

Exhibit No. \_\_\_\_ -T (KMF-1T)  
Docket No. UT-040788  
Witness: Kathleen M. Folsom

BEFORE THE WASHINGTON  
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION,

Complainant,

v.

VERIZON NORTHWEST INC.,

Respondent.

DOCKET NO. UT-040788

TESTIMONY

OF

KATHLEEN M. FOLSOM  
REGARDING INTERIM RATE RELIEF

STAFF OF  
WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION

July 14, 2004

1 I. INTRODUCTION

2

3 Q. Please state your name and business address.

4 A. My name is Kathleen M. Folsom, and my business address is 1300 South  
5 Evergreen Park Drive Southwest, P.O. Box 47250, Olympia, Washington  
6 98504-7250. My business e-mail address is [kfolsom@wutc.wa.gov](mailto:kfolsom@wutc.wa.gov).

7

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

9 A. I am employed by the Washington Utilities and Transportation  
10 Commission (Commission) as a Senior Regulatory Telecommunications  
11 Analyst. My participation in this case is on behalf of the Commission's  
12 Staff (Staff).

13

14 Q. What are your educational and other qualifications?

15 A. I hold a Bachelor of Arts degree in Business Administration from  
16 Washington State University. I also hold an MBA, with a concentration in  
17 Finance, from Portland State University.

18 In April 1988 I began my career with the Commission, including  
19 providing expert testimony on issues related to the establishment of an

1 authorized rate of return for GTE Northwest Incorporated (GTE-NW) in  
2 Docket No. UT-931591 and U S West Communications, Inc. in Docket No.  
3 UT-950200. I have submitted testimony on issues related to transfers of  
4 property and merger issues regarding GTE Corporation and Bell Atlantic  
5 Corporation in Docket No. UT-981367 and regarding U S WEST Inc. and  
6 Qwest Communications International Inc. in Docket No. UT-991358.  
7 Additionally, I was the lead staff in the review of the proposed merger of  
8 Portland General Electric Co. and Northwest Natural Gas Company, in  
9 Docket No. UG-011607. I also provided expert testimony in the review of  
10 the sale of Qwest Dex in Docket No. UT-021120.

11 In my capacity as a Regulatory Analyst, I have presented  
12 recommendations to the Commission on numerous security, affiliated  
13 interest, and transfer of property applications by various utilities.

14

15 **II. SCOPE OF TESTIMONY**

16

17 **Q. What is the scope of your testimony in this case?**

18 A. I am the Staff's policy witness. I provide testimony in response to Verizon  
19 Northwest Inc.'s (Verizon NW or Company) petition for \$29.7 million in

1 interim rate relief, subject to refund. I discuss the following subjects in my  
2 testimony, though I may reference the testimony of other Staff witnesses in  
3 doing so:

- 4 a. The evidence Verizon NW provided and the relief it is seeking.
- 5 b. The factors and analysis applicable to filings for interim rate  
6 relief, and the application of those factors to Verizon NW.
- 7 c. I summarize Staff's recommendations.

8  
9 **III. RECOMMENDATIONS**

10  
11 **Q. Please summarize Staff's recommendations.**

12 A. Verizon NW's request for interim rate relief should be denied. Verizon NW  
13 has not sufficiently demonstrated a need for interim rate relief. If the  
14 Commission rules otherwise, any interim rate increase should be recovered  
15 on an equal percentage basis, across more access lines than the Company  
16 proposes, as described more fully by Staff Witness Timothy W. Zawislak.

1           **IV. VERIZON NW'S PETITION FOR INTERIM RATE RELIEF**

2

3   **Q. Please summarize Verizon NW's Petition for interim rate relief.**

4   A. Verizon NW requests that the Commission approve \$29.7 million in interim  
5   rate relief. The Company offers to have any interim rate increase made  
6   subject to refund, pending a decision in its general rate case. *Petition at 2.*  
7   The \$29.7 million is an annual figure.

8           The Company alleges that its current *intrastate* rate of return is well  
9   below authorized levels and that interim relief is needed to avoid gross  
10   hardship or gross inequity. *Petition at 6.*

11

12   **Q. Upon what factors does Verizon NW base its Petition for interim rate**  
13   **relief?**

14   A. Verizon NW's petition is based on a discussion of the factors listed in the  
15   Commission's Second Supplemental Order in *WUTC v. Pacific Northwest*  
16   *Bell Telephone Co.*, Cause No. U-72-30 tr (October 10, 1972)("PNB Order").  
17   *Petition at 5-9.*

18

1 Q. How does Verizon NW propose to recover the \$29.7 million interim  
2 increase in revenues it is requesting?

3 A. Verizon NW proposes to apply an interim surcharge rate of \$3.54 per line  
4 per month on certain residential and business lines, and offers to make this  
5 increase subject to refund.

6 Staff's Witness on rate design issues, Mr. Zawislak, explains the  
7 inequities of this approach and offers an alternative rate design  
8 recommendation for the Commission's consideration.

9

## 10 V. INTERIM RATE RELIEF FACTORS

11

12 Q. What are the differences between "interim rate relief" and a "general rate  
13 case"?

14 A. Interim rate relief is an emergency rate increase that is short term, *i.e.*, it is  
15 in effect pending the resolution of a utility's general rate case. A general  
16 rate case involves the determination of a utility's cost of service including  
17 revenues, expenses, rate base, and rate of return, for the purpose of  
18 determining the future permanent rates of the utility.

19

1 Q. Should the Commission routinely grant interim relief to compensate the  
2 Company for the lost opportunity to collect its requested increase during  
3 the period of suspension, investigation, and hearing?

4 A. No. The Commission should not grant interim relief as a routine matter to  
5 compensate a company during a suspension period. A company's filed  
6 rates should be considered fair, just, reasonable, and sufficient until the  
7 company demonstrates that they are otherwise. Only after the company  
8 has made this demonstration to the Commission should an increase be  
9 implemented. A practice of routine interim relief during suspension would  
10 shift what is currently a balanced approach to the favor of the company.

11 When a customer complains against a company's rates, the  
12 Commission does not lower the rate while the customer's complaint is  
13 being investigated. For example, when AT&T filed its complaint in Docket  
14 No. UT-020406, it continued to pay charges for 18 months at rates that the  
15 Commission ultimately determined were illegal. The Commission's  
16 ultimate decision in that case was implemented only on a going-forward  
17 basis, and basic fairness and symmetry suggest that the same should be  
18 true when Verizon NW seeks to increase its rates.

1 Q. Does the Commission's PNB Order provide guidance for analyzing  
2 Verizon's request for interim rate relief?

3 A. Yes. The PNB Order sets forth several factors the Commission may  
4 consider when evaluating an interim rate relief request.

5

6 Q. What factors did the Commission set forth in the PNB Order as factors to  
7 consider when analyzing whether a utility qualifies for interim rate  
8 relief?

9 A. The Commission set forth the following six factors to consider:

10 1) The Commission has authority in proper circumstances to grant  
11 interim rate relief to a utility but this should be done only after an  
12 opportunity for an adequate hearing.

13 2) An interim rate increase is an extraordinary remedy and should be  
14 granted only where an actual emergency exists or where necessary  
15 to prevent gross hardship or gross inequity.

16 3) The mere failure of the currently realized rate of return to equal that  
17 approved as adequate is not sufficient, standing alone, to justify the  
18 granting of interim relief.



1           4) The Commission should review all financial indices as they concern  
2           the applicant, including rate of return, interest coverage, earnings  
3           coverage and the growth, stability or deterioration of each, together  
4           with the immediate and short term demands for new financing and  
5           whether the grant or failure to grant interim relief will have such an  
6           effect on financing demands as to substantially affect the public  
7           interest.

8           5) Interim relief is a useful tool in an appropriate case to fend off  
9           impending disaster. However, the tool must be used with caution  
10          and applied only where not to grant would cause clear jeopardy to  
11          the utility and detriment to its ratepayers and stockholders. That is  
12          not to say that interim relief should be granted only after disaster has  
13          struck or is imminent, but neither should it be granted in any case  
14          where full hearing can be had and the general case resolved without  
15          clear detriment to the utility.

16          6) The commission must reach its conclusion with its statutory charge  
17          to "Regulate in the public interest" in mind. This is our ultimate  
18          responsibility and a reasoned judgment must give appropriate  
19          weight to all salient factors.

1    **Q.    Should these factors, along with other relevant analysis, be utilized in**  
2    **this case?**

3    A.    Yes. Verizon NW’s witness Mr. Steven Banta identifies each of these factors  
4    separately and claims that “...Verizon NW satisfies all of them.” *Direct*  
5    *Testimony of Mr. Banta, Exhibit No. \_\_\_\_ (SMB-2T) at 3.* Verizon NW’s witness  
6    Dr. Vander Weide points to the same six factors for evaluating the necessity  
7    of interim relief, including the measurement of financial indices. His entire  
8    testimony discusses those financial indices. *Direct Testimony of Dr. Vander*  
9    *Weide, Exhibit No. \_\_\_\_ (JHV-4T) at 4.*

10                 Since Verizon NW is relying heavily on these six factors for its case  
11    on interim rate relief, Staff is responding to the evidence the Company  
12    presented. Moreover, these factors provide a useful framework, along with  
13    other relevant analysis, for considering any request for interim rate relief.

15    **Q.    What sort of information does the Commission typically review in utility**  
16    **applications for interim rate relief?**

17    A.    The Commission focuses on the utility’s immediate and near-term  
18    financing needs, since the utility’s longer-term needs will be met through  
19    the general rate case process. For example, in a Washington Natural Gas

1 Company case, Cause No. U-80-111, the Commission stated it “will not  
2 consider or give weight to long-range economic projections but will  
3 concern itself only with an analysis of existing and actual conditions and  
4 short-range projections, which in the main are least subject to volatile  
5 economic winds and are more conducive to credible reliability than long  
6 range plans.”<sup>1</sup>

7

8 **Q. What other analyses might the Commission consider when evaluating a**  
9 **request for interim rate relief?**

10 A. The Commission might consider the nature and causes of the alleged  
11 financial emergency, and the utility’s efforts to address the alleged  
12 emergency. This could include review of the actions taken by the utility to  
13 minimize operating expenses in order to offset operating losses in response

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<sup>1</sup> *WUTC v. Washington Natural Gas Co.*, Cause No. U-80-111, Second Supplemental Order (March 1981) at 6. In that case, the Commission concluded: “...the evidence does indicate rather strongly that the Respondent is presently experiencing a deterioration in its financial condition. This deteriorating position manifests itself in the declining trend of the Company’s rate of return, interest coverage, earnings per share, and the inability of the Company to generate sufficient capital from internal sources to finance its construction projects. The Commission believes that without immediate rate relief the Company is and will continue to experience a downward trend in its financial situation, and without immediate rate relief will not be able to raise sufficient capital from external sources to finance its 1981 construction projects.” *Ibid.*

1 to the emergency or other urgent circumstances, along with the utility's  
2 development of contingency plans.

3

4

#### V. VERIZON NW'S EVIDENCE

5

6 **Q. What evidence has Verizon NW provided in support of its interim rate**  
7 **increase request?**

8 A. Verizon NW's witness Mr. Steven M. Banta refers to the \$29.7 million  
9 annual access charge revenue reduction that occurred as a result of the  
10 Commission's order in *AT&T v. Verizon NW*, Docket No. UT-020406. *Direct*  
11 *Testimony of Mr. Banta, Exhibit No. \_\_\_ (SMB-2T) at 2*. He claims that this  
12 amount equates to 35.3% of the investment Verizon NW made in this state  
13 in 2003, or to 38.7% of the amount the Company spent to maintain the  
14 network for service, or to 3.1 months of payroll expense. *Id. at 4-5*. He also  
15 testifies that this access charge revenue reduction in part has caused the  
16 Company's intrastate Washington rate of return to deteriorate. *Id.*

17

1 Q. Has Verizon NW actually reduced its expenses or investment or payroll  
2 by the amounts to which Mr. Banta testifies?

3 A. No. There have been some cost and investment reductions instituted by  
4 Verizon NW in the past year or so, but as I explain later, none were  
5 instituted because of the alleged financial situation regarding Verizon NW's  
6 Washington intrastate operations described in the Company's interim rate  
7 relief case.

8

9 Q. What other evidence does Verizon NW offer?

10 A. Verizon NW's witness Ms. Nancy W. Heuring provides a list of reasons  
11 why the Company's rate of return has declined. She lists a \$30 million  
12 revenue reduction as a result of the merger between Bell Atlantic and GTE,  
13 the access charge reductions described by Mr. Banta, losses in line growth,  
14 and allegedly inadequate depreciation rates. *Direct Testimony of Ms.*  
15 *Heuring, Exhibit No. \_\_\_ (NWH-7T) at 5.*

16 Ms. Heuring also offers a calculation that the Company had a  
17 revenue deficiency of \$158,620,000 for the test year ended September 30,  
18 2003. *Id. at 4.* This calculation incorporated all of the restating adjustments  
19 the Company proposes in its general rate case filing. Her calculation results

1 in a rate of return of negative .47% for Verizon NW's Washington intrastate  
2 operations. *Id.*

3

4 **Q. What other evidence does Verizon offer to support interim rate relief?**

5 A. Verizon NW's witness Dr. Vander Weide presents calculations of several  
6 financial ratios. He bases these calculations on Ms. Heuring's test year  
7 restated results of operations. Dr. Vander Weide's figures are limited to  
8 Washington intrastate financial data. He concludes that on a Washington  
9 intrastate basis, Verizon NW cannot pay its debt obligations, and would  
10 receive a bond rating of "BB," which is below investment grade. *E.g., Direct*  
11 *Testimony of Dr. Vander Weide at 10-13.* He also suggests that Verizon NW  
12 currently has no incentive to invest in its intrastate operations in  
13 Washington State. *Id. at 14.*

14 Dr. Vander Weide does not present any evidence that the requested  
15 \$29.7 million in interim rate relief will allow the Company to obtain any  
16 immediate financing it may need. There is no indication that the granting  
17 of interim relief will then "imply" an A bond rating for Washington  
18 intrastate operations. Finally, his testimony does not explain how obtaining

1 the \$29.7 million will provide an incentive for investing in Washington  
2 intrastate operations.

3

4 **Q. Is all of the evidence Verizon NW provides in support of its direct case**  
5 **for interim rate relief based on Washington intrastate information?**

6 A. No. Verizon NW does not maintain or make available on a Washington  
7 intrastate basis, many of its financial statements and reports, such as its  
8 balance sheet, income statement, cash flow statement and budget. These  
9 financial statements and reports are available only on a Washington State  
10 or total company basis.

11

12 **Q. How does Staff present the information relevant to an analysis of**  
13 **Verizon NW's interim rate relief request?**

14 A. In order to provide a complete picture of the situation, Staff has presented  
15 Verizon NW's financial information at each jurisdictional level – Verizon  
16 NW total company, Verizon NW Washington state, and Verizon NW  
17 Washington intrastate, depending on what information was available.

1                   For example, Standard & Poor’s (S&P) does not issue a bond rating  
2                   for Verizon NW Washington intrastate operations, so Staff discusses the  
3                   bond rating for Verizon NW total company.

4

5   **Q.   When evaluating the Company’s claim that interim relief is needed to**  
6   **avoid “gross hardship” or “gross inequity,” should the Commission**  
7   **consider all relevant information?**

8   A.   Yes. The “gross hardship” or “gross inequity” factors should not be  
9       evaluated in isolation. The analysis could include looking at non-  
10      regulated or non-jurisdictional operations if events or activities at those  
11      corporate levels would adversely affect the utility’s ratepayers. For  
12      example, if a corporate crisis or financial default at the parent company  
13      level were occurring, it might be appropriate to look beyond the company’s  
14      regulated jurisdictional operations in order to determine whether interim  
15      relief is needed. If granting interim relief would protect ratepayers from  
16      greater harm, then the Commission should not deny that relief on the basis  
17      that the regulated operations were not responsible for causing the hardship  
18      or inequity.



1           **VI.   HOW VERIZON NW FINANCES ITS WASHINGTON INTRASTATE**  
2                                   **OPERATIONS**  
3

4           **A.     General**

5   **Q.    Does Verizon NW finance its Washington intrastate operations based on**  
6   **Washington intrastate financial results?**

7   **A.    No.** Verizon NW finances on a total company basis. The Company does  
8       not issue debt or equity on a Washington intrastate basis. Currently, only  
9       the parent company, Verizon Communications Inc., makes public common  
10      stock offerings.

11  
12   **Q.    How does Verizon NW plan to access capital in the near term?**

13   **A.    Verizon NW will meet any capital needs through the issuance of private**  
14       placement notes with its affiliate, Verizon Network Funding Corp., or with  
15       non-affiliated entities. Verizon NW (total company) borrows and invests  
16       funds on a short-term basis with GTE Funding Incorporated and Verizon  
17       Network Funding Corp. *See Response to Staff Data Request No. 32, my Exhibit*  
18       *No. \_\_\_\_ (KMF-2).*

1           **B.     Verizon NW's Credit Arrangements**

2   **Q.    How has Verizon NW been obtaining financing for its intrastate**  
3   **Washington operations?**

4   A.    Since January 1, 1999, Verizon NW has financed using funds from  
5   operations (internally generated funds) and short-term notes with GTE  
6   Funding Incorporated and Verizon Network Funding Corp.

7  
8   **Q.    Please describe the nature of Verizon NW's short-term notes with GTE**  
9   **Funding Incorporated and Verizon Network Funding Corp.**

10  A.    Verizon NW has borrowed and invested short-term funds with GTE  
11  Funding Incorporated, pursuant to a financial services agreement. The  
12  agreement works on a "cash pool" basis and has no associated promissory  
13  note. In general, a "cash pool" is an arrangement in which funds of the  
14  operating company as well as the parent, affiliated and subsidiary  
15  companies, are concentrated or consolidated and then made available for  
16  use by entities within the pool.

1            Verizon NW has also borrowed and invested short-term funds with  
2            Verizon Network Funding Corp., pursuant to a financial services  
3            agreement, also on a “cash pool” basis. A corresponding promissory note  
4            limits the amount of borrowing to \$500 million. The amount borrowed or  
5            invested is rolled over each business day.

6            The average amount of short-term debt outstanding for 2003 was  
7            \$189,493,000, as shown on page 3, column 2 of the Company’s Response to  
8            Staff Data Request No. 29, my Exhibit No. \_\_\_ (KMF-3). The annual interest  
9            rate during the month of September 2003 was 1.115%, as shown on page 3,  
10           column 3 of the Company’s Response to Staff Data Request No. 30, my  
11           exhibit No. \_\_\_ (KMF-4).

12

13    **Q.    What amount is available under these short-term credit arrangements?**

14    A.    Approximately \$310,000,000 is available from the Verizon Network  
15           Funding Corp. credit arrangement. The financial services agreement with  
16           GTE Funding Incorporated does not appear to have an express limit on the  
17           short-term funds available to Verizon NW.

1 Q. Are there any financial ratios or other requirements Verizon NW must  
2 meet in order to access capital under the financing arrangement with  
3 either GTE Funding Incorporated or Verizon Network Funding Corp.?

4 A. None of which I am aware, based on my review of each of the financial  
5 service agreements.

6

7 Q. Are there any financial requirements that Verizon NW's Washington  
8 intrastate operations must meet to access capital under the financing  
9 arrangement with either GTE Funding Incorporated or Verizon Network  
10 Funding Corp.?

11 A. None of which I am aware, based on my review of each of the financial  
12 service agreements.

13

14 Q: Under either of the short-term credit arrangements you just described, is  
15 interim rate relief of \$29.7 million annually from the Company's  
16 Washington intrastate operations necessary in order for Verizon NW to  
17 access either line of credit?

18 A: No.

1 Q. What conclusion could one reach given those financing arrangements?

2 A. Verizon NW does not need to receive either interim rate relief or meet an  
3 interest coverage test to obtain money from those financing arrangements.

4

5 Q. You generally discussed Dr. Vander Weide's testimony regarding  
6 Verizon NW's ability to cover its interest expense. Did he compare the  
7 financial ratios he calculated based on Verizon NW's Washington  
8 intrastate operations, to the Company's debt covenants?

9 A. No. Dr. Vander Weide's testimony does not discuss Verizon NW's actual  
10 effective debt covenants or compare them with his calculated ratios. Dr.  
11 Vander Weide offers an interest coverage calculation based on restated  
12 Washington intrastate operations, which he then compares to median  
13 financial ratios developed by S&P for U.S. industrial companies, in his  
14 Exhibit No. \_\_\_ (JHV-4T) at page 12.

15

1 Q. Do the S&P median financial ratios constitute an absolute test that must  
2 be met in order for a company to achieve a given rating?

3 A. No. S&P states: "Caution should be exercised when using the ratio  
4 medians for comparisons with specific company or industry data because  
5 of major differences in method of ratio computation, importance of  
6 industry or business risk, and impact of mergers and acquisitions."<sup>2</sup>  
7 Further, since S&P's credit ratings are meant to be valid over an entire  
8 business cycle, ratios of an individual firm at any point in the business cycle  
9 may not appear to fall within its debt ratings. S&P also evaluates non-  
10 numeric, qualitative factors in determining a company's creditworthiness.

11  
12 Q. What debt covenants are in effect for Verizon NW?

13 A. According to its supplemental response to Staff Data Request No. 35,  
14 Verizon NW must maintain 2.00 times interest coverage in order to issue  
15 new First Mortgage Bonds and maintain a minimum net worth of \$160.4  
16 million. A copy of this supplemental response is my Exhibit No. \_\_\_ (KMF-  
17 5). Basically, this means the Company must have sufficient income to pay  
18 two times its debt interest before issuing additional first mortgage bonds.

---

<sup>2</sup> *Standard & Poor's Corporate Ratings Criteria, 2004, at 49.*

1 **Q. Does Verizon NW intend to issue first mortgage bonds in the near term?**

2 A. No. As the Company stated in its response to Staff Data Request No. 33:  
3 “The current plan is that for the foreseeable future the Verizon operating  
4 telephone company subsidiaries will issue no long-term securities.” A copy  
5 of this response is my Exhibit No. \_\_\_ (KMF-6).

6  
7 **Q. In any event, assuming a two times interest coverage ratio applies, must**  
8 **that ratio be met from each of Verizon NW’s intrastate jurisdictions**  
9 **separately, in order for Verizon NW to issue additional first mortgage**  
10 **bonds?**

11 A. No. The coverage ratio is calculated on a Verizon NW total company basis.

12  
13 **Q. In your review of Verizon NW’s actual bond covenants, did you**  
14 **determine whether or not any calculations based on Washington**  
15 **intrastate operations are required?**

16 A. Yes, I did. There are no specific financial ratio calculations, including those  
17 provided by Dr. Vander Weide, that are required to be met or determined  
18 on a Washington intrastate basis.

1 Q. Turning to equity financing, in the last ten years, has Verizon NW  
2 received any equity infusions from either its parent company, Verizon  
3 Communications Inc., or any other Verizon entity?

4 A. No. In response to Staff Data Request No. 49, Verizon NW stated that it has  
5 received no equity infusions from any source during the period 1994 to the  
6 present. A copy of this response is my Exhibit No. \_\_\_ (KMF-7).

7

8 Q. Does Verizon NW's parent company plan to provide any equity  
9 infusions in the near future?

10 A. No. In response to Staff Data Request No. 50, the Company states: "There  
11 are no plans to provide equity infusions to Verizon Northwest during the  
12 period 2004 to 2006." A copy of this response is my Exhibit No. \_\_\_ (KMF-  
13 8).

14



1           **C.     Verizon NW's Credit Ratings**

2   **Q.    Do S&P or Moody's issue credit ratings for Verizon NW's Washington**  
3   **Intrastate operations?**

4   A.    No. S&P and Moody's only rate the outstanding debt of Verizon NW, total  
5   company.

6  
7   **Q.    What are Verizon NW's current ratings from Moody's and S&P?**

8   A.    The current Moody's and S&P bond ratings for Verizon Communications Inc.  
9   (parent company) and Verizon NW's debt are shown in the table below:

	<b>Moody's</b>	<b>S&amp;P</b>
Verizon Communications Inc.	A2	A+
Verizon Northwest - First Mortgage Bonds	Aa3	AA
Verizon Northwest – Debentures	A1	A+

10

11                   On March 26, 2004, S&P placed the debt of Verizon Communications  
12   Inc. and the debt of Verizon Communications Inc.'s subsidiaries, including  
13   Verizon NW, on "CreditWatch," with "negative implications."

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**Q. Please explain the significance of maintaining “A” ratings from S&P and Moody’s.**

A. According to S&P’s rating definitions, this means Verizon NW’s “capacity to meet its financial commitment on the obligation is very strong.”  
Moody’s rating definitions provide that “Obligations rated Aa are judged to be of high quality and are subject to very low credit risk. Obligations rated A are considered upper-medium grade and are subject to low credit risk.”

**Q. Please describe the conditions for the CreditWatch issued by S&P.**

A. S&P cites changing wireline industry dynamics as well as regulatory and competitive issues to have increased the business risk environment of the Regional Bell Operating Companies. As a result, S&P placed its long-term ratings for Verizon Communications Inc. and related entities on CreditWatch. The ratings on SBC and BellSouth were also placed on CreditWatch on February 17, 2004, in part as a result of increased business risk for their wireline business.

1 **Q. Is it inevitable that a bond rating downgrade will occur once a**  
2 **CreditWatch has been given?**

3 A. No. CreditWatch listings recognize the potential that future performance  
4 may differ from initial expectations. Ratings appear on CreditWatch when  
5 an event or deviation from an expected trend appears and additional  
6 information is necessary to evaluate the current rating. A CreditWatch  
7 listing does not mean that a ratings change is inevitable, and often a range  
8 of alternative ratings may be shown. Conversely, a rating change may  
9 occur without a prior CreditWatch listing.

10

11 **Q. Does Verizon NW receive commercial paper credit ratings?**

12 A. No. However, in response to Staff data requests, Verizon NW stated that  
13 while it has not maintained commercial paper credit ratings, it has  
14 continued to receive high credit quality long-term debt ratings from all  
15 three major credit rating agencies. Verizon Network Funding Corp.  
16 (VNFC) maintains commercial paper ratings of P1/A-1+/F-1+ from  
17 Moody's, S&P and Fitch credit rating agencies. These ratings represent a  
18 superior ability to repay short-term debt obligations.

1                   Moreover, in response to Staff Data Request No. 46, Verizon NW  
2                   stated: "In order to maintain these high commercial paper ratings, VNFC  
3                   restricts participation in its money pool arrangement to Verizon's high  
4                   credit quality domestic operating telephone companies, including Verizon  
5                   Northwest, and associated administrative and other support services  
6                   companies." A copy of this response is my Exhibit No. \_\_\_ (KMF-9).

7

8   **Q.    In its direct testimony, does Verizon NW conclude that a BB rating would**  
9   **be applicable to Verizon NW's Washington intrastate operations?**

10  A.    Yes. Dr. Vander Weide offers this conclusion in Exhibit No. \_\_\_ (JHV-4T) at  
11        12.

12

13  **Q.    Has any bond rating agency actually issued such a bond rating to Verizon**  
14  **NW's Washington intrastate jurisdiction?**

15  A.    No.

16

1           **D.     Status of Verizon NW's Payments on its Debt**

2   **Q.    Are any of Verizon NW's debt obligations currently in default or close to**  
3   **it?**

4   A.    No.

5

6   **Q.    Is Verizon NW precluded from obtaining additional loans?**

7   A.    No.

8

9   **Q.    Has Verizon NW offered any evidence that it is actually precluded from**  
10 **obtaining any needed financing in the future?**

11 A.    No.

12

13           **E.     Cash Flow Analysis**

14 **Q.    What cash flow information did Verizon NW present in its interim case?**

15 A.    The cash flow information Verizon NW presented is limited to the  
16 intrastate "funds from operations" data presented by Dr. Vander Weide in  
17 Exhibit No. \_\_\_ (JHV-5). This information presents a limited picture of  
18 Verizon NW's sources and uses of cash. A more comprehensive picture of  
19 Verizon's cash flow for the calendar years 1999 through 2003 was provided

1 in Response to Staff Data Request No. 43. A copy of this response is my  
2 Exhibit No. \_\_\_\_ (KMF-10), with an e-mail supplement.

3

4 **Q. Why is it important to analyze the cash flows of the Company?**

5 A. A cash flow analysis provides a picture of the sources and uses of cash  
6 utilized by Verizon NW and offers useful predictive information, which is  
7 especially important when analyzing the resources a company has available  
8 to it to support its operations in the near term, *i.e.*, during the pendency of a  
9 general rate case.

10 Investors look to cash flow as key to a company's ability to pay  
11 dividends, cover interest and principal payments and so on. Cash flow  
12 data informs the investment community and others how much cash can be  
13 used for debt service or reveal a need for borrowing.

14 Additionally, a cash flow analysis will reveal the level of dividends  
15 that have been paid. This is important because dividends are optional and  
16 could be suspended, if an actual financial emergency existed.

17

1 Q. Has Verizon NW paid any dividends to its parent company during any  
2 part of the period 1999 to 2003, the period Verizon NW testified that its  
3 rate of return has been in decline for its Washington intrastate  
4 operations?

5 A. Yes.

6

7 Q. Please identify the amount of dividends Verizon NW paid to its parent  
8 during the 1999-2003 period.

9 A. Since 1999, Verizon NW's annual dividend payments to its parent company  
10 have exceeded \$130 million every year, and were highest in 2003:

11 \$184 million in 1999  
12 \$211 million in 2000  
13 \$181 million in 2001  
14 \$135 million in 2002  
15 \$221.8 million in 2003

16 In total, Verizon NW paid \$932.8 million in dividends to its parent  
17 company over the period 1999-2003.

18

1 Q. Does Verizon NW maintain cash flow information on a Washington  
2 intrastate basis?

3 A. No. Verizon NW does not allocate asset and liability accounts to the  
4 Washington level. In its response to Staff Data Request No. 43, Verizon  
5 NW confirmed that a statement of cash flow is not produced at the state  
6 level. A copy of this response is my Exhibit No. \_\_\_ (KMF-10).

7

8 Q. What does the available information on cash flow indicate?

9 A. Verizon NW's net cash provided from operations is sufficient for the  
10 Company to fund its construction, repay its debt, and pay dividends to its  
11 parent company.

12 Moreover, if Verizon NW had elected not to pay those dividends,  
13 and instead retain that cash, the Company would appear to have had  
14 additional cash flow available for repayment of debt, construction, and/or  
15 other operating purposes.

16



1           **F.      Financial Indicators**

2   **Q.    Did Staff review the financial indicators presented by Verizon NW in**  
3   **support of its request for interim rate relief?**

4   A.    Yes. Staff Witness Paula M. Strain presents a comprehensive review of  
5        Verizon NW’s financial indicators in the near term. Ms. Strain’s  
6        calculations of financial indicators for Verizon NW indicate that the  
7        Company maintains a healthy capital structure and generates cash flow  
8        from operations sufficient to meet its financing obligations and construction  
9        needs, comply with its debt covenants, and pay dividends to its parent  
10       company.

11                As shown in the testimony of Staff Witness Ms. Strain’s, Exhibit No.  
12        \_\_\_ (PMS-1T), at 37, the financial indicators for Washington intrastate  
13        operations are less favorable than those shown for Verizon NW. However,  
14        it appears even on an intrastate basis, the Company’s cash provided from  
15        operations would be sufficient to meet its operating needs pending the  
16        resolution of the general rate case.

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**VI. VERIZON NW'S CAPITAL BUDGET**

**Q. What are Verizon NW's construction needs in the near term?**

A. According to Verizon NW's response to Staff Data Request No. 7a, Verizon NW estimates \$112.5 million in gross additions to Plant in Service (Washington Operations) for 2004. In part b of this response, the Company provided a listing of planned construction projects in Washington State that are greater than \$200,000. A copy of the Company's Response to Staff Data Request Nos. 7a and 7b is my Exhibit No. \_\_\_ (KMF-11).

**Q. Was Verizon NW able to supply information on the amount of gross additions it actually booked or budgeted to Washington intrastate operations?**

A. No. In response to Staff Data Request No. 39b, Verizon NW stated "Nonregulated/Regulated and intrastate/interstate allocations are performed on total plant balances; as such there is no data available for allocations by projects as identified in attachment 7b." A copy of this response is my Exhibit No. \_\_\_ (KMF-12).

1 Q. Is Staff able to determine at this time what percentage of Verizon NW's  
2 total construction needs are Washington intrastate specific?

3 A. Not at this time. Staff has reviewed the project lists provided by the  
4 Company in response to Staff Data Request Nos. 7b and 39b. However,  
5 these lists refer to projects that may be interstate in nature. Also, Verizon  
6 NW's Response to Staff Data Request No. 39b lists many projects that are  
7 multi-year in nature with some projects not scheduled for completion until  
8 2005.

9  
10 Q. Did Verizon NW offer any evidence that \$29.7 million (annual amount)  
11 needs to be granted before any of these projects can be completed?

12 A. No. Company witness Mr. Steven Banta makes the general statement that  
13 if Verizon NW's revenues do not cover its costs on a Washington intrastate  
14 basis, the Company may not fund planned construction, and service quality  
15 will suffer. *Direct Testimony of Mr. Banta, Exhibit No. \_\_\_ (SMB-2T) at 6-7.*  
16 However, he makes no attempt to identify any construction project that is  
17 essential to provide telecommunications service, or whether any such  
18 project might be deferred until the general rate case has been decided,  
19 absent interim rate relief.



1 Q. Is there any evidence Verizon NW's service quality in this state has  
2 suffered due to the financial condition alleged in the Company's interim  
3 rate relief case?

4 A. No. While Verizon NW witness Mr. Steven Banta states that Verizon NW  
5 may need to revise its internal goals of always exceeding service quality  
6 standards (*see* Direct Testimony of Mr. Steven M. Banta, Exhibit No. \_\_\_\_  
7 (SMB-2T), at 7), he provides no evidence that service quality has actually  
8 deteriorated in Washington State.

9  
10 Q. Has Verizon NW presented any evidence that it has decreased employee  
11 salaries or eliminated jobs as a result of the financial condition the  
12 Company alleges regarding its Washington intrastate operations?

13 A. No. Verizon NW's parent company has instituted a "Management  
14 Voluntary Separation Program (MVSP)," under which it offers incentives  
15 for employees to leave Company employment voluntarily. However, in its  
16 supplemental response to Staff Data Request No. 11, Verizon NW indicates  
17 that the MSVP was already in place by fourth quarter 2003, and "that there  
18 are no specific documents showing a connection between MSVP job  
19 eliminations and the financial condition as requested [in Staff's data

1 request]...” Verizon NW observes that the number of employees leaving  
2 due to the MVSP made further headcount reductions unnecessary. A copy  
3 of this response is on pages 2-3 of my Exhibit No. \_\_\_ (KMF-13).

4  
5 **VII. CONCLUSIONS**

6  
7 **Q. Please describe the conclusions reached by Staff based upon its**  
8 **application of the factors from the PNB Order and other relevant**  
9 **analysis.**

10 **A.** Verizon has not identified the level of financing that it needs in the near  
11 term. Assuming it has a specific need for external capital, Verizon NW has  
12 access to financing, as discussed earlier in my testimony, without interim  
13 rate relief. Verizon NW’s debt is A rated. Verizon NW is not in default (or  
14 facing default) on any current debt obligation. In the near term, Verizon  
15 NW can obtain funds through its promissory note with Verizon Network  
16 Capital Funding. There are no financial ratios Verizon NW must meet to  
17 access that capital. There has been no other demonstration that the  
18 Company faces any obstacles to obtaining those funds.

1           The Company's decline in intrastate net operating income was not  
2 sudden; it has existed for several years. Actions by the Company and its  
3 corporate parent over several years appear to have contributed significantly  
4 to the Verizon NW's decline in its Washington intrastate return.

5           In sum, Verizon NW, either at a total company or Washington  
6 intrastate level, has offered no evidence that it needs immediate financing  
7 in order to make additional capital expenditures that cannot be financed on  
8 reasonable terms, or deferred pending the outcome of the general rate case.  
9 The Company has not provided in testimony any analysis that the  
10 requested \$29.7 million in interim rate relief is that amount that will enable  
11 it to obtain any needed fund. A balanced evaluation of all the relevant  
12 information does not lead to a conclusion of "gross hardship".

13

14 **Q. What are Staff's recommendations?**

15 A. Based on the application of the factors from the PNB Order, together with  
16 other analysis, Staff determined that Verizon NW is the entity which would  
17 make any future financing, that Verizon NW has no plans for any future  
18 long-term financing, that the Company has the capability to finance with  
19 short-term debt in the near term, and that there is no evidence presented

1 that shows that granting the \$29.7 million in interim relief will, in fact,  
2 alleviate the alleged “urgent” circumstances pending the outcome of the  
3 general rate case.

4 In reaching this conclusion, Staff also considered the Company’s  
5 actions to date. Although the Company provided information regarding a  
6 diminished rate of return and various other financial ratios, it has not  
7 provided documents that show it is (or will be) insolvent, that executive  
8 management salaries have been cut, that advertising expenses have been  
9 reduced, or that there is any plan to reduce the number or scope of services  
10 provided due to the conditions stated in the Company’s direct testimony  
11 for interim rate relief. Finally, the dividend paid by Verizon NW to its  
12 parent in 2003 was significantly higher than that paid in 2002.

13 Therefore, Verizon NW has not sufficiently demonstrated a need for  
14 interim rate relief and no increase in rates should be granted.

15

16 **Q. If the Commission determines that a need to fund an interim increase is**  
17 **necessary, what is Staff’s recommended rate design for such an outcome?**

18 A. While Staff’s recommendation is that Verizon NW is not entitled to interim  
19 rate relief, Staff Witness Timothy W. Zawislak’s testimony offers an



1 alternative rate design recommendation in the event that the Commission  
2 ultimately determines otherwise. As discussed more fully in Mr.  
3 Zawislak's testimony, Staff recommends that any revenue the Commission  
4 authorizes the Company to collect by way of interim rate relief should be  
5 collected through an equal percentage increase to all intrastate retail and  
6 resale tariffed, price listed, and contracted access lines (excluding  
7 unbundled network elements).

8

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

10 **A. Yes.**