BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. VERIZON NORTHWEST INC., Respondent.	)))))))))))	Docket No. UT-040788 BRIEF OF VERIZON NORTHWEST INC. ON INTERIM RELIEF

I. INTRODUCTION

1. The Commission should promptly award Verizon[1] $29.7 million in interim relief because Verizon has satisfied *any* standard for such relief. First, Verizon has satisfied each of the six factors for interim relief set forth in *WUTC v. PNB*.[2] Evidence in this case clearly establishes a financial emergency:

2.
- Verizon's current intrastate return is a *negative* .47% (Ex. 22);

[1] This brief is filed by Verizon Northwest Inc. on behalf of its Washington intrastate operations. The term "Verizon" refers to those operations unless otherwise indicated.

[2] *WUTC v. Pacific Northwest Bell Telephone Company*, Cause No. U-72-30tr, Second Supplemental Order (1972).

3. • Even if all of Staff's adjustments to Verizon's earnings were accepted, Verizon's intrastate return would be only 2.09%, which equates to a $119 million annual revenue (or 767 basis points) deficiency based on the Commission authorized return of 9.76% (TR. 541-542).

4. • Verizon's interest coverage ratio – one of the most important financial indices – is a *negative* 0.7, significantly less than the 1.5 ratio the Commission applied when awarding interim relief in *Olympic Pipe Line* (Ex. 1T, p. 9, l. 18; TR. 104, ll. 20-25);[3]

5. • Verizon has no net operating income for its Washington intrastate operations – indeed, its operating margin is a *negative* 8% (Ex. 3T, Table 1); and

6. • Verizon's Washington intrastate operations produce a bond rating that is below investment grade (Ex. 1T, p. 12).

7. Given this and the other evidence presented by Verizon, interim relief is necessary and warranted.

8. Commission Staff, Public Counsel, AARP and WeBTECH (the "Opposition") oppose Verizon's request, but they failed to present relevant evidence that refutes Verizon's deteriorating financial condition. Most of their arguments center on the interstate operations or operations of Verizon Northwest Inc. in other states, i.e., they claim Verizon does not have a financial emergency with respect to its Washington intrastate operations because Verizon Northwest Inc. is generating revenues elsewhere and customers of other states and non-Washington jurisdictions should subsidize Verizon. The Commission, however, rejected this very argument in Order No. 5, holding that it would consider only Verizon's intrastate operations. Therefore, Verizon's evidence of its deteriorating intrastate financial picture is virtually unrebutted.

9. Second, even though Verizon satisfies each of the *PNB* factors, the Commission can (and should) grant interim relief independent of these factors given the unique character of this case.

10. The "typical" request for interim relief involves a utility that has reduced revenues or higher expenses (or both) due to events outside the control of both the utility and the

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[3] *WUTC v. Olympic Pipe Line Company*, Docket No. TO-011472, Third Supplemental Order Granting Interim Relief in Part (2002) (hereinafter, "*Olympic Pipe Line*").

Commission; here, however, Verizon has reduced revenues for an event out of its control, which was totally within the control of the Commission. Specifically, the Commission unilaterally reduced Verizon's access charges by $29.7 million because of a change of policy. In previous dockets, the Commission's policy was that (1) access charges should recover a significant portion of a company's total costs and (2) access charges should not be reduced in a vacuum.[4] Under these policies, the Commission did not reduce access charges unless the reduction took place in the context of a full rate case or unless the Commission permitted revenue-neutral rate rebalancing. The Commission, however, changed this policy in the AT&T Access Complaint Case, *AT&T Comm. of the Northwest v. Verizon Northwest Inc.*, Docket No. UT-020406, when it reduced Verizon's access charges to reflect "the competitive realities of the 21st century" even though it recognized that Verizon did nothing wrong in charging the rates the Commission previously (and repeatedly) approved that complied with WAC 480-120-540.[5]

11. Given the unique nature of this case, and given the fact that Verizon is requesting relief equal only to the revenue it lost as a result of a Commission policy change outside Verizon's control, interim relief is appropriate. The Commission has broad powers to award interim relief "when it deems it justified," *Puget Sound Navigation Co. v. Department of Transportation ("Puget Sound")*, 33 Wn.2d 448, 482, 206 P.2d 456 (1949), and Verizon's request is justified given the unique circumstances of this case.

12. Finally, the Commission need not fear, as the Opposition alleges, that it will "open the floodgates" if it grants Verizon's request, which Staff tries to characterize as "routine". (Ex. 121T, p. 6, 1.4) To the contrary, this truly is a unique case. Not only is there substantial

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[4] See *e.g.* See Orders in Docket No. U85-23; General Order No. R-450 (Docket No. UT-970325); and *MCI Telecommunications Corp. v. GTE Northwest*, Docket No. UT-970653, Second Supplemental Order Dismissing Complaint (Oct. 22, 1997).

[5] *Eleventh Supplemental Order* at ¶ 39, page 15.

evidence of a deteriorating financial condition, but Verizon faces a situation no other utility has faced when seeking interim relief. There is little chance that a new precedent of general applicability will be established here. For this to happen in the future, a utility seeking relief would have to show (1) a considerable loss of revenues (2) due to a regulatory policy change over which it had not control and (3) in making the policy change the Commission did not consider or review the utility's revenue requirement.

II. LEGAL AND POLICY ISSUES

A. What Are The Proper Factors For Interim Rate Relief?

13. The Commission is not bound by any specific factors in determining whether to grant interim relief; instead, the Commission should evaluate each case to determine whether a particular request is justified in light of all the facts. This principle was established in *Puget Sound*, where the Washington Supreme Court explained that the Commission could grant interim relief "when it deems it justified." 33 Wn.2d at 482.

14. In the *PNB* case, the Commission set forth six factors to consider in deciding whether to grant interim relief, and these factors are discussed in Section III of this brief. In subsequent cases, however, the Commission has made clear that these factors are not "standards" to be "mechanically applied," and that the critical issue is whether interim relief is in the public interest. As the Commission explained in *Olympic Pipe Line*:

15.
> The question that the Commission must answer in determining whether to grant a request for urgent relief is whether the grant would be consistent with the public interest -- that is, whether the company needs the relief urgently enough that the Commission should grant it, given the agency's role as substitute for the market place, balancer of stakeholder interests that sometimes coincide and sometimes do not, and custodian of statutory policy that recognizes that public service companies do serve a public purpose and that the public interest in access to these services may bear on what otherwise might be a private disagreement.[6]

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[6] *Olympic Pipe Line*, ¶ 37.

16. The Commission echoed this principle in Order No. 5 in this case (¶ 13), where it "cautioned against" a formulaic approach in determining whether interim relief should be granted.[7]

17. The Opposition, however, argues that the Commission must apply a formula to determine interim relief cases; specifically, it argues a utility must prove each of the *PNB* six factors. This is not true. In *Puget Sound*, for example, interim relief was awarded without any discussion of the six factors. Also, in Verizon's last rate case, *General Telephone Company of the Northwest, Inc.*, Cause No. U-81-61, the Commission in its *Second Supplemental Order* granted an interim rate increase of $6.8 million to offset a revenue deficiency in GTE's Washington intrastate operations caused by two regulatory changes of the Federal Communications Commission ("FCC"). The first FCC change involved new accounting procedures, and the second involved a change in depreciation methodology. The Commission recognized that these changes and the resulting revenue loss were beyond the control of the utility and granted interim relief without *any* discussion of the *PNB* factors. This case demonstrates that the Commission as a matter of policy has allowed, and should allow, interim revenue offsets that are the result of changes required by regulatory agencies. This is precisely the case presented here: Verizon has lost revenues due to a Commission policy change beyond the company's control, and therefore interim relief is justified.

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[7] Further evidence of the Commission's flexible approach towards interim relief is the Sixth Supplemental Order in *In re the Matter of Avista Corporation,* Docket No. UE-010395 (2001) (hereinafter "*Avista*"). There the Commission granted "emergency rate relief" to the utility outside of the context of a general rate case because of the Company's dire financial condition. Among other things, it was earning a rate of return of -.7%.

The Opposition, no doubt, will rely upon the Commission's denial of another recent request for emergency relief from an energy company outside of the context of a general rate case. That case, *WUTC v. Puget Sound Energy Co.,* Sixth Supplemental Order, Docket Nos. UE-011163 and 01170 (2001) is factually and procedurally inapposite. First, PSE requested extraordinary "interim relief" independently, with no accompanying general rate case. PSE did not present the sort of detailed, compelling evidence of financial deterioration that Verizon has presented here. For instance, PSE did not claim a negative rate of return, as Verizon now suffers. PSE merely presented projections of a lower than authorized rate of return. There was no evidence that PSE could not make its interest payments, while Verizon has presented such evidence. Finally, more important, PSE had not sustained an extraordinary negative financial loss due to a regulatory order from this Commission like the one that reduced $30 million from Verizon's intrastate revenues without offset.

18. Moreover, in many cases where the Commission applied the *PNB* factors, it did not apply all of them. For example, in *Olympic Pipe Line*, the Commission recognized that many of the financial indices used in the six factors "have no meaning in application" to the utility because – like Verizon – Olympic Pipe Line was not a publicly traded company, but was owned by entities not regulated by the Commission. Thus the Commission focused on the utility's intrastate rate of return, which was negative, and its interest coverage ratio. The Commission's focus on rate of return is especially important given the Commission's statutory and Constitutional obligation to ensure that a utility's rates are "sufficient," i.e., to ensure they "yield to the utility its aggregate required revenue requirement" including a reasonable rate of return.[8] Here, Verizon has shown that it has a *negative* return, and, as discussed in detail below, the adjustments proposed by Staff and Public Counsel – after almost four months of discovery in this case and more than a year of discovery in UT-020406 on Verizon's earnings – produce a return that is more than 700 basis points *below* the authorized level. (TR. 541-542). This equates to an annual revenue deficiency of $119 million.

19. Finally, in those cases where the Commission granted interim relief based on a financial emergency, the financial condition of the requesting utility was not as poor as Verizon's. Indeed, in several cases where the Commission granted interim relief, the utility was earning a positive (although below its authorized) rate of return. Exhibit 151 shows that the other utilities that received interim relief had positive rates of return (with the exception of Avista and Olympic Pipe Line). This exhibit demonstrates first, that the Commission grants interim relief where the utility has a <u>negative</u> rate of return and second, that even a <u>positive</u> rate of return can evidence a deteriorating financial condition.[9]

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[8] *See* RCW 80.36.080, *Power v. WUTC*, 104 Wn.2d 798, 808, 711 P.2d 319, 325 (1985). A public service company is entitled to earn a return on the property it has dedicated to the public, and which is used and useful for service. *Bluefield Water Works & Improvement Co. v. PSC*, 262 U.S. 629, 692, 43 S. Ct. 675, 67 L.Ed. 1176 (1923).

[9] Even though the Opposition argues the "extraordinary" nature of interim relief, approximately half of requests for such relief have been granted. Exhibit 151 lists those decisions.

20. In summary, the Commission has broad powers to award interim relief – there is no single formula the Commission must apply. Based on Commission and Washington Supreme Court precedent, it may (and should) award such relief where:

21. 1. A financial emergency exists, as evidenced by application of all or some of the *PNB* factors, including whether interim relief is needed to remedy a gross hardship or gross inequity;

22. 2. To compensate a utility for revenue losses caused by regulatory decisions beyond the utility's control; or

23. 3. For any other reason to ensure a "just" result that is in the public interest.

24. As discussed below in Section III, Verizon has satisfied *any* standard for receiving interim relief.

B. Order No. 5

25. In Order No. 5, the Commission held that Verizon's initial filing established a *prima facie* case for interim relief. The Commission also rejected the Opposition's claims that the Commission can and should consider the interstate operations and operations of Verizon Northwest Inc. in other states in determining whether to grant interim relief:

26. > We conclude that it would be inappropriate to say, as the joint parties seem to argue, that Verizon should be ineligible for interim rate relief because the nonjurisdictional operations are sufficiently healthy that intrastate customers should not bear the responsibility to sustain their own capital needs in the same way they would if the company operated in a single jurisdiction. We find it appropriate to consider the company's need for interim rate relief based on a Washington intrastate basis only, and to determine whether the level of its intrastate revenues constitutes a "gross inequity" justifying interim relief.

27. This ruling echoes the Commission's decision in *Olympic Pipe Line*, where it considered <u>only</u> the utility's intrastate operations in evaluating a request for interim rates.[10]

28. Staff, however, disagrees with the Commission, and Staff attempted to re-litigate this issue at the hearing.[11] Staff's argument should again be rejected for the reasons stated in Order

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[10] The Commission emphasized "We must look at the intrastate portion of the operations as though it were independent." ¶ 27.

[11] Staff appears to interpret Paragraph 31 of Order No. 5 as allowing the Commission to consider interstate operations as a "relevant factor." (TR. 490, ll. 19-25). However, the last sentence of that paragraph reads:

No. 5. Also, Staff's position in this case is contradicted by Staff's position in *Olympic Pipe Line*. There, Staff explained that the Commission's authority extended only to intrastate operations:

29. The law also refutes Olympic's theories. FERC and Commission ratemaking are exclusive within their respective spheres. RCW 81.28.230 limits the Commission's rate jurisdiction to transportation "within the state." 49 U.S.C. § 1(1)(b) applies the Interstate Commerce Act to transportation between states. Congress has "expressly provided that [the scope of federal regulation] was not to extend to purely intrastate traffic." *Simpson v. Shepard*, 230 U.S. 352, 418, 33 S. Ct. 729, 57 L. Ed. 1511 (1913).

* * *

30. In short, if the Commission proceeds to set only intrastate rates, and if it sets rates on a cost-of-service basis, it will respect the jurisdictional division recognized by Congress and the courts.[12]

* * *

31. Staff recommends the Commission set rates based on Washington intrastate results of operations. Staff prepared its case on that basis. (Twitchell, Ex. 1901-T at 37:4 to 38:5 and Ex. 1903). Setting rates based on intrastate results of operations is a proper way to distinguish the federal and state jurisdictions. *Louisiana PSC v. FCC*, 476 U.S. 355, 375, 106 S. Ct. 1890, 90 L. Ed. 2d 369 (1986).[13]

32. The Commission agreed with the Staff in *Olympic Pipe Line* and used only the intrastate-allocated portion of the Company's investment and expenses.[14] Similarly, RCW 80.01.040(3) confirms the Commission's jurisdiction over telecommunications companies operating "within this state," and 47 U.S.C. § 201 confers jurisdiction over interstate communications upon the FCC. Clearly, Congress and the courts recognize a jurisdictional division for telecommunications, just as in the energy arena.

"Financial distress is one factor to consider, but so is gross inequity based on a review of <u>intrastate operations</u> of an interstate company." (emphasis supplied)

[12] Opening Brief on Behalf of Commission Staff at pp. 9-10, *Olympic Pipe Line, supra*.

[13] *Id*. at 41.

[14] Such allocation can be made, as in *Olympic Pipe Line*, by taking total plant in service and allocating debt and interest to the respective state and federal jurisdictions. (TR. 103, ll. 8-16)

33. In addition, Mr. King, testifying for Public Counsel, acknowledged the jurisdictional separation between interstate and intrastate. He said: "So the other states would only look at costs and revenues in these states and then only for intrastate services." (TR. 443, ll 11-13). This contradicts his theory that the Commission can look elsewhere in this case when setting rates.

34. In sum, RCW 80.01.040(3), coupled with bedrock principles of jurisdictional separations, limits the Commission's jurisdiction to Verizon's intrastate Washington operations.[15] Thus, all financial evidence the Opposition presented based upon other jurisdictions must be disregarded.

C. Precedent on Interim Relief From Other Jurisdictions

35. Verizon has examined the criteria for granting interim relief in Alaska,[16] in the other states where it maintains operations (California, Idaho, and Oregon.), and at the Federal Energy Regulatory Commission (FERC). The law and practice in these jurisdictions support Verizon's request for interim relief in this case.

1. Alaska

36. The Regulatory Commission of Alaska grants interim relief where a utility has raised "serious questions" on the merits of its permanent case, e.g., a claim that its current rates are confiscatory. It does not engage in a multi-factor analysis.

37. For example, the Commission most recently granted interim rate relief to an electric utility in *Golden Valley Electric Association, Inc.*, Docket No. U-04-33; Order No. 5, 2004 Alaska PUC LEXIS 302 (July 2, 2004):

38.
> In analyzing requests for interim and refundable rate relief, we rely on the standard set forth in *A.J. Industries, Inc. v. Alaska Public Service Commission*, 470 P.2d 537 (Alaska 1970). In that case, the Alaska Supreme Court ruled that

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[15] There is no exception for interim rate relief cases.

[16] Staff witness Strain discussed Alaska interim relief in response to questions from Chairwoman Showalter on August 12, 2004 (TR. 588-590), Alaska does have a specific statute authorizing interim relief but it appears to apply only to pipelines. See *Alaska Pipeline Act*, AS 42.06.400(a).

> to determine if a utility qualifies for interim rate relief, we are to consider a balance of the hardships. If the balance weighs in favor of the utility, "it will ordinarily be enough that the plaintiff [utility] has raised questions going towards the merits so serious, substantial, difficult, and doubtful, as to make them a fair ground for litigation and this for more deliberate investigation." *A.J. Industries, Inc.*, at 540. The Court went on to find that if a utility's claims of confiscatory rates are true, it will be irreparably harmed because it cannot recoup those losses.

39. Balancing the hardships in the instant case, we are persuaded that GVEA has met the burden of demonstrating that its current rates are confiscatory because without rate relief GVEA would experience losses during the time its request for permanent rate relief is pending. We recognize that GVEA cannot recover any of these losses from its ratepayers given the prohibition against retroactive ratemaking. These losses may well rise to the level of irreparable harm.

(Id. at *3, *4)

2. California

40. The California Public Utilities Commission also grants interim relief without requiring a showing of financial emergency. The Commission recently granted interim rate relief to a telephone company in *In the Matter of Kerman Telephone Co.*, Decision 03-03-009; Application 02-01-004 (Filed January 4, 2004), 2003 Cal. PUC LEXIS 181. There, the Commission found that interim relief was justified under California law, explaining that "interim rates need not be premised on an "emergency" alone but can be adopted for other reasons, including procedural delays."[17] The Commission noted:

41. The California Supreme Court addressed precisely this issue [interim relief] in *TURN v. CPUC*, (44 Cal. 3d 870, 878 (1988)). In the underlying decision, the Commission granted an interim rate increase while expressly declining to make any finding that "the interim rate increase was required by a financial emergency, or that the reasonableness of the pertinent costs was undisputed." (*Id*. at 875.) The Commission's decision was upheld by the Supreme Court, which found that the overriding circumstance was the prospect of many months and years of hearings and deliberations before a final rate could be determined. (*Id*. at 879.) n3 The Court affirmed that the Commission could set interim rates as long as the rate is subject to refund and sufficient justification for the interim relief has been presented. (*Id*. at 880.)[18]

42. Similarly, the Commission granted relief in *Re Southern California Edison Company*,

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[17] *Id*. at *9.

[18] *Id*. at *9.

28 CPUC 2d 203, 212 (1988)(D. 88-05-074), where it noted that "the existence of a financial emergency is no longer a standard which must be met in granting interim relief."

3. Idaho

43. The Idaho Public Utilities Commission (IPUC) grants interim relief by balancing the interests of the utility and the public without applying any specific test. For example, in *Re Washington Water Power Company*, Case No. U-1008-112, Order No. 13482, 22 P.U.R. 4th 485 (1977), the IPUC held it had the implied authority to grant interim rate relief under its general grant of authority to do "all things necessary to carry out the spirit and intent of the public utilities law."[19] (This reasoning is similar to the Washington Supreme Court's reasoning in *Puget Sound*.) In that case, the IPUC refused to adopt a single standard for granting interim relief, explaining:

44.

> Our review of the cases suggests that an attempt to devise a single test to determine whether interim relief is warranted is a fruitless task. Such decisions ordinarily involve a balancing of short-term costs versus long-run benefits for both the utility and consumers.

45. The IPUC found that relief was warranted because the utility's financial condition, measured by earnings per share, interest coverage and rate of return, was deteriorating and would continue to do so without prompt rate relief. Such relief was granted subject to refund, a condition which cured the due process concerns argued by the rate increase opponent who claimed that "full and complete litigation of every issue was required." In rejecting this argument, the IPUC relied upon a Michigan decision holding that –

46.

> "Such a construction would render nugatory the authority of the commission to act before the effect of the events which the utility seeks to avert had impaired its ability to serve the public. It would be foolhardy navigation to see whitecaps breaking over a reef which lies on a given course, and require that course to be maintained without an in-depth study and report on the advisability of changing it." *Kelley v. Michigan Pub. Service Commission*, (1975) 63 Mich App 69, 234

[19] Publication page references for this decision are not available from WESTLAW.

[20] In this case, the Court of Appeals of Michigan sustained a grant of interim relief by the Michigan Public Service Commission, noting that the Commission could grant such relief without finding that a "financial emergency" exists.

NW2d.[20]

4. Oregon

47. The grant of interim relief in Oregon for a telecommunications company is controlled by ORS 759.185, which provides, in pertinent part, that –

48. (1) The Public Utility Commission may, pending such investigation and determination, order the suspension of the rate or schedule of rates, provided the initial period of suspension shall not extend more than six months beyond the time when such rate or schedule would otherwise go into effect. . . .

* * *

49. (5) The commission may in a suspension order authorize an interim rate or rate schedule under which the telecommunications utility's revenues will be increased by an amount deemed reasonable by the commission, not exceeding the amount requested by the utility. An interim rate or rate schedule shall remain in effect until terminated by the commission.

50. As can be seen from the plain terms of the statute, a financial emergency is not required to grant interim relief and the Commission is left to its discretion in ordering relief. In a recent electric utility case, the Commission granted interim relief under the statute for $22.8 million with little discussion (and little record support). *In the Matter of Pacificorp*, Docket No. UM 995, Order No. 01-186 (Feb. 21, 2001). Upon reconsideration, the Oregon Commission rejected arguments that it failed to apply the proper standard before granting the relief. Order No. 01-503; Docket No. UM 995, Ore. PUC LEXIS 259 (2001).

5. FERC

51. At the hearing, Chairwoman Showalter asked about the procedure for interim relief from the Federal Energy Regulatory Commission (FERC) (Tr. 447-448). That agency allows proposed utility rates to take immediate effect pending final Commission action pursuant to 16 U.S.C. 824d(d). This statute requires "good cause" to be shown before granting interim relief. Recent FERC rulings merely recite that "good cause" had been shown so as to allow interim rates to go into effect.[21] In a recent order, FERC approved rates on an interim basis noting that,

[21] Interim relief was granted by letter rulings in the following dockets: No. ER03-1274-000 (Boston Edison Company), (4/28/94); Nos. ER02-250-000 and ER02-527-000 (California Independent System Operator Corporation)(1/31/02); No. ER00-1319-000 (Wisconsin Energy Corporation Operating Companies)(8/30/00).

"no one will be harmed by this decision because interim approval allows [the utility's] rates to go into effect subject to refunds with interest if the Commission later determines in its final decision not to approve the rates."[22]

6. Summary

52. These cases from other jurisdictions have two principles in common: First, other jurisdictions take a balancing approach, and do not automatically require satisfaction of a stringent "financial emergency" test. Second, other jurisdictions deem the "subject to refund" requirement sufficient to protect customers. The Commission's Order No. 5 in this case echoes these principles. It states that the Commission is not bound by a "formula" for determining interim relief (¶ 13) and that the prospect of refunds "does work to ameliorate to some extent [the Commission's] concerns" that a swift review of Verizon's interim rate request could pose a hardship on consumers (¶ 29).

III. HAS VERIZON SATISFIED THE APPROPRIATE RELIEF FACTORS?

A. Consideration of factors: to what degree, if any, should the following factors bear on the Commission's decision?

53. As discussed in Section II.A, there are no required factors or formulas the Commission must or should apply. Assuming the Commission wishes to apply the *PNB* factors, Verizon has satisfied all of them, as explained below.

1. Factor No. 1

54. *"[T]he Commission should exercise its authority to grant interim rate relief only after an opportunity for an adequate hearing."*

55. This factor requires an opportunity for adequate hearing. There is no question such hearing occurred. All parties had an opportunity to cross-examine Verizon's witnesses on August 10-12, 2004, and a public hearing was held in Everett on August 17, 2004, where numerous members of the public supported the interim increase.

[22] See Order Approving Rates on an Interim Basis and Providing Opportunity for Additional Comments, Docket No. EF03-2011-000 (Issued October 1, 2003).

2. Factor No. 2

56. *"[A]n interim increase is one sort of extraordinary remedy and should be granted only where an actual emergency exists or where necessary to prevent gross hardship or gross inequity.'"*

a. Is there an actual emergency?

57. Verizon's Washington intrastate operations – the only relevant operations to consider as the Commission held in Order No. 5 – undoubtedly face a financial emergency. The evidence shows:

58. - Verizon's rate of return is a *negative* 47% (Ex 1T, p. 14; Ex. 21T, p. 4);

59. - Verizon cannot meet its payment obligations on its intrastate Washington debt due to insufficient revenues ((Ex. 1T, p. 9, 12);

60. - Verizon's financial condition for its intrastate operations would not support an investment-grade credit rating (Ex. 1T, p.3, 10-13);

61. - Verizon's earnings are clearly insufficient to allow the Company to continue to invest in its network in Washington State. (Ex. 1T, p.10, ll. 5-6; Ex. 61T, pp. 6-7);

62. - Verizon's insufficient earnings will affect its ability to obtain financing from Verizon's parent and affiliates (TR. 389-390);

63. - Verizon's expert witness, Dr. Vander Weide, testified that Verizon's bonds, considered on a stand-alone basis, are below investment grade, "and that's a financial emergency as viewed by the financial community." (TR. 115, ll. 23-25; 116, ll. 1-4)

64. Staff disagrees, and appears to take the unreasonable position that a company must face a dire financial emergency akin to imminent bankruptcy before interim relief should be granted.[23] According to Staff witness Kathy Folsom, interim relief is not warranted "as long as there is not a need to obtain financing in the short-term between now and the rate case, and there is sufficient cash." (Tr. 511, 513-15) Similarly, Opposition witness Charles King opined that, "so long as there is some positive cash flow for a company, no financial emergency

[23] This view was rejected by one appellate court that struck down a Kansas rule requiring the cost of stringent financial proof Staff promotes. In *Kansas-Nebraska Nat. Gas Co. Inc. v. Kansas State Corp. Commission*, 217 Kan. 604, 538 P.2d 702, 710-11 (1975), the court said "requiring a showing of virtual impending bankruptcy is indeed too stringent a standard to be fixed before interim rate relief can be granted."

exists.” (Tr. 471)

65. The Commission has rejected such a narrow view of financial emergency which has no previous Commission precedent. For example, in *Puget Sound*, the Commission noted that cash shortfall is not the only condition upon which the Commission would consider extraordinary relief.”[24] The reason for this is obvious: “[T]he financial community requires a cash flow coverage ratio significantly greater than 1.0 to consider a company to be an investment-grade risk,” as Dr. Vander Weide explained. (Ex. 3T at pp. 6-7) Therefore, the mere fact of a slight positive cash flow does not address a company’s need to maintain a sufficient margin for contingencies and to maintain interest coverage ratios in order to continue to have an investment-grade bond. Indeed, in *Olympic Pipe Line*, the Commission established a 1.5 interest coverage ratio to determine interim rate relief as a vehicle for such contingencies. Verizon’s “cash flow” by any calculation in the record fails this ratio.[25] Even Opposition witness King agreed that Verizon, viewed as a stand-alone company, would need a cushion of cash resources. (TR. 471, ll. 7-11).

66. Furthermore, the Commission should measure the adequacy of any potential cash flow against financial trends. Here, too, Mr. King agreed that such an assessment would be relevant. (TR. 438, ll. 4-9). The evidence in the case demonstrates a *declining* trend in revenues and increasing trend in expenses on a Washington intrastate basis. (Ex. 143; TR. 530) This means that Verizon’s cash flow will not improve any time soon unless it is given interim relief.[26]

67. In any event, the Opposition’s calculations of cash flow are erroneous. For instance, Mr. King failed to include the proper amount for actual interest paid, which reduced his cash

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[24] *WUTC v. Puget Sound Energy, Inc.*, Docket No. UE-01163, Sixth Suppl. Order, ¶ 21.

[25] *Olympic Pipe Line* at ¶¶ 51, 51, Table 1.

[26] Both Staff and Mr. King agreed that cashflow coverage would improve only if granted an increase in rates. *See* Ex. 101T, p. 18, ll. 8-10; Ex. 104; TR. 571.

flow estimates down to $1.1 million (Ex. 104, TR. 435-436). Also, Staff witness Strain, in making her cash flow calculations (Ex. 144), failed to account for the $29.7 million access charge rate reduction, i.e., she failed to include these reductions when calculating earnings for her "test year intrastate before adjustments." She also failed to account for any of the other restated adjustments made by Ms. Hearing in the Washington intrastate results operations,[27] and she included imputed directories revenues in her calculations. (As discussed below, directory revenues cannot be imputed.) Therefore her calculations of cash flow are not realistic and should not be relied upon.

b. Is there gross hardship?

c. Is there gross inequity?

68. Verizon is not aware of any Commission decision that defines gross hardship or gross inequity. A "hardship" is commonly described as a deprivation;[28] an "inequity" occurs when someone is treated differently under similar circumstances,[29] and "gross" is defined as "glaringly noticeable."[30] These dictionary definitions show that interim relief is appropriate where a company suffers a considerable reduction in revenue and where the company has been subject to glaringly noticeable disparate treatment. Verizon meets these standards.

69. ***First***, the $29.7 million annual revenue reduction is considerable – the Commission noted this fact in its *Eleventh Supplemental Order* (¶ 144). Moreover, Staff, AT&T, and MCI have previously testified that the reduction is significant and that it warrants rate rebalancing. Prior to the issuance of the Access Charge Order the parties had attempted to settle the docket by agreeing to rate increases of the magnitude requested here by Verizon. Unfortunately, the

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[27] Ms. Strain accepted Verizon's reported Washington intrastate results of operation as the basis for her analysis in Ex. 142. However, she made five additional adjustments as reflected on that exhibit.

[28] Webster's Ninth New Collegiate Dictionary 553.

[29] *Id*. at 618.

[30] *Id*. at 538.

settlement did not become final. Nonetheless, the other parties acknowledged that a $30 million access charge reduction would have a severe revenue impact that should have obtained offset in rate relief including an increase in local rates.[31]

70. ***Second***, in making this reduction, Verizon was treated differently than other carriers because (1) the reduction was made outside of a general rate case and (2) simultaneous revenue-neutral rate rebalancing was not permitted. Prior to the *Eleventh Supplemental Order* in UT-020406, the Commission never considered access charges in a vacuum. For example, Qwest's access charges – the charges Verizon was required to mimic by the *Eleventh Supplemental Order* – were set in a Qwest (then US WEST) rate case (Docket No. UT-950200), where the Commission could consider *all* of the company's costs and revenues. And in General Order No. 450 in Docket No. UT-970325 that adopted a new rule for setting access charges,[32] the Commission allowed all carriers to make revenue-neutral rate rebalancing filings to offset reductions in access charges resulting from the newly created rule. In doing so, the Commission rejected the arguments of Public Counsel and AARP that such rebalancing should not be permitted without an earnings review; in fact, the Commission did not require any company to make *any* kind of financial showing of need.[33] Moreover, this rate rebalancing was allowed to go into effect on a permanent basis.

71. The Commission has refused to examine access charges in a vacuum for a good reason: it has repeatedly recognized that access charges are inextricably linked to a company's overall costs and revenue requirement. For example, in Docket No. UT-970325 the Commission observed that, "[a] significant portion of the total cost of operating the local telephone network is recovered in access charges. Access charges paid by IXCs (and

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[31] *See* Testimony of Glenn Blackmon, March 6, 2003, TR. Vol. VII, pp. 189-193, Docket No. UT-020406.

[32] WAC 480-120-540.

[33] *General Order No. R-450* at 13. *See also MCI*, ft. 4

ultimately their customers) account for almost 20% of total retail revenues in this state, or about $18 per customer per month."[34] The Commission also explained how access charges relate directly to an ILEC's overall profits, which must, by law, be fair, just, reasonable, and sufficient.[35]

72. In Docket No. UT-020406, however, the Commission made a policy change. It found, for policy reasons, that Verizon's originating access charges should be reduced closer to cost, even though it acknowledged that Verizon's rates complied with the Commission's Access Charge Rule.[36] The Commission did not accuse Verizon of any wrongdoing in connection with these rates.[37]

73. Furthermore, there is evidence that Commission Staff views access charge reform to be achieved on a revenue-neutral basis. While no final action has been taken, Commission Staff has pursued access charge reform for Century Telephone on a revenue-neutral basis. (Ex. 134; TR. 487-489) Therefore, given the Commission's policy of access charge reform via revenue-neutral rate rebalancing, Verizon only asks here that it be granted that relief in the form of an interim rate increase of $29.7 million, the amount of the access charge rate reduction. It would be grossly unfair and inequitable to treat Verizon in a manner different than other local exchange companies that have been afforded the opportunity to rate rebalance when access charge reductions were ordered.

74. An additional consideration is found in Order No. 5 where the Commission noted it had suspended the effect of its access charge reduction order for two months "to allow Verizon

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[34] *General Order* R-450 at 4.

[35] *Id. See also POWER v. WUTC*, 104 Wn.2d 798, 711 P.2d 319, 324-26 (1985) (the Commission "is charged by law with the setting of just, reasonable, and sufficient public utility rates," which means that the utility must be allowed to set rates that "will yield to the utility its aggregate allowed revenue requirement"). This obligation is based on the Fifth and Fourteenth Amendments. *See, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

[36] *Eleventh Supplemental Order*, ¶ 28.

[37] Id. at ¶ 28-29.

time to prepare and file a request for rate increase, so (if a need for interim or emergency rates were approved) Verizon's revenue stream would be uninterrupted."[38] As explained by Verizon witnesses Banta and Heuring (Ex. 63T, pp. 4-5; Ex. 23T, pp. 3-4), the company was unable to prepare a general rate case within the two-month time frame, particularly because it was advised that a request for interim relief would be inadvisable outside of the context of a general rate case.[39] Allowing Verizon the opportunity to restore its "interrupted" revenue stream is consistent with the Commission's view that Verizon be given a fair shot at getting rate relief through the filing of a general rate case. Interim rate relief is traditionally examined and granted in this context.[40]

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[38] Paragraph 26, p. 10.

[39] That the Commission contemplated interim rate relief as a remedy to the shortfall produced by the Access Charge Order is further evidenced by the Commission's opposition to Verizon's Motion for Supersedeas before the Snohomish County Superior Court (Attachment B to Verizon Response to Joint Motion for Summary Determination Dismissing Verizon's Petition Seeking Interim Rate Increase). There the Commission said:

> Verizon has the option to file for an interim rate increase, pending the outcome of a formal rate case. This would alleviate Verizon's concerns about the length of time a formal rate case will take. Verizon also may request expedited rate relief outside of the context of a general rate case, and the WUTC could grant such relief if Verizon proved such an increase would be necessary. Therefore Verizon has options to recover the revenue lost by the requirement that it reduce its access charges. Either of these options would be a more reasonable choice for evaluating Verizon's revenue requirement and setting Verizon's lawful and proper rates. By allowing Verizon to continue charging its excessive rates, Verizon would have no incentive to pursue these options.

[40] See *Avista*, *supra*, ft. 2. (discussing view that interim relief is usually considered within the context of a general rate case). *See also* cases identified on Ex. 151.

d. Will interim relief resolve any emergency or prevent any gross hardship or gross inequity?

75. Interim rate relief of $29.7 million will give Verizon a positive return and, as explained by Dr. Vander Weide, will increase Verizon's intrastate bond rating to an investment-grade status (albeit just barely) (Ex. 3T, p. 11). Furthermore, such relief will mitigate -- although not eliminate -- the subsidization of the these Washington intrastate operations by other jurisdictions (TR. 93-93, 113-114) Order No. 5 was concerned about the inequity of this subsidization, noting:

76. We conclude that it would be inappropriate to say, as the joint parties seem to argue, that Verizon should be ineligible for interim rate relief because the non-jurisdictional operations are sufficiently healthy that intrastate customers should not bear the responsibility to sustain their own capital needs in the same way they would if the company operated in a single jurisdiction.[41]

77. Dr. Vander Weide testified that customers in other jurisdictions are currently supporting intrastate customers in Washington:

78. Yes, that's the evidence I present in Table 1 on page 8 [Exhibit 3T]. But in fact the operating margins in other states are considerably higher than they are in Washington intrastate, and in fact the operating margin in Washington intrastate is negative. Washington intrastate, on a stand-alone basis, would have a below-investment grade credit rating, and if one considers the results of operations on a total company basis, my testimony is that would be tantamount to a further requirement that customers in other states support or subsidize more than they already are [sic] customers in Washington intrastate. (TR. 93, ll. 8-19).

79. No party has refuted Dr. Vander Weide's testimony. Mr. King makes the mistaken argument that because rates in the other jurisdictions are set independently, from Washington, they cannot provide a subsidy (Ex. 101T, p. 11, ll. 11-16). Yet, it is the revenues from the rates in other jurisdictions that provide the subsidy. Neither Staff nor Mr. King disprove the jurisdictional subsidization. Indeed, such subsidization is the cornerstone of their argument that the Commission need not consider Verizon's intrastate operations on a stand-alone basis

[41] Id., p.7, ¶ 20.

because it obtains support from its other jurisdictions.[42]

80. The Opposition, also criticizes Verizon for not seeking *more* money in interim relief. They claim that $29.7 million will not solve Verizon's financial emergency, therefore Verizon should not get *any* relief. (e.g. Ex. 101T, pp. 7-9). Verizon agrees that it needs more than $29.7 million to earn sufficient revenues, but this is not the point. As Verizon explained in its petition, Verizon is seeking only to replace the revenues it lost from the access reductions so that its request for interim relief can be expedited. As noted above, this relief will improve Verizon's financial condition, although the Washington intrastate operations will continue to be subsidized. *Complete* relief, however, is the subject of the permanent case, not this interim request.

81. Verizon has proven the facts that demonstrate that it is supported by its non-jurisdictional operations. Therefore "under a stand-alone analysis it faces a gross inequity that renders interim rates consistent with the public interest."[43]

3. Factor No. 3

82. *"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."*

83. The rate of return is one of the most important factors to consider and deserves special emphasis because of the Commission's statutory and Constitutional obligation to ensure a sufficient return. As the Commission explained in its Access Charge Rulemaking, a

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[42] In a line of questioning during the evidentiary hearing, Chairwoman Showalter discussed the issue of whether results should differ for hypothetical Company A and Company B, with Company A being a stand-alone operation and Company B being a larger, multi-jurisdiction operation. She ultimately concluded that it would make no difference from the ratepayer's point of view if both were granted relief. (TR. 468). Mr. King admitted that it would be inequitable to have other parts of Company B subsidize its less profitable part. He somehow justifies this inequity because it wouldn't last long. (TR. 451, 460) Moreover, cross-examination of Staff witnesses revealed that Staff would not recommend interim rate relief even if Verizon were a "stand-alone" company (TR. 496) so a Company A/B distinction would be irrelevant from Staff's point of view.

[43] Order No. 5, ¶ 23, p. 9.

regulated company's overall profits "must, by law, be fair, just, reasonable, and sufficient."[44]

84. Factor No. 3 states that a company's "mere" failure to reach its authorized rate of return, standing alone, does not necessarily require interim relief. Here, however, all the relevant evidence shows that Verizon's return is not "merely" below the authorized level. Indeed, Verizon showed that its current return of a *negative* .047 percent is significantly below that level. As the Commission noted in *Olympic Pipeline*, a negative rate of return reflects "considerably more need than the mere failure to achieve [the] authorized rate of return."[45] The Commission awarded relief in that case and also in the *Avista* case, where the utility showed a negative return.[46]

85. Staff and Public Counsel dispute Verizon's calculation and proffered several adjustments to it. As discussed in Section III (4), their adjustments are wrong and should be rejected. But even if all their adjustments were accepted, the resulting return would still be significantly lower than the authorized return and would warrant interim relief. Staff witnesses Strain's adjustments produce a return of only 2.09%, and Mr. King's modified return is only 1.464% percent after he adopted Ms. Strain's directory imputation figures. (Ex. 105) Staff witness Strain admitted that 2.09% is "a pretty low rate of return" for a company to earn on an intrastate basis. (TR. 543, ll. 7-12).

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[44] Docket No. UT-970325, *General Order R-450* at 4. *See also POWER v. WUTC*, 104 Wn.2d 798, 711 P.2d 319, 324-26 (1985) (the Commission "is charged by law with the setting of just, reasonable, and sufficient public utility rates," which means that the utility must be allowed to set rates that "will yield to the utility its aggregate allowed revenue requirement"). This obligation is based on the Fifth and Fourteenth Amendments. *See, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

[45] *Olympic Pipeline*, ¶ 43

[46] *In re Avista Corp.*, Sixth Supplemental Order, Docket UE-010395.

86. Ms. Strain's calculation equates to an annual revenue deficiency of $119 million. This alone warrants the full interim relief sought by Verizon. In *WUTC v. Puget Sound Power & Light Co.*, Cause No. U-73-57, Second Supplemental Order (1974), the Commission found "alarming" the fact that the utility's return of 5.66% was below its authorized return of 7.6-7.75%, and the Commission awarded interim relief:

87.

> An analysis of the current financial position of Puget indicates very alarming trends. … The overall rate of return likewise, is in a declining position and is currently substantially below the 7.6-7.75 percent range previously found by this Commission. [Puget was earning a 5.66 ROR] The mere failure of rate of return to achieve the allowed level does not justify interim relief, however, it is a significant factor to be considered with all others.[47]

88. If the Commission found a declining rate of return from 7.6% to 5.66% to be "alarming" in 1974, then it should find a *negative* return of .047% or Staff's 2.09% to be equally alarming and to warrant interim rate relief.

4. Factor No. 4 (Financial Indices)

a. Adjustments to consider.

89. As discussed above and in Order No. 5, the only relevant financial indices to be evaluated are those be based on Washington intrastate operations. Thus the financial assessments of Staff witnesses Folsom and Mr. King that are based on non-jurisdictional data must be disregarded.

90. The appropriate starting point for the Commission's analysis of Verizon's financial condition is the company's Results of Operations for the test year. Staff accepted Verizon's Results of Operation contained in Exhibit 22, except for "five adjustments." *See* Exhibit 142. These adjustments are discussed below. As a threshold matter, however, most of them are pro forma adjustments that are improper in the context of an interim rate case. As the Commission noted in the *Olympic Pipe Line* case:

91.

> We note the large number of unanswered questions that we have deferred to, or state a desire to hear more about in, the general rate proceeding. Given the

[47] *Id*. at pp. 4-5.

> 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 result of operation pro forma statement, or the adjustments within it.[48]

(1) Access reduction.

92. As of August 12, 2003 Verizon sustained an access charge reduction on an annualized basis of $29.7 million. It is both proper and necessary to include this amount as a reduction in network access revenues as reflected on the results analyzed by the Company and Staff. (Exs. 22 and 142). Indeed, it is incomprehensible why a Commission-ordered revenue reduction would not be included in Staff's analysis. Dr. Vander Weide explained that the $29.7 million rate reduction for access charges was reflected in the company's quarterly surveillance report for the 12 months ending September 30, 2003 and must be included in any calculation of earnings before interest and taxes ("EBIT") that is meant to reflect Verizon Northwest's financial performance for the test year (12 months ending September 30, 2003). (Ex. 1T, p 5, ll. 4-7.

93. In short, no party seems to dispute the inclusion of the Access Charge Order reduction. It is of particular relevance because this amount is actual revenue that will no longer be received (as opposed to revenue that the company would never have received in the first place, such as imputed directory revenues).

(2) Directory imputation.

94. The largest adjustment made by Staff witness Strain is the addition of $29.2 million to Verizon's total operating revenue for "directory imputation." (Ex. 142) Only by imputing these non-existent revenues was Ms. Strain able to elevate Verizon's rate of return from a negative to a slight positive.

95. The issue of yellow pages directory imputation will no doubt be thoroughly examined in the company's general rate case, and the Commission should not prejudge it here. Until

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[48] *Olympic Pipe Line* at ¶ 57.

then, Staff's adjustment should not be considered. Moreover, the company has presented substantial evidence in the interim case to demonstrate that imputation of directory revenues to Verizon is improper.

96. First and foremost, both Ms. Strain and Mr. King inaccurately equated Verizon's directory operations to those of US WEST (now Qwest) and other Bell Operating Companies. But unlike Qwest and other companies, neither Verizon nor its predecessor ever owned the directory business. Ms. Strain acknowledged that, from an organizational standpoint, beginning with the creation of a General Telephone Directory Company in 1936, Verizon Directories Company, through its predecessor companies and operations in Washington, has been totally distinct and separate from any affiliated company providing telephone service. (*See* Ex. 148, p. 23-25, ll. 5-7; TR. p. 547 ll. 17-25; p. 548, ll. 1-3). Thus, the Opposition's chief argument on this issue is factually incorrect.[49]

97. In the last US WEST rate case the Commission supported yellow pages imputation on the basis that the directory operation had been part of the local telephone company before it was purportedly spun off to an affiliate, and had been developed at rate-payer expense.[50] Thus the rationale of "developed at rate-payer expense" does not apply to Verizon and Verizon Directories Company. The directory company has never been a regulatory asset of the regulated local exchange company. Thus, there is no principled reason to impute yellow pages revenues to Verizon under a rationale applicable only to US WEST/Qwest.[51]

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[49] For this reason the New Hampshire case mentioned by Staff is totally inapposite to Verizon's situation. Ms. Heuring explained this during her cross-examination. (TR. 216-217). Moreover, it is a nonfinal order.

[50] See UT-950200 and UT-980948.

[51] Also, Ms. Strain's adjustment is wrong because she based it upon the formula developed for Qwest's imputation. (Ex. 147, p. 2) There is no evidence that this Qwest-specific formula is appropriate for Verizon even if Ms. Strain's adjustment was theoretically correct (which it isn't).

98. Furthermore, Verizon's ability to derive the revenue stream from its old Master Publishing Agreement ended due to a 1999 FCC order. That order[52] found that the directory business was effectively competitive and established rates of 4 cents and 6 cents for listings and updates, respectively, to be charged by local exchange companies to all directory publishers on a nondiscriminatory basis. The FCC specifically prescribed incumbent local exchange carriers from charging anything more than these cost-based subscriber listing rates. The FCC noted;

99.

> We also reject the idea that incumbent LECs be allowed to charge either whatever they want or value-based prices for subscriber list information. Congress enacted § 2-22(e) to correct a perceived failure in the market for subscriber list information. . . Given that Congress enacted § 2-22(e) to redress a market failure, we do not believe that the passing reference to "value" in the 1995 house report was intended to allow LECs with unique control and access to subscriber list information to recover compensation in excess of incremental costs and a reasonable allocation of common costs and overheads through their subscriber list and information rates. Instead we find that report and the legislative history behind § 2-22(e) consistent with the view that carriers should charge rates equal, or similar, to those that would be charged if there were a competitive market or subscriber list information.[53]

100. Thus, Verizon was required to replace its previous revenue-sharing agreement with a publishing agreement and a billing and collection agreement. This FCC order, which was designed to address a market failure, along with the fact that the directory company does not need to the permission of Verizon Northwest Inc. to use the "Verizon" name, made the prior level of revenue under the Master Publishing Agreement unsustainable.[54]

101. As with the previous revenues from directories, the new revenues from the new contracts are reflected in the financial information in this case (TR. 176, ll: 17-20).

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[52] *In re Implementation of the Telecommunications Act of 1997*, cc Docket No. 96-115, FCC 99-227, 64 FR 5/910, 5 3944 (1999) (exception in Ex. 161)

[53] *Id*. at pp. 46, 49.

[54] The directory company is also not designated the "official" publisher for Verizon Northwest Inc.

102. In short, Verizon and Qwest have had completely different directory publishing relationships, and therefore Staff's adjustment is wrong.[55]

(3) Verizon's restating adjustments.

103. Ms. Heuring explained how Verizon developed its results of operations consistent with Commission accounting rules. This included the use of restating adjustments. (Ex. T21, pp. 4, ll. 10-20). The Staff accepted these results in its analysis. (Ex. 142). Staff witness Strain apparently believes that the Company should not have used booked results, as opposed to restated results, as the starting point for the Company's financial presentation. However, as Ms. Heuring explained, Staff witness Strain takes only a slightly different approach to end up in the same place with respect to its earning analysis. (Ex. 23T, p. 6, ll: 21-23; NWH 11; Ex. 142). In short, no one contests the process used by Ms. Heuring to develop the results of operation presented by her in Exhibit 22. (See Ex. 21T, ll: 10-19). There should be no controversy over restating adjustments.

(4) Employee separation program.

104. Ms. Strain made an adjustment of reducing approximately $7.9 million in expense due to "an employee separation program." As explained by Ms. Heuring in her rebuttal testimony, this adjustment was "more in the nature of a pro forma" that reduces employee labor costs but does not bring in a pro forma which reflects increases in employee-related benefit costs. (Ex. 23T, ll. 8-23).

105. In sum, all expense reductions and expense increases associated with employee labor costs should be more fully and further considered in the general rate case.

b. Levels and trends in financial results

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[55] This issue can also be viewed through a different lens. The FCC's decision to set subscriber listing rates is akin to other FCC changes that affect utility operations, such as the FCC accounting and depreciation changes at issue in *General Telephone*, Cause No. U-81-61. The Commission permitted recover of the costs associated with those FCC changes, and it should do so here.

106. The clearest demonstration of the trends in Verizon's revenues and expenses on a Washington intrastate basis is page 2 of Exhibit 143 prepared by Staff witness Strain. This graph shows the steady and dramatic decline in revenues for Verizon since 2000.

107. This graph is consistent with Verizon's experience as testified to by Ms. Heuring and Mr. Banta. (Ex. 21T, p. 5; Ex. 635, pp. 7-9) Among other reasons cited by Ms. Heuring for the dramatic reduction in intrastate earnings since 2000, besides the substantial revenue loss associated with the access charge order, is the stark fact that the Company has suffered losses in retail lines that will continue into the foreseeable future. Ms. Heuring concludes that, "there is no evidence the Company's financial performance is expected to improve dramatically in the near term absent relief from this Commission." (Ex. 21T, p. 5, ll. 15-16). Indeed, both Mr. King and staff witness Strain agree with this conclusion. (Ex. 101T, p. 18, ll: 8-10; TR. 571) Mr. Banta further explained contributing factors to the Company's decline in revenues in responding to Ms. Strain's contentions that Company actions are the reason for the reduced level of earnings. (Ex. 63T, p. 7, ll. 9-22).

108. The Opposition makes several arguments about the reasons for Verizon's financial decline. First, Ms. Strain appears to think that the $30 million reduction that was agreed to by all parties and approved by the Commission to resolve the 1999 merger case[56] forever precludes Verizon from seeking $30 million in rate relief. Mr. Banta pointed out that the merger case not only concerned approval of the merger but also the resolution of an access charge complaint and an informal earnings review. (Ex. 63T, ll. 7-12). Furthermore, the stay-out period contained in the settlement was for only two years, demonstrating that this was not an evergreen reduction and Verizon might need to seek relief in the future. Things change and the Company's revenue situation could, and did, deteriorate. This is not unusual. As Dr. Blackmon said in his editorial, "Good Phone Service Demands Fair Rates." (Ex. 189)

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[56] *In the Matter of the Application of GTE Corporation and Bell Atlantic Corporation, etc*, Docket No. UT-981367, Fourth Supplemental Order, (Dec. 16, 1999).

109. "The fact that a rate decrease would be followed less than two years later by a rate increase is a sign of the changes in the telecommunications industry. As demand grows and new services and companies enter the business, the phone companies revenues and expenses are anything but stable."

110. Ms. Strain also suggests that Verizon Northwest is somehow shifting revenues from its regulated local exchange service to its non-regulated affiliates. (Ex. 141, pp. 19-20). Yet Staff has not conducted any analysis from which it could draw this conclusion. (Ex. 149, p. 3). Ms. Strain also speculates that Verizon Northwest is losing revenue due to its toll customers switching service to its affiliate, Verizon Long Distance. Again, Staff has conducted no final conclusive analysis on this point. (Ex. 149, p. 4). Nor did Ms. Strain undertake any analysis of the competitive marketplace within which Verizon now operates, even though she acknowledged that the intraLATA toll market is competitive (TR. 562, ll. 11-16). Ms. Strain ignored documentation provided by Verizon Northwest in response to a data request that discussed at length the competitive challenges faced by Verizon. (Ex. 159).[57]

The real facts regarding line loss are as follows:

111.
- DSL - Staff makes much of the fact that Verizon NW is losing second lines when customers switch to DSL. Verizon cannot fathom the relevance of this position. First, customers who need bandwidth will not remain on the 56K speed of an analog line. Verizon NW cannot stop customers from moving to a high-speed interstate service any more than Henry Ford could keep selling black Model T Fords when technology moved on. Second, Staff asserts that Verizon NW should be its own ISP. Again, the position makes no sense. ISPs are not regulated and no revenue would accrue to the intrastate jurisdiction.

112.
- IntraLATA Toll – Staff suggests that Verizon NW is moving customers to Verizon Long Distance ("VLD"). But again, this position makes no sense. First, Verizon NW had little market share left when VLD made market entry. (See Ex. 162C) Thus, the lion's share of the revenues was taken by MCI, AT&T and other carriers. Second, VLD resells Verizon NW intraLATA toll at a 5% discount. In exchange, Verizon NW gets to package a bundle of services including intrastate interLATA toll and interstate toll in order to retain customers and maximize revenues.

113.
- Interstate Toll. Staff's suggestion that Verizon NW should be its own interstate carrier, ignoring again that these revenues would not accrue on the intrastate books. Moreover, this argument does not address the fact that Verizon would have to obtain

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[57] Indeed, with respect to the claim regarding Verizon long distance, Ms. Strain also did not examine the extent to which Verizon lost market share in the intralata toll market prior to the entry of VLD into the Washington market. (*See* Ex. 162C).

national transport capacity, which makes absolutely no sense for a one state operation.

114. • Jurisdictional "mis-match." Ms. Strain alludes to an alleged mismatch in the jurisdictional allocation factors that might contribute to Verizon's declining rate of return in its intrastate jurisdiction. (Ex. 141T, p. 28, ll. 15-20). Again, when asked for more specific information with respect to Staff's investigation into this allegation, Staff could produce no evidence to back up its claim. (Ex. 149, p. 12). As testified to by Ms. Heuring, Verizon properly separates its revenues and expenses pursuant to Part 36 of the FCC's separation rules. (TR. 184) Staff witness Strain never contended that Verizon improperly applied these FCC separation rules. Rather, she seems to take issue with the FCC's separation rules, which have been frozen until 2006.[58] This, of course, is contrary to direct Ninth Circuit precedent that a state commission cannot ignore the FCC's separation rules. *Hawaiian Telephone Co. v. Public Utilities Commission of Hawaii*, 827 F.2d 1264 (9th Cir. 1987). Indeed, she acknowledged, and additional evidence supports, the fact that the jurisdictional "mis-match" that Ms. Strain is concerned about is common throughout the industry and not unique to Verizon. (TR. 565; Ex. 163) Certainly Ms. Strain's incomplete views on jurisdictional separations provides no evidence upon which the Commission could draw any conclusions with respect to Verizon's financial situation.

c. Rate of return/capital structure

115. In Section III.A.3 (Factor No. 3 above), Verizon discussed the implications of its current rate of return. However, the Commission should view seriously the significant decline in Verizon's rate of return to a negative .47% in 2003. (*See* Exs. 25, 26)

116. With respect to the capital structure, Dr. Vander Weide assumed that Verizon's intrastate operations were financed with the same proportion of debt and equity as with Verizon Northwest's total operations. Verizon Northwest total operations are financed with 8.14 percent short-term debt, 29.91 percent long-term debt and 61.95 percent common equity. (Ex. T1, p. 6, ll. 13-19)

117. Staff's only mention of capital structure is by Ms. Strain who observes that the total Company has maintained a relatively healthy capital structure since 1999. Ms. Strain observed that for the total Company, its equity component of capital has increased from 58.44 percent to 62.25 percent. Staff comments that Verizon Northwest as a total Company, has paid dividends to its parent company since 1999. However, as explained by Dr. Vander Weide, because

[58] *In the Matter of Jurisdictional Separations*, cc Docket No. 80-282, Report & Order, (rel. May 22, 2001).

Verizon's Washington intrastate cashflows were insufficient, it could not have contributed toward dividend payments. (Ex. 3T, p. 10, ll. 12-14; *see also* TR. 331).

d. Interest coverage

118. Dr. Vander Weide analyzed the financial condition of Verizon's Washington intrastate operation to determine whether on a stand-alone basis, its financial condition would be sufficient to support an investment grade credit rating and to allow Verizon to attract the capital required to provide telecommunications services. He examined three important ratios that relate to the Company's ability to pay interest and principal. The first ratio, earnings before interest and taxes ("EBIT"), measures the extent to which a company's operating income can decline before the company is unable to meet its interest obligations. Rating agencies place considerable emphasis on the EBIT ratio as a measure of the company' ability to pay interest on debt.

119. The second financial ratio, earnings from continuing operations before interest taxes depreciation and amortization divided by interest ("EBITDA"), measures interest coverage relative to the company's operating cash flows rather than operating income.

120. The third ratio is funds from operations to total debit ("FFO").[59] As the reproduced table from Dr. Vander Weide's testimony (Ex. 1T, p. 9) demonstrates, the three key financial ratios for Verizon's intrastate operations have deteriorated significantly since 1999.

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[59] Staff criticizes Verizon for failing to keep certain records on an intrastate basis. While Verizon might not keep all types of financial information on an intrastate basis, it reports sufficient financial results to the Commission and filed reports such as the quarterly surveillance report and the year-end annual reports (Ex. 150, T-1, p. 4, ll. 18-19). Dr. Vander Weide was able to do his analysis based upon the level of intrastate detailed reporting.

121. **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%

122. Based upon these indicators, Dr. Vander Weide concluded that on an intrastate basis, Verizon's 2003 earnings with the access reductions are insufficient to even pay the interest on its debt. (Ex. T-1, p. 9, ll 20-21) Dr. Vander Weide also concluded that this insufficient interest coverage capability would lower a bond rating to below investment grade, (BB). (Ex. T-1, p. 12)

e. Intermediate and short-term financing demand.

123. Staff argues that Verizon has no intermediate or short-term financing needs because its other operations at the total company or parent corporation level are sufficient. This approach entirely begs the question of whether this Commission should ensure that Verizon's Washington operations stand on their own feet. In Order No. 5, the Commission realistically observed:

124. There is an increasing trend of utility mergers, and intrastate operations in some instances are becoming relatively smaller portions of companies' overall business. We must recognize the realities of today's regulated businesses when examining need for an interim rate increase. It is inappropriate to demand that a small piece of a large company caused the overall business to fall into jeopardy as a minimum criterion for a grant of interim rates.[60]

125. Thus, the fact that Verizon is part of a larger corporate family is not relevant, and does not diminish the immediacy of its need for financial relief to cure its deteriorating intrastate financial condition. This relationship does not justify the continued imposition on the owners

[60] *Id*. p. 6, ¶ 17.

of Verizon Corporation and Verizon Northwest Inc. to continue to carry the financial burden of subsidizing Verizon's intrastate operations. Verizon's intrastate operations should be able to stand on their own feet with respect to achieving a healthy enough financial condition to qualify for financing. Dr. Vander Weide testified that Washington's intrastate operations cannot stand their own feet at the current time without rate relief. The continued financial distress of Verizon's intrastate operations can, and will, have an impact on the ability of those operations to draw from even internal funding sources. (TR 389-390)

f. Effect of the grant of interim relief on financing demands.

126. Verizon has been criticized for asking for too little by way of interim relief because interim relief would not cure all of Verizon's financial difficulties. (Ex. 101T, p. 17, ll. 10-20; Ex. 141T, p. 34, ll. 7-16) As explained by Mr. Banta, the Company quantified its interim relief demand on the basis of the access charge reductions ordered last year, even though the Company's financial situation would have warranted a higher request. Limiting its request only to those revenues cleanly defined for the Commission the revenues that were at stake and lost as a direct result of Commission action. For the reasons stated herein, to not award this amount to Verizon would constitute a gross inequity.

127. An award of this amount would also alleviate some of the financial stress the Company faces. Dr. Vander Weide explained that if Verizon's request is granted, the financial ratios associated with its Washington intrastate operations would rise to a level sufficient to justify the lowest investment grade bond rating of BBB. (Ex. 3T, p. 11; Ex. 2; TR. 123, ll. 18-21)

128. Verizon agrees that the interest coverage ratio still remains too low were it to receive only $29.7 million.[61] However, in the mix of considerations before the Commission in this case, a grant of $29.7 million in interim rate relief on equitable grounds will go a long way to alleviating the financial pressures of Verizon's Washington intrastate operations until the

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[61] Verizon Northwest is required to have a 2.0 interest coverage ratio for its debentures. The Commission also established an interest coverage ration 1.5 percent in the *Olympic Pipe Line* case, ¶ 52, Table 1.

general rate case can be resolved. It would be inequitable to deprive Verizon of these levels when there is such a strong likelihood that permanent relief will be granted as a result of the general rate case. Such rate relief is the only way Verizon's financial condition can improve according to both Mr. King and Staff witness Strain.[62]

5. Factor No. 5 (Clear detriment to the utility)

129. *In the economic climate, the financial health of utility may decline very swiftly. Interim relief stands as a useful tool in an appropriate cast to stave off impending disaster. However, this tool must be used with caution, and must be applied only in a case where not to grant would cause clear jeopardy to the utility and detriment to its ratepayers and stockholders. That is not to say that interim relief should be granted only after disaster has stuck or is imminent, but neither should it be granted in any case where full hearing can be had and the general case resolved without clear detriment to the utility.*

130. All of the financial indicators discussed above demonstrate the clear detriment to Verizon if some immediate effort is not made to restore its intrastate operations to some level of financial health. In fact, a utility that has a negative rate of return suffers an actual disaster, not just an "impending" one. Mr. King and Public Counsel argue that the owners of Verizon's intrastate operations would not let that happen. However, Dr. Vander Weide unequivocally stated that the owners have no incentive whatsoever to continue to invest in the Washington intrastate jurisdiction. (Ex. 1T, p. 14) These owners are similarly situated to the non-regulated owners of Olympic Pipe Line, BP Pipeline North America, Inc. and Equilon Pipeline, LLC. Further financing from the Olympic owners was clearly in doubt because of Olympic's negative financial condition. The Commission recognized that common sense would make Olympic's owners reluctant to provide further funding. It quoted an Olympic witness acknowledging this fact: "Would you make a loan to this company?"[63] Mr. King agreed that BP/Arco would not loan money to "a money losing proposition." (TR. 476-477). The

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[62] *See* ft. 26..

[63] *Olympic* ¶ 16.

Commission should not assume that the owners of Verizon's intrastate operations will continue to do so.[64]

131. Rather, the Commission could reasonably anticipate additional cutbacks in capital deployment. Indeed, because it takes time to turn an oil tanker, the effects on service results has not been immediate but restricted budgets are beginning to produce lower service results. Mr. Banta testified regarding possible repercussions from a denial of interim rate relief. For instance, service levels will decline as the impact of further belt-tightening ripples through the Company's operations, to the detriment of ratepayers. (TR. 326, ll. 8-14)

6. Factor No. 6 (Public interest)

132. *As in all matters, we must reach our conclusion with the statutory charge to the Commission in mind, that is, to "regulate in the public interest." RCW 80.01.040. This is their ultimate responsibility, and a reasoned judgment must give appropriate weight to all salient factors.*

133. The public interest requires interim relief in this case. The salient factors are:

134. 1. Verizon's earnings are negative, based on Verizon's calculations, and 767 basis points below authorized, based on Staff's calculations. Under either calculation, interim relief is warranted. Also, Chairwoman Showalter discussed the likelihood that Verizon will receive permanent relief so that interim relief might make sense (TR. 506-509). An award of interim relief could cushion any rate shock.

135. 2. Verizon's financial indices yield a below-investment grade bond rating.

136. 3. Verizon is seeking only $29.7 million in interim relief, which is the amount its access charge revenues were reduced by the *Eleventh Supplemental Order* in UT-020406. Verizon had no control over these reductions, did nothing wrong in following the Commission's access charge rules and prior policies, and was treated differently than other carriers.

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[64] In addition requiring non-Washington intrastate operations to subsidize Washington intrastate operations would send a very negative signal to other multi-jurisdictional companies about the wisdom of investing in this state.

137. 4. The relief Verizon seeks is subject to refund, and therefore customers will be protected. This balances the interests between the Company and ratepayers.

138. 5. Finally, given the unique nature of this case, granting relief will not "open the floodgates" in future cases.

B. Should this request, seeking rebalancing for reductions in revenue that the Commission ordered, be considered as different in character from other requests for interim relief?

1. What precedent, if any, exists at the Commission regarding rebalancing of the sort requested?

2. What policy factors should bear on determining whether this request differs from other requests for interim relief?

139. As discussed above, Verizon has established its need for interim relief based on the six factors espoused in the *PNB* case. At the same time, however, Verizon's request is different in character from *PNB* and other requests for interim relief because it seeks rebalancing for revenue reductions that were caused by a Commission policy change outside Verizon's control. In other words, the "typical" request for interim relief addressed by the *PNB* factors involves a utility that has experienced reduced revenues or higher expenses (or both) due to events outside the control of both the utility and the Commission. Here, Verizon has reduced revenues *because of* a Commission order. Indeed, this action caused a "*considerable* reduction in Verizon's revenues," as the Commission noted in its *Eleventh Supplemental Order* in UT-020406.[65] Thus, Verizon's request for interim relief is even more compelling than other requests the Commission has faced.

140. There is precedent that supports Verizon's request for interim rate rebalancing: the Commission's *General Order No. R-450*, Docket No. UT-970325. There, the Commission allowed all carriers to make revenue-neutral rate rebalancing filings to offset reductions in access charges resulting from the newly created Access Charge Rule. In doing so, the

[65] *Eleventh Supplemental Order* at 43, ¶ 144 (emphasis added).

Commission rejected the arguments of Public Counsel and AARP that such rebalancing should not be permitted without an earnings review; in fact, the Commission did not require any company to make *any* kind of financial showing of need.[66] Moreover, this rate rebalancing was allowed to go into effect on a permanent basis. Here, Verizon will rate rebalance only on an interim basis subject to refund. Thus, Verizon's rate rebalancing is fully consistent with the letter and spirit of the Commission's precedent in UT-970325.

141. Given the unique character of this request, the Commission can and should grant interim relief regardless of the "six factor" analysis discussed above. The Commission clearly has the power to do so under the long-standing precedent of *Puget Sound Navigation Co. v. Department of Transportation ("Puget Sound")*, 33 Wn.2d 448 (Wa. Sup. Ct. 1949). There, the Washington Supreme Court recognized that the Commission has the power to approve interim rate increases "when it deems justified":

142. Furthermore the Supreme Court quoted from 51 C.J. 48, § 91:

143.

> "A public utility commission having power to regulate rates may, when it deems it justified, fix a temporary rate to be charged by a utility pending a valuation of the utility's property and the determination of a reasonable permanent rate." See, also, 43 Am. Jur. 707, § 202.

Id. at 482.

144. In short, the Commission has broad powers to award interim relief "pursuant to reasonable conditions or limitations" (*id.*), and is not tied to any one test in determining whether such relief should be granted. In this case, public policy strongly supports the granting of interim relief. As the Commission has repeatedly recognized, access charges are inextricably linked to a company's overall costs and revenue requirement. For example, in Docket No. UT-970325, the Commission observed that "[a] significant portion of the total cost of operating the local telephone network is recovered in access charges. Access charges paid by IXCs (and ultimately their customers) account for almost 20% of total retail revenues in this

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[66] *General Order No. R-450* at 13.

state, or about $18 per customer per month."[67] The Commission also explained how access charges relate directly to an ILEC's overall profits, which must, by law, be fair, just, reasonable, and sufficient.[68] Because access charges have been a critical part of telecommunications rates, the Commission has never addressed them in a vacuum. And when the Commission has ordered access reductions, it has allowed carriers to make offsetting rate rebalancing increases. The Commission should apply this same policy here and grant interim relief.

IV. RATE DESIGN

A. Introduction

145. The Commission and its Staff have endorsed a policy of moving business and local residential rates for local service closer together because their underlying costs are similar. (Ex. 188, 189). Verizon's rate design proposal best furthers that policy and minimizes the likelihood of competitive loss of business customers, thereby preserving important revenue streams.

B. Equal percentage increase proposal

146. Staff's proposal would cause business customers to pay on an absolute dollar basis significantly more than residential local exchange customers. (Ex. 181T, pp. 10-11; Ex. 63T, p. 10, ll. 17-21) Yet evidence demonstrates that if anything, business customers cost less than residential customers to serve. (Ex. 74C) Thus, as a matter of fairness, equity and regulatory policy, Staff's equal percentage proposal is flawed and should be rejected.

C. Equal dollar increase proposal

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[67] Docket No. UT-970325, *General Order* R-450 (Ex. 131) at 4.

[68] Docket No. UT-970325, *General Order R-450* at 4. *See also POWER v. WUTC*, 104 Wn.2d 798, 711 P.2d 319, 324-26 (1985) (the Commission "is charged by law with the setting of just, reasonable, and sufficient public utility rates," which means that the utility must be allowed to set rates that "will yield to the utility its aggregate allowed revenue requirement"). This obligation is based on the Fifth and Fourteenth Amendments. *See, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

147. Verizon's proposal would impose the same financial burden on all of its customers and reduce the misalignment between the current cost and cost relationship between residential and business rates and costs. (Ex. 62T, pp. 11-12) Commission Staff agreed that Verizon's proposal is as practical and simple to administer as Staff's proposal. (TR. 614) It also agreed that it is Commission policy to try to move residential and business rates closer to costs. (TR. 620-621) Verizon's proposal of an interim monthly surcharge in an equal dollar amount best achieves the Commission's policy goals. Furthermore, Mr. Banta explained that Staff's proposal would defeat the purpose of Verizon's ability to bundle/package. (Ex. 63T, p. 11, ll. 11-15).

D. Services subject to a surcharge (includes the WTAP issue)

148. Mr. Banta testified that Verizon could support a proposal that applies the interim surcharge to all intrastate retail and resale tariffed, price-listed and contracted access lines except for UNEs on a fixed amount per line basis. Verizon would also agree to apply the surcharge to WTAP lines. (Ex. 63T, p. 12, Ex. 64C)

E. Mechanics of calculating a surcharge if one is authorized

149. Verizon's approach is straightforward. The Company would charge an interim surcharge of $3.54 to the basic local residential and business services listed on Ex. 64C.

V. DEFERRAL ACCOUNT PROPOSAL

150. The concept of a deferral account defeats the purpose of granting immediate interim rate relief because it would deprive Verizon of immediate access to necessary funds. (TR. 332-325; 458-459) Therefore, Verizon would oppose it on that basis. In addition, the administration associated with a deferral account could be complex (unlike a simple refund).

VI. REFUND ISSUE

A. Whether and how to apply refunds

151. Should the Commission order an amount of rate relief that is less than any interim rate allowed Verizon would make a refund. No refunds would be in order if Verizon receives more

rate relief in the general rate case even if the final rate design differs from the interim rate design. Certainly Verizon should be entitled to keep all interim revenues the Commission finds it is entitled to, if more are authorized in the general rate case. Verizon would be precluded from recovering from customers who would have paid less under the interim rate design due to the doctrine against retroactive ratemaking. Therefore, to keep Verizon whole, no refunds should be ordered in situations where customers may pay more during the interim period[69] but may pay less as a result of the final rate design.

VII. CONCLUSION

152. Verizon requests the Commission to order interim rate relief in the amount of $29.7 million, which is the amount of access charge reductions ordered in the *Eleventh Supplemental Order* in Docket No. UT-020406. Recovery of these revenues would be by way of an interim monthly surcharge of $3.54 applied to the basic local residential and business services identified in Exhibit SMB-3C.

DATED this _____ day of August, 2004.

GRAHAM & DUNN PC

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[69] These rates will be just and lawful if approved by the Commission under RCW 80.36.080.