

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

**In The Matter Of The Petition Of)
Verizon Northwest Inc. Seeking)
Interim Rate Increase)**

DOCKET NO. UT-040788

REBUTTAL TESTIMONY OF
JAMES H. VANDER WEIDE, Ph.D.
ON BEHALF OF
VERIZON NORTHWEST INC.

JULY 30, 2004

1 **Q. WHAT IS YOUR NAME AND BUSINESS ADDRESS?**

2 A. My name is James H. Vander Weide. I am Research Professor of Finance and
3 Economics at the Fuqua School of Business of Duke University. I am also President
4 of Financial Strategy Associates, a firm that provides strategic and financial consulting
5 services to business clients. My business address is 3606 Stoneybrook Drive,
6 Durham, North Carolina.

7

8 **Q. ARE YOU THE SAME JAMES H. VANDER WEIDE WHO PROVIDED**
9 **DIRECT TESTIMONY IN THIS PROCEEDING FILED ON APRIL 30, 2004?**

10 A. Yes, I am.

11

12 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

13 A. I have been asked by Verizon Northwest Inc. (“Verizon NW”) to respond to the
14 following issues raised in the direct testimonies of Mr. Charles W. King and Ms.
15 Kathleen M. Folsom:

16 1. Should the Washington Utilities and Transportation Commission (“the
17 Commission”) consider the financial results of non-jurisdictional businesses in
18 assessing Verizon NW’s request for interim rate relief?

19 2. Are Verizon NW’s earnings from intrastate operations in Washington State
20 sufficient to cover its interest expense and capital expenditures in Washington
21 State?

22 3. Will the granting of Verizon NW’s request for interim rate relief alleviate the
23 financial distress of Verizon NW’s intrastate operations in Washington State until
24 the Company’s rate case can be decided?

25 Mr. King’s testimony is presented on behalf of Public Counsel, AARP, and WeBTEC,
26 and Ms. Folsom’s testimony is presented on behalf of the Staff of the Washington
27 Utilities and Transportation Commission.

1 ***I. THE COMPANY'S NEED FOR INTERIM RATE RELIEF SHOULD ONLY BE***
2 ***BASED ON THE FINANCIAL RESULTS OF ITS WASHINGTON INTRASTATE***
3 ***OPERATIONS.***

4
5 **Q. WHAT IS THE BASIS OF VERIZON NW'S REQUEST FOR INTERIM RATE**
6 **RELIEF IN THIS PROCEEDING?**

7 A. Verizon NW requests interim rate relief on the grounds that its Washington intrastate
8 business, which the Commission has an obligation to consider as a stand-alone
9 company, faces such serious financial problems that the granting of interim rate relief
10 is required.

11
12 **Q. DO MR. KING AND MS. FOLSOM SUPPORT VERIZON NW'S REQUEST**
13 **FOR INTERIM RATE RELIEF IN THIS PROCEEDING?**

14 A. No. Mr. King and Ms. Folsom argue that Verizon NW's request for interim rate relief
15 should be denied because Verizon NW finances its activities at the total company
16 level, and the company's non-Washington jurisdictional operations are sufficiently
17 healthy to allow Verizon NW to meet its Washington intrastate financial obligations
18 until its rate case is decided.

19
20 **Q. IS MR. KING'S AND MS. FOLSOM'S ARGUMENT THAT THE FINANCIAL**
21 **RESULTS OF NON-JURISDICTIONAL OPERATIONS SHOULD BE**
22 **CONSIDERED IN ASSESSING VERIZON NW'S REQUEST FOR INTERIM**
23 **RATE RELIEF IN WASHINGTON STATE CONSISTENT WITH THE**
24 **COMMISSION'S CONCLUSIONS IN ORDER NO. 5, ISSUED JULY 2, 2004?**

1 A. No. In Order No. 5, the Commission stated that the request for interim rate relief
2 should be judged based only on Verizon’s Washington intrastate operations. In
3 paragraph 20, the Commission states:

4 We conclude that it would be inappropriate to say, as the joint parties
5 seem to argue, that Verizon should be ineligible for interim rate relief
6 because the non-jurisdictional operations are sufficiently healthy that
7 intrastate customers should not bear the responsibility to sustain their
8 own capital needs in the same way they would if the company operated
9 in a single jurisdiction. We find it appropriate to consider the
10 Company’s need for interim rate relief based on a Washington
11 intrastate basis only,¹ and to determine whether the level of its intrastate
12 revenues constitutes a “gross inequity” justifying interim relief.

13 Thus, the Commission has already clearly rejected the positions advanced by Mr. King
14 and Ms. Folsom.

15

16 **Q. DOES THE COMMISSION EXPLAIN WHY IT CONCLUDED IN ORDER**
17 **NO. 5 THAT VERIZON NW’S REQUEST FOR INTERIM RATE RELIEF**
18 **SHOULD BE JUDGED SOLELY ON THE RESULTS OF VERIZON NW’S**
19 **WASHINGTON INTRASTATE OPERATIONS?**

20 A. Yes. In paragraph 19 of Order No. 5, the Commission states:

21 In the present situation, Verizon's Washington intrastate operations are
22 a small portion of a broader business. Its intrastate operations have
23 been subjected to a significant precipitating factor²— the access charge
24 decision, which is totally intrastate in nature. There is a marked
25 difference, according to Verizon's version of the facts, in performance
26 between the company as a whole and Verizon’s Washington intrastate
27 operations, so looking to the broader company operations would shift a
28 burden of support away from intrastate ratepayers to the other
29 customers of the Company.

¹ Of course, non-jurisdictional activities must be considered to the extent necessary to determine the appropriate separations that define the intrastate jurisdictional activities.

² We note that the access charge decision forms only about one-eighth of Verizon’s claimed need.

1 The Commission also notes in paragraph 16 and 17:

2 The Commission would certainly look with dismay on a situation in
3 which the roles were reversed, and Verizon sought interim relief from
4 the Commission while it was earning its rate of return on intrastate
5 operations because its non-jurisdictional revenues were doing so poorly
6 that it could not finance needed services.

7 ...It is inappropriate to demand that a small piece of a large company
8 cause the overall business to fall into jeopardy as a minimum criterion
9 for a grant of interim rates.

10

11 **Q. DO YOU AGREE WITH THE COMMISSION'S POSITION THAT INTERIM**
12 **RATE RELIEF SHOULD BE BASED ONLY ON THE RESULTS OF**
13 **VERIZON NW'S WASHINGTON INTRASTATE OPERATIONS?**

14 A. Yes. As an economist, I believe that the Commission's position is well taken. If
15 Verizon NW's Washington intrastate operations are financially unhealthy on a stand-
16 alone basis, Verizon NW will have no incentive to continue to invest in its
17 Washington intrastate operations. Furthermore, there is no justification on economic
18 grounds to require customers in other jurisdictions to support customers in
19 Washington State. Economic theory suggests that cost causers should be charged for
20 the costs the company incurs on their behalf. Since Verizon NW's Washington
21 intrastate customers are the cause of the operating and capital expenditures made on
22 their behalf, they should be charged for these costs.

23

1 **II. VERIZON NW'S EARNINGS FROM WASHINGTON INTRASTATE**
2 **OPERATIONS ARE INSUFFICIENT TO COVER BOTH THE INTEREST ON ITS**
3 **DEBT AND ITS CAPITAL EXPENDITURES.**

4
5 **Q. ARE VERIZON NW'S EARNINGS FROM WASHINGTON INTRASTATE**
6 **OPERATIONS SUFFICIENT TO ALLOW VERIZON NW TO PAY THE**
7 **INTEREST ON ITS DEBT AND CONTINUE TO INVEST IN ITS NETWORK**
8 **IN WASHINGTON STATE?**

9 A. No. As shown in Exhibit No.__(JHV-5) of my direct testimony, Verizon NW's
10 Washington intrastate EBIT interest coverage is negative 0.7 without rate relief. This
11 figure indicates that Verizon NW's earnings from Washington intrastate operations are
12 insufficient to allow Verizon NW to pay its interest expenses and continue to invest in
13 its network in Washington State.

14
15 **Q. HAS THE COMMISSION RECOGNIZED IN PREVIOUS INTERIM RATE**
16 **PROCEEDINGS THE NEED TO ALLOW A COMPANY SUFFICIENT**
17 **EARNINGS ON ITS INTRASTATE OPERATIONS TO PAY THE INTEREST**
18 **ON ITS DEBT?**

19 A. Yes. In *WUTC v. Olympic Pipe Line Co.*, Docket No. TO-011472, the Commission
20 used a times interest earned ratio of 1.5 to determine the amount of the company's
21 interim rate relief. (See direct testimony of Paula M. Strain, page 8.) Verizon NW's
22 times interest earned ratio, based on intrastate earnings, is significantly less than 1.5.
23 Applying the criteria in the *Olympic Pipe Line* case, the Commission should grant
24 Verizon NW's request for interim rate relief.

1 **Q. DO EITHER MR. KING OR MS. FOLSOM PROVIDE ANY EVIDENCE TO**
2 **DISPROVE YOUR CONCLUSION THAT VERIZON NW'S EARNINGS**
3 **FROM WASHINGTON INTRASTATE OPERATIONS ARE INSUFFICIENT**
4 **TO ALLOW VERIZON NW TO PAY ITS INTEREST EXPENSE AND TO**
5 **CONTINUE TO INVEST IN ITS NETWORK IN WASHINGTON STATE?**

6 A. No. However, Mr. King and Ms. Folsom argue that the Commission should consider
7 Verizon NW's cash flows from Washington intrastate operations rather than its
8 earnings. They argue, in part, that Verizon NW's request for interim rate relief should
9 be denied because they claim that Verizon NW's cash flows from Washington
10 intrastate operations were approximately equal to the sum of Verizon NW's interest
11 expense and capital expenditures for the 12-month period ending September 30, 2003.

12
13 **Q. DO YOU AGREE WITH MR. KING'S AND MS. FOLSOM'S ASSERTIONS**
14 **THAT VERIZON NW GENERATES SUFFICIENT CASH FROM INTERNAL**
15 **OPERATIONS TO COVER BOTH ITS INTEREST EXPENSE AND ITS**
16 **CAPITAL EXPENDITURES WITHOUT RATE RELIEF?**

17 A. No. While I agree that Verizon NW's cash from operations was approximately equal
18 to the sum of its interest expense and capital expenditures for the 12-month period
19 ending September 30, 2003, these data fail to recognize that Verizon NW's revenues
20 from Washington intrastate operations are declining and that Verizon NW also has a
21 commitment to provide a return on investment to its parent to justify continuing
22 investment. Furthermore, as I explained in my direct testimony, the financial
23 community requires a cash flow coverage ratio significantly greater than 1.0 to

1 consider a company to be an investment-grade risk. There can be little doubt that if
2 Verizon NW's intrastate operations in Washington are considered on a stand-alone
3 basis, neither its earnings nor its cash flows are sufficient to justify an investment-
4 grade bond rating and continued investment in Washington State.

5
6 **Q. MR. KING ASSERTS ON PAGES 10 – 11 THAT VERIZON NW'S SERVICES**
7 **IN OTHER JURISDICTIONS ARE NOT “SUBSIDIZING” WASHINGTON**
8 **INTRASTATE SERVICES. HOW DOES MR. KING ATTEMPT TO DEFEND**
9 **THIS ASSERTION?**

10 A. Mr. King argues that Verizon NW's services in other jurisdictions cannot possibly be
11 subsidizing Washington intrastate services because rates for Verizon NW's services in
12 other jurisdictions are set independently from rates for Washington intrastate services.

13
14 **Q. IS MR. KING'S ARGUMENT CONSISTENT WITH THE ECONOMIC**
15 **DEFINITION OF “SUBSIDIZATION”?**

16 A. No. Economists define subsidization as a situation where one of a company's services
17 is priced above long-run average cost, and hence provides a subsidy, while another
18 service is priced below long-run average cost, and hence receives a subsidy.
19 Independence of the rate-setting process is irrelevant for the economic definition of
20 subsidization.

21

1 Q. DO YOU HAVE ANY EVIDENCE THAT VERIZON NW'S SERVICES IN
 2 OTHER JURISDICTIONS "SUBSIDIZE" WASHINGTON INTRASTATE
 3 OPERATIONS?

4 A. Yes. One way to measure whether services in other jurisdictions subsidize
 5 Washington intrastate operations is to compare the operating margins Verizon NW
 6 earns in other jurisdictions to its operating margin on Washington intrastate services.
 7 The data shown below in Table 1 [which is based on data shown in Ms. Heuring's
 8 Rebuttal Exhibit __ (NWH-10)] indicate that the operating margin for Verizon NW's
 9 services in other jurisdictions is 24%, whereas the operating margin for the
 10 Washington intrastate operations is negative 8%. These data provide strong support
 11 for the conclusion that Verizon NW's services in other jurisdictions subsidize its
 12 Washington intrastate service.

13 **Table 1**
 14 **Operating Margin on Washington Intrastate Operations**
 15 **Compared to Verizon Northwest's Other Jurisdictions—2003**

	Jurisdiction	Revenue	Net Operating Income	Operating Margin
1	Verizon NW States			
2	Washington	678,809	73,122	11%
3	Other State Jurisdictions	484,461	87,418	18%
4	TOTAL Verizon Northwest	1,163,270	160,540	14%
5	Washington State			
6	Interstate/Non-regulated/Other	312,816	101,750	33%
7	Intrastate	365,569	(28,629)	-8%
8	TOTAL Washington State	678,385	73,121	11%
9	Summary			
10	All other jurisdictions	797,277	189,168	24%
11	Washington Intrastate	365,569	(28,629)	-8%

17

1 **Q. ON PAGE 31 OF HER TESTIMONY, MS. FOLSOM CLAIMS THAT**
2 **VERIZON NW DOES NOT MAINTAIN CASH FLOW INFORMATION ON A**
3 **WASHINGTON INTRASTATE BASIS. IS IT POSSIBLE TO ESTIMATE THE**
4 **CASH FLOWS FROM VERIZON NW'S WASHINGTON INTRASTATE**
5 **OPERATIONS WITHOUT A CASH FLOW STATEMENT?**

6 A. Yes. Using reasonable assumptions about the separations process, one can estimate
7 the cash flows generated from Verizon NW's Washington intrastate operations from
8 the information shown in Exhibit ___(JHV-5) of my direct testimony. Specifically,
9 the net cash flow from Washington intrastate operations would equal EBITDA minus
10 interest paid minus capital expenditures. These data indicate that the cash flow from
11 the company's Washington intrastate operations for the 12 months ending
12 September 30, 2003, was barely sufficient to cover interest expenses plus capital
13 expenditures.

14
15 **Q. MS. FOLSOM STATES ON PAGE 30 OF HER TESTIMONY THAT**
16 **VERIZON NW PAID SIGNIFICANT DIVIDENDS TO ITS PARENT OVER**
17 **THE YEARS 1999 TO 2003. IS INFORMATION REGARDING VERIZON**
18 **NW'S TOTAL COMPANY DIVIDENDS RELEVANT TO THE REQUEST**
19 **FOR INTERIM RATE RELIEF IN WASHINGTON STATE?**

20 A. No. The Commission clearly stated in Order No. 5 that Verizon NW's request for rate
21 relief in this proceeding should be based on the results of its Washington intrastate
22 operations only. Since the dividends paid by Verizon NW's total company operations

1 are based on the results of its non-Washington jurisdictional operations, they are
2 irrelevant to the request for interim rate relief in this proceeding.

3
4 **Q. DO THE DATA IN EXHIBIT__(JHV-5) OF YOUR DIRECT TESTIMONY**
5 **CONTAIN INFORMATION REGARDING THE ABILITY OF VERIZON**
6 **NW'S WASHINGTON INTRASTATE OPERATIONS TO CONTRIBUTE**
7 **DIVIDENDS TO THE PARENT?**

8 A. Yes. As noted above, these data indicate that the cash flows from Washington
9 intrastate operations were barely sufficient to cover interest expense and capital
10 expenditures for the 12 months ending September 30, 2003. Since interest expense
11 and capital expenditures must be paid before any dividend payments to the parent, the
12 cash flows from Washington intrastate operations for the 12 months ending
13 September 30, 2003 were insufficient to pay dividends to the parent. Furthermore,
14 Verizon NW's EBIT from Washington State operations is trending downward.

15
16 ***III. THE GRANTING OF VERIZON NW'S REQUEST FOR INTERIM RATE RELIEF***
17 ***WOULD ALLEVIATE THE FINANCIAL DISTRESS IN VERIZON NW'S***
18 ***WASHINGTON INTRASTATE OPERATIONS UNTIL THE COMPANY'S RATE***
19 ***CASE CAN BE DECIDED.***

20
21 **Q. DO MR. KING AND MS. FOLSOM SUGGEST ANY OTHER REASONS WHY**
22 **THEY BELIEVE VERIZON NW'S REQUEST FOR INTERIM RATE RELIEF**
23 **SHOULD BE DENIED?**

1 A. Yes. Mr. King and Ms. Folsom argue that Verizon NW has provided no evidence that
2 granting its request would alleviate the financial distress in the company's Washington
3 intrastate operations.

4
5 **Q. DO YOU HAVE ANY EVIDENCE TO SUPPORT VERIZON NW'S POSITION**
6 **THAT GRANTING ITS REQUEST FOR INTERIM RATE RELIEF WOULD**
7 **ALLEVIATE THE FINANCIAL DISTRESS IN ITS WASHINGTON**
8 **INTRASTATE OPERATIONS UNTIL ITS RATE CASE CAN BE DECIDED?**

9 A. Yes. Verizon NW's \$29.7 million request for interim rate relief is equal to the \$29.7
10 million revenue reduction in Commission-ordered access charges in Docket No. UT-
11 020406. Thus, if Verizon NW's request for rate relief is granted, the financial ratios
12 associated with its Washington intrastate operations would likely approximate the
13 ratios shown in Exhibit___(JHV-5) in my direct testimony, that is, Verizon NW's
14 Washington intrastate EBIT interest coverage, EBITDA interest coverage, and funds
15 from operations/total debt ratio would be approximately 0.6, 6.1, and 35.5%,
16 respectively. As shown in Table 2 in my direct testimony, taken together, these ratios
17 would be just sufficient to justify the lowest investment-grade bond rating of BBB. In
18 contrast, I demonstrated in my direct testimony that without rate relief Verizon NW's
19 key financial ratios from Washington intrastate operations would fail to justify an
20 investment-grade bond rating and continued investment by its parent.

21

22 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

23 A. Yes, it does.