Exhibit No. _______ (NWH-1T)
Docket No. UT-040788
Revised October 4, 2004

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of Verizon Northwest Inc. for an Order Approving Commencement of Bifurcated General Rate Case and Waiver of WAC 480-07-510(2)	**))))**	**DOCKET NO. UT-040788**

DIRECT TESTIMONY OF

NANCY W. HEURING

ON BEHALF OF
VERIZON NORTHWEST INC.

APRIL 30, 2004
REVISED OCTOBER 4, 2004

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Nancy W. Heuring. My business address is 600 Hidden Ridge, Irving, Texas.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Verizon Services Organization Inc. as Director-Regulatory Accounting with responsibilities for the former GTE and Bell Atlantic telephone companies, including the Washington operations of Verizon Northwest Inc. ("Verizon NW" or the "Company"). My principal duties and responsibilities include the direction and supervision of the preparation of accounting information associated with financial filings and regulatory reporting, as required by state regulatory commissions.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE.

A. I graduated from Illinois Wesleyan University, Bloomington, Illinois with a Bachelor of Arts degree in Accounting. I received a Masters in Business Administration degree with a concentration in Telecommunications from the University of Dallas in 1995. I am also a Certified Public Accountant and a Certified Management Accountant.

Since 1981, I have been employed by various subsidiaries of the former GTE Corporation, including GTE Service Corporation, GTE Data Services, GTE Sylvania Lighting Services and GTE Telephone Operations, where I held a number of managerial positions of increasing responsibility, including positions in Audit, Operations Finance, General Accounting, Regulatory Accounting Policy, Regulatory Accounting, Business Affiliates Compliance and Regulatory Compliance. I assumed my current position in June 2000 with the merger of GTE and Bell Atlantic, which formed Verizon Communications Inc.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE STATE REGULATORY COMMISSIONS?

A. Yes. I have testified before the Virginia State Corporation Commission, the California Public Utility Commission, the Indiana Utility Regulatory Commission and the Washington Utilities and Transportation Commission ("WUTC" or "Commission"). In addition, I filed testimony before the Hawaii Public Utilities Commission.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony (1) presents the financial results for the Washington operations of Verizon NW for the twelve-month test period ending September 2003, and (2) discusses the relationships and transactions between Verizon NW and its affiliates that are relevant to this case.

In the first part of my testimony, I demonstrate that the Company's test period results of operations produce a rate of return of *negative* 3.30%~~3.73%~~, which falls substantially short of the required rate of return of 11.64%~~12.03%~~ recommended by Dr. James Vander Weide. My testimony identifies the Company's incremental requirement for increased revenue of $223,364,000~~$239,531,000~~ that is necessary to provide the Company with the opportunity to earn its required rate of return of 11.64%~~12.03%~~ and continue to provide high quality service to its customers.

In the second part of my testimony, I describe Verizon Communications' overall organizational structure and the relationships between Verizon NW's Washington operations and certain affiliates. I also explain why the transactions between Verizon NW and its affiliates are necessary and are provided under appropriate terms.

Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?

A. My testimony is divided into two parts. Part A, which comprises Sections I-V, sets forth the Company's revenue requirement. Section I explains generally why rate relief is necessary and addresses the appropriateness of the test period utilized in this case and the accounting procedures followed in maintaining the financial books and records for Verizon NW. The exhibits filed in support of my testimony are described in detail in Section II. In addition, Section II addresses the development of the revenues, expenses and rate base that represent test period results. Section III demonstrates that the Company's financial results of operations for the test period are expected to continue to decline in comparison to previous years. In addition, Section III addresses the consistency of the revenue requirement presented in this proceeding with the order from the Company's last general rate case.[1] The revenue requirement calculation is presented in Section IV. Finally, Section V summarizes the Company's revenue requirement presentation.

Part B comprises Sections VI-X, and describes the Company's affiliate transactions. Section VI describes Verizon Communications' corporate structure and presents an overview of Verizon NW's affiliate relationships and the pricing of its affiliate transactions. In general, Verizon NW has relationships with three types of affiliates: service companies, regulated affiliates, and non-regulated affiliates. Section VII describes the service company concept and the relationships between Verizon NW and each Verizon service company. Section VIII describes the relationships between Verizon NW and its principal regulated affiliates. Section IX describes the relationships between Verizon NW and its non-regulated affiliates. Finally, Section X summarizes the Company's affiliate transaction presentation.

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[1] Cause No. U-82-45 and U-82-48

Q. WHAT EXHIBITS ARE YOU PRESENTING IN SUPPORT OF YOUR TESTIMONY?

A. I present two exhibits that support the revenue requirement portion of my testimony. Exhibit NWH-2, "Results of Operations," and Exhibit NWH-3, "Revenue Requirement Calculation," provide a summary of the financial data and calculations for the test period utilized in my testimony.

In addition, I present three exhibits that support the affiliate interest portion of my testimony: Exhibit NWH-4, January 1, 2004 Verizon Telephone Companies ("VTC") Part 64 Cost Allocation Manual ("CAM"), Exhibit NWH-5, "Test Year Affiliated Interest Report", and Exhibit NWH-6, "Comparative Schedule of Affiliate Transactions 2001, 2002, and Test Year".

Q. WERE THE EXHIBITS AND ASSOCIATED TESTIMONY PREPARED BY YOU OR UNDER YOUR DIRECTION AND SUPERVISION?

A. Yes, they were.

Q. WHAT ARE YOU PRESENTING IN SUPPORT OF YOUR EXHIBITS?

A. The Company is filing comprehensive supporting workpapers consistent with the testimony.

PART A. VERIZON NW'S REVENUE REQUIREMENT

I. OVERVIEW OF REVENUE REQUIREMENT

Q. WHAT ADDITIONAL REVENUE REQUIREMENT IS THE COMPANY SEEKING IN THIS CASE?

A. The Company is seeking additional annual revenues of $223.4~~$239.5~~ million. These revenues are needed given the Company's poor earnings achieved over the past several years. For example, the Separated Results Summary Quarterly Compliance Report filed with the WUTC for the twelve month-to-date period ended June 2000 showed an intrastate rate of return of 11.74%. The following quarter containing twelve months-to-date data ended September 2000 presented an intrastate return of 7.50%. The return has continued to decline in the intervening periods as shown on Exhibit NWH-2. Indeed, when restating and pro forma adjustments are made, this return drops to a *negative* 3.30%~~3.73%~~.

Q. WHAT MAJOR FACTORS HAVE CAUSED VERIZON NW'S EARNINGS TO DECLINE?

A. There are a number of factors. First, Verizon's revenues were reduced by $30 million per year beginning in May 2000 as a result of the GTE-Bell Atlantic merger Settlement Agreement. Second, the Commission reduced Verizon's intrastate access charges by $29.7 million in the AT&T Access Charge Complaint Case, Docket No. UT-020406. Third, since 2000, Verizon has made more than $508~~526~~ million in additional gross plant investments in Washington resulting in an increased intrastate rate base of $40 million. This additional rate base increases Verizon's intrastate revenue needs (compared to 2000 levels) by $12~~16~~ million per year. Fourth, Verizon's intrastate depreciation expense has increased by $64 million per year. Fifth, Verizon's directory revenues have declined by about $34 million per year due to a new contract with Verizon's directory publisher that reflects the market rate for directory listings.

In addition to these factors, the Company is experiencing increasing pension and post-retirement benefit costs as well as costs associated with employee separation.

Q. HAVE REDUCTIONS IN ACCESS LINES AND MINUTES OF USE ALSO AFFECTED THE INTRASTATE RATE OF RETURN?

A. Yes. Access lines declined each year from 2001 through the test year at 2.2%, 2.4% and 2.9% for each respective period. In addition, intrastate switched minutes of use are declining each year between 2000 and the test year by 3.1%, 15.6%, 11.3% and 15.7% during the respective periods.

In short, the evidence clearly shows that Verizon NW needs relief. Given the growth of competition and the continuing need to provide quality services to our customers, the likelihood of improving the revenue and expense reflected in the pro forma view is extremely limited.

Q. WHAT TEST PERIOD DID VERIZON NW USE TO CALCULATE ITS REVENUE REQUIREMENT ?

A. The revenue requirement calculation is based on the twelve-month period ended September 2003. Revenues and expenses are presented on an average basis for the twelve-month period. The rate base is calculated using a thirteen-month average of monthly averages. The results reflect activity levels that the Company experienced in 2003 under normalized conditions.

Q. IS THERE PRECEDENT FOR USING SUCH A TEST PERIOD?

A. Yes. In the Company's last rate case the parties agreed to a test period with twelve months ending June 30, 1982, which contained the most recent and most complete information available at the time of the proceeding. As in that case, the most recent and most complete data available at this time is the twelve-month period ended September 2003. In addition, the Commission accepted the use of rate base balances calculated on the basis of average of thirteen monthly averages as the most reliable means of matching with operating revenues and expenses.

Q. PLEASE EXPLAIN THE PROCESS USED TO DEVELOP THE REVENUE REQUIREMENT.

A. We started with the Company's detailed regulated accounting records for the period October 2002 through September 2003. (The financial analysis was performed on a combined study area basis, which includes the study areas formerly served by Contel of the Northwest, Inc. and GTE Northwest

Incorporated.) This base data was normalized through the use of "restating adjustments," which modify the booked results to account for out-of-period items (items booked in the base period which relate to a prior accounting period) and other normalizations. The restated results were then modified to reflect several "pro forma adjustments," which reflect significant known and measurable events occurring within the twelve months following the test year. Each of Verizon NW's restating and pro forma adjustments is presented in detail in the supporting workpapers.

Q. ARE THE RESTATING AND PRO FORMA ADJUSTMENTS INCLUDED IN THIS FILING CONSISTENT WITH THE COMMISSION GUIDELINES FOR GENERAL RATE PROCEEDINGS?

A. Yes. WAC 480-07-510(3)(b) requires a detailed portrayal of restating actual adjustments, which it defines as "defects or infirmities in actual recorded results that can distort test period earnings." In addition, this rule describes pro forma adjustments as items that "give effect for the test period to all known and measurable changes that are not offset by other factors."

Q. WERE THE FINANCIAL RESULTS FOR THE TEST PERIOD PREPARED IN ACCORDANCE WITH THE ACCOUNTING RULES AND REGULATIONS PRESCRIBED BY THE FCC AND THIS COMMISSION?

A. Yes. The Company maintains its books and financial records in accordance with the Uniform System of Accounts, as prescribed in Part 32 of the FCC's Code of Federal Regulations ("Part 32") and as required per WAC 480-120-302(2)(a).

In addition, in conjunction with Part 32, the Company's accounting procedures are governed by Part 64 and Part 36 of the FCC's rules. Part 64 sets forth the procedures for distinguishing regulated and nonregulated activity. Part 36 sets forth the procedures for separating property and expense between the intrastate and interstate jurisdictions. The financial data utilized in my testimony was prepared in accordance with these procedures.

Each year the Company files a 43-01 ARMIS Report with the FCC, which the FCC reviews to ensure compliance with its rules. The financial data used in my workpapers and exhibits was prepared from the same source data used to prepare the FCC report.

Q. DOES THE COMPANY PROVIDE OTHER INFORMATION TO THIS COMMISSION THAT IS PREPARED CONSISTENT WITH THE POLICIES PRESCRIBED BY PART 32 AND PART 64?

A. Yes, it does. The Company files with this Commission the Separated Results Summary Quarterly Compliance Report, the Monthly Operating Report, the Annual Report and the Annual Summary Report 43-01 (state). Each of these reports contain financial results that are prepared in compliance with the rules prescribed by Part 32, Part 36, and Part 64.

Q. ARE THE BOOKS AND RECORDS OF THE COMPANY REGULARLY AUDITED BY AN OUTSIDE INDEPENDENT AUDITOR?

A. Yes. Ernst & Young LLP (E&Y) is the Company's independent auditor. E&Y makes a minimum of one complete audit per year in order to provide the certified independent auditor's opinion required for the annual report and other purposes. This opinion has consistently asserted that the financial statements present fairly the financial position of Verizon and its subsidiaries in accord with generally accepted accounting principles.

II. <u>RESULTS OF OPERATIONS</u>

Q. HAVE YOU PREPARED A SUMMARY OF THE COMPANY'S RESULTS OF OPERATIONS?

A. Yes. A summary is presented in Exhibits NWH-2 and NWH-3. These exhibits were prepared using revenues, expenses, taxes, investment and other related rate base elements applicable to the Company's operations.

Q. PLEASE DESCRIBE THE INFORMATION REFLECTED IN EXHIBIT NWH-2.

A. This exhibit presents the Company's net operating income and rate base for Washington intrastate operations for the test period. Column (f), entitled

"Adjusted Intrastate," reflects all restatements and pro forma adjustments, and therefore best reflects the Company's operations for the "going forward" period rates will be in effect.

As shown on line 26 of column (f), the Company's intrastate net operating income is *negative* $31,349,000~~36,036,000~~. The Company's total intrastate rate base is $949,483,000~~965,095,000~~ (line 36, column (f)). These figures yield a return on rate base of *negative* 3.30~~73~~% (line 38, column (f)).

Q. PLEASE DISCUSS THE DIFFERENT RESULTS SET FORTH IN COLUMNS (B) THROUGH (F) OF EXHIBIT NWH-2.

A. Column (b), titled "Regulated," represents regulated, total company booked results of operations for the period October 2002 through September 2003. Column (c) presents *intrastate* results. In other words, the total company data in column (b) was separated pursuant to Part 32 to arrive at the intrastate results in column (c). Line 38 of column (c) shows the booked intrastate rate of return of 2.12~~03~~% (this result excludes restating and pro forma adjustments).

Column (c1) shows the effect of each *restating adjustments*, and column (d) shows the restated results. Column (e) shows the effect of each *pro forma adjustment*. Finally, column (f), titled "Adjusted Intrastate," shows the intrastate results after all restating and pro forma adjustments are made. As shown on line 38 of column (f), the Company's return on these results is *negative* 3.30~~73~~%.

Q. PLEASE DISCUSS COLUMNS (G) AND (H) OF EXHIBIT NWH-2.

A. Column (g) shows the additional intrastate revenue requirement Verizon NW needs in order to have an opportunity to earn a reasonable return. This requirement is $141,869,000~~152,137,000~~ (line 26, column (g)). When the "gross up" factor of 1.574442 is applied to account for taxes and uncollectibles, the total revenue requirement becomes $223,364,000~~239,531,000~~. This calculation is shown on Exhibit NWH-3, line 7, column (b).

Finally, column (h) of Exhibit NWH-2 shows the ongoing intrastate results of operations that reflect the required rate of return of 11.64~~12.03~~%.

A. REVENUES

Q. WHAT CATEGORIES OF TEST YEAR REVENUES ARE REFLECTED IN EXHIBIT NWH-2?

A. The revenue categories are Local Network Services, Network Access Revenues, Long Distance Network Revenues, Miscellaneous Revenues and Uncollectible Revenues. Total intrastate operating revenues in the test period equal $337,262,000~~335,874,000~~ (line 8, column (f)).

Q. GENERALLY, HOW WERE TEST PERIOD REVENUE LEVELS DEVELOPED?

A. The October 2002 through September 2003 book revenues served as the starting point. The base period revenue levels were first adjusted by removing out-of-period items to arrive at restated regulated base period results. Next, any remaining fluctuations in the monthly base period data were analyzed and explained to support the appropriate base period. Finally, pro forma adjustments were overlaid to the restated base period results to arrive at the test period revenue levels.

Q. PLEASE DISCUSS THE PRO FORMA REVENUE ADJUSTMENTS.

A. The pro forma revenue adjustments are derived from either known changes in rates or changes in volumes. First, rate changes occurring within the base period were identified and annualized to ensure the test period reflects the going-level revenues at the new rate. Each of these rate changes impact Local Network Service revenues and are supported by approved tariffs. Next, known rate changes occurring after September 2003 were quantified.

Q. PLEASE IDENTIFY THE PRO FORMA ADJUSTMENT FOR RATE CHANGES OCCURRING AFTER THE BASE PERIOD.

A. Only one rate change was identified as occurring after the base period. In Docket No. UT-020406, the WUTC ordered a reduction in access rates effective October 1, 2003. This rate reduction is incorporated in the test period as a reduction in annual access revenues of $29.7 million.

Q. WHAT PRO FORMA ADJUSTMENTS WERE MADE FOR CHANGES IN VOLUMES?

A. The monthly test year revenues were analyzed by revenue type to identify the actual revenue trend. This trend was then applied to the test year revenue to develop the pro forma test period revenue.

Q. PLEASE DISCUSS THE PRO FORMA ADJUSTMENTS ASSOCIATED WITH UNCOLLECTIBLE OPERATING REVENUE.

A. Two adjustments are included in the test period associated with Uncollectible Revenue. First, the test year Uncollectible Revenues, which are recorded on an accrual basis, were restated to reflect actual write-offs during the test year. To do this, an uncollectible revenue factor was calculated based on the relationship between the test year uncollectible actual write-offs and the associated test year revenue base for uncollectibles. The actual uncollectible revenue factor was applied to the pro forma test year revenue base to derive the test period uncollectible operating revenue. Second, Uncollectible Revenues were restated as a result of the various pro forma adjustments to revenues. A similar adjustment was made for associated fees and taxes which are based on revenues.

Q. PLEASE SUMMARIZE THE PRESENTATION OF REVENUES IN THE TEST PERIOD.

A. The restated intrastate revenues for the twelve months ended September 2003 are $371,689,000. The overall revenue pro forma results in a reduction in test period revenues of $34,427,000~~35,815,000~~ resulting in Total Operating Revenue of $337,262,000~~335,874,000~~. The primary reduction in revenues in the pro forma period is driven by the ordered reduction in access rates.

B. Operating Expenses

Q. WHAT IS THE MAKEUP OF TEST YEAR EXPENSES?

A. The primary income statement categories of expense included in the test year results, reflected in Exhibit NWH-2, include Plant Specific Operations, Plant Nonspecific Operations, Access, Customer Operations, Corporate Operations, Other Operating Income and Expense, Taxes Other Than Income Taxes, and Depreciation. Total intrastate operating expense in the test period equals $395,459,000~~400,077,000~~. The expenses included in these income statement categories can be grouped as follows: salary and wages, pension and other benefits, other employee related, depreciation and all other. Each of the cost categories is a driver and source of the expenses reflected in the income statement line items.

Q. GENERALLY, HOW WERE TEST PERIOD EXPENSE LEVELS DETERMINED?

A. The October 2002 through September 2003 book expense levels served as the starting point from which test period levels were determined. The base period expense levels were first adjusted by reflecting normalizing adjustments to arrive at restated regulated base period results. Next, any remaining fluctuations in the monthly base period data were analyzed and explained to support the appropriate base period. Finally, pro forma adjustments were overlaid to the restated base period results to arrive at the test period expense levels.

Q. PLEASE DESCRIBE THE NORMALIZING ADJUSTMENTS TO OPERATING EXPENSES.

A. Operating expenses were normalized for out-of-period items which were recorded in the test year but which relate to a prior period. In addition, the test year was restated to reflect the policy statement from Docket No. A-921197 related to the treatment of postretirement benefits other than pensions. The policy statement from this docket requires a Company to report cash basis costs ("pay-as-you-go") in the calculation of adjusted earnings. This adjustment is discussed in detail later in my testimony.

Finally, the test year was normalized to properly reflect reclassified items. For the purposes of this proceeding, the Company has removed certain routine business expenditures, which were directly incurred by or allocated to Verizon NW, from the test year results. These include sports related items, company airplanes and executive perquisites, such as gifts and membership fees. While I believe that these items are normal business expenditures, I also realize that such items are only a minor element of total expenses. As such, I want to avoid the prospect of having controversy on such items cloud the urgent need for rate relief. Therefore, these items have not been included in the test year operations.

However, Verizon NW reserves the right to seek recovery of these costs in future rate cases.

Q. PLEASE DISCUSS THE PRO FORMA EXPENSE ADJUSTMENTS.

A. Adjustments were made for certain known changes which occurred after the test year, bringing expense levels to the appropriate rate making level. The expense pro forma adjustments are as follows:

* Salary and Wages
* Benefits
* Rate Case Expense
* Employee Separation Expense
* Voluntary Separation Plan
* Postretirement benefits
* Income taxes

The use of cost categories allows for the development of pro forma expense based on the type of the expense. This approach is practical and allows for specific pro forma adjustments as required based on the nature of an expense, i.e., labor or benefits. The pro forma adjustments by cost category are subsequently categorized by line item for presentation in the exhibits in standard income statement format. I will briefly discuss each of the adjustments.

Q. PLEASE DISCUSS THE PRO FORMA FOR SALARY AND WAGES.

A. The pro forma for salary and wages reflects the following known items:

* Going-level salary and wages associated with actual headcount reductions occurring during the test year.
* Management salary increases and union wage increases per contract.
* Pension and other benefit expense as well as other employee related expense levels that are associated with changes in actual headcount levels.

Q. WHAT PRO FORMA ADJUSTMENTS WERE INCLUDED FOR BENEFITS?

A. In addition to the benefits pro forma associated with changes in headcount mentioned above, specific pro forma adjustments were included to reflect the increasing cost of employee pension and other postretirement benefit costs. Other Assets as well as Other Long Term Liability levels which are associated with changes in pro forma pension and benefits costs were also adjusted accordingly.

Q. HOW WERE RATE CASE EXPENSES TREATED IN THE TEST PERIOD?

A. Incremental expenses associated with rate case activity were estimated and reflected in the test period based on a three year amortization. These expenses include expenditures such as those required to meet customer noticing requirements, consultants and external legal representation. This is consistent with the WUTC order in Docket UT-76-37 which allowed the recovery of rate case expense amortized over a three year period.

Q. PLEASE DISCUSS THE PRO FORMA RELATED TO EMPLOYEE SEPARATION EXPENSE.

A. As noted above, salary and wages during the test year declined due to reductions in headcount. The pro forma for salary and wages accounted for the savings associated with this headcount reduction through the adjustment for going-level wages in the test period. Separation expense associated with the headcount reduction is also included in the test year. The pro forma for employee separation expense amortizes this test year cost over a three year period. This is consistent with the WUTC order in Docket UT-950200 (the US WEST rate case), which netted the test year costs and associated benefits.

Q. PLEASE DISCUSS THE VOLUNTARY SEPARATION PLAN MENTIONED ABOVE.

A. In the fourth quarter of 2003, Verizon Communications Inc. recorded a charge associated with costs incurred in connection with a voluntary separation plan under which approximately 21,000 employees accepted the separation offer. The results of this plan represent headcount reductions occurring after the test year.

Q. WILL THE VOLUNTARY SEPARATION PLAN REDUCE EXPENSES?

A. Yes. Savings associated with headcount reductions represent an elimination of cost. These savings cannot be explicitly accounted for in the accounting records of the organization, however they can be estimated. As savings from the separation plan are realized, they are inherently reflected in the financial results as lower costs are incurred. Net savings from the separation plan initiative are not expected to materialize until after the test period utilized in this case. In other words, cumulative costs of the program will exceed accumulative savings until some period beyond the test year.

Q. HOW IS THE SEPARATION PLAN REFLECTED IN THE TEST YEAR RESULTS OF OPERATIONS?

A. The historical test year does not include any of the costs or savings associated with the voluntary separation plan since this event took place after September 2003. The costs which were recorded to the Washington operations in the fourth quarter of 2003 and the first quarter of 2004 were accumulated and amortized over a five year period. The annual savings in salary, wages and benefits from the net reduction in headcount were estimated. This annual savings number was then netted against one year of the amortized cost with the result being included in the test period operating costs.

Q. PLEASE DISCUSS THE PRO FORMA ADJUSTMENT FOR POSTRETIREMENT BENEFITS.

A. Postretirement benefits include medical and life insurance for retirees. Part 32 and generally accepted accounting principles account for these costs on an accrual basis under FAS 106. As noted above, the Company is required to report financial results including these costs on a cash or pay-as-you-go basis.

The objective of FAS 106 was to better match costs with the events giving rise to those costs. The specified accounting treatment highlights the Company's obligation to its employees, one that must be recognized as a liability on the Company's balance sheet.

The Company records postretirement benefits on an accrual basis. The restating adjustment discussed above removes the FAS 106 accrued capital, expense and liability and reflects pay-as-you-go in the restated intrastate results. The pro forma adjustment removes the cash basis accounting and appropriately reflects the FAS 106 expense, capital and liability.

Q. WHY HAVE YOU INCLUDED FAS 106 COSTS IN YOUR TEST PERIOD RESULTS?

A. FAS 106 costs have been included in test period results because they represent the ongoing level of costs associated with retiree medical and life insurance payments. By recognizing these costs on an accrual basis, current ratepayers are paying for the level of costs required to provide service. If these costs were not recognized on an accrual basis, future ratepayers would have to pay for the cost of benefits earned today.

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Q. HOW ARE INCOME TAXES REFLECTED IN THE FINANCIAL RESULTS?

A. In order to properly match Verizon NW's intrastate taxable income for Washington with the related tax expense, the intrastate federal income tax amount was calculated based on Intrastate Booked and Intrastate Test Period revenue and operating expense (Columns (c) and (f) of Exhibit NWH-2). These recalculated income taxes were substituted for the per book taxes in order to match this cost component with other test year data.

Q. WHAT ABOUT OTHER EXPENSE CATEGORIES?

A. If not specifically mentioned above, then test period expense levels were held constant with the historical period.

Q. PLEASE SUMMARIZE THE PRESENTATION OF OPERATING EXPENSES IN THE TEST PERIOD.

A. The restated intrastate operating expense before depreciation expense for the twelve months ended September 2003 is $233,585,000~~233,595,000~~. The overall expense pro forma results in a reduction in test period operating expense of $9,936,000~~5,614,000~~ resulting in Total Operating Expense of $223,649,000~~227,981,000~~. The primary reduction in expenses in the pro forma period is driven by the reflection of in-period employee separation expense on an amortized basis.

C. DEPRECIATION

Q. DID YOU MAKE AN ADJUSTMENT FOR DEPRECIATION?

A. Yes. I made a pro forma adjustment in depreciation expense to reflect the revised depreciation rates requested by the Company in Docket No. UT-040520.[2] That adjustment resulted in an annual increase in total state depreciation expense of $64.5~~64.9~~ million. The resultant intrastate impact of this increase is approximately $47.1~~47.4~~ million annually. These amounts vary slightly from those presented in Docket No. UT-040520 due to pro forma adjustments associated with Telecommunications Plant in Service discussed in the next section.

Q. WHY IS THIS DEPRECIATION ADJUSTMENT NECESSARY?

A. The current depreciation rates are outdated, inadequate, and do not reflect the appropriate level of depreciation expense. Verizon NW's Washington depreciation rates need to be revised to bring Washington's intrastate accumulated depreciation reserve up to adequate levels. Verizon NW's Washington depreciation reserve is not adequate, and not reasonable when compared to other states. Verizon NW's Washington depreciation rates also need revision to take into account developments since the last depreciation order, today's business environment, and technological advancements. The depreciation rates proposed in Docket No. UT-040520 are based on the same depreciation lives that Verizon NW uses for external financial reporting purposes. The lives that Verizon NW

[2] Docket No. UT-040520 is pending resolution.

uses for its external financial reporting are annually updated, consistent with Generally Accepted Accounting Principles (GAAP), and have been reviewed by Verizon's external auditors.

Q. COULD YOU BRIEFLY DESCRIBE HOW INTRASTATE DEPRECIATION RATES HAVE HISTORICALLY BEEN SET FOR VERIZON WASHINGTON?

A. Typically, Verizon submits a depreciation study that Staff reviews and then makes a recommendation on. The Commission then weighs the evidence presented and orders depreciation rates for intrastate regulatory accounting purposes.

Q. WHEN WAS THE LAST DEPRECIATION ORDER FOR VERIZON WASHINGTON?

A. Verizon's last depreciation order was approved by the WUTC in Docket UT-992009 for revised depreciation rates effective January 1, 2000, which resulted in a total state increase in depreciation expense of approximately $21.5M. The resultant intrastate impact of this increase was approximately $16.1 million.

Q. HOW DOES VERIZON'S WASHINGTON INTRASTATE ACCUMULATED DEPRECIATION RESERVE RATIO COMPARE TO NEIGHBORING STATES, THE FCC, AND GAAP?

A. Verizon NW's accumulated depreciation reserve ratio[3] for Washington intrastate operations is woefully inadequate compared to the accumulated reserve ratio in neighboring states. In fact, Washington's regulated intrastate accumulated depreciation reserve ratio is the lowest of any of Verizon's states. Washington's intrastate accumulated depreciation reserve ratio is 43.3% for the accounts prescribed by the WUTC. As a comparison, the Oregon and Idaho commissions have prescribed depreciation rates allowing the accumulated depreciation reserve ration to grow to 56.5% and 59.0%, respectively. The Washington intrastate accumulated reserve ratio also severely lags both the FCC accumulated reserve for Washington and the financial reporting (GAAP) reserves for Washington of 53.1% and 62.3%, respectively. These comparisons clearly demonstrate that Verizon Washington's accumulated depreciation reserve ration severely lags not only what Verizon believes to be adequate reserve ratio levels, but also what neighboring Commissions have allowed, and even lags the FCC for the same jurisdiction.

D. RATE BASE

Q. WHAT CATEGORIES ARE INCLUDED IN THE TEST PERIOD RATE BASE?

A. The basic components of the Company's rate base reflected in Exhibit NWH-2, are Telecommunications Plant in Service, Other Assets, Investor Supplied

[3] The accumulated depreciation reserve percentage is the ratio of accumulated depreciation in the reserve to original cost.

Working Capital, Depreciation and Amortization Reserve, Deferred Income Taxes, and Other Long-term Liabilities. Total intrastate rate base in the test period equals $949,483,000~~965,095,000~~.

Q. HOW WAS THE TEST PERIOD RATE BASE DEVELOPED?

A. The test period amounts for these components were based on the average of thirteen monthly averages. These levels were first adjusted by reflecting normalizing adjustments to arrive at restated regulated base period results. Next, any remaining fluctuations in the monthly base period data were analyzed and explained to support the appropriate base period. Finally, pro forma adjustments were overlaid to the restated base period results to arrive at the test period levels.

Q. PLEASE DESCRIBE THE NORMALIZING ADJUSTMENTS TO RATE BASE.

A. The rate base normalization essentially reflects two types of adjustments. First, the Other Long Term Liability associated with FAS 106 was removed to reflect cash basis accounting as discussed above. Second, the Other Assets and Deferred Income Taxes categories were adjusted to reflect accounting restatements.

Q. PLEASE DISCUSS THE PRO FORMA ADJUSTMENTS TO RATE BASE.

A. Several of the rate base pro formas are a result of expense pro formas discussed above. These relate to increases in pension and benefits cost as well as reflecting FAS 106 in the test period. In addition, a pro forma adjustment was included to reflect Investor Supplied Working Capital in the test period. Finally, an adjustment was made to reflect the going-level of Telecommunciations Plant in Service and Depreciation and Amortization Reserves.

Q. PLEASE DISCUSS THE PRO FORMA ADJUSTMENT TO PLANT AND THE ASSOCIATED RESERVES.

A. First, several plant and associated reserve accounts included significant retirements in the test year. For these accounts, a new average balance was calculated based on the post-retirement average monthly balances. Next, estimated gross additions and retirements for the twelve months following the test year were added to these new average balances assuming a half year convention. Finally, depreciation expense was calculated using the requested depreciation rates from Docket No. UT-040520 discussed above. The pro forma appropriately reflects the change in plant, reserves, depreciation expense and deferred income taxes.

E. SEPARATIONS

Q. PLEASE DISCUSS THE ROLE OF SEPARATIONS IN THE DEVELOPMENT OF THE REVENUE REQUIREMENT.

A. Most of the property and expenses of the Company are used for both intrastate and interstate services. Part 32 does not provide for a separation of property or expenses between intrastate and interstate jurisdictions. In view of this, the Company records reflect the total investment, expenses and taxes applicable to both jurisdictions. It is, therefore, necessary to separate these costs in order to properly allocate investments, expenses and taxes between the jurisdictions.

Q. HOW ARE COSTS SEPARATED BETWEEN THE INTERSTATE AND INTRASTATE JURISDICTIONS?

A. Costs are separated between the interstate and intrastate jurisdictions in accordance with jurisdictional separations rules contained in the Code of Federal Regulations, Title 47, Part 36 – Jurisdictional Separations Procedures. The Part 36 rules are the result of the Federal Communications Commission (FCC) evaluating and adopting, as deemed appropriate, recommendations made by the Federal-State Joint Board. Part 36 was initially adopted in 1987 and became effective January 1, 1988. There have been a number of changes over the years, as circumstances warranted, based on recommendations by the Federal-State Joint Board and final order by the FCC.

Q. WHAT RECENT CHANGES HAVE BEEN INCORPORATED INTO THE JURISDICTIONAL SEPARATIONS PROCEDURES?

A. An interim freeze of jurisdictional separations factors became effective on July 1, 2001, as a result of FCC Order 01-162 in CC Docket 80-286.

Q. HOW HAVE THESE CHANGES IMPACTED THE DEVELOPMENT OF JURISDICTIONAL SEPARATIONS FACTORS?

A. The interim freeze that was recommended by the Federal-State Joint Board and adopted by the FCC, froze category relationships and allocation factors for certain accounts and separations categories based on calendar year 2000 jurisdictional separations results. The separations freeze will be in effect for five years or until the Commission has completed comprehensive separations reform, whichever comes first. The separations freeze requires Verizon to use these historical 2000 factors in the development of jurisdictional separations factors and results.

Q. DO THE SEPARATIONS FACTORS USED IN THIS PROCEEDING REFLECT THE FCC ORDERED SEPARATIONS FREEZE?

A. Yes. The Verizon separations process is performed in accordance with the Part 36 Jurisdictional Separations Procedures and incorporates the use of the frozen 2000 data year category relationships and allocation factors as ordered by the FCC.

Q. PLEASE EXPLAIN THE METHOD USED TO DEVELOP THE JURISDICTIONAL SEPARATIONS FACTORS.

A. The jurisdictional separations factors were developed through a two-step process. The first step in the process was to determine the regulated costs for the twelve months ended September 2003 for the former GTE Washington and former Contel Washington study areas. The regulated costs for each study area were then put through the Verizon separations process to determine the dollar amounts for the interstate and intrastate jurisdictions. The results for the two study areas were then combined to determine the jurisdictionally separated dollars for all Washington state operations. The Washington intrastate amounts were then divided by the total regulated costs for Washington state to develop the intrastate jurisdictional separations factors. These intrastate factors are applied to total regulated costs used to calculate the Washington intrastate revenue requirement.

III. COMPARISONS

Q. HOW DO THE TEST PERIOD RESULTS COMPARE TO 2001, 2002 AND THE RESTATED TEST YEAR?

A. Restated 2001 and 2002 historical results provide the comparison base. Adjustments were made to 2001 and 2002 revenue, expense and rate base book data for out-of-period items as detailed in the supporting workpapers. The most relevant test of reasonableness is the major components of the results of operations, specifically net revenues, operating expenses, depreciation and rate base.

Q. ARE THE TEST YEAR RESULTS FOR THE TWELVE MONTHS ENDED SEPTEMBER 2003 AND THE PRO FORMA TEST PERIOD SIMILAR TO THE RESTATED 2001 AND 2002 RESULTS?

A. Yes, the results presented in millions are similar as follows:

	2001	2002	2003TY	Test Period
Revenues	$405	$380	$372	$337~~5~~
Operating Expenses*	$208	$216	$233	$224~~8~~
Depreciation	$121	$126	$125	$172
Rate Base	$946	$968	$985	$949~~65~~

(*excluding depreciation)

Revenues over the period reflect a decline due to loss of access lines and minutes of use in addition to the ordered access reduction. Operating expenses before depreciation increased between 2001 and the 2003 test year associated with circuit equipment expense, increased computer services expense, increased pension costs and employee separation costs. The decline reflected in the test period is associated with the amortization of the in-period separation costs partially offset by continued increases in pension and benefits costs.

The growth in depreciation expense from 2001 to 2002 is associated with the continued plant additions as well as the impacts of the filed rate represcription. Growth in rate base over the three year period can be primarily attributed to the increase in plant additions and other assets. The decline in the test period reflects the inclusion of the FAS 106 liability and the increase of the depreciation reserve associated with the depreciation rate resprescription.

The supporting workpapers further detail the comparison of 2001, 2002 and the test period results.

Q. HOW DOES THE PRESENTATION OF THE REVENUE REQUIREMENT PREPARED IN THIS CASE COMPARE TO THE REVENUE REQUIREMENT COMPONENTS AUTHORIZED IN CAUSE NO. U-82-45?

A. The revenue requirement in this case is generally prepared consistent with the positions authorized by the Commission in its past order. However, the test year in this case does not include the following items which were used in the development of the revenue requirement as ordered in U-82-45:

1) Flow-through treatment of federal income tax
2) Interest Synchronization
3) Yellow page contribution

A quantification of these items is presented in the supporting workpapers. Briefly, the Company did not include flow-through treatment of federal income tax because although such treatment was required in the previous rate case, since that time the Commission eliminated its rule requiring flow-through. Also, the Company did not include an interest synchronization adjustment because it believes the actual interest paid should be used. Finally, the Company did not include a yellow page revenue contribution for the reasons stated in the testimony of Verizon witnesses Dennis Trimble and Michael Doane.

Q. HOW DOES THE REVENUE REQUIREMENT CALCULATION IN THIS CASE COMPARE TO THE REVENUE REQUIREMENT CALCULATION AUTHORIZED IN THE LAST US WEST RATE CASE (UT-950200)?

A. The revenue requirement in this case is generally prepared consistent with the positions authorized by the Commission in its past order. A review of the last US West order indicates that many of the issues addressed in the order reflect circumstances unique to US West. The only item that appears to be included in the development of the Company's cost of service that was not allowed in the US West cost of service is national advertising. This item has been quantified in the supporting workpapers.

IV. <u>ADDITIONAL REVENUE REQUIREMENT</u>

Q. WHAT IS THE INCREMENTAL INTRASTATE REVENUE REQUIREMENT NEEDED IN ORDER FOR THE INTRASTATE WASHINGTON OPERATIONS TO EARN ITS REQUIRED RATE OF RETURN ON RATE BASE?

A. The Company's test period rate of return on intrastate rate base is *negative* 3.30~~73~~%. This calculation is based on intrastate net operating income of *negative* $31,349,000~~36,036,000~~ and an average intrastate rate base of $949,483,000~~965,095,000~~ as shown in column (f) of Exhibit NWH-2.

Based on the Company's required rate of return on intrastate rate base of 11.64~~12.03~~% as determined by Dr. Vander Weide, the Company's additional revenue requirement is $223,364,000~~239,531,000~~. This requirement was calculated as follows:

1. Test period net operating income of *negative* $31,349,000~~36,036,000~~, *plus*

2. Required return on rate base of $110,520,000~~116,101,000~~ (intrastate rate base of $949,483,000~~965,095,000~~ x 11.64~~12.03~~%), *multiplied by*

3. A "gross up" factor of 1.574 to account for taxes and uncollectibles.

This calculation is shown on Exhibit NWH-3.

V. SUMMARY – REVENUE REQUIREMENT

Q. PLEASE SUMMARIZE THIS PART OF YOUR TESTIMONY.

A. My testimony demonstrates the urgent need for rate relief for the intrastate Washington operations of Verizon NW. The results of operations depicted in the test period information are representative of the financial results the Company can expect to achieve in the near term.

A revenue increase of $223,364,000~~239,531,000~~ is needed in order for the Company to have an opportunity to earn its required rate of return and to maintain the financial strength necessary to provide the high quality service required by its customers.

PART B. AFFILIATE TRANSACTIONS

Q. WHAT IS THE PURPOSE OF THIS PART OF YOUR TESTIMONY?

A. This part of my testimony, which comprises Sections VI-X, describes Verizon Communications' overall organizational structure and the relationships between Verizon NW's Washington operations and certain affiliates. It also explains why the transactions between Verizon NW and its affiliates are necessary and are provided under appropriate terms. I am sponsoring the following exhibits that support this part of my testimony:

Exhibit NWH-4 – January 1, 2004 Verizon Telephone Companies ("VTC") Part 64 Cost Allocation Manual ("CAM") – Section I, IV, and V

Exhibit NWH-5 – Test Year Affiliated Interest Report

Exhibit NWH-6 – Comparative Schedule of Affiliate Transactions 2001, 2002 and Test Year

Q. HOW IS THIS PART OF YOUR TESTIMONY ORGANIZED?

A. Section VI describes Verizon Communications' corporate structure and presents an overview of Verizon NW's affiliate relationships and the pricing of its affiliate transactions. In general, Verizon NW has relationships with three types of affiliates: service companies, regulated affiliates, and non-regulated affiliates. Section VII describes the service company concept and the relationships between Verizon NW and each Verizon ***service company***. Section VIII describes the relationships between Verizon NW and its principal ***regulated affiliates***. Section

IX describes the relationships between Verizon NW and its ***non-regulated affiliates***. Finally, Section X summarizes my affiliate transaction testimony.

VI. GENERAL AFFILIATE STRUCTURE

Q. PLEASE DESCRIBE THE OVERALL VERIZON ORGANIZATIONAL STRUCTURE AND MANAGEMENT.

A. Verizon Communications Inc. is the corporate parent. It is one of the world's leading providers of communications services, and it is the largest provider of wireline and wireless communications in the United States.

Verizon Communications Inc. is organized into four "segments": Domestic Telecom, Domestic Wireless, International, and Information Services. Verizon NW is a separate legal entity that is in the Domestic Telecom segment. Each Verizon legal entity having a transaction with a Verizon ILEC is identified in Section V of the CAM (Exhibit NWH-4).

Q. PLEASE DESCRIBE THE SERVICES PROVIDED BY VERIZON COMMUNICATIONS INC.

A. The parent company provides overall corporate governance and direction for all Verizon affiliates, including Verizon NW and every other Verizon Telephone

Company (VTC). These services and their costs are primarily associated with the Office of the Chairman.[4]

Q. DOES VERIZON COMMUNICATIONS INC. CHARGE OR ALLOCATE COSTS TO VERIZON NW FOR ANY OF THESE SERVICES?

A. No. Verizon NW does not receive any costs for services performed by Verizon Communication Inc. These costs are retained in the parent company.

Q. IN GENERAL, WHAT PRICING RULES DO VERIZON NW AND ITS AFFILIATES FOLLOW WHEN TRANSACTING BUSINESS WITH EACH OTHER?

A. Verizon NW and its non-ILEC affiliates adhere to the FCC's Service and Asset Valuation Rules. These rules are described in Section V of the CAM (Exhibit NWH-4).

Q. PLEASE SUMMARIZE THE FCC'S PRICING RULES.

A. Under the FCC's rules, the carrier must record transactions involving services or assets in one of three ways: (1) by the tariffed rate; (2) if there is no tariffed rate, by the prevailing price;[5] or (3) if there is no prevailing price, by the higher or lower of fully distributed cost or fair market value, depending on whether the carrier is selling or purchasing goods or services. Specifically, if the VTC is

[4] The Office of the Chairman includes the Chairman and Chief Executive Officer, the Vice Chairman and President and the Chief Financial Officer.
[5] A "prevailing price" exists if 25% or more of specific goods or services are sold to third parties.

providing the product or service, it must charge the *higher* of fair market value or fully distributed cost. But if a non-regulated affiliate provides a service to a VTC, it must charge the VTC the *lower* of fair market value or fully distributed cost.

Finally, service companies have a special rule: they charge fully distributed cost for all services they provide to regulated affiliates such as Verizon NW. A service company is a company that exists solely to provide services to members of its corporate family.

Q. ARE VERIZON NW'S AFFILIATE TRANSACTIONS AUDITED TO ENSURE COMPLIANCE WITH THE FCC'S PRICING RULES?

A. Yes. Verizon NW and its affiliated VTCs have received unqualified external audit opinions finding that the allocation of costs between their regulated and non-regulated activities and the recording of transactions between the VTCs and non-regulated affiliates are in accordance with the CAM, the FCC's Joint Cost Orders, and applicable rules contained in Parts 32 and 64. These audit opinions are filed with the FCC and are publicly available.

Q. PLEASE IDENTIFY THE PRINCIPAL AFFILIATES THAT PROVIDE SERVICES TO VERIZON NW FOR ITS WASHINGTON OPERATIONS.

A. Exhibit NWH-5 lists each affiliate that Verizon NW received services from during the test year. The principal affiliates are Verizon Corporate Services Group Inc. ("Corporate Services"); Verizon Services Corp ("Verizon Services");

Verizon North Inc. – General Office ("GO North"); Verizon Data Services Inc. ("VDSI"); and GTE Communications Systems Corporation ("Verizon Logistics"). Each of these affiliates provided $1 million or more in goods or services to Verizon NW during the test year.

Q. PLEASE DESCRIBE GENERALLY THE SERVICES THESE AFFILIATES PROVIDE TO VERIZON NW.

A. The services fall into three major categories:

1) common corporate services, such as those provided by Corporate Services;
2) common telephone operations management and services, such as those provided by Verizon Services and GO North; and
3) specific products and services provided by various affiliates.

Q. HOW DO VERIZON NW AND ITS CUSTOMERS BENEFIT WHEN VERIZON NW PURCHASES GOODS AND SERVICES FROM ITS AFFILIATES?

A. First, Verizon NW and its customers benefit from lower costs achieved through the economies of scale and scope inherent in the provision of necessary goods and services by a centralized provider and by pricing the transaction in accordance with the FCC's affiliate transaction pricing rules to ensure costs are appropriate. Second, Verizon NW and its customers benefit from the provision of goods and service by individuals who are experts in their areas and dedicated to the provision of such services.

Q. DOES VERIZON NW PROVIDE ANY GOODS AND SERVICES TO AFFILIATED COMPANIES?

A. Yes. In general, Verizon NW provides tariffed telephone services to its affiliates. Exhibit NWH-5 lists each affiliate that received intrastate services from Verizon NW and the resulting intrastate revenues, which are reflected in the test year. Exhibit NWH-6 shows the test year data in a schedule that compares it to similar data for 2002 and 2001 as previously reported to the WUTC in the annual Verizon Northwest Inc. Affiliate Interest Report (Order No. R-460; Docket No. A-9980085; WAC 480-146-360).

Q. DOES VERIZON NW FILE AFFILIATE CONTRACTS WITH THE WUTC?

A. Yes. Verizon NW files affiliate contracts with the WUTC in accordance with WAC 480-146-350.

VII. SERVICE COMPANIES

A. SERVICE COMPANY CONCEPT & COSTS

Q. PLEASE DISCUSS THE SERVICE COMPANY CONCEPT.

A. A service company is a company that exists solely to provide services to affiliated companies. Under the FCC's rule, service companies bill affiliates at fully distributed cost. The following Verizon NW affiliates identified in the test year affiliate report (Exhibit NWH-5) meet the FCC's "service company" designation:

- Corporate Services – provides legal, regulatory, investor relations, policy, external affairs, strategic planning, human resources and corporate financial support.
- Verizon Services – primarily supports the accounting, finance, marketing, sales administration, engineering and operations of the VTCs.
- VDSI – provides information processing and programming services.

Q. WHY DO SERVICE COMPANIES BILL AT FULLY DISTRIBUTED COST UNDER THE FCC'S RULES?

A. The FCC found that service company transactions must be valued at fully distributed cost because there are insufficient third-party sales to substantiate a prevailing price for such services. This is because such services are tailored to the corporate family's unique needs.

The FCC further found that when an affiliate is established to provide services solely to the carrier's corporate family it is able to take advantage of economies of scale and scope, and that the benefits of such economies of scale and scope are reflected in the service company's costs. These benefits are transferred to ratepayers when service companies bill at fully distributed cost. Also, the FCC concluded that requiring companies to attempt to conduct a "fair market valuation" for such transactions would increase the costs to the ratepayers while providing limited benefits. (Accounting Safeguards Under the Telecommunications Act of 1996, *Report and Order*, 11 FCC Rcd 17539, at para. 148 (*Accounting Safeguards Order*)).

Q. HAS VERIZON TAKEN ADDITIONAL STEPS TO DEMONSTRATE THAT THE FCC'S SERVICE AFFILIATE PRICING RULES ARE APPROPRIATE?

A. Yes. Verizon studied various categories of service company costs and used objective data to determine whether these fully distributed costs were consistent with fair market value. The study showed that for each category of cost studied, that the service corporation costs fell within the market range.

Q. PLEASE LIST THE TYPES OF COST THAT WERE EXAMINED.

A. There are four major categories: (1) Salary and Wages; (2) Pensions and Benefits; (3) Rents; and (4) Vendor Purchases.

Q. PLEASE EXPLAIN HOW SALARY AND WAGES WERE ANALYZED.

A. Salary and wages constitute a significant portion (approximately 37%) of total service company expense. The salaries and wages for all associate employees are generally set by the Collective Bargaining Agreement. This negotiated agreement is the very definition of a market rate.

It is Verizon's compensation policy to target pay for the General Management population to the median of the market using nationally accepted survey data. Jobs are placed in the career bands and market reference ranges that correspond most closely to the market data at the 50th percentile (as represented by the "Market Reference Rate"). General Management salaries average below the respective Market Reference Rates and within the market reference ranges for the jobs.

Q. PLEASE EXPLAIN HOW PENSION AND BENEFIT EXPENSES WERE ANALYZED.

A. Employee pension and benefits constitute approximately 7 percent of total service company expenses. The pension and benefits for all craft employees are set by the Collective Bargaining Agreement. The pension and benefits for management employees are set by Verizon's Human Resources Department. This department conducts market analyses to ensure that Verizon's plans are competitive. For example, Hewitt Associates (Hewitt) conducts annual market surveys and uses actuarial techniques to benchmark pension and benefits, and Verizon's Human Resources Department ensures that service company pension and benefits are within the range of Hewitt's market analysis.

Q. PLEASE EXPLAIN HOW RENTS WERE ANALYZED.

A. Approximately 3 percent of service company expense is a result of land and building lease arrangements with third parties. The Corporate Real Estate department is responsible for ensuring that Verizon enters into leases that are at market rates. This department uses four main brokerage firms to survey the market for facilities that meet Verizon's specific requirements. All lease arrangements are, by definition, at market rates because they are set by competitive negotiations.

Also included in this category of costs are depreciation on service company assets and return on investment. Depreciation is based on the estimated useful lives of the underlying assets in conformance with generally accepted accounting principles. As such, actual depreciation matches market value. A return on investment component is also included in accordance with the FCC definition of fully allocated cost.

Q. PLEASE EXPLAIN HOW VENDOR PURCHASES WERE ANALYZED.

A. Vendor purchases are made by service company employees from independent vendors, and constitute 34 percent of all service company expense. These purchases are primarily procured through Verizon's Corporate Sourcing organization. Corporate Sourcing negotiates each purchase at arms length with independent vendors who have been pre-qualified based on cost, quality and performance. Thus, these purchases are made, by definition, at fair market value.

This category of cost also includes the cost of insurance. Verizon's Corporate Risk Management Department establishes these costs through competitive bidding.

Q. PLEASE SUMMARIZE THIS PART OF YOUR TESTIMONY.

A. Verizon NW and its customers benefit from the various services provided by the various service companies. Verizon NW needs these services, and the prices Verizon NW pays are reasonable because they reflect fully distributed cost as required by the FCC's pricing rules. Moreover, Verizon's analysis of these fully distributed costs confirms they are consistent with market-based prices.

B. Service Company Cost Allocations

Q. DO THE SERVICE COMPANIES THAT PROVIDE SERVICE TO VERIZON NW ALSO PROVIDE SERVICES TO OTHER VERIZON AFFILIATES?

A. Yes. The three service companies I identified earlier – Corporate Services, Verizon Services, and VDSI – each provide services to other Verizon affiliates.

Q. HOW DOES VERIZON ENSURE THAT THESE VARIOUS SERVICE COMPANY COSTS ARE ALLOCATED PROPERLY?

A. Each service company is required to follow procedures and is subject to various internal controls to ensure that costs are allocated properly.

1. Corporate Services

Q. PLEASE EXPLAIN THE PROCEDURES AND CONTROLS FOR CORPORATE SERVICES.

A. As I explained earlier, Corporate Services provides certain human resources, finance, legal, strategic planning, and public affairs services to Verizon affiliates, including the VTC. The allocation of the cost for these services to the Verizon affiliated legal entities are based on a time survey prepared by each work group in Corporate Services. The work group provides distribution percentages between the VTCs in total and the other affiliates. The work group also indicates the specific VTC jurisdictions supported, such as the Washington jurisdictions. A functional weighted average is calculated and applied to the work groups that indicate a distribution between the VTCs and the other affiliates. Cost assigned to the total VTCs are allocated to the appropriate jurisdictions of that VTC as indicated on the work group's time survey using an operating expense and tax factor. The functional weighted average is not applied to work groups that indicate a distribution of 100% to the total VTCs. Rather they are allocated only to the jurisdictions indicated on the time survey using the operating expense and tax factor.

Q. FOR WHICH FUNCTIONS ARE WEIGHTED AVERAGES CALCULATED?

A. Functional weighted averages are calculated for Human Resources, Finance, Finance Operations, Legal, Public Policy and External Affairs, Security, Strategic Planning, Public Affairs, and Fiduciary.

Q. DOES THE OPERATING EXPENSE AND TAX FACTOR REPRESENT A FAIR AND REASONABLE BASIS FOR ALLOCATING COST AMONG THE VTC JURISDICTIONS?

A. Yes. The use of the operating expense and tax factor to allocate the costs attributable to the individual VTC jurisdictions recognizes the need for a representative and administratively efficient methodology based on a common denominator that: (1) is equally applicable to each VTC jurisdiction, and (2) is reflective of the collective and individual total business activity of each jurisdiction.

Q. WHAT WAS THE TOTAL CORPORATE SERVICES ALLOCATION IN 2003?

A. The total Corporate Services allocation was approximately $2.1 billion of which Verizon NW – Washington received $32.6 million or 1.5%.

Q. IS VERIZON NW CHARGED FOR THE CORPORATE GOVERNANCE COSTS INCURRED BY CORPORATE SERVICES?

A. No. Corporate governance costs incurred by Corporate Services are not allocated to the VTCs. These costs include:

- Cost of the Office of Chairman
- Cost of the Executive Vice President and General Counsel
- Merger and Acquisition costs where the M&A work does not directly benefit a particular or group of subsidiary(s).
- Uniquely identified costs that are not allocated. Some examples are: Foundation grant expenses, expenses related to Executives whose costs are retained or allocated 100% to Parent (i.e., Airplanes which are used exclusively for the Executives retained by Parent), and costs benefiting the Corporate & Other segment.

Q. WHAT OTHER MEASURES ARE TAKEN TO ENSURE THAT THE CORPORATE SERVICES ALLOCATION PROCESS IS REASONABLE AND CONSISTENTLY APPLIED FROM YEAR TO YEAR?

A. A responsible executive is assigned to manage Corporate Services in accordance with the affiliate transaction rules. One of the critical steps is to ensure internal controls are in place to maintain ongoing compliance. Generally speaking, this is done by making available compliance-related communications and training for employees, as needed; instituting validation procedures and remedial action plans; maintaining records reflecting the steps taken to achieve and maintain compliance and; providing feedback to the proper internal management.

2. Verizon Services

Q. PLEASE EXPLAIN THE PROCEDURES AND CONTROLS FOR COST ALLOCATIONS FROM VERIZON SERVICES.

A. As noted earlier, Verizon Services provides marketing, sales, customer services, advertising, brand management, technology, procurement, construction, operations and engineering, information technology, e-business, operator and public communications services to the VTCs as well as non-regulated affiliates.

To allocate the costs of these services, Verizon Services follows the allocation processes set by the FCC (Dockets 86-111, 96-150). Specifically, costs are apportioned into three categories: directly assigned, directly attributed, and indirectly attributed. In the first category, costs are directly assigned when the services provided by a service provider are identified, accumulated, and exclusively charged to one benefiting affiliate. The second category, direct attribution, applies when the service is provided to more than one benefiting affiliate. Within this category, there are two methods of direct attribution used: (1) usage (e.g., IT) or (2) the relative size of the benefiting organizations (e.g., Real Estate). In the third category, costs that cannot be directly assigned or directly attributed are indirectly attributed using a size-related allocator such as a composite of revenues, assets and wages.

Q. PLEASE PROVIDE SOME EXAMPLES OF HOW DIFFERENT COSTS ARE ALLOCATED AMONG AFFILIATES.

A. Once it is determined that the costs of an organization benefit more than one affiliate, an allocation basis is assigned that fairly allocates the costs to the benefiting affiliate. There are multiple allocation bases used depending on the organization performing the service. Each base is causally related to the functions performed by those organizations. Several examples are:

Wholesale Services Statistics – Each affiliate's revenue, which is attributable to the Wholesale Services sales force, is used to distribute the costs of this group.

ESG Revenue – Enterprise Services Group revenues recorded by each affiliate is used to distribute the costs of the ESG organization.

Telecommunications Plant in Service – Each State's total telecommunications plant-in-service is used to distribute costs related to telecommunications plant operations.

Three-Part Allocator – The three equally-weighted components of this allocator are each affiliate's net capital assets, external operating revenue, and wages and salaries. This basis measures the relative size of an affiliate, which is an indirect measure of cost causation, and complies with Federal Acquisition Requirements.

Q. HOW ARE THE AFFILIATES THAT BENEFIT FROM A PARTICULAR CENTRALIZED SERVICE IDENTIFIED?

A. The departmental organizations within Verizon Services that actually perform the various functions define the affiliates that benefit from those functions. Periodic reviews of each centralized organization are conducted to assure that the organizations costs are fairly allocated to the benefiting affiliate.

Q. WHAT MEASURES ARE TAKEN TO ENSURE THAT THE VERIZON SERVICES ALLOCATION PROCESS IS REASONABLE AND CONSISTENTLY APPLIED FROM YEAR TO YEAR?

A. Allocated costs are a component of the financial statements that are subject to annual external audits. Importantly, it should be noted that the opinion of the external auditors was that the financial statements were fairly stated. Additionally, as noted earlier in my testimony, Verizon NW and its affiliated VTCs have received unqualified external audit opinions finding that the allocation of costs between their regulated and non-regulated activities and the recording of transactions between the VTCs and non-regulated affiliates are in accordance with the CAM, the FCC's Joint Cost Orders, and applicable rules contained in Parts 32 and 64. These audit opinions are filed with the FCC and are publicly available.

3. VDSI

Q. PLEASE EXPLAIN THE RELATIONSHIP BETWEEN VDSI AND VERIZON NW.

A. As noted, VDSI provides computer processing and professional information services management to various Verizon affiliates. It does so through the establishment and/or operation of a network of data centers to meet the computer service demands of the VTCs, including Verizon NW. These services are necessary for Washington to obtain rapid access to information utilized in daily operations, which enables Verizon NW to operate more efficiently and to make informed management decisions.

VDSI's costs are allocated to the affiliate utilizing the particular service at fully distributed cost. Fully distributed costs are developed as a rate per hour for labor and a rate per unit for processing. Where multiple affiliates are benefitting from the same service, the costs are allocated among the benefitting affiliates utilizing the 3-Part factor (Sales/Wages, Revenue and PP&E).

Q. HAS VDSI TAKEN ADDITIONAL STEPS TO DEMONSTRATE THAT THE FCC'S SERVICE AFFILIATE PRICING RULES ARE APPROPRIATE?

A. Yes. A study was performed which compared the market prices for computer processing and professional information services management to the fully distributed costs charged by VDSI to its affiliates, including Verizon NW. The study concluded that VDSI's fully distributed costs fell within the market range and in select instances below the market range.

Q. PLEASE SUMMARIZE THIS PART OF YOUR TESTIMONY.

A. This part of my testimony proves that (1) the services Verizon NW receives from its service company affiliates are necessary, (2) the services are priced in accord with FCC rules and are consistent with the market, and (3) the costs of the services are allocated appropriately to Verizon NW and other affiliates.

VIII. REGULATED AFFILIATES

Q. FROM WHICH PRINCIPAL REGULATED AFFILIATES DID VERIZON PURCHASE GOODS OR SERVICES FROM DURING THE TEST PERIOD?

A. The only such affiliate is Verizon North Inc. - General Office ("GO North"). GO North is a regulated affiliate providing various services to a number of VTCs, including Verizon NW. The GO North allows for the allocation of shared telephone operating company expenses to multiple supported jurisdictions. By sharing certain telephone operating company employees and assets, the company is able to achieve economies of scope and scale. Allocable telephone operating expenses, referred to as Verizon North GO (General Office) allocations, are incurred within the regulated operating telephone companies and distributed to each benefitting jurisdiction.

Q. WHAT DOES GO NORTH CHARGE VERIZON NW FOR THE SHARED EMPLOYEES AND SHARED ASSETS?

A. GO North charges fully distributed cost. As noted, GO North allows the VTCs to share employees and assets that they otherwise would have to pay for themselves, and thus economies of scale and scope are achieved. By using fully distributed costs, the VTCs are assessed the same type of costs they would have incurred on their own (book costs), but receive the benefit of consolidation.

Q. HOW ARE THE SHARED COSTS ALLOCATED TO VERIZON NW AND THE OTHER AFFILIATES?

A. At least annually, a review is performed to identify allocable work centers that include "shared" employees in the following VTCs: Verizon Florida, Verizon South, Verizon Southwest, Verizon North, Verizon California, Verizon NW, and Verizon Hawaii. These are the VTCs included in the General Office allocation. Shared employees are those whose work functions support more than one jurisdiction. (Employees who report time to capital accounts or supervise employees that report time to capital accounts are not included.)

As part of the annual review, the responsible work center owner identifies the jurisdictions supported by the employees in the work center. Work centers are aligned with the hierarchical and functional structure of the organization. Each allocable work center is associated with a specific cost pool comprising of a unique group of benefiting jurisdictions to which costs are allocated. An allocation basis is assigned that fairly allocates the costs to the benefiting VTCs. There are multiple allocation basis used depending on the organization performing the service. Each basis is causally related to the functions performed by those organizations. Several examples are:

ESG Revenue – Enterprise Services Group revenues recorded by each affiliate is used to distribute the costs of the ESG organization.

Telecommunications Plant in Service – Each State's total telecommunications plant-in-service is used to distribute costs related to telecommunications plant operations.

Three-Part Allocator – The three equally-weighted components of this allocator are each affiliates' net capital assets, external operating revenue, and wages and salaries. This basis measures the relative size of an affiliate, which is an indirect measure of cost causation and complies with Federal Acquisition Requirements. It is applied to costs incurred by the Finance organization.

Q. HOW ARE SHARED ASSETS ALLOCATED?

A. Investment in assets such as land, buildings, computers and other equipment at locations occupied by shared VTC employees are identified annually. These are referred to as shared investment or shared assets. With the shared investment as the basis, a capital carrying charge consisting of ROI, maintenance expense, depreciation expense and property taxes is calculated. The shared investment capital carrying charge is then allocated to the supported jurisdictions based on a weighted allocation factor for all the shared employee work centers in that jurisdiction. This ensures that the VTC where the shared asset is located recovers an appropriate portion of the asset's costs.

Q. WHAT MEASURES ARE TAKEN TO ENSURE THAT THE VERIZON SERVICES ALLOCATION PROCESS IS REASONABLE AND CONSISTENTLY APPLIED FROM YEAR TO YEAR?

A. Allocated costs are a component of the financial statements that are subject to annual external audits. The opinion of the external auditors was that the financial statements were fairly stated.

IX. NON-REGULATED AFFILIATES

Q. PLEASE IDENTIFY THE PRINCIPAL NON-REGULATED AFFILIATES FROM WHICH VERIZON NW PURCHASED GOODS OR SERVICES DURING THE TEST PERIOD.

A. The only such affiliate is Verizon Logistics.

Q. PLEASE DESCRIBE VERIZON LOGISTICS AND ITS RELATIONSHIP WITH VERIZON NW.

A. Verizon Logistics acts as Verizon NW's agent in obtaining materials, supplies and services. Verizon Logistics provides two types of services to Verizon NW: (1) it sells telecommunications material and supplies; and (2) it manages the procurement and provisioning function, also referred to as "logistics related services", down to the local telephone company supply points.

Verizon Logistics provides the same procurement and provisioning services to Verizon NW that it provides to the other VTCs under equivalent agreements. Also, the agreement with Verizon Logistics provides that Verizon NW will receive terms comparable to or better than those offered by Verizon Logistics to any of its other customers.

Q. WHO ARE VERIZON LOGISTICS' OTHER CUSTOMERS?

A. Verizon Logistics has several large unaffiliated customers, including other Regional Bell Operating Companies ("RBOCs"), independent telephone companies and other users of telecommunication material and supplies.

Q. PLEASE DESCRIBE THE PROCUREMENT AND PROVISIONING SERVICES VERIZON LOGISTICS PROVIDES TO VERIZON NW.

A. Verizon Logistics provides the following procurement and provisioning services:

1) All purchasing functions including vendor contact, contract negotiation and administration, order processing, expediting, record-keeping and mechanized system file maintenance;
2) Material management functions including database maintenance, freight bill auditing, stocking, tracking of material, administration of supplies and

materials to be delivered directly to Verizon NW, and management of inventory required to support products;

3) Coordination of the material and supply requirements of the VTCs so that the cost of acquiring necessary material and supplies will be minimized. (Verizon NW, as well as the other VTCs, maintains responsibility for purchasing decisions. Verizon Logistics acts on those decisions by procuring the materials and supplies identified by Verizon NW consistent with previously described procurement services);

4) Administration of the storage of all materials, including furniture and office supplies, and leased storage facilities;

5) Administration of all activities required for the staging of material for distribution;

6) Inventory management of central office equipment re-use stock;

7) Administration of the repair and return process and management of all replacement spare inventory for central office line cards;

8) Coordination of the repair of non-electronic equipment;

9) Administration of business and project plans required for the procurement and use of materials and supplies by the VTCs, including budget preparation, tracking, systems development implementation and support; and

10) All other services required to distribute materials and supplies at such locations as specified by Verizon NW.

Q. WHAT TYPES OF MATERIALS AND SUPPLIES ARE OFFERED BY VERIZON LOGISTICS TO VERIZON NW AND OTHER CUSTOMERS?

A. Verizon Logistics offers a wide assortment of telecommunications materials and supplies including cable and other outside plant, transmission equipment, customer premise equipment, premises distribution systems, data equipment and central office minor tools and repair parts.

Q. DOES VERIZON NW BENEFIT FROM USING VERIZON LOGISTICS AS A COMMON PROVIDER OF MATERIALS, SUPPLIES AND SUPPLY-RELATED SERVICES?

A. Yes. Having a common provider of materials and supplies and supply-related services provides benefits to Verizon NW (and the other the VTCs) in the following areas:

The larger quantities of combined VTC purchases generate volume related price reductions for materials and supplies, as well as reduced inventory carrying costs;

Negotiating leverage is enhanced to provide for the most favorable vendor contracts available;

Duplicative facility and administrative costs are eliminated;

The organizational structure provides for a single work force under the direction of Verizon Logistics;

Standardized management information systems and inventories can be managed and maintained at one point; and

Other volume related discounts for non-material purchases freight, and computer equipment can be achieved.

In short, Verizon NW's relationship with Verizon Logistics leads to significant operational efficiencies and cost savings. This relationship serves Verizon NW and its ratepayers well in every respect, including the efficient performance of its duties as a telecommunications carrier and the resulting benefit to its customers.

Q. WHAT DOES VERIZON LOGISTICS CHARGE VERIZON NW FOR THE SERVICES AND SUPPLIES IT PROVIDES?

A. Pursuant to the FCC's pricing rules described earlier, and as explained in the CAM (Exhibit NWH-4), Verizon Logistics sells materials and supplies to Verizon NW and other VTCs at the prevailing market price, if one exists. If no such price exists, then Verizon Logistics charges the lower of cost or market. Verizon Logistics provides all supply-related services at the lower of cost or estimated fair market value. As with the other Verizon affiliates, external auditors attest each year to Verizon Logistics' compliance with the FCC's rules.

Q. HOW DOES VERIZON LOGISTICS BILL FOR THE MATERIALS AND SUPPLIES AND SUPPLY-RELATED SERVICES IT PROVIDES TO VERIZON NW?

A. Verizon Logistics bills for materials and supplies when the materials and supplies are shipped. For supply-related services, Verizon NW is billed on a monthly basis.

X. SUMMARY OF AFFILIATE TRANSACTIONS

Q. PLEASE SUMMARIZE THIS PART OF YOUR TESTIMONY.

A. The goods and services Verizon NW receives from affiliates are essential for Verizon NW's business. Verizon NW and its customers benefit from lower costs achieved through the economies of scale and scope inherent in the provision of service by a common provider and by pricing the transaction in accordance with the FCC's affiliate transaction pricing rules. Also, Verizon NW and its customers benefit from the provision of goods and service by individuals who are experts in their areas and dedicated to the provision of such services. For all these reasons, all of Verizon NW's affiliate costs are reasonable and necessary and must be included for ratemaking purposes.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes. However, as this proceeding progresses, issues may arise which could impact the Company's presentation. For example, there are other dockets underway which may impact the revenue requirement, such as the Company's recent depreciation filing. The resulting orders from this and other dockets may impact the financial presentation in this case. Updates to the financial exhibits will be made at the appropriate time.