Exhibit No. ___-T (PMS-1T)
Docket No. UT-040788
Witness: Paula M. Strain

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

TESTIMONY OF

PAULA M. STRAIN
REGARDING INTERIM RATE RELIEF

STAFF OF
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

July 14, 2004

I. INTRODUCTION

Q. Please state your name and business address.

A. I am Paula M. Strain. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504-7250.

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

A. I am employed by the Washington Utilities and Transportation Commission as a Telecommunications Expert. My participation in this case is on behalf of the Commission's Staff (Staff).

Q. How long have you been employed by the Commission?

A. I have worked for the Commission for over eleven years.

Q. Would you please state your educational and professional background?

A. I am a 1977 graduate of the University of California, Berkeley, holding a Bachelor of Science degree in Business Administration with an emphasis in Accounting. I worked for a public accounting firm for four years, and am a Certified Public Accountant. In 1981 I joined the staff of the Alaska Public Utilities Commission (now known as the Regulatory Commission of Alaska) and worked there until 1992 as a financial analyst. While employed there I participated as lead analyst in numerous rate cases, testifying on revenue requirement, cost of service, rate design, and cost of capital issues involving telephone, electric, water, sewer, oil pipeline, and cable television utilities.

I joined the Staff of the Washington Utilities and Transportation Commission in November 1992, and participated in telephone cases involving GTE Northwest Incorporated, the Washington Exchange Carriers Association, and other telephone utilities. After a year working at the Washington Office of the Insurance Commissioner, I rejoined the staff of the WUTC, again working in the telecommunications section. I testified in Docket No. UT-950200 (US West general rate case) on affiliated interest issues and the calculation of the Yellow Pages imputation; in Docket No. UT-960369 on avoided cost wholesale discounts, and in Docket No. UT-980948, US West's petition for an accounting order regarding yellow pages imputation.

I was the Staff team lead in the Commission's docket regarding Qwest's application for approval to re-enter the interLATA long distance market, Docket Nos. UT-003022/003040, which involved participating in workshops and proceedings over a two-year period and assisting the

Administrative Law Judge and Commissioners in drafting recommendations to the FCC regarding Qwest's application.

In December 2002, I became the Commission's policy advisor on telecommunications issues and worked on numerous dockets in an advisory role to the Commissioners. I rejoined the Commission's Telecommunications Section Staff in February 2004.

Q. What is the purpose of your testimony?

A. My testimony responds to Verizon Northwest Inc.'s (Verizon NW or the Company) Petition for interim rate relief of $29.7 million, subject to refund. I provide analysis regarding the following issues:

a. Calculations of results of operations, financial ratios and other indices pertaining to Verizon NW at several jurisdictional levels
b. Discussion of the trends in Verizon NW's revenues and expenses and their impact on the Company's rate of return and financial ratios.
c. The possible causes of Verizon NW's decline in rate of return in its Washington intrastate jurisdiction.

Q. What exhibits are you presenting in support of your testimony?

A. I am sponsoring Exhibit No. ___ (PMS-2), a recalculation of Verizon NW's Washington intrastate Results of Operations including Commission-basis adjustments; Exhibit No. ___ (PMS-3), charts and schedules summarizing components of Verizon NW's Quarterly Compliance Reports to the Commission for the years 1994 through 2003; and Exhibit No. ___ (PMS-4), reflecting recalculations of financial indicators for Verizon NW at the total company, Washington, and Washington intrastate jurisdictional levels.

Q. Can you please summarize your testimony?

A. Based on my analysis of Verizon NW's results of operations and financial indices, I conclude that Verizon NW's overall rate of return has declined in recent years, and that its intrastate rate of return is below the rate of return currently authorized by this Commission.

My calculations of other financial indicators for Verizon NW indicate that the Company maintains a healthy capital structure and generates cash flow from its operations sufficient to meet its financing obligations and construction needs, comply with its debt covenants, and pay dividends to its parent company.

My analysis of the Company's results of operations for the past ten years indicates the Company's decline in intrastate net operating income was not sudden; it has existed for several years. My analysis also indicates that there may be reasons for the decline in Verizon NW's intrastate revenues and return that are within the control of the Company and its corporate parent, and that may not indicate gross hardship or inequity for the company's intrastate operations such as would justify interim rate relief.

II. INTERIM RATE RELIEF FACTORS TO CONSIDER

Q. What criteria are applied by the Commission in determining whether a utility qualifies for interim rate relief?

A. As discussed more fully in Ms. Folsom's testimony, the Commission considers numerous factors in deciding whether to grant a company interim rate relief, among them are the six factors from the Commission's order in *WUTC v. PNB,* Cause No. U-72-30 tr. My testimony focuses on Factors 2, 3 and 4 from that Order, which are stated as follows:

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

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

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

Q. What types of financial information does the Commission typically review analyzing these factors for interim rate relief?

A. In the recent cases involving petitions for interim rate relief, the Commission has reviewed Commission-basis financial results of operations submitted by the companies, along with debt covenants, cash flow information, and construction budgets. The Commission has used the Commission-basis financial results to calculate financial ratios for the companies. The Commission has used cash flow and construction budget information to determine levels of financing needed for immediate-term construction or operations. The Commission has looked to debt covenants and other lender requirements, if any, to determine how much of an increase is necessary to allow the company to obtain the financing it needs to perform its necessary functions in the near term.

Q. Can you provide some examples from recent dockets involving interim rate increases?

A. Yes. In the case of *WUTC v. Olympic Pipe Line Co.*, Docket No. TO-011472, both the company and Commission Staff had calculated an interim rate increase based on results of operations that included a few restating and pro forma adjustments. However, the Commission decided the amount of the interim increase based on the total company's immediate investment needs and the amount by which total company revenues would need to increase to allow the company to obtain the necessary financing for those investment projects.[1] The Commission then subtracted an interstate revenue increase Olympic received to determine the amount of intrastate revenue needed.

Similar to Verizon NW, Olympic Pipe Line obtained its debt financing from internal affiliated sources; therefore a times interest earned ratio of 1.5 was used as a surrogate for a lender's typical debt covenant requirements.

In the case of *WUTC v. Avista Utilities*, Docket No. UE-010395, the Commission looked at the company's rate of return based on the company's Commission-basis reports. The Commission also reviewed evidence provided by Avista regarding its construction needs in the near term. In that proceeding, the company had not filed a general rate case, and the Commission agreed with the Staff that the case presentation was not the norm for a petition for interim rate relief.[2]

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[1] The Commission stated, "We note the large number of unanswered questions that we have deferred to, or stated a desire to hear more about in, the general rate proceeding. Given the degree of need, the refundability of rates, the number of issues that must be addressed in the general rate proceeding, and the nearness of the general rate proceeding, we decline to consider a results of operation *pro forma* statement, or the adjustments within it." *WUTC, v. Olympic Pipe Line Co.* Docket No. TO-011472, Third Supplemental Order (January 31, 2002) at ¶ 57. *See also* Table 1 in Appendix A to that order.

[2] *In re Avista Corporation, d/b/a Avista Utilities*, Docket No. UE-010395); Sixth Supplemental Order (September 24, 2001) at¶ 26 and n. 2.

In the case of *WUTC v. Puget Sound Energy Co.*, Docket Nos. UE-011163/011170, the company asked for expedited rate relief, but again, the company had not filed a general rate case. All of the company's projections were filed as confidential, but in general, the analysis was based on actual and forecasted expenses and revenues.

Q. Verizon witness Mr. Banta explains that "gross hardship" exists for Verizon's intrastate operations because the Company's intrastate results of operations show a negative return for the test year. ***Exhibit No. ___ -T (SMB-2T) at 6.*** **He also mentions the access charge reduction as one reason for the decline in rate of return. Did Verizon NW's intrastate rate of return begin to decline after October 2003, when those access charge reductions were ordered to be implemented by the Commission in Docket No. UT-020406?**

A. No. The information I present in Exhibit No. ___ (PMS-4) shows the decline in the Company's intrastate earned rate of return began in the year 2000. For the four years prior to 2000, Verizon NW's Washington intrastate operations earned a return in excess of that authorized by the Commission.

As I discuss later in my testimony, the declines in intrastate return that began in 2000 were not caused by the access charge reduction ordered in Docket No. UT-020406. Rather, actions by the Company and its corporate parent over several years appear to have contributed significantly to the decline, and any alleged "gross hardship or inequity" that the Company's intrastate operations are experiencing.

II. VERIZON NW'S INTERIM REVENUE REQUIREMENT

Q. What evidence on revenue requirements did Verizon provide in support of its interim increase request?

A. Verizon NW, through witness Nancy Heuring, filed a calculation showing that it had a revenue deficiency of $158,620,000 for the test year ended September 30, 2003. Verizon NW's revenue requirements calculation results in a rate of return of negative .47%. *Direct Testimony of Ms. Heuring, Exhibit No. ___ (NWH-7T) at 4.* According to Ms. Heuring's testimony, Verizon incorporated all of the restating adjustments it proposes in its general rate case filing in this calculation, and the

Company included its access charge reduction as part of the revenue deficiency. *Id.*

Q. How do the Company's restating adjustments affect Verizon NW's intrastate rate of return?

A. As shown in column (c) of Exhibit No. ___(PMS-2), the Company's restating adjustments reduce net operating income by $4.5 million, and increase rate base by $52.4 million. Exhibit No. ___ (PMS-2), column (b), also shows that Verizon NW's intrastate test year rate of return before restating adjustments is 2.03%, rather than the 1.46% depicted on Ms. Heuring's Exhibit No. ___ (NWH-6). Both of these percentages are below Verizon NW's authorized rate of return of 9.76%.

Q. Has Staff audited Verizon NW's revenue requirement components or restating adjustments?

A. No. Staff has not had the opportunity to perform comprehensive audit work on the figures Verizon NW uses in its calculations, or the basis for its restating adjustments to test year results of operations. Staff's review of Verizon NW's interim rate relief filing has been limited to reviewing the information filed by Verizon NW, along with some of the Company's responses to follow-up data requests.

Staff is still in the process of investigating all of this information, as well as the Company's pro forma adjustments, in the general rate case proceeding.

Q. Does Staff have any concerns regarding the Company's test year presentation?

A. Yes. The Company testifies that the restating and normalizing adjustments it has included in the test year were made to modify its financial results for the impact of out-of-period items or one-time or miscellaneous items. *Direct Testimony of Ms. Heuring, Exhibit No. ___ (NWH-7T) at 4*. However, Staff believes several additional adjustments should be made to accomplish this "smoothing out" of the test year for purposes of evaluating the Company's need for interim rate relief.

Q. Does Staff propose any additional restating adjustments to the Company's revenue requirement calculations?

A. Yes. My Exhibit No. ___ (PMS-2) reflects Staff's proposed adjustments to Verizon NW's test year revenue requirement components.

Q. Please explain the adjustments Staff proposes.

A. The first adjustment is to recognize the overall effect on Verizon NW of its corporate parent's voluntary employee separation program. This program involved Verizon Communications Inc. offering incentive separation packages to management employees company-wide, and resulted in 21,000 employees leaving the Verizon companies. Verizon NW states that the program resulted in a reduction of 160 employees in Washington State (Verizon NW's Response to Staff Data Request No. 11). My adjustment in column (f) of Exhibit No. ___(PMS-2) reflects an appropriate level of cost savings for this program.

Verizon NW indicates that it will save $17.1 million annually associated with actual test-year headcount reductions. *See Exhibit No. ___ (PMS-2), page 2, Verizon Response to Staff Data Request No. 25*. However, Verizon NW did not adjust for this amount in its case for interim rate relief. Indeed, the test year includes over $10 million in costs associated with this program, but only $9.1 million in savings. The analysis should include all of the test year savings from the program, or an additional $8 million, as a reduction to operating expenses.

The second adjustment is for uncollectibles, shown in column (g) of Exhibit No. ___ (PMS-2). In its general rate case presentation, Verizon adjusted its intrastate uncollectible expenses to reflect actual write-offs for the test year. However, this adjustment was not included in the Company's interim rate relief calculations, even though it is characterized by Ms. Heuring as a restatement. *See Exhibit No. ___ (PMS-2) page 3, Verizon NW's Response to Public Counsel Data Request No. 8*. This adjustment should be made for purposes of evaluating interim rate relief. It increases net income by $2.2 million.

As shown at column (h) of Exhibit No. ___ (PMS-2), these two additional restating adjustments result in net operating income of $2 million, and a return on rate base of positive 0.2%, compared to the Company's calculated return of negative 0.47%.

Q. Has Staff considered the effects of adjustments based on previous Commission ratemaking precedent?

A. Yes. I have also included on my Exhibit No. ___ (PMS-2) adjustments that recognize prior Commission precedent for directory revenue imputation, flow-through of Federal income tax items, and synchronized interest expense. These adjustments shown at columns (i), (j), and (k) of Exhibit

No. ___ (PMS-2), are based on information provided by Verizon NW in its general rate case workpapers in compliance with WAC 480-07-510(3)(b). If Verizon NW's test year is adjusted for these items, it results in intrastate net operating income of $21.2 million and a return on rate base of 2.09%.

Q. Why is it appropriate to make an adjustment for directory advertising for purposes of the Company's interim case?

A. This adjustment reflects the level of directory revenues Verizon NW was retaining before the Company and its affiliate agreed to reduce those revenues to zero. The Company's testimony on interim rate relief emphasizes the importance of reviewing the Verizon NW Washington operations in isolation. Staff views this adjustment as doing exactly that. If Verizon NW's intrastate operations were a stand-alone company, it presumably would have been able to preserve the revenue stream from its official directory publisher, on the grounds that it reflects the value of that relationship to the publisher.

III. TRENDS IN VERIZON NW'S REVENUES AND EXPENSES

Q. At page 5 of her direct testimony, Exhibit No. ___ (NWH-7T), Ms. Heuring provides the Commission with four reasons explaining the decline in Verizon NW's intrastate revenues beginning in 1999. Have you reviewed the reasons the Company offers?

A. Yes.

Q. First of all, did the Company's rate of return decline beginning in 1999?

A. No. The Company incorrectly states that Verizon NW's Washington intrastate revenues began to decline in 1999. As I explained earlier, based on a review of Verizon NW's quarterly compliance reports filed with the Commission, Verizon NW's intrastate return began to decline in the year 2000.

Until 2000, Verizon NW's intrastate revenue had increased every year since 1994, and was 12.5% as of December 1999. This is shown on the summary of Verizon NW's reports to the Commission, provided in my Exhibit No. ___ (PMS-3).

Q. What is the first reason Verizon NW gives to explain its decline in rate of return?

A. Verizon NW says "the Company reduced its intrastate earnings by $30 million per year beginning in 1999 as a result of the Bell-Atlantic-GTE Merger Order." *Direct Testimony of Ms. Heuring, Exhibit No. ___ (NWH-7T) at 5*.

Q. Is Verizon NW's statement correct?

A. No. The Commission's Order in that merger case was not entered until December 1999, and it clearly states that any of the revenue reductions agreed to by the Company were to be phased in over a two-year period starting in May 2000 and ending in July 2001.[3] Accordingly, it is not possible for there to have been a revenue impact of that merger beginning in 1999, as Verizon NW suggests.

[3] *In re Application of GTE Corporation and Bell Atlantic Corporation*, Docket No. UT-981367, Fourth Supplemental Order (December 16, 1999) at 21.

Q. Was Verizon NW required to accept a reduction in revenues in that merger case?

A. No. Verizon NW agreed to those reductions as part of a settlement the Company signed.

Q. What is the second reason the Company offers?

A. The Company refers to the effect of the access charge revenue reductions last year in "the AT&T Access Complaint Case, Docket No. UT-020406." *Direct Testimony of Ms. Heuring, Exhibit No. ___ (NWH-7T) at 5.*

Q. When was the Commission's order issued in that case?

A. The Commission's order requiring the access charge reductions was issued on August 12, 2003, but the Commission delayed the effective date to October 1, 2003, to allow Verizon NW the opportunity to make a filing to address the approximate $30 million reduction in access charges. *AT&T v. Verizon NW*, Docket No. UT-020406 (Eleventh Supplemental Order)(August 12, 2003) at ¶186.

Q. Did Verizon NW file by October 1, 2003, to address that revenue reduction?

A. No. Verizon NW did not submit a rate increase request within that period; instead, the Company filed for interim rate relief, but not until April 30, 2004.

Q. What is the third reason cited by Verizon NW for the decline in its rate of return for its Washington intrastate operations?

A. The Company refers to "losses in line growth." *Direct Testimony of Ms. Heuring, Exhibit No. ___ (NWH-7T) at 5*.

Q. Has the Company demonstrated the nature and causes of any such line growth losses?

A. No, and the causes are not apparent. Staff continues to investigate the extent to which Verizon NW's local exchange customers are shifting their services to other Verizon affiliates, such as Verizon Wireless or GTE.NET, or to other Verizon NW services, such as Digital Subscriber Line (DSL) service, that would result in reductions in Verizon NW switched access lines. To the extent this occurs, it causes a decline in intrastate minutes of use and switched access lines, resulting in revenue reductions for Verizon

NW's regulated intrastate operations, and a shift in revenues to unregulated or nonjurisdictional Verizon services. At the same time, as discussed below, the related costs of these services may remain in Verizon NW's revenue requirement for intrastate ratemaking purposes.

Q. What is the fourth and final reason the Company gives for its decline in rate of return for Washington intrastate operations?

A. The Company says depreciation expense needs to increase. *Direct Testimony of Ms. Heuring, Exhibit No. ___ (NWH-7T) at 5*.

Q. Is this a plausible cause of a decline in rate of return?

A. Staff questions the Company's characterization of this reason as a cause for current declines in rate of return. The Company's current financial condition cannot be affected by depreciation rate changes that have not yet occurred.

Q. Has Verizon NW requested a represcription of its depreciation rates?

A. Yes. The Company filed its request on April 2, 2004. That matter has been assigned Docket No. UT-040520. Staff is investigating that filing, but has not reached any conclusions. That docket is not yet resolved.

Q. If depreciation rates were a problem for Verizon NW, are you aware of anything that prevented the Company from filing to change those depreciation rates before April 2, 2004?

A. No.

Q. Did Verizon NW fail to include any other material causes of revenue decline in its list?

A. Very definitely. The Company failed to mention a $34 million revenue reduction associated with directory revenue. In 2000, the agreements between the Verizon operating companies, including Verizon NW, and Verizon Directory Corporation, an affiliated company, were revised. The contracts were changed from a revenue sharing arrangement to a fee for service arrangement. This resulted in a revenue reduction to Verizon NW of $34 million annually, based on the 1999 revenue amount. This is explained in my Exhibit No. ___ (PMS-2, page 4), which is the Company's response to Staff Data Request No. 20.

Before these contract revisions, these substantial revenues had all been recorded as Washington intrastate operating revenues.

Q. Why did Verizon NW fail to include this item in its list of reasons for a decline in its rate of return?

A. It is my understanding that the Company's list was not intended to be exhaustive. On the other hand, this is a major revenue change that is larger than the access charge reduction the Company did include on its list. In my opinion, the Company should have mentioned this major change in revenues.

Q. Did Verizon NW discuss whether it is losing revenues due to its toll customers switching service to its affiliate, Verizon Long Distance?

A. No. Verizon has offered no evidence explaining whether any reduction in its Washington intrastate revenue is due to migration of customers formerly using Verizon NW's regulated intrastate long distance services to Verizon NW's unregulated long distance services affiliate, Verizon Long Distance (VLD).

In the AT&T access charge complaint case, Docket No. UT-020406, the Commission raised concerns regarding the relationship between Verizon Long Distance and Verizon NW, and the effect of that relationship on the regulated company, Verizon NW. Staff, and presumably other parties to this proceeding will continue to investigate these relationships for the permanent rate proceeding.

Q. Did the Commission in its Order in Docket No. UT-020406 require Verizon NW to address this issue of migration of usage to Verizon Long Distance (VLD) from Verizon NW?

A. In the Eleventh Supplemental Order in that case, the Commission expressed its concern regarding the relationship between VLD and Verizon NW and stated:

> We expect to see a thorough exploration of the relationship, and its consequences, in any future proceeding where the revenues or the consequences of the actions of the two entities are relevant to the matter at issue.

Q. Has Verizon NW directly addressed that issue in this case?

A. No. The Company apparently believes its general discussion on affiliated interests satisfies the Commission's order, but the Company has not directly addressed the concern identified by the Commission. *See, my Exhibit No. ___ (PMS-5), Verizon NW's Response to Staff Data Request No. 203.*

Q. Are the revenue declines you have discussed above the only reasons that Verizon NW's intrastate rate of return has declined?

A. No. Both Ms. Heuring and Dr. Vander Weide discuss the erosion in Verizon NW's earnings before interest and taxes (EBIT), and in its return on rate base. *Direct Testimony of Ms. Heuring, Exhibit No. ___ (NWH-8) at 5, lines 1-4; Direct Testimony of Dr. Vander Weide, Exhibit No. ___ (JHV-4T) at 4, 9, 12.*

Q. Has Staff performed any analysis of EBIT and return on rate base for Verizon NW's operations?

A. Yes. Exhibit No. ___ (PMS-3) presents a summary of year-end results of operations for Verizon NW's Washington operations, broken down by interstate and intrastate amounts, for the years 1994 through the test year. Pages 4 through 6 of the exhibit summarize the year-end results for Washington intrastate, Washington interstate, and total Washington state operations, respectively. For the Washington intrastate and interstate results, the net operating income components are also shown as a percent of those components for the total state. The first three pages of the exhibit present comparisons of the numerical data in chart form.

The first chart, on page 1, presents comparisons of interstate and intrastate revenues, and interstate and intrastate expenses. The second chart, on page 2, presents the trends in Verizon NW's intrastate revenues and expenses over a 10-year period. The third chart, on page 3, compares trends for rate base and net operating income for Verizon NW's Washington operations and its Washington intrastate operations.

Q. Are large net additions to Verizon NW's rate base a significant cause of earnings erosion?

A. No. As shown on page 3 of my Exhibit No. ___ (PMS-3), the erosion is primarily due to declines in EBIT rather than to increases in rate base. Moreover, a comparison of Verizon NW's intrastate revenues and expenses in my Exhibit No. ___ (PMS-3), pages 2 and 5, shows that the declines in EBIT are due as much to increases in operating expenses as to declining revenues.

In addition, page 5 of that exhibit shows a spike in Verizon NW's intrastate operating expenses in 2000, from $298 million to $356 million, an increase of over 19%. This increase may reflect the costs of the GTE-Bell Atlantic merger, which the Commission approved in December 1999. Although Verizon NW's Washington intrastate expenses become somewhat lower in 2001, they remain at a significantly higher level in subsequent years than the pre-merger levels.

Q. Are these trends the same for Verizon NW's total Washington operations?

A. Not entirely. The increase in operating expenses from 1999 to 2000 is consistent across both the Washington interstate and intrastate jurisdictions. However, as shown on my Exhibit No. ___ (PMS-3), page 1 and pages 4-6, Verizon NW's intrastate revenues reflect a decline that has not occurred for its interstate operations. In fact, Verizon's interstate revenues have been increasing substantially.

As pages 4-6 of my Exhibit No. ___ (PMS-3) show, for the year ended September 30, 2003, Verizon NW reported EBIT of $126 million for its Washington interstate operations, compared to a $12 million loss for Washington intrastate operations, for a net of $114 million EBIT for Verizon NW's total Washington operations.

Q. Is this disparity between net income for interstate and intrastate operations a recent phenomenon?

A. No. The disparity in net income between the jurisdictions has existed for several years, but it has become more pronounced in recent years.

Q. What is causing this disparity?

A. A review of Verizon NW's quarterly compliance reports for the past ten years indicates that the cause may be due to a change in the allocation of revenues between the jurisdictions, while the allocation of rate base and expenses has remained essentially the same.

Q. Can you summarize the trends shown in Exhibit No. ___ (PMS-3)?

A. Yes. The exhibit shows several trends over the 10-year period 1994-2003:

- A steady increase in interstate revenues
- A steady decline in intrastate revenues since 1999
- An overall decline in total Washington state revenues and rate of return, beginning in 2000
- Increases in operating expenses in both inter- and intrastate jurisdictions

- Intrastate revenues as a percent of total Washington revenues have decreased from 75.6% in 1994 to 58% in 2003, while expenses have decreased from 78% in 1994 to 74.6% in 2003
- As a percent of total Washington, interstate revenues have increased from 24% in 1994 to 42% in 2003, while expenses have increased from 22% in 1994 to 25% in 2003

Q. Has Verizon explained the reasons for these trends?

A. No. The reasons the Company offers to explain the decline in intrastate revenues, which I have already discussed earlier in this testimony, explain the reduction in intrastate revenues, but they do not explain the increasing differences in the percentage of revenues versus expenses allocated to the intrastate jurisdiction.

Q. Why should the Commission be concerned about this?

A. The declining rate of return in Verizon's intrastate jurisdiction may be caused purely by flawed allocation factors. Based on preliminary investigations, Staff believes there may be a mismatch in the jurisdictional allocation factors applied to Verizon NW's plant and operating expenses compared to the way the Company's revenues are assigned to the interstate and intrastate jurisdictions. This issue was previously raised, but not resolved, in the AT&T access charge complaint case against Verizon NW, Docket No. UT-020406.

Q. What information indicates such a mismatch exists?

A. Staff has reviewed several responses to data requests from Verizon NW, which indicate that its plant and operating expense accounts are allocated to the jurisdictions based on allocation factors in Part 36 of FCC rules. Many of these factors, or the inputs used to determine them, were "frozen" by the FCC in July 2001, at December 2000 levels. Currently, this freeze is supposed to stay in effect until June 30, 2006.

For most of Verizon NW's accounts, roughly 75% of plant and operating expenses are allocated to the intrastate jurisdiction, and 25% are allocated to the interstate jurisdiction. Verizon NW's allocation factors have remained at these levels for many years.

However, in the years since 2000, several services, notably DSL (digital subscriber lines), have been classified by the FCC, and recorded by Verizon NW, as interstate in nature. According to Verizon NW's Response to Public Counsel Data Request No. 6, revenues that the Company receives for DSL services are recorded as 100% interstate. *See*

Exhibit No. ___ (PMS-3), page 7, Verizon NW's Response to Public Counsel Data Request No. 6. However, Verizon NW's workpapers appear to indicate that the Company's DSL-related costs (plant and expenses) are allocated between interstate and intrastate operations.

Ms. Heuring provides Verizon's Part 36 allocation factors in her Workpaper A3, and confirms in a response to Staff Data Request No. 39, that Verizon applies separation procedures to plant balances rather than to plant additions. *See Exhibit No. ___ (KMF-11), Verizon Response to Staff Data Request No. 39 and Attachment 39b.* Attachment 7b to the Company's Response to Staff Data Request No. 7, includes a list of projects included in Verizon's planned 2004 construction of $112 million, some of which appear to be DSL-related (e.g. "DSL Wire Center Move" and "DSL PIP Blanket Work Order"). *See Exhibit No. ___ (KMF-12).*

To the extent that the revenues for a service are recorded to the interstate jurisdiction, but the costs incurred in producing the service are allocated in part to the intrastate jurisdiction, there will be an inappropriate mismatch between intrastate revenues and expenses.

More investigation needs to be performed on Verizon NW's jurisdictional allocations during the general rate case proceeding for Staff to understand the total picture. In the meantime, the Company has not proved that its intrastate results of operations reflect a proper match of revenues, expenses, and rate base.

III. VERIZON NW'S CALCULATION OF FINANCIAL INDICATORS

Q. Did Verizon NW offer any calculations of financial indicators, or ratios, on a total Washington or total company basis?

A. No. In response to Staff Data Request No. 15, Verizon NW stated that an analysis of financial ratios is not available for Verizon NW, and that the financial ratio analysis contained in Dr. Vander Weide's testimony was a "special project" developed specifically for purposes of his testimony. This response is in my Exhibit No. ___ (PMS-4) at page 3.

In response to Staff Data Request No. 28, the Company stated that Dr. Vander Weide studied only Washington intrastate data for the test year and calendar years 1999 through 2002. This response is in my Exhibit No. ___ (PMS-4) at page 4.

Q. What inputs did Dr. Vander Weide use in his calculations of financial ratios?

A. His inputs included:

1. earnings before interest and taxes (EBIT),
2. interest expense,
3. gross interest paid,
4. income tax expense,
5. deferred income taxes,
6. depreciation and amortization expense,
7. short-term debt,
8. long-term debt, and
9. common equity.

Q. Does Verizon NW maintain each of these inputs on a stand-alone basis for Verizon NW's Washington intrastate operations?

A. No. Only the EBIT and depreciation and amortization expenses are maintained on a Washington intrastate basis, based on allocations performed to distinguish between regulated and non-regulated operations (FCC Part 64) and between interstate and intrastate operations through the separations process (FCC Part 36). And, as I mentioned previously, Verizon NW's responses to Staff data requests seem to indicate that the Company does not assign plant projects specifically to either jurisdiction when they are added to the plant balances. *See Exhibit No. ___ (KMF-11), Verizon NW's Response to Staff Data Request No. 39.*

Verizon does not maintain a balance sheet at the Washington state level, or at the Washington intrastate level. *See Verizon Response to Staff Data Request No. 276d and 276e, my Exhibit No. ___ (PMS-4), page 6*.

Q. How did Dr. Vander Weide determine Washington intrastate amounts for those inputs that the Company does not maintain for the Washington intrastate jurisdictional?

A. Dr. Vander Weide's workpapers and underlying calculations indicate that in order to perform the financial ratio calculations in his testimony, Verizon NW total company amounts were the starting point. For calculations that required intrastate Washington components, such as debt and equity components, Dr. Vander Weide used the test year Plant in Service to determine Washington intrastate inputs. Other inputs, such as interest expense, were allocated to the intrastate Washington jurisdiction based on FCC Part 36 separations factors.

Q. Dr. Vander Weide discusses Verizon NW's ability to repay its debt and cover its interest expense. Do his testimony, exhibits or workpapers compare the ratios he calculated based on Verizon NW's intrastate operations to the Company's actual debt covenants?

A. No. Dr. Vander Weide's testimony, exhibits or workpapers do not discuss Verizon NW's actual debt covenants, nor do they contain any comparison of those covenants to the financial ratios he calculated.

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

A. Verizon NW must maintain 2.00 times interest coverage in order to issue new First Mortgage Bonds. Staff witness Ms. Kathy Folsom discusses these covenants in her testimony.

Q. Assume Verizon NW's interest coverage requirement were applied to its Washington intrastate operations. Under that assumption, would the $29.7 million interim rate increase Verizon is requesting result in operating income sufficient to meet such a 2.00 times interest coverage requirement?

A. No, it would not. In Exhibit No. ___ (JHV-5), Dr. Vander Weide calculated a Times Interest Earned ratio of 0.6 based on Verizon NW's restated test year intrastate results of operations, including the effect of the requested interim increase. This is below the 2.0 times interest coverage requirement in the Company's debt covenants.

IV. STAFF'S CALCULATIONS OF FINANCIAL INDICATORS

Q. Please describe the calculations of financial indicators Staff has performed to determine Verizon NW's financial condition in the near term.

A. Staff's calculations are reflected in my Exhibit No. ___ (PMS-4). In order to present the Commission with a more comprehensive picture of Verizon NW's financial situation, and to recognize that much of the Company's financial data is not available at a Washington intrastate level, Staff presents calculations of financial ratios based on Verizon NW's Washington intrastate results of operations; based on the Company's total Washington operations; and based on total company operations.[4] These ratios are presented both with and without the addition of the $29.7 million interim increase requested by Verizon.

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[4] For consistency, the Washington intrastate results exclude any normalizing, restating or Commission basis adjustments.

Q. Why is it appropriate to look beyond Verizon NW's intrastate operations in calculating these financial indicators?

A. As more fully discussed in Ms. Folsom's testimony, Verizon NW (total company) is the entity that operates in Washington and provides Washington intrastate services; Verizon NW's Washington intrastate operations do not constitute a stand-alone legal or operating entity.

As I stated earlier in this testimony, much of the information used as inputs to calculations of financial indicators is not maintained at an intrastate or state level. Verizon NW does not issue financings, develop budgets, or perform construction on a Washington-intrastate stand-alone basis.

Therefore, in applying the Commission's interim rate relief factors to Verizon NW's operations, the Commission should look at the operating level at which the company finances; budgets; and builds. This level is Verizon NW. This level of review is consistent with the Commission's orders in other recent interim relief cases.

Q. What are the results of your calculations?

A. The following table summarizes the results. For comparison purposes, the ratios calculated by Dr. Vander Weide for the same period are also presented. A comparison of the ratios calculated for Verizon's unrestated results for Washington intrastate operations, to the median financial ratios presented in Table 2 of Dr. Vander Weide's testimony (Exhibit No. ___ (JHV-4T), at 12), indicates that the ratios calculated for Washington intrastate operations (Column (b) of Table 1) would fall in the "BBB" to "A" range for the EBITDA Interest Coverage and FFO/Total Debt criteria, and between "B" and "BB" for the EBIT interest coverage criterion.

Table 1
Summary of Financial Ratios for
Verizon Northwest, Verizon Washington, and
Verizon Washington Intrastate before Restatement

		Intrastate Restated JHV-4T p.9	Intrastate Unrestated PMS-4	Verizon Washington	Verizon Northwest
	Financial Indicator	(a)	(b)	(c)	(d)
	EBIT Interest Coverage				
1	Without interim increase	-0.7	0.9	4.8	4.9
2	With Increase	0.6	1.7	5.4	5.3
	EBITDA Interest Coverage				
3	Without interim increase	4.8	6.4	10.6	11.0
4	With Increase	6.1	7.2	11.3	11.4
	FFO/Average Debt				
5	Without interim increase	29.9%	36.5%	50.8%	55.5%
6	With Increase	35.5%	42.0%	55.0%	58.1%

Q. Why are the ratios for EBITDA Interest Coverage and FFO/Average Debt higher than the EBIT Interest Coverage ratio?

A. As shown at Exhibit No. ___ (PMS-4), page 1, EBITDA and Funds from Operations are both calculated from net income, with depreciation and amortization expense (a large non-cash expense item) added back. These calculations provide some information about cash flow provided by Verizon NW's Washington intrastate operations, even though Verizon NW does not prepare or maintain comprehensive cash flow statements at the Washington intrastate level. The levels of EBITDA and funds from operations calculated in my exhibit, when compared to Verizon's planned total state construction budget for 2004 and its test year interest expense, indicate that Verizon NW's Washington intrastate operations generate cash flow sufficient to fund its construction and financing needs for intrastate purposes during the processing of the Company's general rate case.

Q. Did Staff perform calculations of other financial indicators?

A. Yes. In addition to recalculating the financial ratios offered by Dr. Vander Weide, Staff presents a summary of Verizon NW's capital structure for the test year and for the years 1999 through 2002. Because the Company does not maintain balance sheets, and therefore debt and equity accounts, at either a state or intrastate level, capital structure data is only available at the Verizon NW level.

Staff calculated the test year equity both before and after the $29.7 requested revenue increase, which Verizon NW estimates would result in an increase to net operating income of $19 million.

Q. What does this analysis show?

A. It shows that Verizon NW has maintained a relatively healthy capital structure since 1999. From 1999 to the test year, its equity component of capital has increased from 58.44% to 62.25%. As Staff witness Ms. Folsom discusses in her testimony, the Company has maintained this level of equity while also paying dividends every year to its parent company.

Q. Can you please summarize the conclusions you reach based on your analysis of Verizon NW's request for interim rate relief?

A. Based on my review and analysis, I conclude that Verizon NW's decline in Washington intrastate earnings has been a gradual, rather than emergent, condition.

Some of the major causes of a decline in Verizon NW's rate of return for its Washington intrastate jurisdiction were the result of actions the Company took, or failed to take, to address that decline. For example, the Company failed to identify at least one significant cause for the earnings decline – the reduction of revenues the Company had retained from directory advertising. This revenue reduction, along with questions about the Company's allocation of expenses and plant to the intrastate jurisdiction, and its failure to timely file for rate relief to address a declining rate of return, raises doubts about whether or not the Company is experiencing "gross hardship" or "gross inequity" that requires interim rate relief, rather then waiting until the general rate case is complete.

I also conclude that the Company's Washington intrastate operations generate cash flow that is sufficient to meet the Company's immediate construction and financing needs during the course of the general rate case.

Q. Does this conclude your testimony?

A. Yes.