BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

WUTC v. VERIZON

DOCKET NO. UT-040788

DIRECT TESTIMONY OF DAVID PARCELL (DP-1T)

ON BEHALF OF

PUBLIC COUNSEL

November 22, 2004

I. INTRODUCTION AND QUALIFICATIONS

Q: Please state your name, address, and occupation.

A: My name is David C. Parcell. I am Executive Vice President and Senior Economist of Technical Associates, Inc. My business address in Suite 601, 1051 East Cary Street, Richmond, Virginia, 23219.

Since 1970, Technical Associates has performed a wide array of services to both governmental and private clients. A primary component of these services has involved various aspects of public utility regulation and ratemaking. In connection with these studies, members of the firm have testified in well over 700 utility ratemaking proceedings through the United States and Canada.

Q: Please describe your background and experience.

A: I hold B.A. (1969) and M.A. (1970) degrees in economics from Virginia Polytechnic Institute and State University (Virginia Tech) and a M.B.A. (1985) from Virginia Commonwealth University. I have been continuously employed by Technical Associates since 1970. The large majority of my consulting experience has involved the provision of cost of capital testimony in utility ratemaking proceedings. I have previously testified in about 350 utility proceedings before more than 30 regulatory agencies in the United States and Canada.

Exhibit No. ___, DP-2 provides a more complete description of my background and experience.

Q: What is the purpose of your testimony in this proceeding?

A: I have been retained by the Public Counsel to evaluate certain aspects of the current filing of Verizon Northwest Inc. ("Verizon NW" or "Company"). The primary focus of my testimony is to analyze the current cost of capital for Verizon NW. Since Verizon NW is

a subsidiary of Verizon Communications Inc. ("Verizon" or "Parent"), I have also evaluated this entity in my analyses.

Q: Have you prepared exhibits in support of your testimony?

A: Yes, I have prepared fourteen exhibits. These exhibits were prepared either by me or under my direction. The information in these exhibits is correct to the best of my knowledge and belief.

Q: How is your direct testimony organized?

A: My testimony is organized into twelve parts as follows:

I. Introduction
II. Recommendations and Summary
III. Economic/Legal Principles and Methodologies
IV. General Economic Conditions
V. Verizon NW's Operations and Business Risks
VI. Capital Structure
VII. Discounted Cash Flow Analysis
VIII. Capital Asset Pricing Model Analysis
IX. Comparable Earnings Analysis
X. Return on Equity Recommendations
XI. Total Cost of Capital
XII. Comments on Company Testimony

II. RECOMMENDATIONS AND SUMMARY

Q: What are your recommendations in this proceeding?

A: My overall cost of capital recommendation for Verizon NW is as follows:

	Percent	Cost	Return
Long-Term Debt	49.3%	6.99%	3.45%
Short-Term Debt	5.8%	1.75%	0.10%
Common Equity	44.9%	10.0-11.0%	4.49-4.94%
Total Cost of Capital	100.00%		8.04-8.49%

I recommend that Verizon NW be awarded a total cost of capital that is no higher than the mid-point of this range, or 8.26 percent.

Q: Please summarize your analyses and conclusions.

A: This proceeding is concerned with the regulated local exchange operations of Verizon NW. My analyses are concerned with the Company's total cost of capital. The first step in performing these analyses is the development of the appropriate capital structure. I have employed the consolidated capital structure of Verizon in my cost of capital analyses.

The second step in a cost of capital calculation is a determination of the embedded cost rates of long-term and short-term debt. I have utilized the September 30, 2004 cost rate for long-term debt of Verizon NW and the current rate for commercial paper as the cost of short-term debt in my analyses.

The third step in the cost of capital calculation is the estimation of the cost of common equity. I have employed three recognized methodologies to estimate the cost of equity for Verizon NW. Each of these methodologies is applied to a group of telecommunications companies, as well as the natural gas distribution industry. These three methodologies and my findings for the telecommunications group and natural gas industry are:

	Telecommunications Group	Gas Distribution Group
Discounted Cash Flow	10.2 - 10.7%	8.1 - 8.4%
Capital Asset Pricing Model	11.8 - 12.9%	9.9 - 10.7%
Comparable Earnings	N/A	10 - 11%

Based upon these findings, my recommendation of the fair cost of common equity for Verizon NW is a range of 10 percent to 11 percent, with a mid-point of 10.5 percent. This range reflects a risk-adjusted cost of equity for the telecommunications group. This range also reflects the current cost of capital for the gas distribution group.

Combining these three steps into a weighted cost of capital results in an overall rate of return of 8.04-8.49 percent, with a mid-point of 8.26 percent. I recommend the Commission adopt this capital structure and an overall return of 8.26.

III. ECONOMIC/LEGAL PRINCIPLES AND METHODOLOGIES

Q: What is your understanding of the economic and legal principles which underlie the concept of a fair rate of return for a regulated utility?

A: Rates for regulated public utilities have traditionally been primarily established using the "rate base - rate of return" concept. Under this method, utilities are allowed to recover a level of operating expenses, taxes and depreciation deemed reasonable for rate setting purposes, and are granted an opportunity to earn a fair rate of return on the assets utilized (i.e., rate base) in providing service to their customers. The rate base is derived from the asset side of the utility's balance sheet as a dollar amount and the rate of return is developed from the liabilities/owners' equity side of the balance sheet as a percentage. The rate of return is developed from the cost of capital, which is estimated by weighting the capital structure components (i.e., debt, preferred stock, and common equity) by their percentages in the capital structure and multiplying these by their cost rates. This is also known as the weighted cost of capital.

Technically, the fair rate of return is a legal and accounting concept which refers to an ex post (after the fact) earned return on an asset base, while the cost of capital is an economic and financial concept which refers to an ex ante (before the fact) expected or required return on a liability base. However, in regulatory proceedings, the two terms are often used interchangeably and are so used in my testimony.

From an economic standpoint, a fair rate of return is normally interpreted to incorporate the financial concepts of financial integrity, capital attraction, and

comparable returns for similar risk investments. These concepts are derived from economic and financial theory and are generally implemented using financial models and economic concepts such as discounted cash flow (DCF), capital asset pricing model (CAPM), and comparable earnings (CE).

From a legal standpoint, two U.S. Supreme Court decisions are universally cited as providing the legal standards for a fair rate of return. The first is Bluefield Water Works and Improvement Company v. Public Service Commission of the State of West Virginia, 262 U.S. 679 (1923). In this decision, the Court stated:

> What annual rate will constitute **just compensation** depends upon many circumstances and must be **determined by** the **exercise of a fair and enlightened judgment**, having regard to all relevant facts. A **public utility** is entitled to such rates as will permit it to **earn a return** on the value of the property which it employs for the convenience of the public equal to that **generally being made** at the same time and in the same general part of the country on **investments in other business undertakings** which are **attended by corresponding risks and uncertainties**; but it has **no constitutional right to profits** such as are realized or anticipated in **highly profitable enterprises** or **speculative ventures**. The **return** should be reasonably sufficient to assure confidence in the **financial soundness** of the utility, and should be adequate, under efficient and economical management, to maintain and **support its credit** and **enable it to raise the money** necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally. [Emphasis added]

This decision established the following standards for a fair rate of return: comparable earnings, financial integrity, and capital attraction. It also noted the changing level of required returns over time.

The second decision is Federal Power Commission v. Hope Natural Gas

Company, 320 U.S. 591 (1942). In that decision, the court stated:

> The rate-making process under the (Natural Gas) Act, i.e., the fixing of 'just and reasonable' rates, involves a **balancing** of the **investor** and **consumer interests** . . . From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the **return** to the **equity owner** should be **commensurate** with **returns** on **investments** in **other enterprises having corresponding risks**. That return, moreover, should be sufficient to assure confidence in the **financial integrity** of the enterprise, so as to **maintain its credit** and to **attract capital**. [Emphasis added]

This case affirmed the primary standards of the Bluefield case, as well as the public interest standard. The Hope case is also credited with the establishment of the "end result" doctrine, which maintains that the methods utilized to develop a fair return are not important as long as the end result is reasonable.

I believe the Bluefield and Hope decisions, as well as subsequent cases which cite these decisions, have identified three economic and financial parameters relevant to the determination of a fair rate of return:

1. comparable earnings
2. financial integrity and
3. capital attraction.

It is apparent that these legal standards reflect the economic criteria encompassed in the "opportunity cost" principle of economics, which holds that a utility and its investors should be afforded an opportunity (not a guarantee) to earn a return commensurate with returns they could expect to achieve on investments of similar risk. The opportunity cost principle is consistent with the fundamental premise on which regulation rests, namely that it is intended to act as a surrogate for competition.

Q: How can these standards be employed to estimate the cost of capital for a utility?

A: Neither the courts nor economic/financial theory have developed exact and mechanical procedures for precisely determining the cost of capital. This is the case since the cost of capital is an opportunity cost and is prospective, which indicates it must be estimated.

There are several useful models that can be employed to assist in estimating the cost of equity capital, which is the capital structure item that is the most difficult to determine. These include the discounted cash flow method (DCF), the capital asset pricing model (CAPM), the comparable earnings analysis (CE) and the risk premium (RP) method. Each of these methods (or models) differs from the others and each, if properly employed, can be a useful tool in estimating the cost of common equity for a regulated utility.

In performing analyses of the cost of common equity, it is customary and appropriate to consider the results of several alternative methods. At the very least, alternative methods should be used as a check on a primary or preferred method.

Q: Which methods have you employed in your analyses of the cost of common equity?

A: I have utilized three methodologies in my testimony. These are DCF, CAPM (version of RP) and CE.

IV. GENERAL ECONOMIC CONDITIONS

Q: What is the importance of economic and financial conditions in determining the cost of capital?

A: The costs of capital, for both fixed-cost (debt and preferred stock) components and common equity, are determined in part by economic and financial conditions. At any given time, each of the following factors has direct and significant influences on the costs of capital: the level of economic activity, the stage of the business cycle, the level of inflation, and expected economic conditions. My understanding is that this position is

consistent with the Supreme Court's Bluefield decision that noted that "[a] rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally." Bluefield, 262 U.S. at 693.

Q: What indicators of economic and financial activity have you evaluated in your analyses?

A: I have examined several sets of economic statistics for the period 1975 to the present. I chose this period because it permits the evaluation of economic conditions over three full past business cycles plus the current cycle to date, and thus makes it possible to assess changes in long-term trends. A business cycle is commonly defined as a complete period of expansion (recovery and growth) and contraction (recession). A full business cycle is a useful and convenient period over which to measure levels and trends in long-term capital costs because it incorporates the cyclical (i.e., stage of the business cycle) influences and thus permits a comparison of structural (or long-term) trends.

Q: Please describe the prior three business cycles and the most current cycle.

A: The most recent complete cycle began with an expansion in April of 1991 and ended in the fourth quarter of 2001, constituting a length of more than ten and one-half years. Recently, the economy slowed considerably in late 2000 and 2001 and was in a recession during 2001, notwithstanding the Federal Reserve lowering interest rates eleven times in 2001 (as well as twice in 2003) in an aggressive effort to create a soft landing and avoid a recession. The events of September 11, 2001 further damaged the U.S. economy.

This cycle and the two prior complete cycles covered the following periods:

Business Cycle	Expansion Period	Contraction Period
1975-1982	Mar. 1975-July 1981	Aug. 1981-Oct. 1982
1983-1991	Nov. 1982-July 1990	Aug. 1990-Mar. 1991
1991-2001	Apr. 1991- Mar. 2001	April 2001-Nov. 2001
Current	Dec. 2001-Present	

The expansion phase of the most recent complete cycle surpassed the average length of expansions in the post-World War II era (i.e., about five years). The 1982-1990 expansion (seven years, eight months) was the previous longest peacetime expansion of this era.

Q: Please describe recent and current economic and financial conditions and their impact on the costs of capital.

A: Exhibit No. ___, DP-3 shows several sets of economic data. Page 1 contains general macroeconomic statistics while pages 2 and 3 contain financial market statistics. Page 1 shows that the initial stage of the current cycle was somewhat slower than the typical initial recovery period, and growth has actually slowed in 2004. This is indicated by the growth in real (i.e., adjusted for inflation) Gross Domestic Product, industrial production, and the employment rates.

The rate of inflation is also shown on page 1. As indicated, the Consumer Price Index (CPI) rose significantly during the 1975-1982 business cycle and reached double digit levels in 1979-1980. The rate of inflation declined substantially in 1981 and remained at or below 6.1 percent during the 1983-1991 business cycle, as the CPI generally grew by about 4 percent annually from 1982-1989 (each year except one from 1982-1989 had a CPI rate between 3.8% and 4.6%). Since 1991, the CPI has been 3.4 percent or lower. The 1.6 percent rate of inflation in 2003 was among the lowest levels over the past twenty-nine years.

Q: What have been the trends in interest rates?

A: Page 2 shows several series of interest rates. Rates rose sharply in 1975-1981 when the inflation rate was high and rising. Rates then fell substantially throughout the remainder of the 1980's and into the 1990's. During the recent business cycle, long-term rates remained relatively stable, in comparison to the prior cycles, and currently are lower than at any time during the prior three cycles. Over the past three years, both long-term and short-term interest rates have declined significantly to the lowest levels since the 1950's. This very low level of interest rates, in conjunction with the apparent strengthening of the U.S. economy, may create an expectation that any near-term movement of interest rates will be upward. In fact, the Federal Reserve has recently increased short-term interest rates on four occasions, although by only a small 0.25 percent level on each occasion, in an attempt to insure that any perceived inflationary expectations will not stifle continued economic growth. Nevertheless, the economic recovery to date has not resulted in a pronounced increase in long-term rates and, even if rates were to increase moderately, they would still remain well below historical levels.

Q: What have been the trends in common share prices?

A: Page 3 shows several series of common stock prices and ratios. These generally indicate that share prices were basically stagnant during the high inflation/interest rate environment of the late 1970's and early 1980's. On the other hand, the 1983-1991 business cycle and the 1991-2001 cycle witnessed a significant upward trend in stock prices. Over the past three years, however, stock prices have been volatile and have declined substantially from their highs reached in 1999 and early 2000. Share prices increased somewhat in 2003 but have slightly declined in 2004.

Q: What conclusions do you draw from this discussion of economic and financial conditions?

A: It is apparent that capital costs are currently low in comparison to the levels that have prevailed over the past three decades. In addition, even a moderate increase in interest rates, as well as other capital costs, would still result in capital costs that are low by historic standards.

V. VERIZON NORTHWEST'S OPERATIONS AND BUSINESS RISKS

Q: Please describe Verizon NW and its operations.

A: Verizon NW is a subsidiary of Verizon Communications, Inc. Verizon NW was formerly named GTE Northwest. This company operates in the states of California, Idaho, Oregon and Washington.

Q: Please briefly describe Verizon and its operations.

A: Verizon was formed in 1999 by the merger between Bell Atlantic and GTE. The 2003 operations of Verizon are shown on Exhibit No. ___, DP-4 and can be summarized as follows:

	Operating Revenues	Operating Income	Capital Expenditures	Assets
Domestic Telecom	$39.6 billion	$7.2 billion	$6.8 billion	$82.1 billion
	58%	53%	58%	51%
Domestic Wireless	$22.5 billion	$4.1 billion	$4.6 billion	$65.2 billion
	33%	30%	39%	40%
Information Services	$4.1 billion	$2.0 billion	$0.08 billion	$2.4 billion
	6%	15%	1%	2%
International	$1.9 billion	$0.3 billion	$0.4 billion	$11.9 billion
	3%	2%	3%	7%
Verizon Consolidated	$68.2 billion	$13.6 billion	$11.9 billion	$161.6 billion

Note: Percentages may not add up to 100% due to inter-company eliminations and other factors.

Source: Verizon Communications 2003 Form 10-K.

Q: What does this indicate concerning the contribution of domestic telecom to the Verizon system?

A: This indicates that Domestic Telecom (which includes Verizon NW) accounts for about one-half of the operations of Verizon. This correspondingly indicates that about one-half of Verizon's operations are unregulated businesses.

Q: What are the current bond ratings of Verizon?

A: This is shown on Exhibit ___, DP-5. As this indicates, Moody's (the only major rating agency that still provides independent ratings for each subsidiary and/or entity of a corporate structure) rates Verizon NW with similar (i.e., A1) ratings to most of the other telephone subsidiaries of Verizon, and higher ratings than the non-telephone operations (i.e., Verizon Global Funding) of Verizon. This reflects the perceived similar risks of Verizon NW, in comparison to other domestic telephone operations of Verizon, and lower risks than the non-regulated operations.

Q: What are your conclusions concerning the risks of Verizon NW and its business position within Verizon?

A: It is apparent that Verizon NW is less risky than the unregulated operations of Verizon. It is also apparent that Verizon NW has similar risk to that of the other domestic telephone operations of Verizon.

Q: How should the lower risk of Verizon NW's local exchange operations be reflected in the cost of capital?

A: As I will describe more fully in later sections of my testimony, the relatively lower risk of local exchange operations requires that a downward adjustment be made to the market costs of common equity (e.g. DCF and CAPM) for the telecommunications industry. This follows since the market-based results for the publicly-traded telecommunications group reflects the impact of the higher-risk and resulting higher required returns for non-local exchange operations such as long distance and cellular.

VI. CAPITAL STRUCTURE AND COST OF DEBT

Q: What is the importance of determining a proper capital structure in a regulatory framework?

A: A regulated company's capital structure is important since the concept of rate base - rate of return regulation requires that a company's capital structure be determined and utilized in estimating the total cost of capital. Within this framework, it is proper to ascertain whether the regulated company's capital structure is appropriate relative to its level of business risk and relative to other regulated companies.

As noted in Section III, the purpose of determining the proper capital structure for a regulated company is to help ascertain the capital costs of the company. The rate base - rate of return concept recognizes the assets which are employed in providing services and provides for a return on these assets by identifying the liabilities and common equity (and their cost rates) which are used to finance the assets. In this process, the rate base is derived from the asset side of the balance sheet and the cost of capital is derived from the liabilities/owners' equity side of the balance sheet. The inherent assumption in this procedure is that the capital structure and the rate base are approximately equal and the former is utilized to finance the latter.

The common equity ratio is the percentage of common equity in the capital structure. This is the capital structure item which normally receives the most attention, since common equity: (1) usually commands the highest cost rate; (2) generates associated income tax liabilities; and (3) causes the most controversy since its cost cannot be precisely determined.

Q: How have you evaluated the capital structure of Verizon NW?

A: I first examined the five-year historic capital structure ratios for Verizon NW and Verizon. These ratios are shown on Exhibit No. ___, DP-6.

Page 1 indicates the capital structure ratios of Verizon NW. I have summarized below the common equity ratios for Verizon NW on two bases:

	Including S-T Debt	Excluding S-T Debt
1999	58.4%	60.1%
2000	57.0%	61.4%
2001	58.9%	68.7%
2002	62.8%	68.9%
2003	57.3%	65.4%

Page 2 shows the capital structure ratios of Verizon. The consolidated common equity ratios of Verizon have been:

	Including S-T Debt	Excluding S-T Debt
1999	35.7%	40.7%
2000	37.6%	43.8%
2001	33.6%	38.7%
2002	37.6%	38.6%
2003	42.4%	42.9%
6/30/04	44.9%	47.7%

The common equity ratios of Verizon (consolidated) are seen to exhibit somewhat lower common equity ratios than Verizon NW.

Q: Have you compared the capital structure ratios of Verizon with other publicly-traded telephone companies?

A: Yes, I have. Exhibit No. ___, DP-7 shows the June 30, 2004 capital structure ratios for the group of telephone companies identified in the following section. This indicates the following common equity ratios:

	Including S-T Debt	Excluding S-T Debt
Telecommunications Group	53.5%	55.9%

These equity ratios are slightly above those of Verizon. However, as Exhibit ___, DP-13 shows, Verizon has generally superior "risk indicators" to the other companies making up the telecommunications group. This indicates lower risk for Verizon, notwithstanding its lower equity ratio.

Q: What factors have you considered in determining the proper capital structure to use in this proceeding?

A: I first gave consideration to the capital structure utilized by this Commission in Verizon NW's last rate proceeding (i.e., Cause No. U-81-61 in 1982 involving GTE NW). In that decision, the Commission employed a capital structure containing 40 percent common equity. This capital structure reflected a hypothetical capital structure.

Second, I considered the capital structure of Verizon NW. However, I gave little weight to this capital structure for several reasons:

- The Verizon NW capitalization has not been stable in recent years, both from a percentage basis and a dollar basis.
- The subsidiary capital structure can be controlled by the parent company.

- Even though Verizon NW does issue its own debt, the subsidiary capital structure is not reflective of a capital structure that is characterized by a market-driven ration of debt and equity.

Third, I considered the consolidated capital structure of Verizon, since this reflects the actual financing of the entire entity. This capital structure, unlike the Verizon NW capital structure, reflects a market-driven ration of debt and equity.

Q: What capital structure do you recommend for use in this proceeding?

A: I propose that the consolidated capital structure of Verizon be utilized for the purpose of estimating the total cost of capital for Verizon NW. As noted above, this reflects the actual financing of all of the operations of Verizon.

Q: What is the cost of long-term debt and short-term debt for Verizon NW?

A: For the cost of long-term debt, I used the September 30, 2004 embedded cost rate of long-term debt for Verizon NW, as was provided in response to Data Request No. 490. For the cost of short-term debt, I used the September, 2004 yield on 90-day commercial paper.

Q: Can the cost of common equity be determined with the same degree of precision as the costs of debt?

A: No. The cost rate of debt is largely determined by interest payments, issue prices, and related expenses. Even though alternative methodologies exist for determining the embedded cost rate, the cost rate for debt is generally agreed to, at least within a relatively small range.

The cost of common equity, on the other hand, is not susceptible to specific measurement, primarily because this cost is an opportunity cost. There are, however, several models which can be employed to estimate the cost of common equity. Three of

the primary methods - DCF, CAPM, and comparable earnings - are developed in the following sections of my testimony.

VII. DISCOUNTED CASH FLOW ANALYSIS

Q: What is the theory and methodological basis of the discounted cash flow model?

A: The discounted cash flow (DCF) model is one of the oldest, as well as the most commonly-used models for estimating the cost of common equity for public utilities. The DCF model is based on the "dividend discount model" of financial theory, which maintains that the value (price) of any security or commodity is the discounted present value of all future cash flows. When applied to common stocks, the dividend discount model describes the value of a stock as follows:

$$P = \frac{D_1}{(1+K_1)} + \frac{D_2}{(1+K_2)^2} + \ldots + \frac{D_n}{(1+K_n)^n} = \sum_{i=1}^{n} \frac{D_t}{(1+K)^t}$$

where: P = current price

D_1 = dividends paid in period 1, etc.

K_1 = discount rate in period 1, etc.

n = infinity

This relationship can be simplified if dividends are assumed to grow at a constant rate of g. This variant of the dividend discount model is known as the constant growth or Gordon DCF model. In this framework, the price of a stock is determined as follows:

$$P = \frac{D}{(K-g)}$$

where: P = current price

D = current dividend rate

K = discount rate (cost of equity)

g = constant rate of expected growth

This equation can be solved for K (i.e., the cost of equity) to yield the following formula:

$$K = \frac{D}{P} + g$$

This formula essentially states that the return expected or required by investors is comprised of two factors: the yield (current income) and expected growth (future income).

Q: Please explain how you have employed the DCF model.

A: I have utilized the constant growth DCF model. In doing so, I have combined the current dividend yield for each group of stocks described below with several indicators of expected growth.

My DCF analyses are performed for the following group of telecommunications companies:

ALLTEL Corp.
BellSouth Corp.
Century Tel
SBC Communications
Sprint Corp.
Verizon Communications

These are all publicly-traded telecommunications companies who have significant local-exchange operations and who currently pay dividends.

In addition, I have performed DCF analyses for the natural gas distribution industry, as measured by Moody's "Gas Distribution Group." This is relevant since this group represents a largely-regulated industry which is subject to some of the same types of competitive pressures (e.g., by-pass) as local exchange companies. This group is

comprised of the following companies:

AGL Resources
KeySpan Corp.
Laclede Group
Northwest Natural Gas
People's Energy
WGL Holdings

Q: How did you derive the dividend yield component of the DCF equation?

A: There are several methods which can be used for calculating the yield component. These methods generally differ in the manner in which the dividend rate is employed, i.e., current versus future dividends or annual versus quarterly compounding of dividends. I believe the most appropriate yield component is a quarterly compounding variant which is expressed as follows:

$$Yield = \frac{D_o(1+0.5g)}{P_o}$$

This yield component recognizes the timing of dividend payments and dividend increases.

The P_o in my yield calculation is the average (of high and low) stock price for each company for the most recent three month period (July-September 2004). The D_o is the current annualized dividend rate for each company.

Q: How have you estimated the growth component of the DCF equation?

A: The growth rate component of the DCF model is usually the most crucial and controversial element involved in using this methodology. The objective of estimating the growth component is to reflect the growth expected by investors that is embodied in the price (and yield) of a company's stock. As such, it is important to recognize that individual investors have different expectations and consider alternative indicators in

deriving their expected yield. A wide array of techniques exists for estimating the growth expectations of investors. As a result, it is evident that no single indicator of growth is always used by all investors. It therefore is necessary to consider alternative indicators of growth in deriving the growth component of the DCF model.

I have considered five indicators of growth in my DCF analyses. These are:

1. 1999-2003 (5 year average) earnings retention, or fundamental growth;
2. 5 year average of historic growth in earnings per share (EPS), dividends per share (DPS), and book value per share (BVPS);
3. 2007-09 projections of earnings retention growth;
4. 2002-2008 projections of EPS, DPS, and BVPS; and
5. 5 year projections of EPS growth as reported in FirstCall.

I believe this combination of growth indicators reflects a representative and appropriate set with which to estimate investor expectations of growth for the groups of comparison companies.

Q: Please describe your DCF calculations.

A: Exhibit ___, DP-8 presents my DCF analysis for the telecommunications and natural gas groups. Page 1 of each schedule shows the calculation of the "raw" (i.e., prior to adjustment for growth) dividend yield. Pages 2-3 show the growth rate for the groups of companies. Page 4 shows the DCF calculations. These results can be summarized as follows:

	Mid-Point	Average	Median	Range
Telecommunications Group	10.7%	10.3%	10.2%	9.3-12.1%
Gas Distribution Group	8.4%	8.3%	8.1%	7.5-9.2%

Q: What do you conclude from your DCF analyses?

A: Based upon my analyses, I believe a range of 10.2-10.7 percent represents the DCF cost of equity for the group of telecommunications companies, relative to their consolidated operations. The cost of equity for the gas distribution group is much lower, at 8.1-8.4 percent.

VIII. CAPITAL ASSET PRICING MODEL ANALYSIS

Q: Please describe the theory and methodological basis of the capital asset pricing model.

A: The Capital Asset Pricing Model (CAPM) is a version of the risk premium method. The CAPM describes and measures the relationship between a security's investment risk and its market rate of return. The CAPM was developed in the 1960s and 1970s as an extension of modern portfolio theory (MPT), which studies the relationships among risk, diversification, and expected returns.

Q: How is the CAPM derived?

A: The general form of the CAPM is:

$$K = R_f + \beta(R_m - R_f)$$

where: K = cost of equity

R_f = risk free rate

R_m = return on market

∃ = beta

R_m-R_f = market risk premium

As noted previously, the CAPM is a variant of the risk premium method. I believe the CAPM is generally superior to the simple risk premium method because the CAPM

specifically recognizes the risk of a particular company or industry, whereas the simple risk premium method does not.

Q: What groups of companies have you utilized to perform your CAPM analyses?

A: I have performed CAPM analyses for the same groups of publicly-traded telecommunications companies and natural gas distribution companies evaluated in my DCF analyses.

Q: What rate did you use for the risk-free rate?

A: The first term of the CAPM is the risk free rate (R_f). The risk-free rate reflects the level of return which can be achieved without accepting any risk.

In reality, there is no such thing as a risk less asset. In CAPM filings, the risk-free rate is usually recognized by use of U.S. Treasury securities because Treasury securities are default-free owing to the government's ability to print money and/or raise taxes to pay its debts.

Two types of Treasury securities are often utilized as the R_f component - short-term U.S. Treasury bills and long-term U.S. Treasury bonds. I have performed CAPM calculations using the three month average yield (July-September, 2004) for 20 year U.S. Treasury bonds. Over this three month period, these bonds had an average yield of 5.07 percent.

Q: What betas did you employ in your CAPM?

A: I utilized the most current Value Line betas for each company. These are shown on Exhibit ___, DP-10 and are seen to be within a range of 1.00 to 1.10 for the telecommunications group and 0.65 to 0.80 for the gas distribution industry (the beta for the entire market is 1.00).

Q: How did you estimate the market return component?

A: The market return component (R_m) represents the expected return from holding the entire market portfolio. In the CAPM, this term technically reflects the return from holding the weighted combination of all assets (i.e., stocks, bonds, real estate, collectibles, etc.). However, the traditional use of CAPM in utility rate proceedings focuses on R_m as the return on common stocks.

Alternative methods have been prepared with which to estimate R_m. As was the case in the DCF analysis concerning investors' expectations of growth, investors do not universally share the same expectations of the return on the overall market. My analysis of the R_m focuses on various returns for the Standard & Poor's 500 composite group which is a well-recognized index of the overall stock market. Two measures of return for the S&P 500 group have been performed.

Exhibit ___, DP-9 shows the return on equity for the S&P 500 group for the period 1978-2002 (all available years reported by S&P). The average return on equity for the S&P 500 group over the 1978-2002 period is 13.85 percent. Based upon these returns, I conclude that the expected return on equity is 13.85 percent for the S&P 500 group.

I have also considered the total return for the S&P 500 group, as tabulated by Ibbotson Associates, using both arithmetic and geometric means. I have considered the total returns for the entire 1926-2003 period, which are as follows:

Arithmetic	12.4%
Geometric	10.4%

I conclude from this that the expected total return for the S&P 500 group is about 11.4 percent (i.e., average of arithmetic and geometric means). I combine the results of the

return on common equity (13.8 percent) and the total return (11.4 percent) and conclude that 12.6 percent is the expected R_m.

Q: Please describe the results of your CAPM analyses.

A: Page 1 of Exhibit ___, DP-10 shows my first set of CAPM results. The results are as follows:

	Mean	Median
Telecommunications Group	12.9%	12.8%
Gas Distribution Group	10.6%	10.7%

Q: Have you performed an alternative set of CAPM calculations?

A: Yes I have performed an additional set of CAPM calculations in order to consider an alternative method of measuring the risk premium component. In this alternative CAPM, I did not use individual values of R_m and R_f to calculate the risk premium but rather used the historic risk premium from Ibbotson & Associates. I have developed such a risk premium by comparing the 1926-2003 total returns for:

Large Company Stocks	12.4%
Long-term Government Bonds	5.8%
Risk Premium	6.6%

Page 2 of Exhibit ___, DP-10 shows my CAPM calculations using this risk premium. The results are:

	Mean	Median
Telecommunications Group	11.8%	11.8%
Gas Distribution Group	9.9%	10.0%

Q: What is your conclusion concerning the CAPM cost of equity?

A: The CAPM results collectively indicate costs of approximately 11.8-12.9 percent for the group of telecommunication companies, relative to their consolidated operations. The CAPM results for the regulated gas distribution industry is much lower, at 9.9-10.7 percent.

IX. COMPARABLE EARNINGS ANALYSIS

Q: Please describe the basis of the comparable earnings methodology.

A: The comparable earnings method is derived from the "corresponding risk" standard of the Bluefield and Hope cases. This method is based upon the economic concept of opportunity cost. As previously noted the cost of capital is an opportunity cost - the prospective return available to investors from alternative investments of similar risk.

The comparable earnings method is designed to measure the returns expected to be earned on the original cost book value of similar risk enterprises. Thus, this method provides a direct measure of the fair return, because it translates into practice the competitive principle upon which regulation rests.

The comparable earnings method normally examines the experienced and/or projected returns on book common equity. The logic for returns on book equity follows from the use of original cost rate base regulation for public utilities that uses a utility's book common equity to determine the cost of capital. This cost of capital is, in turn, used as the fair rate of return that is then applied (multiplied) to the book value of rate base to establish the dollar level of capital costs to be recovered by the utility. This technique is thus consistent with the rate base methodology used to set utility rates.

Q: How have you employed the comparable earnings methodology in your analysis of the cost of common equity?

A: I conducted the comparable earnings methodology by examining realized returns on equity for several groups of companies and evaluating the investor acceptance of these returns by reference to the resulting market-to-book ratios. In this manner it is possible to assess the degree to which a given level of return equates to the cost of capital. It is generally recognized for utilities that market-to-book ratios of greater than one (i.e., 100%) reflect a situation where a company is able to attract new equity capital without dilution (i.e., above book value). As a result, one objective of a fair cost of equity is the maintenance of stock prices above book value.

I would further note that the comparable earnings analysis, as I have employed it, is based upon market data (through the use of market-to-book ratios) and is thus essentially a market test. As a result, my comparable earnings analysis is not subject to the criticisms occasionally made by some who maintain that past earned returns do not represent the cost of capital. In addition, my comparable earnings analysis uses prospective returns and thus is not strictly backward looking.

Q: What time periods have you examined in your comparable earnings analysis?

A: My comparable earnings analysis considers the experienced equity returns of the telecommunications groups and natural gas industry for the period 1992-2003 (i.e., last 12 years), as well as prospective returns. The comparable earnings analysis requires that I examine a relatively long period of time in order to determine trends in earnings over at least a full business cycle. Further, in estimating a fair level of return for a future period, it is important to examine earnings over a diverse period of time in order to avoid any undue influence by unusual or abnormal conditions that may occur in a single year or shorter period. Therefore, in forming my judgment of the current cost of equity I have

focused on two periods: 1999-2003 (last five years), and 1992-2001 (most complete recent business cycle).

Q: Please describe your comparable earnings analysis.

A: Exhibit ___, DP-11 and Exhibit ___, DP-12 contain summaries of experienced returns on equity for several groups of companies, while Exhibit ___, DP-13 presents a risk comparison of telecommunications and natural gas companies versus unregulated firms. Exhibit ___, DP-11 shows the earned returns on average common equity and market-to-book ratios for the groups of telecommunication and natural gas distribution companies. These can be summarized as follows:

	Historic		Prospective
	ROE	M/B	ROE
Telecommunications Group	16.3-18.6%	359-368%	12.6-14.5%
Gas Distribution Group	11.0-11.1%	160-167%	11.0-11.4%

These results indicate that historic returns of 16.3-18.6 percent have been adequate to produce market-to-book ratios of 359-368 percent for the telecommunications group.

Furthermore, projected returns on equity for 2004, 2005 and 2007-2009 are within a range of 12.6-14.5 percent for the telecommunications group. These relate to 2003 market-to-book ratios of 219 percent.

The results for the gas distribution industry are much lower, as historic returns on equity of 11.0-11.1 percent have resulted in market-to-book ratios of 160-167 percent. Projected returns of 11.0-11.4 percent relate to 2003 market-to-book ratios of 166 percent.

Q: Have you also reviewed earnings of unregulated firms?

A: Yes. As an alternative, I also examined a group of largely unregulated firms. I have examined the Standard & Poor's 500 Composite group, since this is a well recognized group of firms that is widely utilized in the investment community and represents an indication of the competitive sector of the economy. Exhibit ___, DP-12 presents the earned returns on equity and market-to-book ratios for the S&P 500 group over the past eleven years (i.e., 1992-2002). As this exhibit indicates, over the two periods this group's average earned returns ranged from 12.7-14.5 percent and with average market-to-book ratios ranging between 334-399 percent. Over the past eleven years, earnings levels have not increased, while market-to-book ratios have increased; reflecting a decline in the return levels required by investors. Since 1992, market-to-book ratios have been over 240 percent; they exceeded 300 percent in 1997-2002.

Q: How can the above information be used to estimate the cost of equity for telecommunications companies?

A: The recent earnings of the telecommunications, natural gas and S&P 500 groups can be utilized as an indication of the level of return realized and expected in the regulated and competitive sectors of the economy. In order to apply these returns to Verizon NW, however, it is necessary to compare the risk levels of the telecommunications and natural gas industries with those of the competitive sector. I have done this in Exhibit ___, DP-13 which compares several risk indicators for the S&P 500 group, the telecommunications and natural gas groups, and several other groups.

The information in this exhibit indicates that the S&P 500 group is more risky than the telecommunications group. This exhibit also indicates that the non-telephone (i.e., non local exchange service) operations of the telecommunications groups are viewed as much more risky than the overall telecommunications groups. This implies

that the provision of local exchange service is much less risky than the other operations of the telecommunications groups. This exhibit also clearly indicates that the regulated natural gas distribution industry is much less risky than the other groups.

Q: What return on equity is indicated by the comparable earnings analysis?

A: Based on the recent earnings and market-to-book ratios, I believe the comparable earnings analysis indicates that the cost of equity for local exchange operations is 10-11 percent. In reaching this conclusion, I relied primarily on the returns and market to book ratios of the natural gas distribution industry. The extremely high market to book ratios of the telecommunications group and S&P 500 group make it very difficult to evaluate past and projected return levels. Recent returns for the natural gas distribution industry of 11.0-11.1 percent have resulted in market-to-book ratios of 160 or over. Prospective returns of 11.0-11.4 percent have been accompanied by market-to-book ratios of 166 percent. As a result, it is apparent that returns below this level would result in market-to-book ratios of well above 100 percent. An earned return of 10-11 percent or less should thus result in a market-to-book ratio of at least 100 percent.

X. RETURN ON EQUITY RECOMMENDATION

Q: Please summarize the results of your three cost of equity analyses.

A: My three methodologies and findings are summarized below:

	Telecommunications Group	Gas Distribution Industry
Discounted Cash Flow	10.2-10.7%	8.1-8.4%
Capital Asset Pricing Model	11.8-12.9%	9.9-10.7%
Comparable Earnings	N/A	10-11%

I note that the DCF and CAPM cost rates for the telecommunications group reflect the consolidated operations and risks of these companies. Most of their non-local exchange

operations involve more risky operations, such as long-distance, cellular & paging, telecommunications equipment, and foreign telecommunications. The higher risk of these operations carry a correspondingly higher cost of capital. In order to estimate the cost of equity differentials between local exchange operations and these non-telephone operations, I performed DCF and CAPM analyses for several sets of publicly traded companies who are engaged in the types of operations in which many of the telecommunications groups' companies are diversified into. These calculations are shown on Exhibit ___, DP-14.

The average DCF and CAPM cost rates for these groups of companies are:

Group	DCF 1/	CAPM	Average
Wireless Group	16.4%	15.7%	16.1%
Wireless Networking Group	12.5%	17.6%	15.1%
Telecommunications Equipment	13.2%	16.9%	15.1%
Foreign Telecommunications	10.7%	13.6%	12.2%
Publishing	14.2%	11.6%	12.9%
Average			**14.3%**

1/ The DCF results for these groups employ only forward-looking growth rates since many of these groups' companies do not have meaningful historical results.

These indicate a 14.3 percent average DCF/CAPM result for these non-regulated companies. This compares to the 11.4 percent average (i.e., average of 10.2-10.7% DCF results and 11.8-12.9% CAPM results) for the consolidated telecommunications group, or some 2.9 percentage points below the required returns for the non-regulated groups.

Given the much higher than average returns for unregulated operations, clearly, the required cost of capital for the local exchange operations of the telecommunications groups is well below the 11.4 percent average DCF and CAPM cost rates. I believe the cost of equity for the regulated local exchange operations should be at least 100 basis

points (1 percent) below the 11.4 percent consolidated cost of equity for these groups. This is a reasonable adjustment given that equity costs for unregulated companies are almost 3 percent higher than the consolidated cost of equity. As a result, I believe that 10.5 percent represents the upper limit of the cost of equity for the local exchange operations of Verizon NW

Q: What cost of equity do you recommend for Verizon NW?

A: I recommend a return on equity range of 10 percent to 11 percent for Verizon NW's local exchange operations. This range reflects the DCF (10.2-10.7%) and CAPM (11.8-12.9%) results of the telecommunications group, adjusted downward by 100 basis points to reflect the much lower risk which the local exchange operations face relative to the more risky operations of the consolidated telecommunications groups. The bottom end of this range also reflects the current cost of equity or the natural gas distribution industry, based upon the results of my DCF (8.1-8.4%), CAPM (9.9-10.7%), and comparable earnings (10.0-11.0%) analyses.

XI. TOTAL COST OF CAPITAL

Q: What is the total cost of capital for Verizon NW?

A: This is shown on Exhibit ___, DP-15 which reflects the total cost of capital for the Company using the capital structure, cost of debt, and my cost of common equity recommendation. The resulting total cost of capital is a range of 8.04-8.49 percent (8.26 percent mid-point). I recommend a cost of capital for Verizon NW of no greater than 8.26 percent.

XII. COMMENTS ON COMPANY TESTIMONY

Q: Have you reviewed the testimony of Verizon Northwest witness Vander Weide?

A: Yes, I have.

Q: What is your understanding of Dr. Vander Weide's cost of capital recommendation?

A: Dr. Vander Weide recommends a total cost of capital for Verizon Northwest of 11.64 percent. This incorporates a cost of equity of 13.46 percent that he derives by applying a DCF analysis to a group of S&P Industrial companies and a group of Value Line companies. He applies this 13.46 percent cost of equity to a market-based capital structure comprised of 75 percent equity and 25 percent debt.

Q: What parts of Dr. Vander Weide's analyses do you disagree with?

A: I disagree with the following aspects of Dr. Vander Weide's cost of capital analyses:

- Use of quarterly DCF model;
- Exclusive reliance of earnings per share (EPS) forecasts as growth component;
- Use of S&P Industrials and Value Line as proxy groups; and,
- Use of market-based capital structure.

Q. Please explain why it is improper to use the quarterly version of the DCF model.

A. Dr. Vander Weide claims that it is necessary to use a quarterly DCF model since most firms pay dividends quarterly and since "Investors can expect to earn a higher annual effective return on an investment in a firm that pays quarterly dividends than in one which pays the same amount of dollar dividends once at the end of each year (pages 27-28)."

The quote of Dr. Vander Weide may be correct but this does not justify use of a quarterly DCF model. As investors receive dividends on a quarterly basis, they can either spend them, save them, or reinvest them. Each of these options essentially increases the return on their investment. If they spend the dividends, they enjoy the benefits (utility) sooner; if they save or reinvest the dividends they already get a higher return due to the

compounding effects. As a result, there is no need to use a quarterly DCF model, since this had the effect of double counting the impact of compounding.

Q. Why is it improper for Dr. Vander Weide to rely exclusively on 5-year EPS projections?

A. It is clear that investors rely on a number of factors when making investment decisions. It is naïve to believe that all investors rely exclusively on a single statistic in all circumstances. Yet this is what Dr. Vander Weide is proposing.

Dr. Vander Weide claims (page 29) that "There is considerable empirical evidence that analysts' forecasts are more highly correlated with stock prices than are firm's historical growth rates, and thus, that investors actually use these forecasts." Dr. Vander Weide has not addressed the proper question, which should be – Do investors all rely exclusively on a single estimator of growth? I believe it is naïve to believe this is the case. Investors are provided with many types of information, presumably for the purpose of assisting them in making investment decisions – projected earnings per share is merely one of many types of information.

I also note that Dr. Vander Weide's own "study" (page 30) does not address the "exclusive" indicator question, but rather focuses on the "best" indicator question. Unlike Dr. Vander Weide's 1998 study, which merely asked if analysts' forecasts are a better predictor (at that time) of stock prices than historical growth rates, other studies have asked a more relevant question: do investors rely on estimates of growth other than analysts' forecasts? Not surprisingly, the answer is "Yes."

One such example is a 1987 study by Conroy and Harris (in Management Science, Vol. 33, No. 6, June 1987, 725-738) that directly compared IBES projections vs. historic growth in EPS as indicators of stock price performance. They found that

analysts' forecasts were better than historic EPS over the short-term, but the advantage declined over time. They also found that a combination of forecasts and historic EPS is better than just forecasts of EPS.

A second study, also in 1987, by Newbolt, Zumwalk and Kannan (in International Journal of Forecasting, 3, 1987, 229-238) compared Value Line EPS projections with historic growth of DPS, EPS and retention growth as indicators of stock price performance. They found that analysts' forecasts of EPS are better than only historical data, but that a combination of forecasts and historic data is best.

A third study was published in 1989 by Timme and Eisemann (in Financial Management, Winter 1989, 23-35). This study compared IBES and Value Line projections with historic growth of DPS. They concluded that analysts' forecasts of EPS are superior to exclusive use of historic data, but do not contain all relevant information utilized by investors. They further concluded that a combination of forecast and historic data is better than exclusive use of analysts' forecasts.

Further, more recent academic scholarship has even challenged the accuracy of analysts' EPS forecasts. A prominent example is a 1998 article (in the Financial Analysts Journal, Vol. 54, No. 6, Nov./Dec. 1998, 35-42) titled "Why So Much Error in Analysts' Earnings Forecasts?", by Vijay Kumar Chopra. In this article, the author concluded, "Analysts' forecasts of EPS and growth in EPS tend to be overly optimistic." He concluded that analysts' forecasts of EPS over the past 13 years have been more than twice the actual growth rate.

Another source is less academic and more directly in the financial mainstream. On March 26, 2002, Federal Reserve Chairman Alan Greenspan spoke to an audience at the Stern School of Business of New York University. In that speech, (available at the

FRB's website: http://www.federalreserve.gov), the Chairman addressed the historical relationships and roles of corporations, financial institutions and brokerage-based investment analysts:

> "For the most part, despite providing limited incentives for board members to safeguard shareholder interest, this paradigm has worked well. We are fortunate for financial markets have had no realistic alternative other than to depend on the chief executive officer to ensure an objective evaluation of the prospects of the corporation. Apart from a relatively few large institutional investors, not many existing or potential shareholders have the research capability to analyze corporate reports and thus judge the investment value of a corporation. This vitally important service has become dominated by firms in the business of underwriting or selling securities."
>
> "But, **as we can see from recent history, long-term earnings forecasts of brokerage-based securities analysts, on average, had been persistently overly optimistic. Three-to five-years earnings forecasts for each of the S&P 500 corporations, compiled from projections of securities analysts by I/B/E/S, averaged almost 12 percent per year between 1985 and 2001. Actual earnings growth over the period averaged about 9 percent."**
>
> "Perhaps the last sixteen years for which systematic data have been available are a historic aberration. But the persistence of the bias year after year suggests that it more likely results, at least in part, from the proclivity of firms that sell securities to retain and promote analysts with an optimistic inclination. Moreover, the bias apparently has been especially large when the brokerage firm issuing the forecast also serves as an underwriter for the company's securities."

Still another source of new insight and perspective is, unfortunately, the well-publicized financial debacles of Enron and WorldCom. These sagas demonstrate dramatically how analysts are often either unwilling or incapable of discerning potentially disastrous impacts on a Company's projected EPS, and how even current earnings can be distorted by the complex financial machinations of large, aggressive corporations.

Finally during 2003, ten of the nation's largest securities firms agreed to pay a record $1.4 billion in penalties to settle U.S. government charges involving investor abuses, many of which resulted from analysts' forecasts and recommendations that the government charged were biased and subject to conflicts-of-interests. This settlement largely grew out of a New York State investigation and reflects the national, and even international, scope of the negative perceptions of analysts' forecasts and recommendations. These and other, similar investigations and complaints have underscored a growing awareness that analysts' estimates cannot be considered an unbiased source of growth expectations by investors, and this has important implications for a DCF analysis that exclusively incorporates any such estimates.

In summary, investors are now very much aware of recent scandals involving security analysts, including the Enron and WorldCom debacles, conflicts of interest that have resulted in settlements, fines, and public admonishments, as well as other negative connotations related to the reliability of analysts' forecasts. If there ever was a tendency for investors to rely exclusively on analysts' forecasts, a dubious proposition, clearly the landscape has changed in recent years and investors have ample reasons to doubt the reliability of such forecasts at the present time.

Q: What are your comments about Dr. Vander Weide's proxy groups?

A: Dr. Vander Weide selected two proxy groups to which be applied his DCF analysis: 1) a subset of the S&P Industrials that have reported stock prices, pay dividends and have at least three analysts' growth estimates; and 2) a group of companies meeting certain Value Line criteria. Neither of these proxy groups is a suitable proxy group for Verizon NW.

The purpose of selecting a proxy group for a regulated company, such as Verizon NW, is to identify a set of companies that have similar risk and operating characteristics

to the subject company. It is obvious that Dr. Vander Weide's two proxy groups are much less similar to Verizon NW than are the telecommunications group and gas distribution group I utilize in my cost of capital analyses. For example, my telecommunications group is comprised of companies that have significant local exchange operations; Dr. Vander Weide's group does not. In addition, my groups provide essential services and are, to some extent, regulated; Dr. Vander Weide's groups are not.

Q: Do you agree with Dr. Vander Weide's use of market-value capital structures?

A: No, it is not proper to utilize the market-value capital structure framework as proposed by Dr. Vander Weide, whereby the number of shares of stock is multiplied by the stock price to derive the equity component of the capital structures without a demonstration that this is consistent with the manner is which either Verizon or Verizon NW would be expected to finance its local exchange operations. I say this because Dr. Vander Weide's proposed methodology does not reflect the actual dollars of capital which Verizon (or his S&P Industrials of Value Line groups) has available to invest in the facilities needed to provide local exchange operations. The fact that the current market value of the Telecom Companies common stock, for example, represents about 80% of its market-value of capital does not indicate that these firms would choose to finance their operations in this manner. Clearly, there is a financial incentive to employ leverage in financing a company, as long as the expected return exceeds the cost of debt. As a result, what is important and proper for the purposes of this proceeding is to estimate how a competitive firm would capitalize its investment in the facilities required to provide local exchange operations.

Q: Is Verizon capitalized in the manner suggested by Dr. Vander Weide?

A: Not at all. As I show in Section VI of my testimony above, Verizon has far less equity than Dr. Vander Weide would impute in his capital structure – over 45 percent less. Dr. Vander Weide's proposed market-based capital structure has no foundation in how Verizon actually chooses to finance its operations, and should not be adopted by this commission.

Q: Does that conclude your testimony?

A: Yes.