition. One method of entry is resale of Incumbent Local Exchange Carrier (“ILEC”) retail telecommunications services. Section 252(d)(3) of the Act requires ILECs to develop discounted retail rates adjusting for costs that “will be avoided by the local exchange carrier” when its services are offered at wholesale rather than retail.

Attached to my testimony, as Exhibit JW-1 (and supporting Exhibit JW-1a) is an avoided cost study calculated using year 2003 data. This exhibit identifies the costs Verizon actually avoids when making its retail telecommunications services available for resale in Illinois. Resale can be provided in two ways:

- 44 1) The reseller uses Verizon Operator Services and Directory Assistance (“OS/DA”), or
45 2) The reseller uses its own platform (or the platform of a third party other than
46 Verizon) to provide OS/DA functions.

47
48 Based on the submitted avoided cost study, Verizon’s retail discounts when its retail
49 telecommunications services are resold by wholesale carriers are:

- 50 1) 11.40% if the reseller uses Verizon OS/DA functions, and
51 2) 13.11% if the reseller uses its own platform to provide OS/DA functions.

52
53 Also attached to my testimony is Exhibit JW-2, which describes in detail the
54 methodology used to calculate the wholesale discount.

55
56 **III. BACKGROUND**

57
58 **Q. WHAT IS VERIZON’S CURRENT RESALE DISCOUNT IN ILLINOIS?**

59 A. An interim resale discount rate of 17.50 percent was ordered by the Illinois Commerce
60 Commission on December 3, 1996 through an arbitration proceeding between AT&T
61 Communications of IL and Verizon.¹

¹ The case was with predecessor GTE North Incorporated and GTE South Incorporated. Case No. 96-AB-005, approved on December 3, 1996.

62 **Q. DID VERIZON ALREADY FILE RESALE DISCOUNT TESTIMONY IN THIS**
63 **PROCEEDING?**

64 A. Yes, in December 2000.

65
66 **Q. DID YOU USE THE SAME METHODOLOGY IN THE STUDY ATTACHED TO**
67 **YOUR TESTIMONY AS WAS USED IN DECEMBER 2000?**

68 A. No. The study that Verizon presented in 2000 was designed to comply with the
69 methodology prescribed by the FCC in its August 18, 1996, *Local Competition Order*,
70 and codified in 47 CFR § 51.607 and 609. The FCC's methodology calculated wholesale
71 rates based on the costs that were potentially avoided by Verizon under a hypothetical
72 construct in which Verizon completely exited its retail business and became a 100
73 percent wholesale company in Illinois.

74
75 The FCC's methodology for determining resale discounts was invalidated by the Eighth
76 Circuit Court of Appeals in its decision in *Iowa Utilities Board v. FCC* issued in July
77 2000. Consequently, in the attached study, Verizon follows the standard of those costs
78 that "will be avoided"² – the exact language of the Act – when services are offered for
79 sale at wholesale rates. Specifically, the Eighth Circuit ruled that the Act provided a
80 clear standard in § 252(d)(3) for determining the wholesale discounts. The Court stated:

81 The language of the statute is clear. Wholesale rates shall exclude "costs
82 that will be avoided by the local exchange carrier." ... The plain meaning
83 of the statute is that costs that are actually avoided, not those that could be
84 or might be avoided, should be excluded from the wholesale rates.

² *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 755-56 (8th Cir. 2000). Although the U.S. Supreme Court ultimately reviewed part of that Eighth Circuit Order, certiorari was not granted on this point. See *Iowa Utils. II*, 121 S. Ct. 878 (2001) (granting certiorari on 3 issues). The resale discount aspect of the Eighth Circuit's decision therefore stands as final.

The Court also addressed the FCC's hypothetical construct of a 100 percent wholesale company. The Court stated:

The statute recognizes that the ILEC will itself remain a retailer of telephone service with its own continuing costs of providing that retail telephone service. ... Under the statute as it is written, it is only those continuing costs of providing retail telephone service which will be avoided by selling to the competitor the services it requests which are to be excluded.

Q. HAVE ANY OTHER STATE COMMISSIONS SET RESALE DISCOUNTS FOR VERIZON COMPANIES UNDER THE "AVOIDED" COST LEGAL STANDARD?

A. Yes. The District of Columbia Public Service Commission had a recent proceeding that set resale discounts under the standard provided by the Eighth Circuit.³ The Commission adopted a resale discount rate of 12.72 percent if the reseller uses Verizon's Operator Services and 14.79 percent if the reseller does not.

Additionally, the FCC's Wireline Bureau, in an interconnection agreement arbitration for the state of Virginia, used the "actual avoided costs" standard to determine a resale discount for Verizon's affiliate in that state.⁴ The Bureau ordered rates of 13.11 percent if the reseller uses Verizon's Operator Services/Directory Assistance and 14.74 percent if the reseller does not.

³ Formal Case No. 962, *In the Matter of the Implementation of the District of Columbia Telecommunications Competition Act of 1996 and Implementation of the Telecommunications Competition Act of 1996*, Order No. 12610, December 6, 2002, para. 67, and re-affirmed in *Partial Order On Reconsideration*, April 3, 2003, Order No. 12695, paras. 22 – 48.

⁴ Before the Federal Communications Commission, Memorandum Opinion and Order DA 03-2738, Adopted August 28, 2003, para. 673.

108

109 **Q. HOW DO VERIZON'S AVOIDED COSTS MAP WITH THE ACT'S**
110 **DEFINITION?**

111 A. § 252(d)(3) of The Act states:

112 For the purposes of section 251(c)(4), a State commission shall determine
113 wholesale rates on the basis of retail rates charged to subscribers for the
114 telecommunications services requested, excluding the portion thereof
115 attributable to any marketing, billing, collection, and other costs that will
116 be avoided by the local exchange carrier.
117

118 The following chart displays how Verizon aligns specific avoided cost functions with the
119 broad language of the Act:

120 **IV. COST STUDY METHODOLOGY**

121

122 **Q. PLEASE DESCRIBE THE METHODOLOGY THAT YOU USED TO**
123 **DETERMINE VERIZON'S ACTUAL AVOIDED COST, WHICH WAS THEN**
124 **USED TO CALCULATE THE RESALE DISCOUNT RATE.**

125 A. Expense data for the 2003 calendar year are used as the starting point in determining the
126 avoided costs for Verizon. Detailed studies are conducted to determine the marketing,
127 billing, collection, and other costs that will be avoided by Verizon when its retail
128 telecommunications services are resold to wholesale carriers. Exhibit JW-1 is the
129 avoided cost study used to determine Verizon's resale discount rate. Exhibit JW-2
130 describes in detail the methodology used to determine Verizon's actual avoided costs.

131

Q. IN WHICH ACCOUNTS DOES VERIZON AVOID DIRECT EXPENSES?

A. Verizon avoids expenses in accounts associated with selling, providing, managing and maintaining customer services. Verizon avoids some of the expenses in the following direct accounts:

- Account 6533 – Testing (Customer Repair Service Bureau)
- Account 6611 – Product/Market Management
- Account 6612 – Sales
- Account 6623 - Customer Servicing & Billing
- Account 530X - Uncollectibles.

Verizon avoids all of the expenses in the following direct accounts if the reseller chooses *not* to use Verizon’s operator services and directory assistance platform:

- Account 6621 – Operator Services
- Account 6622 – Number Services
- Account 6220 – Operator Systems

Q. HOW DOES VERIZON TREAT NETWORK EXPENSES?

A. For the most part, Verizon does not avoid any Network expenses. Verizon only avoids expenses from accounts associated with “customer facing” activities or those that are primarily associated with dealing with customers rather than maintaining and operating the network (See Exhibit JW-1, WP3, Lines 9 - 56). The remaining accounts are network related, and no part of the network expenses in these accounts would be avoided, with one exception. Although Testing Expense - Account 6533, is normally considered a

network expense, there is a portion of the account that pertains to customer facing activities, and these expenses are avoided. Consequently, part of the expenses in Account 6533 are avoided. (See Exhibit JW-2, Section 2a.)

Q. WHAT EXPENSES ARE AVOIDED IN ACCOUNT 6611 - PRODUCT/MARKET MANAGEMENT?

A. Account 6611 includes both Product Management and Market Management expenses. Product Management expenses are not avoided since they must be performed whether the customer is a reseller or end-user. Whether a product is sold as retail or resale, the product must be fully designed, developed, and delivered in order to be available to any customer, wholesale or retail.

The Market Management portion of Account 6611 is 100 percent avoided since Market Management expenses are considered variable with respect to market share or customer base. (See Exhibit JW-2, Section 2b).

Q. WHAT EXPENSES ARE AVOIDED IN ACCOUNT 6612 - SALES?

A. Account 6612 is examined by Line of Business (LOB). The amount of expenses in Account 6612 assigned to the Retail LOB are avoided. (See Exhibit JW-2, Section 2c).

Q. HOW DID YOU TREAT EXPENSES IN ACCOUNTS 6621 - CALL COMPLETION, 6622 -- NUMBER SERVICES AND 6220 - OPERATOR SYSTEMS?

A. These expenses are only avoided if Resellers do not use Verizon's Operators. Thus, when the reseller opts not to use Verizon's operators, expenses associated with Call Completion/Number Services and Operator Systems are included in the avoided costs (the numerator) for use in the development of the avoided cost discount. If the reseller is using its own operator services platform, these expenses are avoided.

Q. WHAT EXPENSES ARE AVOIDED IN ACCOUNT 6623?

A. Account 6623 includes both Customer Services and Billing Operations (billing and payment processing). The amount of Customer Services avoided is based on sub-account detail (See Exhibit JW-2, Section 2d). The amount of Billing Operations avoided is determined from a special study. (See Exhibit JW-2, Section 2e).

Q. HOW DID YOU TREAT UNCOLLECTIBLES?

A. Retail uncollectibles are treated as an avoided cost in the resale discount calculation. (See Exhibit JW-2, Section 2f).

Q. HAVE YOU IDENTIFIED ALL EFFECTED ACCOUNTS WHERE VERIZON ACTUALLY AVOIDS EXPENSES?

A. Yes. The applicable avoided cost standard is that Verizon includes only costs that are actually avoided when calculating the resale discount. Verizon has listed all of those accounts here and in Exhibits JW-1 and JW-2. Other expenses which do not meet the avoided cost standard are not included in the resale discount calculation. They are not

actually avoided when products are offered for resale to wholesale carriers. Included in the expenses not avoided are:

- 61XX General Support Expenses
- 62XX – 65XX Network Operations Expense (except for the Customer Repair Service Bureau portion of 6533)
- 661300 – Product Advertising
- 67XX – General and Administrative Expenses

Q. TURNING NOW TO THE DENOMINATOR IN THE CALCULATIONS, WHAT ARE THE APPROPRIATE REVENUES TO USE IN THE CALCULATION OF THE RESALE DISCOUNT RATES?

A. Verizon includes revenues for all retail telecommunications services that must be offered for resale at wholesale rates. (See Exhibit JW-2, Part 3). Revenues excluded from the denominator are:

1. Non-retail revenues - The resale discount applies to the tariffed retail rates. (e.g., rent revenue for collocation or unbundled network elements)
2. Access Revenues – These services are not subject to the resale discount since they are not in the retail tariffs and by definition not available to the public generally. Under the Act, “The term ‘telecommunications service’ means the offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used”.

The FCC order in paragraph 980 states that the Inter-exchange Carrier must “purchase access services from incumbent LECs outside of the resale framework of 251(c)(4), through the existing interstate access tariffs. Not subject to resale at discount rates (e.g., Carrier Access services).

3. Nonregulated services revenues (e.g., Billing, Inside Wire Maintenance) – These revenues, as identified in FCC Part 64 Separation of Regulated and Nonregulated Costs, are associated with services that are not tariffed communications services.

4. Interstate revenues – These have been removed since the resale discount only applies to Intrastate services.

V. COST STUDY CALCULATIONS

Q. HAVE YOU PROVIDED THE STEP-BY-STEP CALCULATIONS CONTAINED IN THE COST STUDY WORKSHEETS?

A. Exhibit JW-2 contains detailed descriptions of the cost study calculations. Exhibit JW-1 contains the actual avoided costs and resale discount calculations.

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VI. STUDY RESULTS

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245 **Q. IN SUMMARY, WHAT ARE THE RESALE DISCOUNT RATES THAT ARE**
246 **APPROPRIATE FOR VERIZON?**

247 A. As mentioned earlier, I have developed two discounts - a discount for resellers who resell
248 Verizon's Operator Services (for both Call Completion and Directory Assistance Calls),
249 and a discount for resellers who provide their own Operator Services. The discounts are
250 displayed in Exhibit JW-1, WP1 Line 23.

251

252 Resale Discount Assuming Reseller Uses Verizon OS/DA 11.40 %

253 Resale Discount Assuming Reseller Uses Own or Third Party OS/DA 13.11 %

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255 **Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?**

256 A. Yes, it does.