Exhibit No. ________(NWH-1T)
Docket No. UT-020406

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

AT&T COMMUNICATIONS OF	**)**	
THE PACIFIC NORTHWEST, INC.,	**)**	
COMPLAINANT	**)**	**DOCKET NO. UT-020406**
v.	**)**	
VERIZON NORTHWEST INC.,	**)**	
RESPONDENT	**)**	

DIRECT TESTIMONY OF

NANCY HEURING

ON BEHALF OF
VERIZON NORTHWEST INC.

DECEMBER 3, 2002

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Nancy Heuring. My business address is 600 Hidden Ridge, Irving, Texas.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Verizon Services Organization Inc. as Director-Regulatory Accounting with responsibilities for former GTE telephone companies, including Verizon Northwest Inc. ("Verizon" or the "Company").

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE.

A. I graduated from Illinois Wesleyan University, Bloomington, Illinois with a Bachelor of Arts degree in Accounting. I received a Masters in Business Administration degree with a concentration in Telecommunications from the University of Dallas in 1995. Since 1981 I have been employed by various subsidiaries of the former GTE Corporation, including GTE Service Corporation, GTE Data Services, GTE Sylvania Lighting Services and GTE Telephone Operations, where I held a number of managerial positions of increasing responsibility, including positions in Audit, Operations Finance, General Accounting, Regulatory Accounting Policy, Regulatory Accounting, Business Affiliates Compliance and Regulatory Compliance. I assumed my current position in June 2000 with the merger of GTE and Bell Atlantic, which formed Verizon Corporation. My principal duties and responsibilities include the direction and supervision of the preparation of accounting information associated with financial filings and regulatory reporting, as required by the regulatory commissions in the states in which Verizon operates. I am also a Certified Public Accountant and a Certified Management Accountant.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE STATE REGULATORY COMMISSIONS?

A. Yes. I have testified before the Virginia State Corporation Commission and the California Public Utility Commission. In addition, I filed testimony before the Hawaii Public Utilities Commission.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony sets forth Verizon's current intrastate return, and calculates what the return would be if Verizon's access charges were reduced by $32 million per year as proposed by the Commission's Staff.

Specifically, Verizon's current intrastate return as of September 2002, which I calculated using Commission-prescribed inputs and adjustments, is only 2.84%. If Verizon's revenues are decreased by $32 million with no offset, the resulting return drops to 0.73%. (As I explain later, these returns are actually over-stated because they reflect merger savings but not merger costs.)

My testimony also sets forth Verizon's intrastate return calculated to reflect actual market conditions including the rate of return provided by Dr. Vander Weide in his testimony. This calculation produces a current intrastate return of *negative* 3.13%. Obviously, reducing Verizon's revenues by $32 million drops this return even more.

The bottom line is that either calculation produces a return significantly below the Commission last authorized return of 9.76%. As Mr. Fulp explains, the Commission cannot reduce Verizon's revenues by any amount – let alone $32 million – because any reduction would result in unjust, unreasonable, and insufficient rates and revenues.

Q. WHAT FINANCIAL EXHIBITS ARE YOU PRESENTING IN SUPPORT OF THIS TESTIMONY?

A. Exhibits NWH-2 through NWH-4 provide a summary of the financial data and calculations used in my testimony, as follows:

NWH-2 Results of Operations

NWH-3 Revenue Requirement Calculation

NWH-4 Results of Operations Summary

I discuss each exhibit and the information contained therein in more detail later in my testimony.

Q. WERE THE EXHIBITS AND ASSOCIATED TESTIMONY PREPARED UNDER YOUR DIRECTION AND SUPERVISION?

A. Yes, they were.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. First, I present the results of operations. Second, I explain how these results were developed on a Commission basis. Third, I present the results of operations that were developed using adjustments that reflect the current telecommunications marketplace. These results – which Verizon believes more accurately reflect its earnings – provide even stronger support for Verizon's position that the Commission cannot reduce access charges without increasing other rates.

II. RESULTS OF OPERATIONS

Q. WHAT ARE THE FINANCIAL RESULTS FOR THE INTRASTATE WASHINGTON OPERATIONS?

A. The intrastate rate of return for the twelve month-to-date period ended June 2002 is 2.11%. This return is below the authorized return 9.76% and represents a continuation of a downward trend in earnings over the last two years - from 5.59% and 5.50% for the period ended December 2000 and December 2001, respectively.

Q. IS THE RETURN FOR THE PERIOD ENDED JUNE 2002 REPRESENTATIVE OF THE RETURN ANTICIPATED FOR THE UPCOMING TWELVE MONTHS?

A. Yes. Verizon's intrastate return utilizing the nine month-to-date period ended September 2002 annualized is 2.84%. The financial information in support of this return and the returns for the historical periods noted above is summarized in Exhibit NWH-2.

Q. WHAT IMPACT WOULD A REDUCTION OF $32 MILLION IN INTRASTATE SWITCHED ACCESS REVENUES HAVE ON VERIZON'S EARNINGS?

A. Absent a corresponding increase in other revenues, such a reduction would cause the pro forma 2002 return to drop by another 211 basis points to 0.73%.

Q. PLEASE DESCRIBE THE DRIVERS BEHIND THE DOWNWARD TREND IN INTRASTATE EARNINGS OVER THE PERIOD PRESENTED?

A. The primary drivers are a decline in net revenues during a period of continued investment that is only partially offset by the overall reduction in non-depreciation operating expense associated with merger benefits and cost containment efforts. The decline in net revenue is associated mainly with access line and minutes of use loss and the increase in the provision of uncollectible accounts receivables from other carriers.

Q. HOW ARE THE IMPACTS OF THE VERIZON MERGER REFLECTED IN THE RESULTS OF OPERATIONS PRESENTED FOR 2000, 2001 AND 2002?

A. The savings resulting from the merger are reflected in the cost of service and contribute to the reduction in operating expense. However, the costs incurred to obtain these benefits were removed from each year's cost of service as a nonrecurring item. Accordingly, it is appropriate to include the total merger cost amortized over a reasonable period, in the going forward cost of service. This serves to reduce the 2002 pro forma return of 2.84% to 2.37%.

Q. ARE THE HISTORICAL AND PRO FORMA RETURNS PRESENTED ABOVE CONSISTENT WITH THE COST OF SERVICE ORDERED IN THE COMPANY'S LAST RATE CASE, U-82-45 & U-82-48?

A. Yes. Although the Company is not presenting a rate case financial package, the Company utilized the last rate case order, the commission accounting and reporting rules and the rate case filing rules as guidance in developing the financial presentation. With the exception of revenues from directory yellow page advertising, the cost of service shown on NWH-2 is presented consistent with this guidance. The cost of service from the last case included revenues related to yellow page advertising plus a subsequent disallowance for payments to the affiliate directory company that were found to be higher than reasonable. The revenues presented for each time period in NWH-2 do not include yellow page advertising revenue since Verizon Northwest did not receive such revenue in any of those periods. As a surrogate for the yellow page revenues previously included in the cost of service, the Commission's Staff provided Verizon a suggested calculation to impute a portion of the earnings of Verizon Information Services. While Verizon Northwest does not support such a surrogate, that calculation is presented for informational purposes. It would increase the historic and pro forma return noted above by an estimated 226 basis points, which is still far short of the authorized level.

Q. PLEASE DESCRIBE THE EXHIBITS WHERE THE INTRASTATE RETURNS AND RESULTS OF OPERATIONS, AS DISCUSSED ABOVE, ARE PRESENTED.

A. Exhibit NWH-2 provides the results of operations for the periods ending December 2000, December 2001, and year-to-date September 2002 annualized. The starting point for this exhibit is the Separated Results Summary Quarterly Compliance Report filed with the WUTC. The financial results filed with the WUTC were further adjusted to reflect normalized levels. These annual results are further summarized and compared on Exhibit NWH-4. Exhibit NWH-3, page 1 of 2, presents the revenue deficiency for each time period compared to the authorized return of 9.76%, ordered in Docket UT-931591 on December 21, 1994.

In sum, my calculations show a revenue deficiency of $60.9M, $64.4M and $105.0M for the years 2000, 2001 and pro forma 2002 respectively. Reducing access charges without commensurate offsets would make the deficiency significantly larger.

III. DEVELOPMENT OF RESULTS OF OPERATIONS

Q. PLEASE EXPLAIN THE PROCESS USED TO DEVELOP THE RESULTS OF OPERATIONS FOR PURPOSES OF THIS PROCEEDING?

A. The Separated Results Summary Quarterly Compliance Report served as the starting point for the development of the results of operations. This report is filed quarterly with the WUTC. The Compliance Report presents total regulated and intrastate financials on a booked and adjusted commission basis in accordance with reporting requirements, per Washington Administrative Code (WAC) 480-120-031(9). The adjusted basis reflects the impact of 1) adjustments required to reflect the financials in accordance with WUTC accounting rules, 2) adjustments for accounting transactions identified as relating to a prior accounting period, and 3) adjustments for other miscellaneous items required to restate the financials to a normalized level.

Q. WHAT FINANCIALS SERVE AS THE BASIS FOR THE COMPLAINCE REPORT?

A. As noted above, the compliance report contains both booked and adjusted financial data. The booked data reflects the books and records of the Company, which are maintained in accordance with the Uniform System of Accounts (USOA) Part 32, as prescribed by the FCC and adopted by the WUTC in WAC 480-120-031(1). The booked data is audited by the Company's outside auditing firm and is also the source for reporting to the Securities and Exchange Commission and to the Federal Communications Commission.

Q. PLEASE DESCRIBE THE ADDITIONAL ANALYSIS CONDUCTED TO PRESENT THE RESULTS OF OPERATIONS FOR THIS PROCEEDING.

A. The monthly financials for the period January 2001 through September 2002 were further analyzed to identify any out-of-period items that occurred after the Compliance Reports were filed. In addition, the financials were reviewed to identify unusual, nonrecurring activity.

No additional analysis was made of the monthly financials for the year 2000.

Q. GENERALLY DESCRIBE THE ADDITIONAL RESTATEMENTS PRESENTED IN THIS PROCEEDING AND WHY THEY ARE NECESSARY.

A. Restatements reflect adjustments to booked amounts 1) to remove items that do not reflect activity related to a particular year, 2) to include related items that were omitted from the year, or 3) to make changes necessary for rate making purposes. Where applicable, the associated income tax and non-regulated transfer impacts of revenue and expense items are included in each adjustment.

Restatements are necessary to properly reflect a base year level of revenues, expenses and rate base. Restatements adjust booked amounts for any defects in recorded results and are also used to adjust booked results in order to arrive at amounts acceptable for rate making. By adjusting booked results in this manner the base year is more reflective of the current year level of operations than are the unadjusted booked results. In addition, restating adjustments are appropriate per the filing requirements associated with general rate cases (WAC 480-09-330(2)(b)(i)).

Q. WERE NONREGULATED AND INTERSTATE RESULTS REMOVED FROM THE ACCOUNTING DATA PRESENTED IN THIS CASE?

A Yes. As noted above, the starting point for the analysis is the regulated books and records of the Company. The regulated books do not include items that are booked directly to non-regulated accounts. They are presented after the cost allocation process that is conducted in accordance with Part 64. Jurisdictional separation factors, calculated in accordance with Part 36, were applied to the regulated restated results to produce the intrastate financial results. The Part 36 and Part 64 relationships are consistent with those utilized in the quarterly Compliance Report filed with the PUC.

Q. PLEASE GENERALLY DESCRIBE THE DEVELOPMENT AND PURPOSE OF THE 2002 PRO FORMA FINANCIALS.

A. Pro forma financials are necessary to reflect significant changes in operating revenues, operating expenses and rate base that are anticipated to occur in the year following a base year and are known at the time of filing. A pro forma presentation is permitted per the filing requirements associated with general rate increases. (WAC 480-09-330(2)(b)(ii))

The pro forma financials were developed using year-to-date September 2002 financials prepared consistent with the filed Compliance Reports. This data was annualized to develop a pro forma 2002 view.

IV. RESULTS OF OPERATIONS THAT REFLECT CURRENT CONDITIONS

Q. PLEASE DESCRIBE THE RESULTS OF OPERATIONS YOU PREPARED THAT REFLECT CURRENT CONDITIONS.

A. I simply took the results of operations described earlier and adjusted them by making two changes: I used Dr. Vander Wiede's required rate of return; and I adjusted for the impact of correcting the current level of Verizon's depreciation reserve deficiency.

Q. WHY ARE THESE CHANGES APPROPRIATE?

A. They provide a more accurate picture of Verizon's intrastate earnings. Dr. Vander Weide explains why his cost of capital is appropriate and Verizon's reserve deficiency is addressed below.

Q. PLEASE EXPLAIN VERIZON'S CURRENT LEVEL OF DEPRECIATION RESERVE DEFICIENCY.

A. The depreciation reserve is the amount of investment the Company has recovered on its books through the accumulation of annual depreciation expenses. The higher the reserve (or "reserve ratio"), the more investment has been recovered and the less the risk that the investment will never be fully recovered.

The depreciation reserve deficiency that I present is the difference between the accumulated depreciation reserve on the intrastate books, based on the Commission's prescribed depreciation parameters, and the Company's Securities and Exchange Commission (SEC) financial reporting books. As of January 1, 2002 the reserve difference was $569 Million. Using currently prescribed intrastate depreciation rates, the depreciation reserve will not reach parity with the financial reporting depreciation reserve for 60 years.[1] Due to ongoing investment and the accelerating changes in technology, such a large deficiency means that the Company will never fully recover its investment in Washington.

[1] The current Commission prescribed depreciation rate is 6.5%, while the current financial reporting depreciation rate is 6.1%. Therefore the reserve deficit is currently decreasing by 0.4% per year. $569 Million is 24% of the depreciable plant balance, and it would take 60 years for the reserves to reach parity at 0.4% per year.

Q. PLEASE EXPLAIN THE CAUSES OF THE CURRENT DEPRECIATION RESERVE DEFICIENCY?

A. The accumulated depreciation reserve as reported to stockholders in the SEC 10K report represents Verizon's best estimate of the depreciation reserve that is economically correct in today's environment. There are two primary reasons why there is currently a depreciation reserve deficiency. First, Verizon uses different depreciation parameters (life and salvage) on the financial reporting books than on the regulatory books. Verizon's financial reporting life and salvage parameters are the company's best estimate of the useful life of its assets and consider the impacts of technology and competition. On the other hand, the regulatory books are based on life and salvage estimates prescribed by the Commission. Second, the Commission delayed implementation of ELG[2] in the depreciation rate calculation until 1995. For financial reporting books, Verizon uses ELG for investments from 1982 forward, which is consistent with the FCC's adoption of implementation of ELG in the early 1980's.

Q. IS THERE A RESERVE DEFICIENCY WHEN VERIZON'S FINANCIAL REPORTING DEPRECIATION RESERVES ARE COMPARED TO THE FCC OR INTERSTATE DEPRECIATION RESERVES?

A. Yes. The Interstate depreciation reserves are significantly greater for Washington than are the intrastate reserves. Verizon's interstate accumulated depreciation reserves for Washington are nearly 50% while the intrastate accumulated reserve deficiency is not

[2] ELG (Equal Life Group) is a calculation method adopted by the FCC and most state commissions in the early 80's. This calculation method groups investments made in a particular year into groups with equal lives then composites the remaining lives of those equal groups, rather than the traditional approach of calculating a composite remaining life of the remaining lives of the individual investment dollars in that year.

even 40%. The average Verizon Interstate reserves are in excess of 50%, as is the total RBOC national average.[3] In other words, in jurisdictions other than Washington the Company has already recovered more of its investment.

Q. WHAT ADJUSTMENT DO YOU RECOMMEND TO ALLEVIATE THE CURRENT DEPRECIATION RESERVE DEFICIENCY?

A. I recommend a reserve deficiency amortization over a reasonable time period in order to totally alleviate the reserve deficiency. Verizon recommends that the amortization should take place over five years. Using this option, the current Commission prescribed depreciation rates would remain unchanged through the amortization period.

Q. WHY DO YOU BELIEVE THAT THE DEPRECIATION ADJUSTMENT IS APPROPRIATE?

A. Past Commission practices created the depreciation reserve difference. Because of the past practices, the accumulated intrastate depreciation reserves in Washington are lower than any other state in Verizon's Local Exchange territories by a significant amount. Verizon's intrastate accumulated depreciation reserves for Washington are less than 40% while the comparable number for the states is greater than 50%. The impact of this low reserve is that the net plant is high, and the annual depreciation expense is also higher than it would be if there were higher reserves due to remaining life depreciation methods. The adjustments are necessary for the customers of Verizon in Washington to realize the

[3] Report On Depreciation Reserve Analysis for 2001, Federal Communications Commission, Common Carrier Bureau, Accounting Safeguards Division Reporting Management and Analysis Branch, September 2001.

benefits of appropriate depreciation practices, and for Verizon to have a realistic opportunity of recovering its investment in Washington.

Q. WHAT IS THE INTRASTATE RATE OF RETURN AND ASSOCIATED DEFICIENCY REFLECTING THE CONDITIONS DISCUSSED IN THIS SECTION?

A. The intrastate return, which includes the amortization of the depreciation reserve deficiency, is *negative* 3.13%, which reflects a deficiency of $223M when compared to the rate of return recommended by Dr. Vander Weide.

V. CONCLUSION

Q. PLEASE SUMMARIZE THE COMPANY'S FINANCIAL SITUATION.

A. Based on 2002 restated and pro forma results of operations, the Company is earning 2.84% on its intrastate regulated rate base in Washington, which is less than its 9.76% authorized rate of return. This return is significantly lower if we make adjustments that better reflect market realities.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.