Exhibit No. ____ (JHV-4T)
Interim Rate Relief Filing
Docket No. UT-

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In The Matter Of The Petition Of	**)**	
Verizon Northwest Inc. Seeking	**)**	**DOCKET NO. UT-**
Interim Rate Increase	**)**	

DIRECT TESTIMONY OF

JAMES H. VANDER WEIDE, Ph.D.

ON BEHALF OF
VERIZON NORTHWEST INC.

APRIL 30, 2004

Q. WHAT IS YOUR NAME AND BUSINESS ADDRESS?

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

Q. WOULD YOU PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND PRIOR ACADEMIC EXPERIENCE?

A. I graduated from Cornell University in 1966 with a Bachelor's Degree in Economics. I then attended Northwestern University where I earned a Ph.D. in Finance. In January 1972, I joined the faculty of the School of Business at Duke University and was named Assistant Professor, Associate Professor, and then Professor.

Since joining the faculty, I have taught courses in corporate finance, investment management, and management of financial institutions. I have taught a graduate seminar on the theory of public utility pricing and lectured in executive development seminars on the cost of capital, financial analysis, capital budgeting, mergers and acquisitions, real options, cash management, short-run financial planning, and competitive strategy. I have conducted seminars and training sessions on similar topics for a wide variety of U.S. and international companies, including ABB, Accenture, Allstate, Ameritech, AT&T, Bell Atlantic, BellSouth, Carolina Power & Light, Contel, Fisons, Glaxo Wellcome, GTE, Lafarge, MidAmerican Energy, New Century Energies, Norfolk Southern, Pacific Bell

Telephone, The Rank Group, Siemens, Southern New England Telephone, TRW, and Wolseley PLC. I have also served as Program Director of executive education programs at the Fuqua School of Business, including the Duke Advanced Management Program, the Duke Executive Program in Telecommunications, Competitive Strategies in Telecommunications, and the Duke Program for Manager Development for managers from the former Soviet Union.

In addition to my teaching and executive education activities, I have written research papers on such topics as portfolio management, the cost of capital, capital budgeting, the effect of regulation on the performance of public utilities, and cash management. My articles have been published in *American Economic Review, Financial Management, International Journal of Industrial Organization*, *Journal of Finance, Journal of Financial and Quantitative Analysis*, *Journal of Bank Research*, *Journal of Accounting Research*, *Journal of Cash Management*, *Management Science, The Journal of Portfolio Management*, *Atlantic Economic Journal*, *Journal of Economics and Business*, and *Computers and Operations Research.* I have written a book titled *Managing Corporate Liquidity: An Introduction to Working Capital Management* and a chapter for *The Handbook of Modern Finance*, "Financial Management in the Short Run."

Q. HAVE YOU PREVIOUSLY TESTIFIED ON FINANCIAL OR ECONOMIC ISSUES?

A. Yes. As an expert on financial and economic theory, I have testified on the cost of capital, competition, risk, incentive regulation, forward-looking economic cost, economic pricing guidelines, depreciation, accounting, valuation, and other financial and economic issues in approximately 350 cases before the U.S. Congress, the Canadian Radio-Television and Telecommunications Commission, the Federal Communications Commission, the National Telecommunications and Information Administration, the Federal Energy Regulatory Commission, the public service commissions of 40 states, the insurance commissions of five states, the Iowa State Board of Tax Review, and the National Association of Securities Dealers. In addition, I have testified as an expert witness in proceedings before the U.S. District Court, District of Nebraska; U.S. District Court, Eastern District of North Carolina; Superior Court, North Carolina; the U.S. Bankruptcy Court, Southern District of West Virginia, and the United States District Court for the Eastern District of Michigan. With respect to implementation of the Telecommunications Act of 1996, I have testified in 26 states and in Washington, D.C. on issues relating to the pricing of unbundled network elements and universal service cost studies. I have also consulted with Bell Canada, Deutsche Telekom, and Telefónica on similar issues.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been asked by Verizon Northwest Inc. ("Verizon NW") to assess the financial condition of Verizon NW's intrastate operations in Washington and to determine whether its financial condition is sufficient to support an investment-grade credit rating and to allow Verizon NW to attract the capital required to provide telecommunications services. As I explain below, the answer to both these questions is "no".

Q. WHY HAVE YOU BEEN ASKED TO ASSESS THE FINANCIAL CONDITION OF VERIZON NW'S INTRASTATE OPERATIONS?

A. The Washington Utilities and Transportation Commission ("WUTC") has adopted six guidelines for evaluating the necessity of interim rate relief, including an assessment of the applicant's financial condition as measured by key financial indices. (See *WUTC v. PNB*, Cause No. U-72-30, Second Supplemental Order, Oct. 10, 1972). My testimony discusses these key financial indices.

Q. IS VERIZON NW REQUIRED TO REPORT THE FINANCIAL RESULTS OF ITS INTRASTATE OPERATIONS TO THE COMMISSION ON A REGULAR BASIS?

A. Yes. Verizon NW is required to report the financial results of its intrastate operations to the Commission on a quarterly basis.

Q. WHAT HAS BEEN THE FINANCIAL CONDITION OF VERIZON NW'S INTRASTATE OPERATIONS IN WASHINGTON STATE OVER THE LAST SEVERAL YEARS?

A. As reported in its Quarterly Surveillance Reports to the Commission, Verizon NW's earnings before interest and taxes ("EBIT") has declined from $159.2 million in 1999 to $36.2 million in 2002. Verizon NW's EBIT for the 12 months ending September 30, 2003, as reported in the Quarterly Surveillance Report, declined further to *negative* $12.4 million.

Q. DO THE DATA CONTAINED IN THE QUARTERLY SURVEILLANCE REPORTS REFLECT THE COMMISSION'S ACCESS CHARGE REDUCTIONS IN DOCKET NO. UT-020406?

A. Yes. The $29.7 million rate reduction in that docket was reflected in the Quarterly Surveillance Report for the 12 months ending September 30, 2003. And, in fact, this reduction must be included in any calculation of EBIT that is meant to reflect Verizon NW's financial performance for the test year (12 months ending September 30, 2003).

Q. IN ADDITION TO THE $29.7 MILLION REDUCTION IN INTRASTATE ACCESS CHARGES, ARE ANY OTHER ADJUSTMENTS REQUIRED TO REFLECT VERIZON NW'S FINANCIAL PERFORMANCE FOR THE TEST YEAR?

A. Yes. Verizon NW witness Nancy Heuring describes several additional restating adjustments that are required to reflect Verizon NW's EBIT for the test year. My analysis of the financial condition of Verizon NW's intrastate operations on a going-forward basis relies on the data presented in Ms. Heuring's testimony.

Q. HOW DID YOU DETERMINE WHETHER VERIZON NW'S FINANCIAL CONDITION IS SUFFICIENT TO ASSURE CONFIDENCE IN ITS FINANCIAL INTEGRITY, MAINTAIN ITS CREDIT, AND ATTRACT CAPITAL?

A. I determined whether Verizon NW's financial condition is sufficient to assure confidence in its financial integrity, maintain its credit, and attract capital by seeking answers to the following four questions:

1. Are Verizon NW's earnings and cash flows sufficient to allow Verizon NW to pay the interest and principal on its debt?

2. Are Verizon NW's earnings and cash flows sufficient to allow Verizon NW to continue to invest in its network in Washington State?

3. Are Verizon NW's financial ratios sufficient to maintain its credit and assure access to the capital markets?

4. Is Verizon NW earning a return on its investment that is commensurate with returns on other investments of the same risk?

Q. HOW DID YOU MEASURE WHETHER VERIZON NW'S EARNINGS AND CASH FLOWS ARE SUFFICIENT TO PAY THE INTEREST AND PRINCIPAL ON ITS DEBT?

A. I examined the values of three key financial ratios used by Standard & Poor's to assess a company's ability to pay the interest and principal on its debt: (1) EBIT interest coverage; (2) EBITDA interest coverage; and (3) funds from operations ("FFO") to total debt. To calculate these ratios, I assumed that Verizon NW's intrastate operations were financed with the same proportion of debt and equity as Verizon NW's total operations. Verizon NW's total operations are financed with 8.14% short-term debt, 29.91% long-term debt, and 61.95% common equity.

Q. HOW ARE THESE FINANCIAL RATIOS DEFINED?

A. EBIT interest coverage is defined as earnings from continuing operations before interest and taxes divided by interest. EBITDA interest coverage is defined as earnings from continuing operations before interest, taxes, depreciation, and amortization divided by interest. FFO to total debt is defined as earnings from continuing operations before depreciation and amortization and changes in deferred taxes divided by total debt.

Q. CAN YOU DESCRIBE MORE FULLY HOW THESE RATIOS ARE CALCULATED?

A. Yes. As shown on Exhibit JHV-5, the EBIT interest coverage of 1.5 times in 2002, for example, is equal to earnings before interest and taxes of $36.2 million divided by gross interest paid of $24.5 million. This calculation is based on gross interest paid rather than interest expense because interest expense includes allowance for funds used during construction ("AFUDC"), and AFUDC does not represent an actual current interest expense savings.

Similarly, the EBITDA interest coverage of 6.7 times in 2002 is equal to earnings before interest, taxes, depreciation, and amortization of $163 million divided by gross interest paid of $24.5 million.

Finally, the FFO/total debt of 37.7% in 2002 is equal to funds from operations of $138.8 million divided by average total debt of $368.5 million.

Q. WHAT DO EBIT INTEREST COVERAGE, EBITDA INTEREST COVERAGE, AND FFO/TOTAL DEBT MEASURE?

A. EBIT interest coverage measures the extent to which a company's operating income can decline before the company is unable to meet its interest obligations. For example, if

EBIT interest coverage is equal to 2, then the company's earnings before interest and taxes can decline by 50% and still be sufficient to pay the interest on its debt obligations.

EBITDA interest coverage is similar to the EBIT interest coverage ratio, but it measures interest coverage relative to the company's operating cash flows rather than operating income. EBITDA interest coverage ratios are generally significantly higher than EBIT interest coverage ratios. However, the rating agencies put less emphasis on EBITDA interest coverage in their financial ratio analysis than they do EBIT interest coverage because EBITDA interest coverage does not take into account that depreciated assets will need to be replaced in order to maintain on-going operations.

Both the EBIT interest coverage and the EBITDA interest coverage ratios reflect only a company's ability to repay the interest on its debt, not the outstanding principal. The FFO/total debt ratio, also known as the cash flow ratio, is a measure of the company's ability to generate cash to pay the principal on its debt obligations, assuming all cash flow from operations is devoted to debt repayment. The lower the ratio, the less financial flexibility the company has to raise capital, and the more likely that financial problems could arise in the future.

Q. HAVE YOU CALCULATED THE VALUE OF THESE THREE KEY FINANCIAL RATIOS FOR VERIZON NW'S INTRASTATE OPERATIONS IN WASHINGTON STATE?

A. Yes. The values of these three financial ratios for Verizon NW's intrastate operations in Washington State are summarized in Table 1 below. Data shown for the years 1999 through 2002 are actual data for the 12 months ending December 31 as reported in Verizon NW's Quarterly Surveillance Reports to the Commission. The data for 2003 Restated are for the 12 months ending September 30, 2003, as adjusted for certain out-of-period adjustments described in the testimony of Verizon NW Witness Heuring. The data for 2003 With Access Reduction is the best measure of going-forward earnings.

Table 1
Summary of Key Financial Ratios for
Verizon NW's Intrastate Operations in Washington State

Criterion	2003 With Access Reduction	2003 Restated	2002	2001	2000	1999
EBIT Interest Coverage	(0.7)	0.6	1.5	2.1	1.8	5.5
EBITDA Interest Coverage	4.8	6.1	6.7	6.3	5.4	9.4
FFO/Total Debt Ratio	29.9%	35.5%	37.7%	40.4%	38.2%	57.6%

Q. FROM YOUR ANALYSIS OF THESE FINANCIAL RATIOS, WHAT ARE YOUR CONCLUSIONS REGARDING VERIZON NW'S ABILITY TO PAY THE INTEREST ON ITS DEBT?

A. I conclude that Verizon NW's ability to pay the interest and principal on its debt has deteriorated significantly since 1999. Indeed, Verizon NW's EBIT interest coverage ratio declined from 5.5 in 1999 to *negative* 0.7, its EBITDA interest coverage declined from 9.4 to 4.8, and its FFO/total debt ratio declined from 57.6% to 29.9%. These data further suggest that Verizon NW's 2003 earnings With Access Reduction are insufficient to pay even the interest on its debt.

Q. WHAT DO VERIZON NW'S FINANCIAL RATIOS INDICATE REGARDING VERIZON NW'S ABILITY TO CONTINUE TO INVEST IN ITS NETWORK IN WASHINGTON STATE?

A. Since Verizon NW's 2003 earnings With Access Reduction are insufficient to pay the interest on its debt, Verizon NW's earnings are clearly insufficient to allow the company to continue to invest in its network in Washington State.

Q. WHAT IS VERIZON NW'S TARGET BOND RATING?

A. Verizon NW targets its bond rating to be no lower than A.

Q. IS AN "A" BOND RATING A REASONABLE TARGET RATING FOR VERIZON NW?

A. Yes. Investors consider debt securities rated in the four highest categories, which include AAA, AA, A, and BBB, to be investment grade, whereas debt securities rated BB and below are considered to be speculative grade. Institutional investors are generally prohibited from investing in speculative-grade securities, and many individual investors voluntarily limit their bond investments to investment-grade securities. Thus, if Verizon NW's debt were rated below investment grade, Verizon NW would be unable to obtain financing from these investors, and its access to the capital markets would be severely limited.

Furthermore, an A bond rating gives Verizon NW the flexibility to issue additional debt, even if competition continues to erode its local exchange revenues. Since a BBB rating is only marginally investment grade, Verizon NW's flexibility to access the capital markets in difficult times would be reduced if its bond rating were lowered to BBB. For example, Standard & Poor's points out that "adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity" of a BBB-rated "obligor to meet its financial commitment on the obligation".[1]

Q. IS THE FINANCIAL RISK PROFILE OF VERIZON NW'S STAND-ALONE INTRASTATE OPERATIONS IN WASHINGTON STATE CONSISTENT WITH AN "A" BOND RATING?

A. No. Verizon NW's EBIT interest coverage, EBITDA interest coverage, and FFO/total debt ratios are below the values required for an A bond rating. The median values of these ratios for companies with an A bond rating are: EBIT interest coverage, 6.3; EBITDA interest coverage, 8.5; and FFO/total debt, 42.2. (See Table 2 below.) In contrast, Verizon NW's EBIT interest coverage, based on 2003 earnings With Access Reduction, is *negative* 0.7; its EBITDA interest coverage ratio is 4.8; and its FFO/total debt ratio is 29.9%.

[1] www.ratingsdirect.com, *Standard & Poor's Corporate Ratings Criteria*, 2004, pp. 7-8.

Table 2[2]
Median Financial Ratios for
U.S. Industrial Companies with Different Bond Ratings

Criterion	AAA	AA	A	BBB	BB	B	CCC	Verizon NW
EBIT interest coverage (x)	23.4	13.3	6.3	3.9	2.2	1.0	0.1	(0.7)
EBITDA interest coverage (x)	25.3	16.9	8.5	5.4	3.2	1.7	0.7	4.8
FFO/total debt (%)	214.2	65.7	42.2	30.6	19.7	10.4	3.2	29.9

Q. WHAT BOND RATING IS IMPLIED BY THE FINANCIAL RATIOS FOR VERIZON NW'S INTRASTATE OPERATIONS IN WASHINGTON STATE?

A. The financial ratios associated with the Verizon NW's Washington intrastate operations would likely support a bond rating of only BB. This conclusion is based on my observations that Verizon NW's *negative* 0.7 EBIT interest coverage ratio, based on 2003 earnings With Access Reduction, is below the median EBIT interest coverage ratio of industrial companies with the lowest non-bankruptcy bond rating of CCC, and its EBITDA interest coverage and FFO/total debt ratios are below the benchmark for companies with a bond rating of BBB. I also note that EBIT interest coverage is a more meaningful measure of a company's ability to pay the interest on its debt than EBITDA interest coverage or FFO/total debt, because EBIT interest coverage recognizes a company's need to make additional investments in its network in order to maintain service, while EBITDA interest coverage and FFO/total debt do not. The significant downward trend in Verizon NW's financial ratios since 1999 would likely confirm a below-investment grade rating of BB.

[2] www.ratingsdirect.com, *Standard & Poor's Corporate Ratings Criteria*, 2004, p. 50.

Q. ON THE BASIS OF YOUR REVIEW OF THE FINANCIAL RATIOS ASSOCIATED WITH VERIZON NW'S INTRASTATE OPERATIONS IN WASHINGTON STATE, WHAT IS YOUR CONCLUSION REGARDING VERIZON NW'S ABILITY TO MAINTAIN ITS CREDIT AND ASSURE ACCESS TO THE CAPITAL MARKETS?

A. As noted above, I conclude that Verizon NW's intrastate operations in Washington State would likely have a BB bond rating if it were a stand-alone entity. Since a bond rating of BB is below investment grade, and many investors do not invest in below-investment grade bonds, a BB bond rating is insufficient to allow Verizon NW to maintain its credit and assure access to the capital markets.

Q. WHAT IS VERIZON NW'S RATE OF RETURN WITH ACCESS REDUCTION ON ITS INTRASTATE RATE BASE IN WASHINGTON STATE?

A. As described in the testimony of Company Witness Heuring, Verizon NW's rate of return on its intrastate rate base in Washington State is *negative* 0.47%.

Q. IS A *NEGATIVE* 0.47% RATE OF RETURN COMMENSURATE WITH THE RETURN THAT VERIZON NW'S INVESTORS COULD EARN ON OTHER INVESTMENTS OF THE SAME RISK?

A. No. My studies indicate that Verizon NW's investors could earn a rate of return of 12.03% on investments of comparable risk. I discuss these studies in my testimony that supports Verizon NW's general rate case application. For purposes of interim relief, however, Verizon NW is assuming that its current authorized rate of return of 9.76% is appropriate, and I used this figure in my analysis. Obviously, a rate of return of *negative* 0.47% is well below the Commission-prescribed rate of 9.76%.

Q. DOES VERIZON NW CURRENTLY HAVE ANY INCENTIVE TO INVEST IN ITS INTRASTATE OPERATIONS IN WASHINGTON STATE?

A. No. Common sense suggests that a company has no incentive to invest in operations when its investors could earn a higher return on other investments of the same risk. My studies indicate that Verizon NW's investors could earn a rate of return of 12.03% on other investments of the same risk, and for purposes of this interim relief case I assume investors could earn 9.76%. Since Verizon NW's intrastate rate of return is *negative* 0.47%, Verizon NW currently has no incentive to invest in its intrastate operations in Washington State.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.