BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

WUTC v. VERIZON

DOCKET NO. UT-040788

DIRECT TESTIMONY OF STEVEN C. CARVER (SCC-1T)

ON BEHALF OF

PUBLIC COUNSEL, AARP AND WEBTEC

THIS DOCUMENT IS THE NON-CONFIDENTIAL VERSION OF THIS TESTIMONY PURSUANT TO THE PROTECTIVE ORDER IN THIS DOCKET.

November 22, 2004

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STEVEN C. CARVER**

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Steven C. Carver. My business address is 740 NW Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. What is your present occupation?

A. I am a principal in the firm Utilitech, Inc., which specializes in providing consulting services for clients who actively participate in the process surrounding the regulation of public utility companies. Our work includes the review of utility rate applications, as well as the performance of special investigations and analyses related to utility operations, cost allocation and ratemaking issues.

Q. On whose behalf are you appearing in this proceeding?

A. I am appearing on behalf of the Washington Attorney General – Public Counsel Section ("Public Counsel"), AARP (formerly, the American Association of Retired Persons), and Washington Electronic Business & Telecommunications Coalition ("WeBTEC"), collectively referred to as "Consumers." Utilitech was jointly retained by Consumers to review and respond to the certain revenue requirement issues related to the Application of Verizon Northwest Inc. ("Verizon" or "VZNW") for an increase in its intrastate rates and revenues. The scope of work undertaken by Utilitech included submission of testimony with this Commission regarding the results of our review, regarding selected revenue requirement issues under the traditional approach to utility regulation.

Q. Have you previously testified in telecommunications proceedings or before this Commission?

A. Yes. I have previously filed testimony before this Commission in two proceedings involving Qwest Corporation (formerly U S West Communications) in Docket Nos. UT-930074 / UT-930307 (sharing plan) and UT-950200 (general rate case). I have also prepared and presented revenue requirement recommendations in a number of proceedings involving telecommunications providers in other jurisdictions, including: GTE Hawaiian Telephone Company (currently Verizon Hawaii Inc.); Qwest Corporation (four Arizona rate cases and one each in Utah and New Mexico); Southwestern Bell Telephone Company (Missouri and Oklahoma); and SBC Pacific Bell (California).

Generally, my responsibilities in this docket encompass the review and evaluation of certain specific rate base and operating income items proposed by Verizon. As a result, I address and quantify several adjustments on behalf of Consumers identified on the earlier table of contents. Because of the limited scope of our engagement, we are not sponsoring or presenting an overall revenue requirement recommendation. Instead, the rate base and operating income adjustments I sponsor are set forth in Exhibits SCC-7C, SCC-8 and SCC-9.

II. EDUCATION AND EXPERIENCE

Q. What is your educational background?

A. I graduated from State Fair Community College, where I received an Associate of Arts Degree with an emphasis in Accounting. I also graduated from Central Missouri State University with a Bachelor of Science Degree in Business Administration, majoring in Accounting.

Q. Please summarize your professional experience in the field of utility regulation.

A. From 1977 to 1987, I was employed by the Missouri Public Service Commission ("MoPSC") in various professional auditing positions associated with the regulation of public utilities. In April 1983, I was promoted by the Missouri Commissioners to the position of Chief Accountant and assumed overall management and policy responsibilities for the Accounting Department. I provided guidance and assistance in the technical development of Staff issues in major rate cases and coordinated the general audit and administrative activities of the Department.

I commenced employment with the firm in June 1987. During my employment with Utilitech, I have been associated with various regulatory projects on behalf of clients in the States of Arizona, California, Florida, Hawaii, Kansas, Illinois, Iowa, Indiana, Mississippi, Missouri, Nevada, New Mexico, New York, Oklahoma, Pennsylvania, Texas, Utah, Washington, West Virginia and Wyoming. I have conducted revenue requirement and special studies involving various regulated industries (i.e., electric, gas, telephone and water). Since joining the firm, I have also appeared as an expert witness before the MoPSC on behalf of various clients, including the Commission Staff. Additional information regarding my professional experience and qualifications are summarized in Exhibits SCC-2 and SCC-3.

III. EXECUTIVE SUMMARY

Q. Do the Consumers have an overall revenue requirement recommendation for VZNW's Washington intrastate regulated operations?

A. No. Because our efforts and analyses were directed to specific areas of the Company's filing, there are various VZNW adjustments that have not been analyzed with the same degree of detail attributed to those issue areas on which Mr. Brosch or myself sponsor adjustments. Since any calculation of overall revenue requirement would necessarily start with VZNW's proposed rate base and operating income,[1] the inclusion of various Company adjustments without modification or detailed review would not provide a true measure of the overall recommendation that Consumers would necessarily endorse. As a result, our efforts have been directed to the quantification of incremental adjustments to Verizon's revised filing. The adjustments I do sponsor would reduce rate base by approximately $91.5 million (Exhibit SCC-8) and decrease operating expense (before income tax) by $3.8 million (Exhibits SCC-7C & SCC-9).

Q. Do your Exhibits SCC-7C through SCC-9 provide calculation detail supporting each Consumers adjustment?

A. Yes. These Exhibits set forth the individual adjustments that I sponsor and show quantification detail related to each rate base and operating income adjustment, with footnote references to supporting documentation. Since virtually all information used in developing these adjustments was supplied by VZNW in response to written discovery, the individual adjustment exhibits refer to the relevant data sources, most of which is already in the Company's possession.

Q. Please describe how the remainder of your testimony is organized.

A. The remainder of my testimony is arranged by topical section, following the table index presented previously. This index identifies the specific areas I address in testimony and references the testimony pages as well as any related adjustment support located in the joint accounting schedules.

IV. FAS106 OPEB COSTS

Q. Please describe the Consumers adjustment identified as Exhibit SCC-7C.

1 Verizon's revised filing of October 4, 2004.

A. Exhibit SCC-7C modifies Verizon's pro forma adjustments recognizing FAS106 other postretirement benefits costs ("OPEB" costs) on an accrual basis to the pay-as-you-go ("PAYGO") or cash basis.

Q. Please provide a brief overview of FAS106.

A. In December 1990, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard No. 106 ("FAS106"), Employers' Accounting for Postretirement Benefits Other Than Pensions, also known as "OPEBs" or "PBOPs". These benefits generally include health care and life insurance benefits provided outside a pension plan to retirees and their spouses, dependents and beneficiaries.

In general, FAS106 requires employers to accrue the cost of OPEBs to expense during the employees' service period, thereby recognizing a balance sheet liability for such obligations for financial reporting purposes. Since pay-as-you-go ("PAYGO") or cash basis was the predominant method of accounting for financial and regulatory accounting for OPEBs prior to the issuance of FAS106, a major component of the incremental cost of moving from the cash to accrual basis of accounting for OPEBs is the transition obligation.

Q. What is the "transition obligation"?

A. Generally, the transition benefit obligation ("TBO") represents the excess of the actuarial present value of the cumulative benefits attributed to employee service over the fair value of any plan assets, as of the date of plan adoption. In other words, the TBO is the unrecognized liability to both active and retired employees attributable to services rendered prior to the date of accrual accounting adoption. FAS106 provides two alternative methods for recognizing this previously unrecognized TBO upon adoption:

- The immediate recognition of the cumulative effect of the change as a current period charge; or

- The straight line amortization of the unrecognized obligation over the average remaining life of employees, or twenty years if longer.

Verizon's response to Data Request PC-266 indicates that a TBO of $30,296,000 is being amortized over a 15-year period for Washington regulatory purposes.

Q. Please summarize the Company's proposed adjustments related to OPEB costs.

A. Verizon witness Heuring sponsors several adjustments that relate to OPEB costs. As discussed at page 17 of Ms. Heuring's revised testimony,[2] Verizon recognizes that the Commission's policy statement from Docket No. A-921197 requires the Company to report OPEB costs on a PAYGO basis in calculating adjusted earnings. Consequently, Verizon Adjustment WP R8-03 removes test year accrual basis OPEB costs and recognizes cash basis accounting. Verizon Adjustments WP P15 and WP P12 then reinstate test year accrual expense and recognize a "forecast" test period[3] accrual estimate for such costs. The following table summarizes the impact of the first two of

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2 Heuring direct testimony, revised October 4, 2004.

3 Verizon quantifies escalation growth rates to apply to adjusted historical test year (ending September 2003) operating results to develop estimated results for the future test period (ending September 2004).

those Company adjustments:

Verizon OPEB Costs Total Washington (000's)					
Description	Adj. Ref.		Total State (Exp & Cap)		Intrastate Expense
Adjust TY Accrual to PAYGO:	WP R8-03				
Remove TY Accrual			(11,710)		(5,972)
Add TY PAYGO			10,854		7,357
Net Adjustment			(856)		1,385
Reverse PAYGO to TY Accrual:	WP P15				
Add TY Accrual			11,710		5,972
Reverse TY PAYGO			(10,854)		(7,357)
Net Adjustment			856		(1,385)
Source: Verizon adjustment workpapers WP R8-03 & WP P15.					

In effect, the purpose of Verizon's restating adjustment (WP R8-03) is to remove book OPEB costs accrued during the test year (twelve months ended September 2003) and reflect PAYGO, pursuant to the Commission's order in Docket No. A-921197. Verizon then reverses the test year PAYGO amount and reinstates the original OPEB accrual (WP P15), which is further adjusted by an incremental pro forma adjustment (WP P12) to reflect estimated accrual basis costs for the test period (twelve month period ended September 2004).[4]

Q. Referring to the above table, could you explain why Verizon Adjustment WP R8-03 shows a reduction to expense on a Total State basis, but the intrastate adjustment actually increases expense?

A. In the calculation of PAYGO intrastate expense, Verizon did not allocate the total PAYGO amount between expense and capital accounts unlike its FAS106 accounting,

4 Verizon response to Data Request PC-120.

which allocated the accrual amount about 75%/25% between expense and capital. Instead, the intrastate regulated portion of PAYGO was assigned 100% to expense. As a consequence, this inconsistent capitalization method caused the Company's intrastate expense adjustment to be higher under PAYGO than under FAS106, when FAS106 is actually the higher amount before allocation and separation. Verizon Adjustment WP R8-03 should have allocated a portion of PAYGO to capital accounts, consistent with the FAS106 accrual costs.

Q. Why does this table not show comparable amounts associated with Verizon Adjustment WP P12?

A. Unlike more typical revenue requirement presentations, Verizon did not quantify and post a specific, stand-alone adjustment to recognize the expense impact of its 2004 OPEB estimate. Instead, Adjustment WP P12 uses various techniques to quantify pro forma wage, salary and employee benefit expenses for purposes of developing an escalation growth rate. This rate, which included the impact of OPEB costs, was used to forecast or inflate the historic test year expenses (after restating adjustments) to the future test period, ending September 2004. As a result, the quantification of the impact of Verizon's OPEB accrual estimate is less than straight forward and is not easily summarized for presentation purposes.

Q. Referring to Exhibit SCC-7C, do you agree with the Company's PAYGO valuation before allocation and separation?

A. No. In the confidential response to Data Request PC-120, Verizon provide additional support for the PAYGO costs used in quantifying Company Adjustments WP R8-03 and WP P15. The PAYGO amount Verizon used in these adjustments represented "gross" charges to the Company, before recognizing retiree contributions. As a result, the $10,854,033 of test year PAYGO costs would be reduced to $**[CONFIDENTIAL BEGINS] ********* [CONFIDENTIAL ENDS]** after recognizing retiree contributions. Exhibit SCC-7C quantifies Consumers' adjustment based on the lower "net" cost to Verizon, which is then subject to allocation between regulated and nonregulated operations and between regulated expense and capital accounts and then subject to separation to intrastate operations.

Q. If the Commission were to conclude that overall revenue requirement should continue to recognize PAYGO as the basis for determining OPEB expense in this proceeding, should the PAYGO amount be net of participant contributions?

A. Yes. In response to Data Request PC-265, Verizon concurred that PAYGO should be recognized net of retiree contributions in the even the Commission decided to continue cash basis accounting for OPEB costs. I would note, however, that this oversight in the Company's filing was minimized because Verizon Adjustments WP R8-03 and WP P15 net to "zero".

Q. Why has the Company recognized OPEB costs on an accrual in test year expense?

A. In direct testimony, Ms. Heuring provides the following explanation:

> 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.
> [Heuring revised direct, p. 22]

According to the response to Data Request PC-121, the Company relied on generally accepted accounting principles ("GAAP") and FCC Part 36 (uniform system of accounts or "USOA") as the basis for proposing accrual accounting for OPEB costs pursuant to FAS106. This response also states: "The objective of FAS 106 was to better match costs with the events giving rise to the costs. By including FAS 106 cost, current rate payers pay for current benefits earned."

Q. Do you agree?

A. No. In the early to mid 1990's, a number of regulatory issues arose with regard to cash basis accounting or FAS106 adoption. State regulatory jurisdictions took various paths in assessing the issue, typically leading to some form of accrual accounting being recognized for regulatory purposes. Washington was no different. However, given the absence of formal Verizon rate case activity in Washington since 1983,[5] neither the Company nor the Commission appear to have explicitly considered OPEB accrual accounting for intrastate ratemaking purposes since FAS106 was issued and implemented.

Q. In deciding to recognize FAS106 accrual basis, rather than PAYGO, OPEB costs in revenue requirement, did Verizon rely on any decision by the WUTC that modified or reversed the policy statement issued in Docket No. A-921197?

A. No.[6]

Q. Why have you recommended that the Commission continue to recognize OPEB costs on a pay-as-you-go basis, rather than the accrual accounting approach recommended by Verizon?

5 Verizon's original response to Data Request PC-131.
6 Verizon response to Data Request PC-121.

A. Although Ms. Heuring cites to the WUTC policy statement in Docket No. A-921197 as support for Adjustment WP R8-03, which Verizon promptly reverses with Adjustment WP P15, the brief Company testimony on this issue does not appear to comply with the requirements set forth by the Commission.

Q. Please explain.

A. Exhibit SCC-4 is a copy of the WUTC policy statement in Docket No. A-921197, supplied by Verizon in response to Data Request PC-119. According to the Commission policy statement, utility rates had been set using PAYGO prior to FAS106. In order to substantiate claims for regulatory recovery of the higher accrual costs, the policy statement set forth various criteria with which each company was required to comply, including the following excerpts:

- Demonstrate in a general rate case that the higher FAS106 accrual basis expense claimed for ratemaking purposes is reasonable, prudently incurred and determined under conservative assumptions.
- Demonstrate that the requested expense is supported by prudent and safe funding of the entire amount based on tax free asset transfers and fund income.
- Demonstrate that there is a benefit to ratepayers from reflecting the higher FAS106 expenses in rates over time.
- Determine FAS106 expense under prudent, conservative, and reasonable assumptions, including full tax deductible funding, regardless whether actual contributions are fully tax deductible.

The WUTC policy statement also defined the word “conservative”, as used in this context, as follows:

> By “conservative”, the Commission intends that it be understood that the lowest reasonable assumptions be used for inflation related matters and the lowest reasonable costs be used. To the extent that this definition of conservative differs from that which is meant for financial reporting

> purposes, the Commission will accept its own definition for ratemaking purposes in preference to that of the accounting community.

I am not aware of any testimony or other evidence filed by Verizon that attempts to meet the requirements of the WUTC policy statement or demonstrates that the future period estimated FAS106 costs were estimated in conformance with the Commission's definition of "conservative" assumptions.

Q. Does the Commission's policy statement require PAYGO regulatory accounting, as indicated by Ms. Heuring?

A. Yes. While the policy statement also established a framework to enable regulated utilities to defer and potentially amortize the excess of FAS106 over PAYGO during a transitional period, the last paragraph of Attachment A appended to the policy statement contained the following requirements:

> Any company not choosing to defer the incremental expense of SFAS 106, and not intending to request the amount to be reflected for ratemaking purposes, is encouraged to keep appropriate records. The company should keep records which would indicate the amount of annual, incremental SFAS 106 expense and, if it capitalizes a portion of the annual incremental cost of SFAS 106, keep available the records and information which will enable the restatement of plant and accumulated depreciation reserve balances to eliminate the capitalized portion for future ratemaking purposes. For Commission basis regulatory reporting purposes such companies must reflect "pay-as-you-go" or cash basis in the calculation of adjusted earnings.[7]

Q. Have you previously submitted testimony addressing the issue of OPEB cost recovery?

A. Yes. I have testified opposing or modifying the quantification of FAS106 for ratemaking purposes in various jurisdictions, including:

7 Verizon's filing did not quantify the cumulative effect of capitalized FAS106 accrued costs since adoption, in order to restate plant and accumulated depreciation reserve balances.

- Arizona: Docket E-1051-88-146 (U S West complaint), Docket E-1551-89-102 and 103 (Southwest Gas Corporation) and Dockets E-1051-93-183 and T-1051B-03-0454 (U S West).

- Indiana: Dockets 39584 & 40003 (Public Service of Indiana).

- Utah: Docket 97-049-08 (U S West).

As indicated in the following excerpt from Decision No. 58927 (Docket No E-1051-93-183), the Arizona Corporation Commission essentially adopted the recommendations of Staff and Residential Utility Consumers Office ("RUCO") and denied Qwest's (formerly U S West Communication) proposed adjustment to transition from PAYGO to accrual accounting:

> …we are still not convinced that a change from the cash method to an accrual method which includes past and current costs is appropriate at this time. We are making this decision based upon an overall comparison of the Paygo method versus an accrual method which includes the Transition Costs. We share some of the Company's concerns regarding intergenerational inequities. Ideally, each generation of customers will pay the OPEB costs that directly benefit them and not pay those costs which directly benefit other generations of customers. The existence of the Transition Costs demonstrates that the paygo method does not meet the ideal situation of matching costs and benefits. A change to the accrual method without consideration of the Transition Costs could provide a better match of costs and benefits. Even though the Company for financial purposes has written off the Transition Costs, the Company made it clear it preferred the Paygo method over a straight accrual method without Transition Costs. Based on all the above, we will not recognize for ratemaking purposes the effect of the accounting change proposed by the Company for post-retirement benefits.
>
> …
>
> The Company's real concern is whether, when and if it is placed in a completely competitive, unregulated environment, it still will be able to recover all of its OPEB costs and still be competitive. In our mind, such a concern is not all bad since it forces the Company to closely monitor its OPEB costs. Accordingly, we will not adopt the Company's $28 million adjustment.
>
> [ACC Decision No. 58927, pages 44-45 (Docket No E-1051-93-183)]

Q. Since the 1993 Arizona rate case, have you filed testimony opposing Qwest's proposed adoption of FAS106 accrual accounting in Arizona?

A. No. In the 1997 time period, Staff and the Arizona Corporation Commission revised their consideration of this issue and proposed or adopted accrual accounting in other proceedings. In the pending Arizona Qwest rate case, the Company and I appear to disagree on the calculation of the annual TBO amortization that should be recognized for ratemaking purposes.

Q. Are you opposing Verizon's proposed adoption of FAS106 for Washington ratemaking purposes because PAYGO is more appropriate or because the Company has failed to comply with the WUTC policy statement?

A. While I do believe that PAYGO should be adopted for regulatory accounting and ratemaking purposes instead of FAS106 accrual accounting, I have proposed adoption of PAYGO in the current proceeding because Verizon has not complied with the requirements of the WUTC policy statement issued in Docket No. A-921197. Further, Verizon's test year approach uses a preliminary estimate of the 2004 FAS106 costs. However, the 2004 actuary report, including revised FASB guidance on new Medicare RX Plan, will not be available until mid-year 2005. I disagree with the Company's forecast technique and oppose adoption of the estimated 2004 FAS106 expense, as quantified by Verizon.

V. FAS87 PENSION ASSET

Q. Should the Commission adopt Verizon's proposal to include the pension asset in rate base?

A. No. Exhibit SCC-8 represents Consumers adjustment eliminating Verizon's proposed inclusion of the pension asset in rate base. This adjustment also removes the related accumulated deferred income tax reserve from rate base.

Q. Have you addressed this issue in past rate proceedings?

A. Yes. I have sponsored testimony in various jurisdictions opposing the inclusion of a pension asset in rate base, including:

Jurisdiction	Case / Docket	
Arizona Corporation Commission	E-1051-93-183	(a)
	T-1051B-99-105	(a)
	T-1051B-03-0454	(c)
Public Utilities Commission of Hawaii	94-0298	(e)
Oklahoma Corporation Commission	PUD 001151	(d)
Utah Public Service Commission	97-049-08	(a)
Washington Utilities and Transportation Commission	UT-930074	(b)

Note (a): Qwest Corp. rate case.
Note (b): Qwest Corp. AFOR – sharing.
Note (c): Qwest price cap review.
Note (d): Oklahoma Natural Gas.
Note (e): GTE Hawaiian Telephone.

Q. In the proceedings identified in this table, did you recommend the complete elimination of the pension asset from rate base?

A. Yes, except for the most recent Arizona proceeding (ACC Docket No. T-1051B-03-0454). In the remaining dockets, my pension asset analysis was similar to the analysis prepared in the current proceeding and resulted in recommendations excluding the pension asset from rate base. However, in the recent Qwest proceeding in Arizona, the update of my earlier analyses did support, for the first time, the inclusion of the pension asset in rate base. Absent a demonstration that ratepayers had materially participated in the cumulative pension credits comprising the pension asset, my analyses have fairly consistently questioned whether the alleged benefits were instead enjoyed by investors, not ratepayers.

Pension Cost Accounting

Q. Please describe the events or circumstances giving rise to the pension asset.

A. In December 1985, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 87 ("FAS87"), concerning employers' accounting for pension costs. FAS87 was effective for fiscal year beginning after December 15, 1986, for financial accounting purposes. Prior to FAS87, the amount of pension costs distributed to expense and capital accounts was equal to the level of contributions actually made to the pension fund. After the adoption of FAS87, pension costs expensed/ capitalized and pension contributions began to diverge. Since the adoption of FAS87, Verizon has recorded negative pension costs (a pension credit) instead of positive pension costs since at least 1993.[8] The pension asset balance represents the accumulation of those pension "credits".

Consumers Approach

Q. Could you briefly outline the rate base concept?

A. Rate base is commonly viewed as being comprised of net utility asset investments used and useful in providing service to customers. When investors provide the funds

8 According to Verizon's responses to Data Request PC-128 and PC-261. Thus far, Verizon has been unable to produce pension cost information prior to 1993.

necessary to support these company investments, those amounts are generally included in rate base, allowing investors an opportunity to earn a return on invested capital. Similarly, funds advanced, reimbursed, or otherwise paid for by customers are properly excluded from rate base.

The direct testimony of Company witness Heuring (page 27) only makes passing reference to the inclusion of the pension asset in Verizon's rate base. However, the most succinct explanation of Verizon's rationale for rate base inclusion was provided in response to Data Request PC-215(b), as follows:

> Yes. The Company has passed back to the ratepayers the benefit of the FAS 87 accounting change and the performance of the pension fund assets by reducing its cost of service over the years through the recording of a pension expense credit on its books. The ratepayer has received the full benefit of reduced reported operating expense over the years, while the Company has suffered an annual outlay of cash that has no other valid way of being recognized. As such, the Company is seeking to earn a fair return on these financial resources which have been so committed. If the pension expenses had not been substantially reduced since 1987, the need for rate relief would have been more acute. In addition, as shown in the corrected response to PC-131, the ratepayers benefited from the negative pension cost associated with the rate reduction ordered in Docket UT-991164.
>
> In Docket No. UT-950200, the Commission accepted US West's position that the pension asset should be included in the rate base. "All of the return earned in the fund is used to reduce the need for further investment by the Company, and thus it works to reduce the pension expense." [Data Request PC-215(b)]

Q. Does the mere existence of pension credits result in an automatic and substantial decrease to the cost of service benefiting ratepayers?

A. No. Under traditional utility regulation, utility rates are based on a test year cost of service, theoretically designed to balance the various components of the ratemaking equation. Once determined, those rates are generally considered just and reasonable until a moving party presents evidence that the utility is materially under, or over, earning the authorized return in support of revised rates. In general terms, the utility is considered to have recovered all costs recorded between rate cases and achieved a reasonable return on its rate base investment.

However, it is not uncommon for regulators to be presented with various issues associated with accounting changes (e.g., transition from pay-as-you-go to FAS106 accrual accounting for OPEB costs, adoption of FCC Part 32 capital to expense shifts), cost deferrals (e.g., storm damage, demand-side management costs), amortization requests (e.g., depreciation reserve deficiency, workforce reduction program costs) or tracking mechanisms (fuel adjustment clause) that deviate from this general framework. If the mere <u>recording</u> of a transaction meant that ratepayers symmetrically funded increases and benefited from decreases in expense, there would seem to be no need for the many deferral, cost tracker or amortization issues that arise in utility regulation. The fact is that such issues do arise and have existed for many years. Rather than dismissively reject these requests, regulators typically review the facts and circumstances unique to each situation and determine whether the regulatory treatment requested by the utility should be accepted, rejected or modified.

The pension asset is no different. While negative pension credits have been recorded by some utilities since the late 1980's, the question is whether Verizon's Washington ratepayers have adequately participated in the reduced expense to support rate base inclusion of the pension asset. In other words, have negative pension costs been included in the cost of service or somehow separately flowed through to customers "as recorded" each year since the adoption of FAS87? If the ratepayers are not the beneficiaries of those pension credits, then the Company and its investors are the only remaining parties that could have benefited from the cost reductions through higher earnings than would have otherwise been achieved.

While Verizon has alleged that the Company "has suffered an outlay of cash that has no other valid way of being recognized", but for rate base inclusion of the pension asset, Verizon has provided no factual support that a cash "outlay" has indeed occurred in support of the proposed pension asset treatment. Rate base inclusion is appropriate only if it is reasonably demonstrated that a comparable level of cumulative pension credits have been flowed through to the benefit of Verizon's Washington ratepayers.

Q. Do you believe that ratepayers receive the benefit of pension credits merely as a result of recording the negative pension costs?

A. No. The mere act of recording costs or credits does not conclusively demonstrate "who" may have funded, or benefited from, the pension credits. Since Verizon has sought rate base treatment of the pension asset, the Company should bear some burden to demonstrate that such inclusion is proper. When rate base inclusion is premised on the "as recorded" concept (i.e., the company recorded credits so ratepayers have benefited) or the "cash outlay" concept (i.e., somehow translating a non-cash accrual entry into an expenditure of cash), I disagree with reliance only on those theories for determining ratepayer <u>benefit</u> and rate base inclusion. Absent some attempt to assess ratepayer participation in those cumulative pension credits, Verizon's rate base proposal would charge ratepayers with a rate base return on funds they may have never received – unnecessarily benefiting Verizon and its investors.

Q. Does Verizon concur that the pension credits have resulted in higher earnings?

A. Yes. Data Request PC-215(e) sought confirmation that the Company agreed that the recording of negative pension costs pursuant to FAS87 had the cumulative effect of increasing Verizon's net operating income above levels that would have been realized absent FAS87. The Company responded as follows:

> The pension asset balance is the accumulation of the recording of net pension income since the adoption of FAS 87 that has resulted in the Company increasing its net operating income.

Q. By attempting to assess ratepayer participation in the pension credits recorded by the Company over the years, are you suggesting that the Commission engage in retroactive ratemaking?

A. No, absolutely not. I do not propose or suggest that Verizon should pay back past excessive profits or recoup past operating losses, as implied by that concept. Instead, the retrospective analysis or review that I propose would solely be used to gauge the extent of benefits received by ratepayers or retained by investors in determining whether the pension asset balance is includable in rate base.

Q. Please explain.

A. Prior to FAS87, the pension costs charged to expense/capital accounts and contributed to the pension fund were equal. Subsequent to FAS87, the Company has recorded negative pension costs, since at least 1993,[9] and has made no pension fund contributions, since **[CONFIDENTIAL BEGINS] ****.CONFIDENTIAL ENDS]** [10] In order to establish whether ratepayers have inappropriately benefited to the investors' detriment, neither the

9 According to the response to Data Requests PC-128 and PC-261, Verizon has been unable to locate any accounting records showing the amount of any pension costs recorded during calendar years 1987-1992.

10 Verizon's confidential responses to Data Request PC-129 and 130, indicate that the last pension contributions were made in **[CONFIDENTIAL BEGINS] ********************************. **[CONFIDENTIAL ENDS]** No contributions are expected in 2004.

act of recording costs nor making contributions necessarily establish the pension cost amount ratepayers have "invested" in or "benefited" from through cost of service.

In assessing whether these pension credits have inured to the benefit of ratepayers to the detriment of investors, Verizon would need to demonstrate that the cumulative pension credits reasonably flowed through to its Washington intrastate customers equal or exceed the pension asset it proposes to include in rate base. If analytical results cannot demonstrate substantial ratepayer benefits, Verizon's proposal to include the pension asset in rate base should be rejected.

Q. Has your approach been used for any other element of rate base?

A. No, it has not. However, such a criticism fails to address the key points of concern relative to this issue:

- Have ratepayers benefited from the pension credits?
- If so, by how much?
- Is the cumulative extent of any benefits enjoyed by ratepayers sufficient to include the pension asset in rate base?

The implementation of FAS87 resulted in a significant shift in accounting method from a cash basis to an accrual basis – a shift implemented by the Company for accounting purposes outside the context of a rate proceeding.[11] This shift resulted in Verizon recording negative expenses (i.e., pension credits) since at least 1993. Because the existence of these pension credits are the sole cause of a pension asset being recorded, I believe that it is responsible and reasonable for regulators to question the extent to which

11 The original response to Data Request PC-131 indicated that the Company's "last formal rate review" was in 1983, Docket Nos. U-82-12 and U-82-48.

ratepayers, not the Company and its investors, have enjoyed the benefits of those annual pension credits.[12]

All components of the ratemaking equation change over time – revenues, expenses and investment. As each component changes, a utility should have a reasonable opportunity to achieve its authorized return (i.e., not materially over or under earn), so long as the components remain in relative balance or changes to one component are mitigated or offset by changes to the others. I generally agree that the prohibition against retroactive ratemaking presumes that recorded costs are assumed to be recovered, regardless of explicit inclusion in cost of service. This presumption holds the utility accountable for incurred costs and prevents a potentially abusive process of collecting past earnings deficiencies from current and future ratepayers.

Since adoption of FAS87, the amount of pension credits recorded by Verizon has varied significantly from year to year.[13] In the absence of rate case activity or some mechanism to flow the volatile annual pension credits through to benefit ratepayers, FAS87 pension accounting may have resulted in large pension credits increasing utility income and investor returns. Contrary to implications otherwise, the evaluation of this issue is <u>not</u> designed, intended nor does it result in a retrospective inquiry of past earnings to impose a surcharge for past under-recoveries or a refund for past over-recoveries. Instead, my approach is designed to evaluate, based on available information, whether it is reasonable to assume that ratepayers have sufficiently enjoyed the benefits of the ever fluctuating pension credits (supporting rate base inclusion of some portion of the pension

12 See discussion of the "benefit-burden test" in the incentive compensation testimony section.

13 The amount of annual pension credits recorded since 1993 have ranged from about $(6.9) million to $(14) million, before jurisdictional separation – Verizon non-confidential response to Data Request PC-128.

asset) or whether the resulting earnings benefits have been retained by investors (supporting the rate base exclusion). Exhibit SCC-5C compares the annual pension credits for the periods for which available information has been provided.

Q. Since Verizon's adoption of FAS87, how does the amount of pension costs included in cost of service compare to the pension credits recorded by the Company?

A. Although it is not possible to precisely quantify the amount of accumulated net pension recoveries from or benefits provided to ratepayers over the decades predating or following the adoption of FAS87, I have prepared a series of calculations which attempt to estimate the level of pension credit benefits ratepayers might have received since the adoption of FAS87. Relying on Company's responses to Data Requests PC-131 and PC-262, the last formal rate review in Washington occurred in 1983 (WUTC Docket Nos. U-82-45 and U-82-48). Since the adoption of FAS87, Verizon identified a series of rate reductions implemented in 2000 and 2001 that did not result from a fully litigated or formal rate review proceeding.[14] According to the corrected response to Data Request PC-131, Verizon's financial results for calendar year 1998 served as the basis for Staff's informal review, which included pension credits of about $7.9 million, before jurisdictional separation, or $5.3 million intrastate.[15.]

Based on this information, Exhibit SCC-6 represents an analysis of the net pension credits that might have been flowed through to ratepayers, under several conservatively generous assumptions. First, this analysis assumes that 100% of the pension credits recorded in 1998 was directly flowed through to the benefit of ratepayers

14 Docket No. UT-991164 (informal earnings-review investigation initiated by WUTC Staff), UT-981367 (Verizon merger) and UT-990672 (access charge complaint) were resolved by an "omnibus" Settlement Agreement that resolved all three dockets and implemented a four-step rate reduction: $7 million by May 1,

via the 2000-2001 rate reductions. Second, although it is likely that the 1983 rate case would have included positive pension expense, this analysis assumes "zero" pension expense in all calendar years prior to 2000 – the first year of the four-step rate reductions. Finally, Exhibit SCC-6 assumes that the negative pension costs included in the 1998 financials would continue to flow through to the benefit of ratepayers until the "next" rate case, which is the current proceeding. Such conservative assumptions would indicate that ratepayers may have received no more than $15.5 million cumulative pension credits, as compared to the <u>negative</u> $138 million of cumulative pension credits, gross of accumulated deferred income tax reserves, Verizon proposes to include in rate base.

Q. Why have you characterized these assumptions as "conservatively generous"?

A. It may not be possible to accurately or precisely quantify the exact amount of cumulative net pension recoveries from or benefits provided to ratepayers, particularly over the decades predating the adoption of FAS87. However, it is <u>reasonable</u> to consider all relevant information available to assess regulatory intent and estimate the amount of cumulative pension credits that might have been reasonably flowed through to the benefit of ratepayers, in the context of Verizon's proposed rate base treatment and theories regarding the flow through of those pension credits to ratepayers. The assumptions underlying Exhibit SCC-6 are conservatively generous in that, in the aggregate, they maximize the cumulative value of pension credits provided to ratepayers.

If any positive value is assigned to the pension cost included in the 1983 rate proceeding, the amounts shown for years 1987-1999 would increase above "zero", resulting in the cumulative pension credits approaching "zero" and possibly swinging

2000; $8 million by July 1, 2000; $8 million by January 1, 2001; and $7 million by July 1, 2001.

positive. Similarly, if only a portion of the $5.3 million intrastate pension credits recorded in 1998 is attributed to the 2000-2001 rate reductions, the cumulative pension credits would also approach "zero". As a consequence, the $15.5 million of cumulative pension credits set forth on Exhibit SCC-6 represents a maximum credit value – conservatively and generously.

Under alternative assumptions, it is reasonable to expect that the cumulative amount could be positive, not negative, given the regulatory history and cost information unique to Verizon's Washington operations. In any event, Exhibit SCC-6 supports cumulative pension credits of only $15.5 million, far short of the Company's $138 million pension asset, indicating that ratepayers have not yet received substantial cumulative benefits from the pension credits to support rate base inclusion of the pension asset. Therefore, the Commission should reject Verizon's proposed rate base treatment.

Q. Exhibit SCC-6 relies on a series of rate reductions implemented in calendar years 2000 and 2001 that resulted from a negotiated settlement. Have you previously filed testimony that you were unable to determine what amount of pension credits may have been flowed through to ratepayers as a result of the settlement process?

A. Yes. I have taken the position that, in assessing the amount of pension credits flowed through to ratepayers, only those orders which specifically address the various components of cost of service be considered. Settlements are typically non-specific, by design, and entail any number of compromises in the interest of reaching an acceptable resolution. By its very nature, a settlement agreement reflects a compromise that can

15 Verizon's response to Data Request PC-262(a).

often be valued in various ways, not necessarily reflecting the filed positions of any particular party.

However, on further reflection, the amount of pension credits included in negotiated settlements may not change, even if the rate case were litigated, provided pension cost valuations were uncontested. With regard to Verizon's specific situation, the pension credits recorded in 1998 that may have been recognized in quantifying these negotiated reductions cannot be known with certainty. However, even assuming the maximum credit does not support Verizon's rate base treatment. As a result, Exhibit SCC-6 is conservative in quantifying possible ratepayer participation in the Washington pension credits.

Q. Do you believe that all elements of the cost of service included in past rates should be reconciled with current cost levels to determine prospective rate treatment for each item?

A. No. As a matter of ratemaking policy, I do not recommend that the Commission rely solely on or otherwise reconcile past decisions in establishing cost of service for future periods. However, the consideration of past rate orders is indeed relevant in assessing whether investors have some claim to inclusion of the pension asset in rate base. As discussed above, I am not recommending the inclusion of the pension in rate base.

VI. INCENTIVE COMPENSATION

Q. Is an adjustment to the test year amount of incentive compensation expense Verizon has included in revenue requirement being proposed by Consumers?

A. Yes. In quantifying its overall revenue requirement, Verizon's revised Adjustment WP P12 appears to increase the amount of incentive compensation accrued during the test year to reflect the estimated impact of pro forma wage and salary increases.[16] Exhibit SCC-9 quantifies a Consumers adjustment representing a partial disallowance of test period incentive compensation expense Verizon has included in overall revenue requirement. This Consumers adjustment eliminates the incentive costs associated with the financial components of Verizon's incentive compensation plan, while allowing ratemaking recovery of test period expense associated with nonfinancial components.

Q. How has the amount of incentive bonuses paid to employees charging costs to VZNW's Washington operations changed over the years?

A. In response to WUTC Data Request 459, Verizon provided the amount of regulated incentive compensation for management and associates during the period 1998-2003:

Year		Amount
1998		$ 4,067,565
1999		7,350,537
2000		9,473,178
2001		7,320,428
2002		5,451,674
Test Year		5,118,770
2003		5,013,611

Source: Data Request PC-111.

Q. Please describe the incentive programs offered by the Company during the test year.

A. During the test year, the Company offered various long-term and short-term incentive plans, including: Verizon Incentive Plan ("VIP"); Senior Manager Verizon Short-Term Incentive Plan ("STI"); Verizon Long-Term Incentive Plan ("LTI"); and Verizon Team Performance Award ("TPA"). Verizon's response to Data Request PC-111 contained non-confidential copies of various Company incentive programs, as summarized below:

16 Verizon revised WP P12.1.3 & WP P12.1.4.

Verizon VIP:

- Regular general management employees, Executive Director & lower.

- VIP objectives linked to corporate, business unit and individual/team performance:

  - Corporate & business unit performance objectives include financial measures (EPS, revenue growth, net income) and non-financial measures (e.g., customer service); and
  - Individual: objectives set with supervisor. Team: relative performance compared to other teams in same organization.

- Target ranges from 10%-34% of pay, with possible payout awards ranging from 0%-200% of target.

Verizon STI:

- Available to Senior Managers.

- Primary STI measures: 70**%** financial (EPS, revenue growth, net income) and 30% non-financial (customer service, diversity).
- Individual ratings adjust the financial/non-financial rating +/-20% based on performance against individual work objectives.

- Incentive maximum ranges from **[CONFIDENTIAL BEGINS]******** [CONFIDENTIAL ENDS[** of base salary, depending on salary band of individual.[17]

Verizon LTI:

- All employees and Non-Employee Directors are eligible for the plan, subject to selection and award by the Human Resources Committee or other designated committee of the Board.[18.]

- Performance measures, at the Company or subsidiary or operating unit level, include: income measures (gross profit, operating income, earnings before or after taxes, or earnings per share); return measures (return on assets, investment, equity or sales), cash flow return on

17 Verizon's confidential response to WUTC Data Request 459a.

18 Verizon's confidential response to WUTC Data Request 459a identified plan participants as **[CONFIDENTIAL BEGINS]** ***.**[CONFIDENTIAL ENDS]**

investment, gross revenues, marked valued added, economic value added, and share price (growth measures and total shareholder return).

- Awards include stock options, restricted stock, performance shares or other awards.

- LTI objectives include optimizing the profitability and growth of the Company through long-term incentives consistent with Company goals and linking the interests of participants to those of the Company's shareholders.

<u>Verizon TPA</u>:

- All full-time and part-time regular hourly employees – bargaining employees.

- Performance objectives include, but are not limited to: quality/ value of service delivered, productivity, expense budget, and revenue.

- Target ranges from 0%-4% of pay, with possible maximum payout of 120% of target.

Q. How does the amount of incentive compensation expense breakdown between these incentive plans in recent years?

A. The following table provides a comparison of accrued incentive compensation expense recorded to Verizon-Washington regulated accounts:

	2002	Test Year	2003
VIP	$ 1,787,175	$ 1,804,870	$ 1,747,708
STI	15,194	111,262	107,063
LTI		31,368	31,368
TPA	2,004,577	1,374,086	1,048,611
Total	$ 3,806,946	$ 3,321,586	$ 2,934,750

Source: Verizon nonconfidential response Data Request PC-111.

Q. How did you quantify Exhibit SCC-9?

A. As indicated by the earlier excerpts from the various incentive plan documents provided in the non-confidential response to Data Request PC-111, certain Verizon incentive plans are heavily weighted to financial targets and objectives. Based on this information, Exhibit SCC-9 removes 50% (allowing 50%) of VIP, 70% of STI and 100% of LTI incentive compensation expense recorded during the test year. Exhibit SCC-9 does not eliminate any of the test year costs associated with TPA.

Q. Why have you proposed to disallow a portion of the test year incentive plan cost?

A. There are several reasons why this adjustment is appropriate. First, a significant portion of certain Verizon incentive compensation plans focus on financial results. Those Company employees directly or indirectly supporting the provision of telecommunications service in the State of Washington may have limited ability or opportunity to materially affect overall financial results.

Second, efforts to enhance targeted financial results may not be consistent with the interests of Verizon's Washington customers or reasonable pricing of regulated service offerings. The typical financial targets are not linked to customer service, employee safety, cost reduction, or operational achievements or efficiencies in Verizon's Washington service territory.

Third, to the extent that the inclusion of financial targets in the incentive plans assist Verizon in achieving improved financial results, the cost of the Company's discretionary incentive plans should be funded by the increased levels of net income, cash flow and other financial resources, rather than through the revenue requirement used to support prices charged to Verizon's Washington customers.

Obviously, a decision by management to incur incentive compensation costs is an indication that such costs were viewed as reasonable by the Company, but regulators need not allow above-the-line accounting for all discretionary costs incurred by management absent a showing that such costs provide direct, tangible benefits to ratepayers. With this in mind, Consumers propose recovery of test year incentive costs reasonably allocable to service quality and other nonfinancial measures.

Q. Earlier, you stated that "regulators need not allow above-the-line accounting for all discretionary costs incurred by management absent a showing that such costs provide direct, tangible benefits to ratepayers." Could you further elaborate on this statement?

A. Yes. In considering amendments to Part 65 of the FCC rules prescribing the components of rate base and net income for dominant carriers, the FCC discussed the framework surrounding its proposed changes.

> 7. In developing our proposal, we were guided by two historically applied principles – the "used and useful" standard and the benefit-burden test. The "used and useful" standard denotes property dedicated to the efficient conduct of a utility's business, presently or within a reasonable period. That standard reflects the principles that owners of public utilities must receive an opportunity to be compensated for the use of their property in providing a public service and that ratepayers must not be forced to pay a return on investment that does not benefit them directly. The benefit-burden test is based on the principle that the party who bears the financial burden of a particular utility activity should also reap the benefits resulting therefrom. We proposed to apply these two general principles to specific assets and asset categories established in Part 32 of our Rules, which will become effective January 1, 1988. [footnote omitted][19]

Although incentive compensation is only partially allocable to the plant in service component of rate base, Consumers' approach follows the conceptual framework of the "benefit-burden" test. In other words, the party who benefits from a particular transaction or activity should bear the related financial burden. If ratepayers have not

19 CC Docket No. 86-497, FCC Report and Order, released December 24, 1987, par. 7.

benefited from the achievement of the incentive plan targets (e.g., financial results), ratepayers should not be responsible for that portion of the cost of the incentive plans.

Q. How does the amount of test year incentive compensation expense compare to Verizon's basic wages and salaries, excluding incentive compensation?

A. According to Company's revised Adjustment WP P12.1.3, Verizon's incentive compensation expense represents additional employee compensation of about 3.5% (management) and 3.4% (associate) of test year basic wages and salaries, on average.

Incentive compensation is a method of providing monetary awards to the work force through unguaranteed bonus, or other payment program, in addition to base wages. Incentive compensation plans are typically designed to attract, retain and motivate employees, enhance teamwork and high levels of achievement, and to facilitate the accomplishment of specific corporate, business unit and individual goals. By linking employee compensation to predetermined targets or objectives, individual employees are theoretically incented to perform well by directly influencing their day-to-day actions and activities – because if they do not achieve the target levels, they will not receive incentive compensation pay.

Based on this test year data, Verizon's cost of service recognizes that employees could receive, on average, an additional 3.4% - 3.5% of at-risk, ratepayer funded compensation above and beyond their base wages/ salaries and overtime pay. The potential for indirect shareholder incentives do not directly influence the day-to-day actions and activities of individual employees. Instead, it is, or should be, the risk of losing the additional 3.4 – 3.5% of compensation that will sufficiently incent an employee to help the Company achieve its targets and goals.

Q. If employees fail to achieve the corporate targets or individuals goals, will shareholders be required to forego all benefits associated with the incentive plans?

A. No. Since incentive compensation is "at-risk" to the employee, the amount of such compensation from year to year is not fixed, regular nor even certain to occur. In the event that minimum targets are not met, employees do not receive incentive payments and the amount of incentive compensation included in rates would contribute to increasing utility profits. In other words, ratepayers would be placed at-risk to fund incentive plan costs regardless of payout while employees are at-risk because targets might not be achieved for any number of reasons. At the same time, neither the Company nor its shareholders would necessarily be at-risk with respect to the amount of total incentive pay included in test year expense, because the allowed expenses would be recovered through rates, regardless of future payouts.

Q. Has the Commission previously addressed incentive compensation for regulated telecommunications providers?

A. Yes. The Commission addressed incentive compensation plan costs in rate proceedings involving Qwest Corporation, then US West Communications, in the early 1980's (consolidated Docket Nos. U-81-44 and U-82-19) as well as both the 1995 and 1997 general rate case proceedings (Docket Nos. UT-950200 and UT-970766). Although well before the more recent increased reliance on incentive compensation plans, the Commission's Second Supplemental Order (page 19) in Docket No. U-82-19 determined that one-time bonuses (i.e., lump sum payments awarded to managers) were allowable on an actual basis, but pro forma annualization was not appropriate, observing that:

"Bonuses are one-time payments which may or may not be repeated in subsequent periods; annualizing their amounts distorts their effect on operating results."

In the 1995 rate case (Docket No. UT-950200), the Commission disallowed discretionary bonus payments, as the amounts paid are not certain at any level. The Commission also disallowed team and merit awards, indicating that such "awards have not been shown to benefit the ratepayer." While a portion of the incentives were directly tied to service-related elements, the heavy weighting of financial goals could fully offset any lost bonuses due to service quality deficiencies. Citing to its 1993 Washington Natural Gas Company order,[20] the Commission observed:

> …there is a potential tension between service quality and earnings. A firm can concentrate on financial elements so heavily that it can lose sight of the importance of providing customer service. In a public utility service, where many customers have no reasonably substitutable alternatives, the Commission must substitute for the competitive market in assuring that customer service remains a priority to the business. Financial goals are at best a very crude way to measure specific efficiencies that employees can accomplish.
>
> The Commission finds that the Company's team award plan is not acceptable because, with a structure allowing financial awards to eclipse customer service failures, it sends the message to employees that service quality is much less important than financial performance. This provides motivation to choose cost saving measures that unduly compromise service quality. The Company plan fails to tie payments to goals that clearly and directly benefit ratepayers. The Company's service quality clearly failed to meet acceptable standards during the test period, as discussed above, while the Company exceeded its financial goals. Whether or not the structure of the team awards contributed to this circumstance, it is certainly consistent with the circumstance.

In Docket No. UT-970766, the Commission disallowed certain incentive compensation costs because of the continued reliance on achieving financial targets and poor service

20 WUTC Docket No. UG-920840, 4th Supp. Order (1993).

quality performance.[21] While the facts and circumstance for then- US West Communications is admittedly different than currently exists for Verizon, the Commission's concern about tension between financial and service quality considerations is well placed and applicable today. Similarly, the Commission's observation that "financial goals are at best a very crude way to measure specific efficiencies that employees can accomplish" was aptly said. For incentive plans to properly motivate employees of regulated enterprises, it is important that employee actions can influence the achievement of the target goals and objectives and that those objectives not place heavy reliance on financial parameters.

VII. INTEREST SYNCHRONIZATION

Q. How should the Commission quantify the interest expense deduction in computing income tax expense in the current proceeding?

A. The Commission should quantify the interest deduction for income tax purposes by multiplying the weighted cost of debt included in the capital structure times the rate base investment. This method of annualizing interest expense is commonly referred to as interest synchronization.

Q. Please describe and define the concept of interest synchronization, as applied in the ratemaking process.

A. Generally, the concept of interest synchronization refers to the process of setting the amount of interest expense used as a deduction in computing income tax expense for ratemaking equal to the result of multiplying the weighted cost of debt included in the regulatory capital structure times the investment in rate base. In other words, interest

21 WUTC Docket No. UT-970766, Tenth Supplemental Order, pp. 13-16.

synchronization is a method which provides for the allocation of an interest expense deduction for income tax purposes to ratepayers equal to the ratepayers' contribution to the Company for interest expense, regardless of the Company's actual or estimated interest payments to its creditors.

Since revenue requirement is partially driven by the application of a rate of return to the rate base investment, the Company will theoretically recover from ratepayers an amount of interest expense equal to the effective weighted cost of debt embedded in that rate of return. Thus, ratemaking interest can be quite different from the actual interest expense which might otherwise be deductible on a company's consolidated or stand-alone corporate tax return. Interest synchronization merely "synchronizes" the ratemaking tax deduction for interest with the interest expense ratepayers are required to provide the Company in utility rates.

Q. Did the Company propose the use of interest synchronization in quantifying its proforma level of income tax expense?

A. No. In direct testimony (page 33), Company witness Heuring briefly identifies and describes three areas in the current case that are inconsistent with the development of revenue requirement in Docket No. U-82-45, including the following statement: "Also, the Company did not include an interest synchronization adjustment because it believes the actual interest paid should be used." WUTC Data Request 235 sought all reasons and all documents relied upon in support of the position that actual interest should be used, to which Verizon responded as follows:

> Actual interest expense should be used in determining revenue requirement because it reflects the interest expense paid and recorded on the books of the Company to service its debt obligations.

> However, if interest synchronization is calculated using the Company's proposed capital structure, it would have resulted in lower interest expense, higher income taxes, lower net operating income and a higher revenue deficiency. Interest synchronization calculation was provided as Schedule C6.1.2 on Book 2, Tab 5.
>
> Verizon reserves the right to submit detailed testimony on this issue if necessary.

Q. If the Company did not employ interest synchronization in developing its revenue requirement and claims that such method would have increased overall revenue requirement, why should the Commission adopt this methodology for ratemaking purposes?

A. There are several reasons that interest synchronization should be adopted for ratemaking purposes. First, as noted previously, it matches the interest expense used to calculate income tax expense with the amount of interest required of ratepayers through the ratemaking equation. Second, this method has been widely accepted and adopted for many years. Third, the Company's characterization of the method increasing its overall revenue deficiency is misleading in its brevity.

Q. Have you previously testified on this issue?

A. Yes. I have sponsored testimony on this issue for many years, dating back to the early 1980's before concerns with its compatibility with Internal Revenue Code restrictions were favorably and finally resolved. In fact, I proposed this methodology in the 1995 US West Communications rate case (Docket No. UT-950200), which the Commission adopted.

Q. Please elaborate on your comment that the Company's characterization of the revenue requirement impact of this issue is misleading.

A. The quoted response to WUTC Data Request 235 was accurate, in the sense that response was tied to the Company's original proposed capital structure and rate base investment. However, Verizon's original proposed capital structure was heavily equity weighted (75%), which significantly diminished the debt ratio (25%). By comparison, Public Counsel witness Parcell sponsors a capital structure that is approximately 55.1% debt (short-term and long-term) and 44.9% equity. The following table illustrates the significant difference in the calculation of interest synchronization, using the original Verizon and Public Counsel capital structure recommendations and the Company's proposed rate base for illustrative purposes:

(000's) Desciption		Verizon		Public Counsel
Intrastate Rate Base		$ 932,894		$ 932,894
Proposed Weighted Cost of Debt		1.570%		3.550%
Annualized Interest Expense		14,646		33,118
Less: Intrastate Book Interest		19,987		19,987
Pro Forma Interest Adjustment		$ (5,341)		$ 13,131
Source: Verizon Schedule C6.1.2 & Direct Testimony of Public Counsel witness Parcell.				

Even though Verizon's proposed capital structure and cost rates generate a higher weighted cost of capital (original 12.03% revised to 11.79% per Verizon witness Vander Weide, page 33) than proposed by Public Counsel (8.26%), the thin debt ratio recommended by Verizon dramatically reduces the amount of pro forma interest expense. So, in the context of Verizon's rate filing, the response to WUTC Data Request 235 was accurate. However, the impact of the interest synchronization methodology on overall revenue requirement shifts significantly using the capital structure proposed by Public Counsel – as depicted by the $18.5 million increase in tax deductible interest.

Q. If Verizon had employed interest synchronization in developing overall revenue requirement, would it still be necessary for Commission to quantify an adjustment for interest synchronization?

A. Yes. Had the parties concurred in the valuation of both rate base and cost of capital, a separate adjustment for interest synchronization would not have been necessary. However, when Public Counsel or Staff proposes, or the Commission ultimately orders, a different valuation of rate base or weighted cost of debt, it is necessary to quantify a separate incremental adjustment to recognize the impact of such changes on the ratemaking deduction for interest expense. Once the Commission ultimately adopts and approves a rate base and capital cost valuations in this proceeding, interest synchronization should be recalculated using those Commission findings, thereby appropriately synchronizing these revenue requirement elements. Consequently, the amount of pro forma interest expense ultimately recognized for ratemaking purposes should simply "roll out" from the Commission's final decisions on allowable values of jurisdictional rate base and weighted cost of debt.

Q. Does this conclude your direct testimony?

A. Yes.