Exhibit No.______ (NWH-13T)
Docket No. UT-040788

**BEFORE THE**

**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

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| **WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,** | ) | |
| | ) | |
| **Complainant,** | ) | |
| | ) | |
| **v.** | ) | **DOCKET NO. UT-040788** |
| | ) | |
| **VERIZON NORTHWEST INC.,** | ) | |
| | ) | |
| **Respondent.** | ) | |
| | ) | |
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**REBUTTAL TESTIMONY OF**
**NANCY W. HEURING**

**ON BEHALF OF**
**VERIZON NORTHWEST INC.**

**FEBRUARY 2, 2005**

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## I. INTRODUCTION

**Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.**

A. My name is Nancy W. Heuring. I am Director – Regulatory Accounting. My business address is 600 Hidden Ridge, Irving, Texas.

**Q. DID YOU FILE DIRECT TESTIMONY IN THIS CASE?**

A. Yes. I filed direct testimony on April 30, 2004.

**Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

A. My testimony rebuts the intrastate earnings presentation of Paula M. Strain from the Washington Utilities and Transportation Commission ("WUTC" or "Commission") Staff ("Staff"). In addition, I rebut specific earnings adjustments presented by other Staff witnesses Betty A. Erdahl, David E. Griffith, Danny P. Kermode, and Timothy W. Zawislak and Consumers'[1] witnesses Steven C. Carver and Michael Brosch[2]. Finally, I address comments made by Dr. Glen Blackmon regarding Verizon NW's earnings.

The Staff witnesses make inappropriate adjustments to the *negative* 3.30%[3] intrastate rate of return for the Washington operations of Verizon Northwest Inc. ("Verizon NW" or the

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[1] Steven C. Carver and Michael Brosch are appearing on behalf of the Washington Attorney General – Public Counsel Section, AARP, and Washington Electronic Business & Telecommunications Coalition, collectively referred to as "Consumers".

[2] Consumer's witnesses make no recommendation on overall revenue requirement. Instead, they focus on specific issues. Where these issues overlap with those raised by Staff, the rebuttal to Consumer is included in my rebuttal to Staff issues.

[3] From Exhibit NWH-2 revised September 2004, column (f), line 83.

"Company") and generate a paper revenue surplus of approximately $26 million. As explained in my testimony, the Company is certainly not overearning and is in dire need of a rate increase, not a rate reduction.

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

A. Exhibit Nos. NWH-14 through NWH-30 provide a summary of the financial data and calculations used in my testimony, as follows:

| | |
|---|---|
| NWH-14 | Intrastate Results of Operations and Revenue Requirement |
| NWH-15 | Summary of Adjustments by Sponsoring Witness |
| NWH-16 | Reconciliation of Verizon NW Revenue Requirement Deficiency ($223 million) to Staff Revenue Requirement Excess ($52 million) |
| NWH-17 | Reconciliation of Revised Verizon NW Revenue Requirement Deficiency ($222) to Staff Revenue Requirement Excess ($26 million) |
| NWH-18 | Company's Revision to Staff Adjustment SP26 – Interest Synchronization |
| NWH-19 | Company's Revision to Staff Adjustment SR26 – Partial Normalization |
| NWH-20 | Company's Revision to Staff Deferred Tax Adjustment on PMS-10C and PMS-12C |
| NWH-21 | Company's Revision to Staff Embedded Deferred Tax Factor |
| NWH-22 | Correction to Verizon NW Calculation of P17 |
| NWH-23 | Company's Revision to Staff Calculation of P17 |
| NWH-24 | Insurance Expense Restatement |
| NWH-25C | Company's Revision to Staff Adjustment SP22 - Line Sharing Revenue Imputation |
| NWH-26 | Summary of Company's Revision to Staff Calculations |
| NWH-27 | Company's Revision to Staff Calculation of Uncollectible Revenues |
| NWH-28 | Company's Revision to Staff Calculation of Other Taxes |

NWH-29 Company's Revision to Staff Calculation of P20 MVSP Savings

NWH-30 Nonregulated Wireline Revenues – Summary of Data from Dr. Blackmon Workpapers

**Q. ARE THERE OTHER VERIZON WITNESSES SPONSORING REBUTTAL TESTIMONY TO THE STAFF'S PROPOSED ACCOUNTING ADJUSTMENTS?**

A. Yes. Exhibit No. NWH-15 lists each adjustment sponsored by the Company, Staff and Consumer and the corresponding witness for each party.

## II. PAULA M. STRAIN

### *A. General Comments*

**Q. PLEASE SUMMARIZE MS. STRAIN'S PRESENTATION.**

A. Ms. Strain states that Washington intrastate operations are earning a return of 11.97% with an associated revenue surplus of $52,181,000.[4] Ms. Strain subsequently filed errata testimony on January 14, 2005 which shows a revenue requirement excess of $25,989,000 with an associated return of 9.81%.

In addition to sponsoring specific adjustments, Ms. Strain presents a summary of the adjustments for all Staff witnesses. Each of the adjustments presented in Ms. Strain's testimony and exhibits is addressed by Verizon witnesses as detailed in Exhibit No.

[4] PMS-6TC pg. 3 and PMS-7 Revised December 15, 2004. This was a revision from the initial filing November 22, 2004 which showed a revenue surplus of $51,164,000 and a return of 11.86%.

NWH-15. In addition, Ms. Strain makes general observations regarding the Company's case.

**Q. WHAT ISSUES COMPRISE THE DIFFERENCE BETWEEN THE COMPANY'S ACTUAL REVENUE REQUIREMENT DEFICIENCY AND THE STAFF'S PRESENTATION?**

A. Exhibit No. NWH-16 provides a reconciliation between the revenue requirement deficiency of $223,364,000 as filed by Verizon NW[5] to the revenue requirement excess of $52,181,000 as filed by the Staff. As noted above, the Staff subsequently made various corrections to their case to reflect a revenue requirement excess of $25,989,000. Exhibit No. NWH-17 provides a reconciliation of this number back to the Company's filing.

In both cases, the primary differences in the incremental revenue requirement are associated with required rate of return, affiliate issues including directory revenue imputation, capital recovery, and accounting for employee benefits.

**Q. WAS THIS RECONCILIATION PROVIDED AS PART OF THE STAFF'S TESTIMONY?**

A. No. The Staff included no summary or reconciliation in their direct case. The reconciliations provided in Exhibit Nos. NWH-16 and NWH-17 are the result of Verizon NW Data Request No. 119 and 120. The Staff's presentation starts with what it calls the

[5] Revised September 2004

Regulated books of Verizon NW[6] although this column does not appear to be utilized. Next, the Staff presents a column labeled Unadjusted Intrastate which ties to the Company Exhibit No. NWH-2.[7] From this point, the Staff details each restating and pro forma adjustment used to derive their computation of the revenue requirement including those initially proposed by the Company and accepted by the Staff. While this presentation is very detailed, it does not provide a reconciliation of the Staff's presentation of the revenue requirement to the Company's revenue requirement presentation.

**Q. MS. STRAIN COMMENTS ON THE COMPANY'S USE OF A SPLIT TEST YEAR VERSUS A CALENDAR YEAR USED IN THE ROUTINE REPORTING PREPARED BY THE COMPANY. IN ADDITION, SHE COMMENTS ABOUT THE COMPANY'S EXTENSIVE USE OF WORKPAPERS INSTEAD OF EXHIBITS. PLEASE ADDRESS.**

A. Ms. Strain's comments have no merit. The rate case filing utilized the most currently available data at the time of the filing. The Company routinely files with this Commission monthly, quarterly and twelve month-to-date financial data. This data is available as a matter of routine and can be used to support any test period. In addition, the work papers supporting the direct filing include 36 months of financial data on a booked and normalized basis along with period over period variance explanations. While the Staff appears to prefer the presentation of financial data in the form of exhibits versus

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[6] Although the Staff presents this column as Regulated, the data includes nonregulated amounts. In addition, the return calculated on this column is meaningless as it includes amounts not regulated by this Commission.
[7] The initial presentation by the Staff on November 22, 2004 and December 15, 2004 included an incorrect number for Federal Income Tax expense. This has been corrected in the errata filing on January 14, 2005.

workpapers, the format is irrelevant since the initial filing includes the data necessary to support the rate case financial presentation.

**Q. MS. STRAIN COMMENTS ABOUT THE ADEQUACY OF THE HARD COPY AND ELECTRONIC DOCUMENTATION PROVIDED WITH THE COMPANY'S INITIAL FILING. PLEASE ADDRESS.**

A. Ms. Strain's comments are unwarranted and without merit. First, the Staff completed its initial review of the case and accepted the filing. Second, the booked financials and associated adjustments as presented in the Company's filing are supported by copies of journal entries or other documents from the Company's financial system. Finally, the Company worked closely with the Staff including a meeting up-front to walk the Staff through the detailed accounting workpapers and supporting documentation.

Electronic files for each exhibit and workpaper were provided in their original format. No formulas were removed from the electronic files as implied by the Staff. In addition, the Company provided cross referencing on the hard copy of the workpapers to highlight the flow of the numbers between workpapers and exhibits.

***B. Revenue Related Price Changes (P5, P6, P21) and New Services Revenue (SP25)***

*Approximate revenue requirement – ($8,415,000)*[8]

**Q. PLEASE DESCRIBE THE COMPANY'S PROPOSED PRO FORMA ADJUSTMENTS FOR REVENUE RELATED PRICE CHANGES.**

A. The Company identified various tariff filings for rate changes which became effective during the test year. Pro forma revenue adjustments were calculated to ensure the test period reflects the going-level revenues at the new rate. The services addressed in the revenue pro forma are as follows:

P5 - Transparent LAN Services effective March 1, 2003
P6 - Inmate Corrections Collect Call rate effective March 14, 2003
P21 - CyberDS1 Service effective March 21, 2003
P21 - Frame Relay Service effective July 10, 2003

In each case, the revenue estimate used by the Company for the pro forma adjustment was the Year 1 revenue estimate provided with the tariff filing.

**Q. DOES MS. STRAIN INCLUDE A SIMILAR PRO FORMA ADJUSTMENT IN HER PRESENTATION?**

A. Yes. However, Ms. Strain uses the Year 2 revenue estimate provided with the tariff filing in place of the Year 1 revenue estimate. Ms. Strain believes that the Year 2 revenue

[8] This value represents the difference in revenue requirement between the revised Company position and the revised Staff position. A number in brackets indicates that the Staff proposed adjustment decreases the revenue requirement. See Exhibit NWH-17 for a complete reconciliation of the Company revenue requirement deficiency to the Staff revenue requirement excess.

estimates (which are higher than Year 1 estimates) are more reflective of the level of revenue expected in the first year rates will be in effect in this Docket. In addition, the Staff proposes a pro forma increase in revenue for five additional Verizon NW tariff filings for new features, services or packages as follows:

Call Referral Service effective June 15, 2003
ISDN Caller ID with Name effective July 3, 2003
ISDN Term Package effective January 15, 2004
Transparent LAN 1000 Mbps effective April 1, 2004
Local Package and Local Package Elite effective June 19, 2004

Again, the Staff uses Year 2 revenue estimates to compute the pro forma revenue increase.

**Q. DO YOU AGREE WITH MS. STRAIN'S USE OF YEAR 2 REVENUE ESTIMATES TO DERIVE THE PRO FORMA?**

A. No. Year 2 estimates represent periods past the pro forma test period ended September 2004. The Year 2 revenue estimates are for the following approximate periods:

Transparent LAN Services - March 2004 through February 2005
Inmate Corrections Collect Call rate - April 2004 through March 2005
P21 - CyberDS1 Service – April 2004 through March 2005
P21 - Frame Relay Service - July 2004 through June 2005

Call Referral Service – July 2004 through June 2005

ISDN Caller ID – July 2004 through June 2005

ISDN Term Package – February 2005 through January 2006

Transparent LAN 1000 Mbps – April 2005 through March 2006

Local Package and Local Package Elite – July 2005 through June 2006

The rate case financials include the booked revenue at the new tariff rate for each of the tariff changes which became effective during the test year October 2002 to September 2003. In addition, anticipated changes in volume during the pro forma period October 2003 to September 2004 were applied to the test year revenue to develop the pro forma test period revenue. Use of Year 2 revenue estimates overstates the revenue pro forma and is not consistent with the pro forma revenues, expenses and rate base included in the remainder of the test period ended September 2004. Ms. Strain's proposed pro forma for revenue related price changes, which increases intrastate revenues by over $8 million should not be accepted.

**Q. FINALLY, DOES MS. STRAIN'S PROPOSED INCREASE TO PRO FORMA REVENUES REFLECT THE COMPANY'S ACTUAL REVENUE EXPERIENCE?**

A. No. The restated intrastate revenues (gross of uncollectible revenue) for the twelve months ended September 2003 are $380,177,000. The overall revenue pro forma presented by the Company results in a reduction in test period revenues of $35,818,000 resulting in pro forma intrastate revenues of $344,358,000 for the twelve months ended

September 2004.[9] This rate case presentation of declining revenues is consistent with the level of actual, realized revenue reported on the Separated Results Summary Quarterly Compliance Report for the twelve-month period ended September 2004 of $338,737,000. In fact, annualizing the revenues for the month of September 2004 results in revenues of only $330,758,000. Clearly, revenues are not increasing.

***C. P19 Uncollectible Revenues, Taxes & Fees***

*Approximate revenue requirement – ($1,282,000)*

**Q. PLEASE SUMMARIZE STAFF'S ADJUSTMENT TO THE COMPANY'S PRESENTATION OF UNCOLLECTIBLE REVENUE AND OTHER TAXES.**

A. The intrastate financials which serve as the starting point for the rate case include a provision for uncollectible revenue as well as other tax expense for revenue-based taxes (Regulatory Fee and Business & Occupation Tax). The restating and pro forma revenue adjustments were summarized on P19 and used to calculate the associated incremental change in uncollectible revenue and revenue-based taxes. Ms. Strain takes exception to this summarized approach and instead presents an uncollectible revenue and other tax expense with each pro forma adjustment.

**Q. DO YOU HAVE ANY CONCERNS WITH MS. STRAIN'S APPROACH AS IT RELATES TO PRO FORMA REVENUE ADJUSTMENTS?**

A. No. Either method should produce the same end result since the staff utilizes the same uncollectible and tax factors presented in the Company's original case.

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[9] NWH-2 Revised September 2004

**Q. DOES THE STAFF TAKE THIS SAME APPROACH WITH THE PRESENTATION OF RESTATING REVENUE ADJUSTMENTS?**

A. No. The Staff gives no treatment to uncollectible revenue and other taxes associated with their presentation of the restating revenue adjustments even though they remove the Company computation of these amounts included in workpaper P19. Staff does not address in their testimony their failure to compute these amounts associated with their presentation of the restating adjustments.

**Q. ONE OF THE STAFF'S PROPOSED RESTATING ADJUSTMENTS IS AN IMPUTATION OF REVENUES THAT ARE ACTUALLY RECEIVED BY AN AFFILIATE COMPANY. SHOULD UNCOLLECTIBLE REVENUE AND OTHER TAXES BE CALCULATED ON REVENUES IMPUTED TO THE INTRASTATE JURISDICTION FOR RATEMAKING PURPOSES?**

A. The revenues and associated uncollectibles and fees should be treated consistently throughout the revenue requirement presentation. The Staff proposes a pro forma imputation of line sharing revenue to the intrastate jurisdiction.[10] In the calculation of this proposed imputation, the Staff computes uncollectible revenue and other taxes. Additionally, in the calculation of the overall revenue requirement surplus on PMS-8, the Staff utilizes a revenue conversion factor which includes the provision for uncollectible revenue, the Regulatory Fee and the Business & Occupation Tax. As such, the sum of all revenue adjustments, whether they are adjustments to the books or imputed revenues, is grossed up for these items in determining the overall revenue requirement.

[10] Exhibit TWZ-15-c, adjustment SP22

**Q. WHAT IS THE CORRECT PRESENTATION OF UNCOLLECTIBLE REVENUE AND TAX EXPENSE ASSOCIATED WITH THE STAFF'S REVENUE RESTATEMENTS?**

A. See Exhibit No. NWH-27 Company's Revision to Staff Calculation of Uncollectible Revenue and Exhibit No. NWH-28 Company's Revision to Staff Calculation of Other Taxes.

***D. SR24 – Shared Regulated Expenses***

*Approximate revenue requirement – ($696,000)*

**Q. PLEASE SUMMARIZE RESTATING ADJUSTMENT SR-24 – SHARED REGULATED EXPENSES PROPOSED BY MS. STRAIN.**

A. Ms. Strain proposes an adjustment to the test year level of Verizon Northwest expenses allocated to the state of Washington. The aggregate percentage of expense allocated to Washington during the last three months of 2002 was greater than the relative percentage allocated in the first nine months of 2003. Ms. Strain's adjustment restates the actual allocated expenses for the 2002 portion of the test year to reflect the actual percentage for the last nine months of the test year. This proposed adjustment decreases test year operating expenses.

**Q. DOES MS. STRAIN FIND THAT THE ALLOCATED EXPENSES FOR THE LAST QUARTER OF 2002 ARE INCORRECT?**

A. No. Ms. Strain does not challenge the accuracy of the allocated expenses to Washington. She merely identifies that the relationship of allocated expenses for one time period varies from another time period.

**Q. IS IT UNUSUAL FOR THE RELATIONSHIP OF THE AGGREGATE EXPENSE ALLOCATED TO WASHINGTON TO THE TOTAL ALLOCABLE EXPENSE TO FLUCTUATE MONTH-TO-MONTH?**

A. No. Ms. Strain relies on data provided in the response to WUTC Data Request No. 212 to develop her adjustment. This response includes one schedule with the dollar amount of expenses allocated to Washington for the fourth quarter of 2002 by account along with a total percentage allocated to Washington during that time period. A similar schedule is included for the first three quarters of 2003. The total percentage allocated to Washington is simply a compilation of all of the individual allocations by account or workcenter. This total can fluctuate month-to-month depending on the mix of accounts and workcenters where the allocable costs are incurred.

**Q. PLEASE PROVIDE AN EXAMPLE.**

A. The following illustrates how the aggregate percentage allocated to Washington can fluctuate month-to-month based on the mix of activity by account or workcenter.

Example 1

| | Allocable Expense | | Allocation Factor | | Allocated Amount | Aggregate Percentage |
|---|---|---|---|---|---|---|
| Account A | $100 | x | 50% | = | $50 | |
| Account B | $200 | x | 40% | = | $80 | |
| Total | $300 | | | | $130 | 43% |

Example 2

| | Allocable Expense | | Allocation Factor | | Allocated Amount | Aggregate Percentage |
|---|---|---|---|---|---|---|
| Account A | $200 | x | 50% | = | $100 | |
| Account B | $100 | x | 40% | = | $40 | |
| Total | $300 | | | | $140 | 47% |

The fluctuation in the aggregate percentage is not an indication of an incorrect level of allocations but simply reflects the reality that costs are not incurred equally by account or workcenter by month.

In short, Ms. Strain's adjustment for the three months in question is not correct. The test year includes the correct level of allocated costs based on the mix of expenses incurred in each time period.

**Q. IS MS. STRAIN'S ADJUSTMENT CALCULATED PROPERLY?**

A. Ms. Strain's original adjustment failed to consider the Part 64 allocation of the FCC's Code of Federal Regulation ("Part 64") Cost Allocation Manual ("CAM") and the subsequent allocation to the intrastate jurisdiction. These errors appear to be corrected in the errata filed January 14, 2005. However, although this correction more accurately states the result Ms. Strain intended, this restatement is not appropriate for the reasons stated above.

***E. P17 Rate Base Pro Forma (Depreciation)***

*Approximate revenue requirement - ($46,366,000) rate change, ($1,707,000) plant pro forma*

**Q. PLEASE SUMMARIZE THE STAFF'S PROPOSED ADJUSTMENTS TO THE PRO FORMA FOR TELEPHONE PLANT IN SERVICE AND ASSOCIATED DEPRECIATION EXPENSE.**

A. Ms. Strain proposes two adjustments to the Company's presentation. First, she correctly identifies an error made in the calculation of this adjustment.[11] The corrected adjustment is presented as Exhibit No. NWH-22 Correction to Verizon NW Calculation of P17 and is reflected in the impact on the overall revenue requirement at Exhibit No. NWH-14. Second, the Staff used depreciation rates currently prescribed by the Commission in place of those proposed by the Company in Docket UT-040520. As noted by Ms. Strain, the Company and Staff have mutually agreed to subsequently update depreciation expense for use in the cost of service in this rate case to reflect the depreciation rates approved in UT-040520.

**Q. DOES VERIZON NW HAVE ANY CONCERNS ABOUT THE STAFF'S CORRECTED PRESENTATION OF P17?**

A. Yes. The Staff proposes an incremental change in depreciation expense (using currently authorized rates multiplied times pro forma telephone plant in service). However, the

[11] Consumer's Witness Brosch also files testimony regarding this error.

Staff does not reflect the corresponding impact on the accumulated depreciation reserve or deferred income taxes. The Staff's calculation must be updated to ensure a consistent presentation of depreciation expense and the associated rate base items. See Exhibit No. NWH-23 Company's Revision to Staff Calculation of P17.

**Q. CONSUMERS' WITNESS BROSCH STATES THAT THE P17 PRO FORMA UNDERSTATES THE GROWTH THAT WILL OCCUR IN THE DEPRECIATION RESERVE. DO YOU AGREE?**

A. No. As I stated in my direct testimony, the pro forma test period reflects the estimated gross additions and retirements for the twelve months following the test year using a half year convention. The use of the half year convention was necessary since the rate base is based on the average of thirteen monthly averages. As such, telephone plant in service, accumulated depreciation reserve, deferred taxes, and depreciation expense were all adjusted to reflect an incremental half year of activity. It is inappropriate, as Mr. Brosch suggests, to take just one of the rate base or cost of service elements and reflect a full year's worth of activity. Mr. Borsch's recommended adjustment should not be accepted.

***<u>F. Deferred Tax Impact of Staff Adjustments</u>***

*Approximate revenue requirement - $2,746,000*

**Q. PLEASE COMMENT ON THE PRESENTATION OF DEFERRED INCOME TAXES ON EXHIBITS PMS-10C AND PMS-12C.**

A. Ms. Strain calculates and presents a deferred tax impact on Staff proposed restating adjustment SR22 on PMS-10C and pro forma adjustments P17, SP23 and SP24 on PMS-

12C. There are three errors with the deferred tax amounts on each of these adjustments. First, Ms. Strain uses a deferred tax rate of 11.4% as proposed by Mr. Kermode. As explained later in my testimony, these amounts should be calculated using the correct rate of 18.51%. Second, Ms. Strain calculates the deferred tax impact using the change in the Depreciation and Amortization Reserve instead of the change in the Net Plant in Service upon which a deferred tax rate is based. Finally, for adjustments SR22, SP23 and SP24, the deferred tax adjustments presented by Ms. Strain are presented incorrectly as an increase to the Deferred Income Tax balance instead of a reduction. When embedded plant is removed from the rate base, as is proposed by the Staff in these adjustments, the related embedded deferred tax needs to be removed (reduction to deferred income taxes).

See Exhibit No. NWH -20 Company's Revision to Staff Deferred Tax Adjustment on PMS-10C and PMS-12C.

## III. BETTY A. ERDAHL

***A. R15-03 Reclassified Items***

*Approximate revenue requirement – ($2,059,000)*

**Q. PLEASE DESCRIBE ADJUSTMENT R15-03 RECLASSIFIED ITEMS AS PRESENTED BY VERIZON NW IN THE DIRECT CASE.**

A. As stated in my direct testimony,[12] the test year was normalized to remove certain business expenditures for which Verizon NW chose not to seek recovery in this case. These included business expenditures in addition to items miscoded to Washington and charitable contributions coded to regulated operating expenses in error.

**Q. DOES THE STAFF ACCEPT THE COMPANY'S ADJUSTMENT?**

A. The Staff accepts the adjustment by the Company. However, Ms. Erdahl includes a criticism of the Company's presentation and claims that the responses to two data requests do not tie back to the R15-03 workpaper. This criticism is purely unfounded and simply reflects a misunderstanding on the part of Ms. Erdahl regarding the documents in question.

**Q. DOES STAFF PROPOSE ADDITIONAL AMOUNTS TO REMOVE FROM OPERATING EXPENSES AS PART OF R15-03?**

A. Yes. In addition to the amounts removed by the Company, the Staff proposes to remove the entire amount booked to account 672217 Regulated Public Relations and the entire amount booked to account 672210 Common Public Relations, including the amount identified by Verizon NW as corporate image advertising. This results in a reduction to intrastate operating expense.

**Q. DOES MS. ERDAHL PROVIDE A REASON FOR PROPOSING TO REMOVE THE ENTIRE EXPENSE IN ACCOUNT 672210 AND THE INCREMENTAL**

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[12] NWH-1T page 17-18

**AMOUNTS IN ACCOUNT 672217 (THOSE NOT IDENTIFIED AS CORPORATE IMAGE ADVERTISING) FROM THE RESULTS OF OPERATIONS IN THIS CASE?**

A. No. However, Ms. Erdahl does state that lobbying expenses are not allowed for ratemaking purposes but she does not identify any lobbying expenses included in these accounts.

**Q. HOW DOES VERIZON NW RECORD LOBBYING EXPENSES?**

A. They are recorded as nonoperating expenses and not included in the regulated books which are the basis of this rate case.

**Q. WHAT TYPES OF EXPENSES IS MS. ERDAHL PROPOSING TO DISALLOW BY REMOVING THE ENTIRE AMOUNT IN ACCOUNT 672210 AND THE INCREMENTAL AMOUNT IN 672217?**

A. Both accounts include labor, benefits and departmental expenses incurred by the Group President – Northwest and Southwest Regions,[13] the Vice President Public Policy and External Affairs - Verizon Northwest[14] and their direct reports in their day-to-day interaction with the WUTC Staff. Expenditures of this type are appropriate for inclusion in ratemaking. Ms. Erdahl's proposed adjustment of these amounts has no basis and should not be accepted.

[13] Mr. Steve Banta
[14] Mr. David Valdez

**Q. NOT WITHSTANDING THE OBJECTION ABOVE, IS THE STAFF'S PROPOSED ADJUSTMENT CALCULATED CORRECTLY?**

A. On Exhibit BAE-3, Ms. Erdahl applied incorrect CAM and separation factors. She acknowledged this in response to Verizon NW Data Request number 144 and provided a revised exhibit with her January 15, 2004 errata filing. The errata uses the appropriate factors.

***<u>B. SR20 – Insurance Expense</u>***

*Approximate revenue requirement – ($504,000)*

**Q. PLEASE SUMMARIZE RESTATING ADJUSTMENT SR20 – INSURANCE EXPENSE PROPOSED BY MS. ERDAHL.**

A. Staff proposes an adjustment to decrease actual insurance expense for the test year ended September 2003 to the level incurred by Verizon NW in the calendar year 2003. This results in a reduction to intrastate operating expense.

**Q. IS MS. ERDAHL'S ADJUSTMENT CORRECT AND APPROPRIATE?**

A. No. Ms. Erdahl merely reduces the test year insurance expense down to the calendar year 2003 level without considering the reasons for the fluctuations in the expense levels.

**Q. IS THE INSURANCE EXPENSE INCLUDED IN THE TEST YEAR AT THE CORRECT LEVEL?**

A. No. In researching the fluctuation in insurance expense between the calendar years 2002 and 2003 and the test year, the Company identified an entry booked in November 2003 which significantly reduces insurance expense. This entry relates to the time period January through September 2003 and should have been included as a restatement to the historical test year in the rate case filing. The Company's revenue requirement has been updated to reflect this restatement at Exhibit No. NWH-24 Insurance Expense Restatement and subsequently on Exhibit No. NWH-14.

**Q. WHAT LEVEL OF INSURANCE EXPENSE HAS THE COMPANY INCURRED OVER THE PAST SEVERAL YEARS?**

A. Insurance expense was $5.9 million in 2002, $7.9 million in the test year and $3.6 million in 2003.[15] Once the test year is restated for the November 2003 true-up entry of $3.6 million discussed above, the test year insurance expense is $4.3 million. This level is consistent with the level incurred in the 2002 and 2003 calendar years. In addition, it is consistent with the actual insurance expense incurred during the pro forma period twelve months ended September 2004 of $4.1 million.

**Q. MS. ERDAHL INCLUDES PREMIUM AMOUNTS AS OF AUGUST 2004 FOR COMPARISON TO HISTORIC INSURANCE EXPENSE LEVELS. HOW SHOULD THIS DATA BE CONSIDERED?**

A. The insurance premiums for January to August 2004 are $3.8 million.[16] This demonstrates that the insurance expense for the first eight months of the calendar year following the test year are in excess of the $3.6 million that the Staff recommends as the

[15] See Verizon response to WUTC Data Request No. 334
[16] See Verizon response to WUTC Data Request No. 514.

appropriate expense for a twelve-month period. The Staff's number is simply too low and does not reflect actual insurance expense incurred.

**Q. IS THERE ANY REASON WHY THE COMMISSION SHOULD ACCEPT THE ARBITRARY ADJUSTMENT PROPOSED BY MS. ERDAHL INSTEAD OF REFLECTING THE KNOWN RESTATEMENT TO TEST YEAR INSURANCE EXPENSE?**

A. No. As stated in my direct testimony, the rate case presentation starts with the books and records of the Company, normalized through the use of restating adjustments to account for out-of-period items and other normalizations.[17] The booked test year should be adjusted to reflect the normalization identified above. There is no basis for rejecting the use of a known item.

**Q. DID THE STAFF ACCEPT SIMILAR NORMALIZATIONS APPLIED TO THE LEVEL OF BOOKED OPERATING EXPENSE?**

A. Yes. The Company's original filing included several normalizations in order to restate the operating expenses for accounting adjustments. The Staff accepted each of these adjustments without exception. The actual restatement identified above and shown in Exhibit No. NWH-24 should be also accepted in lieu of the adjustment proposed by the Staff which understates the incurred insurance expense.

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[17] NWH-1T page 8 – 9.

***C. P12 Salary, Wages, Benefits & Other Employee Benefits***

*Approximate revenue requirement – ($4,122,000)*

**Q. PLEASE SUMMARIZE THE COMPANY'S PRESENTATION OF SALARY, WAGES AND BENEFITS IN PRO FORMA ADJUSTMENT P12.**

A. The pro forma adjustment contains the following components:

Salary and wages
- * reduces going-level salary and wages associated with actual headcount reductions occurring during the test year
- * increases going-level salary and wages for management salary increases and union wage increases per contract

Benefits
- * reduces going-level benefits associated with actual headcount reductions occurring during the test year
- * increases going-level benefits associated with known cost increases

Any salary, wage or benefit severance expenses associated with the actual headcount reductions occurring during or immediately following the test year are included in adjustments P18 Employee Separation and P20 Management Voluntary Separation Program.

**Q. HOW DOES THE STAFF'S PROPOSED ADJUSTMENT TO REFLECT THE IMPACT OF SALARY AND WAGES OF HEADCOUNT REDUCTIONS DIFFER FROM THE COMPANY'S PRESENTATION?**

A. Ms. Erdahl criticizes the Company's calculation of the impact of headcount reduction on salary and wages but then puts forth a Staff calculation which produces a similar answer. By Ms. Erdahl's criticisms of the Company's calculation, it appears that she fails to understand the primary difference between the approach put forth by the Company versus the approach proffered by the Staff. To more accurately reflect the known changes in headcount on the Washington state payroll, the Company presentation first computes the change to direct wages and then applies the results to the wages allocated to Washington. The Staff calculation starts with a wage number which reflects both direct and allocated wages from which to compute the reduced wages. The same data was used in both cases and consequently produces similar results. Ms. Erdahl's criticisms of the Company's approach are meaningless.

**Q. HOW DOES THE STAFF'S PROPOSED ADJUSTMENT TO REFLECT MANAGEMENT AND UNION SALARY AND WAGE INCREASES DIFFER FROM THE COMPANY'S PRESENTATION?**

A. As stated in my direct testimony, the expense pro forma was based on cost category instead of by FCC account. In order to accomplish this, the Company used managerial data to develop relationships between the historical test year and the pro forma test period. These relationships were then applied to the data maintained by FCC account to derive the appropriate adjustment to the test year intrastate results. The Staff also used the managerial data to calculate their adjustment. However, Ms. Erdahl did not apply this relationship back to the regulated books, but instead used the managerial data to compute her pro forma adjustment.

**Q. DO YOU AGREE WITH THE STAFF'S METHODOLOGY?**

A. No. The Staff's method improperly computes the pro forma adjustment for changes in salary and wages. The managerial data used by Ms. Erdahl is on an external reporting basis and does not reflect accounting differences as required for regulatory accounting.

For example, in the area of salary and wages, the external books reflect severance related expenses when they become known and measurable. However, for regulatory accounting, these amounts are recognized when paid.

As I noted above, this managerial data is used in the case solely to develop period to period relationships that can then be applied to the regulated books. It is inappropriate to compute an adjustment using the managerial data as Ms. Erdahl has done since this data is not reflected in the cost of service in the test year. Ms. Erdahl's proposed adjustment to the Company's number is not appropriate and should not be accepted.

**Q. DO YOU HAVE OTHER CONCERNS WITH THE STAFF'S PROPOSED ADJUSTMENT TO REFLECT THE IMPACT OF SALARY AND WAGE INCREASES?**

A. Yes. Ms. Erdahl's calculation is at a Washington total company level. As such, she must apply the Part 64 CAM allocation to remove amounts applicable to nonregulated activities. However, Ms. Erdahl ignores the actual CAM factors provided by the Company at Schedule A4 that are used by the Company as well as by the Staff throughout the rate case filing. Instead, she chooses to create her own factor using data that has nothing to do with Part 64 or the relationship between regulated and total company data. This is just not supportable. The actual CAM factors used throughout the remainder of this case should also be used in the calculation of salary and wage adjustments in place of these made-up factors.

**Q. HOW DOES THE STAFF'S PROPOSED ADJUSTMENT TO REFLECT GOING LEVEL CHANGES IN BENEFITS DIFFER FROM THE COMPANY'S PRESENTATION?**

A. As noted above, the pro forma related to benefits is comprised of the impact related to head count reductions and the impact of known price changes. The Staff and Company benefit expense adjustment associated with headcount reductions is very similar. However, the benefit expense adjustments associated with known price changes differ greatly. The Company's benefit expense pro forma reflects the increase in employee benefit cost between the historical test year and the pro forma test period. Both time periods are supported by actuarial reports which document the drivers to the increasing cost between the time periods.[18]

**Q. HOW DID MS. ERDAHL CALCULATE THE PRO FORMA CHANGE IN BENEFIT EXPENSE?**

A. Ms. Erdahl states that it is not rational for benefit expense to increase more than the increase in salary and wages. Therefore, she limits the increase in pro forma benefits to the same percentage as the increase in the salary and wages pro forma. In doing so, Ms. Erdahl totally ignores the actuarial reports provided in support of the booked and pro forma benefit expense. In the response to Verizon NW Data Request No. 151, Ms. Erdahl maintains that "if all other factors are equal", a 2% merit increase in a given year would also yield a 2% increase in benefit cost. This is simply incorrect. Benefit costs (including such items as employee medical and dental) are not driven by or linked to

[18] See response to Staff Data Request No. 361.

annual merit increases. Ms. Erdahl's pro forma benefit expense adjustment has no basis in reality and should not be adopted.

**Q. FINALLY, MS. ERDAHL COMMENTS THAT THE COMPANY'S BENEFIT EXPENSE PRO FORMA IS FLAWED BECAUSE IT RESULTS IN DOUBLE RECOVERY OF EXPENSE INCLUDED IN P18 AND P20. PLEASE COMMENT.**

A. As I noted at the beginning of this section, workpaper P12 includes test year salary, wages and associated benefits. Workpaper P18 reflects employee severance related to headcount reductions which occurred during the test year. Workpaper P20 reflects the employee severance associated with a specific program which occurred after the test year. Ms. Erdahl provides no support to her claim that reflecting unique expenses in three different workpapers results in double recovery. In addition, she provides no support to her claim that test year benefit costs for the period October 2002 through September 2004 could somehow double count severance costs incurred after September 2004. Ms. Erdahl's comments are without merit.

***D. P18 Employee Separation***

*Approximate revenue requirement – ($3,407,000) non-cash expense, ($955,000) amortization period*

**Q. PLEASE SUMMARIZE THE COMPANY'S ADJUSTMENT P18 RELATED TO EMPLOYEE SEPARATION EXPENSE.**

A. The Company incurred employee separation expense associated with headcount reductions occurring during the test year. The Company's pro forma adjustment P18 amortizes this separation expense over a three year period. The severance expense includes items such as actual severance payments, salary and insurance continuation, outplacement, special termination benefits and pension settlement/curtailment gains and losses.

**Q. DOES STAFF ACCEPT THE COMPANY ADJUSTMENT?**

A. Ms. Erdahl recommends that the Company be allowed to recover actual cash payments related to employees who leave the Company but recommends against allowing recovery of non-cash employee separation expenses incurred simply because these expenses can fluctuate year-to-year. Additionally, the Staff recommends that the recovery of cash expenses be amortized over five years instead of the three year period recommended by the Company.

**Q. PLEASE IDENTIFY THE EMPLOYEE SEPARATION EXPENSES THAT MS. ERDAHL REMOVES FROM THE P18 PRO FORMA ADJUSTMENT.**

A. There are two types of employee separation expenses in question. The first is Special Termination Benefits. These amounts are associated with workforce reductions and are incremental pension benefits paid as a severance benefit. These benefits are immediately recognizable as an expense under the requirements of the Statement of Financial Accounting Standards No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits ("FAS 88"). These are actual severance expenses incurred by the Company and should be included for recovery in this case. In addition, the amortization of these amounts over three years should address Ms. Erdahl's concerns regarding possible year-to-year fluctuations.

**Q. PLEASE DISCUSS THE SECOND TYPE OF EMPLOYEE SEPARATION EXPENSE THAT MS. ERDAHL REMOVES FROM THE P18 PRO FORMA ADJUSTMENT.**

A. The second type of severance expense is pension settlements and curtailments. A pension settlement occurs when an employee essentially "settles" their pension and thereby relinquishes the Company's associated obligation for any future pension amounts. A pension curtailment occurs when employee services are terminated earlier than expected. These charges would generally be recognized, over time, under Financial Accounting Standards No. 87, Employers' Accounting for Pensions ("FAS 87") had not an event, such as a downsizing, triggered their immediate recognition. Again, these are actual, known severance expenses incurred by the Company and are appropriate for recovery in this case.

**Q. PLEASE COMMENT ON THE STAFF'S RECOMMENDATION TO INCREASE THE AMORTIZATION PERIOD OF THE P18 SEVERANCE COSTS FROM 3 TO 5 YEARS.**

A. Ms. Erdahl provides no support to the recommendation for the five-year period except that it is consistent with the Company's proposed amortization of net annual savings related to the Management Voluntary Separation Program ("MVSP") in adjustment P20. The Company selected the five-year amortization period for the MVSP related costs primarily due to the size of the costs involved and due to the unusual nature of the overall transaction. As acknowledged by Ms. Erdahl, the severance reflected in adjustment P18 is associated with business-as-usual downsizing. As such, there is no basis to extend the amortization period from the three year period recommended by the Company. This is consistent with the amortization of rate case expense filed and accepted by the Staff in this case.

***E. P20 Management Voluntary Separation Program***

*Approximate revenue requirement – ($8,035,000) non-cash expense, ($4,479,000) recalculation of savings number, $91,000 recalculation of payment number*

**Q. PLEASE SUMMARIZE THE COMPANY'S ADJUSTMENT P20 RELATED TO THE MANAGEMENT VOLUNTARY SEPARATION PROGRAM.**

A. The Company incurred employee separation expense associated with a separation program which occurred during the fourth quarter of 2003. The Company's pro forma adjustment P20 amortizes this separation expense over a five year period netted against the associated annual savings. The severance expense includes items such as actual severance payments, salary and insurance continuation, outplacement, special termination benefits and pension settlement/curtailment gains and losses.

**Q. DOES STAFF ACCEPT THE COMPANY ADJUSTMENT?**

A. Ms. Erdahl recommends that the Company be allowed to recover actual cash payments related to employees who leave the Company but recommends against allowing recovery of non-cash employee separation expenses incurred. In addition, Ms. Erdahl performs her own calculation of MVSP savings. She also uses her calculated MVSP *savings* as a surrogate for employee severance *expense* instead of using actual, booked severance expense.

**Q. PLEASE IDENTIFY THE EMPLOYEE SEPARATION EXPENSES THAT MS. ERDAHL REMOVES FROM THE P20 PRO FORMA ADJUSTMENT.**

A. Similar to the adjustments Ms. Erdahl recommends to P18, her proposed adjustment to P20 removes Special Termination Benefits and pension settlement and curtailment expense. These amounts are associated with workforce reductions and are recognized as an expense under the requirements of FAS 88. These are actual, known severance expenses incurred by the Company and should be included for recovery in this case.

In addition, even though Ms. Erdahl recommends that the Company be allowed to recover actual cash payments related to employees who leave the Company, she removes the known, booked payments from the Company's P20 adjustment and replaces them with a number she calculates for MVSP savings. In response to Verizon NW Data Request No. 137, Ms. Erdahl explains this by stating that "it was the Staff's intent to substitute the estimated amount with a calculated pro forma amount using known and measurable amounts." However, as stated on workpaper P20 and as supported in response to Staff Data Request No. 525 by actual journal entries, the severance expenses included in the Company's presentation of P20 *are* the actual severance amounts paid and journalized. There is no reason why these expense amounts should be removed and replaced with a hypothetical number calculated by Ms. Erdahl.

**Q. PLEASE COMMENT ON MS. ERDAHL'S CALCULATION OF MVSP SAVINGS.**

A. Ms. Erdahl uses actual salaries and wages for the employees who accepted the MVSP to calculate estimated savings. These amounts were provided in response to Staff Data Request No. 234a. In that response, the Company identified that a portion of these employee salaries, specifically 27.027%, is capitalized. These employees clearly charged part of their time to capitalized projects. If these employees were to stay on with the Company, part of their on-going salary would continue to be capitalized as was done in the test year. However, in Ms. Erdahl's calculation of MVSP savings, she allocates *none* of the reduction in on-going salary and wages to capital. In response to Verizon NW Data Request No. 134, Ms. Erdahl explains this by stating "The savings in salary and related expenses (pension and benefits) represent amounts that will not be paid; so therefore, no amount of the savings in salary expense will be capitalized". Plain and simple, Ms. Erdahl overstates her calculation of MVSP expense savings by including amounts which were previously not charged to expense. This is not correct.

**Q. DOES MS. ERDAHL'S CALCULATION OF MVSP SAVINGS INCLUDE OTHER ERRORS?**

A. Yes. Ms. Erdahl's calculation is at a Washington total company level. As such, she must apply a Part 64 CAM allocation to remove amounts applicable to nonregulated. However, Ms. Erdahl ignores the actual CAM factors provided by the Company at workpaper A4 that are used throughout the rate case filing. Instead, she chooses to create her own factor using data that has nothing to do with Part 64 or the relationship between regulated and total company data. This is wrong and not supportable. If Ms. Erdahl's calculation of MVSP savings is used in place of the MVSP savings presented by the Company, her errors need to be corrected. Although the Company is not suggesting that her methodology be used, we are providing a revision to her exhibit to correct for the specific errors discussed above. See Exhibit No. NWH-29 Company's Revision to Staff Calculation of P20 MVSP Savings.

**Q. CONSUMERS' WITNESS MR. BROSCH ALSO ADDRESSES COMPANY ADJUSTMENTS P18 AND P20 BUT RECOMMENDS AGAINST INCLUSION OF SEVERANCE EXPENSE. PLEASE COMMENT.**

A. Mr. Brosch theorizes about whether severance costs have already been "recovered" through retained labor savings not yet recognized in any rate case. This discussion has no merit. First, it is inappropriate to selectively pick one issue in the cost of service and assume some theoretical recovery. The Company has a complete cost of service on file in this rate case which utilizes a specific test year cost of service. The employee severance cost should be considered in this context not as a stand alone issue for determination of recovery. Second, the savings in salary and wages associated with headcount reductions in the test year and with the MVSP are included in the cost of service in the rate case. As such, it is appropriate to include the associated severance costs which gave rise to these savings. Mr. Brosch's recommendation should not be accepted.

***<u>F. Other Post Employment Benefits (R8-03, P11, P15)</u>***

*Approximate revenue requirement - $2,524,000*

**Q. PLEASE SUMMARIZE THE DISCUSSION FROM YOUR DIRECT TESTIMONY WHERE YOU DESCRIBE THE COMPANY'S PRESENTATION OF POSTRETIREMENT BENEFITS IN THE TEST PERIOD RESULTS.**

A. Verizon NW accounts for postretirement benefits on an accrual basis in accordance with Part 32 of the FCC's Code of Federal Regulations ("Part 32") and generally accepted accounting principles. However, for the purpose of reporting intrastate results to the WUTC, the Company is required to reverse the impact of accrual accounting and instead reflect postretirement benefits on a pay-as-you-go ("paygo") or cash basis. Restating adjustment R8-03 accomplishes this reversal of accrual accounting for the purposes of restating the historic test year financials.

Subsequently, in developing the pro forma test period financials, the Company submits two pro forma adjustments; P15 which reverses the paygo accounting in R8-03 and returns the financials to the original accrual accounting and P11 which moves the test year historic accrual levels to the test period pro forma levels in accordance with the most recent actuarial report. The result is a pro forma test period that reflects accrual accounting per Financial Accounting Standards Board Statement No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions ("FAS 106"). FAS 106 costs have been included in the test period because they represent the ongoing level of costs associated with retiree medical and life insurance payments.

**Q. HOW ARE PAYGO (CASH) AND FAS 106 (ACCRUAL) ACCOUNTING REFLECTED IN THE FINANCIALS?**

A. Paygo represents the amounts paid by the Company for medical benefits on behalf of current retirees. In a simplified example, these amounts would be recorded as an increase to benefits expense and a reduction to cash. In the case of accrual accounting, actuarial data is used to determine the Company's obligation for benefit expense associated with active and retired employees. This obligation is recorded as an increase to benefit expense and an increase to a FAS 106 liability. Actual payments made on behalf of current retirees are not reflected in the Company's income statement.

**Q. HOW ARE CASH AND ACCRUAL ACCOUNTING REFLECTED IN THE COST OF SERVICE FOR RATEMAKING?**

A. In the Company's presentation of paygo for the historic test year, the associated benefit expense is reflected as an increase in operating expenses. The presentation of accrual accounting in the pro forma test period includes benefit expense and a FAS 106 liability. The liability is a reduction to rate base.

**Q. DOES MS. ERDAHL AGREE WITH THE COMPANY'S APPROACH OF USING FAS 106 ACCOUNTING FOR THE PRO FORMA TEST PERIOD?**

A. No. Ms. Erdahl recommends the use of cash accounting. As such, she accepts the Company's restating adjustment R8-03 (although she reduces the paygo expense amount) and rejects pro forma FAS 106 adjustments P11 and P15. Her proposed cost of service includes test year paygo amounts, net of retiree contributions with no rate base reduction for the FAS 106 liability. Consumers' Witness Carver also files testimony in support of using paygo amounts. However, he does not remove the FAS 106 liability from the rate base. This is inconsistent since there would be no FAS 106 liability under cash accounting.

**Q. IS THERE ANY MERIT TO THE ARGUMENTS PUT FORTH BY MS. ERDAHL IN SUPPORT OF USING PAYGO IN LIEU OF FAS 106?**

A. No. Ms. Erdahl simply states that paygo is fairly steady and that it can be measured. In addition, she comments about the "much higher" accrual amount. Her arguments are without merit. Both paygo and FAS 106 have produced stable benefit expense and both items can be and are specifically measured.[19] FAS 106 does not produce "much higher" benefit amounts as Ms. Erdahl claims. In fact, as shown in Exhibit NWH-17, the revenue requirement associated with FAS 106 accounting is only $2.5 million higher than the revenue requirement associated with paygo.[20] The Company has in fact provided documentation which demonstrates that the FAS 106 amounts are reasonable, prudent and conservative.[21] This same data is subject to the continual scrutiny of Verizon NW's external auditors as part of their process to express an opinion on the Company's financials. There is simply no basis to accept paygo accounting over FAS 106 accounting.

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[19] The response to Staff Data Request No. 512 shows the paygo amounts in thousands for 2002, test year and 2003 as $10,374, 10,854 and $11,077. The response to Public Counsel Data Request No. 122a shows FAS 106 amounts in thousands for the same time periods as $10,465, $12,180 and $12,751.
[20] Sum of R8-03, P11 and P15
[21] Response to Staff Data Request No. 361

**Q. AS DISCUSSED LATER IN YOUR TESTIMONY, MS. ERDAHL ALSO RECOMMENDS CASH ACCOUNTING OVER ACCRUAL ACCOUNTING FOR PENSIONS. SHOULD THE ACCRUAL VERSUS CASH ACCOUNTING ISSUE FOR POSTRETIREMENT BENEFITS AND PENSIONS BE CONSIDERED SEPARATELY?**

A. No. As stated in the accounting standard, to the extent that the promise to provide pension benefits and the promise to provide postretirement benefits are similar, the provisions of FAS 106 are similar to those prescribed in FAS 87. Both statements require the use of accrual accounting to determine benefits as the sum of service costs, plus interest costs, less expected return on external trust assets, plus or minus the amortization of prior gains and losses. The amortization of the prior gains and losses aids in keeping the benefit costs relatively smooth year over year.

Accrual accounting requires that expenses be recognized in the appropriate period, although cash payments may take place at some other time. Accrual accounting properly assigns costs to the generation of customers to whom these costs are attributable. The basic assumption underlying accrual accounting is that current transitions often produce future assets or future liabilities. This is exactly the case with postretirement and pension benefits.

Although Verizon NW and the Commission[22] both support accrual accounting for ratemaking purposes, if the Commission determines that cash accounting is more appropriate, it should be adopted for all ratemaking elements of both postretirement benefits and pensions.[23]

**Q. CONSUMERS' WITNESS CARVER STATES THAT PAYGO AMOUNTS IN R8-03 SHOULD HAVE A PORTION ALLOCATED TO CAPITAL ACCOUNTS CONSISTENT WITH FAS 106 ACCRUALS. IS HE CORRECT?**

A. No. FAS 106 requires employers to accrue the cost of postretirement benefits to expense during the employees' service period. Consistent with the recording of other labor and benefits, a portion of this expense is charged to capital accounts if the employee is working on projects that are subsequently capitalized. However, paygo amounts are cash payments made by Verizon NW on behalf of retirees. Since the retirees are not actively employed by the Company, they cannot be working on capital projects nor can costs associated with these retirees be capitalized. The expense treatment of paygo costs is appropriate and is consistent with the recording of paygo under ("Part 32") prior to the adoption of FAS 106.

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[22] Docket No. UT-950200, 15th Supplemental Order, Page 48, Section 5, the Commission accepted accrual basis accounting for employee benefits for ratemaking purposes.

[23] The ratemaking elements associated with pension and postretirement benefits include benefit expense, pension asset, FAS 106 liability, deferred taxes and investor supplied working capital related to the pension asset.

***G. Pensions (R9-02, SR21, P14)***

*Approximate revenue requirement – ($10,836,000)*

**Q. PLEASE SUMMARIZE THE COMPANY'S PRESENTATION OF PENSION BENEFITS IN THE TEST PERIOD RESULTS.**

A. Verizon NW accounts for pension benefits on an accrual basis in accordance with Part 32 and generally accepted accounting principles. The test year accrual levels were adjusted to remove the impact of an entry booked to Washington in error (R9-02). This restated accrual level was further adjusted for two pro forma items P12 and P14 to move the test year historic restated accrual levels to the test period pro forma levels in accordance with the most recent actuarial report. The result is a pro forma test period amount that reflects accrual accounting per Financial Accounting Standards Board Statement No. 87, Employers' Accounting for Pensions. FAS 87 costs have been included in the test period because they represent the ongoing level of cost of employee pension benefits.

**Q. HOW ARE CASH AND FAS 87 (ACCRUAL) ACCOUNTING REFLECTED IN THE FINANCIALS?**

A. Under accrual accounting, actuarial data is used to determine the Company's obligation for benefit expense associated with active and retired employees. This obligation is recorded as an increase or decrease to benefit expense and an increase to a FAS 87 asset or liability. Accounting for pensions on a cash basis represents the amounts paid by the Company to an external trust on behalf of retirees. These amounts would be recorded as an increase to benefits expense and a reduction to cash. Actual payments made from the external trust on behalf of current retirees occur separate and apart from the Company and are not reflected in the Company's financials.

**Q. HOW ARE CASH AND ACCRUAL ACCOUNTING REFLECTED IN THE COST OF SERVICE FOR RATEMAKING?**

A. The benefit expense recorded under cash accounting is reflected as an increase in operating expenses. In the Company's presentation of accrual accounting in the historic test year and pro forma test period, pension benefits are reflected as a reduction to expense and an increase to the pension asset. The asset is an addition to rate base.

**Q. PLEASE EXPLAIN WHY THE PENSION BENEFITS ARE A REDUCTION TO EXPENSE.**

A. Previously in my testimony, I identified the cost components of FAS 87 benefit expense. The return on external trust assets and amortization of prior gains exceeds the combination of service and interest costs. Accordingly, this results in the recording of a negative expense on the income statement and a prepaid pension asset on the balance sheet.

**Q. WHAT DOES THE PENSION ASSET TRULY REPRESENT?**

A. Ms. Erdahl's use of the terms pension asset and pension fund seem to indicate that she believes these two distinct items are the same thing. The external pension trust (fund) consists of all the Company contributions and fund earnings from the inception of the plan. Prior to 1987, a trust fund was established for the purpose of paying pension benefits to retired employees. Contributions to the fund were made in accordance with Employee Retirement Income Security Act ("ERISA") and tax rules. This trust is held by an independent source for the sole benefit of plan participants and their beneficiaries. In addition, none of the contributions or earnings are available for the Company's use. Since the external trust fund is managed separate and apart from the assets of the Company, the trust assets are not included in the Company's balance sheet and the return on the fund is not available for the Company's use.

The prepaid pension asset on the Company's balance sheet is the accumulation of the negative pension costs recorded by the Company since the adoption of FAS 87. Ms. Erdahl testifies that the pension asset reflects the difference between the market value of the assets and the projected benefit obligation. This explanation is not correct. Her explanation refers to the funded status of the external trust and not the asset shown on the Company's books.

**Q. DO STAFF AND CONSUMER WITNESSES AGREE WITH THE COMPANY'S APPROACH OF USING FAS 87 ACCRUAL ACCOUNTING FOR THE PRO FORMA TEST PERIOD?**

A. No. Ms. Erdahl recommends the use of cash accounting. In Staff proposed adjustment SR21, Ms. Erdahl removes the test year pension asset. In addition, she does not accept the Company pro forma increase in pension expense at P14 or the impact on the pension asset shown in restating adjustment R9-02. Her proposed cost of service includes zero pension benefit expense and no rate base addition for the pension asset.

Consumers' witness Carver also files testimony in support of removing the pension asset from the rate base. However, he leaves the negative pension expense in the cost of service. This inconsistency does not properly match rate base and cost of service in the revenue requirement. Mr. Carver is attempting to treat pensions on an accrual basis for expenses and on a cash basis for rate base. If it is determined that the pension asset should not be included in the ratebase, consistency and fairness would dictate that the negative pension expense be removed from cost of service. This would effectively treat pension recovery on a cash basis.

**Q. IS THERE ANY MERIT TO THE ARGUMENTS PUT FORTH BY MS. ERDAHL IN SUPPORT OF THE REMOVAL OF THE PENSION ASSET FROM RATE BASE OR USING CASH VERSUS ACCRUAL ACCOUNTING?**

A. No. Ms. Erdahl states that it is unfair for the Company to earn on "this fund" twice – once by the earnings of the trust and again by the inclusion of the pension asset in rate base. Ms. Erdahl clearly has confused the external pension trust and the prepaid pension asset. As I stated above, the earnings on the external pension trust are not available to the Company. Even Ms. Erdahl recognizes in her testimony that there is precedent to allowing the pension asset in rate base when credits to expense have also been flowed through to income.[24]

While Ms. Erdahl correctly recognizes that both components of pension benefits – the negative expense and the prepaid asset – must be treated the same, she provides

[24] US West Docket No. UT-950200

absolutely no justification for the use of cash accounting versus accrual accounting. The intention of the Financial Accounting Standards Board when moving to accrual accounting was to better match the recognition of revenues and expenses in the time period for which they are incurred. Under the accrual method, the current ratepayer bears the cost of the benefits that are being accumulated by the employees at the time they are receiving service. This is in contrast to the cash basis as proposed by Staff, where a current ratepayer is paying the cost of benefits that a retiree earned possibly 15-20 years prior. There is simply no basis to accept cash accounting over FAS 87 accrual accounting.

**Q. WHY SHOULD THE PENSION ASSET BE A COMPONENT OF RATE BASE?**

A. The pension accrual has been a long standing cost of service that is known and measurable. The Company is conforming to generally accepted accounting principles and FCC Part 32 Rules in the recording of its pension credit and related pension asset under the accrual method of accounting. The Company is passing back to the ratepayers the benefit of the FAS 87 accounting change and the performances of the pension fund assets by reducing its cost of service through the recording of a pension credit on its books.

The Company receives no cash from the pension fund for booking this credit. No cash is provided to the Company from either the ratepayer or the pension fund, yet the Company has reduced the level of its revenue requirement and, therefore, the rates paid by its customers. The Company must finance with its own cash resources the reduction in rates created by the pension credit. In effect, these amounts represent a loan to the ratepayer. The recognition of negative pension costs represents a net cash outflow from the Company to ratepayers. Accordingly, the Company should be allowed to earn its cost of money on this asset to compensate for a reduction in costs without receipt of cash payment.

**Q. IF THE PENSION ASSET IS INCLUDED IN RATEBASE, WILL THE RATEPAYER PAY A RETURN ON FUNDS THEY ALREADY PROVIDED THROUGH PRIOR PENSION EXPENSE?**

A. No. The Company is not requesting recovery of the external pension fund, or any overfunding, in ratebase. The earnings of the pension fund remain in the fund and are not available for Company use. The pension asset is not the earnings of the fund passed to the Company. The pension asset is a result of a negative pension cost recorded on the Company's books. The ratepayers are receiving a benefit from their past contributions in the form of the Company's pension credit. The Company receives no cash payment from the fund, so there is no double recovery. The Company is merely asking for a return on the non-cash portion of this transaction, the pension asset.

**Q. DOES THE FCC PROVIDE ANY GUIDANCE ON ACCRUAL ACCOUNTING FOR PENSIONS OR ON APPROPRIATE TREATMENT OF THE ASSOCIATED ASSET?**

A. Yes. The FCC in its consideration of amending Part 32 for FAS 87, addressed the rate base treatment of prepaid pensions.

> Unlike most other types of prepayments that are merely operating expenses paid in advance of revenues and were excluded from the rate base in Docket 19129 decision, excess amounts paid into the fund earn a return for the fund which is later used to the benefit of ratepayers. These returns are used in future periods in the calculation of the annual pension costs for those periods, and normally serve to reduce the costs calculated for those periods. Since the earnings attributable to these fund payments in excess of SFAS-87 calculated annual pension costs are used to reduce expenses in later periods, we agree with Southwestern Bell's suggestion that payments into the fund, which exceed the SFAS-87 periodic pension cost calculation, should be included in the rate base. Conversely, if the SFAS-87 calculations result in a cost which exceeds actual funding and a liability is created, carriers should deduct the unpaid liability from the ratebase.[25]

The FCC recognized the role of the separate pension fund investment income in reducing future period costs and rightly included the offset to the reduced pension costs as a component of ratebase. It also identified the consistent treatment whether the result was either an asset or a liability.

This decision was later confirmed in a review of Part 65 rate base components.[26] In this matter, the FCC additionally outlined its criteria for ratebase determination.

> 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

[25] FCC 87-335, RM-5835, - In the Matter of: Use of Certain Generally Accepted Accounting Principles in Part 32 of the Commission's Rules, Memorandum Opinion and Order, Released October 30, 1987, page 6677, Section C.15.
[26] FCC 87-391, CC Docket No. 86-497, In the Matter of Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, Released December 24, 1987, Page 275, Section IV.C.2.

> 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 there from.[27]

In applying this standard to the determination of including the pension asset in the rate base, the FCC clearly found that the ratepayer benefits from the inclusion of the negative pension cost in the cost of service.

In addition, the WUTC has already set prior precedence for including these items in the intrastate rate base. In Docket No. UT-950200, the Fifteenth Supplemental Order, page 64, the WUTC accepted US West's proposed inclusion of the pension asset in the rate base as a discrete item.

**Q. PLEASE SUMMARIZE.**

A. The use of accrual accounting for the ratemaking treatment of pension and postretirement benefits is appropriate and properly assigns the costs to the generation of customers to whom these costs are attributable. The accounting for the expense associated with these two benefits is designed to be the same and, as such, the ratemaking treatment of both elements should be consistent. The cost of service and rate base elements for pension and FAS 106 should be treated consistently.

[27] FCC-87-391, CC Docket No. 86-497, In the Matter of Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, Released December 24, 1987, page 269, Section III.7.

## IV. DAVID E. GRIFFITH

***A. SR22 Missing Plant***

*Approximate revenue requirement – ($4,873,000)*

**Q. PLEASE SUMMARIZE THE IMPACT OF STAFF'S PROPOSED ADJUSTMENT SR22 MISSING PLANT ON THE TEST YEAR FINANCIAL RESULTS.**

A. Mr. Griffith proposes an adjustment for what he calls missing plant. This adjustment decreases telephone plant in service, accumulated depreciation reserve and depreciation expense. In addition, an adjustment is made to deferred taxes, which is discussed earlier in my testimony.

**Q. HOW WERE THE AMOUNTS USED IN THIS ADJUSTMENT DETERMINED?**

A. Verizon NW Witness Goldrick addresses in detail the process used by Mr. Griffith. Generally, the amounts used in Adjustment SR22 were arrived at by extrapolating the results of a review conducted by Mr. Griffith to the related Washington plant and accumulated depreciation reserve total company account balances as of September 2003. Mr. Griffith then applied an intrastate separations factor to the balances and subsequently calculates what he calls intrastate depreciation and deferred taxes.

**Q. IS HIS CALCULATION OF INTRASTATE AMOUNTS CORRECT?**

A. No. As noted above, Mr. Griffith utilizes total company plant and reserve balances in his calculation. He fails to apply the Part 64 CAM allocation to nonregulated operations. As such, his adjustments to plant, depreciation reserve, depreciation expense and accumulated taxes are all overstated.

**Q. IN REALITY, HOW ARE PHYSICAL INVENTORIES THAT RESULT IN THE IDENTIFICATION OF MISSING PLANT REFLECTED IN THE BOOKS AND RECORDS OF THE COMPANY?**

A. Plant that is included in the books and records of the Company but not located during a physical inventory is processed as a retirement in accordance with FCC Part 32, Section 2000 (d), "For items included on the retirements unit list, the original cost of any such items retired shall be credited to the plant account and charged (or debited) to Account 3100, Accumulated Depreciation, whether or not replaced." The net impact on the intrastate rate base is zero.

Like other regulated telecommunications companies, Verizon NW uses group depreciation methodology for recovery of capital assets. Per Public Utility Depreciation Practices (August 1996), published by the National Association of Regulatory Utility Commissioners ("NARUC"): "Under group depreciation, no gain or loss is recognized for retirement of individual assets. Upon retirement of an asset from the group, the cost of the asset is debited to the accumulated depreciation account and credited to the asset account."

**Q. DOES MR. GRIFFITH'S PROPOSED MISSING PLANT ADJUSTMENT FOLLOW THE FCC AND NARUC ACCOUNTING GUIDANCE?**

A. No. As noted above, Mr. Griffith computes his adjustment to accumulated deprecation separately from the plant original cost. The result is a net reduction in rate base, not the zero impact identified in the accounting direction provided by Part 32. Mr. Griffith's adjustment SR22 is therefore incorrect and should not be accepted.

**Q. MR. GRIFFITH DISCOUNTS THE PART 32 REQUIREMENTS ASSOCIATED WITH RETIREMENTS SINCE THE COMPANY DID NOT RECORD A RETIREMENT WITHIN A MONTH AFTER THE PLANT WAS WITHDRAWN FROM SERVICE.[28] SHOULD AN ADJUSTMENT OF THIS NATURE BE COMPUTED IN ACCORDANCE WITH THE ACCOUNTING RULES GOVERNING RETIREMENTS?**

A. Yes. The Company maintains a thorough capital activity policy which dictates the processes that must be followed before capital can even be ordered, let alone put into service. As such, there is no doubt that the plant recorded on the Company books did in fact exist. The only correct way to reflect the subsequent removal of this plant, either for accounting or ratemaking purposes, is to recognize a retirement with zero impact on rate base.

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[28] Verizon NW Data Request No. 149

## V. DANNY P. KERMODE

### *A. SR26 Partial Flow Through Taxes*

*Approximate revenue requirement – $1,558,000*

**Q. PLEASE SUMMARIZE MR. KERMODE'S ADJUSTMENT RELATED TO PARTIAL FLOW-THROUGH ACCOUNTING.**

A. The accumulated deferred income taxes included in the Company's proposed ratebase reflect full normalization accounting. Mr. Kermode proposes an adjustment to remove the non-property related deferred taxes currently embedded in the accumulated deferred tax balance. This reduces the deferred tax balance to a level that relates only to property. Mr. Kermode describes the result of his adjustment as partial flow-through accounting.

**Q. DO YOU AGREE WITH MR. KERMODE'S RECOMMENDATION TO FLOW THROUGH NON-PROPERTY RELATED BOOK/TAX TIMING DIFFERENCES INSTEAD OF DEFERRING THEM?**

A. No. Tax normalization is more properly cost-based for ratemaking purposes than flow-through. Normalization provides for more equitable distribution of tax benefits between current and future ratepayers since, under normalization, the benefits of tax deductions associated with expenditures are recognized for rate purposes as the underlying expenditures become recoverable for rate purposes. This is no different than depreciating an asset over time to properly match the cost and benefit to the customer. In contrast, flow-through accounting treats the continuing deferrals as though these were permanent tax savings, which is inaccurate.

The accumulated deferred income tax reserve represents a zero cost of capital to customers since it reduces rate base. This rate base reduction is properly stated in the Company's direct filing to represent full normalization.[29] The Staff's proposed adjustment to partial flow-through is not appropriate and should not be accepted.

**Q. NOT WITHSTANDING YOUR OBJECTIONS TO PARTIAL FLOW-THROUGH ACCOUNTING, IS MR. KERMODE'S ADJUSTMENT SR26 CALCULATED CORRECTLY?**

A. No. This adjustment contains two errors. First, Mr. Kermode is not consistent in treating three specific items for the 2002 portion of his adjustment versus the 2003 portion of his adjustment. Since the test year covers both annual periods, Mr. Kermode uses Schedule M information from each respective period. Three items that he selects from the Schedule M for flow through in 2003 (LTIP-SAR, SERP, 401K) are not selected for flow through in 2002 even though these items are also on the 2002 Schedule M. The calculation in SR26 should reflect the flow through of these three items for both years so the test year is consistent. Exhibit No. NWH-19, Company's Revision to Staff Adjustment SR26 – Partial Normalization, along with the supporting workpapers reflects this correction.

**Q. PLEASE ADDRESS THE SECOND ERROR IN THE CALCULATION OF THE STAFF'S PROPOSED ADJUSTMENT SR26.**

[29] Also, see the response to Staff Data Request No. 236, which addresses the change in the accounting rule WAC 480-120-320.

A. In the calculation on SR26, Mr. Kermode inappropriately removes an item labeled Prior Depreciation Flow Through adjustment from the income tax calculation. In his response to Verizon NW Data Request No. 160, Mr. Kermode states that "The Company's proposed adjustment accounts only for tax-basis differences that are "turning-around". It fails to recognize the effects of all property related tax/book timing differences." The Company agrees with Mr. Kermode that when the originating tax-basis difference is normalized, the related turnaround depreciation should also be normalized. However, the Prior Flow Through adjustment represents turnaround depreciation associated with property related timing differences that were flowed through in prior years. As such, this depreciation needs to be amortized over the lives of the associated assets and flowed through as were the originating timing differences, such as capitalized relief and pension and capitalized sales tax. These amounts will never be recovered if the Prior Flow Through adjustment is removed from the tax calculation as Mr. Kermode proposes.

***<u>B. Embedded Deferred Tax Factor</u>***

*Approximate revenue requirement - $514,000*

**Q. DOES THE STAFF'S CASE INCLUDE ADJUSTMENTS TO ACCUMULATED DEFERRED INCOME TAX OTHER THAN TO REFLECT PARTIAL FLOW-THROUGH ACCOUNTING?**

A. Yes. The Staff proposes several adjustments that impact plant and the associated reserve. In order to compute the corresponding impact on deferred taxes, Mr. Kermode computes an embedded deferred tax rate of 11.4%. Mr. Kermode states that this factor is calculated based on the relationship between total accumulated deferred tax, after adjustment to reflect partial flow-through accounting, and plant in service net of accumulated depreciation.

**Q. DO YOU AGREE THAT THIS APPROACH PRODUCES AN APPROPRIATE RESULT?**

A. Theoretically, the calculation of an embedded deferred tax rate to apply to plant-related adjustments is a sound concept. However, Mr. Kermode's calculation of the 11.4% contains an error. Instead of using net plant as described in his testimony, Mr. Kermode actually uses gross plant in the calculation. The factor using the correct plant data is 18.51%. Exhibit No. NWH-21 Company's Revision to Staff's Embedded Deferred Tax Factor shows the corrected calculation.

***C. SP26 Interest Synchronization***

*Approximate revenue requirement – ($4,477,000)*

**Q. PLEASE SUMMARIZE MR. KERMODE'S PROPOSED PRO FORMA ADJUSTMENT SP26 – INTEREST SYNCHRONIZATION.**

A. Mr. Kermode proposes an adjustment that increases the Company's actual interest expense to a "pro forma" level consistent with the Staff's proposed pro forma rate base and weighted cost of debt. This pro forma interest expense is used in the Staff's tax calculation and has the effect of reducing tax expense. Consumers' witness Mr. Carver also files testimony in support of interest synchronization.

**Q. DOES THE USE OF INTEREST SYNCHRONIZATION ACCURATELY REFLECT ANNUAL INTEREST PAYMENTS?**

A. No. Interest synchronization is a theoretical concept that attempts to match the cost of debt component of the capital structure used in the calculation of the overall rate of return with the interest deduction used to compute income tax expense for ratemaking purposes. The Company disagrees with the concept and methodology of attempting to "estimate" interest expense when those costs are already available and truly represented by the actual expense amount incurred during the test year. The effect of the proposed adjustment is to reflect interest payments the Company never made. This is not appropriate.

**Q. DOESN'T THE COMPANY RECOMMEND CHANGES TO THE BOOKED REVENUE, EXPENSES AND RATE BASE TO DERIVE THE TEST PERIOD AMOUNTS?**

A. Yes. However, in each of these cases, the starting point is the actual books and records of the Company. The Company's adjustments simply restate the books to remove out-of-period items while the pro froma adjustments reflect known and measurable changes. This is in contrast to the use of interest synchronization which derives an estimate with no relationship to the actual booked interest.

**Q. MR. KERMODE INCLUDES CONSTRUCTION WORK IN PROGRESS ("CWIP") IN HIS CALCULATION ON INTEREST SYNCHRONIZATION. PLEASE COMMENT.**

A. As Mr. Kermode notes in his testimony, interest synchronization adjustments are made to synchronize the calculation of interest expense with the rate base. CWIP is ***not*** a component of rate base in this case. It is inappropriate to compute interest on an item that is not included in rate base and on which the Company is not earning a return from ratepayers. Its inclusion defeats the very purpose of why the interest synchronization adjustment is made in the first place.[30]

Additionally, the inclusion of CWIP appears to arise from a desire to flow through the book/tax difference, in this case the difference between Allowance for Funds Used During Construction ("AFUDC") and 263A Interest.[31] However, Mr. Kermode proposes to flow through only non-property related tax timing differences in SR26. The difference between AFUDC and 263A interest is a property related tax timing difference.

**Q. DOES MR. KERMODE'S PROPOSAL TO INCLUDE CWIP IN THE CALCULATION OF INTEREST SYNCHRONIZATION RESULT IN CONSISTENT TREATMENT OF TAX TIMING DIFFERENCES?**

A. No. Mr. Kermode selectively used CWIP in his calculation which results in a reduction to tax expense. As I noted above, the CWIP used above results from the property related tax timing difference between AFUDC and 263A interest. In this instance, Mr. Kermode utilizes the book and tax interest expense. However, in his calculation of interest

[30] Hahne, Accounting for Public Utilities page 7-17, "The interest expense in the computed tax schedule must be synchronized with the rate base (a point of controversy exists as to how this is done) to exclude tax benefits associated with non-rate-base investments (e.g., construction work in progress amounts)."
[31] 263A Interest represents the amount of interest expense incurred by an entity that is associated with the construction of plant for tax purposes.

synchronization, Mr. Kermode chooses to ignore both book and tax interest in favor of a hypothetical interest expense. This selective use of actual data when it serves to decrease the tax expense used in the case is simply not appropriate or consistent.

**Q. WHAT IS THE COMMISSION PRECEDENT RELATED TO THE INCLUSION OF CWIP IN THE CALCULATION OF PRO FORMA INTEREST?**

A. In Docket No. UT-950200, the Staff proposed to include interest on CWIP as part of pro forma interest. The order in that case notes that while previous orders allowed inclusion of CWIP in the calculation of interest to the extent companies were not required to capitalize interest for tax purposes, there was no evidence of such circumstances in UT-950200. As recognized in the order, current tax laws require the capitalization of interest. As such, Verizon NW should be allowed to normalize capitalized interest.

**Q. NOTWITHSTANDING YOUR OBJECTION TO INCLUDING CWIP IN THE INTEREST SYNCHRONIZATION CALCULATION, DO YOU AGREE WITH THE CALCULATION OF INTEREST EXPENSE SHOWN ON DPK-7?**

A. No. There are two additional errors in the calculation.

First, the "intrastate" CWIP amount used by Mr. Kermode is sourced from Staff Exhibit TWZ-21, Page 4, which is on a Total Company Washington basis. Mr. Kermode filed an errata update to this exhibit on January 14, 2005 but he still fails to include the appropriate Washington intrastate CWIP in his calculation.

Second, the weighted average calculation of Section 263A interest of $136,883[32] assumes an amount of zero for the first nine months of 2003. This is inappropriate, both intuitively and in fact. Starting with 2003, all 263A items were reflected as one line item on tax documents.[33] Prior to 2003, Section 263A interest was reflected as a separate item on tax documents.[34] Consequently, while Mr. Kermode appropriately picked up the 2002 Section 263A interest expense for his analysis, he failed to include this item for 2003. Using the actual 2003 263A interest of $461,900 in his calculation would change the weighted average Section 263A interest from $136,883 to $483,308. See Exhibit No. NWH-18 Company's Revision to Staff Adjustment SP26 – Interest Synchronization

**Q. PLEASE SUMMARIZE.**

A. Mr. Kermode's proposed pro forma adjustment for interest expense is not appropriate. However, if the adjustment is accepted, it should be corrected for the appropriate treatment of CWIP and to reflect the correction of the errors discussed above.

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[32] DPK-7, Column c, line 28.
[33] See Workpaper C6.1.1.4 Capitalized Costs Other 263A.
[34] See the response to WUTC Data Request 467b.

## VI. TIMOTHY W. ZAWISLAK

### *A. SR17 and SP22 Line Sharing Revenue Imputation*

*Approximate revenue requirement – ($3,003,000) restatement, ($2,400,000) pro forma*

**Q. PLEASE SUMMARIZE RESTATING ADJUSTMENT SR17 AND PRO FORMA ADJUSTMENT SP22 RELATED TO LINE SHARING AS PROPOSED BY MR. ZAWISLAK.**

A. Mr. Zawislak calculates an increase to the test year revenue by multiplying the $4 line sharing rate times the test year monthly DSL units provided by VZ Northwest. In addition, he calculates an increase to the pro forma test period revenue by multiplying the $4 line sharing rate by September 2004 DSL units provided by VZ Northwest and nonaffiliated entities and annualizes this amount by multiplying the result by 12. These proposed adjustments increase the intrastate operating revenues by $2.9 million and $2.3 million, respectively.

**Q. ARE THESE ADJUSTMENTS CORRECT AND APPROPRIATE?**

A. No. Mr. Fulp addresses the reasons why these adjustments are not necessary or appropriate. I will address the mathematical accuracy of Mr. Zawislak's proposed adjustments. Adjustment SP22 contains two errors that overstate the proposed adjustment.

**Q. PLEASE ADDRESS THE FIRST ERROR.**

A. Mr. Zawislak's pro forma adjustment is presented in two parts; the first labeled Verizon NW DSL Lines and the second labeled Non-Affiliated DSL Lines. In the first part of his adjustment, to calculate a pro forma revenue level for the test period, Mr. Zawislak uses Verizon Northwest DSL units in service as of September 2004. He multiplies these units by the $4 line sharing rate and then annualizes the resulting amount. Using these end-of-period units overstates the pro forma amount and is inconsistent with the remainder of the intrastate revenue pro forma which is presented on an average basis.

**Q. EXPLAIN HOW THIS APPROACH IS INCONSISTENT WITH THE TEST PERIOD REVENUE PRO FORMA.**

A. As stated in my direct testimony,[35] the revenue requirement is based on the twelve-month period ended September 2003. Revenues are presented on an average basis for the twelve-month period. In addition, the monthly test year revenues were analyzed to identify the actual revenue trend. This trend was applied to the test year revenue to develop the pro forma test period revenue.[36] Mr. Zawislak's calculation employs an end-of-period approach which is inconsistent with the remainder of the test period revenues.

**Q. DOES THE STAFF RECOMMEND THAT THE AVERAGE TEST YEAR AND AVERAGE PRO FORMA REVENUES PRESENTED BY THE COMPANY IN**

[35] NWH-1T, page 8.
[36] NWH-1T, page 15 and Workpapers P1, P2, P3 and P4.

**WORKPAPERS P1 THROUGH P4 SHOULD BE PRESENTED ON AN END-OF-PERIOD BASIS?**

A. No. As stated in Ms. Strain's testimony, "Staff proposes no revisions to the Company's restating adjustments to operating revenues,"[37] and "Staff does not contest Company Pro forma Adjustments P1 through P4, P7 and P8."[38] Additionally, as I described earlier in my testimony, the use of end-of-period revenues in lieu of the average monthly revenues would result in a significant reduction to the rate case test period revenues.

**Q. HOW SHOULD THE CALCULATION OF THE PRO FORMA LINE SHARING REVENUES BE CORRECTED?**

A. As detailed in the testimony of Mr. Fulp, this adjustment is not necessary or appropriate. However, any pro forma adjustment to line sharing revenue should be consistent with the remainder of the test period and be presented on an average basis. Exhibit No. NWH-25C Company's Revision to Staff's Adjustment SP22 - Line Sharing Revenue Imputation presents the correction to Mr. Zawislak's calculation.

**Q. PLEASE ADDRESS THE SECOND ERROR IN THE CALCULATION OF MR. ZAWISLAK'S PROPOSED ADJUSTMENT SP22.**

A. This error is in the second portion of Mr. Zawislak's proposed adjustment labeled as Non-Affiliated DSL Lines. It is not clear from Mr. Zawislak's testimony or exhibits why he includes this in his calculation. As Mr. Zawislak points out, the Company is charging

[37] PMS-6TC, page 15
[38] PMS-6TC, page 26

non-affiliated companies for line sharing. However, in his adjustment, he takes what he identifies as non-affiliated line sharing units and associated revenues from September 2003, multiplies the revenues by 12, and includes the result in his proposed pro forma to increase revenue. This adjustment is wrong since the booked test year revenues and associated pro forma test period revenues already include line sharing revenues billed to nonaffiliated customers.

***B. P13 Investor Supplied Working Capital***

*Approximate revenue requirement - $0*

**Q. MR. ZAWISLAK PROPOSES FIVE ADJUSTMENTS TO THE COMPANY'S PRESENTATION OF INVESTOR SUPPLIED WORKING CAPITAL. PLEASE SUMMARIZE THESE ADJUSTMENTS.**

A. Generally, the adjustments Mr. Zawislak proposes are as follows:

* Remove duplicate application of intrastate separation factor
* Reverse the sign on Unamortized Debt Issuance Expense
* Reclassify nonregulated plant
* Include Materials and Supplies account
* Include Investment in Affiliated Companies and Other Investments, Deferred Debits and Credits accounts

**Q. DO YOU HAVE ANY COMMENT ON THESE PROPOSED ADJUSTMENTS?**

A. No. Verizon NW accepts the adjustments to P13 as proposed and has incorporated these changes into the revenue requirement calculation as shown on Exhibit NWH-14.

## VII. MICHAEL L. BROSCH

***A. Test Period Matching***

**Q. MR. BROSCH SPECIFICALLY STATES THAT THE COMPANY'S PROPOSED RATE BASE OF $949 MILLION IS "AT ODDS WITH HISTORICAL TRENDS" AND THAT THE PRO FORMA OPERATING EXPENSES OF $378 MILLION "APPEAR TO BE OVERSTATED". PLEASE COMMENT.**

A. Mr. Brosch uses the Company's Quarterly Compliance Report as filed with the WUTC to compare to the pro forma rate case financials. In doing so, he fails to identify the primary drivers for the difference in rate base and operating expenses. For example, the rate case pro forma operating expenses include a pro forma increase in depreciation expense of $47 million. The primary driver to this is the Company's request for increased depreciation rates in Docket UT-040520. As shown on Exhibit No. NWH-2, operating expenses before depreciation are actually lower in the pro forma case than they were in the actual unadjusted test year. As such, pro forma operating expenses are not overstated as Mr. Brosch claims.

The test year booked intrastate rate base prior to adjustment is $933 million. The increase in the pro forma rate base is driven primarily by two items. First, the deferred income tax balance in the booked test year was overstated. This booked balance has subsequently been corrected and this correction was reflected as a restating adjustment in the rate case. The correction lowers the deferred tax balance and increases the rate base. Second, the rate case pro forma rate base includes a calculation of investor supplied working capital. This item in not included in the rate base in the Quarterly Compliance Report. The Company's calculation of investor supplied working capital, as submitted in the Company's filing, was an increase to rate base. These two items account for the increase in pro forma rate base.

## VIII. GLENN BLACKMON

### ***A. Comparison to Qwest***

**Q. AT PAGE 13 OF HIS TESTIMONY, DR. BLACKMON COMPARES WHAT HE REFERS TO AS THE "INTRASTATE" WASHINGTON EARNINGS OF QWEST (THEN KNOWN AS US WEST) AND VERIZON NW (THEN KNOWN AS GTE NORTHWEST) FOR THE YEAR 1999. PLEASE COMMENT ON THIS COMPARISON.**

A. Dr. Blackmon's attempt to compare Qwest and Verizon NW is inappropriate. To develop this comparison, Dr. Blackmon uses data from the "State" column of the FCC 43-01 reports of Qwest and Verizon NW. As noted in the footnote table to the respective Verizon 43-01 reports, the State column is not "Intrastate" results.[39] For example, the depreciation expense reported in the State column is not based on depreciation rates approved by the WUTC. In addition, the retiree health care costs are reported on a FAS 106 accrual basis, not on a cash basis as required by the WUTC for intrastate reporting.

[39] The 'State' amounts reflected in column (h) through (w) are not developed pursuant to State Public Utility Commission rate-making rules and accordingly should not be used for state rate-making purposes.

These are just two examples that show how the State reporting in the FCC 43-01 is not the same as Intrastate results.

Also, the comparison of revenues (Total Operating Revenues) and earnings (Total Operating Revenues less Total Operating Expenses) for a single period does not encompass operating differences or unique circumstances of each company. For example, 1999 is the year that Qwest merged with US WEST and likely incurred significant merger related costs. In short, the comparison Dr. Blackmon makes between Qwest and Verizon NW using 1999 State data is meaningless and has no relevance to the Verizon Northwest Washington intrastate earnings.

***B. Unregulated Revenue***

**Q. DR. BLACKMON PRESENTS UNREGULATED REVENUE OF THE WIRELINE SEGMENT IN A CHART ON PAGE 5 OF HIS TESTIMONY. HE FURTHER DISCUSSES THIS REVENUE ON PAGE 7. PLEASE COMMENT ON HIS PRESENTATION.**

A. The wireline segment comprises roughly 58% of the operating revenue of Verizon Communications based on Securities and Exchange ("SEC") data presented on the Verizon Communications website. Dr. Blackmon takes this percentage for the wireline segment and divides it between interstate, intrastate and unregulated. He accomplishes this using data filed in the FCC Report 43-01, the Annual ARMIS Summary Report ("43-01"). In using this approach, the data he presents as unregulated is a plug and does not represent true unregulated revenues.

**Q. PLEASE DISCUSS THE ERRORS IN THE PRESENTATION OF THE UNREGULATED REVENUES.**

A. The presentation contains two errors. The first error is that it fails to recognize the SEC revenue data presented on the Verizon website and the operating revenues from the FCC 43-01 report are not comparable without adjusting for uncollectible revenue. The SEC operating revenue is presented gross of reserve for uncollectible revenue. For SEC purposes, the reserve for uncollectible revenue is presented as an expense. However, the operating revenues from the FCC 43-01 are presented net of the reserve for uncollectible revenue. In Dr. Blackmon's presentation, this difference is plugged to Wireline - Unregulated revenue for purposes of calculating the 7% on the chart on Page 5 of GB-1T and the 40 percent shown on page 7 line 12. Exhibit No. NWH-15 line 18 shows how this difference is included in the Wireline – Unregulated data.

**Q. PLEASE DISCUSS THE SECOND ERROR IN THE PRESENTATION OF UNREGULATED REVENUE.**

A. As noted above, the total operating revenue per the FCC 43-01 was used by Dr. Blackmon to split the wireline segment revenues between interstate, intrastate and unregulated. The Total Operating Revenues per the 43-01 are segmented into three columns of data: Nonregulated, Adjustments and Subject to Separations. The Subject to Separations column is further delineated between State and Interstate. For the purpose of calculating the percentages on the chart on page 5 of GB-1T, Dr. Blackmon's workpaper's include a query showing operating revenues for each Verizon entity that files a report 43-01 with the FCC. The sum of the Interstate column and the sum of the

State column from this 43-01 query were applied against total Verizon Communications revenue to derive the applicable Wireline – Interstate and Wireline – Intrastate percentages. However, his schedule then calculates an incorrect unregulated percentage as the sum of the Nonregulated column and the Adjustments column divided by total Verizon Communications revenue.

Per the FCC Report 43-01 – Report Definition,[40] nonregulated activities are recorded in the Nonregulated column. The Adjustments column includes items such as prior period adjustments and adjustments necessary to arrive at the amount subject to separations. The Wireline - Unregulated revenue percentage on the chart on Page 5 of GB-1T and the calculation of the 40 percent shown on page 7 line 12 are impacted by this error. Exhibit No. NWH-15 line 6 shows how the Adjustments column was included in the Wireline – Unregulated data.

**Q. DID YOU PROVIDE A CORRECTED PRESENTATION?**

A. No. Since this data is not used in my revenue requirement presentation, I did not attempt to assemble the data necessary to make a correct presentation. However, if the presentation of this data is relevant to the Staff's presentation, the errors noted should be corrected.

**Q. DR. BLACKMON CONCLUDES HIS DISCUSSION ON UNREGULATED REVENUES BY NOTING THAT VERIZON NORTHWEST'S WASHINGTON**

[40] Approved by Office of Management and Budget, 3060-0512, Edition Date December 2003

**UNREGULATED REVENUES DECREASED BY $32 MILLION WHILE OPERATING EXPENSES ALLOCATED TO UNREGULATED ACTIVITIES HAVE ONLY DECREASED BY $9.5 MILLION. PLEASE COMMENT.**

A. The numbers presented by Dr. Blackmon were calculated using data from the FCC 43-01 reports and are factually correct. However, it should be noted that the nonregulated operating expenses referred to by Dr. Blackmon represent <u>all</u> nonregulated operating expenses, not just those that are the result of an allocation process. As stated in my direct testimony, the Company's accounting procedures are governed by Part 64. Part 64 sets forth the procedures for distinguishing regulated and nonregulated activity and requires direct assignment whenever possible.

**Q. DID THE STAFF WITNESSES IDENTIFY ANY CONCERNS IN THE RECORDING OF VERIZON NW'S WASHINGTON OPERATING EXPENSES BETWEEN REGULATED AND NONREGULATED ACTIVITIES?**

A. No.

**Q. SHOULD THIS COMMISSION BE CONCERNED THAT NONREGULATED REVENUES DECREASED MORE THAN NONREGULATED EXPENSES OVER THE PAST SEVERAL YEARS?**

A. No. If anything, from a regulatory perspective, this means that even though nonregulated services revenues are declining, costs are <u>not</u> being shifted to regulated operations.

***C. Operating Expense***

**Q. DR. BLACKMON COMMENTS ABOUT THE OPERATING EXPENSES OF THE COMPANY SINCE THE TIME OF THE MERGER. ARE HIS COMMENTS VALID?**

A. No. The data used by Dr. Blackmon in his analysis is the State column from the ARMIS 43-01 report. As I explained earlier, this data is not on the same basis as the intrastate results reported to the Commission. As such, the numbers calculated by Dr. Blackmon are not relevant. The Company has already provided an analysis of the changing financial intrastate condition since the merger. This can be found in my direct testimony NWH-1 and in my rebuttal testimony concerning interim relief, NWH-9T, including supporting Exhibit No. NWH-12.

## IX. CONCLUSION

**Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.**

A. The Company has responded to many data requests during the course of this proceeding. Actual test year data has been reviewed in order to confirm the reasonableness of the pro forma test period. Direct testimony submitted by the Staff and Consumers has been reviewed and responded to in rebuttal testimony. Where appropriate, the Company adopts recommendations by the parties and where inappropriate, the Company rebuts the recommendations. In addition, the Company provides corrections to Staff calculations where mathematical or computation errors exist. A summary of the impact of these errors is presented at Exhibit No. NWH-26 Summary of Company's Revision to Staff Calculations.

The Company's additional revenue requirement as revised in September 2004 was $223,364,000. The updated additional revenue requirement depicted in Exhibit No. NWH-14 is $222,216,000. The minor difference resulting from this update confirms the accuracy and reasonableness of the results of operations depicted in the original filing.

**Q. DOES THIS CONCLUDE YOUR WRITTEN REBUTTAL TESTIMONY?**

A. Yes.