0000010513

EXHIBIT

S-7

Admitted

BEFORE THE ARIZONA CORPORATION COMMISSION

U S WEST COMMUNICATIONS, INC.

DOCKET NO. E-1051B-99-105

PREPARED TESTIMONY OF

STEVEN C. CARVER

MICHAEL L. BROSCH

STAFF ACCOUNTING SCHEDULES

On Behalf of the
Arizona Corporation Commission Staff

August, 2000

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Marta T. Hetzer
Administrator/Owner

Suite Three
2627 North Third Street
Phoenix, AZ 85004-1103
(602) 274-9944
FAX: (602) 277-4264

EXPLANATION REGUARDING CONFIDENTIAL EXHIBITS NOT ENCLOSED HERE

HAND DELIVERED

December 6, 2000

TRANSMITTAL OF CONFIDENTIAL EXHIBITS

Ms. Jane L. Rodda
Acting Chief Administrative Law Judge
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, AZ 85007

Re: Qwest / Rates T-01051B-99-0105, etc.

Dear Ms. Rodda:

The following exhibits are enclosed for your safekeeping:

AT&T - 1, 2, 4, 5, 6, and 8;
Cox - 2 and 3;
Qwest - 47;
RUCO - 1, 2, 3, 6, 7, 10, 12 and 20;
Staff - 21 and 22;
WCom - 1, 2, and 3.

These exhibits are subject to the confidentiality agreement and have been omitted from the filing with Docket Control.

If you have any questions, or if we can be of any further assistance, please let us know.

Very truly yours,

Marta T. Hetzer
Administrator/Owner

Enclosures

Copy to: ACC Legal Division
AT&T
Cox
Qwest
RUCO
WorldCom

TABLE OF CONTENTS
PREPARED TESTIMONY OF
MICHAEL L. BROSCH

BEFORE THE
ARIZONA CORPORATION COMMISSION
PREPARED TESTIMONY OF
MICHAEL L. BROSCH

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. By whom are you employed?

A. I am a principal of Utilitech, Inc., a consulting firm engaged primarily in utility rate and regulation work. The firm's business and my responsibilities are related to special services work for utility regulatory clients, including rate case reviews, cost of service analyses, jurisdictional and class cost allocations, financial studies, rate design analyses, and focused investigations related to utility operations and ratemaking issues.

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

A. I am appearing on behalf of the Utilities Division Staff of the Arizona Corporation Commission ("Staff" or "ACC"). Utilitech was retained to review and respond to the Application of US West Communications, Inc., (now Qwest), for a finding of jurisdictional earnings, fair value, fair rate of return and rate schedules. My work was coordinated with the efforts of Steven Carver of Utilitech and with Utilitech's co-consultants, William Dunkel & Associates and Mr. Stephen Hill. I have prepared this testimony and certain Exhibits described herein as a result of such engagement. In general, my testimony addresses revenue issues and adjustments. An executive summary of my testimony appears starting at page 5.

Q. Given the recent merger of U S West, Inc. and its subsidiaries into Qwest Corporation, how will you refer to the Applicant in testimony?

A. Staff's testimony will continue to refer to the Applicant as "U S West" or "USWC", in keeping with the Company's name in the Application and throughout the discovery responses and other materials quoted throughout the testimony.

Q. Will you summarize your educational background and professional experience in the field of utility regulation?

A. I graduated from the University of Missouri, Kansas City, in 1978 with a Bachelor of Business Administration Degree, majoring in accounting. I hold a CPA Certificate in the State of Missouri and in the State of Kansas. I am a member of the American Institute of Certified Public Accountants, the Missouri Society of Certified Public Accountants, and the Kansas Society of Certified Public Accountants. Since completion of formal education, my entire professional career has been dedicated to utility operations and regulation consulting.

From 1978 to 1981, I served as a public utility accountant with the Staff of the Missouri Public Service Commission. While employed by the Missouri Commission, I participated in rate case examinations involving electric, gas, water, steam, transit, and telephone utilities operating in Missouri.

In December, 1981, I accepted employment with Troupe Kehoe Whiteaker & Kent, a Kansas City CPA firm, in its public utility department. While with Troupe Kehoe Whiteaker & Kent, I was involved in the review, analysis, and presentation of a wide range of utility rate case issues and various other utility management advisory functions for both utility company and regulatory agency clients. In May of 1983, I commenced employment with Lubow McKay Stevens and Lewis, an accounting and public utility consulting firm. While with that firm, I was involved in numerous regulatory proceedings and directed the conduct of a variety of special projects.

In June of 1985, Dittmer, Brosch and Associates, Inc. (now Utilitech, Inc.) was organized. The firm specializes in public utility regulatory and management consulting in the electric, gas, telecommunications, water, and waste water industries. As a principal of the firm, I am responsible for the supervision and conduct of the firm's various regulatory projects. A majority of the firm's business involves representation of utility commission staff and consumer advocate agencies in utility rate proceedings and special or focused investigations. I have testified before utility regulatory agencies in Arizona, Arkansas, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, Nevada, New Mexico, Ohio, Oklahoma, Utah, Washington and Wisconsin in regulatory proceedings involving electric, gas, telephone, water, sewer, transit, and steam utilities.

Q. Have you participated in many prior USWC regulatory proceedings?

A. Yes. My firm has represented regulatory agency clients in USWC proceedings in six different states over the past 14 years. With respect to Arizona, I have participated as Staff's consultant in the three most recent general rate cases involving USWC. I served as advisory consultant to the Wyoming PSC Staff in rate case negotiations in that state. In Washington, I assisted the Attorney General's Office in negotiation and subsequent review of USWC's Alternative Form of Regulation (AFOR) plan in 1991, and then as a witness in the Company's two most recent Washington general rate cases. I also testified in a 1999 Washington proceeding involving directory imputation issues on behalf of the Washington Attorney General and other intervenors. In 1997, I served as a revenue requirements and affiliated interest witness in the USWC Utah rate case. I also consulted and submitted testimony regarding the recently consummated Qwest / U S West merger on behalf of clients in Iowa, Utah and Washington. I served as a witness in the pending New Mexico rate case, in support of the Public Regulation Commission Staff's revenue requirement position.

Beyond USWC, I have considerable experience in the rate regulation of other regional Bell telephone companies as well as major independent telephone companies and have addressed the sources of value and imputation issues associated with directory publishing affiliates of such companies on many prior occasions.

Q. What is the purpose of your testimony in this Docket?

A My testimony is responsive to the prefiled direct testimony, supplemental testimony and related exhibits of Company witnesses Mr. George Redding, Ms. Ann Koehler-Christensen and Ms. Nancy Heller Hughes. I sponsor and support a series of accounting adjustments related generally to revenues, affiliate transactions, cash working capital and several special issues raised in the Company's filing. My work and Mr. Carver's work is quantified in a series of accounting adjustments that are included within the Staff's Accounting Schedules that are bound within this volume. The specific adjustment schedules that I sponsor are listed in the index to my testimony and on the cover page of the Accounting Schedules.

Q. What test period was employed in the performance of your work?

A. The basic test period was updated by USWC to the year ended December 31, 1999. In keeping with the test year concept and cutoff explained by Mr. Carver, the data I relied upon and the calculations I performed are generally limited to known and measurable changes as of December 31, 1999 with an exception for the sale of rural exchanges now under consideration by Commission in a separate Docket. Most of the major elements of the test period presentation of Staff are annualized at year-end, to coincide with the use of a December 31, 1999 rate base, to the extent annualization adjustments are feasible and produce representative results. In certain areas where annualization adjustments are not feasible, the average test period amounts are used by Staff and are adjusted to restate for unusual or non-recurring transactions or known and measurable changes in underlying data.

EXECUTIVE SUMMARY

Q. What issues within Staff's revenue requirement presentation are addressed in your testimony?

A. My testimony describes and supports adjustments proposed by Staff in the areas of revenue annualization, service quality program costs, uncollectibles, rent compensation, directory imputation, cash working capital, affiliate transactions, public policy costs, unrecorded plant retirements, fair value and the Company's proposal for treatment of broadband services as well as special ratemaking for reciprocal compensation.

Q. How are the revenue adjustments that you sponsor different from the Company's proposed adjustments?

A. U S West has proposed the indiscriminate annualization of all revenue accounts based upon December 1999 recorded revenues, multiplied by twelve (months) to arrive at test period levels. In essence, the Company proposes a "single-month" test period by the adjustments it has proposed. The revenue annualization adjustments in the Company's case are not sensitive to the different types of revenues contained in the various accounts, so as to recognize that variability in non-recurring revenues in any single month makes USWC's proposed single-month test period distortive of ongoing, normal revenues. The Company's approach produces unreasonable results for non-recurring local revenues, access revenues and miscellaneous revenues.

The Staff's case, in contrast, utilizes an annualization approach that is sensitive to the underlying nature of each type of revenue being adjusted. Only certain specific revenue accounts contain recurring monthly charges that are stable from month to month, so that a single month "times 12" approach can produce reasonable results. For these recurring accounts, Staff's revenue adjustments generally coincide with USWC's calculations. In other accounts, no adjustment is proposed by Staff except to annualize ACC-approved rate changes.

The first four Staff operating income adjustments, Schedules C-1 through C-4, deal with revenue annualization issues.

Q. Please describe the directory imputation difference between Staff and USWC that is addressed in your testimony.

A. Staff has imputed directory revenues based upon the stipulated $43 million level that was previously agreed upon with Staff and approved by the Commission, rejecting the Company's position that imputation should cease. The $43 million directory imputation stipulation was relied upon by the Company in its successful appeal reversing the higher ACC-ordered imputation amount from the last USWC rate case. My testimony explains that imputation should continue in recognition of the many benefits the directory publishing affiliate receives from its relationship with the regulated USWC business – benefits that are not fairly compensated under the non-arm's length Publishing Agreement that exists between the affiliates. I describe and quantify a much higher imputation adjustment could be justified by the financial performance of U S West Dex, which makes the per-stipulation $43 million amount in Staff's filing quite conservative to the benefit of the Company.

The Company's testimony argues that it should now be excused from even the minimal $43 million imputation it had previously agreed upon with the Commission. According to Company testimony, the cost of publishing white pages that is incurred by Dex should now be treated as a "value" reducing the amount of imputation. Another "value" in the form of white pages revenues already recorded on USWC's books is also proposed as a reduction to imputation. Staff rejects these arguments since they completely ignore the large revenue stream realized and retained by Dex from publishing white pages and yellow pages. My testimony explains that the market value of U S West's official directories far exceeds the costs of publishing them, such that Dex, USWC or another publisher could readily publish the directories without charging the telephone company such costs. Even the white pages in isolation produce large revenue streams that serve to offset much of the costs of publishing white pages, revenues that are ignored in the Company's analysis. It must be recognized that any prudent incumbent Bell telephone company would also to realize the large yellow pages profits achievable from the exclusive right to publish the "official" directories. Imputation is required to capture some of this profit opportunity for customers. Schedule C-5 sets forth Staff's imputation amount.

Q. How are costs and foregone revenues associated with the Arizona service quality program treated in the Company's and the Staff's revenue requirement calculations?

A. U S West would include all of the costs it incurs in waived charges, penalties and alternative service arrangements under the Arizona Service Quality Plan Tariff as part of the revenue requirement to be collected from ratepayers. Staff opposes rate case recovery of service quality program costs from the general body of ratepayers as contrary to the intent of the program, a disincentive to management to improve service quality, and fundamentally unfair to ratepayers. These costs represent penalties and remedies for inadequate service performance by the Company. If such costs were simply re-allocated to other customers within rate cases, the incentive to the Company to improve service quality is diminished. Management could tolerate inadequate service and simply file rate cases to be made whole for any foregone revenues or program costs that may result. Staff urges the Commission to adopt a policy of non-recovery of service program costs and penalties. Schedule C-8 adds back the foregone revenues and disallows the costs incurred under USWC's Arizona service quality tariff.

Q. Has the Staff proposed any adjustments for uncollectible revenues?

A. Yes. Uncollectibles are annualized in Staff's filing, based upon recent actual uncollectible experience of the Company, in Schedule C-7.

Q. How is the Company's broadband cable service in Arizona treated within Staff's filing?

A. U S West has organized its broadband cable venture within a separate affiliate company and has proposed the transfer of certain assets from USWC to this affiliate in a separate Docket before the Commission. In addition, this new affiliate entity requires considerable ongoing support services from USWC, which creates large affiliate transactions and yields significant revenues and expense credits to USWC. Staff's Schedule C-6 annualizes the test period affiliate transactions with the new broadband affiliate, while Schedule B-6 reverses the Company's asset transfer adjustment, so as to recognize the suspension of USWC's Application proposing these transactions. It may be necessary to later revise these adjustments to reflect Staff's position in the specific Docket established to address broadband issues.

Q. Another revenue element is rent compensation recorded on USWC's books for shared assets among the state jurisdictions. How has Staff treated these revenues?

A. Rent compensation calculations are restated in Staff Schedule C-28, based upon the overall rate of return being proposed by Staff witness Hill. The result of this adjustment is that ratepayers pay the same uniform rate of return on investment used to serve them, even if such investment resides in other USWC state jurisdictions.

Q. What other affiliate adjustments are included in Staff's revenue requirement presentation?

A. Schedule C-9 includes a series of true-up adjustments to the affiliate billings applicable to the test period. This adjustment is required to remove out-of-period bookings related to affiliate transactions. Another adjustments is proposed at Schedule C-20 to partially disallow certain departmental costs from the U S West, Inc. parent entity that are not properly charged to ratepayers. These costs include excessive senior executive management costs, corporate development, strategic planning, legislative, public relations and cash management costs that are of no direct tangible benefit to ratepayers. This adjustment is similar to the disallowance of such costs ordered by the Commission in the Company's last Arizona rate case.

Q. Does Staff also propose partial disallowance of legislative and public relations costs incurred directly by USWC?

A. Yes. In Schedule C-19, Staff has recognized that only 8 percent of the costs of USWC's Public Policy organization are classified below-the-line as lobbying or charitable activity on the books. Staff has increased this below-the-line allocation to 50 percent, in accordance with the Commission's order in the last Arizona rate case.

Q. Are any changes in the jurisdictional allocation of costs addressed in your testimony?

A. Yes. I propose a small adjustment at Schedule C-21 to allocate a portion of employee telephone service concessions to the interstate jurisdiction, so as to recognize that Company employees work for the benefit of both interstate and intrastate customers and the cost of these benefits should be equitably allocated across jurisdictions, in the same manner wages are allocated.

Q. How is reciprocal compensation treated in your testimony?

A. In Schedule C-30, reciprocal compensation is adjusted to appropriate test period levels by reversing the Company's adjustment that reaches into the year 2000 to include higher net reciprocal compensation costs. My testimony also explains the many reasons why Mr. Redding's proposed automatic rate adjustment for reciprocal compensation should be rejected by the Commission.

Q. Have you proposed any revisions to the detailed calculations and allocations of costs to the Arizona exchanges being sold by USWC to Citizens?

A. Yes. In Schedule C-29 I propose changes to the Company's proposed expense allocations to such exchanges, to include reasonable allocations of marketing and corporate operations expenses to such exchanges being sold.

Q. Do you propose any adjustments to plant in service or depreciation expenses in your testimony?

A. Yes. I explain the serious issues raised by FCC auditors with regard to the Company's plant asset accounting procedures and also describe certain apparent deficiencies in such accounting on Arizona books. In Schedule B-1 certain plant asset balances that appear to be obsolete and reflective of unrecorded retirements are removed from rate base, while the corresponding depreciation expense effects of such unrecorded retirements are quantified at Schedule C-22.

Q. Are you responsible for Staff's calculation of cash working capital in rate base?

A. Yes. Schedule B-4 represents the test period lead lag study of cash working capital that has been prepared by Staff. It includes several revisions to lag day values associated with the payment of employee compensation and benefits, interest expense, payroll taxes and miscellaneous cash vouchers. In addition, Schedule B-4 recalculates cash working capital based upon Staff's revised test period revenue and expense amounts.

Q. Does this conclude your executive summary?

A. Yes. However, I would note that Mr. Carver's testimony describes how the Staff's adjustments sponsored by me and other witnesses are combined to derive the overall revenue requirement for the 1999 test period.

REVENUE ADJUSTMENTS

Q. How has USWC quantified its annual test period intrastate revenue amounts in this Docket?

A. USWC has annualized all revenue accounts as of December 31, 1999, using a procedure in which all revenue amounts in each sub-account recorded in December 1999 are simply multiplied by a factor of twelve to determine the annualized amount. Where individual revenue accounts or groups of accounts were thought to not contain representative recorded amounts in December, the Company made limited "normalizing" adjustments to produce more representative results. This "December times twelve" methodology was applied by USWC to local service, intrastate toll, intrastate access and miscellaneous revenue accounts. The result of the Company's approach is to adopt a one-month test period for revenue measurement purposes.

Q. Does Staff agree that, as a matter of general principle, revenues should be annualized at year-end levels?

A. Yes. In instances where it is feasible to quantify a reasonable year-end annualization adjustment that is representative of ongoing conditions, such adjustments should be made. This is in keeping with the use of a year-end rate base valuation and is consistent with annualization of other revenue requirement determinants such as payroll and depreciation expense. However, the indiscriminate multiplication of December 1999 recorded revenues times 12 does not always produce reasonable results. Staff has more carefully applied annualization methodologies that fit the factual circumstances and any observable trends in each type of revenue earned by the Company.

In general, Staff has annualized the revenue accounts that are exhibiting meaningful trends and for which reliable adjustments can be calculated. In certain instances, the observable trends and relative stability in specific revenue sub-accounts caused Staff to concur with USWC's proposed December 1999 times 12 calculation. In other instances, variability in monthly recorded revenues or the absence of meaningful trends in the data suggested either no annualization or an alternative calculation approach.

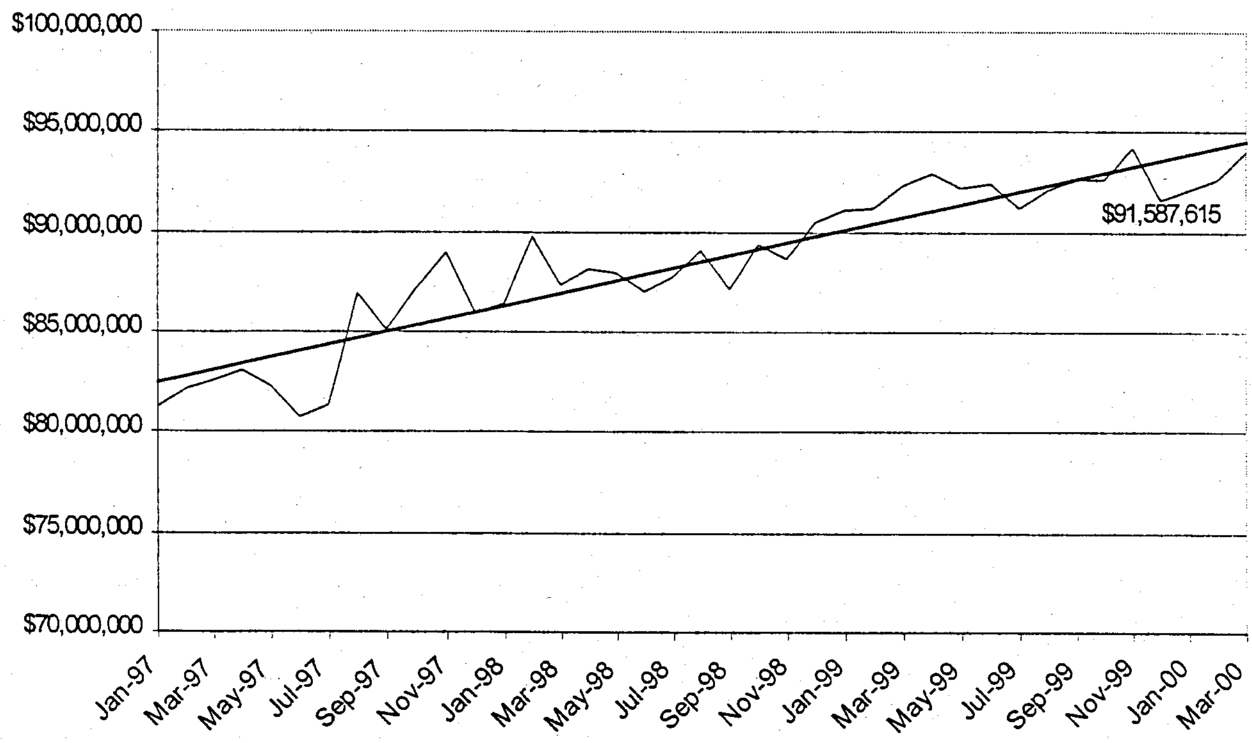
Q. Are certain types of revenues amenable to the Company's proposed "one month times twelve" methodology for annualization?

A. Yes. Revenues that are earned through a recurring monthly flat-rate charge can be reasonably quantified by looking at a single normalized month of recorded results and multiplying by twelve. Examples of such revenues include basic recurring charges for 1FR and 1FB services, recurring charges for custom-calling features, and recurring charges for centrex and local private line services. Unlike message revenues or non-recurring charges for installation of services that can vary considerably from month to month, the recurring charges for basic local and other services do not vary due to seasonal influences, the number of days in the month or other potentially distortive influences. When a customer purchases basic local exchange service that is priced on a recurring monthly flat rate basis, the monthly recurring revenues in any particular month are predictive of the revenues to be charged that customer on an ongoing basis. On the other hand, when certain customers make toll calls or incur installation charges, the amounts that are earned by USWC in a particular month do not reliably quantify ongoing annual revenue levels by simply multiplying that month's revenues by twelve.

Q. Can you illustrate the difference in variability of monthly revenue amounts using actual test period data?

A. Yes. I have prepared a graph to illustrate the problems associated with assuming that a December 1999 times twelve approach will always produce reasonable results. The Company's revenue annualization adjustment includes recurring, non-recurring, local message, toll, access and all other types of revenues for adjustment purposes. The recorded monthly local, toll and access revenue accounts subject to this process are set forth in the following graph containing amounts from January 1997 through April 2000. A linear trend line has been superimposed on the data, to illustrate the overall trend in recorded intrastate local, toll and access revenues within the revenue accounts subjected to the Company's adjustment methodology.

Monthly Intrastate Local, Toll & Access Revenues



What is obvious from this overall view of the unadjusted, per-books revenue data is that the Company's selection of December 1999 as the starting point for the annualization is unlikely to yield reasonable results because the December 1999 data point of $91.6 million is significantly below the trend line for the entire period. Even with the several attempts made by USWC to normalize the December values prior to multiplying by twelve, the Company's results are unreliable and inconsistent with observable revenue trends. It should also be noted that the trend line shown above tends to understate revenue volume growth, because of the large price reductions implemented in October 1999 (upon termination of the directory surcharge) that reduce subsequent months' recorded revenues and the slope of the trend line.

Q. Why is it significant that the December 1999 data that was relied upon by USWC for revenue annualization is below the trend line?

A. Any abnormality or seasonality in the December 1999 recorded data is amplified under the Company's approach, which multiplies the reported data, less any known accounting adjustments, times 12 (months) to annualize. There is significant month-to-month fluctuation in the overall revenue data, particularly in the revenue accounts that do not contain recurring monthly charge-type revenues. The fundamental reason why the Company's approach cannot produce reasonable results is that December 1999 data is most representative for only the normal and recurring-charge types of revenue, not the accounts containing non-recurring charges, message charges or other variable billing determinants.

<u>Local Service Revenues</u>

Q. Are local service revenues one of the revenue categories of test period revenues that the Company has annualized using a December times 12 approach?

A. Yes.

Q. What are some examples of Local Service revenue accounts included in the Company's annualization adjustment that should <u>not</u> be annualized based upon a "one month times twelve" approach?

A. The non-recurring charges associated with service installations and rearrangements are driven by fluctuating levels of inward and outward movement of customers. Thus, these revenues are variable from month to month and cannot be reliably annualized using a single month "times

12" methodology. To illustrate how the impact of variability in the non-recurring revenue accounts, I have prepared the following table showing the results of the Company's methodology if the test year in this Docket were to end only one or two months earlier than the December 1999 month that was used by USWC to annualize these revenues:

Alternative Calculation Months	Oct-99	Nov-99	Dec-99
Non-recurring Local Service Revenues	5,475,249	5,909,094	4,450,692
Times 12 to Annualize	65,702,989	70,909,131	53,408,299
Difference by Month versus December x12	**12,294,691**	**17,500,833**	**used by USW**

Moving the test period and the Company's annualization of non-recurring local revenues only one or two months would cause the resulting adjustment to increase by $12.3 million to $17.5 million simply due to typical month to month variability in the data. I do not recommend using any of these alternative months, but merely make this comparison to illustrate the severity of distortion that can be created by assuming any particular month's recorded non-recurring or message revenues are representative enough to be multiplied by 12 to annualize.

Q. Is the variability in non-recurring local service revenues isolated to only the October, November and December 1999 figures you have compared in the previous table?

A. No. During the test period, total non-recurring revenues experienced month-over-month increases and decreases of up to positive 20 percent to negative 25 percent, respectively. Individual non-recurring revenue accounts within this broad category of revenue experienced even more dramatic monthly fluctuation. It is simply not appropriate to attempt to annualize these non-recurring revenues based upon a single month's data.

Q. How does the Company's inclusion of non-recurring local service December 1999 recorded revenues in its annualization methodology impact its asserted revenue requirement?

A. By including non-recurring local service revenues, based upon December 1999 times 12, the Company has adjusted revenues downward by $5.0 million. This adjustment amount directly increases USWC's asserted intrastate revenue requirement.

Q. Did the Commission address the issue of annualizing non-recurring local service revenues in the last USWC rate case in Arizona?

A. Yes. At page 16 of Decision No. 58927, the Commission stated:

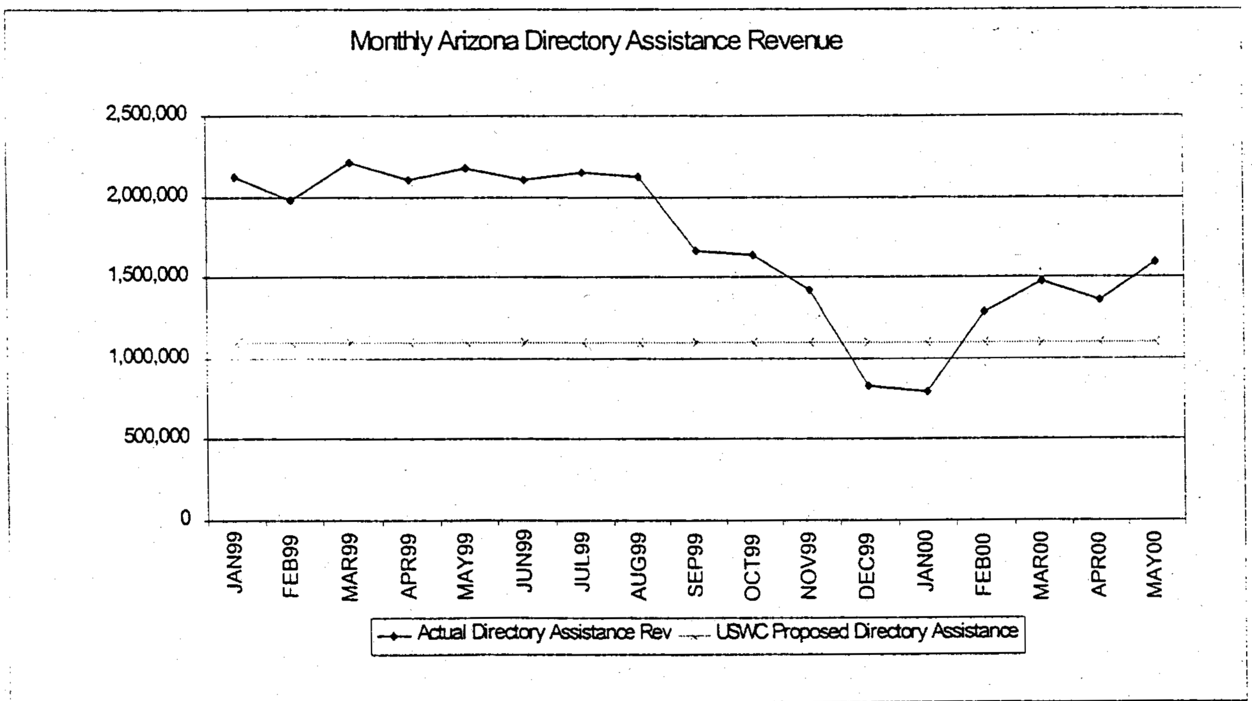
> The Company annualized TY non-recurring local service revenues by multiplying first quarter 1993 levels by four. With respect to residential and business non-recurring revenues, Staff recommended utilizing the actual TY amounts. Staff did not recommend any adjustment to the TY amounts because of the variability in amounts from month to month. Accordingly, Staff proposed eliminating the Company's pro forma adjustment of ($749,000).
>
> The Company did not dispute that these non-recurring revenues were variable from month to month. Accordingly, we find Staff's recommendation to be reasonable and approve the $749,000 adjustment.

Q. What is proposed by Staff with respect to annualization of local service revenues in this Docket?

A. As noted above, Staff proposes a local service revenue annualization approach that is sensitive to the nature of the underlying data. Specifically, certain recurring monthly revenue accounts have been annualized by Staff using USWC's proposed December 1999 times 12 approach, after correcting for abnormal transactions in the data. However, for other non-recurring and message revenue accounts, no adjustment is proposed by Staff because there is no obvious increasing or declining trend in the volumes or revenues being experienced by the Company. Schedule C-1 has been prepared to calculate Staff's proposed annualization of local service revenues, including the local service revenue accounts where a single month's data can be relied upon. Staff's annualization result is compared at line 21 to the Company's proposed local service revenue annualization, to yield the net adjustment proposed by Staff to the Company's prefiled case.

Q. You described the problems with USWC's one-month-times-twelve adjustment methodology with reference to non-recurring charges to customers. Is there a specific type of local revenue where the Company's methodology produces unreasonably large downward reductions in revenues?

A. Yes. The Company's methodology results in a downward adjustment of about $9.4 million in Arizona Directory Assistance ("DA") revenues. While it is true that certain DA rate reductions were implemented during the test period that have been annualized in Staff's adjustment at line 17, the Company's adjustment for DA is excessive. The fundamental problem is that these revenues fluctuate monthly, such that selection of a specific month to multiply by twelve cannot be expected to yield reasonable results that are consistent with revenue trends, as shown in this DA revenue graph:



Q. How does the Staff's Local Service revenue annualization adjustment treat the Directory Assistance revenues depicted in this graph?

A. Staff's proposed adjustment fully accounts for the DA rate reductions that were made effective in October 1999 at line 17 of Schedule C-1, but leaves the DA service volumes stated at test period average (rather than USWC's December-times-12) levels. The result is an adjusted DA revenue amount in Staff's case of about $1.5 million per month.

Q. What are the amounts appearing in the "Adjustment to Normalize Recorded Amount" column D of Schedule C-1?

A. The recorded December 1999 revenues in certain revenue sub-accounts contained unusual accounting accruals or adjustments that must be removed or "normalized" to remove such effects . By removing the abnormal transactions, the local service revenues are annualized in Staff's case exclusive of these aberrations. The adjustments Staff has made for these accounts coincide with the Company's own normalizing adjustments.

Q. You have described certain local service revenue accounts where you have agreed with the Company's proposed annualization approach and other accounts where you disagree with USWC's adjustment. For those accounts that Staff has not annualized, are there other adjustments required?

A. Yes. Certain rate changes occurred during the test period that must be considered, if they occurred in accounts that are not being annualized by Staff. These rate changes were quantified in the Company's responses to Staff Data Requests UTI 43-20 (Attachment B) and in UTI 44-04 (Attachments A and F). The adjustment required to annualize these rate changes that were recorded in accounts not otherwise annualized by Staff are set forth Lines 16 through 20 of Schedule C-1.

Toll Revenues

Q. Has Staff made any adjustment to the Company's proposed annualized level of intrastate toll revenues?

A. Yes. Staff agrees with USWC that intrastate toll revenues should be annualized, however the USWC proposal to annualize based upon December 1999 results multiplied by twelve contains a data input error. Due to the competitive losses and persistent declining revenue trend being experienced by USWC in the Arizona intrastate toll market, Staff believes that toll revenues should be annualized at year-end based upon either a fourth quarter times four approach or a linear regression analysis, so as to smooth and normalize for fluctuations in volumes and revenues in particular months, while still capturing year end levels of toll calling activity. As noted above, a single month's data should not be relied upon to annualize revenues that are not recurring monthly charges. However, it just so happens that the recorded December 1999 state toll revenues of USWC coincides very closely with a linear regression of such revenues that was used by the Company as a test of its December times 12 methodology (UTI 47-18A). Therefore, Staff has accepted the Company's methodology because in this instance it yields a reasonable result irrespective of the inherent unreliability of the methodology. However, even using the same adjustment approach as the Company, an input error in USWC's December data that is corrected in Schedule C- 2 causes Staff's adjustments to produce revenues approximately $360,000 more toll revenues than are proposed by USWC.

Q. Did the Commission include any annualization of intrastate toll revenues in the last rate case, Docket E-1051-93-183?

A. No. In that Docket, USWC proposed adjusting toll revenues based upon the recorded revenues in the last quarter of the test period, times four to annualize. In that Docket, the Commission stated:

> According to Staff's analysis, toll revenues are volatile from month to month. Further, Staff determined that two of the three months in which

> the Company experienced its lowest level of revenues during the TY occurred in the first quarter of 1993. The company's methodology resulted in its annualization being based upon two of the three months that contain the lowest level of toll revenues experienced throughout the TY. For that reason, Staff concluded the Company's proposed adjustment was not proper and recommended it be disallowed. The Company did not dispute these non-recurring revenues were variable from month to month. Accordingly, we find Staff's recommendation to be reasonable and will deny the Company's ($3,132,000) adjustment.

As in the last case, there continues to be variability in toll revenues from month to month. However, the current test period data, unlike the prior rate case data, reflects a declining trend in toll revenues that should not be ignored in determining the Company's revenue requirement, particularly since the Commission has approved 1+ intraLATA toll competition in Arizona. Since the December data is consistent with such trend and is representative in amount, Staff supports toll revenue annualization in this Docket using the Company's methodology with corrected data.

Q. How have USWC's intrastate toll revenues changed over the past three years?

A. Intrastate toll revenues have declined significantly. According to the Company's response to UTI 31-09, USWC has experienced consistent declines in market share and overall intrastate toll usage revenues since January 1996. While the details of this data response are confidential, it appears that implementation of 1+ competition for intraLATA toll in May 1996 contributed considerably to these declines. Approval of the toll revenue annualization advocated by Staff (and USWC) will recognize the impact of the Company's competitive toll losses in a balanced manner at test year-end.

Access Revenues

Q. Did USWC propose any annualization adjustment for intrastate access revenues?

A. Yes. As with local and toll revenues, the Company proposes annualization of access revenues by multiplying December 1999 revenue values times twelve. The result of this analysis is an adjustment increasing test year access revenues by approximately $2 million.

Q. What is Staff's response to the Company's proposed access revenue annualization?

A. The analysis of monthly fluctuation in intrastate access revenues that was prepared by Staff does not indicate any significant trend in such revenues, but does reveal moderate monthly fluctuation. Month to month increases and decreases were as large as positive 8.7 percent to negative 7.6 percent during the test period. The selection of a particular month for multiplication times 12 under the Company's approach is unlikely to produce a result more reasonable than unadjusted test period revenues. Therefore, Staff has reversed the Company's proposed adjustment, restating the test period without annualization of access revenues. Staff's rejection of the Company's adjustment has the effect of increasing the Company' asserted revenue requirement by about $1.8 million.

Q. Were intrastate access revenues annualized in the Company's prior Arizona rate case?

A. USWC proposed an annualization of intrastate access revenues in Docket No. E-1051-93-183 based upon a calendar quarter times four methodology, but the Commission rejected the adjustment. In Decision No. 58927 at page 17 the issue was resolved:

> Access revenues include all state tariffed charges assessed by local exchange carriers for access to the local exchange network for intrastate telecommunications. The Company annualized TY revenues by multiplying first quarter 1993 levels by four and proposed an upward adjustment to revenues in the amount of $1,399,000.
>
> Staff analyzed intrastate access revenues over time and was unable to determine any trend that would indicate such revenues were increasing.

> As a result, Staff recommended reversing the Company's upward adjustment to TY revenues.
>
> The Company did not dispute Staff's allegation that there was no trend indicating intrastate access revenues were increasing. Accordingly, we find Staff's recommendation to be reasonable and will deny the company's $1,399,000 adjustment.

Miscellaneous Revenues

Q. What is the final category of revenues for which the Company has proposed ratemaking adjustments?

A. Miscellaneous revenues are earned by USWC in several categories, including sales of directory listings, rental income, billing & collection charges, late payment charges and certain affiliate service transactions. Near the end of the test period, large miscellaneous revenue transactions also commenced with the new U S West Broadband Services, Inc. ("USWBSI") affiliate involving network and administrative services being purchased from USWC pursuant to new affiliate contracts. Staff's analysis of miscellaneous revenues considers these new affiliate transactions, as well as reciprocal compensation and rent compensation, separately from the other miscellaneous revenues.

Q. Does Staff propose annualization of all miscellaneous revenues at test period end?

A. No. The Company's sweeping annualization of all miscellaneous revenues using a December times 12 methodology is not supported by Staff. Instead, Staff has separately analyzed and adjusted individual components of miscellaneous revenues, such as rent compensation, reciprocal compensation and the aforementioned USWBSI revenues. Staff's analysis of the remaining miscellaneous revenues indicates considerable variability from month to month and no obvious trend or reliable annualization approach. Therefore, Staff has reversed the Company's inappropriate annualization of test period miscellaneous revenues based upon December times 12. Schedule C-4 sets forth the detailed calculation of this reversal.

SERVICE QUALITY PENALTIES

Q. What is the purpose of Staff's adjustment at Schedule C-8 ?

A. USWC experienced service quality deficiencies in the test period that caused the Company to incur certain costs and foregone revenues under the ACC-approved Service Quality Plan Tariff. The Company has proposed that its penalties, expenses and foregone revenues under the service quality plan/tariff should simply become part of its jurisdictional revenue requirement, to be recovered from the general body of ratepayers. Staff rejects this proposal and proposes a ratemaking adjustment that will impose such costs on shareholders, rather than other ratepayers.

Q. How does the Company explain its position with respect to the service quality program/tariff costs and foregone revenues?

A. In response to Staff data request UTI 4-17, USWC stated:

> It is U S WEST's policy to book bill credits, payments to commissions under service quality plans and the costs of vouchers to operating expense as a normal cost of doing business, especially where U S WEST is the provider of last resort (POLR). Nonregulated companies often pay for missed service committments [sic] as part of their customer service initiatives. No company, especially when they are required to provide service to any customer in their service area, can expect their service to be perfect. It does not make sense to penalize a company for the cost of alternatives in the attempt to provide adequate customer service.

In its response to RUCO data request 12-04, the Company stated,

> Neither the FCC or the ACC has provided specific accounting guidance concerning payments for service quality. Absent specific direction, the Company has determined that payments to states or other institutions for service quality issues are a normal operating expense of the company and should be booked to account 6728.99. U S WEST is the provider of last resort (POLR) and considered this as a normal cost of doing business.

From these responses, it is apparent that "specific accounting guidance" with respect to the ACC service quality plan/tariff is required from the Commission in this Docket. As noted above, Staff's position on this matter is that U S West shareholders, rather than ratepayers, should bear the costs associated with the ACC service quality plan/tariff.

Q. Do you agree with the Company's characterization that the Arizona service quality plan/tariff requires the Company to provide "perfect" service?

A. No. A review of the specific provisions of the plan indicate that reasonable intervals are provided within which the Company can provision new services or repair existing services. In its response to Staff data request UTI 30-05, the Company retreated from this "perfect service" characterization stating, "The remark simply says that 'no company can expect its service to be perfect' - without comment as to whether the Arizona Service Quality plan requires 'perfect' as opposed to 'good' service."

Q. What are the test period costs that are involved in this issue?

A. While the Company has designated the specific amounts confidential, the service quality costs in the test period include Held Order Credits, Out Of Service adjustments, Cellular Vouchers, Remote Call Forwarding Credits, Penalties and Missed Installation Appointment credits (UTI42-11). In total, approximately [redacted] in total costs and foregone revenues were incurred in the test period across these categories.

Q. Please explain the calculations at lines 4 and 5 of Schedule C-8 in your adjustment.

A. Some of the service quality penalties and foregone revenues may be associated with the exchanges being sold to Citizens Communications that are addressed in a different Company-proposed ratemaking adjustment. In its response to Data Request UTI 50-02, USWC stated that it does not keep records of service program costs at an exchange level of detail. Therefore, it is necessary to estimate the expense portion of service quality costs that should be attributed to exchanges being sold.

Q. For what reasons does Staff believe that the costs and foregone revenues associated with the ACC service quality plan/tariff ("plan costs") should be classified below-the-line and borne by shareholders rather than ratepayers?

A. Fundamentally, it must be recognized that service quality plan costs represent penalties for inadequate service performance by the Company. If such costs were simply re-allocated to other customers within rate cases, the penalty incentive to the Company to improve service quality is eliminated. Management could elect to tolerate inadequate service and simply file rate cases to be made whole for any plan cost penalties that may result.

Beyond the incentive consideration, it is fundamentally unfair to the general body of ratepayers to be made responsible for the Company's failure to provide adequate service to specific customers. There has been no showing by the Company that ratepayers in general have received any cost savings or other benefits in relation to service quality problems encountered by certain customers. While USWC may argue that treating plan costs as simply another cost of doing business leads to efficient decisions by management, the obvious outcome of such a policy is the need for ever larger penalties to encourage good service quality. My review of the Commission's decisions implementing the service quality plan and tariff does not reveal any findings by the ACC that customer credits and penalties were designed to be large enough to outweigh the incremental staffing or new network investment costs faced by USWC in improving service. Ultimately, the Commission must determine what policy it intended upon implementation of the service quality plan and tariff. My recommendation is that, absent compelling arguments to the contrary, regulators should find that penalties paid by regulated utilities to governmental agencies or aggrieved customers should not simply be recovered from other ratepayers.

Q. Do the Commission's prior Decisions with regard to service quality provide any insight into the basis for the existing service quality plan/tariff?

A. Yes. The service quality plan/tariff has its origin in the last rate case, Docket No. E-1051-93-183. In Decision No. 58927 in that case, the Commission indicated that it had considered arguments regarding fairness, competition and the information superhighway and found them to be related to the service quality issue – stating, "We find it is only fair that the Company accept the responsibility for some mis-judgements. We also believe that if the Company is serious about its arguments regarding the pervasiveness of competition, then it must improve on its quality of basic telephone service or its alleged competitors will leave the company in the dust." (page 122). The same Decision concludes the need for the plan/tariff, stating:

> Based on all the above, we agree with Staff and RUCO that the Company needs to implement a plan that will improve its quality of service. The number of "held orders", the poor record of customer complaints, as well as the comments from the public at the public meetings, indicate that the Company has below-acceptable level of quality of service. As indicated hereinabove, it is clear that the Company is stressing the importance of competitive or soon-to-be competitive services over the monopoly residential markets, and this causes us additional concerns related to quality of service. In the competitive market, there is a built-in incentive to provide excellent service to customers. In the residential monopoly market, there is no such incentive, so therefore, the Commission through regulation must mandate a comparable level of quality of service. (Page 123)

Staff and RUCO were directed by the Commission to "work together to devise an acceptable program" in this Decision. A plan/tariff was developed and considered by the Commission, with implementation through Decision No. 59147 on July 14, 1995. Upon Application for Rehearing, the Commission revised the plan/tariff in Decision No. 59421 dated December 20, 1995.

Q. Have USWC service quality problems been observed by several other state commissions having jurisdiction over the Company?

A. Yes. I am aware of serious service quality concerns in other USWC jurisdictions from my work and research for other clients. With this experience in mind, I inquired of the Company regarding what other state regulators have imposed a service quality plan, what the elements of the plans include and whether or not costs and foregone revenues are includable in revenue requirements, as proposed by the Company in this Docket. The Company "responded" with an objection that this request, "is not reasonably calculated to lead to the discovery of admissible evidence and is unduly burdensome." However, I can state from my experience that the Company has been required to provide alternative service remedies for held orders and other service assurance measures in several other states as a result of its deficient service levels.

Q. Do these other states allow recovery of service quality program costs in setting the Company's rates?

A. Most of the other states have some form of alternative regulation in place. However, the issue of rate case recovery of service quality program costs has been addressed by the Iowa Public Utilities Board in its Rules which require such costs not be included in rates[1] and by the New Mexico Commission in its 1992 USWC rate order that denied rate recovery of such costs.[2]

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1 Iowa Administrative Code 199–22.6(2)(e).

2 New Mexico State Corporation Commission Order dated February 1, 1996 in Docket No. 94-192-TC, pages 40-41.

DIRECTORY IMPUTATION

Q. What is directory imputation and why is it necessary?

A. Directory imputation is the ratemaking process of recognizing that white and yellow pages advertising revenues exist in connection with providing telephone service and should be accounted for as a reduction to USWC's revenue requirements, even though the Company has acted to transfer this lucrative segment of its business to a separate subsidiary so as to keep the directory revenues and profits for shareholders. Imputation puts back what the parent company of USWC has consistently tried to remove by corporate reorganization and a series of imprudent and one-sided directory publishing agreements that have existed between U S West, Inc. affiliates since 1984. The directory publishing affiliate has been named U S West Direct ("USWD"), U S West Dex ("DEX") and new Qwest Dex since the last rate case, and I will refer to this entity as USWD/DEX throughout this section of testimony.

Q. What is the position taken by USWC with respect to directory revenue imputation?

A. In the testimony of Ms. Ann Koehler-Christensen, the Company argues that no imputation of directory revenues should occur in this rate case. According to page 2 of her testimony, "the current booked fees and the value of services U S WEST receives from DEX are already reflected in the financial filings included in this rate case. Consequently, there is no need for any further adjustment to U S WEST's revenue requirement to reflect additional directory imputation." Her testimony also attempts to rationalize the complete elimination in 1989 of the publishing fees that were previously paid by USWD/DEX, claiming that such elimination still does not justify any imputation of yellow pages revenues for the benefit of telephone ratepayers.

Q. What are the amounts that are relied upon by Ms. Koehler-Christensen to conclude that imputation is no longer appropriate?

A. According to Ms. Koehler-Christensen at page 4, "The cost of publishing the White Pages and of delivering the White and Yellow Pages to U S WEST customers between [sic] in 1999 was approximately $12.8 million." Her theory is that USWC, "would have incurred an additional $12.8 million" in test period Arizona expenses in order to meet its "obligation" to publish white pages and deliver both white and yellow pages in Arizona, if not for the provision of this publishing and distribution function by USWD at no charge to USWC.

The other element of fees and value Ms. Koehler-Christensen mentions is addressed at page 8 of her testimony, where she observes that "The total Account 5230, Directory Revenue, included in this test year is $18,652,343", implying that this amount should also be considered as part of the value that should be considered in denying further imputation. However, Ms. Koehler-Christensen also notes at page 9 that only $855,753 of this revenue amount is actually paid by USWD to USWC.

Q. Does Staff agree with the Company's analysis and conclusions regarding imputation?

A. No. As an absolute minimum, the $43 million imputation amount that the Company agreed to reflect in subsequent rate cases[3] should be included in this rate case, with downward adjustment only for actual "fees received by Mountain Bell from USWD" that were recorded in the test period. As my testimony will demonstrate, a much larger imputation adjustment would actually be required to fully and equitably reflect the "fees and value of services received by Mountain Bell from USWD under publishing agreements with USWD". However, this much larger adjustment is not included in Staff's revenue requirement calculation, but is instead used to indicate the extreme conservatism associated with imputation of only $43 million.

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[3] Stipulation dated May 27, 1988 in Docket No. E1051-86-252, approved in ACC Decision No. 56020.

Q. Please describe the adjustment proposed by Staff with respect to directory imputation issue.

A. At Schedule C-5, an imputation amount is reflected to increase test period revenues at the stipulated $43 million amount from the 1988 Settlement Agreement, reduced by the $1.66 million in actual fees and expense credits received from USWD/DEX in the test period.

Background Information

Q. Was yellow pages imputation ordered by the Commission in the Company's prior rate case in Arizona?

A. Yes. In Decision No. 58927, the Commission ordered imputation in the annual amount of $60.3 million, above and beyond the fees actually paid to USWC by USWD and any other "value" provided to USWC. I sponsored the Commission's imputation adjustment in the last rate case, which adjustment was based upon the actual profitability of USWD/DEX in Arizona at that time. This imputation amount was ultimately reduced upon appeal and remand to the ACC, limiting the amount of imputation to a $43 million annual amount previously agreed upon in a Settlement Agreement between the Company and the Staff.

Q. What was the origin of the $43 million amount found reasonable by the Court of Appeals of Arizona?

A. In Decision No. 56020 dated June 13, 1988, the Commission approved a Settlement Agreement in which a negotiated directory benefit of $43 million was to be included as yellow pages compensation. I have attached as Appendix MLB-1 a complete copy of the Settlement Agreement and related Commission Order. This negotiated $43 million imputation amount was not to be reduced for the costs incurred by USWD/DEX in publishing and distributing books and was in addition to white pages revenues earned and retained by USWC on its books.

Q. Has USWC, after appealing the larger imputation amount Ordered by the Commission in the prior rate case and convincing the Court to enforce the stipulated imputation amount, now honored the Settlement Agreement to impute $43 million per year?

A. No. Instead, Ms. Koehler-Christensen now suggests that the Commission cease any revenue imputation and consider as part of the "value" received by USWC an estimate of the costs (but not the revenues) that USWC might experience if it were to publish and distribute its own directories in Arizona. When the avoided cost of publishing directories is combined with USWC's own white pages premium listing revenues and actual listing fee revenues in the test period, Ms. Koehler-Christensen seems to conclude that USWC is now receiving the full value in fees and services provided and no further imputation is required. However, this analysis is factually and conceptually flawed, as will be explained in this testimony.

Q. Please recapitulate the historical facts that created the need to impute revenues to USWC in order to properly account for directory publishing operations.

A. Coincident with divestiture from AT&T in 1984, U S West organized a separate affiliate and transferred assets and employees involved in directory publishing from the telephone company into the new affiliate. A Publishing Agreement and other affiliate contracts were made effective in 1984, with certain amendments in subsequent years. The initial Publishing Agreement provided for the payment of large publishing fees to the telephone affiliate in return for various rights and benefits, including the exclusive right to publish the official telephone directories of USWC (then Mountain Bell). The publishing fees negotiated between the affiliates, although large, were never adequate in amount and were routinely rejected as inadequate by regulators in rate cases. To make matters worse, in 1989 USWC modified the publishing agreement with its affiliate, completely discontinuing the publishing fees previously paid to the regulated telephone company affiliates and receiving nothing of value in return for such cessation.

It is important to recognize that ratepayers remain entitled to economic participation in the lucrative yellow pages revenue and income stream that has consistently been reflected in the determination of Arizona telephone rates over the years. This principal of ratepayer entitlement was recognized by both parties in the Settlement Agreement the Staff entered into with U S West in 1988 and by the ACC in ordering higher amounts of imputation in the prior rate case.

Q. Did this Commission previously recognize the transfer of directory publishing assets to the separate affiliate to be improper and void, requiring the reassumption of control by Mountain Bell over the Yellow Pages?

A. Yes. In Decision No. 55755 dated October 8, 1987, the ACC ordered that Mountain Bell immediately reassume control over its directory publishing assets and that in the next rate case the Commission would "presume that the amount of net profits from 'Yellow Pages' advertising included in the local intrastate telephone revenues of Mountain States Telephone and Telegraph Company for rate making purposes will be the entire Arizona related profits of Direct <u>or</u> $43 million as adjusted for inflation since the Test Year in Decision 54843, whichever number is <u>higher</u>." Decision No. 55755 was appealed to the Superior Court of Arizona (No. CV 87-33850) and that appeal was resolved by adoption, in ACC Decision No. 56020, of the Settlement Agreement included as my Appendix MLB-1.

Q. Why should USWD/Dex continue to provide publishing fee compensation to USWC or otherwise share the yellow pages revenue and income stream through imputation to the telephone company's ratepayers?

A. Compensation to the telephone company affiliate for directory operations, either through the payment of fees or through imputation, is necessary when setting rates <u>because the yellow pages revenues and profits are created primarily from the unique benefits of affiliation with USWC, benefits that arise from and are integrally related to the provision of local telephone</u>

services. The unique benefits of affiliation with USWC that are enjoyed by U S West DEX include:

1) USWD/Dex's exclusive right to publish the U S West directories, including use of common trade names and marks that link the directories to USWC, the widely recognized provider of regulated telephone services in 14 western and mid-western states (UTI 27-10); and

2) Public perception that the USWD directory is the sole "official book", containing the most comprehensive and accurate listings, that is most widely distributed, retained and used by telephone customers (UTI 21-10, 21-12); and

3) Exclusive placement and maintenance of USWD directories in USWC payphones (UTI 28-15); and

4) Exclusive provision to USWD of billing and collection services from USWC, services not received by any other directory publisher (UTI 27-17), and

5) Exclusive arrangement for purchase of directory advertising accounts receivables by USWC (UTI 27-18); and

6) Benefits of shared corporate management, information technology, shared space, common administrative personnel and the financial resources of U S West (UTI 27-19, 27-20, 27-21), and

7) Referrals of USWC customer inquiries regarding directory advertising to USWD on an exclusive basis (UTI 9-15).

Evidence of the value of these benefits can be observed in the supra-competitive profits of USWD and the higher yellow pages advertising prices charged by USWD than are charged by other independent publishers.

Q. Would it be necessary to impute directory revenues to USWC's Arizona earnings if affiliate transactions had been structured differently?

A. Perhaps not. The imputation of directory revenues is only necessary because of the parent entity's decision to remove directory publishing personnel and systems from the telephone company's operations and financial results at divestiture, without adequate reasonable ongoing compensation to USWC. For most of the Company's history, Mountain Bell and USWC concurred in the policy judgment that local telephone ratepayers were entitled to participate in directory related profits. Prior to divestiture, directory operations were fully reflected within the telephone company's books. At divestiture, U S West removed directory personnel, cash and certain publishing assets and placed them within a separate corporate affiliate, but the traditional above-the-line treatment of publishing fees and imputed directory revenues continued. If the directory publishing personnel and tangible assets had not be moved into the affiliate at divestiture <u>or</u> if reasonable ongoing compensation had been provided for USWC under publishing agreements effective since that date, directory imputation regulatory adjustments would not be required.

Q. Does USWD/DEX remain the official publisher of USWC's directories and receive benefits on an exclusive basis as a result of this status?

A. Yes. According to the current Publishing Agreement at paragraph 5.2:

> 5.2 <u>Official Publisher Designation</u>.
>
> a) For as long as this Agreement is in effect, LEC shall not designate any other directory publisher as an official directory publisher for the LEC service areas covered by this Agreement. Where appropriate, LEC will identify USW Dex as LEC's official directory publisher in public announcements, promotional and advertising materials, and LEC sales channel contacts. LEC further agrees that any referrals it makes in response to inquiries concerning yellow pages advertising will be made to USW Dex., including inquiries from new LEC customers and existing LEC subscribers whose service areas are covered by this Agreement.

As noted in prior testimony, there are numerous and important benefits arising from the relationship between USWD/DEX and USWC, for which no compensation is flowed under the

Publishing Agreement since the cessation of publishing fees in 1989. The right to publish directories on an exclusive basis for the incumbent LEC that has a dominant entrenched local telephone service and directory advertising market position is extraordinarily valuable.

Q. What amounts of publishing fees were paid by USWD and recorded in Arizona for the privilege of serving as the official publisher for U S West?

A. Fees were paid for only the first five years after divestiture, in the following Arizona amounts (UTI 27-2):

1984	$28,294,790
1985	40,316,060
1986	46,301,020
1987	30,391,240
1988	25,663,149

Notably, the year in which the Settlement Agreement was negotiated with the ACC Staff was the last year in which any publishing fees were received by USWC/Mountain Bell.

Q. Why did USWD stop paying publishing fees in 1989?

A. According to a December 1988 letter between the affiliates amending the Publishing Agreement effective at that time (UTI 27-3, Att. A):

> The Exhibit B 'subsidy' issue is controversial and is currently the subject of litigation in several states. Until those issues are resolved, U S WEST Direct is willing to continue the terms and conditions of the existing contract, absent the Exhibit B 'subsidy' portion, on a month to month basis subject to an 18 month notice of cancellation or termination by either party. Therefore, U S WEST Direct will only pay for listings and other services actually received during 1989. Accordingly, the intercompany 'subsidy' payment will cease to be effective 12/31/88.

Publishing fees were not paid after 1988, even though the directory affiliate continued to serve as the publisher of the official U S West directories and continued to receive the benefits of affiliation with the incumbent provider of telephone services across the 14 state region. A new Publishing Agreement became effective May 28, 1997 that perpetuated the official carrier status of USWD, with no publishing fee compensation for the related intangible benefits received from USWC. In my opinion, it was wholly inappropriate and imprudent for USWC to continue its affiliated relationship with USWD as official publisher while discontinuing the payment of publishing fees, particularly after reaching a Settlement Agreement in Arizona to provide annual directory compensation of at least $43 million to ratepayers.

Q. Was any cash or non-cash consideration received by Mountain Bell at the time it agreed to eliminate the annual publishing fees from the affiliate Publishing Agreement with USWD?

A. No.

Q. Has USWC or Mountain Bell ever solicited competitive bids for the publication of its official directories, so as to determine the market value of being designated the official publisher?

A. No competitive bids have ever been solicited (UTI 27-06). The value of services and benefits transferred between the affiliates has not been tested under market conditions, but is instead the product of non-arm's length affiliate dealings with inadequate compensation to the USWC regulated business. Because of this affiliate arrangement, the true value of the services and relationship between USWC and its publishing affiliate can only be determined through observation of the financial performance of the affiliate. Further, in the absence of competitive bidding or genuine arm's length negotiations, USWC does not know if any non-affiliated publishers would publish and distribute USWC's official white and yellow pages directories at no cost to USWC and also pay a publishing fee for the exclusive right to do so.

Q. Is it your opinion that the Publishing Agreement that was effective during the test period fully reflected the value of services transferred between these two affiliates, USWC and USWD/DEX?

A. No. If an appropriate level of fees and value had been provided under the publishing agreement, a large fee or share of yellow pages and white pages advertising revenues would have been credited to the telephone company. The Company's proposed rate case treatment of directory issues with no rate case imputation, not only fails to honor the $43 million commitment pursuant to the earlier Settlement Agreement that was approved by the Commission in 1988, it also fails to recognize the current level of fees and values that are transferred between the affiliated companies in jointly producing the "U S West" books.

Rebuttal to Ann Koehler-Christensen

Q. In your previous response, you stated that a share of white pages advertising revenues should be shared with the telephone company. Doesn't USWC retain all of the white pages revenues that result from the white pages directories that Ms. Koehler-Christensen's testimony would attribute entirely to USWC as a telephone company cost or "value"?

A. No. Even though the Company's testimony seems to attribute full cost responsibility for the white pages in evaluating fees and value of services, no mention is made of the fact that much of the revenue earned from premium white pages listings are billed and retained by USWD/DEX because the affiliates have deemed such revenues to be "advertising". According to the response to Data Request UTI 59-27, the test period amount of white pages advertising retained by USWD/Dex was [redacted].

Q. Is there any validity in Ms. Koehler-Christensen's argument that avoidance of the costs to publish and distribute directories is a "value" received by USWC from USWD/Dex?

A. No. I believe that USWC could readily contract with another publisher or reacquire internal publishing capabilities and realize net revenues or, at an absolute minimum, receive such publishing and distribution at no cost in return for the granting of official publisher status.

Q. Even if we accepted her avoided publishing cost theory of value, would it be appropriate to reduce Ms. Koehler-Christensen's estimated cost of producing and distributing directories in Arizona by the amount of white pages revenues earned from such directories?

A. Yes. It would be completely irrational to assume USWC is responsible for the costs of publishing white pages and not also assume that if USWC incurred such costs it would continue to give away the advertising revenues in the white pages. The net costs of publishing white pages can be derived by subtracting this white pages advertising revenue from the $12.8 million value cited in her testimony. However, even this lower net cost of white pages is outside the scope of the $43 million value agreed upon in the Settlement Agreement.

Q. Did USWD produce and distribute the white and yellow pages directories at no expense to USWC when the $43 million imputation stipulation was approved by the Commission?

A. Yes. The costs of publishing and distributing directories has always been borne by USWD/DEX, since this affiliate was established at divestiture. It is disingenuous for the Company to now argue that these publishing costs that are "avoided" by USWC, should now count against and reduce the negotiated imputation value. USWD/DEX has never charged USWC for the costs to publish the white pages.

Q. What is wrong with Ms. Koehler-Christensen's assertion at page 3 that, "If DEX had not published and distributed Arizona directories to U S WEST's customers under the terms of the Publishing Agreement, U S WEST would have had to incur these costs" associated with publishing directories?

A. This assertion is fundamentally wrong, because USWC would not incur costs to publish directories. In fact, USWC would undoubtedly realize additional white and yellow pages net revenues rather than costs, in the absence of its unreasonable relationship with the affiliate publisher. Prudent management simply would not operate the largest incumbent telephone company across 14 states and spend money to publish only white pages, without also exploiting the profitable yellow pages business opportunity that is a natural by-product of such incumbency. USWC could either directly realize the "lost" revenues associated with white and yellow pages advertising through re-entry into the business or it could contract with another publisher and thereby participate in the lucrative yellow pages advertising business. Under a third scenario, assuming (contrary to historical fact) a compliant U S West, Inc. parent company, the publishing assets and employees within USWD/DEX could be transferred back into USWC, so as to include the net benefits of directory publication within the telephone company's regulated books, consistent with what was once ordered by this Commission.

Q. Isn't it true that USWD/DEX does incur certain costs to publish and distribute white and yellow pages?

A. If considered in isolation, yes, significant costs are incurred to publish the books and distribute them. However, these costs are more than offset by selling advertising in the white and yellow pages directories at prices that are reflective of the market dominance of the directories produced by the incumbent telephone company. In other words, the direct costs of the directory books is much less significant than the market value of the books in the advertising marketplace. The net cost of producing and distributing white and yellow pages is considerably negative, when the offsetting yellow page advertising revenues are properly considered. In addition, the Settlement Agreement requires consideration of the value of services provided to the regulated business by the publishing affiliate and publishing and distributing white and yellow pages has a value of zero or less, since any informed and capable directory publisher would eagerly accept the opportunity to serve as USWC's official publisher and publish its directories at no cost.

Q. How do you know USWC would be able to contract with a publisher to produce its white and yellow pages at no cost or negative costs (publishing fee income) if the affiliate arrangement with Dex did not exist?

A. We know that, under the present Publishing Agreement, Dex provides white and yellow pages to all USWC customers at no charge to USWC. In response to UTI 21-13, the Company admitted that "DEX is fully compensated for the services it provides to USWC" under the Publishing Agreement, even though there is no charge to USWC for directory publishing and distribution expenses. This admission indicates the reality that there is no net cost associated with publication and distribution of the official USWC directories, contrary to Ms. Koehler-Christensen's assertions.

In its response to UTI 3-30, the Company stated, "DEX is willing to incur the costs associated with the publishing and delivering of directories to U S WEST customers because U S WEST has designated DEX as U S WEST's 'official' publisher and because the inclusion of white pages listings adds value to the DEX directory." If the affiliate Publishing Agreement with DEX were abandoned, it is likely that some other publisher would also see considerable opportunity and value in U S WEST official publisher status. There has been no showing by the Company that USWC is avoiding any directory costs by contracting with DEX that could not also be avoided by contracting with another non-affiliated entity.

Q. Does USWD/DEX charge independent LECs or competitive LECs for the costs of manufacturing and distributing DEX directories that contain the listings of such LECs pursuant to publishing agreements its has with such LEC's?

A. No (UTI 62-04) DEX has publishing agreements with thirteen CLECs, seven of which are certified to provide service in Arizona and with approximately one hundred independent LECs, eight of which provide service in Arizona. It makes no sense to attribute value to USWC for the costs avoided when USWD/Dex publishes directories on behalf of the Company, when this service is routinely provided at no cost to other telephone companies.

Q. Has Ms. Koehler-Christensen considered or quantified the value of the U S West official directories and the exclusive right to publish such directories in the advertising marketplace?

A. No. Her testimony is concerned only with costs incurred by USWD, ignoring the revenues that are produced from directory advertising. A more balanced view of the situation would recognize that the directory businesses of regional bell operating companies do not represent expenses to be borne by ratepayers, but are instead large revenue generators. Absent unreasonable publishing agreement terms between USWD/DEX and USWC, the regulated telephone business could more fully participate in the realization of the market value of directory advertising, in an amount greatly exceeding $43 million per year.

Q. At page 2 of her testimony, Ms. Koehler-Christensen states, "The cost of publishing the White Pages and delivering the White and Yellow Pages to U S WEST customers in 1999 was approximately $12.8 million." Is this figure indicative of any value received by USWC?

A. No. In my opinion, USWC could easily more than support any reasonable cost of publishing directories by selling advertising in these directories. USWC does not receive value from USWD/DEX for its production of white pages, but instead gives value to the publishing affiliate by granting the right to publish the official U S West directories to only the affiliate. USWD/DEX acts as official publisher of both the white and yellow page directories, the directories within which USWC customers are listed alphabetically and by business classification, that bears the "U S WEST" name on the cover. The net cost of publishing and distributing white and yellow pages in Arizona is a large negative value that should be "received" by USWC, but is not received under the existing affiliate contracts or the Company's proposed ratemaking approach.

Q. Should the white pages revenues that are retained by USWD/DEX be recognized to directly offset Ms. Koehler-Christensen's estimate of the costs of publishing and delivering the white pages in Arizona?

A. Yes. Even though her testimony seems to characterize the white pages as simply a cost that should be attributed to USWC and its ratepayers, Ms. Koehler-Christensen has ignored the fact that even the white pages produce considerable revenues. According to the response to UTI 33-12, "DEX offers over thirty white pages advertising products. These products include bold listings, superbold listings, banner listings, logos, color, indented listings, cross-reference listings, internet pointers and in column ads." As noted earlier, considerable revenues are earned from white pages publishing that have not been recorded on USWC's books, but have instead been deemed "advertising" and retained by USWD/DEX. The Arizona white pages revenues earned by USWD/DEX in 1999 totaled about [redacted].

If USWC published its own white pages, as assumed by Ms. Koehler-Christensen, it could earn and retain all potential white pages revenues. Inexplicably, the Company's witness would attribute "value" to USWC for only the costs incurred by DEX to publish and deliver white pages, while allowing DEX to retain white pages revenues earned from these same directories. The only explanation offered for this inconsistency is that the affiliate publishing agreement does not require DEX to sell advertising to USWC's customers, thus, according to the response to UTI 33-14, "If USWC published its own white pages then it similarly would not be required to sell advertising to its customers."

Q. Has the Company previously recognized that the telephone company is providing more value to the publishing affiliate than it receives from the affiliate?

A. Yes. In the initial publishing agreement between Mountain Bell and U S West Direct, large publishing fees were actually paid to the telephone company for the right to be the publisher of the official directories on an exclusive basis. In 1988, USWC committed to pass $43 million through to telephone company customers in the Settlement Agreement, recognizing the ratepayers' claim to the value derived and retained by USWD from selling advertising in the directories. The value of official publisher status has increased over the years since 1988, as evidenced by the dramatically increased revenues and profits earned by USWD/DEX.

Q. Is there any reason why, in the absence of the existing non-arm's length affiliate Publishing Agreement with DEX, the regulated USWC telephone company could not publish its own white and yellow pages and earn advertising revenues to offset its costs and generate additional income?

A. I am aware of no reason why USWC could not terminate the unreasonable Publishing Agreement and solicit competitive proposals from independent publishers to re-enter the white and yellow pages business. If not for anticipated resistance from its own parent company, USWD/DEX's directory operations could be simultaneously terminated to avoid having USWD/DEX compete with any new USWC publishing arrangement.

Q. When the present affiliate Publishing Agreement was made effective between USWC and DEX, were any analyses undertaken by or for USWC to determine the reasonableness of the terms, rights, obligations, pricing and other provisions of the Agreement?

A. No. According to the Company's response to UTI 3-31, "No studies, analyses, projections, workpapers, correspondence, research materials, surveys and other documents exist. U S WEST utilized the knowledge and expertise of its employees during the negotiation process."

Q. Is there any evidence that USWC employees negotiated the maximum possible compensation to USWC for inclusion as fees within intrastate revenues, so as to reduce the regulated telephone affiliates revenue requirements?

A. No. In fact, the unreasonable omission of any contractual compensation for the official publisher status and other beneficial linkages to USWC within the Publishing Agreement indicates the lack of any arm's length negotiations between DEX and USWC. The absence of any documentation during negotiations and the Company's admission that it has never solicited competitive publishing bids (UTI 27-06) is further evidence of the imprudence of USWC's actions. Since 1984, DEX directory revenues and profits have consistently increased while USWC's fees and value of services received from DEX has consistently declined, all pursuant to affiliate contractual arrangements that have been hostile to ratepayers' interests while seeking to maximize consolidated U S West, Inc income by reducing regulatory recognition of directory revenues.

<u>Value of Fees and Services</u>

Q. What is required under the Settlement Agreement approved by the Commission in 1988 with respect to directory imputation?

A. The Settlement Agreement requires:

> c) That included in Mountain Bell's 1984 rate case (which is the basis for rates currently charged the ratepayers) were fees received from USWD under publishing agreements with USWD; that in future rate cases filed by Mountain Bell, the Commission, in arriving at the test year operating income of Mountain Bell, will consider the fees and value of services received by Mountain Bell from USWD under publishing agreements with USWD; that Mountain Bell and the Commission Staff may present evidence in support of or in contradiction to those fees and the value of those services. Mountain Bell and the Commission agree that in subsequent rate cases downward adjustments from the $43 million in fees received by Mountain Bell from USWD and included in Mountain Bells' 1984 rate case will require more than a showing by Mountain Bell that it negotiated a lesser amount with USWD. (Settlement Agreement, page 2)

The Company appears to be proposing a "downward adjustment from the $43 million in fees" by not increasing by imputation the actual fee income from USWD from the per books $1.6 million amount recorded in the test period. Contrary to the Company's position, this section of my testimony will demonstrate that the value of what is actually transferred between USWC and the publishing affiliate supports a larger imputation than $43 million, even though Staff is not proposing any increase to the Settlement Agreement imputation amount at this time.

Q. What larger imputation would be required to fully recognize the fees and value of services received by Mountain Bell (now USWC)?

A. The best quantification of what is actually received by USWC is measured by the financial results under actual market conditions that are being experienced by USWD/DEX. In other words, if USWD/DEX is providing official publisher services that yield revenues in excess of costs, the "value of services received by USWC from USWD under publishing agreements with USWD" is actually negative when netted against the value of the official publisher right that is given up by USWC in return for such services.

Q. Is there any indication from the USWD/Dex financial results that USWC is not receiving adequate compensation from the publishing affiliate?

A. Yes. One would expect that if USWC is excessively compensated at the level of fees and values recorded in the test period, the earnings of USWD/DEX would be negative or at least producing a below average rate of return. Alternatively, if USWC is insufficiently compensated through fees from USWD/DEX, the actual earnings of USWD/DEX would be excessive in relation to the investment and cost of capital actually incurred by USWD.

Q. Why do USWD earnings have anything to do with the fees paid to USWC under the Publishing Agreement?

A. Every dollar of fees actually paid to USWC for listings, billing & collection services, business referrals, or publishing fees directly reduces the earnings levels experienced by USWD. For instance, when publishing fees were eliminated in 1989, USWD's actual earnings increased dramatically and in direct proportion to the decline in earnings experienced by USWC because of this change. Therefore, USWD's earnings are indicative of the market value of services provided by both USWC and USWD in publishing and distributing the official U S West white and yellow pages, net of the underlying fees and costs associated with such efforts.

Q. What level of earnings has actually been experienced by USWD in the recent past?

A. USWD earnings have consistently increased over the years. The Commission noted in its Decision No. 58927 in the Company's last rate case that "the profits of Direct continue to increase resulting in much higher returns than allowed to regulated businesses."(page 13). Since the last case, that trend has continued. According to the confidential response to Data Request UTI 60-22, net income of the core directory printing business has [redacted] percent from 1994 to 1999 and the return on equity percentages in all of these years has ranged from [redacted] percent to [redacted] percent annually. Of course, no Publishing Fees are being paid by USWD/DEX, since such fees were eliminated by the imprudent actions of USWC management in 1988. The payment of publishing fees or the recognition of imputation amounts as a charge to the affiliate would reduce the excessive earnings of USWD/DEX.

Q. Didn't the Court of Appeals rule, in the appeal taken after the last rate case, that the earnings of USWD could not be relied upon to determine imputation under the Settlement Agreement?

A. According to the Court's Order:

> The imputation method approved in the agreement was not the excess-profit imputation adopted by the Commission but rather a method dependent upon proof of 'the fees and the value of services received by Mountain Bell from USWD under publishing agreements with USWD'. During oral argument, the parties agreed that an appropriate imputation of fees and value of services was $43 million. And the parties jointly

> interpret the agreement as providing for a presumptive imputation of $43 million in subsequent rate cases. The parties disagree, however, whether this presumptive figure may be adjusted upward or downward, as the Commission maintains, or only downward, as US West maintains.[4]

Thus, the "excess-profit" imputation methodology adopted by the Commission in the last case was found by the Court to be inadequate to support an upward adjustment to the presumptive imputation of $43 million, as evidenced by the ordered language:

> In this case, however, the Commission did not rely on evidence of the value of the fees and services; nor did the staff submit any evidence that USWD's fees and services to US West in the base year were of a value greater than the $43 million that US West accepts as the presumptive imputation. Accordingly, because the Commission relied on a methodology that its 1988 agreement renders invalid, and because the staff introduced no evidence that would support a greater imputation under the proper methodology, we set aside the Commission's greater imputation and direct it on remand to impute only $43 million of directory revenue.[5]

Q. Did the Court prescribe a methodology for the Commission to use to determine an alternative "value of the fees and services", in place of the presumptive imputation amount of $43 million?

A. No. However, several current measures of the value of the affiliate linkages involved in U S West directory publishing in Arizona other than DEX's consistently high earnings suggest that $43 million amount is woefully inadequate as imputation of a reasonable ratepayers' share of the directory publishing business.

Q. What is a reasonable estimate of the current value of fees and services transferred between USWC and USWD/Dex in the test period?

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[4] 915 P.2d 1232, 1237

[5] Ibid.

A. Using the amounts negotiated in the Settlement Agreement as a starting point, the current value of the fees and services properly credited to USWC in Arizona is no less than $93.1 million, rather than only $43 million. To derive this amount, I started with the recorded 1985 USWD directory revenues. Then, I developed factors to restate and escalate such values from 1985 to 1999 based upon actual revenue and operating margin trends of the USWD/Dex directory publishing business. The valuation factors I considered were based upon the actual gross revenue growth experienced by USWD/Dex over this 14 year period and the actual growth in gross margin (revenues less publishing expenses) experienced over this same period. I selected the lower of these two value multipliers for application to the 1985 vintage imputation amount of $43 million, to derive the $93.1 million amount. This approximate doubling of the Settlement Agreement amount is easily understood in light of the tremendous growth in revenues and margins earned by USWD/Dex since the $43 million imputation amount was initially determined over 14 years ago. An even larger imputation than $93.1 million could be supported under the USWD/Dex income-based formula, but that formula was found unreasonable by the Court after it was last used by this Commission. If the Commission were able to utilize the income approach that it approved in the Company's last rate case, 1999 imputation would be about $104 million.

Q. Why is it reasonable to consider the Staff's proposed imputation based upon the Settlement Agreement to be extremely conservative and beneficial to the Company?

A. The best indication of fees and value of services is the realized financial benefit of affiliation between USWD and USWC, as evidenced by favorable directory revenue and margin trends since the $43 million figure was negotiated. Contrary to Ms. Koehler-Christensen's testimony, USWC is actually receiving <u>negative</u> value from the affiliate for its contribution to the directory publishing effort, because the fair value of the grant of official publisher status to USWD/DEX and the other resource transfers in favor of Dex far exceed the value being received by USWC.

UNCOLLECTIBLE REVENUES

Q. Has the Company proposed an adjustment to annualize uncollectible revenues at year end?

A. Yes. Part of the Company's end of period adjustment P-01 includes an annualization of uncollectibles at year-end. The Company's adjustment is based upon a December times 12 methodology, but contains a normalization adjustment to restate the December recorded amounts for non-recurring abnormal entries booked in December. According to the Company's response to Data Request UTI 48-13, the result of the Company's adjustments is an effective uncollectible ratio of 1.49 percent of intrastate local, toll and access revenues.

Q. Has Staff prepared a comparable uncollectible annualization adjustment?

A. Yes. Staff Schedule C-7 employs the Company's 1.49 percent uncollectible ratio, applied to Staff's proposed adjusted revenue levels. This results in a small adjustment to uncollectibles in Staff's filing. The 1.49 percent uncollectible ratio appears reasonable, based upon historical and recent uncollectibles experience in Arizona.

Q. Is there a corresponding change also required in the uncollectible amount applied to the rate change, in Schedule A-1, the Revenue Conversion Factor?

A. Yes. Staff believes the same uncollectible ratio should be employed for annualization purposes and for conversion of the income deficiency into revenue requirements. Consistent use of the same uncollectible ratio for both purposes is the reason for a difference between Staff's and the Company's Revenue Conversion Factor, as shown at line 2 of Schedule A-1. The Company had inexplicably used an inconsistent factor for uncollectibles in the Gross Revenue Conversion Factor.

EMPLOYEE CONCESSION SERVICE

Q. What is employee concession service and how has it been treated in the Company's filing?

A. Employees are offered discounts on their telecommunications services purchased from USWC and these discounts are referred to as "concessions". The revenues foregone by USWC for such concessions represent employee benefits that are accounted for on the books solely within the intrastate revenue accounts.

Q. Are these concessions the same as the retiree concessions that have been previously disallowed by the Commission?

A. No. Prior Commission orders have disallowed concessions granted to retirees, but not concessions for active employees. Retirees' concession costs are eliminated from the Company's asserted revenue requirement in ratemaking adjustment C-02 (Exhibit GAR-S6B), sponsored by Mr. Redding. However, the concessions granted to employees remain on the books and serve to reduce recorded test year revenues.

Q. Are you recommending that employee concessions also be disallowed, in the manner the Commission has disallowed retiree concessions?

A. No. My concern is merely with the jurisdictional accounting being afforded such employee concession costs. These costs are incurred as part of the overall package of wages and other benefits that are provided to employees. However, unlike other wage and benefit costs, employee concessions are not separated between the interstate and intrastate jurisdiction. Instead, since the discounted services are entirely intrastate in nature, all of such costs are charged entirely into the intrastate revenue requirement. This is inequitable and overstates the intrastate revenue requirement.

Q. Does USWC have an opportunity to recover all of the costs of employee concessions if a portion of such costs is removed from the intrastate revenue requirement as you propose?

A. Since interstate ratemaking is based upon a price cap form of regulation, increased or decreased costs to the interstate jurisdiction do not translate into price changes. Thus there is no need or explicit opportunity to "recover" costs shifted to interstate. However, if USWC is concerned about full cost recovery, it should explore alternative accounting procedures or the distribution of vouchers to employees to more appropriately account for the costs of employee concessions so they are not entirely charged to the intrastate jurisdiction on the books.

Q. Please explain your adjustment Schedule C- 21.

A. This Schedule reduces the recorded amount of foregone test period revenues associated with employee concessions, by an amount allocable to the interstate jurisdiction. A composite separation factor is employed to reflect an appropriate interstate "share" of this employee benefit, so as to acknowledge that employees work for the benefit of both the interstate and intrastate jurisdictions. The end result of this adjustment is an accounting for employee concession costs that is comparable to the accounting provided to all other employee benefits, such as medical, dental, pension and payroll tax costs, across both the interstate and intrastate jurisdictions.

RENT COMPENSATION

Q. What is rent compensation and how does it impact the Arizona operations of U S West Communications?

A. Rent compensation is an accounting cost allocation process that recognizes that many of the assets used by the Company are shared among and for the benefit of multiple states, beyond the state in which they are physically located. USWC owns and rents various buildings, office equipment, computers and other assets that are recorded on the books of the state in which they are physically located, but the costs of such "shared" assets must be allocated among the other states that benefit from use of the assets. A rent compensation study is performed twice per year to evaluate the utilization of USWC shared buildings and support assets among the states, assigning a rate of return, depreciation and other costs in relation to such utilization. In the case of Arizona, the corporate and regional shared assets located in the State are proportionately less than Arizona's allocated share of out-of-state assets, such that Arizona "pays" net rent compensation to certain other states through a monthly journal entry that transfers rent revenues among the 14 states. In fact, Arizona is the largest "payer" of rent compensation, while the state of Colorado receives the largest credit from the other states.

Q. How much rent compensation is included in the Company's proposed test period income statement?

A. The Company has adjusted test period rent compensation to an annualized level that is a total charge of $48 million, prior to allocation to the intrastate jurisdiction. This amount is actually booked as a negative rent revenue amount in Arizona. The Company's proposed annualized level of rent compensation is based upon the January 2000 update of the rent compensation study. However, due to some overlap in the assembly of the Company's revenue annualization adjustments, the rent compensation annualization was inadvertently posted twice by the

Company, once as part of the miscellaneous revenue annualization (December times 12) and again to annualize the January 2000 rent compensation study amounts.

Q. Does Staff agree that the January 2000 rent compensation study should serve as the basis for the test period annualized level of this cost to Arizona?

A. Yes. Since the basic test period ends December 31, 1999, the January 2000 study represents the best accounting "match" with the test year and actually employs 1999-vintage data. More current rent compensation studies are now available, but recognizing them would introduce a distortion in test period matching because revenue growth and rate base changes have not also been updated into 1999. However, even though Staff agrees with the January 2000 study used by USWC, it is necessary to make two specific adjustments to the rent compensation test period amounts so as to correct the Company's overlapping adjustment error and to reflect more reasonable rates of return on investment within the study.

While not quantified at this time, Staff also recognizes that it may be appropriate to recognize changed Arizona depreciation rates in the rent compensation study. However, since proper depreciation for Arizona assets remains at issue, as addressed in the testimony of Staff witness Mr. Dunkel, any quantification of rent compensation depreciation effects would first require final resolution of this issue.

Q. What rate of return is included in the January 2000 rent compensation study, for determination of charges for Arizona's use of shared assets in other states?

A. The rent compensation study uses a weighted average of the allowed rates of return from the state commissions that regulate USWC. In the January 2000 study, the overall rate of return across all states for rent compensation purposes is 10.17 percent. Since several of the states involved have not issued a rate order in many years, some of the "allowed" return amounts embedded in the rent compensation study date back many years. For example, the Arizona authorized rate of return used in the study was determined in 1994, while the returns in other states may be even more dated. A more current rate of return determination would reduce the amount of rent compensation that is "paid" by Arizona to more current cost levels.

Q. How should the rate of return be adjusted for purposes of rent compensation?

A. Staff has adjusted rent compensation to the rate of return that is recommended by Staff witness Mr. Hill. The effect of this adjustment is for USWC to earn the same return on its Arizona-allocated investment from out-of-state that it is allowed to earn on rate base investment recorded directly on Arizona books. Staff's recommended overall rate of return is 9.68 percent, which is lower than the return included in USWC's rent compensation study.

Q. If the Commission approves a rate of return that is higher or lower than Staff recommends, can the impact upon rent compensation be estimated?

A. Yes. It would be reasonable to increase or reduce the intrastate rent compensation expense by about $108,000 for each 10 basis point (0.1 percent) increase/reduction in the overall return authorized rate of return in the Commission's order, relative to staff's recommended overall return.

Q. How are the depreciation rates that the Commission prescribes used in the rent compensation study?

A. The ACC-approved depreciation accrual rates are applied to Arizona investment that is shared among other states, as part of the calculation of rent compensation. Thus, when the prescribed rates are changed, a corresponding change in rent compensation is required. However, for each of the other 13 states' compensable investment, the accrual rates approved for use in that state are recognized in the rent compensation study. While Arizona depreciation accrual rates have recently changed, Staff has not quantified the rent compensation impact of such changes, in part because such changes are not applicable to the other states' assets subject to rent compensation. According to the Company's response to Data Request UTI 30-03:

> U S WEST's practice in rate proceedings is not to adjust the depreciation rates in the rent compensation study. The study is compiled using the rates in effect at the time of the study. The depreciation rates used are based on the physical (state) location of the plant subject to rent compensation. Additionally, the Rent Compensation study is conducted every 6 months and does take into account changes in the depreciation rates as new orders are issued.

Staff has adopted this policy and does not propose the imposition of Arizona depreciation rates upon other states where the assets and plant mortality data in those states may justify different accrual rates.

Q. Did the Commission approve rent compensation adjustments comparable to those recommended herein in its last rate order?

A. In Decision No. 58927, the Commission rejected Staff and RUCO adjustments to restate the return rate included in rent compensation payable to other states, because "...if an Arizona rate of return is utilized, then Arizona depreciation rates should also be used." (Decision 58927, page 19). Staff respectfully asks the Commission to reconsider the applicability of Arizona depreciation rates to investment physically located in other states. If any depreciation adjustment is applied to the rent compensation study, it should be applicable to only Arizona investment and can be calculated only after accrual rates for relevant plant accounts have been finally determined.

PUBLIC AFFAIRS/ RELATIONS EXPENSES

Q. What is the purpose of Staff Schedule C-19?

A. This adjustment is to partially disallow the Company's test period public policy expenses that are associated with public affairs and public relations activities. The Company maintains a large "Public Policy" organization that includes regulatory and governmental affairs activities. Included in Public Policy are the expenses associated with USWC's Federal and state regulatory affairs, legislative advocacy, government relations, community welfare services, political action committee and memberships. The Staff's adjustment includes Arizona charges associated with the State Vice President and in-state Public Policy organization as well as the USWC corporate Public Policy Staff organization.

Q. Does USWC account for a portion of its Public Policy costs below the line, to recognize the need for shareholder, rather than ratepayers, funding of lobbying, charitable contributions and other community welfare programs?

A. In theory, yes. The Company has adopted policies requiring below-the-line accounting for certain defined types of costs in these areas. For example, USWC's Accounting Standards are published and distributed to its employees. These standards first generally define below the line "lobbying" activities as:

> DIRECT LOBBYING - FEDERAL AND STATE - Includes work and costs associated with advocating the Company's position to Federal and State public officials.
>
> GRASSROOTS LOBBYING - Includes work and costs associated with advocating the Company's position to the public with respect to legislation, referenda, or ordinances.
>
> DIRECT LOBBYING - Includes work and costs associated with advocating the Company's position to local public officials or governing bodies with respect to legislation, referenda, or ordinances, but only when the work or costs pertain to matters of the respective local council or governing body.

Then, further restrictive descriptions and examples of activities and costs that actually meet these general definitions are set forth in the Accounting Standard, which is attached as Appendix MLB-2. The lobbying descriptions tend to minimize the costs charged below the line, because of the many forms of supporting activities that are not defined and treated as actual lobbying. Activities not treated as below-the-line lobbying, under the Company's Accounting Standards, could include:

* Reviewing and analyzing pending or proposed legislation,
* Communicating with members of Congress or Legislators for any reason other than for the specific purpose of advocating the Company's position,
* Entertaining or hosting meals for members of Congress or Legislators when not for the specific purpose of advocating the Company's position,
* Appearances before regulatory agencies or efforts to influence administrative regulations.
* Attending a meeting or seminar that is addressed by legislators where the meeting is widely attended and no lobbying contact is made.

Because the accounting policies that are employed by USWC personnel in determining whether to charge time and expenses below-the-line define "lobbying" fairly narrowly, many efforts to develop and maintain relationships with legislators to facilitate USWC access and influence are not considered lobbying.

Employing these accounting "rules", USWC recorded only about eight percent of overall Arizona test period Public Policy expenses to below the line accounts. The majority of such costs (the other 92 percent) are recorded above-the-line and are included in USWC's asserted revenue requirements.

Q. Why should a significant portion of the public affairs and public relations functions within the USWC Public Policy organization be accounted for below the line, rather than collected from ratepayers?

A. Some larger fraction of such expenditures should be accounted for below the line because ratepayers derive no direct tangible benefits from legislative/public affairs and image enhancement expenditures made by the Company. Public affairs and public relations expenditures are generally not necessary to provide telephone service to Arizona ratepayers. Moreover, when such costs are incurred by the Company to further its public relations and political agenda, it is likely that such agenda is designed specifically to be more favorable to the Company's shareholders than its ratepayers. USWC management can reasonably be expected to pursue public policy issues in the manner most beneficial to the Company's investors, since investor interest are most directly represented by the US West, Inc. Board of Directors who appoint and direct the actions of management.

Q. Have you prepared an adjustment based upon a conclusion that the Accounting Standards described above and USWC's resulting eight percent Public Policy cost assignment below the line is unreasonable?

A. Yes. Certain personnel within the USWC Public Policy organization are heavily involved with legislative affairs and public relations activities which appear to be of little or no direct benefit to ratepayers. However, the Company's proposed accounting treats the majority of such personnel and costs as above the line recoverable expenses. Staff Schedule C-19 restates the Company's per books assignment of Public Policy costs, so as to classify below the line 50 percent of the costs of Corporate Public Policy and Arizona Public Affairs organizations.

Q. Why do you propose to increase the percentage booked below the line to 50%?

A. The adjustment I propose is based primarily upon the position descriptions for each of the Public Policy position/job descriptions provided in response to Data Requests, which are included in Appendix MLB-3. These documents describe the relative importance of various responsibilities of each such position. For example, the responsibilities of USWC's Director of Public Affairs- Managing includes:

> (25%) Supervises and directs work activities of subordinates; provides strategic direction and guidance relative to team effectiveness: seeks and offers opportunities for personal and professional development
>
> (25%) Direct/coordinates the efforts of the company lobbyists at the state and national level to ensure proper advocacy on behalf of the U S West Companies.
>
> (25%) Direct/participate the efforts of the company to achieve the most favorable forms of alternative regulation as is required or may be achieved through passage of legislation.
>
> (15%) Identifies and tracks emerging issues to enable the corporation to respond in a timely and appropriate fashion
>
> (10%) Develop recommendations that will allow officers and key managers of the business to maximize the effectiveness of the company's public affairs efforts.

The Arizona Vice President – Public Policy position has a more generalized statewide policy role, with duties stated to include:

> ...has responsibility for developing, integrating, advocating and executing Public Policy strategies, activities and initiatives within Arizona while ensuring that such efforts support the achievement of U S WEST's corporate objective and goals.

A number of corporate Public Policy positions are also allocable to Arizona and are included in the Staff's partial disallowance of costs. Pages 5 through 22 of Appendix MLB-3 are position descriptions for these corporate staff personnel. The adjustment I propose treats Corporate Public Policy and Public Policy Support RC's allocated to Arizona as supportive of these direct efforts at the State level.

Q. How were Public Policy organization costs treated by the Commission in the Company's prior Arizona rate case?

A. The Commission approved essentially the same adjustment in Docket No. E-1051093-183 that is proposed by Staff in this proceeding. At page 45 of Decision No. 58927, the Commission stated:

> We concur with Staff. The Company has not justified over 94 percent of the public affairs and public relations costs being passed through to ratepayers. These are areas which clearly provide benefits to the shareholders. We find that Staff's proposal to split the costs between ratepayers and shareholders to be a fair resolution.

Q. Did you inquire into the specific public policy goals and objectives that USWC was focused upon in the test period, so as to better understand the nature of legislative and regulatory issues being addressed by the Company?

A. Yes. I reviewed the incentive compensation business unit goals and targets established for Public Policy personnel, as set forth in the confidential responses to Data Requests UTI 17-16 and UTI 60-11 and found the goals to be largely oriented toward shareholder benefits, such as [redacted].

Q. In your opinion, should the Public Policy adjustment you propose be considered conservative?

A. Yes. The position descriptions included in Appendix MLB-3 indicate the emphasis of these efforts on influencing legislative, regulatory and key business leaders through maintenance of relationships and active lobbying. The business objectives documented for incentive compensation to Public Policy personnel also indicate the emphasis placed upon shareholder interests. It appears that far more than the 50 percent disallowance I propose could be justified based upon these documents.

CASH WORKING CAPITAL

Q. What is cash working capital?

A. Cash working capital is the amount of invested capital required to operate the business that is associated with the timing of cash flows through the business. A lead lag study is prepared to measure the timing of cash flows associated with each of the sources of intrastate revenues and each of the recurring cash expenses incurred in providing service. If the lead lag study supports a conclusion that the costs incurred to provide regulated service must be paid more rapidly than the Company can collect its revenues, investors must provide cash working capital to bridge this timing gap. On the other hand, if the Company is able to collect cash from customers more rapidly than it must pay its bills associated with payroll, materials and other costs, negative cash working capital is the result.

Q. Why is cash working capital included in rate base?

A. Cash working capital, whether positive or negative in amount, must be included in rate base so as to properly recognize the amounts of investor-supplied capital required to operate the business. When added to other working capital elements such as materials and supplies and to the larger amounts invested in telephone plant in service and deferred tax reserves, cash working capital is an indispensable element of the investment base associated with Arizona operations.

Q. Has USWC prepared a lead lag study to determine its intrastate cash working capital requirement in the test period?

A. Yes. A lead lag study exists to support the Company's proposed cash working capital allowance in rate base. The Company's updated test period study supports a rate base amount of negative $46.2 million. However, in preparing its update filing, the Company posted an incorrect adjustment amount for cash working capital that results in an incorrect amount of negative $39.2 million actually being included in USWC's proposed rate base. This problem was disclosed in the Company's response to RUCO Data Request 28-07.

Q. Does Staff agree with the lead lag study that USWC has proposed in the current case?

A. Unlike in prior cases, USWC has properly scoped its lead lag study, so as to exclude the non-cash expense elements that were previously rejected by the Commission. This scoping change eliminates much of the controversy arising from prior USWC lead lag studes. However, there are still a number of specific mechanical corrections, updates and other issues raised by the Company's study. Staff has prepared a series of restatements to the Company's prefiled lead lag study that are associated these issues.

Q. Do the Staff's adjustments change the basic approach to the study that the Company prepared?

A. No. The changes proposed by Staff relate to the calculated lag day values in several areas, but not the basic approach to the study. However, beyond the lag day restatements, Staff's results will also differ from the Company's because of differences in adjusted test period expense amounts which serve as inputs into the study calculation. It is necessary to reflect Staff's revised income statement amounts in the input values used to calculate cash working capital. These input values are derived from the adjusted values in Staff's adjusted income statement at Schedule C, column D. The difference in input values causes certain differences in resulting cash working capital that are not substantive issues, but rather are simply the result of changed inputs. The Company concurs in the need to reflect updated income statement inputs in calculating cash working capital, according to the response to RUCO Data Request 28-06.

Q. What accounting schedule have you prepared to display Staff's proposed lead lag study calculations, with the revisions that are required?

A. Schedule B-4 is the lead lag study proposed by Staff. It employs the adjusted income statement revenue and expense amounts for each line item that are consistent with other Staff ratemaking adjustments. In addition, some of the lag day revisions are evident from the study Schedule B-4, while others are embedded within composite lag day values for expense line items that are different from the values proposed by USWC.

Q. What is Staff's first lead lag study adjustment?

A. The salaries and wages lag day value calculated by USWC includes consideration of incentive compensation amounts that are paid considerably in arrears, making the weighted average lag longer than for normal payroll. Since Staff has challenged rate recovery of such incentive compensation, the salaries and wages lag has been recalculated to exclude such items.

Q. Is there another adjustment that Staff has proposed to the salaries and wages lag value?

A. Yes. Some wage expenses on the books relate to accrued compensated absences. This expense is an accrual, rather than an actual cash payment, that recognizes that employees earn the right to take vacation and other time off prior to when such time and pay is actually taken. Accrued vacation expenses should be treated as non-cash expenses, so that only actual cash payments for wages are allowed to influence the lead lag study result. To accomplish this treatment, the expense lag for vacation accruals has been set equal to the overall revenue lag in Staff's calculations.

Q. With respect to the employee benefits lag calculation, has Staff found it necessary to adjust the Company's proposed lag calculations?

A. Yes, several adjustments are required. As in the case of non-cash compensated absences, the Company's pension plan is over-funded and no cash contributions to the fund are being made. So as to neutralize the cash working capital effect of negative pension expenses on the books, these amounts are assigned an expense lag value set equal to the overall revenue lag.

For group life, medical, dental and vision plan contributions, the Company has simply assumed a zero lag day value. The zero assumed lag is apparently based upon the Company's practice of reimbursing vendors for the paid claims for employees on a daily basis, via wire transfer. In effect, the Company has assumed that employees earn these benefits, receive covered services, submit claims and are reimbursed immediately. However, in reality, considerable lags are associated with the time between earning such benefits and USWC's cash payment. When asked in Data Request UTI 29-29 about the lag time for only the claims processing portion of this time line, USWC responded "The lag time that might exist between the health care provider submitting claims to the health insurance company for payment is data that U S WEST does not have available." Instead of simply assuming a zero lag value and dramatically understating the overall benefit lag days, Staff has adopted the benefit lag day value assigned to this item in the Company's most recent FCC lead lag calculations, which are based upon a turnover analysis of the relevant benefits liability account. Using the FCC basis lag value for these insurance items also requires elimination of the "Average Benefit Liability" balance that USWC had included as a reduction to cash working capital at line 26 of Schedule B-4.

The final Staff adjustment to the employee benefits lag calculation is to recognize the statutory timing of remittances of Federal and State unemployment contributions, which are due and payable at the end of the month following each calendar quarter. The Company's calculation relates the statutory payments to the mid-point of a calendar year, so as to presume that the average payment of FUTA and SUTA precedes the actual service by employees throughout the year that creates the tax liability. In reality, these taxes are not prepaid in anticipation of future employee service and wages and the Company's calculation is simply incorrect. It is true that most FUTA and SUTA is paid early in a calendar year because of the relatively low wage base to which such taxes apply. However, the tax liability arises from current employee service and is paid on new employees whenever their first wage payments begin to create the tax liability to the Company.

Q. What is Staff's next lead lag study adjustment?

A. In calculating the lag days for interest expense, USWC included amortization of issuance expenses as if these were cash expenditures with an assumed zero lag value. This treatment is inconsistent with the Company's treatment of all other non-cash amortization and depreciation expenses and improperly increases cash working capital. Staff has modified the interest expense lag day value to recognize only cash interest expenses payable by USWC.

Q. Please describe the Staff's final lead lag study adjustment.

A. A sample-based analysis of miscellaneous cash vouchers is performed to estimate the average lag days associated with the payment of the Company's various expenses other than wages, benefits and rents. Staff noted in its review that the Company's study of cash voucher payment lag days is extremely dated and inquired into the availability of study updates. In its response to Staff Data Request UTI 29-30, the Company stated, "USWC is currently investigating the feasibility of performing this study in the second half of 1999. Since this is a relatively important study item that impacts many dollars of test period expense, I recommend that the Commission require this study to be updated for consideration in any future rate proceedings.

In the absence of an updated cash voucher study, Staff noted in discovery regarding another issue that USWC has modified its accounts payable practices to extend the payment date on certain transactions (UTI 30-11). According to USWC's response to Data Request UTI 17-35, "The Company implemented stricter balance sheet management which included slowing down accounts payable payments, timing of payables, etc." An estimate of the cash voucher lag day value associated with this change in internal cash management has been included as a 0.6 day Staff adjustment to the voucher lag value included in the Company's study.

PLANT RECORDS ADJUSTMENT

Q. What is the purpose of the adjustment set forth on ACC Staff Schedule C-22?

A. This Schedule sets forth an adjustment to reduce depreciation for plant assets that appear unlikely to be in service and for which the Company cannot demonstrate that the plant is actually in service. Staff has treated these assets as "unrecorded retirements" and removed them from rate base and depreciation expense, subject to the Company affirmatively showing the assets to be in service and of benefit to customers. A corresponding adjustment to rate base is set forth at Schedule B-1, although it has a zero net impact upon rate base because FCC-prescribed mass asset accounting procedures assume that any asset, upon normal retirement, is fully depreciated. This causes the retirement entries to the books to consist of offsetting reductions to the Plant in Service and Accumulated Depreciation accounts, with no net impact upon rate base.

Q. What is the assumption behind Staff's treatment of General Purpose Computers on the first line of Schedule C-22?

A. The Company is required by the FCC to maintain Continuing Property Records ("CPRs") of its Plant in Service Investment by vintage year of acquisition, when each asset is placed into service. In the case of General Purpose Computers, USWC has a large balance of mini and micro computer units and monitors that are on the books with a 1989 vintage date. Since these types of assets have a relatively short useful life and are subject to dramatic technological improvement, it is unlikely that much if any vintage 1989 personal computer and mini computer equipment remains in service. Rather, Staff believes this category of Plant in Service represents unrecorded retirements and has removed the 1989 vintage balance from rate base and from depreciation expense.

Q. Is there any available itemization of the assets within the 1989 vintage of General Purpose Computers?

A. Yes. In response to Data Request UTI 52-06, USWC provided a 97 page confidential listing of assets contained within the 1989 vintage of General Purpose Computers. When asked to "identify any of such equipment that is no longer in service that should be retired, the Company responded, "It would be impossible to determine equipment no longer in service without conducting a special study." In response to a follow-up Data Request UTI 54-13, the Company elaborated by stating, "The special study that would be required would consist of conducting a physical inventory and reconciling it to the accounting records. Since General Purpose Computer assets are extremely mobile, such an inventory could involve all U S WEST locations."

Q. Do the Company's vintage records indicate that any General Purpose Computers remain in service after being acquired in years earlier than 1989?

A. Yes. According to page 26 of Ms. Heller-Hughes RCND study Supplemental Exhibit, there are much smaller balances of General Purpose Computers in years prior to 1989, totaling about $4.3 million for all years 1976 through 1988.

Q. When were the majority of General Purpose Computers added to the Company's Plant in Service?

A. In vintage years subsequent to 1989, the other $84 million making up the total investment of $112 million in Arizona General Purposes Computers was recorded, with the largest investments being in 1993, 1994, 1995 and 1999. It is highly unusual for an account containing computing technology to have the single largest vintage of its assets concentrated over ten years ago in 1989. It is probably that the physical inventory required to verify the existence of such assets would reveal that this equipment, if still owned by USWC, is not actually used and useful in serving customers.

Q. Is the adjustment proposed by Staff likely to be conservative in amount?

A. Yes. With respect to the General Purpose Computers, as well as the other Plant accounts listed on Schedule C-22, Staff removed only the single largest early vintage account that appeared to contain a concentration of unrecorded retirements. There are other vintages earlier than the selected year of adjustment that are smaller in dollar amount that were not investigated or adjusted by Staff, but which likely also contain significant amounts of unrecorded retirements. These other vintages were not adjusted to intentionally add conservatism to Staff's estimated adjustment for unrecorded retirements, but the Company should also be held accountable for justifying its recorded investment in these earlier years.

Q. What vintages and types of assets are included in the Digital Switching and Digital Circuit Equipment accounts, as contained on lines 2 and 3 of Schedule C-22?

A. An unusually large amount of Digital Switching and Digital Circuit Equipment is concentrated within the 1955 vintage plant records. Digital Switching is the current technology used to switch voice circuits and data traffic, using a computer to convert all traffic into digital format, and then process, route and control the traffic. Digital Circuit equipment includes pair-gain digital devices used to reduce the physical pairs required to serve customers and digital electronic equipment used for amplification, modulation, signaling, balancing and control of interoffice channels. Such circuit equipment may be located in central offices, in manholes, on poles, in cabinets or huts or at other company locations. What is unusual about the Company's records, is the large amount of recorded investment in a 1955 vintage, long before digital equipment became available for telecommunications networks.

Q. When was the first digital switch installed by the Bell System?

A. The Bell System introduced its first digital switch in 1976.[6] This suggests that it is impossible for USWC to have Digital Switching plant on its books as of 1955. It is reasonable to expect that certain central office equipment and hardware in existing central offices was retained in service to support new digital switch installations, when older electromechanical or analog equipment was removed. Nevertheless, it is unlikely that such equipment would be concentrated within the 1955 vintage, as reflected in the Company's vintage property accounting records. In response to Data Requests UTI 52-07 and 52-08, the Company did not identify any of this equipment to be either in service or retired, claiming, "The requested data is not available without performing a special study."

Q. What is the basis for Staff's elimination of depreciation expense for the 1925 vintage Underground, Buried and Intra-building Cable accounts at lines 4 through 6 of Schedules B-1 and C-22?

A. As with the General Purpose Computers, Digital Switching and Circuit Equipment, the Company has apparent unrecorded retirements for these Cable accounts, as indicated by the disproportionately large amounts of plant in the earliest indicated vintage for these Cable plant asset accounts. The recorded vintage distribution for these Cable Accounts can be observed at pages 45, 48 and 53 of Ms. Heller-Hughes' Supplemental Exhibit. It is unlikely that such large cable investments that are 73 or more years old remain in service for the benefit of ratepayers in Arizona.

Q. How does the Company explain large balances in 1925 vintage Cable accounts?

A. In responding to Data Requests UTI 52-09 and 52-11, USWC stated, "Certain Outside Plant assets were not kept with vintage data prior to 1989. These assets are assigned a 'fictitious' year of 1901 on the accounting records. The depreciation studies reports provide [sic] by Ms.

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[6] Hyman, Leonard S., *The New Telecommunications Industry: Evolution and Organization*, Vol. I, Public Utilities Reports, Inc., Arlington VA. 1987. p.37

Heller-Hughes aggregate all 1925 and prior vintages into the 1925 amount, the majority of which are the 'non-mortality' records. It would be impossible to determine plant no longer in service without conducting a special study" From this response, it is obvious that the Company has no idea whether the plant remains in service or what vintage the costs actually belong in. Staff's concerns with the adequacy and accuracy of the Company's plant records has been translated into a reduction in depreciation expense to allow for apparent unrecorded retirements, as a conservative remedy for the apparent problems with plant records.

Q. Has the Company also recently been audited by the Federal Communications Commission with respect to the accuracy and adequacy of its property accounting records?

A. Yes. FCC auditors in the Accounting Safeguards Division of the Common Carrier Bureau conducted audits of Regional Bell Operating Companies' (RBOC's) central office equipment, seeking to verify the completeness and accuracy of continuing property records ("CPR") information recorded on the books. These audits included sample-based physical examinations of hard-wired central office equipment in selected USWC central office locations, including facilities in Arizona. In audit reports filed with the FCC, the auditors claimed they were unable to locate certain central office equipment which is recorded on the books of the RBOC's, including USWC. The auditor's reports also state that the CPR records contained deficiencies and did not comply with the FCC's rules. In its recommendations, the audit report stated that US West should write off $597.2 million from its central office equipment to remove the estimated cost of its missing Hard-wired Equipment and Undetailed Investment and engage an independent auditor to review US West's practices, procedures and controls for maintaining CPR.[7]

Q. Has the Company disputed the audit findings and recommendations?

[7] UTI 1-27, ASD Audit Report, Recommendation paragraphs 38 and 39.

A. Yes. U S West and the other RBOC's are vigorously disputing the audit reports and have submitted formal responses to the FCC explaining the issues raised by the audits. In its submissions to the FCC, U S West claims it has "found" most of the central office plant assets that the FCC auditors were unable to locate. In addition, USWC responded to the sampling techniques employed by the FCC auditors, claiming them to be "fatally flawed". While acknowledging that its CPR records were not perfect, USWC argued that the FCC's recordkeeping rules are extraordinarily detailed and burdensome.

Q. Has the FCC taken any formal action with respect to the CPR audits?

A. To date, the FCC has published the audit reports and on April 7, 1999 issued a Notice of Inquiry in CC Docket No. 99-117 to receive public comments on the issues raised by the audits. Comments have been received by the FCC and no further action has been taken at this time.

Q. Has USWC conducted its own internal review of the recorded central office equipment balances and underlying continuing property records?

A. Yes. The result of the Company's internal review was the recording of a minimal adjustment to the Arizona records, retirements to plant totaling less than $12,000 (UTI 4-30). The Company has also increased its efforts to train personnel on the accounting requirements for central office equipment (UTI 14-03).

Q. What would be the impact if further adjustments were required to the recorded Arizona plant in service balances due to overstated investment amounts, as suggested by the FCC audit?

A. If additional retirements should be recorded, there would be no impact upon rate base. This is because of the mass asset accounting procedures, as noted in earlier testimony. However, any additional retirements that should be recorded would translate into reduced depreciation expense, in an amount based upon the appropriate accrual rate times the plant balance impact.

Q. Has Staff proposed any adjustment at this time with respect to the FCC audit report or ongoing inquiry?

A. No. Staff has not independently conducted any physical audit of the Company's plant investment in Arizona and there has been no resolution of the issues at the Federal level. It is Staff's recommendation that the Company promptly report to the Director of the Utilities Division upon receipt of any FCC Order associated with the CPR audit and inquiry that is ongoing. Moreover, Staff encourages the Commission to approve the adjustments to depreciation expense in Schedule C-22 so as to not charge customers for depreciation of assets that are likely not in service. Finally, the FCC may also consider imposing additional physical CPR audit requirements upon the Company in a systematic and cost-effective manner, to ensure that all unrecorded retirements are identified and the continuing property records are more accurately stated in the future. A reporting of the results of any such additional FCC-imposed plant audits to the Utilities Division should be required of USWC.

SALE OF EXCHANGES

Q. Has the Company proposed a pro-forma adjustment in its updated filing to account for the pending sale of 38 rural exchanges to Citizens Communications?

A. Yes. Adjustment P-07 "Arizona Access Line Sale" is proposed in the Company's filing. This adjustment reduces Intrastate Operating Income by $4.3 million and Rate Base by $103.3 million to exclude the estimated impact of the exchanges being sold from calculated revenue requirements. The adjustment is designed to extract actual test period revenues and net plant from recorded data, while the expense elements of the adjustment are estimates based upon allocations of Arizona expenses due to the lack of exchange-specific expense accounting records.

Q. Does the Staff take exception to any elements of the Company's pro-forma adjustment to remove the exchange sale?

A. Yes. Certain expense allocations within the Company's pro-forma adjustment fail to reasonably attribute costs to the exchanges being sold. One problem is the absence of any cost allocations for Corporate Operations expenses to the exchanges, as if these corporate costs are entirely fixed and will not be reduced when the scope of the Arizona business is reduced. Another problem is created by the Company's arbitrary reduction of marketing costs otherwise allocable to the sold exchanges, as if marketing cannot be reduced proportionately when access lines and revenues are reduced from the exchange sale. Finally, depreciation expense related to the sold exchanges is removed from the test period based upon recorded booked expense amounts, which creates an inconsistency in the Company's filing, because of the annualization of overall intrastate depreciation (including exchange sale plant investment) in another of the Company's pro-forma adjustments using revised new depreciation parameters. Depreciation must be removed for the sold exchanges at the same accrual rates used to calculate annualized depreciation in other parts of the Company's asserted revenue requirement.

Q. Have you prepared an Accounting Schedule for the purpose of restating the Company's Exchange sale adjustment?

A. Yes. In Schedule C-29, Staff has proposed adjustments for these known problems, so as to restate the exchange sale pro-forma expense adjustment to more reasonable levels. At lines 1 through 5 of Schedule C-29, test period marketing expenses are allocated by Staff to the exchanges being sold based upon relative revenues in such exchanges, as a percentage of total Arizona revenues. This approach is consistent with the allocation factor used by USWC, but does not accept the Company's arbitrarily further reduction of the allocated marketing expenses by [redacted]. USWC's adjustment assumes that the majority of its marketing is done in urban areas and the share of marketing in rural areas is less. According to the Company's response to Data Request UTI 62-22, "When an informal survey of product manager [sic] was conducted in 1998, most managers said that they believed that about half as much marketing dollars were spent in rural areas as compared to urban areas on a per access line basis." Staff believes this reduction to be unreasonable and not supported by any studies or specific facts. There is no reason to believe that USWC could not reduce its marketing costs in proportion to its smaller business operations in Arizona after selling exchanges.

The second element of Staff's adjustment on Schedule C-29, at lines 6 through 10, is to attribute some reduction in Arizona Corporate Operations Expenses to the exchange sale, rather than accepting USWC's apparent assumption that all of these expenses are fixed in amount and cannot be reduced when part of the Company's business in Arizona is sold. Even though the exchange sale represents over [redacted] percent of Arizona plant investment and over [redacted] percent of revenues and access lines, Staff has conservatively estimated that corporate operations expenses could be reduced by only one percent as a result of the reduced scope of Arizona operations. In contrast, the Company's adjustment assumes absolutely no reduction in USWC Corporate Operations Expenses will occur with the exchange sale.

The third element of Staff's Schedule C-28, at lines 11 through 13, is to remove depreciation expense using the revised depreciation parameters recently approved by the Commission. This change corrects an inconsistency in the Company's filing caused by the use of new depreciation parameters for overall plant in service in the State, versus lower per-books depreciation in the Company's exchange sale adjustment. The quantification of this part of the Staff's adjustment is based upon the Staff's proposed updated depreciation accrual rates and is set forth as a separate column in Mr. Carver's Schedule C-15, the depreciation annualization adjustment. A different adjustment than appears at line 13, reducing depreciation by $8.9 million, would be required to achieve consistency in depreciation rates if the Company's proposed depreciation accrual rates are approved by the Commission in place of Mr. Dunkel's proposed accrual rates (UTI 52-14).

Q. Why is it reasonable to expect USWC to reduce marketing costs proportionately with the sale of exchanges?

A. It should be recognized that marketing activities and costs are discretionary and are incurred when a market "payback" can be realized above incremental costs that are incurred. The exchange sale reduces the size of the addressable market in Arizona for USWC's regulated intrastate services. This reduced market size will impact the economics of discretionary marketing decisions and make it more difficult to achieve favorable results from a given expenditure level. In addition, the smaller Arizona regulated market should cause regional and corporate marketing expenses to be allocated away from Arizona, toward states that are not reducing access lines as significantly as Arizona. Of course, marketing activities and costs are even more uncertain in the future, after the planned exchange sales are to close, due to the Qwest merger and broadening of product mix and market areas outside the traditional U S West service territories. In this dynamic environment, it is important to recognize that Arizona is becoming a smaller part of a much larger business enterprise, in part due to the pending exchange sale.

Q. Why is it reasonable to assume that some portion of USWC corporate operations expenses will be reduced as a result of the exchange sale?

A. Corporate Operations expenses include executive, planning, legal, accounting, finance, external relations, human resources, information management, procurement, research and development and other general corporate expenses. While many of these expenses do not vary directly with the size of Arizona's regulated business, they are not completely fixed expenses as assumed by USWC. For example, certain charges to USWC from affiliates are based upon the relative size of USWC compared to other affiliated entities. When the sale of exchanges by USWC reduces the size of the regulated business, a somewhat lower percentage of these affiliate-allocated expenses are chargeable to USWC. Other regional and corporate expenses within USWC are also allocated among states using corporate prorate factors that are based upon relative size-based statistics in each state. Since Arizona's pending access line sale is larger than proposed sales in other states, it is reasonable to expect that somewhat lower shares of regional and corporate costs will be allocable to Arizona in the future. Finally, it cannot be ignored that USWC is selling exchanges that are rural in nature, presumably for economic reasons. To realize the full potential economic benefit of such sales, it is necessary for the Company to reduce the size of its corporate overheads to match the reduced scope of the regulated business.

Q. Has the Company proven that its corporate operations expenses are entirely fixed and cannot be reduced upon sale of the rural exchanges?

A. No. The Company explained its position in response to Data Request UTI 62-23 as follows:

> USWC believes that corporate operations expenses are relatively fixed. These expenses include items like systems costs, executive, accounting, external relations, legal and other expenses which would not be materially impacted by the sale of a small percentage of USWC's access lines. These types of corporate expenses are not access line sensitive - and cannot be attributed to specific exchanges. Most corporate operations expenses benefit not only all of Arizona, but all of USWC. USWC has performed no special studies. It is USWC's view that these costs are not variable in nature, and therefore will not be materially reduced due to this exchange sale.

Q. Is the one percent corporate cost reduction factor you propose based upon your judgment, rather than any detailed analytical study?

A. Yes. The Company has failed to prove that its corporate operations expenses are entirely fixed and cannot be reduced in some amount as a result of significant reduction in the scope of Arizona regulated operations. Clearly, some corporate costs are driven by relative size-based allocators that will be reduced as a direct result of pending announced access line sales. Other Arizona corporate costs represent administrative support for the business and its employees, some of which can be reduced when employee levels decline and Arizona operations are reduced in scope. In my opinion, a one percent allocation factor is a reasonably modest target for such reductions in the absence of Company evidence to the contrary.

Q. Is there another reason why some portion of USWC's corporate operations expenses should be attributed to the exchanges being sold to Citizens Communications?

A. Yes. The Company has entered into a series of network support service agreements with Citizens to be effective upon closing of the sale. According to the Company's response to UTI 63-11, "There were no adjustments made either within the updated test period or as a proforma for services that may be provided to Citizens because the sale has not yet taken place. Any such amounts would be speculation at this time, and the criteria for proforma adjustments is that they be known and measurable." The premise behind the Company's adjustment to reflect the exchange sale is to quantify the estimated proforma effects of the sale as if the transaction has occurred. Thus, rigid application of the known and measurable standard must be relaxed because the exchange sale quite obviously had not received ACC approval or been closed at the time the Company's or Staff's rate case filing was due. In estimating the pro-forma effects of the exchange sale, some allowance for contract support services to be provided by USWC to Citizens could be recognized as a reduction to ongoing intrastate expenses incurred by USWC. Approval of Staff's revisions to the Company's proforma adjustment with a one percent corporate operations expense allocation reflects, in an indirect manner, such recognition.

Q. Has the Company provided any estimate of the gain on sale of exchanges that is anticipated in Arizona?

A. Yes. In response to Data Request No. UTI 50-01, the Company estimated the gain associated with the Arizona access line sale to be approximately [redacted] before taxes and allocations to intrastate, and about [redacted] after income taxes and intrastate allocations. The Company has proposed to retain this gain for its shareholders, while Staff witness Ms. Linda Jaress has proposed alternative treatments for such gains. I mention this gain estimate in my testimony solely as a convenience to the Commission as it integrates any findings from Docket No. T-1051B-99-0737 into the Company's rate order.

Q. Does the Staff's revenue requirement recommendation include any crediting of this gain amount to the benefit of ratepayers?

A. No.

BROADBAND CABLE TRANSACTIONS

Q. What is proposed in the Company's filing with respect to the new broadband cable service business operations in Arizona?

A. The Company's updated filing adjusts the net plant investment, revenues and expenses associated with the provision of cable entertainment services in Arizona, so as to treat this business segment within a non-regulated affiliate for ratemaking purposes. Mr. Redding explains the Companys's position at page 13 of Supplemental Testimony. He notes that a separate subsidiary has been established by the parent company that is referred to as "Broadband Services, Inc. ("BSI") and that "...U S West currently has an open docket, Docket No. T-1051B-99-0499 in which it is requesting the transfer of the assets related solely to the provision of cable services from U S WEST Communications to BSI." To facilitate the operations of the BSI affiliate, a variety of new transactions have commenced pursuant to new affiliate contracts between USWC and BSI. The affiliate is heavily dependent upon USWC for network, marketing, billing & collection and other general administrative services. These affiliate transactions between BSI and USWC were recorded in 1999 and are ongoing in nature, even if the transfer of assets to the new affiliate is delayed or does not occur.

In its filing, the Company includes within the details of revenue and expense adjustments certain pro-forma levels of affiliate transactions with the BSI entity. Within revenues, the Company has included $22.9 million of charges to BSI (prior to intrastate separations). Within proposed test period expenses, another $816,000 of charges to BSI are recognized as negative expenses (RUCO 26-03) based upon the Company's flawed December times 12 expense annualization methodology. A third adjustment to reduce end-of-period rate base is separately presented in the Company's filing as Adjustment P-09 (Supplemental Exhibit GAR-S7F).

Q. Do any of the adjustments in the Company's filing presume Commission approval of the broadband video asset transfer to the separate affiliate?

A. Yes. The Company's rate base asset transfer adjustment is directly linked to the pending separate Application in Docket No. T-01051B-99-0499. In its response to Data Request RUCO 26-03, the Company admitted two errors in its quantification of the asset transfer rate base adjustment amount. I am advised by Staff Counsel that USWC has recently requested suspension of the procedural schedule in Docket No. T-01051B-99-0499 and that changes to the asset transfer proposal may ultimately occur. Therefore, Staff's rate base adjustment Schedule B-6 has eliminated the Company's asset transfer adjustment.

Q. Does suspension of the asset transfer Application before the ACC eliminate the need for the operating income adjustments to account for test period affiliate transactions occurring between USWC and the BSI affiliate?

A. No. BSI was established as a separate affiliate in March 1999 and has continuing operations in Arizona requiring ongoing transactions with USWC. It would not be appropriate to eliminate the operating income adjustments for transactions with the Broadband affiliate because such transactions will continue without regard to the asset transfer. Moreover, because the underlying costs incurred by USWC to provide services to BSI remain within test period expenses of USWC, a reasonable accounting for affiliate revenues from BSI is required to offset such incurred costs.

Q. Are the amounts of the Company's proposed broadband operating income adjustments reasonable?

A. No. The Company's filing includes rough estimates of the ongoing revenues to USWC from affiliate transactions with BSI. A footnote within the Company's revenue workpapers makes the following statement:

> The Broadband Services Amts are the payments from affiliate to USWC primarily for use of the USWC network. Other charges include

> payment for general services such as accounting, HR, etc. and for Billing and Collection (included in acct 5262). This is what was booked in 1999 for 10 mos and included some items that will go away eventually (payment for assets to be transferred). I left it thinking the decrease would be offset by 2 more months of revenue. I will try to get a better estimate as we go forward.

Unfortunately, no better estimate was produced by the Company in response to Staff's discovery in this area. In discussions with Company personnel and in response to Staff Data Request UTI 62-12, it was revealed that "In order to prepare the Broadband Video Cable adjustment in the short time allowed, an assumption was made that the amount for 10 months billing, including one time charges would be somewhat comparable to 12 months of billing." It now appears to Staff that the Company's estimates are dramatically understated in relation to actual ongoing BSI transaction levels in 2000.

Q. How have transactions between USWC and BSI changed since the end of the 1999 updated test period?

A. Charges from USWC to BSI have [redacted] since the end of the test period. The confidential response to Data Request UTI 60-31 indicates that such charges to BSI [redacted] after only the first six months of 2000. Because of this trend, Staff's adjustment for BSI transactions must be viewed as conservative.

Q. Did Staff attempt to obtain detailed transaction information, including historical 1999 and ongoing year 2000 quantities and prices for each type of ongoing transaction, so as to improve upon the Company's gross assumptions in its proforma adjustments?

A. Yes. However, despite conversations with Company personnel, considerable discovery problems and delays in this area, information in usable form was difficult to obtain. With respect to the 1999 information relied upon in the Company's proforma adjustment, requests for detailed monthly transaction support yielded only high-level accruals that were reversed in the following month and non-informative invoice and journal details (UTI 53-08, 62-15 and 62-16). Year 2000 information was received for Arizona transactions with BSI only the week before testimony was due to be filed, precluding any detailed follow-up analysis.

Q. In light of these circumstances, what is proposed by Staff with respect to proforma adjustments for BSI affiliate transactions and operating income adjustments?

A. BSI was formed in March of 1999 and was in business for only the last 10 months of the test period. Because of this, Staff has adjusted the recorded 1999 test period transactions with BSI, so as to annualize the 10 months of recorded year-to-date December revenue activity through multiplication by 12/10. This approach is reflected in Schedule C-6 at lines 1 through 6. Then, the corresponding expense elements of the adjustment are recognized at lines 7 through 13 of Schedule C-6. This second part of the Staff's adjustment starts with actual recorded negative expenses associated with services provided by USWC to BSI in the test period of $5.7 million (after reversal of Mr. Redding's flawed non-labor end of period adjustment, as described in Mr. Carver's testimony). These negative recorded expenses for the last 10 months are also annualized through multiplication by 12/10.

Q. Is a different adjustment required if Mr. Redding's non-labor end of period annualization adjustment (December times 12) is accepted by the Commission, over the objections of Staff?

A. Yes. In place of the $5.7 million of recorded negative expenses for BSI transactions, it would be necessary to substitute Mr. Redding's $816,000 negative expense result at line 7, resulting in a larger expense reduction than the $822,000 now depicted at line 12 of Staff's Schedule C-6. This larger adjustment would reduce expenses by $4,348,000 rather than $822,000, as explained in footnote (a) on Schedule C-6.

Q. Are the Schedule C-6 operating income adjustments proposed by Staff necessarily based upon assumptions and estimates that are subject to change?

A. Yes. The BSI affiliate transaction amounts reflected in Staff's filing represent an extrapolation of recorded actual 1999 transactions to an annualized level as of December 1999, without regard to the substantial changes in the underlying transactions that are occurring in 2000. This is also true of the Company's rate case adjustments, as noted in the footnote quoted above. However, given the rapid growth in BSI business activity and the level of transactions with USWC, I expect that Staff's proposed level of charges to BSI is significantly understated to the Company's benefit in the rate case. In its response to Staff Data Request UTI 62-10, the Company provided actual year 2000 monthly BSI transactions with USWC and stated, "The volumes associated with all the listed services [provided to BSI] are expected to grow commensurate with the growth in subscribers". In the confidential response to UTI 60-28, the Company stated the number of Arizona subscribers to BSI service has [redacted] in March 1999, to [redacted] in December of 1999 and [redacted] by June of 2000. None of [redacted] has been recognized in Staff's adjustment.

Q. Are there reasons why charges from USWC to BSI may decline in the future?

A. The Company's response to Data Request UTI 65-12 suggests that revenues from BSI for one type of service may decline in the future, due to pending asset transfers now before the ACC:

> The assumptions used [in USWC's BSI adjustments] were based upon historical data. Since BSI is a new affiliate, there is little history, but no better assumptions were available. The Company does know that if the ACC approves the asset transfer from Qwest to BSI, revenues received from BSI will drop substantially. An estimate based on historical data would put "after transfer" revenue at approximately $8M annually. However, the amount cannot be substantiated at this time.

Staff has relied upon the same 1999 recorded transactions with BSI for its adjustments that were used in the Company's adjustment. If the proposed asset transfer is now anticipated to reduce annual revenues from the BSI affiliate by as much as $15 million annually ($22.9 versus $8M), the Commission should be quite concerned in approving such asset transfers and creating such a large revenue loss to USWC's Arizona business.

Q. How does the pending asset transfer compare to the potential loss of USWC rental revenues from BSI?

A. Given the Company's pretax return requirement of 14 percent on rate base assets, the transferred assets would need to be valued at more than $100 million to "save" as much return on investment as would be "lost" from BSI rental revenues. However, the asset transfer before the Commission involves only $1.4 million of net intrastate Arizona investment (See Schedule B-6). Even considering the cost of depreciation on such assets, it would be unreasonable to transfer only $1.4 million of investment to BSI if rental revenues to USWC would decline by as much as USWC now suggests.

Q. If the separate proceeding, ACC Docket No. T-1051B-99-0499 is suspended and asset transfers do not occur for consideration in this rate proceeding, what should be done to determine USWC's revenue requirement?

A. The Company's rate base adjustment for asset transfers should be reversed in order to reflect continued USWC ownership of the assets, as depicted in Schedule B-6. However, the Staff's proposed adjustments to USWC operating income in Schedule C-6 should be approved, so as to reflect the ongoing transactions with BSI that will continue even if the asset transfer does not occur.

RECIPROCAL COMPENSATION

Q. What is reciprocal compensation and how has it been treated in the Company's filing?

A. Pursuant to interconnection agreements between USWC and competing carriers, traffic generated by customers of a local carrier that relies upon the facilities of another carrier for completion may require the payment of compensation to or from that other carrier. In the test period, USWC recorded both revenues and expenses associated with the receipt and payment of reciprocal compensation as follows:

Test period recorded reciprocal compensation revenues	$6,561,701
Test period recorded reciprocal compensation expenses	17,982,288
Net Per Books Cost - Reciprocal Compensation	11,420,587

However, by ratemaking adjustment, the Company has removed all of these recorded transactions and has substituted a pro-forma net cost of $13,252,000 as an addition to the bottom-line revenue requirement shown on Mr. Redding's Supplemental Exhibit GAR-S1. This addition is captioned, "Automatic Adj. Mechanism Revenue Requirement" to coincide with Mr. Redding's proposal that an "automatic rider" serve to change the rates paid by customers for all future changes in reciprocal compensation.

Q. What arguments are advanced by Mr. Redding for this special treatment of reciprocal compensation?

A. At page 15 of his supplemental testimony, Mr. Redding states, "Right now net reciprocal compensation is growing very rapidly. In the future, as agreements are modified or renegotiated, this level may drop. In other words, the situation is very volatile. An automatic adjustment mechanism would ensure that the Company received no more in rates than it is entitled to, whereas inclusion in the base revenue requirement would ensure that the Company would either over or under collect in the future." Mr. Redding's proposed automatic rider would be changed every six months or quarter based upon reported amounts to the Commission that would be subject to audit at any time.

Q. Does USWC have automatic rate adjustment riders for any other elements of its Arizona revenue requirement?

A. No. The Company's proposal represents a significant departure from traditional regulation of USWC in which all elements of cost of service are included in base rates and are reviewed and quantified within a test period and in the context of general rate cases.

Q. Does Staff support the adoption of an automatic rate adjustment mechanism for USWC's reciprocal compensation net expenses?

A. No. The Company's proposal for such an adjustment mechanism should be rejected for a number of reasons, including:

- It is improper, piecemeal ratemaking to single out one isolated element of the overall revenue requirement for rate adjustments, while ignoring other changing revenues and costs that may tend to offset the isolated element.

- Other elements of USWC's revenue requirement are more significant and more variable, yet are not proposed for automatic rate adjustments, causing the Company's proposal to be asymmetrical and distortive of the overall cost of service.

- The costs in question are not significant enough to materially impact USWC earnings if automatic rate adjustments are not approved.

- The incentives for USWC to prudently negotiate and administer reciprocal compensation agreements is diminished if the costs of reciprocal compensation can simply be passed through to ratepayers.

- The administrative cost and complexity of introducing quarterly or semi-annual filings, audits and rate adjustments for reciprocal compensation are not justified in light of the relative importance of such costs to the accurate measurement of USWC's revenue requirement in Arizona.

- The Company has not sufficiently developed its proposal to allow full review and consideration of the significant reporting, rate design, tariff administration or customer bill disclosure issues that are created.

Automatic adjustment of customers' rates should not be granted for these reasons. Instead, a reasonable quantification of reciprocal compensation should be included in base rates and any future changes in such costs should be considered along with and at the same time as all other revenue requirement elements.

Q. What percentage of the Company's overall intrastate revenues does the net cost of reciprocal compensation represent?

A. At the Company's proposed net cost level of $13.3 million, reciprocal compensation represents only one percent of total Arizona intrastate operating revenues of about $1.2 billion.

Q. Do other elements of the Company's revenue requirement change more dramatically than the net cost of reciprocal compensation?

A. Yes. For example, USWC has quantified the effects of wage and salary increases to be over $13 million for only the increases in March and August of 2000. Salary and wage increases are routinely granted by USWC and do not receive automatic rate adjustments treatment. Offsetting such cost increases are the ongoing effects of access line and local recurring revenue growth, that Staff has quantified to add approximately $26 million to USWC's Arizona pretax income in only six months time (Schedule C-1, line 15). Because costs and revenues are dynamic and change continuously and significantly between rate case test periods, it is unreasonable to allow a single type of cost to be singled out for automatic rate adjustment except in very special circumstances. It is important to maintain the balance and matching of test period regulation and not allow piecemeal regulation of selected cost items so as to recognize that growth in revenues will continue to be available to USWC to offset increases in wages, reciprocal compensation or other areas of the business.

Q. Is there another issue area in the Company's proposed filing that is more deserving of special ratemaking or automatic rate adjustment than reciprocal compensation?

A. Yes. USWC transactions with the new Broadband Services affiliate involve [redacted] revenues to USWC for support services being provided this affiliate. The amounts of such affiliate transactions in the test period are quite large and volatile and the Company's proforma ratemaking adjustments in this area were very tentative. In the first six months of 2000, revenues to USWC from this source have [redacted], yet the Company has proposed no automatic rate adjustment for these transactions. Clearly, selection of only certain increasing cost elements for automatic rate adjustment, while ignoring other offsetting new revenue sources, can be very distortive of the Company's ongoing revenue requirement.

Q. What types of special considerations have been recognized by regulators to justify the adoption of piecemeal automatic adjustment clauses and rate adjustments between test periods?

A. Where an extremely large cost or revenue item is truly not controllable by management and could adversely impact the financial stability of the business if not tracked into prices, automatic rate adjustments are used by some regulators. The most common examples are for fuel and purchased power expenses incurred by electric utilities and for purchased gas expenses for gas distribution utilities. These costs are very large components of the overall cost of service and are subject to competitive market price fluctuations that are largely outside the control of management. Even so, regulators in some states including Arizona have sought to carefully review and in some instances eliminate automatic fuel cost rate adjustment mechanisms for some of the same reasons USWC's new tracker is objectionable.

Q. Do the reciprocal compensation net costs faced by USWC represent extremely large, uncontrollable costs that threaten the financial stability of the business if not subject to automatic rate adjustment in Arizona?

A. No. While it is true that such costs will continue to vary in the future, as policy issues are resolved and contracts are negotiated, the magnitude of the costs does not rise to a level justifying rate tracking of the costs. Moreover, to my knowledge the Company has no automatic rate adjustment for such costs in its other state jurisdictions.

Q. Has USWC produced any estimates of its anticipated reciprocal compensation costs, so as to evaluate its claim that the costs are growing very rapidly are expected to be very volatile?

A. No. In fact, in a recent dispute before the ACC over reciprocal compensation for internet service provider traffic involving Sprint, the Company prevailed and such traffic was ordered to be compensated on a bill and keep basis, thereby reducing the Company's exposure to increased reciprocal compensation.[8] The Company claims that it is impossible for it to forecast reciprocal compensation amounts that may be payable in the future.

Q. What do you propose with respect to the basic test period treatment of reciprocal compensation costs in lieu of Mr. Redding's proposed automatic adjustment of future rates for such costs?

A. Adjustment C-30 includes in the test period the actual 1999 reciprocal compensation revenues and expenses that were recorded on the books, but then removed by USWC in its annualization adjustments. Upon Staff's inclusion of the actual 1999 amounts, there is no need for the separate line item adding $13.3 million to the calculated revenue requirement on Staff Schedule A and there is no need for future automatic rate adjustment for changes in this level of costs. In the event the Company presents compelling evidence in its rebuttal presentation in support of a different level of reciprocal compensation than was recorded in 1999 and that does not distort other test period relationships, alternative amounts may prove reasonable for consideration as part of the revenue requirement. At this time, the test period recorded values included by Staff represent the only known and measurable amounts that are consistent with

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[8] Decision No. 62650 in Docket No. T-02432B-00-0026, June 13, 2000

the other test period revenue and expense levels. According to the Company's response to UTI 64-21:

> The amount of reciprocal compensation expense during the test period is now known and measurable. The FCC may change the compensation arrangement for reciprocal compensation but the Company does not know if or when such a changes will be made. The reciprocal compensation docket has already been pending for several years now. The FCC's February 25, 1999 decision is available at www.fcc.gov.

Until issues are permanently resolved with respect to this issue, the Staff's adjustment to include test period actual revenues and expenses is the most appropriate ratemaking provision for reciprocal compensation.

AFFILIATE TRUE-UP ADJUSTMENTS

Q. What is the purpose of Staff Adjustment Schedule C-9?

A. Many of the U S West affiliates that regularly transact business with USWC submit monthly billing for services they provide that are based upon estimates, subject to periodic true-up adjustment and revised billings. Since the true-up adjustments may occur and be booked outside the test period, or be recorded within the test period but affect months outside the test period, it is necessary to account for the true-up adjustments in a manner that properly matches costs with the test period. The purpose of Staff Adjustment C-9 is to recognize affiliate true-up adjustments in a manner consistent with the calendar 1999 test period.

Q. Does the Company concur in the adjustments shown on Schedule C-9?

A. USWC has proposed that all its expenses be annualized based upon a single month, December 1999, multiplied by twelve. Staff rejects the Company's proposed single-month test period and asked USWC to prepare all of the required normalization adjustments for the entire test year as if its single-month annualization were not employed. In its response to Data Request UTI 43-20, the Company provided the "adjustments not made" due to its December times 12 approach, including this affiliate true-up out of period adjustment that is now proposed by Staff. I believe the Company recognizes the propriety of this adjustment in Staff's case, since Staff is utilizing a full 12 month test period.

Q. Should this adjustment be made if the Company prevails in its December times twelve annualization position?

A. No. However, the affiliate transaction expense amounts are not stated at reasonable and representative levels in December and other normalization adjustments are clearly required, but have not been made by the Company.

U S WEST INC. DISALLOWANCES

Q. What is the purpose of Staff Adjustment Schedule C-20?

A. Adjustment C-20 represents a partial disallowance of U S West, Inc. ("USWI") parent company charges for certain responsibility centers ("RCs") that are allocated to USWC and its Arizona operations.

Q. What are the USWI parent company charges that this adjustment relates to?

A. The parent company maintains a staff of administrative personnel that provide centralized services and allocates its costs to USWC and other affiliates such as U S West DEX, U S West Communications Services, U S West !nterprise America, U S West Wireless and other entities. These services include the following:

Executive Management	Human Resources	Public Relations
Treasury	Tax Administration	Financial Management
Strategic Planning	Benefits Administration	Corporate Development
Legal	Accounting	Insurance/Risk Management
Legislative	Regulatory Affairs	Market Research

Direct and overhead costs are accumulated into a series of RC's in each USWI functional area and are charged or allocated among the subsidiaries of U S West Inc. based upon time reporting or certain relative-size-based allocation factors. Because it is the largest of the subsidiaries of USWI in the test period, USWC bears the majority of these allocated parent company allocated costs.

Q. What is the total amount of such USWI parent company charges included in the test period Arizona revenue requirement asserted by USWC?

A. Total actual test period recorded intrastate USWI charges total $10.4 million for headquarters billings on an Arizona intrastate basis (UTI 42-20). These charges are accumulated within approximately 75 individual RCs that charge a share of incurred costs to USWC based upon the presumption that the activities and costs in each RC are of benefit to USWC and its customers. However, a different and seriously understated level of USWI costs is embedded within the Company's asserted revenue requirement, if the Commission adopts the Company's one-month times twelve annualization of all expenses, based upon costs in December 1999.

Q. How much USWI headquarters expense is included if the Company's end of period non-labor annualization adjustment is accepted, over the objections of Staff?

A. USWI costs are understated in the Company's filing because of Mr. Redding's flawed end of period approach because December actual USWI headquarters allocations to Arizona intrastate totaled <u>negative</u> $242,072. Since the Company multiplies December times 12 to annualize expenses, the result is an annual level of intrastate parent company headquarters costs of <u>negative</u> $2.4 million. However, since Mr. Carver sponsors a Staff adjustment to reverse the Company's December-times-twelve non-labor annualization adjustment, the starting point for Staff's adjustment must be the recorded test period amount stated above.

Q. How many dollars and RCs are addressed in Staff's proposed disallowance?

A. Staff proposes the partial disallowance of charges from only nine of the U S West, Inc. RCs representing total charges of about $2.3 million and a disallowance of 50 percent or $1.1 million. Thus, Staff's adjustment represents about ten percent of total parent company allocated charges to USWC's Arizona operations.

Q. Was the adjustment you propose approved by the Commission in the Company's last Arizona rate case?

A. Yes. In Decision No. 58927 at pages 25 through 31, the Commission approved either 100 percent or 50 percent disallowances for the USWI functions addressed in Schedule C-20. I have applied a 50 percent disallowance factor to all of the USWI functions in the current rate case.

Q. What is the reason for Staff's disallowance of the costs for the nine RCs at only 50 percent?

A. The activities and allocated costs within the subject RCs are not entirely without value to ratepayers, but should not be charged entirely to ratepayers for ratemaking purposes. So as to recognize that both shareholders and ratepayers receive some benefit from these activities, the costs are equally shared by placing 50 percent above-the-line for inclusion in revenue requirements.

Q. What are the reasons why 50 percent of these parent company costs should be excluded?

A. In general, the activities and costs within the RCs listed in Schedule C-20 are not of tangible direct benefit to USWC's regulated telephone business and its customers and should be partially retained by the parent company. This is because of the following basic principles:

- Senior executive management and certain other costs of the parent company would be subject to disallowance if incurred directly by USWC, such as extraordinary compensation costs, portfolio management costs (mergers/acquisitions), large corporate aircraft expenses and extraordinary travel and entertainment expenses (UTI 53-13S1 and 55-05);

- The Company has not demonstrated any need for the extra layers of senior management contained within USWI, to which senior USWC management personnel directly report;

- Strategic planning and corporate development costs at the parent represent costs of managing the portfolio of diversified holdings of USWI and include merger/acquisition costs that should be absorbed by owners of the business;

- Senior executive management costs of USWI allocated to USWC were unduly concentrated in the test period, due to the corporate separation of MediaOne in

1998 and the resulting large allocations of such corporate costs to USWC in 1999. This concentration is non-recurring due to the merger with Qwest.

- Public relations and legislative initiatives are of no direct tangible benefit to USWC customers and may reflect the desires and agenda of the shareholders rather than consumers;

- Cash management (interest) income of USWC and USWI is recorded below the line and is retained by shareholders, such that costs incurred to maximize such income should be partially borne by shareholders rather than ratepayers.

- Corporate contributions and the costs incurred to administer USWI's foundation should not be included in regulated revenue requirements.

The following testimony will elaborate upon the activities in the specific RCs that are partially disallowed by Staff, indicating how these principles apply to such activities.

Q. What is the nature of activities undertaken by U S West's President and CEO in the test period?

A. Mr. Sol Trujillo was the President and CEO in 1999. According to the confidential response to UTI 52-19, the President and CEO, "[redacted]." In this capacity, the President and CEO has general oversight responsibility of USWC as well as the entire consolidated business enterprise in matters of policy or strategic importance (UTI 29-10). According to the organization chart effective during the test period, 12 presidents and executive vice presidents of USWC and other subsidiaries directly report to the President and CEO (UTI 22-07, Attachment A).

Q. What percentage of the President/CEO expenses were attributed to USWC in the test period?

A. Because of its large relative size, compared to the other affiliated entities, USWC was charged about [redacted] percent of the allocable costs of this RC (UTI 49-03), which exceeded $[redacted] million in the test period. The Arizona intrastate share of such costs exceeds [redacted] million, as shown at line 1 of Schedule C-20.

Q. How many employees' salaries, bonuses and expenses are included in these allocable costs for the President/CEO's RC?

A. According to the confidential response to UTI 50-14, there were [redacted] total employees, including Mr. Trujillo, a manager of legal staff, and three administrative/executive assistants. The regular salaries in this RC totaled [redacted] million, while another [redacted] million in senior executive incentive compensation and [redacted] million in other employee benefits also contribute to such costs (UTI 49-03). Also contributing to the large costs allocable from the President/CEO RC of USWI are professional fees of [redacted] million and corporate aircraft allocated costs of [redacted] million (UTI 49-03 and 53-06).

Q. Are most of the salary and benefits costs in the President/CEO attributable to Mr. Trujillo, rather than the other employees?

A. Yes. According to public disclosures of Mr. Trujillo's 1999 compensation in U S West, Inc's SEC reporting, the salary component was $896,552, the bonus was $1,025,000, other annual compensation was $119,132 and restricted stock awards were $16,293,750. Footnote description of the restricted stock item states, "Mr. Trujillo was granted 300,000 shares of restricted U S WEST common stock as part of the August 1999 merger retention plan" while the response to Data Request UTI 55-50S1 states, [redacted]" was recorded in allocable USWI expenses. Total President/CEO compensation costs allocated to USWC in 1999 totaled $[redacted] million, of which the Arizona intrastate share was [redacted] million (UTI 55-05S1).

Q. Was Mr. Trujillo retained as part of the Qwest post-merger executive management team?

A. No. Mr. Joseph Nacchio is the Chairman and CEO of Qwest Communications International, Inc. and he has announced a new top executive team that does not include Mr. Trujillo (UTI 46-21). Prospectively, USWC will receive some relatively smaller allocation of senior management costs associated with the newly named Qwest executive team.

Q. Is Staff also concerned that test period recorded President/CEO costs may include labor and expenses associated with the Global Crossing and Qwest merger discussions, negotiations and related activities?

A. Yes. Costs of these mergers were to be retained by the parent company and not be charged to USWC or included within revenue requirements. However, the confidential response to Data Request UTI 53-12S1 indicates that Mr. Trujillo's total reported time involvement in meeting, negotiating and securing board and shareholder approval for the sale/merger of his Company in 1999 was [redacted] hours with respect to the Global Crossing merger agreement and only [redacted] hours with respect to the Qwest merger, [redacted]. Other executives also reported quite low hours assignable to the two test period merger transactions. Staff's partial disallowance of the identified USWI responsibility center costs is intended to remedy the apparent under-reporting of merger labor time and expenses to the mergers & acquisitions function within the parent organization.

Q. Are there unique attributes of the 1999 test period that caused overall USWI costs allocable to USWC to be increased, relative to other periods of time?

A. Yes. Prior to June of 1998, the President/CEO costs were allocated among USWC and the Media Group entities that were controlled by U S West until the corporate separation of Media Group occurred. This caused a much smaller share of President/CEO costs and other RC's costs to be allocable to USWC prior to June 1998. After the corporate separation occurred, USWI senior executive management costs became primarily allocable to USWC, due to the absence of Media Group support of such costs. However, senior executive management costs in 2000 and beyond will again be spread more broadly across the consolidated Qwest business, of which USWC is a much smaller component for purposes of cost allocations. The 1999 test period is an anomaly in that U S West, Inc. was temporarily a smaller firm for only a brief period of time.

Q. Did the Commission express any concern about the adverse parent company cost allocation impacts that may result from the Media Group corporate separation transaction in 1998?

A. Yes. In Decision No. 61075 in Docket No. T-01051B-98-0104 the Commission approved the corporate separation of the Media Group and Communications Group and cited certain cost allocation concerns as follows:

> 39. Staff also believes that there is a possibility that some additional costs may be allocated to or incurred by Arizona jurisdiction as a result of the proposed restructuring. Staff requested an estimate of total expenses to be allocated to the Arizona jurisdictional operations of USWCI for the first 12 months after the proposed separation to determine if allocated costs will increase. The Company did not supply this information because it "...would require an extensive special analysis."
>
> 40. In response to Data Request STF-01-039, the Company indicated that "[i]t is not anticipated that additional costs will be allocated to Arizona as a result of the restructuring." However, the Company also indicated in response to Data Request STF-01-038, that "[t]here is a possibility that economies of scale related to some of the shared services currently provided by U S WEST, Inc. such as in the Legal, Tax and Audit areas could be impacted in the future."
>
> 41. In addition, U S WEST will incur significant separation expenses in conjunction with the proposed transaction which will be allocated to U S WEST and MediaGroup. While some of these expenses will be allocated to the Arizona jurisdiction, in response to STF 04-099, USWCI states that its share of these expenses will be recorded below-the-line for regulatory book purposes, and the company will not seek recovery of such expenses from ratepayers.

> 42. Nonetheless, when the responses of the Company are considered as a whole, it appears that the possibilities of increased or decreased allocations to the Arizona jurisdiction are about equal and have not been estimated at this time. These allocations should be examined in the Company's next rate case.

The shared corporate services provided by U S WEST, Inc. were clearly subject to lost economies of scale as a result of the corporate separation in 1998.

Q. Has the Company addressed this issue in its testimony or prepared any information to quantify the allocation impacts of the corporate separation so the issue can "be examined in the Company's next rate case"?

A. No. It appears that USWI allocated costs to Arizona have increased significantly from the earlier test period ended June 1998 to the updated test period ended December 1999. When the Company was asked to explain the increase in Data Request UTI 64-19, the Company responded:

> The allocated charges from U S WEST, Inc. for the 1999 test period are not comparable to the July 97-June 98 test period due to the split of Media One from USWI as of 6/13/98. The main reason for the increase in allocated charges is due to the transfer of executives, Treasury, Investor Relations, Audit and Benefits Accounting from USWC to USWI. Prior to the split, these costs were a direct cost of USWC. Post-split, these costs are allocated to USWC and other affiliates, through the headquarter allocation process.

The Company failed to provide the "quantification of the monthly adjustments necessary to restate the recorded amounts for any abnormalities or other changes affecting comparability" that was also requested in this request. Absent restatement for the changes in scope of USWI operations mentioned in the Company's response, it is not possible to conduct the examination of allocation impacts that was clearly intended from the Commission's earlier order.

Q. How did the overall USWI costs allocated to USWC change after the corporate separation occurred?

A. In its confidential response to Data Request UTI 64-11, the Company stated, "On a percentage basis, USWC received a higher percentage of post-split corporate allocations because USWC represented a relatively larger financial entity as a whole in the U S WEST Inc. consolidated entity" and USWC provided the following confidential financial information quantifying this phenomena:

USWI Corporate Costs	**Pre-Split Jan-June 1998**	**Post-Split July-Dec 1998**
Total Allocable USWI $	$[redacted]	$[redacted]
Allocated to USWC (all 14 states)	[redacted]	[redacted]
USWC Percent of Total	[redacted]	[redacted]

Q. Is it reasonable to consider Staff's adjustment to disallow 50 percent of President/CEO and Executive Vice President/CFO costs to serve as an equitable adjustment for adverse allocation impacts from the corporate separation, as cited in the Commission's earlier Order?

A. Yes. In fact, all of the corporate functions included in Staff's adjustment were subject to increased allocation to USWC as a result of the corporate separation in 1998 and should now in 2000 again be subject to broader sharing upon closing of the Qwest merger.

Q. Another general reason you described for partial disallowance of parent company allocated costs is that such activities and costs may be considered portfolio management costs. Please explain what you mean by this.

A. USWI executive management oversees a portfolio of regulated and non-regulated businesses, including wireless, data communications, long distance, publishing and communications hardware subsidiaries. Analysis and decision making related to management of this portfolio, by merger, acquisition, asset sales or divestiture, are not appropriately included in the determination of regulated telephone company revenue requirements, since ratepayers do not participate in the market gains and losses or financial results of such diversified business activities. By way of analogy, if an institutional investor retained consultants to build and manage a portfolio of businesses, that investor would have no opportunity to charge his analysis and transaction costs to the businesses that are owned. However, because USWI is the owner of a regulated telephone subsidiary, it does allocate and recover the majority of such costs to USWC's regulated operations.

Q. Should USWI's Strategic Planning and Corporate Development costs be partially disallowed as portfolio management costs?

A. Yes. The Company routinely argues that ratepayers have no entitlement to the gain on sales of telephone exchanges. Moreover, shareholders rather than ratepayers realize the benefits of diversified business portfolio changes and the capital gains realized upon merger with Qwest or corporate separation from Media Group. At least a portion of the parent company incurred costs should equitably follow such benefits attributed to shareholders.

Q. Why should USWI's Vice President of Public Relations costs be partially disallowed?

A. Costs associated with activities to enhance the public image and reputation of U S West are not of direct tangible benefit to USWC ratepayers and should not be included in the revenue requirement. However, a certain amount of media relations and corporate communications activity is unavoidable, such that a 50 percent disallowance provides some above-the-line support for these activities.

Q. Why should retired officer support and U S West Foundation costs be partially disallowed?

A. There has been no showing by U S West that such costs are of any benefit to ratepayers. Nevertheless, in the event retired officers may be available as a resource of value to USWC when and if needed, a partial disallowance represents a conservative adjustment of such costs.

Q. Do the cash management activities of USWI produce any benefits to ratepayers?

A. Yes. To the extent cash management efficiencies reduce the cash working capital requirements of USWC, regulated rate base is lowered. However, cash management activities also serve to maximize the returns on invested cash owned by U S West and such returns are retained for shareholders rather than being credited to ratepayers. For these reasons, a partial disallowance is appropriate.

Q. Why have you partially excluded the costs of legislative staff within USWI?

A. As described in earlier testimony regarding public and legislative affairs activities, both ratepayers and shareholders may benefit, but the interests of shareholders are a fiduciary responsibility of management in dealing with public affairs issues. The costs of monitoring and attempting to maintain relationships and influence legislation are routinely disallowed by regulators. In this instance, a 50 percent disallowance provides some above-the-line recovery of costs to represent ratepayers' interests regarding legislative and regulatory issues of concern, while increasing the likelihood that lobbying and support costs are not excessively charged to ratepayers.

FAIR VALUE

Q. What is proposed by USWC with respect to fair value rate base?

A. The Company has proposed that a 50/50 weighting of original cost and reproduction cost new, less depreciation ("RCND") valuation of its Arizona plant investment be recognized as fair value rate base. The Company's proposed fair value rate base does not appear in Mr. Redding's Supplemental Exhibit GAR-S1 because of the later filing date permitted for the updated RCND study evidence. However, according to the Company's response to Data Request UTI 58-02, Attachment B, the estimated Arizona fair value rate base is approximately $350 million larger than the original cost rate base shown in Mr. Redding's Supplemental Exhibit.

Q. What rate of return is applied to fair value rate base in the Company's filing?

A. USWC has proposed that the same rate of return be applied to both original cost and fair value rate base. This approach causes the resulting revenue requirement to be considerably larger for the fair value rate base than for the original cost rate base. The Data Request UTI 58-02 response, referenced above, indicates about $65 million in additional intrastate revenue requirement is caused by the "Fair Value" rate base valuation in excess of "Original Cost". Notably, USWC offers no support for its proposed fair rate of return on fair value.

Q. Does the Staff's methodology for determining the required rate of return on Accounting Schedule A represent a fair rate of return on fair value rate base?

A. Yes. To the extent the valuation of rate base is increased to account for estimated fair value, a corresponding reduction in the required rate of return is necessary to recognize that the income required to meet investors' requirements does not change when property valuation approaches are changed. Said differently, USWC creditors and shareholders don't require more interest and dividend income or cash flow in fair value jurisdictions like Arizona, than they require in other states. The business income required to attract capital on reasonable terms is the same, irrespective of the basis of property valuation. No bonus income is required or warranted by the Company as a result of its fair value.

Q. Does Mr. Redding provide any capital structure or weighted cost of capital evidence that is consistent with his asserted fair value rate base?

A. No. His Supplemental Exhibit GAR-S2 reflects a capital structure and cost rates that are identical to the conclusions in Mr. Cummings' testimony. Mr. Cummings explains these capital structure and cost amounts set forth in Exhibit PCC-02 to be based upon, "...the fair return on book equity and USWC's actual capital structure and embedded debt cost..". Thus, Mr. Cummings' recommendations are applicable to a book basis statement of invested capital, including book equity and debt capital balances used to derive the capital structure and cost rates, not larger fair value balances.

Q. What return on book equity would result from acceptance of Mr. Redding's proposal to simply apply Mr. Cummings' recommendations to the larger fair value rate base?

A. An additional $38 million of "Operating Income Deficiency" is produced under the Company's fair value approach, as a result of applying Mr. Cummings' rate of return recommendation to the higher fair value rate base. This has the effect of increasing the Company's requested ROE of 14 percent to an equivalent authorized percent return rate on book equity of more than 19 percent . However, neither Mr. Cummings or Mr. Redding have supported such a high rate of return for equity investors, nor have they explained why USWC requires this additional $38 million of Arizona net income.

Q. Has Mr. Cummings prepared any studies, analyses, surveys, calculations, workpapers or other information supportive of the fair rate of return percentage that should be applied to USWC's fair value rate base in Arizona?

A. According to the response to Data Request UTI 58-05, he has not. It appears that Mr. Redding is solely responsible for the Company's asserted rate of return on fair value rate base, rather than Mr. Cummings.

Q. Has the Staff calculated the required overall fair rate of return on fair value rate base?

A. Yes. Staff Schedule A, at column E in line 2, reflects the required fair rate of return in order for USWC to meet its requirements to creditors and earn a reasonable return on its equity capital, based upon the testimony and exhibits of Mr. Stephen Hill.

Q. How did Staff derive the amounts shown as "fair value rate base" on Schedule B?

A. Staff's calculation of fair value rate base is set forth on Schedule B. The fair value amount shown for U S West starts with the updated 1999 RCND estimates sponsored by Ms. Heller-Hughes, after correction of certain input errors (UTI 58-02). The Company's total adjusted Arizona fair value rate base according to this response is $1,772,112,000. At line 12, column (C) of Schedule B, the Staff's total adjustments to original cost rate base are also applied to the fair value rate base. At line 13, an additional Staff adjustment to fair value rate base is posted, to reflect restatement for inconsistencies in Ms. Heller-Hughes updated study that are described in detail within the testimony of Staff witness Mr. Dunkel.

Q. Does the "fair value rate base" amount, as estimated by either USWC or Staff, have any relationship to the fair market value of the Company or its assets in Arizona?

A. No. The actual value of the Company and its assets is not linked in any meaningful way to a 50/50 weighting of reproduction cost and original cost of rate base assets.

Q. Does this conclude your direct testimony?

A. Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

MARCIA WEEKS
Chairman
RENZ D. JENNINGS
Commissioner
DALE H. MORGAN
Commissioner

IN THE MATTER OF THE COMMISSION'S COMPLAINT AND ORDER TO SHOW CAUSE AGAINST MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY REGARDING THE PUBLISHING AGREEMENT.

DOCKET NO. E-1051-86-252

DECISION NO. 56020

ORDER

OPEN MEETING
June 8, 1988
Phoenix, Arizona

BY THE COMMISSION:

On October 8, 1987, the Arizona Corporation Commission (Commission) entered Decision No. 55755 which declared that the transfer of Yellow Page assets from Mountain States Telephone and Telegraph Company (Mountain Bell) to U.S. West Direct was void because Mountain Bell had not complied with the provisions of A.R.S. § 40-285.

On December 15, 1987 Mountain Bell then filed an action in the Superior Court of Arizona (No. CV 87-33850) challenging Commission Decision No. 55755. Subsequent to December 15, 1987 the parties have entered into settlement discussions concerning the status of Mountain Bell's Yellow Pages assets. As a result of these settlement discussions, the parties have agreed to the terms and conditions as set forth in Exhibit No. 1 to resolve controverted positions.

Based upon the Settlement Agreement, the Commission enters the following Findings of Facts, Conclusion of Laws, and Orders.

FINDINGS OF FACT

1. The Mountain States Telephone and Telegraph Company is a public service corporation as defined in Article 15 Section 2 of the Arizona Constitution and was issued Certificates of Convenience and Necessity by the Arizona Corporation Commission.

2. On October 8, 1987 the Commission entered Decision No. 55755 which declared that the transfer of Yellow Pages assets from Mountain Bell to U.S. West Direct was void because the Company did not comply with the provisions of A.R.S. § 40-285.

3. On December 15, 1987 Mountain Bell filed an action in the Superior Court of Arizona challenging Commission Decision No. 55755.

4. The Commission and Mountain Bell entered into a Settlement Agreement intended to resolve the action filed by Mountain Bell in the Superior Court.

5. The Settlement Agreement is just and reasonable and is in the best interest of the public.

CONCLUSIONS OF LAW

1. The Commission has jurisdiction pursuant to A.R.S. § 40-252 to enter an Order in this matter.

2. The Settlement Agreement attached hereto as Exhibit No. 1 is intended to resolve disputed issues raised in Commission Decision No. 55755 and Superior Court action No. CV 87-33850.

3. The Commission has authority pursuant to A.R.S. § 40-252 to amend Decision No. 55755.

. . .

. . .

. . .

[redacted]

E-1051-86-252

ORDER

THEREFORE, IT IS ORDERED that each provision of the Settlement Agreement attached hereto as Exhibit No. 1 is approved and adopted.

IT IS FURTHER ORDERED that Commission Decision No. 55755 is hereby amended to reflect the terms and conditions of Exhibit No. 1.

IT IS FURTHER ORDERED that the terms and conditions of Exhibit No. 1 supercede any inconsistency with Decision No. 55755.

IT IS FURTHER ORDERED that this Order shall become effective immediately

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN — COMMISSIONER — COMMISSIONER

IN WITNESS WHEREOF, I, JAMES MATTHEWS, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of this Commission to be affixed at the Capitol in the City of Phoenix, this 13 day of June, 1988.

JAMES MATTHEWS
Executive Secretary

DISSENT

SJG/mm

 Decision No. 56020

[redacted]

SETTLEMENT AGREEMENT

This agreement is entered into this 27th day of ~~April~~ MA, 1988 between the Arizona Corporation Commission ("Commission") and The Mountain States Telephone and Telegraph Company ("Mountain Bell"). The parties agree as follows:

1. On October 8, 1987, the Commission entered Decision No. 55755 which declared that the transfer of Yellow Pages assets from Mountain Bell to U S West Direct ("USWD") was void because the provisions of A.R.S. § 40-285 had not been complied with by Mountain Bell.

2. On December 15, 1987, Mountain Bell filed an action in the Superior Court of Arizona (No. CV 87-33850) challenging Commission Decision No. 55755.

3. The parties desire to settle the issues relating to the transfer of Yellow Pages assets from Mountain Bell to USWD on the following basis:

   (a) Mountain Bell agrees to dismiss Action No. CV 87-33850 and to take no further action to challenge the $5,000 fine assessed in Decision No. 55755.

   (b) For purposes of this settlement (and not as an admission by Mountain Bell that the Commission has jurisdiction over the Yellow Pages asset transfer or an admission by the Commission that it does not have jurisdiction over the Yellow Pages asset transfer) the parties agree that the transfer of Yellow Pages assets from Mountain Bell to USWD will be accepted by the parties as valid and the Commission will take no further action to challenge that transfer.

(c) That included in Mountain Bell's 1984 rate case (which is the basis for rates currently charged the ratepayers) were the fees received from USWD under publishing agreements with USWD; that in future rate cases filed by Mountain Bell, the Commission, in arriving at the test year operating income of Mountain Bell, will consider the fees and the value of services received by Mountain Bell from USWD under publishing agreements with USWD; that Mountain Bell and the Commission Staff may present evidence in support of or in contradiction to those fees and the value of those services. Mountain Bell and the Commission agree that in subsequent rate cases downward adjustments from the $43 million in fees received by Mountain Bell from USWD and included in Mountain Bell's 1984 rate case will require more than a showing by Mountain Bell that it negotiated a lesser amount with USWD.

(d) Mountain Bell agrees that in subsequent Mountain Bell rate cases the Commission will be provided with reasonable access to the financial records of USWD (hereinafter "USWD" includes any U S West subsidiary or affiliate made a party to the publishing agreement or a successor to the directory publishing activities on behalf of Mountain Bell) for the purpose of verifying the amount of fees received by Mountain Bell from USWD under publishing agreements with USWD and the value of services provided by/to Mountain Bell to/by USWD. "Financial records" as used in this paragraph, shall include, but not be limited to, financial statements, books, records and related supporting documents. Further, if the records of USWD are not maintained on a basis comparable to that of a regulated utility, Mountain Bell agrees that the Commission will be provided with any available accounting records reconciling or relating the fees and the value of services received by Mountain Bell from USWD under publishing agreements with USWD to the accrual basis of accounting.

(e) Mountain Bell agrees that USWD will submit written confirmation to the Commission that it will cooperate with Mountain Bell in its fulfillment of subparagraph 3(d).

4. The parties agree that Decision No. 55755 will be amended to reflect this settlement.

ARIZONA CORPORATION COMMISSION

By____________________
Steve Glaser
Its Attorney

THE MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY

By____________________
C. Webb Crockett
Its Attorney

Arizona
Docket No. T-1051B-99-105
UTI UTI02-UTI007

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: UTI007

Please provide a complete copy of the internal documentation employed by USWC to inform external relations personnel of Company policy regarding the allocation/assignment of labor and other costs above-the-line versus below-the-line for lobbying activities.

RESPONSE:

Attachment A contains a copy of the March 27, 1998 training packet which instructs employees on the procedures for cross charging time for lobbying and non-lobbying expenses.

Reed Peterson
Manager - Public Policy
3033 N. 3rd St. Rm. 1001
Phoenix, AZ 85012

MEMORANDUM

DATE: May 6, 1998

TO: Jim Smiley, Wayne Allcott, Scott McClellan, Kevin Smith

FROM: Mike Paradis MP

RE: Cross Charging Lobbying Efforts

One of the more tedious activities that you and your team have to contend with is the cross charging of lobbying time.

Carla Fewkes in the Idaho Public Policy office recently completed a training packet for the Northern region on this subject. The packet clarifies some of the issues and processes around lobbyist cross charging. Carla suggested that you might want to get a copy of the material for your review and potential use. If you decide to share this with your staffs, Carla is comfortable taking calls with questions on it.

March 27, 1998

MEMO TO:
Northern Region State VPs
Northern Region PA Contacts

From:
Carla Fewkes
Idaho Public Policy
Tel. No. 208 385-2563
e-mail: cfewkes@uswest.com

RE: Revised Training Packet for Cross Charging Time for Lobbying and Non-Lobbying Activities

Thank you for your feedback on the original training packet distributed March 2. As a result of your input, Attachments A and B have been revised to reflect the **correct account code for Direct Lobbying Activities. Please review these attachments.** Please redistribute the updated training packet. (Note: Attachment F - Payroll Training Package is not being redistributed, if you want a copy please keep the original Attachment F.)

I have enclosed, for your information, material which explains Account Code 7370. This information can be found on the Finance homepage of the intranet. Questions regarding the Lobbying codes can be directed to Andrew Kaser, Tax Dept., 303 740-2902.

Another issue that has been raised is the need for daily time reporting (weekly time reporting was on our wish list). The not-so-good news – we still have to report time daily (bummer). The better news – Payroll is working on an intranet web site for time reporting. I will share information regarding the site as it becomes available.

Once again, thanks for your support. I really appreciate your input, comments and suggestions.

Keep up the GREAT work!

Enclosure

cc: Sue Euser - Public Policy
Andrew Kaser - Tax Dept/Lobbying
Mike Paradis/Sue Weihe - Human Resources
Pat Quinn - Public Policy
Barbara Taylor - Payroll
Ed Tobin - Public Policy

ACCOUNT 7370
SPECIAL CHARGES

7370.31 DIRECT LOBBYING - FEDERAL AND STATE 7370.31
01-01-96 (SPCL CHGS-LBYNG-DIR-FED/ST)

Includes work and costs associated with:

- Advocating the Company's position to **Federal and State public officials**. Typical activities include:
  - Appearing before members of Congress, submitting statements to members of Congress, and other communications with members of Congress, with the specific purpose of advocating the Company's position on pending legislation
  - Preparing and presenting the Company's case on pending legislation to a legislator or staff member with the express purpose of advocating the Company's position on that legislation
  - Answering an information request from a legislator or staff member with the specific purpose of advocating the Company's position on pending legislation
  - Communicating with members of any state legislative body, but only when the communication pertains to matters of the respective state legislature and the express purpose of the communication is to advocate the Company's position on pending state legislation
  - Hosting a meal for a legislator or staff member with the express purpose of advocating the Company's position on specific wording in a pending bill
  - Providing support for all Acct. 7370.31 functions

Cost Consideration:

- Employees who perform or support direct lobbying functions must Exception Time Report their time and expenses to Acct. 7370.31. This applies to employees who spend at least one hour in a calendar day on direct lobbying activities. See the General information in the front of this SECTION for Exception Time Reporting information.

  When state legislatures are in session, 100% of a state lobbyist's time and expenses are assumed to be for direct lobbying functions and should be assigned to Account 7370.31. Time and expenses spent on other activities must be Exception Time Reported to other Accounts.

  When state legislatures are out of session, 100% of a state lobbyist's time and expenses are no longer assumed to be for direct lobbying and should be assigned to a non-lobbying Account(s). Lobbyists must Exception Time Report time and expenses to Account 7370.31 when performing direct lobbying functions.

Exclusion:

- For communicating with and appearing before regulatory bodies in connection with reporting the Company's existing or proposed operations, see Acct. 6722.9. These types of activities include:
  - Reviewing existing or pending legislation
  - Preparing and presenting information for regulatory

purposes, including tariff and service cost filings
- Obtaining radio licenses and construction permits

7370.32 GRASSROOTS LOBBYING 7370.32
01-01-96 (SPCL CHGS-LBYNG-GRASSROOTS)

Includes work and costs associated with:
- Advocating the Company's position to the public with respect to legislation, referenda, or ordinances. Typical activities include:
  - Communicating with media groups, business interest groups, U S WEST customers, members of state governmental bodies, social and community groups, and U S WEST employees and retirees to encourage support for legislation, referenda, or ordinances
  - Preparing and printing specific statements or pamphlets addressed specifically to the legislative program urging shareowners, media groups, business interest groups, members of state governmental bodies, social and community groups, U S WEST customers, employees, or retirees to write to Congress
  - Conducting employee meetings or seminars that present information with the specific purpose of advocating the Company's position to its employees with regard to legislative issues or public officials
  - Polling public opinion regarding political issues or candidates
  - Providing support for all Acct. 7370.32 functions.

Exclusion:
- For communicating with and appearing before regulatory bodies in connection with reporting the Company's existing or proposed operations, see Account 6722.9. These types of activities include:
  - Reviewing existing or pending legislation
  - Preparing and presenting information for regulatory purposes, including tariff and service cost filings
  - Obtaining radio licenses and construction permits

Cost Consideration:
- Employees who perform or support grassroots lobbying functions must Exception Time Report their time and expenses to Acct. 7370.32. This applies to employees who spend at least one hour in a calendar day on grassroots lobbying activities. See the General information in the front of this SECTION for Exception Time Reporting information.

7370.33 POLITICAL ACTION COMMITTEES AND CONTRIBUTIONS 7370.33
01-01-96 (SPCL CHGS-LBYNG-PACS/CONTRBNS)

Includes work and costs associated with:
- Establishing, administering, and operating Political Action Committees. Typical activities include:
  - Soliciting PAC contributions
  - Serving as a member on PAC Committees
  - Processing PAC payroll deductions
  - Preparing PAC reports in accordance with Federal and State laws
- Providing support for all Acct. 7370.33 functions.

Exclusion:
- For an employee who performs work in support of Union PAC activities, use the employee's normally assigned Accounts.

Cost Consideration:
- Employees who perform or support political action functions

must Exception Time Report their time and expenses to Acct. 7370.32. This applies to employees who spend at least one hour in a calendar day on political action activities. See the General information in the front of this SECTION for Exception Time Reporting information.

J.34 DIRECT LOBBYING - LOCAL COUNCIL OR GOVERNING BODY 7370.34
01-01-96 (SPCL CHGS-LBYNG-LCL CN/GOV BD)

Includes work and costs associated with:

- Advocating the Company's position to local public officials or governing bodies (including any Indian Tribal Council or other governing body) with respect to legislation, referenda, or ordinances, but only when the work or costs pertain to matters of the respective local council or governing body. Typical activities include:
  - Appearing before members of a local council or governing body, submitting statements to members of a local council or governing body, and other communications with members of a local council or governing body
  - Preparing and presenting the Company's case on pending legislation to a local council or governing body member for the express purpose of advocating the Company's position on that legislation
  - Answering an information request from a local council or governing body member with the specific purpose of advocating the Company's position on pending legislation
  - Hosting a meal for a local council or governing body member with the express purpose of advocating the Company's position on specific wording in a pending bill
- Providing support for all Acct. 7370.34 functions.

Exclusion:

- For communicating with and appearing before regulatory bodies in connection with reporting the Company's existing or proposed operations, Account 6722.9. These types of activities include:
  - Reviewing existing or pending legislation
  - Preparing and presenting information for regulatory purposes, including tariff and service cost filings
  - Obtaining radio licenses and construction permits

Cost Consideration:

- Employees who perform or support local council or governing body lobbying functions must Exception Time Report their time and expenses to Acct. 7370.34. This applies to employees who spend at least one hour in a calendar day on local council or governing body lobbying activities. See the General information in the front of this SECTION for Exception Time Reporting information.

Revised 3/98
(Attachments A and B Update)

"How To Cross Charge Time for Lobbying and Non-Lobbying Activities"

Here it is, the long awaited package for Cross Charging Time for Lobbying and Non-Lobbying Activities. I hope you find this information useful. If you have questions on this packet, please call Carla Fewkes 208 385-2563. For general payroll questions, please contact Payroll 1-800-636-9011, option 1

Background Information

(aka. stuff you probably already know but here is a review just in case)

State Lobbyists

Time reporting for state lobbyists is reported as either "in session" or "out of session." When legislatures are "**in session**", state lobbyists initiate account code changes so their time will be directed to **lobbying** codes. When legislatures are "**out of session**", state lobbyists initiate account code changes to change their time to **non-lobbying codes.** (i.e., regular time). (NOTE: For instructions on changing account codes for lobbyist, please contact Human Resources.)

"In Session" Guidelines

While using "in session" lobbying codes, time spent on **non-lobbying** activities must be "exception time" reported. Time off, such as vacation, illness, PDP, etc. can be reported using the EZ Touch System. **HOWEVER, if more than one hour per day of work time is spent performing non-lobbying activities, this time must be cross charged to non-lobbying codes using RG07-0050.** Non-lobbying work activities must be reported on a daily basis . (The EZ Touch system cannot be used.)

"Out of Session" Guidelines

While using "out of session" non-lobbying codes, work time spent on **lobbying** activities must be "exception time" reported. Time off, such as vacation, illness, PDP, etc. can be reported using the EZ Touch System. **HOWEVER, if more than one hour per day of work time is spent performing lobbying activities, this time must be cross charged to lobbying codes using RG07-0050.** Lobbying work activities must be reported on a daily basis. (The EZ Touch system cannot be used.)

Non-Lobbying Employees Who Perform Lobbying Work Activities

If a non-lobbying employee spends more than one hour per day performing work activities that are related to lobbying, their time must cross charged to lobbying codes. Lobbying work activities must be reported on a daily basis using form RG07-0050. (The EZ Touch system cannot be used.)

Arizona
Docket No. T-1051B-99-105
UTI UTI02-UTI008

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: UTI008

Please provide an organization chart for the Arizona Public Affairs organization and written position descriptions in as much detail as exists for each employee therein.

RESPONSE:

There are two employees within the Arizona Public Affairs organization. They are the Public Affairs Director and Administrative Assistant. Position descriptions for these two employees are contained in Attachment A.

Reed Peterson
Manager - Public Policy
3033 N. 3rd St. Rm. 1001
Phoenix, AZ 85012

U S West Communications

Director Job Description

Director Grade 010 | Director OJE Number D092197

Position Title: Dir. Public Affairs Managing | Date: 4/1/91

Incumbent Name

Business Unit: State Public Polocy Org.

SSN:

Position Reports to: State Vice President

Completed BY: | Date:

Review BY: Mike Meno | Date: 3/29/91

Approved BY: | Date:

Summarize in one paragraph the primary purpose of this position.

This position is responsible for directing the public affairs efforts of U S West. Major emphasis includes policy development, strategy design and implementation, coordinating state and federal lobbying efforts, issue identification, coordination with sound recommendations on enhancing the company's political presence. Develops and maintains relationships and an overall public environment that allows USWC to accomplish its goals and to enhance its image as a good corporate citizen.

RESPONSIBILITES: Inorder of importance, list this position's main functions. Indicate percent of time spent on each (round to the nearest 10 percent).

1. (25%) Supervises and directs work activities of subordinates: provides strategic direction and guidance relative to team effectiveness: seeks and offers opportunities for personal and professional development.
2. (25%) Direct/coordinates the efforts of the company lobbyists at the state and national level to ensure proper advocacy on behalf of the U S West Companies.
3. (25%) Direct/participate the efforts of the company to achieve the most favorable forms of alternative regulation as is required or may be achieved through passage of legislation.
4. (15%) Identifies and track emerging issues to enable the corporation to respond in a timely and appropriate fashion.
5. (10%) Develop recommendations that will allow officers and key managers of the business to maximize the effectiveness of the company's public affairs efforts.

ACCOUNTABILITY/IMPACT: Indicate how this postion is best measured (i.e., cusotmer/employee implications, infuluence on key decisions, policy/strategy, development, financial contributions, etc.)

position is best measured in terms of the impact upon the corporation resulting from the policy recommendations that flow from the group and the effectiveness in implementing the strategy developed under the leadership of the incumbent's. As an example, successful implementation of the corporation:'s top priority, deregulation, would have the potential to increase net earnings significantly. The position has the responsibility of successfully coordinating the lobbying strategy of the corporation. Success or failure on any given issue can have significant financial and operational impacts.

DECISION MAKING/PROBLEM SOLVING: Provide three characteristic examples of decisions made and/or problems solved by this position. For each, state the specific situation, stakeholder(s) involced, decision made, and decision impact.

(1). Policy development of the ultimate objectives to be obtained in deregulation legislation and the minimum deregulation provisions acceptance by a state in a deregulation bill. Analyzing the impact specific legislation will have on the corporation, assessing the pro and cons of taking a specific position and recommending a course of action directly to the public policy council, the V.P. - Public Policy or other officers of the corporation. (3). Developing specific plans to enhance the corporation's overall political presence and ability to deal with others in the political arena: and working directly with state V.P. and other key public affairs representatives to implement those plans.

MJE:C120297 Administrative Assistant

Summary:

POSITION SUMMARY:

Provide administrative support to the Public Policy State Staff. Requires effective interaction with customers, all levels of management and U S WEST officers. Responsibilities include preparation of presentation materials, prioritization and distribution of correspondence and reports, coordination of meetings, travel arrangements, voucher and extensive calendaring. Proactive and reactive responses to verbal and written communications. Reports time for payroll and interfaces with HR on payroll changes/benefits questions. Requires working effectively with highly confidential materials and decision processes.

Arizona
Docket No. T-1051B-99-105
UTI 07-026

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 026

(Ref. USWC's response to UTI 4-35) Please provide complete, detailed position descriptions for the following positions within the Public Policy organization:

a. Executive Vice President-Public Policy, Human Resources and Law
b. Vice President - Arizona
c. Vice President - Public Policy Staff

RESPONSE:

U S WEST is in the process of gathering the requested information, which will be provided as soon as possible.

Supplemental Response: 05/06/99

a. The Executive President-Public Policy, Human Resources and Law has executive responsibility for U S WEST's Public Policy organization, Human Resources organization and Law Department covering all fourteen states and Washington, DC.

b. The Arizona Vice President-Public Policy has responsibility for developing, integrating, advocating and executing Public Policy strategies, activities and initiatives within Arizona while ensuring that such efforts support the achievement of U S WEST's corporate objective and goals.

c. The Vice President-Public Policy Staff has executive responsibilities for the centralized Public Policy Staff organization in Denver, Colorado.

Sue Weihe
Human Resources Operations Manager
1801 California St., Rm. 4750
Denver, CO 80202

Arizona
Docket No. T-1051B-99-105
UTI 23-010

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 010

Please provide copies of detailed position descriptions for all of the personnel within the Vice President Public Policy Staff's organization, including but not limited to those personnel responsible for wholesale advocacy, retail advocacy, legislative advocacy, PAC and pioneers activities.

RESPONSE:

Please see Attachment A which provides detailed position descriptions for all of the personnel within the Vice President Public Policy Staff's organization. Attachment A also includes those personnel responsible for wholesale advocacy, retail advocacy, legislative advocacy, PAC and pioneers activities.

Sue Weihe
Human Resources Operations Manager
1801 California St., Rm. 4750
Denver, CO 80202

MANAGEMENT JOB EVALUATION SUMMARY

ARIZONA
DOCKET NO. T-01051B-99-0105
UTI023- 010
ATTACHMENT: A

Date: 22 Oct 97

JOB CATEGORY: REGULATORY

JOB SUB CATEGORY: PUBLIC POLICY (09.30)

JOB TITLE: Director - Public Policy

SALARY GRADE: 010

POSITION TITLE: Director - Public Policy MJE#: D093097

Note: In D.C. Directors carry the Executive an Executive Director so the Director-P.P. on the P.P. staff is also represented by this description.

File: all other

U S West Communications

Director Job Description

Director Grade	~~6~~ 010	Director DJE Number	~~D1491~~ D093097
Position Title:	Director-Public Policy	Date:	2/7/91
Incumbent Name	Ray Trankle		
Business Unit:	Small Business Services		
SSN:			
Position Reports to:	Sol Trujillo - Vice President & General Manager-SBS		
Completed BY:	Pam Zandler	Date:	2/7/91
Review BY:	Pam J. Zandler	Date:	2/21/91
Approved BY:	Sol Trujillo	Date:	2/21/91

Summarize in one paragraph the primary purpose of this position.

This position is responsible for SBS involvement in the legislative, regulatory and public policy arenas. Analyzed state and federal legislative issues as they relate to SBS. Position initiates legislative policy as required and interacts with U S WEST state and federal lobbyists. Monitors, advises and is involved with multi-state regulatory activity and its impact on SBS. Works closely with the Market Mangers to ensure market objectives are considered in state regulatory/legislative/public policy activities.

RESPONSIBILITES: Inorder of importance, list this position's main functions. Indicate percent of time spoent on each (round to the nearest 10 percent).

1. Analysis, review and advice on pertinent state and federal legislation that could impact the business climate for SBS. This includes review of proposed legislation; determination of impact; suggestions for changing, opposing or supporting the legislation and working with state public affairs groups and the corporate office of public policy to advise on appropriate action.
2. Interfaces with Market Managers, Product Directors to ensure marketing issues are considered in regulatory, legislative and public policy arenas. Will speak for the Market Managers and Product Managers of SBS in dealings with the MIG and Corporate Pubic Policy group to ensure continuing support of the market unit concept and SBS goals and objectives. Provides direction and coordination to resolve conflict in the legislative and regulatory arenas to ensure consistency with in the fourteen state operating region.
3. Develops SBS strategies in support of AFOR to provide pricing and market flexibility in all fourteen states. The objective is to have pricing ranges that allow us to meet changes in customer expectations without costly rate cases. Represents the market place demands to the appropriate legislative or regultory groups.
4. This corporation is an advocate of the market unit needs with the Corporate Public Policy organization. It presents the ongoing need to focus on regulatory changes that allow market trials, promotions and integrated solutions to be presented to our customer without additional rate cases. This position is also responsible for the privacy of customer information and meeting legal requirements.
5. This position is responsible for writing and negotiating service agreements with the state regulatory organizations to ensure that they understand the SBS mission, will incorporate market based solutions into rate cases and resolve conflicts between both organizations. This position is also the PAC (Political Action Committee) representative for SBS. Incumbent serves on the U S WEST PAC and is responsible for disbursal of PAC funds to appropriate individuals. Respresents the Vice President/General Manager SBS and provides access for the VP/GM to the legislative/regulatory activities in our fourteen state region.

ACCOUNTABILITY/IMPACT: Indicate how this postiion is best measured (i.e., cusotmer/employee implications, infuluence on key decisions, policy/strategy, development, financial contributions, etc.)

Establishes and implements Small Business Services' public policy strategies and objectives. Ensures stakeholder representation in all regulatory policy and legislative involvement. Pubic policy issues are multi-state and precedent setting. Legislative relationships are established and maintained on a national level through U S WEST, Inc. Office of Federal Relations. Manages the relationships between SBS and the public affairs offices to insure the market unit position is represented effectively in all state legislative and regulatory actions. Position the market unit to act as an advocate for small business issues by impacting state and national organizations that have legislative interest.

DECISION MAKING/PROBLEM SOLVING: Provide three characteristic examples of decisions made and/or problems solved by this position. For each, state the specific situation, stakeholder(s) involced, decision made, and decision impact.

Identifies and analyzes emerging and critical issues and provides recommendations to market unit executive staff regarding state and federal legislative regulatory actions, and Public Relations and Employee Information action plans. Topics include issues related to samll business such as economic development, education, legislation, product implications and political campaigns. This position has responsibility for identification and advice on issues that will impact our ability to meet customer needs in a timely, efficient and cost-effective manner. Most of the activities will have a creative impact on our ability to deal with our customers more easily; to offer them more products and services; and to complete market trials and pricing changes in all geographic locations in the future.

KNOWLEDGE/SKILLS: List any unique, specific knowledge and/or skill required for this position (i.e., certification, degree, etc.)

Professional background in areas of legislative and regulatory processes and the ability to form working alliances. Business degree, with Master's or MBA preferred.

GENERAL COMMENTS: Please include any additional comments or information that would help provide a complete understanding of this position.

ORGANIZATION STRUCTURE:

A. Title of this position's supervisor: Director-Communications

B. Title of this position: Director-Public Policy

C. Title(s) and function(s) of directly reporting positions(if appropriate):

	Title	Function
C1.	None.	This is an individual contributor.
C2.		
C3.		
C4.		
C5.		
C6.		

Total Number of employees Supervised (if appropriate):

Directly reporting:	Management:	Occupational:
Indirectly Reporting:	Management:	Occupational:

INCUMBENT LIST: Identify all individuals within the business unit on this position:

Name	SSN	RC

ORGANIZATION: PUBLIC POLICY, U S WEST COMMUNICATIONS

Position Title:
JOB DESCRIPTION: Director - Wholesale Advocacy (Universal Service)
MGE #: D093297

This position is responsible for the development and implementation of public policy advocacy and advocacy support for USWC's state and federal initiatives around **universal service and wholesale cost recovery**. The position works collaboratively with the effected internal market groups and support organizations, state public policy organizations and regulatory litigation and litigation support organizations to ensure consistent and well reasoned positions are advocated on all fronts. This position will also work closely with other companies in the joint development of cost models to support USWC's objectives. The person will be both an individual contributor and direct other managers.

The job will include the following responsibilities:

1. Development of the BCPM. This will include selection of the underlying theories for the model, as well as supervision of the actual code development. In order to be effective, the person filling this position must have an advanced understanding of many areas of the business, be able to solve complex problems that are vaguely defined and have never before been addressed in the required depth. He/she shares responsibility for the development of cost and pricing principles and insuring that the model developed by multiple companies conforms to USWC's own objectives. Developing a model which can be adopted in regulatory proceedings is a high priority for this position.

2. Development of advocacy support. This will include the development of policy positions and proactive public policy plans to have the positions adopted by state and federal regulators. This includes directing the development of template testimony in support of advocacy in generic cost dockets, interconnection arbitrations, ICAM dockets, proceedings involving construction charges, and other related proceedings. It also includes preparation of position papers in support of public forums, workshops and informal advocacy with Commissioners and staffs.

3. Witness/witness support. This will include testifying in regulatory proceedings as needed, assisting states in ensuring consistent, high quality testimony is filed by all witnesses in wholesale cost and/or universal service dockets. This position will be required to make policy decisions in the heat of hearings.

4. Litigation support. This will include assisting the regulatory litigation and litigation support groups in discovery and depositions during state regulatory litigation.

This position will supervise three managers in support of the performance of the position's responsibilities. Supervisory responsibilities will include directing work activities; providing strategic direction and guidance; offering opportunities for personal and professional development; and generally managing performance.

This position requires exceptional analytical skills, strategic thinking, an ability to quickly learn and assimilate various elements of the Company's business plans and imperatives. Exceptional verbal/written communications skills are essential. The person filling this position should have a masters degree in business, telecommunications, or other related filed. The position requires the ability to work long irregular hours. The person must be able to work under a high degree of stress and be able to travel as needed.

ORGANIZATION: PUBLIC POLICY, U S WEST COMMUNICATIONS

(POSITION TITLE:
JOB DESCRIPTION: Director - Wholesale Advocacy (Interconnection)
MGE #: D093297

This position is responsible for the development and implementation of public polic advocacy and advocacy support for USWC's state and federal initiatives around **interconnectio agreements, access charge reform, wholesale service quality and USWC's entry into in region interLATA markets (271)**. The position works collaboratively with the effected marke groups, network organizations, state public policy organizations, and regulatory litigation an litigation support organizations to ensure consistent and well reasoned positions are advocated o all fronts. In order to be effective, this requires a thorough understanding of many disciplines i telecommunications and public policy. The person filling this position will be both an individua contributor and direct other managers.

The job will include the following responsibilities:

1. Development of advocacy support. This will include the development and implementation of policy positions and proactive plans for achieving USWC's objectives related to interconnection arbitrations, access charge reform, wholesale service quality, and 271. This position will direct the development of template testimony, as well as support for various pleadings to be filed in federal regulatory or legal proceedings. This also includes preparation of position papers in support of public forums, workshops and informal advocacy with Commissioners and staffs.

2. Identification and resolution of regulatory/legislative issues. This will require in depth knowledge of the current issues and an ability to predict/identify emerging issues. The issues to be addressed by this position will often be vague and ill-defined. This position is expected to properly frame the issue, quickly analyze the data, and make a policy decision on the appropriate resolution. This will require maintaining an awareness of issues and advocacy on related topics by other parties in and out of region, and how activities in other areas impact USWC.

3. Client support. This includes supporting the state public policy organizations in a variety of ways to maximize the likelihood of positive outcomes for state specific initiatives. It is expected that, in order to effectively influence the successful implementation of advocacy plans, this person will develop a thorough understanding of the priorities of USWC's senior executives, state Commissions, their staffs, executive and legislative officials and other key constituents.

4. Witness/witness support. This will include testifying in regulatory proceedings as needed, and assisting state in ensuring consistent, high quality testimony is filed by all witnesses in the regulatory proceedings outlined above. This position will have the authority to resolve specific issues that arise during the hearing process.

5. Litigation support. This will include assisting the regulatory litigation and litigation support groups in discovery and depositions during state regulatory litigation.

This position will supervise two managers in support of the performance of the position's responsibilities. Supervisory responsibilities will include directing work activities; providing strategic direction and guidance; offering opportunities for personal and professional development; and generally supervising performance.

This position requires exceptional analytical skills, strategic thinking, an ability to apply advanced principles, theories and concepts in problem solving, and the ability to quickly learn and assimilate various elements of the Company's business plans and imperatives. Exceptional verbal/written communications skills are essential. The person filling this position should have a masters degree in business, telecommunications, or other related filed. The position requires the ability to work long irregular hours. The person must be able to work under a high degree of stress and be able to travel as needed.

ORGANIZATION: U S WEST COMMUNICATIONS
PUBLIC POLICY

JOB TITLE: EXECUTIVE DIRECTOR - WHOLESALE ADVOCACY

This position is responsible for the development, and implementation of advocacy and advocacy support with regard to all regulatory and legislative initiatives before the fourteen state regulatory agencies and legislative assemblies and the FCC required by the wholesale business group. The position works collaboratively with the effected markets groups (primarily Carrier), the state vice president organizations, the staff finance organization, the staff legislative organization, the staff tariff organizations, the local markets organization, the public relations organization, and the regulatory litigation and litigation support organizations to ensure timely implementation of the Company's wholesale regulatory and legislative initiatives. The person will be both an individual contributor and supervisor.

It is anticipated that the current areas of responsibility will include interconnection arbitrations, interconnection rulemaking, general statements of terms and conditions for interconnection, interconnection cost dockets, ICAM, wholesale service standards, access charge reform, state and federal appeals from interconnection decisions, high cost/universal service, and other matters identified as effecting the wholesale responsibilities of the Company.

The position must ensure continuous and strong positive advocacy support through a combination of well reasoned and well documented advocacy positions, consistent with the One Voice Process, which are supported by law, fact and logic.

The job will include the following responsibilities, both directly and through supervision of other directors and managers working within this persons group:

1. Identification and resolution of regulatory/legislative issues. This will require maintaining awareness of issues and advocacy by other parties in and out of region of similar and new issues and will require collaborative work with the Carrier markets group, network, finance and the law department.

2. Education of advocates. This will include training sessions for internal and external witnesses and advocates in support of the Company's positions and the availability as an ongoing resource to clarify and reinforce positions. It is anticipated that educational efforts will also extend to participation/presentation in public forums and participation/presentation with state vice presidents' advocacy teams in workshops and informal advocacy with Commissioners and staffs.

3. Development of advocacy support. This will include the development of template testimony in support of advocacy in formal proceedings before state and federal regulatory agencies and assisting the state and federal advocacy teams in customizing template testimony to particular dockets and other formal proceedings. It also includes preparation of position papers in support of public forums, workshops and informal advocacy with Commissioners and staffs and support of third part advocacy efforts.

4. Witness identification. This will include identifying subject matter expert witnesses, securing their commitment, and coordinating their participation in formal dockets before state and federal regulatory commissions. It is also anticipated that this person will also be a witness in selected state and federal regulatory proceedings.

5. Litigation support. This will include assisting the regulatory litigation and litigation support groups in discovery and depositions during state regulatory litigation.

6. Tariff support. This will include assisting the tariff support organization in ensuring that the group is sufficiently informed such that it can craft conforming state and federal tariffs where appropriate.

7. Appeals. This will include assisting the law department in the prosecution of any appeals, trial de novo or other appellate process appropriate for protecting the rights of the company. It is anticipated that the position will offer the same areas of support in such appeals as were provided in the initial formal proceedings.

8. Compliance. This will include conveying the results of formal regulatory proceedings (including follow up clarifications and responses) to the appropriate groups within the Company to ensure compliance with the lawful orders from such regulatory agencies.

This position will supervise an undetermined number of directors and managers in support of the performance of the position's responsibilities and in doing so will supervise and direct work activities of subordinates; provide strategic direction and guidance; provide direction and guidance as to team effectiveness; seek and offer opportunities for personal and professional development; and otherwise supervise the performance of such subordinates.

This position is deemed to be critical to the success of the Company's initiatives by ensuring regulatory approval and compliance. The person must be a professional in all aspects of the job and will often be thrust into decision making positions where his/her action can gain or lose millions of dollars. The position requires exceptional analytical skills, strategic thinking, an ability to quickly learn and assimilate various elements of the Company's business plans and imperatives, and exceptional verbal/written communication skills, and strong leadership skills. State regulatory experience is desired. The person must have a proven track record of obtaining positive results.

The person filing this position should have a bachelors degree with an MBA, JD or other advanced degree desired.

This position requires the ability to work long irregular hours. The person must be able to work under a high degree of stress. The ability to travel and utilize keyboard skills is required.

ORGANIZATION: U S WEST COMMUNICATIONS
PUBLIC POLICY

JOB TITLE: EXECUTIVE DIRECTOR - RETAIL ADVOCACY

This position is responsible for the formulation, development, and implementation of advocacy and advocacy support with regard to all regulatory and legislative initiatives before the fourteen state regulatory agencies and legislative assemblies and the FCC required by the retail business groups. The position works collaboratively with the effected retail markets groups, the state vice president organizations, the staff finance organization, the staff legislative organization, the staff tariff organizations, the local markets organization, the public relations organization and the regulatory litigation and litigation support organizations to ensure timely implementation of the Company's retail regulatory and legislative initiatives.

It is anticipated that the current areas of responsibility will include general rate cases , retail rate rebalancing, regulatory reforms (deregulation, price caps, alternative forms of regulation), product initiatives, carrier of last resort obligations, retail service quality standards and requirements, and other initiatives effecting the retail responsibilities of the company.

The position must ensure continuous and strong positive advocacy support through a combination of well reasoned and well documented advocacy positions, consistent with the One Voice Process, which are supported by law, fact and logic.

The job will include the following responsibilities, both directly and through supervision of other directors and managers working within this persons group:

1. Identification and resolution of regulatory/legislative issues. This will require maintaining awareness of issues and advocacy by other parties in and out of region of similar and new issues and will require collaborative work with the affected retail markets group, network, finance and the law department.

2. Education of advocates. This will include training sessions for internal and external witnesses and advocates in support of the Company's positions and the availability as an ongoing resource to clarify and reinforce positions. It is anticipated that educational efforts will also extend to participation/presentation in public forums and participation/presentation with state vice presidents' advocacy teams in workshops and informal advocacy with Commissioners and staffs.

3. Development of advocacy support. This will include the development of template testimony in support of advocacy in formal proceedings before state and federal regulatory agencies and assisting the state and federal advocacy teams in customizing template testimony to particular dockets and other formal proceedings. It also includes preparation of position papers in support of public forums, workshops and informal advocacy with Commissioners and staffs and support of third part advocacy efforts.

4. Witness identification. This will include identifying subject matter expert witnesses, securing their commitment, and coordinating their participation in formal dockets before state and federal regulatory commissions. It is also anticipated that this person will also be a witness in selected state and federal regulatory proceedings.

5. Litigation support. This will include assisting the regulatory litigation and litigation support groups in discovery and depositions during state regulatory litigation.

6. Tariff support. This will include assisting the tariff support organization in ensuring that the group is sufficiently informed such that it can craft conforming state and federal tariffs where appropriate.

7. Appeals. This will include assisting the law department in the prosecution of any appeals, trial de novo or other appellate process appropriate for protecting the rights of the company. It is anticipated that the position will offer the same areas of support in such appeals as were provided in the initial formal proceedings.

8. Compliance. This will include conveying the results of formal regulatory proceedings (including follow up clarifications and responses) to the appropriate groups within the Company to ensure compliance with the lawful orders from such regulatory agencies.

This position will supervise an undetermined number of directors and managers in support of the performance of the position's responsibilities and in doing so will supervise and direct work activities of subordinates; provide strategic direction and guidance; provide direction and guidance as to team effectiveness; seek and offer opportunities for personal and professional development; and otherwise supervise the performance of such subordinates.

This position is deemed to be critical to the success of the Company's initiatives by ensuring regulatory approval and compliance. The person must be a professional in all aspects of the job and will often be thrust into decision making positions where his/her action can gain or lose millions of dollars. The position requires exceptional analytical skills, strategic thinking, an ability to quickly learn and assimilate various elements of the Company's business plans and imperatives, and exceptional verbal/written communication skills, and strong leadership skills. State regulatory experience is desired. The person must have a proven track record of obtaining positive results.

The person filing this position should have a bachelors degree with an MBA, JD or other advanced degree desired.

This position requires the ability to work long irregular hours. The person must be able to work under a high degree of stress. The ability to travel and utilize keyboard skills is required.

ORGANIZATION: U S WEST COMMUNICATIONS
PUBLIC POLICY

JOB TITLE: EYEC DIRECTOR - LEGISLATIVE ADVOCACY

This position is responsible for the formulation, development, and implementation of advocacy and advocacy support with regard to all legislative initiatives before the fourteen state legislative assemblies and to provide support to the state vice presidents' advocacy teams with regard to their responsibilities with the United State Congress. The position works collaboratively with the effected markets groups, the state vice president organizations, the staff finance organization, the staff wholesale, retail and new business advocacy groups, the local markets organization, the public relations organization and the federal office and the law department to ensure timely implementation of the Company's legislative and congressional initiatives.

It is anticipated that the current areas of responsibility will include regulatory reform, universal service/high cost funding, cost based pricing requirements, regulatory parity, tax parity, minimizing municipal regulation and all other legislative initiatives affecting the interests of the Company.

The position must ensure continuous and strong positive advocacy support through a combination of well reasoned and well documented advocacy positions, consistent with the One Voice Process, which are supported by law, fact and logic.

The job will include the following responsibilities, both directly and through supervision of other directors and managers working within this persons group:

1. Identification and resolution of legislative issues. This will require maintaining awareness of issues and advocacy by other parties in and out of region of similar and new issues and will require collaborative work with the markets groups, network, finance and the law department.

2. Education of advocates. This will include training sessions for internal and external advocates in support of the Company's positions and the availability as an ongoing resource to clarify and reinforce positions. It is anticipated that educational efforts will also extend to participation/presentation in public forums and participation/presentation with state vice presidents' advocacy teams before permanent, special and interim legislative committees.

3. Development of advocacy support. This will include the development of model legislation for identified legislative initiatives, assistance in customizing legislation to particular state needs, review of amendments proposed and required to affect the Company's positions, position papers and other advocacy pieces for use with the legislature and other affected government officials.

4. Witness identification. This will include identifying subject matter expert witnesses, securing their commitment, and coordinating their participation in proceedings before permanent, special and interim legislative committees.

5. Legislation review. This will include development and maintenance of a system for internal review of legislation introduced throughout the fourteen state region. The responsibilities will include distribution of bills to affected departments, consolidation of responses, resolution of conflicting internal views and responses and recommendations to the states on a timely basis.

6. Organizational support. This will include active participation in national organizations of elected officials (NCSL, NGA, ALEC, etc.) in support of the Company's legislative agenda. It is anticipated that person will be an active presenter during formal sessions and will provide position papers and other presentations for distribution to the organizations members in an effort to secure support of Company positions by the organization.

7. Third party support. This will include providing research and preparation support to senior public policy officials identified to interface with other internal organizations and national and regional organizations considered to be vital to public policy initiatives.

8. Internal political education and advocacy. This will include providing research and support to senior public policy officials identified to develop and implement the interal political education and advocacy programs. The person will be expected to provide advice and counsel for administration of the Federal Political Action Committee.

9. Congressional support. It is anticipated that the primary responsibility for congressional advocacy rests with the federal office. This position will interface with the federal office and the state vice presidents organizations to assist in coordinating contact between the state vice president organizations and the congressional delegations.

10. Municipal franchise issues. This will include support for the state vice president organizations in negotiations for franchise agreements and/or ordinances, including providing information on standards and issues from other states, recommended uniform language, position papers, etc. If special witnesses (e.g. network outside plant specialist, etc.) are required, this position will assist in identifying and committing such resources and assist in the preparation of such specialist for participation in the municipal processes.

This position will supervise an undetermined number of directors and managers in support of the performance of the position's responsibilities and in doing so will supervise and direct work activities of subordinates; provide strategic direction and guidance; provide direction and guidance as to team effectiveness; seek and offer opportunities for personal and professional development; and otherwise supervise the performance of such subordinates.

This position is deemed to be critical to the success of the Company's initiatives by ensuring regulatory approval and compliance. The person must be a professional in all aspects of the job and will often be thrust into decision making positions where his/her action can gain or lose millions of dollars. The position requires exceptional analytical skills, strategic thinking, an ability to quickly learn and assimilate various elements of the Company's business plans and imperatives, knowledge of the state legislative process, and exceptional verbal/written communication skills, including an understanding of bill drafting requirements and strong leadership skills. The person must have a proven track record of obtaining positive results.

The person filing this position should have a bachelors degree with an MBA, JD or other advanced degree desired.

This position requires the ability to work long irregular hours. The person must be able to work under a high degree of stress. The ability to travel and utilize keyboard skills is required.

This would serve as the description of E.D. Pioneers.

Region Vice President

Role as defined in the Constitution of the Telephone Pioneers of America (TPA)
The vice presidents. as Association representatives. shall maintain frequent contacts with the chapters in their respective Association regions, advise with the chapters regarding Pioneer activities, represent the chapters on the Association Executive Committee and represent the Executive Committee in relations with the chapters.

Responsibilities

1. Direct administration of Pioneer organization for the sponsor company
   - administer goal setting, rating, personnel selection, development, etc. of the Pioneer staff
   - develop, track and control the Pioneer budget
   - coordinate with the volunteer leaders of the Chapters, Councils and Clubs to initiate action to:
     - involve all employees, retirees and family members in Pioneer community service
     - develop projects that meet community needs while improving sponsor company relations in the community
     - promote sponsor company branding to improve brand loyalty
     - groom new employees for future leadership positions
     - develop diverse group of leaders
     - involve a diverse group of volunteers
     - reward and recognize volunteers and projects
     - ensure financial integrity of the local Pioneer units
   - communicate with senior management of the sponsor company, including publishing a Pioneers annual report which reflects the business value of Pioneering
   - coordinate with community relations, foundation/corporate contributions, internal communications and media relations to maximize business value
   - Track key measurements (% consumers aware, % key leaders aware. media mentions, # of employees involved and # of retirees involved) and implement action to maximize the results
2. Plan and moderate sponsor company Pioneer annual conference
   - identify and arrange for outside speakers
   - arrange for senior management attendance
   - arrange for hotels. meals, agenda, etc
   - invite key sponsor company Pioneer leaders
   - track and control the budget for this event
3. Serve on the TPA Executive Committee which is the TPA policy making body
   - as a member of the EC, develop plans to strengthen the TPA association
   - represent the interests of the respective sponsor company at four meetings a year
   - serve on subcommittees
   - communicate association issues of importance to local sponsor company Pioneer units
4. Represent the Pioneers to other organizations
5. Personally become involved in Pioneer community service efforts which requires substantial volunteer work during non-work hours

Director. Public Policy
Region Vice President. Region 3. Telephone Pioneers of America
Administrator of the U S WEST Political Action Committee (U S WEST PAC)

Job Description

- Direct administration of the U S WEST Pioneer Organization:
  - Coordinate volunteer leaders of the Chapters Councils and Clubs;
  - Develop, track and control budget;
  - Communicate with senior management of U S WEST about Pioneers;
  - Coordinate with community relations, foundation, internal communications and media relations to maximize business value of Pioneers;
  - Track key measurements and implement action to maximize results of U S WEST Pioneers;
- Plan and moderate U S WEST Pioneer annual conference.
- Serve on the Telephone Pioneers of America (TPA) Executive Committee, which is the TPA policy making body.
- Represent the Pioneers to external organizations.
- Personally become involved in Pioneer community service efforts.
- Direct the solicitation of eligible U S WEST employees for membership in the U S WEST PAC:
  - Determine the policies and procedures to be utilized in the solicitation of contributions to U S WEST PAC;
  - Supervise or conduct all solicitation activity.
- Oversee the preparation and distribution of any printed or graphic material to be used in connection with the activities of U S WEST PAC.
- Request disbursements from the U S WEST PAC at the direction of the Contributions Committee.
- Provide regular reports on U S WEST PAC activities to senior management and PAC members.

EXHIBIT
S-8
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TABLE OF CONTENTS
SURREBUTTAL TESTIMONY OF
MICHAEL L. BROSCH

BEFORE THE
ARIZONA CORPORATION COMMISSION
SURREBUTTAL TESTIMONY OF
MICHAEL L. BROSCH

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. Are you the same Michael L. Brosch who previously submitted prepared Direct Testimony in this Docket?

A. Yes. My qualifications and work experience were provided in my Direct Testimony.

Q. What is the purpose of your Surrebuttal Testimony in this Docket?

A My testimony is responsive to the rebuttal testimonies and related exhibits of Company witnesses Mr. George Redding, Ms. Ann Koehler-Christensen and Mr. Kerry DennisWu. The index prepared for this testimony lists the topics addressed herein, in the same sequence the issues appeared in my earlier Direct Testimony. Where an issue and adjustment was contained in my index for the earlier Direct Testimony that is not listed in the Surrebuttal index, the Company has submitted no rebuttal on that subject.

EXECUTIVE SUMMARY

Q. Has the Company's rebuttal evidence caused you to revise any of the adjustments that are addressed in your Direct Testimony?

A. No. In each of the areas where the Company's rebuttal was critical of my specific proposals, I see no need to make revisions to the adjustments in Staff's direct filing based upon review of such rebuttal. In several areas addressed in my Direct Testimony, including revenue annualization, uncollectibles, rent compensation, affiliate true-up transactions, public policy costs, fair value and the treatment of broadband services, the Company's rebuttal either accepts the adjustment I propose or is not critical of my adjustments. There is, however, one change to Staff Accounting Schedule / Adjustment C-30 dealing with reciprocal compensation. This change is due to corrections made by USWC to its response Data Request 62-18 that was relied upon to quantify Staff's initial adjustment.

Q. Please summarize the status of Staff's revenue adjustments other than directory imputation that you sponsor?

A. In Mr. Redding's rebuttal, a graph is presented that seems to indicate that the Company believes Staff's adjustments to normalize and annualize revenues at year-end (Staff Schedules C-1, 2, 3 and 4) produce an overall result that is reasonable. At page 16 of his rebuttal, Mr. Redding states, "As to Revenues, Rebuttal Exhibit GAR-R1 shows that Qwest, Staff and RUCO are all very close with the exception of directory imputation". This statement, and the absence of any rebuttal to Staff's revenue annualization schedules, suggests that the Company does not dispute the referenced adjustments.

Q. Please summarize the status of the dispute regarding costs associated with the Arizona service quality program.

A. Mr. Redding argues that such costs should be included in revenue requirements as part of the ongoing normal cost of doing business, particularly since the Company is the supplier of last resort. Staff continues to oppose rate case recovery of service quality program costs from the general body of ratepayers as contrary to the intent of the program, a disincentive to management to improve service quality, and fundamentally unfair to ratepayers. These costs represent penalties and remedies for inadequate service that should not simply re-allocated to other customers within rate cases. Treating such costs as routine costs of doing business removes the incentive to the Company to improve service quality.

Q. Please summarize the directory imputation issue remaining between Staff and USWC that is addressed in your Surrebuttal Testimony.

A. Staff has imputed directory revenues based upon the Settlement Agreement $43 million level that was previously agreed upon between the Company and Staff and approved by the Commission, rejecting the Company's position that imputation should cease. My Surrebuttal explains why Ms. Koehler-Christensen is incorrect in concluding that Staff has not fully complied with the directory Settlement Agreement. I note the many infirmities in her assumptions and conclusions with respect to the sources and amounts of "value of services".

Q. Should the costs of employee benefits in the form of telephone service concessions be fully charged to intrastate customers, as indicated by Mr. Redding?

A. No. Staff Schedule C-21 allocated a portion of employee telephone service concessions to the interstate jurisdiction, so as to recognize that Company employees work for the benefit of both interstate and intrastate customers and the cost of these benefits should be equitably allocated across jurisdictions, in the same manner wages and other benefits are allocated. Mr. Redding's rebuttal suggests that such an allocation is effectively a disallowance of such costs. In Surrebuttal, I explain that there is no such disallowance, because the Company's interstate rates are not subject to cost-based regulation where the concept of disallowance has any meaning.

Q. What is the status of differences in the calculation of cash working capital in rate base?

A. Staff's filing includes several revisions to lag day values associated with the payment of employee compensation and benefits, interest expense, payroll taxes and miscellaneous cash vouchers. The Company's rebuttal states no specific criticism of these adjustments, but instead indicates USWC was unable to replicate Staff's lag day results.. Workpapers have been provided to fully document Staff's adjustments and they remain appropriate for the reasons stated in my Direct Testimony. Most of the cash working capital difference between Staff and USWC relates to a $7 million error in USWC's filing, as conceded in Mr. Redding's rebuttal.

Q. Please summarize your Surrebuttal regarding the unrecorded plant asset retirements and corresponding depreciation expense effects that are quantified in Staff's Schedule C-22.

A. Staff has proposed no rate base adjustment for unrecorded retirements, contrary to Mr. Wu's rebuttal. The Company offers no evidence that the old vintages of plant challenged by Staff has been investigated to determine if it remains in service and subject to ongoing depreciation expense. No recalculation of depreciation accrual rates is required due to Staff's adjustment.

Q. What remains at issue with regard to the detailed calculations and allocations of costs to the Arizona exchanges being sold by USWC to Citizens?

A. Mr. Redding disputes my adjustment to include reasonable allocations of marketing and corporate operations expenses to the exchanges being sold. My Surrebuttal explains the rationale for Staff's allocations and the reasons why such costs are not completely fixed in nature, as suggested by USWC.

Q. Please summarize your Surrebuttal regarding reciprocal compensation costs and ratemaking?

A. I explain that reciprocal compensation is best treated as part of the Company's total revenue requirement, and does not merit the extraordinary rate rider treatment advocated by USWC. There is no evidence that reciprocal compensation is now, or in the future will ever be, large enough or volatile enough to warrant special rate tracking with all the associated costs, risks and complexity such rate tracking may involve for ratepayers.

REVENUE ADJUSTMENTS

Q. How did Mr. Redding respond in rebuttal to the Staff adjustments to annualize local, access, toll and miscellaneous revenues?

A. Mr. Redding has no rebuttal to the individual issues and adjustments set forth on Staff Schedules C-1, C-2, C-3 and C-4 that correct and restate the Company's year-end revenue annualization adjustments. Instead, an overall test of the reasonableness of Staff's revenue result is presented in graph form in Mr. Redding's Exhibit GAR-R1. According to page 16 of his rebuttal, "These charts clearly show that the Company's advocacy to bring all elements of revenue and expense to end of period levels is more representative of future conditions than either Staff's or RUCO's. As to Revenues, Rebuttal Exhibit GAR-R1 shows that Qwest, Staff and RUCO are all very close with the exception of directory imputation, which was excluded for this chart." Thus, it appears that Mr. Redding's analysis corroborates Staff's own analysis.

These four Staff revenue adjustments (C-1, C-2, C-3 and C-4) adhere to prior Commission-ordered treatment of revenue annualization, based upon the types of revenues in each account, as described in my Direct Testimony. In addition, two of these Staff adjustments correct errors in the Company's filing that were acknowledged in discovery responses. Given the reasonableness of Staff's overall result and the importance of correcting errors and maintaining consistency with prior ratemaking policies established by the Commission, it is important that these four adjustments be approved by the Commission.

Q. What is the Company's response to the Staff's proposed treatment of Broadband affiliate revenues and expenses in Staff adjustment Schedule C-6?

A. At page 47 of his rebuttal, Mr. Redding states, "The Company has reviewed Staff's adjustment to the affiliate billing estimates between Qwest and Broadband Services, Inc. (BSI), the broadband affiliate. Given the start-up nature of BSI's operations, the Company does not believe that Mr. Brosch's adjustments to the estimated billing between Qwest and BSI are unreasonable."

Q. Are the additional revenues associated with Staff's Broadband Schedule C-6 adjustment also included within Staff's total adjusted intrastate revenues shown to be reasonable in Mr. Redding's Exhibit GAR-R1 graph?

A. Yes.

Q. In his rebuttal at page 47 on this issue, Mr. Redding also observes that Staff's Schedule B-6 rate base adjustment that reverses the Company's Broadband asset transfer is not objectionable, "Pending clarification of the Company's intent with regard to the transfer of the assets...". Are the Staff's proposed income statement adjustments contained in Schedule C-6 contingent upon what happens with respect to the transfer of Broadband assets?

A. No. While the asset transfers may have some impact upon rental revenues to be realized by USWC, the Staff's adjustment for ongoing affiliate transactions with BSI is conservative in relation to actual transaction trends, as noted at page 81 of my Direct Testimony.

SERVICE QUALITY PENALTIES

Q. What is Mr. Redding's response to Staff' adjustment attributing service quality program costs to shareholder rather than ratepayers?

A. According to page 40 of his rebuttal, "Qwest is the provider of last resort (POLR) for its service territory in Arizona. As the POLR, it is obligated to serve every customer who wishes to have service. This is an obligation not shared or borne by any other provider in Qwest's operating territory in Arizona. Sometimes, the best way to provide service to a customer, when traditional telephone facilities are not in place, is to provide alternative services during an intervening period." Mr. Redding says the Company charges alternative service arrangements to operating expenses because "they are a reasonable cost of doing business, and because Qwest is indeed providing service the customer has requested."

Q. How do you respond to Mr Redding's "provider of last resort" claim?

A. Under the service quality program effective in Arizona, the Company is allowed an interval of time to install service to customers and only when such installation does not occur within the allowed time period are alternative service arrangement required. There has been no showing by the Company that this Commission-approved installation interval is unreasonable or that the benefits of incumbency realized by the Company in Arizona do not offset Mr. Redding's claimed burden of being a provider of last resort. The "obligation" to serve all customers might instead be viewed as a considerable market "opportunity" associated with the incumbency advantage that is not possessed by the other providers. In addition, USWC has not been authorized to substitute at its discretion cellular or other alternative service options for the wireline telephone services the customer has requested.

Q. Are service program costs part of the Company's "reasonable cost of doing business" as Mr. Redding asserts?

A. No. Revenue credits, service program penalties and the other interim service arrangements due to service quality deficiencies imposed upon the Company were not intended to simply become part of the normal cost of service. With respect to cellular and other forms of alternative service, the Commission should not condone a policy of acceptance of failures to serve and the widespread substitution of resold cellular services in place of wireline services. With a policy of non-recovery of such costs, the Company faces an appropriate incentive to consistently provide high-quality services within reasonable time periods. Adoption of the Company's position of full recovery removes such incentives and introduces an attitude of indifference with respect to serving individual customers that is not consistent with the public interest. I encourage the Commission to find such costs a shareholder responsibility, consistent with the policies applicable in Iowa and New Mexico that were described in my Direct Testimony.

DIRECTORY IMPUTATION

Q. According to Company witness Ms. Koehler-Christensen's rebuttal, "Staff and RUCO consider the fees received by Qwest from DEX, but rather than determining the current value of the services received, they rely on the $43 million level from the original agreement." Did you fail to fully consider the value of fees and services received by USWC as suggested by Ms. Koehler-Christensen?

A. No. My Direct Testimony at pages 37 through 48 exhaustively analyzes the Company's novel theories of value creation and allocation and addresses the value of fees and services received by USWC from Dex. I conclude at page 48, "Using the amounts negotiated in the Settlement Agreement as a starting point, the current value of the fees and services properly credited to USWC in Arizona is no less than $93.1 million, rather than only $43 million." My testimony also explains in considerable detail how this amount was derived and why the $43 million Settlement Agreement value must be viewed as an extremely conservative amount for imputation purposes.

Q. At page 4 of her rebuttal, Ms. Koehler-Christensen states, "While Mr. Brosch claims the current value is higher than I maintain, he provides no analysis or calculations to support his claim. In fact, the only calculation he provides is based on the profits of DEX, a methodology that the Arizona Appellate Court has squarely rejected." Is this correct?

A. No. The $93.1 million value of services is completely documented in my workpapers and was not based upon the profits of DEX, nor did it rely upon the method rejected by the Arizona Appellate Court. In fact, the method that <u>was</u> rejected by the Court yields a $104 million imputation result, as noted at page 48, lines 13 through 17 of my Direct Testimony.

Q. Is your calculation of the $93.1 million a "roundabout way of calculating directory imputation using DEX's profits in excess of Qwest's authorized rate of return", as claimed by Ms. Koehler-Christensen at page 5 of her rebuttal?

A. No. The $93.1 million does not rely upon DEX net income or any determination of any "authorized rate of return". As I noted in the prior response, the income-based calculation produces an even higher $104 million result that is entirely consistent with the ordered imputation methodology in the Commission's last rate order, prior to reversal by the Court.

Q. Another claim made by Ms. Koehler-Christensen with respect to your testimony is that, "In particular, he ignores the changes in the contractual relationship between the Company and DEX, the legislative and regulatory changes that have reduced the value of the services provided and the considerable changes that have occurred in both the publishing and the telecommunications industries." Is this correct?

A. No. My testimony describes the unreasonable and imprudent changes effected in the affiliate publishing agreements between USWC and US West Direct (later DEX) over the years. The Settlement Agreement and history of imputation in Arizona and other states is ample evidence of how "changes in the contractual relationship" between these corporate affiliates should not be used to the disadvantage of ratepayers. As explained in my testimony, the Publishing Agreement has been recognized by regulators to be a contrived arrangement between corporate affiliates that is designed to convey to Dex the valuable benefits of affiliation with the incumbent LEC for inadequate compensation.

With respect to the "legislative and regulatory changes" referred to by Ms. Koehler-Christensen, there has been no showing of any negative impact upon the value USWC brings to the affiliate publishing venture with DEX. In fact, the favorable trend in revenues and profits of DEX indicates just the opposite, that the value of the affiliate publishing relationship with USWC continues to increase. Today, just as in the past, advertisers who can afford to advertise in only one yellow pages must advertise in the official Dex book to have confidence that their advertisement reaches the broadest audience.

Q. At page 5 of her rebuttal, Ms. Koehler-Christensen asserts that "The Company has a contract with DEX to assure that its regulatory obligations are met and that directories are published and delivered to all Qwest's customers. This contract is the same as DEX has with over one hundred CLECs and ILECs." Is this important?

A. No. The specific contractual terms of the affiliate Publishing Agreement between USWC and DEX do not serve as the basis for imputation in Arizona. If the ACC had been able to rely upon the Publishing Agreement to protect Arizona ratepayers, it would never have been necessary to make imputation adjustments or negotiate Settlement Agreements to preserve a directory revenue for ratemaking purposes.

While it seems important to Ms. Koehler-Christensen to make the point that on paper and pursuant to affiliate contract, the DEX and USWC relationship is not unique, it is unrealistic to conclude that DEX's symbiotic relationship with USWC is fully documented or fairly compensated within the Publishing Agreement. In fact, my Direct Testimony at page 33 explains the many intangible benefits of affiliation with USWC that are realized only by DEX. Furthermore, the Settlement Agreement that governs imputation in this case did not make imputation contingent upon the affiliate publishing agreement or upon the offering of the same publishing agreement services to non-affiliated telephone companies. In fact, the Settlement Agreement at paragraph 3(c) specifically provides that changes in the terms of the affiliate publishing contract will <u>not</u> control imputation:

> Mountain Bell and the Commission agree that in subsequent rate cases downward adjustments from the $43 million in fees received by Mountain Bell from USWD and included in Mountain Bell's 1984 rate case will require more than a showing by Mountain Bell that it negotiated a lesser amount with USWD.

The parties to the Settlement clearly recognized that corporate affiliates could not be trusted to negotiate in good faith in a manner that preserves the ratepayers' financial interest in the publishing business.

Q. At page 6 of her rebuttal, Ms. Koehler-Christensen criticizes you for not providing evidence of the value of official publisher status under competitive bids. Is it Staff's obligation to solicit bids or identify comparably transactions in order to honor the Settlement Agreement imputation amount?

A. No. Staff has presented evidence that the value of services received by USWC from Dex is considerably negative and that a much larger imputation than $43 million would be reasonable because of the value Dex realizes in jointly producing directories in cooperation with the dominant incumbent LEC in Arizona. I agree with Ms. Koehler-Christensen that other incumbent LEC's have not solicited bids for publishing services. This is undoubtedly because they also sought to retain directory profits and minimize the regulatory recognition of the lucrative directory publishing opportunity associated with being the incumbent telephone company and directory publisher. U S West is not unique in its efforts to retain for shareholders the maximum level of directory profits that will be tolerated by regulators.

Q. At page 7 of her rebuttal, Ms. Koehler-Christensen states, "No publisher has ever approached the Company and the Company has no reason to believe that another publisher would offer the Company an arrangement that would be more favorable than the current publishing agreement with DEX." Does this statement indicate anything about the value of fees and services in the Dex/USWC relationship?

A. No. There has never been any serious solicitation by U S West seeking competitive publishing services for the incumbent directory business in USWC's territory. There is no basis for competing publishers to assume that U S West would ever seriously consider outside suppliers to displace Dex's core business relationship with USWC. Instead, Dex's services have consistently been contracted without any exposure to competitive bidding or any other "test" of the non-arm's length affiliate contract terms that were made effective. There is simply no reason for another publisher to assume USWC ever intended to terminate its contract with the Dex affiliate for exclusive official publishing services and allow a non-affiliated third party to become involved in the lucrative business of publishing U S West in-region directories.

Q. Ms. Koehler-Christensen also criticizes you for providing "no evidence" to support your assertion that "the Company could contract with another publisher and 'at an absolute minimum receive publishing and distribution at no cost in return for the granting of official publisher status." How do you respond?

A. Some claims are self-evident. The clearest evidence on this point is the existing Publishing Agreement between USWC and Dex, which provides publishing and distribution services to USWC at no cost. Dex provides such services at no cost to USWC because this is, in my opinion, the minimum reasonable compensation that maintains any credibility before regulators. If Dex tried to actually charge USWC for manufacturing the white pages and delivering the directories, while simultaneously retaining for itself all yellow pages and white pages advertising revenues, the Publishing Agreement would be utterly indefensible. In its present form, the Publishing Agreement allows Ms. Koehler-Christensen the opportunity to argue that USWC gets the same publishing "deal" as other non-affiliated telephone companies receive from Dex – even though such argument ignores the considerable value associated with Dex' use of the intangible assets of USWC without compensation.

Additional proof that telephone companies would, at a minimum, receive "free" publication of white and yellow pages directories in return for "official" publishing status can be observed in the Dex contracts with non-affiliated telephone companies. Dex does not charge other telephone companies for publishing their white and yellow pages listings. However, Ms. Koehler-Christensen's theory of value is that Dex could or should charge USWC for the costs of such publishing services. It appears that this theory was created for the sake of regulatory argument, since it is completely inconsistent with Dex's publishing agreements with USWC and with independent and competitive LEC's.

Q. At pages 8 and 9 of her rebuttal, Ms. Koehler-Christensen challenges your claims with respect to the unique benefits Dex receives from its affiliation with USWC. Has she indicated any factual errors in your Direct Testimony with regard to these points?

A. No. She suggests that Dex's use of common trade names and marks with USWC is simply a coincidence of having the same corporate owner and has nothing to do with any public perception that Dex seeks to achieve that its directories are the sole official book. The Washington Utilities and Transportation Commission recently ruled that this view was not credible:

> We find no indication that the logo of U S WEST Communications, Inc., connotes in the popular view an entirely different company from that connoted by any other U S WEST corporate family logo [footnote omitted]. We find it not credible that consumers see the U S WEST Communications logo, with its stylized U S WEST lettering, see the identical U S WEST lettering with the name "Dex," and view them as totally distinct and unrelated companies as opposed to related products under a single umbrella. In any event, the substitution of the U S WEST logo for that of PNB was a choice made by U S WEST, Inc. and PNB and should not be used to justify the evaporation of any publishing rights or financial benefits previously held by PNB.[1]

Ms. Koehler-Christensen also does not challenge the fact that Dex and only Dex has its advertising charges included within USWC's telephone service billings. Dex is the only publisher allowed to sell its receivables to USWC , share corporate management with USWC and receive referrals for advertising from USWC, the primary incumbent LEC in Arizona. It is, in my opinion, beyond dispute that Dex leverages its affiliation with USWC to profitable advantage in dominating the published directory markets in its service territory.

Q. At page 9 of her rebuttal, Ms. Koehler-Christensen states that Dex does not inappropriately earn and retain revenues from selling white page advertising. Why does it matter in this Docket that Dex earns advertising revenues from white pages?

A. It matters because an important claim in Ms. Koehler-Christensen's Direct Testimony was that USWC receives a large "value" from Dex in avoiding incurrence of the cost of manufacturing

[1] WUTC Fourteenth Supplemental Order; Order Denying Petition in Docket No. UT-980948 at page 39 (July 2000) "PNB" stands for Pacific Northwest Bell, one of the three pre-divestiture Bell operating companies that became USWC.

and delivering white pages. If Dex earns white pages "advertising" income that offsets its incurred costs of manufacturing and delivering the white pages, USWC should also be assumed to have the ability to earn such offsetting revenues. However, in her value quantification, Ms. Koehler-Christensen addresses only the costs of white pages and ignores the advertising therein. She improperly relies upon distant history in her rebuttal stating, "When the directory operations were part of Mountain Bell, the Company did not sell advertising in the white pages." My point is that if Ms. Koehler-Christensen wants us to assume (contrary to the Publishing Agreement) that USWC has cost responsibility for producing the white pages today, we should not ignore the fact that white pages produce offsetting advertising revenues today. Her assumptions regarding value of services to USWC have the effect of making USWC a publisher of white pages in terms of cost responsibility, yet Ms. Koehler-Christensen argues that "Publishers, not LECs, sell white pages advertising" and she improperly ignores these offsetting revenues in her analysis.

Q. At page 10 of her rebuttal, Ms. Koehler-Christensen says it is "not reasonable" to expect that USWC could easily reenter the publishing business and earn a net profit. Would it be necessary for the Company to hire employees and develop publishing systems in order to reenter the publishing business?

A. Not necessarily. It is entirely possible for USWC to reenter the business by contracting with an existing publisher that already has the personnel and systems required to publish profitable directories. However, the larger problem with USWC reentry, as noted in my Direct Testimony, would be the need to eliminate obstruction in such a reentry strategy that could be mounted by Dex and the common parent company. All of the challenges of reentry that are noted by Ms. Koehler-Christensen originated with the uncompensated transfer of directory publishing assets, personnel and customer relationships at divestiture and the subsequent publishing agreements that have been found to be unreasonable by the ACC and other Commissions. For example, the aforementioned Washington Utilities and Transportation

Commission Order earlier this year found as follows with respect to the initial transfer of directory publishing to U S West Direct ("USWD"):

> 160 U S WEST states that it always provided full disclosure about the transaction *U S WEST Brief, p.33*. In light of the record and USWC's earlier positions, this statement is difficult to understand. If it intended a transfer of the entire business, not only did it not tell the Commission it was transferring the entire business (nor the value of the ongoing business ostensibly transferred), its application stated that it was arranging for publication, and it subsequently represented through the sworn statements of witnesses (Ms. Koehler-Christianson and Mr. Johnson) and legal positions [footnotes omitted] that no transfer of intangible assets occurred. Mr. Inouye states at transcript pages 263-264 and Ms. Koehler-Christianson acknowledges at transcript page 1001 that the changes in their statements are the result of the Company's desire to support the existence of a completed, permanent transfer that the Company contends is demanded by its interpretation of the Court's decision.
>
> 161 U S WEST's statements now about the facts and the meaning of its own actions are so clearly contrary to the events and representations at the time that they cast serious doubt on the credibility of the Company's case. If we are to believe that it did in fact transfer all rights to the business, it never once told the Commission that is was effecting the complete and total transfer of an immensely valuable asset, contrary to its obligation under law to seek approval for such a transaction. The Company failed to maintain the documentation ordered by the Commission that is essential to the valuation of the asset that it now seeks us to make. Again and again, the contemporaneous information that PNB and USWC provided and its arguments are inconsistent with the facts and the positions that USWC now espouses.[2]

As I noted in my Direct Testimony at page 39, it would be quite possible for USWC to reenter the directory publishing business <u>if</u> the common parent company of USWC and Dex desired such reintegration of publishing with telephony. Transferring employees, automated systems, physical assets and customer relationships back into the telephone company could position

[2] Ibid, page 42.

USWC to realize all of the costs and revenues of directory publishing in Arizona, rather than only $43 million in imputation.

Q. According to page 11 of Ms. Koehler-Christensen's rebuttal, the value of official publisher status has decreased over the years. Do you agree?

A. No. The value realized by Dex in serving as official publisher for USWC continues to increase. This is amply demonstrated by the strongly favorable trends in revenues, gross margins and income realized by Dex. The only structural advantage Dex has relative to other competitive independent publishers is its relationship with USWC and beneficial access to intangible assets of USWC that convey value to Dex. If not for these benefits, competition in directory publishing would serve to reduce the realized returns of Dex toward the cost of capital. In my view, the value of the official publisher status conveyed to Dex has increased since the Settlement Agreement was approved by the Commission.

EMPLOYEE CONCESSION SERVICE

Q. At page 49 of his rebuttal, Mr. Redding claims that your employee concession adjustment allocating part of this employee benefit cost to the interstate jurisdiction is "entirely unnecessary and inappropriate". As his first point in this regard, he claims, "This is inappropriate because USWC can only discount its intrastate intraLATA services to its employees and retirees." How do you respond?

A. What is being discounted, intrastate versus interstate, should not matter. The reality is that an employee benefit is being provided to employees that serve both jurisdictions and all other costs of such employment, including wages, health insurance, pensions, payroll taxes and compensated absences are allocated between the intrastate and interstate jurisdictions. Equity demands a similar allocation for the employee concession employee benefit. Even Mr. Redding admits at page 50 of his rebuttal that Staff's consistency argument is "superficially plausible". In truth, it is absolutely necessary to make this adjustment to avoid the unreasonable outcome on the books where all concession costs are charged entirely to the intrastate jurisdiction solely because the services being discounted happen to be intrastate services. If equivalent compensation value was given employees in any other form, the incurred costs would be subject to allocation across both jurisdictions.

Q. How do you respond to Mr. Redding's other argument for rejection of your allocation of employee concessions?

A. Mr. Redding suggests that allocating these employee benefits is unfair to the Company because of the inability to recover such costs from interstate customers. He claims at page 50:

> ...that assignment of a portion of these costs to the interstate jurisdiction is a disallowance of these costs more akin to a penalty. QWEST can recover none of the cost of Mr. Brosch's imputation of revenues to the interstate jurisdiction because the separations procedures do not allow any portion of the revenue upon which the discount is given to be allocated to the interstate jurisdiction. Consequently, Mr. Brosch is really proposing to penalize the Company by disallowing recovery of

> a perfectly legitimate, long-standing and long-accepted employee benefit.

However, there is no substance to this argument. The Company's rates to interstate customers are not based upon traditional regulation and periodic test period allocations of cost of service. Therefore, even if the allocation problem Mr. Redding theorizes did not exist, there would be no opportunity to explicitly increase interstate rates to recover such costs.[3]

Q. Even if interstate rates were not price-capped, should Mr. Redding's asserted inability to recover allocated employee concessions from the interstate jurisdiction force the Arizona Commission to include excessive costs in determining intrastate revenue requirements?

A. Not in my opinion. The Commission has historically adopted a policy of allowing rate case recovery of employee concessions, but disallowing concession services provided to retirees. In the absence of an equitable jurisdictional allocation of employee concession costs, the Commission should reconsider its policy and explicitly disallow a portion of such costs as excessive when attributed entirely to the intrastate jurisdiction.

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[3] This statement was confirmed by Mr. Redding in response to UTI 69-25.

CASH WORKING CAPITAL

Q. Does the Company agree with Staff's adjustments to cash working capital?

A. Mr. Redding's rebuttal at page 42 acknowledges that most of the difference in cash working capital between Staff and the Company is associated with an error in the Company's filing. With regard to the other lag day adjustments, Mr. Redding claims to be "unable to replicate" the changes made by Staff. In addition, Mr. Redding asserts that two problems exist in the lag day adjustments made by Staff.

Q. Did Staff provide the Company with workpapers supportive of its lag day adjustments?

A. Yes.

Q. Is Mr. Redding correct in his statement at page 43 that your lag day adjustment for compensated absence timing "is unnecessary since this was already done on worksheet 24 of the basic study"?

A. Not entirely. It is true that both the Company and Staff assign a revenue to this non-cash expense. The adjustment in this area deals solely with the fact that the revenue lag used in the Company's worksheet 24 was 23.0 days, while Staff's is 22.7 to match the composite revenue lag on Schedule B-4. The financial effect of this change is revealed in Staff's workpapers to be relatively inconsequential. The more significant adjustment made to the wage lag involves Staff's incentive compensation adjustment.

Q. Do you agree with Mr. Redding on page 43 of rebuttal that part of the "Average Benefit Liability" that you removed relates to the "liability for the savings plan" that needs to be retained?

A. Yes. However, in response to Data Request UTI 69-23, the Company provided this amount and it would reduce rate base by $75,755 if included in Staff's calculations. The revenue requirement effect of this change is only about $10,000 and did not cause the Staff to recalculate the lead lag study.

Q. Mr. Redding claims that your 0.6 day reduction to the cash voucher lag day value "has no apparent basis". How do you respond?

A. The basis for this adjustment was the Company's response to Data Request UTI 30-11 which stated that changes that increased payables processing time from 28 to 32 days was, "...done in several billing systems, which account for approximately 15% of total dollars paid." From this information, Staff applied a 15 percent weighting to the additional 4 days of cash voucher processing time, yielding the 0.6 day adjustment (4 days * .15 = 0.6 days). These calculations were contained in Staff's workpapers.

Q. In his discussion of Mr. Carver's SOP98-01 accounting adjustment at page 22 of Rebuttal, Mr. Redding refers to a needed "adjustment to cash working capital". Is this a valid consideration?

A. No. At page 22, Mr. Redding states, "The next point I would like to address is the non-cash nature of the accounting change. Mr. Carver has completely ignored this reality in his adjustment. He has proposed to make an otherwise non-cash impacting adjustment reduce cash by adopting this accounting change for regulatory purposes. To make the situation worse, he fails to make an adjustment to cash working capital, which would recognize the increase to cash requirements of his proposed adjustment."

In reality, Staff's filing requires no further adjustment to cash working capital if SOP 98-01 accounting is recognized. In response to Data Request UTI 69-16, the Company acknowledged this, stating, "Mr. Redding's testimony at the location noted is incorrect. Staff has included the effect of its SOP 98-1 accounting advocacy in its calculation of cash working capital in this case. However, if the Commission adopts a different position, the effect of that position will need to be incorporated into the commission's own calculation of cash working capital."

Q. Do you agree that the lead lag study could be recalculated to reflect the Commission's findings in preparing the rate order in this Docket?

A. Staff does not oppose such a recalculation.

PLANT RECORDS ADJUSTMENT

Q. At page 12 of his rebuttal, Mr. Wu states, "Mr. Brosch proposes a $55.3 million reduction in rate base to reflect either the retirement or the writeoff of investment that Mr. Brosch does not believe is still in service." Is this an accurate statement of your testimony?

A. No. There is no Staff rate base adjustment for unrecorded retirements. Had Mr. Wu carefully reviewed ACC Staff Schedule B-1 or my Direct Testimony at page 66, lines 6 through 11, he would understand that the rate base adjustment has no impact upon rate base because of FCC-prescribed mass asset accounting procedures. The only financial impact of Staff's adjustment to the Company's plant records for the categories of investment set forth at Schedule B-1 is to eliminate depreciation expense on such investment, as shown on Schedule C-22, in the amount of $2.9 million.

Q. Do you agree with Mr. Wu that the adjustment you sponsor is "Based on speculation that this investment is [no] longer in service"?

A. The adjustment I sponsor is based upon the fact that the Company has failed to meet its burden to demonstrate that these elements of rate base are in service and are used and useful in providing service to customers. As I noted in my Direct Testimony, the Company was asked to identify from a listing of the assets in question any individual items from the 1989 vintage of Arizona General Purpose Computers that are no longer in service and the Company declined to perform the special study or physical inventory that would be required. It is quite unusual for the single largest vintage of an account containing computer technologies, such as mini and micro-computers, terminals, data communications equipment and other computer peripherals, to be ten years old. The ELG projection life for such assets is only five years, according to the Company's response to Data Request WDA 34-27. I believe it entirely speculative for the Company to include such assets in Arizona revenue requirements without satisfying Staff's inquiries that at least some or most of the assets in question remain in service.

Q. According to Mr. Wu's rebuttal at page 13, "The general computer account consists not only of computers, but also peripheral equipment. Examples of peripherals include power equipment, printers and 'dumb' terminals." Were you aware of these other assets included within the 1989 computer vintage records?

A. Yes. The listing of assets USWC was asked (and declined) to verify service status from indicates that these types of peripherals were included in the 1989 vintage investment balances. A fairly insignificant portion of the $24 million total is indicated to be power equipment or printers. Terminal units make up a somewhat larger share of the investment, but USWC has done nothing to verify that any of this plant remains in service. Other examples of peripherals in the $24 million balance include data communications equipment, local area network controllers and mainframe disk drives. All of this type of equipment is subject to technological obsolescence and is unlikely to be in productive use by USWC ten years after installation.

Q. At page 14 of his rebuttal, Mr. Wu states, "When older technology is retired, where possible, the remaining investment used to support the successor technology is transferred to the successor's account, but the remaining investment keeps its original vintage placement date." Does this testimony support a conclusion that your adjustment is inappropriate?

A. In theory, it might. The transfer of older 1955 assets for reuse with subsequent technology might explain some of the extremely old vintages of digital circuit and switch investment on Arizona books. However, in response to Staff discovery on this point, Mr. Wu admitted, "In further reviewing vintage 1955 digital circuit and switch equipment, all had the wrong placement year assigned. None of the vintage 1955 digital circuit and switch investment was from a predecessor account."

Q. At pages 15 and 16 of his rebuttal, Mr. Wu argues that your depreciation adjustment for unrecorded retirements should be offset by a recalculation of higher depreciation accrual rates as if the retirements were recorded prior to a depreciation study. Is such a hypothetical retirement recalculation of accrual rates necessary or appropriate?

A. It would be reasonable to consider the effects of accounting corrections to booked plant investment in the next depreciation study, after any corrections for unrecorded retirements have been verified by physical audit and recorded on the books. At such time, the final outcome of the unresolved FCC audit adjustments to USWC's continuing property records might also be considered. It is not necessary to retroactively restate the most recent completed depreciation study for unrecorded retirements that are discovered in physical audits of plant. Notably, the FCC audit referenced in my Direct Testimony did not specify any depreciation study restatement as a result of the central office equipment that could not be verified by the auditors.

Q. Assuming for the sake of argument that Mr. Wu's rebuttal recalculation of depreciation accrual rates for unrecorded retirements at page 16 is necessary, are the calculations shown at lines 14 through 16 accurate?

A. Staff witness Mr. Dunkel addresses these calculations and refutes Mr. Wu's results in his Surrebuttal Testimony.

Q. Mr. Wu also disputes your treatment of 1925 metallic cable as an unrecorded retirement and states, "As we explained to Mr. Brosch, the accounting system assigns a year of placement of 1901 when the asset's actual vintage year is not identified. This could be plant placed in 1985 or 1999." Is this statement consistent with the Company's responses to Staff discovery?

A. No. In its response to Data Request UTI 52-10, the Company stated, "Certain Outside Plant assets were not kept with vintage data prior to 1989. These assets are assigned a 'fictitious' year of 1901 on the accounting records." If this reference to "...not kept with vintage data prior to 1989" is true, the problem with USWC's records cannot relate to any plant placed in 1999.

Q. Has the Company made any effort in its rebuttal evidence to verify by sampling or physical inspection that any of the older vintage plant assets challenged by Staff are in service or should be retired?

A. No.

SALE OF EXCHANGES

Q. What response to your proposed adjustments to the exchange sale allocations is contained in the Company's rebuttal evidence?

A. Mr. Redding objects to the additional allocation of marketing expenses in Staff Adjustment Schedule C-29, claiming that "It is fact that Qwest does very little marketing in the exchanges offered for sale. The Company's adjustment reflects reality. There are no marketing people located in the exchanges offered for sale. Qwest's TV, newspaper, and radio media buys are heavily concentrated in the metropolitan areas. Mr. Brosch does not offer any evidence that Qwest's marketing efforts in the exchanges being sold is at the same level as the exchanges in the rest of the state."

Mr. Redding also rebuts my attribution of one percent of test period corporate operations expenses to the sold exchanges with the claim "Mr. Brosch talks in generalities about cutting corporate operations expenses, but does not offer any specific reasoning or support for his statement."

Q. If the Company's marketing personnel and media buys are in the major metro markets, doesn't it follow that such costs will not decline upon sale of rural exchanges?

A. No. In truth, the marketing costs incurred by the Company are discretionary expenditures, driven by the economics of increased sales that may result from additional marketing efforts and costs. This is why, as I noted in my Direct Testimony, marketing costs should be reduced in proportion to the size of the market being served because the opportunity for a revenue "payback" has been reduced when the exchanges are sold. It is not surprising that media buys and personnel are concentrated in major metropolitan areas – this is where the most television and radio broadcasts occur and where labor resources can be centralized. However, the location of media does not define the scope of the markets being reached. Similarly, the location of marketing personnel does not define the scope of markets they serve. Mr. Redding seems to presume that because the marketing moneys are spent in the cities, no messages reach the small towns. This makes little sense unless we are to assume that USWC has historically ignored and left unserved the demands in its smaller markets.

Q. Is your corporate operations allocation at one percent to the sold exchanges based upon any specific reasoning or support?

A. Yes. I explained in my Direct Testimony that affiliate charges to USWC from the parent company are based upon relative-size-based allocation factors. Thus, when USWC becomes smaller relative to Dex, Long Distance and the other affiliates, the share of parent costs chargeable to USWC in Arizona will decline. In addition, the immediate effect of the Arizona access line sale is a reduction in the relative size of Arizona business in relation to other USWC states, such that corporate expenses that are pro-rated to Arizona will decline.

Q. Mr. Redding seems to dispute this pro-rate effect in his rebuttal, stating, "Arizona is one of Qwest's fastest growing states. Average annual growth in access lines exceeds the number of access lines that Qwest is selling in Arizona. During the regulatory approval process Qwest will have added more new lines than were sold to Citizens. Taking into account growth and all other factors, Arizona will have a higher corporate prorate factor in the future even with the exchange sales." How do you respond to these claims?

A. Mr. Redding is improperly mixing other issues such as general demand growth with the exchange sale effects in Arizona. It is true that Arizona growth may continue to occur in the future and influence prorate factors. However, this growth phenomena is not an immediate effect of the exchange sale transaction and should not be part of the analysis of exchange sale effects.

RECIPROCAL COMPENSATION

Q. What rebuttal is offered by the Company with respect to reciprocal compensation costs?

A. Mr. Redding claims that my inclusion of reciprocal compensation costs within revenue requirements is acceptable, but he objects because such approach "... makes no provision for the future. This item is very volatile and can increase or decrease rapidly." According to Mr. Redding, "This is why the Company proposed its automatic rider. The rider protects all parties, regardless of whether the cost increases or decreases."

Q. Has Mr. Redding addressed any of the six bullet point reasons you set forth in Direct Testimony as reasons why automatic rate rider treatment of this cost is inappropriate?

A. No. The Company has offered no credible estimates of its future exposure to reciprocal compensation to justify special single-issue ratemaking for this element of the revenue requirement. There is no evidence that the Company's financial condition will be jeopardized by changes in reciprocal compensation. Parties to this proceeding should not be allowed to isolate individual costs for special rate treatment and shift the risk of cost changes to ratepayers without compelling evidence of a need to depart from traditional and balanced review of all revenue requirements within a test period.

Q. Aside from the Company's request for extraordinary automatic rate rider treatment for reciprocal compensation, is there any needed correction to the Staff's adjustment for reciprocal compensation?

A. Yes. Staff relied upon the Company's response to Data Request UTI 62-18 for the amounts of reciprocal compensation expense recorded in the 1999 test period. After Staff's filing was prepared, the Company submitted a corrected and revised response to this request. I have attached as Surrebuttal Appendix MLB-1 a copy of a Revised Schedule C-30 reflective of this change, which increases Staff's revenue requirement by approximately $130,000.

U S WEST, INC. DISALLOWANCES

Q. Does Mr. Redding disagree with Staff's disallowance of U S West, Inc. allocated parent company charges?

A. Yes. However, only generalized statements that such functions are "necessary to any large corporation" and are "usual and normal to the operation of any business" are offered at page 47 of his rebuttal.

Q. Did these representations apply to U S West, Inc. and its allocated costs that were disallowed by the Commission in the Company's prior Arizona rate case?

A. Yes. The nature of the parent entities business functions has not appreciably changed since the last rate case. I explained the Commission's prior rationale for adjustment of parent company allocated costs in the last case, and related this rationale to the functions performed in the 1999 test period in my Direct Testimony.

Q. Mr. Redding also claims in rebuttal that the parent company's "...executives are responsible for structure and organization as well as policy, future direction, and focus for the Company as a whole." Does this mean that an allocation of all of such costs should be charged to USWC customers?

A. No. Certain of the parent entity's costs are not required for USWC's business operation, but rather are holding company portfolio management costs that are rightfully retained by the parent organization as an offset to its income.

Q. Does this conclude your Surrebuttal Testimony?

A. Yes.

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
RECIPROCAL COMPENSATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

REVISED
ACC Staff
Schedule C-30

LINE NO.	DESCRIPTION	SOURCE	TEST PERIOD RECORDED REVENUES	TEST PERIOD RECORDED EXPENSES	NET COST OF INTRASTATE RECIPROCAL COMP.
	(A)	(B)	(C)	(D)	(E)
1	Recorded Test Period Reciprocal Compensation - Eliminated by	Co Adj. W/Ps	$6,561	$18,112	$11,551
2	ACC STAFF ADJUSTMENT TO RESTATE RECIPROCAL COMPENSATION AT TEST PERIOD RECORDED LEVELS				($11,551)

Before the

ARIZONA CORPORATION COMMISSION

In the Matter of the Application of US West Communications, Inc., a Colorado Corporation, for a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules Designed to Develop Such Return	**Docket No. T-1051B-99-0105**

Supplemental Direct Testimony

of

LEE L. SELWYN

on behalf of

AT&T COMMUNICATIONS
OF THE MOUNTAIN STATES, INC.

November 13, 2000

EXHIBIT
AT&T 3
admitted

TABLE OF CONTENTS

SUPPLEMENTAL DIRECT TESTIMONY

Introduction

Q. Please state your name, position, and business address.

A. My name is Lee L. Selwyn. I am president of Economics and Technology, Inc., One Washington Mall, Boston, Massachusetts 02108.

Q. Are you the same Lee L. Selwyn who has previously filed direct and surrebuttal testimony in this proceeding?

A. Yes. I prepared direct testimony that was filed on August 8, 2000 and surrebuttal testimony that was filed on September 8, 2000.

THE PROPOSED QWEST/STAFF SETTLEMENT AGREEMENT

The "compromise" that is reflected in the proposed Settlement Agreement is not based upon any specific ratesetting principles and ignores entirely contrary evidence that has been offered *in this proceeding.*

Q. Dr. Selwyn, have you reviewed the "Settlement Agreement" entered into by Qwest and the Commission's Staff and the testimony offered by both parties in support thereof?

A. Yes, I have.

Q. Will the proposed Settlement Agreement, if adopted by this Commission, result in just and reasonable rates?

A. No, it will not. As readily conceded by Staff witness Brosch, "there was no issue-by-issue negotiation and the total revenue requirement that was agreed upon is not premised upon specific outcomes for particular issues. *The Settlement Agreement should not be viewed as an agreement regarding any theories or positions that are at issue in this Docket.* Rather, the Settlement is a compromise of all of the issues between Staff and the Company."[1] Unfortunately, this "compromise" is so distant and disconnected from the evidence that has been offered in this proceeding that there is no basis upon which the Commission can properly evaluate the "justness and reasonableness" of the rate level and rate structure that the Settlement Agreement contemplates.

1. Brosch (Staff), Supplemental Testimony at 1-2, emphasis supplied.

Ms. Gately addresses the proposed $42.9-million in rate increases, and demonstrates that in accepting this "compromise" the Staff has ignored compelling evidence that, in fact, Qwest's rates overall should be *reduced*, not increased. The proposed price cap regulation plan, which calls for a productivity offset or "X" factor to be applied to a limited number of Qwest services, with other rates either being frozen or permitted to rise by as much as 10% annually during the three-year term of the plan, is unduly generous to Qwest, will result in excessive and unreasonable rates for certain "Basket 3" services that do not confront effective, price-constraining competition, and by freezing "Basket 2" rates at their existing levels, will impose a price squeeze upon competing local carriers. Finally, the proposed rate design, together with the "Basket" structure of the proposed price cap plan, will result in excessive and unreasonable rates for many Qwest services. Like the rest of the Settlement Agreement, this rate design is devoid of basis or principle.

Q. What is your overall recommendation to this Commission with respect to the proposed Settlement Agreement?

A. The Settlement Agreement as presented should be rejected. It may be possible to modify the Agreement so as to eliminate some of its more blatant deficiencies but, since the Agreement itself precludes such modification,[2] the Commission should permit the various contested issues to be litigated.

2. Settlement Agreement, at 8.

The proposed price cap regulation system will result in inadequate rate decreases for the "Basket 1" services to which the X-factor will apply, and will produce excessive rates for services classified in "Baskets" 2 and 3.

Q. What exactly is "price cap regulation," and how does it operate to produce just and reasonable rates?

A. Under rate-of-return regulation (RORR), the aggregate rate level is set based upon a "revenue requirement" that is comprised of the utility's operating expenses including depreciation on its capital assets, plus a "competitive return"[3] on its invested capital. *Price cap regulation*, by contrast, is intended to *disconnect* prices from costs, substituting in place of company-specific costs a *projected* cost level that is based upon the economywide inflation rate less an offset that reflects ILEC *industry-wide* productivity growth experience. Assuming that the productivity offset has been properly set, over time an ILEC subject to price caps should continue to earn the RORR "competitive rate of return" if its own productivity experience is the same as the industry as a whole, should see an increase in its rate of return if its productivity growth exceeds the industry level, and should see an erosion in its earnings if its performance falls below industry levels.

Q. How does price cap regulation benefit ratepayers?

3. Generally, a "competitive return" is one that would be realized from an investment in a nonregulated competitive enterprise with risk and liquidity that is comparable to that characteristic of a public utility subject to rate-of-return regulation, where the utility can expect to be "made whole" with respect to earnings erosion and various other business losses.

A. Price caps is a form of "incentive regulation" in which the ILEC is rewarded for superior efficiency and penalized for inefficiency, as measured by an industry-wide standard. Presumably, this system of "rewards" and "penalties" is supposed to afford the regulated firm an incentive to increase its operating efficiency and produce its services at lower overall cost. However, ratepayers will benefit from the salutary effects of price caps only to the extent that any efficiency gains are ultimately, if not immediately, flowed through in the form of reduced prices.

In principle, that flow-through should be accomplished via the productivity offset factor. However, the calculation of such a factor has been highly controversial; if it is set too low, ILECs realize a windfall gain in earnings that arises not from their own efficiency but rather as a result of the *misspecification* of the productivity offset factor. There are specific devices that have been incorporated into price cap plans to protect against such misspecification. These include, among other things, periodic reviews, "sharing" of excessive earnings with ratepayers, and "low-end adjustment mechanisms" that protect the utility against a misspecification of the productivity offset factor in the opposite direction.

Q. Should utilities subject to price cap regulation be permitted to retain indefinitely the benefits of any efficiency gains that result from the incentive regulation system?

A. No. In competitive markets, firms are able to benefit financially from efficiency or productivity gains only as long as those efficiencies are not replicated by competing firms; in other words, the financial benefits of an efficiency gain are temporary at best.

If under price cap regulation a utility is enabled to generate *consistent* supracompetitive profits, there is strong reason to suspect that the price cap offset factor has been *misspecified* rather than that the ILEC's productivity gains have been so spectacular.

Q. What can be done to overcome this problem?

A. Three things. First, the productivity offset factor must be correctly calculated and accurately specified. Second, some default mechanism, such as the sharing with ratepayers of excessive earnings, should be put in place so as to protect against misspecification. Finally, the price cap plan should be subject to periodic reviews and *reinitialization* of rates at a "competitive" rate of return, as well as a possible adjustment in the productivity offset factor, based upon the performance of the utility during the term of the price cap plan.

Q. But doesn't this cut both ways — what if the ILEC's earnings erode under a price cap regime?

A. The ILEC always has the ability to come back to the Commission and ask for extra-ordinary relief or even a return to RORR. Ratepayers, on the other hand, would have no specific mechanism to seek relief in the event of excessive earnings, except through a review type of proceeding or through some preestablished device, such as sharing.

Q. To what productivity offset factor is Qwest subject with respect to its *interstate* services?

A. The FCC has established a productivity offset or so-called "X" factor of 6.5%.[4] The 6.5% X-factor that was adopted by the FCC for *interstate* services is based upon *unseparated* total company productivity results; indeed, the United States Telephone Association (USTA) and the various ILECs participating in the FCC price cap proceedings — *including Qwest's predecessor US West* — have consistently argued that jurisdiction-specific results are not economically meaningful because, they claim, any cost separation would necessarily be arbitrary. While I personally disagree with that conclusion and have so stated on numerous occasions,[5] the fact remains that the FCC has adopted the USTA/ILEC position on this subject. Now, if the Arizona Commission were to adopt a different, and lower, X-factor than that adopted by the FCC — which is precisely what the Staff has recommended and which the Settlement Agreement expressly contemplates — the result would be a windfall gain for Qwest. Accordingly, since the cost conditions extant in the federal jurisdiction are *by definition* identical to and inseparable from those extant at the state level (by virtue of the FCC's decision, supported by Qwest, to base the interstate X-factor upon total company unseparated

4. FCC, *In the Matter of Price-Cap Performance Reviews for Local Exchange Carriers*, CC Docket No. 94-1, Fourth Report and Order, Para. 141, 12 FCC Rcd 16642, 16697 (1997).

5. Lee L. Selwyn and Patricia D. Kravtin, *Establishing the X-Factor for the FCC long-term LEC price cap plan*, FCC CC Docket 94-1, on behalf of the Ad Hoc Telecommunications Users Committee, December, 1995, at 48-49; Lee L. Selwyn and Patricia D. Kravtin, *Reply to X-Factor Proposals for the FCC Long-Term LEC Price Cap Plan*, FCC CC Docket 94-1, on behalf of the Ad Hoc Telecommunications Users Committee, March, 1996, at 6; In the Matter of the Application of Bell Atlantic - New Jersey for Approval of A Modified Plan for an Alternative Form of Regulation and to Reclassify All Rate Regulated Services as Competitive Services, Rebuttal Testimony of Lee L. Selwyn on behalf of the State of New Jersey Division of Ratepayer Advocate, September 8, 2000, at footnote 32, p. 32.

productivity results), there is no basis for this Commission to adopt a different productivity offset factor than the one adopted by the FCC.

Q. What are your specific objections to the price cap plan that is contained in the Settlement Agreement?

A. There are several serious deficiencies that should render the proposed plan unacceptable. First, the plan itself, while portrayed as a major departure from the traditional rate-of-return regulation (RORR) to which Qwest is presently subject, continues to offer Qwest the principal *protections* of rate-of-return regulation while permitting and affording the Company the means to achieve a potentially significant increase in its earnings. The short duration of the plan — only three years — coupled with the expectation that any adjustments that may be made after three years will be based upon a productivity "study" to be conducted by Qwest itself, essentially afford Qwest the ability to claim a revenue shortfall and revert to rate-of-return regulation (or adjust the productivity offset factor to accomplish the equivalent result) in the event that Qwest's earnings erode under the Settlement. On the other hand, if Qwest is able to increase its earnings above the level that would otherwise be authorized under RORR, it would be permitted to retain those excessive earnings without a requirement that they be shared with ratepayers or that rates be reduced to eliminate the excess. As drafted in the Settlement, the price cap plan amounts to a "heads I win, tails you lose" arrangement for Qwest, providing no assurance that the rates that will actually materialize under this plan will come even remotely close to satisfying the "just and reasonable" standard as expressly required by Ariz. Const. Art. 15 §3.

Q. What are the specific defects that you believe exist in the price cap plan that is contemplated in the Settlement Agreement?

A. The first issue relates to the proposed 4.2% X-factor. Staff had originally recommended adoption of a 4.2% X-factor based upon the 3.7% productivity growth rate developed by Staff witness Harry M. Shooshan based upon Qwest data,[6] plus a 0.5% "Consumer Productivity Dividend" ("CPD").[7] Staff apparently conducted no independent productivity study. Instead, it relied upon expense and revenue data supplied by Qwest,[8] and developed an average productivity growth rate for the period 1995 through 1998. Productivity growth is calculated by comparing the change in the dollar expenditure on *inputs* (capital, labor and materials) to the change in the dollar value of *outputs* (the products and services that Qwest produces and sells). The extent to which output (as defined by revenues) growth exceeds input growth represents the *productivity gain* for that particular year. The productivity growth for those four years, according to the Qwest data relied upon by the Staff, was 4.4%, 4.5%, 4.3% and 1.6%, respectively, for 1995, 1996, 1997 and 1998. No explanation is offered for the dramatic drop that was experienced in 1998. More importantly, there was no attempt to analyze the *input* growth

6. Shooshan (Staff), Direct Testimony, at 14.

7. *Id.*

8. See Staff's response to AT&T 1-001.

— particularly the capital investment input — to determine the extent to which it is being driven by *monopoly* (Basket 1 and Basket 2) services or by "*competitive*" (Basket 3) services. There is, in fact, a strong likelihood that much of Qwest's recent capital purchases have been driven by the desire to upgrade the Arizona network to accommodate various new services, such as DSL, which would be classified in Basket 3.

Q. Is there anything wrong with the Company pursuing such an investment strategy?

A. No, and in fact such investments and infrastructure upgrades will benefit the Arizona economy and Arizona ratepayers. The problem is that such capital outlays have the effect of increasing input growth and in so doing will *depress* the resulting productivity growth calculation because the capital investments will necessarily precede the ramp-up of revenues. The sharp drop in calculated productivity growth for 1998 vs. 1995-1997 may well be entirely attributable to this phenomenon.

Q. What is the solution to this problem?

A. As long as the resulting price cap index is to apply to only a limited number of Qwest services — in the case of the Settlement Agreement, to Basket 1 services only — it is necessary that productivity growth be calculated solely with respect to the services to which the X-factor is to apply. Thus, capital investments and other expenditures, along with associated revenues, that are directly associated with Basket 3 services should be *excluded* from the productivity calculation that is then used to develop the *Basket 1* X-factor. Alternatively, if the X-factor is developed across the entire Company service mix, as is the case with the Staff's calculations, then the resulting X-factor must be applied across *all* of the services over which it was calculated.

Q. The US Court of Appeals for the District of Columbia (Court) has since remanded this decision back to the FCC.[9] Why should the Arizona Commission give this 6.5% number any weight?

A. The Court did not reject the underlying studies or model upon which the FCC relied.[10] The Court did, however, fault the FCC's justification (as set forth in its written decision) for the specific selection of 6.0% for the productivity factor and 0.5% for the consumer productivity dividend.[11] The FCC Staff developed seven averages of total productivity ranging between 5.1% and 6.1%. My understanding of the Court decision is that it determined that the FCC failed to provide sufficient rationale for its particular selection of 6.0%. The DC Circuit stayed this ruling on June 21, 1999, giving the FCC until April of 2000 to respond to the remand order.[12] The FCC opened a remand proceeding in

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9. *United States Telephone Association, et al., v. FCC*, No. 99-1469, (D.C. Cir. May 21, 1999). 188 F.3d 521 (1999), 1999 U.S. App. Lexis 9768.

10. *Id.*, at 529.

11. *Id.*, at 524-525, 527.

12. *United States Telephone Association, et. al, v. FCC,* No. 97-1469 (D.C. Cir. June 21, 1999) (Order granting FCC's motion to stay the mandate).

which X-factors in the range of 5.5% to 8.51% were supported.[13] The FCC has since adopted the CALLS *settlement* plan in lieu of making a specific finding pursuant to the remand.[14] The 6.5% X-factor governs the scheduled reductions in interstate switched access charges set forth in the CALLS plan, effectively settling the price cap (X-factor) issue and locking in the 6.5% value for X.

Q. Did Qwest/US West support the adoption of the 6.5% X-factor as part of the CALLS settlement?

A. Yes. Qwest was a signatory to the CALLS plan, setting in motion a transition to cost-based access charges that would, among other things, retain the 6.5% X-factor until switched access charges reach 0.55 cents per minute for the Bell Companies and GTE, and 0.65 cents per minute for other price cap LECs.[15] Qwest has supported this plan, which incorporated the FCC's 6.5% X-factor in driving the annual price adjustments. In view of the FCC's action in rejecting jurisdiction-specific productivity in favor of a

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13. *In the Matter of Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, FCC CC Docket Nos. 94-1, 96-262, Further Notice of Proposed Rulemaking, November 15, 1999 (*Price Cap and Access Reform Further Notice of Proposed Rulemaking*).

14. *Access Charge Reform*, CC Docket No. 96-262, Sixth Report and Order in Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket 96-45, FCC 00-193 (*rel.* May 31, 2000).

15. FCC CC Docket No. 96-262, *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Long Distance Users, Federal-State Joint Board on Universal Service,* CC Docket Nos. 98-262, 94-1, 99-249, 96-45, *Notice of Proposed Rulemaking,* released September 15, 1999, Appendix C, "Memorandum in Support of the Coalition for Affordable Local and Long Distance Service Plan."

productivity growth factor based upon unseparated total company operations, it is inconsistent and inappropriate for this Commission to adopt an X-factor that is so much less than the 6.5% adopted by the FCC based upon *total company* operating results.

Q. Do you agree with the methodology that Mr. Shooshan utilized in calculating the 3.7% productivity growth rate upon which the 4.2% X-factor was based?

A. No. Mr. Shooshan's methodology is highly simplistic and ignores a broad range of issues, some of which I have already discussed. However, even within the context of his methodology, he appears to have selected the "adjusted revenue" series rather than the "unadjusted revenue" from the same Qwest data set, yet offers no explanation as to what the "adjustment" was or why it should have been used. Revenue represents a monetary measurement of "output" and is, in effect, a *revenue-weighted* measure of *physical* output. There is considerable debate as to the efficacy of utilizing a revenue-weighted output measure, particularly in jurisdictions such as Arizona where local exchange service is generally furnished on a "flat-rate" basis. Growth in the *utilization* of the network — i.e., in the number of minutes of use — will not be tracked by a revenue-based metric where usage is furnished on a flat-rate basis. There are likely other anomalies that work to render the use of a revenue-weighted output measure inappropriate for use in a price cap productivity study.

Q. Have you been able to replicate Mr. Shooshan's calculation using the *unadjusted* revenue series that was contained in the Qwest data?

A. Yes, I have. Substituting the Qwest unadjusted revenue for the adjusted revenue, the productivity growth rate for the period 1995-1999 (the same period studied by Mr. Shooshan) is 4.8% rather than the 3.7% that he had calculated. Attachment 1 to this testimony provides a summary of that calculation.

Q. What would be the X-factor based upon this 4.8% productivity growth rate?

A. Mr. Shooshan has recommended adding a 0.5% "consumer productivity dividend" to his calculated productivity growth rate. On that basis, the X-factor based upon an unadjusted revenue productivity calculation would be 4.8%+0.5%, or 5.3%.

Q. As you have already mentioned, in the FCC's price cap proceeding, the ILECs argued that the Commission should base its productivity growth calculation upon *total company unseparated* operating results, rather than confine it to jurisdictionally *interstate* results, and the FCC accepted that argument. Does the same argument that the ILECs have advanced with respect to not utilizing jurisdiction-specific X-factors also apply with respect to X-factors applicable to services in each of the three "Baskets" contemplated in the Settlement Agreement?

A. Yes, indeed. If one takes the position that separating productivity between intrastate and interstate services is "arbitrary" as Qwest/US West and USTA have done, then exactly the same can be said with respect to rate regulated vs. "competitive" services. Of course, as I have stated, I disagree with the ILECs' and the FCC's determination on this point; in my view, separate productivity results can and should be calculated, both as between interstate and intrastate services, and as between rate regulated and "competitive" services. However, given the ILECs' and the FCC's position on this issue, only a single productivity measure should be calculated across all ILEC services, monopoly as well as competitive.

Q. Is that what the Staff has done here in developing its 4.2% X-factor proposal?

A. Yes, the calculation was made across *all* services, Baskets 1 and 2 monopoly services as well as Basket 3 "competitive" services. There is no indication, in the data supplied by Staff in response to AT&T 1-001, that any attempt was made to limit the productivity calculation only to monopoly services.

Q. What are the implications of this construct for price cap plan that has been incorporated into the Settlement Agreement?

A. It underscores the need to require that in the aggregate *all* services — *monopoly as well as "competitive"* — be subject to the common companywide X-factor. Thus, whatever pricing flexibility may be afforded to Qwest with respect to its Basket 3 "competitive" services should be reflected in monopoly service rates by assuring that the overall rate changes are consistent with the overall price cap.

Q. Why is it important that Basket 3 "competitive" services be included within the application of the overall price cap index?

A. It is likely that productivity growth is higher for monopoly services than for those that have been classified as "competitive" since truly competitive services would tend to exhibit slimmer price margins and would likely involve large product development costs, marketing/advertising and sales expenses, large new capital expenditures, and various other items that would not apply to monopoly services and that will tend to reduce the potential productivity growth in the "competitive" segment of Qwest's output. I have already noted that the precipitous drop in productivity growth in 1998 relative to the immediately preceding three years may well be explained by capital investments aimed at supporting the introduction of services that would be classified as "competitive" and thus exempt from application of the X-factor. In that case, using a companywide productivity growth rate rather than one that had been developed exclusively with respect to monopoly services would produce a lower *apparent* productivity growth rate for the monopoly services, because it would in effect shift costs incurred for the benefit of competitive services to monopoly services.

Q. If as you have suggested the productivity growth rate for truly competitive services is lower than the companywide average and hence lower than the productivity growth rate that would apply for monopoly services were these to be separately studied, what are the implications for the X-factor that would need to be applied to monopoly services only if in fact it is not possible to include "competitive" services within the scope of the price cap index?

A. In that event, the X-factor applicable to monopoly services should be increased to reflect the deaveraged productivity growth rate.

Q. Are you proposing such an adjustment in this case?

A. No, I do not have the basis upon which to perform such a calculation. However, the fact that the X-factor applicable to monopoly services only would necessarily be greater than one derived across all of the Company's services underscores the fundamentally *conservative* nature of the recommendation that I have made, i.e., that the FCC's total company X-factor (whose calculation includes services that Qwest has classified as "competitive") should be adopted for application to Arizona intrastate services.

Q. One seemingly novel aspect of the proposed plan is that notwithstanding the level of inflation, the resulting price cap index cannot be increased above 1.00. Will this feature have the effect of preventing prices from rising if economywide inflation increases?

A. No, it will not. If the economywide inflation rate (GDP-PI) exceeds the 4.2% X-factor, then this constraint would become operative. Of course, the US inflation rate has been running in the 1.5% to 2.5% range for nearly a decade, and so it is highly improbable that this feature of the proposed plan would ever be invoked. Moreover, the specifics of this feature would actually permit the Company increase rates in later years if rate decreases had occurred in previous years. So in fact there may be no real upward price constraint at all.

Q. Please explain.

A. Suppose that the inflation rate in year 1 is 2.0%. Applying the GDP-PI – X formula, the Price Cap Index (PCI) would drop from 1.00 to 0.978. Supposing, however, that in the second year inflation jumps to 6%. In that event, the PCI would actually be increased by (6.0% – 4.2%), or 1.8%, to 0.996. So the "protection" ostensibly being afforded consumers by this capping feature would be effectively neutralized.

Q. What about the 4.2% X-factor itself - is this a reasonable value for X?

A. No. As I have already explained, the 4.2% is based upon total intrastate operations rather than being confined to those services to which the 4.2% X-factor would actually apply. In addition, the Staff's calculation gives no effect to yet another factor that has been expressly adopted by the FCC and by a number of state commissions — the so-called "input price differential."

Q. What is the "input price differential?"

A. The rapid and accelerating pace of technological innovation in the telecommunications industry has resulted in persistent and substantial price *decreases* for the principal capital purchases that are made by local telephone companies, which consist of computer-based electronic digital switching systems (both circuit- and packet-switched) and fiber optic transmission systems, including both the physical fiber optic cable itself and associated electronics. This reduction in "input prices" reflects productivity growth *in the supplier sector*, and should be included within the overall X-factor calculation. LEC input prices are growing at a significantly slower rate than the overall economywide inflation rate. The use of a GDP-PI – X price cap index formula improperly applies the productivity offset to the economywide inflation rate rather than to the cost inflation rate that is actually being experienced by ILECs. Inclusion of the input price differential corrects for this problem.

Q. What specific rationale did the FCC offer for its adoption of an input price differential?

A. During its price cap proceedings, the FCC has found that LECs purchase goods and services (or inputs) whose costs change relative the economy as a whole. If the prices for these goods and services are moving at the same rate as the national economy then these price movements will be reflected in the GNP-PI that is used in determining the price cap index annual adjustment. However, the FCC has concluded that if the inflation factor (GNP-PI) does not accurately reflect changes in a LEC's input costs (because, for example, telecommunications input prices are not rising as fast as prices in the national economy) an X-Factor that does not include an input price differential and is based solely on productivity changes "will not capture the full extent of the differences between changes in LEC unit costs and the economy-wide inflation adjustment."[16] The FCC has consistently concluded that changes in LECs' costs of producing a unit of output are the product of both changes in productivity (or the quantity of resources used) and changes in input prices and as such, "the X-Factor should include both a measure of productivity growth and a measure of input price changes."[17]

Q. Has Qwest accepted an X-factor in excess of 4.2% in any of its other state jurisdictions?

A. Indeed it has. As I noted in my direct testimony, the Utah PSC has proposed a 6.2% value for the X-factor in its price cap formula.[18] In that both Utah and Arizona will

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16. Federal Communications Commission, *In the Matter of Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, First Report and Order, Released April 7, 1995, para. 160.

17. Federal Communications Commission, *In the Matter of Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, CC Docket Nos. 94-1, 96-262, Fourth Report and Order in CC Docket No. 94-1, Second Report and Order in CC Docket No. 96-262, Released May 21, 1997, para. 95.

18. The Public Service Commission of Utah recently issued a proposed rule in Docket 00-352-01 governing the implementation of price caps regulation for Qwest. Proposed Rule Number R746-352 would establish a GDP-PI minus X-factor price cap, with the X-factor set at 6.2% for at least the first year of the plan. (See subsection 4(B)(2) of the proposed rule, available at http://www.psc.state.ut.us/rules/352oct.htm). The language in subsection 4(B)(2) is as follows:

> 2. The productivity factor to be used in calculating the maximum prices for tariffed public telecommunication services pursuant to Section 54-8b-2.4(5) shall be

(continued...)

have established their respective X-factors through settlements rather than through litigation, there seems no reason why Arizona should accept a value for X that differs so dramatically from the value that Qwest had accepted in the adjoining state. Indeed, all else being equal, one would expect that the significantly greater population density characteristic of Arizona relative to Utah would result in larger cost decreases than those experienced in the more rural jurisdiction, suggesting an X-factor that is even greater than 6.2%, such as the 6.5% value adopted by the FCC.

As I have also noted, Qwest has been subject to an X-factor of 6.5% at the federal level since 1997, and by its participation in the so-called "CALLS" settlement it has effectively accepted the 6.5% on a prospective basis. Moreover, since the FCC's price cap formula and X-factor were based upon *total company* rather than separated interstate productivity experience, it is entirely reasonable for this Commission to apply this same 6.5% X-factor for intrastate services in Arizona.

Q. Given the differing treatment being afforded the three "Baskets" with respect to the applicability of the X-factor, is the *effective* productivity offset that is to be adopted under the Settlement Agreement even as high as the 4.2% that the Staff has calculated?

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18. (...continued)

6.2 percent for at least the first year in which the index is in effect. At the end of the first year, a change in the factor percentage shall be considered by the Commission upon a request for change in the productivity factor, X.

It is my understanding that Qwest is not opposing the adoption of this rule or the 6.2% X-factor.

A. No, it clearly is not. Under the Settlement Agreement, only "Basket 1" services would be subject to the operation of the X-factor. "Basket 2" rates would be frozen, and "Basket 3" rates would actually be allowed to rise by as much as 10% per year. Since we do not have an exact breakdown of the distribution of the Company's intrastate revenue among the three proposed "Baskets," we cannot make a precise calculation of the *effective X factor*. However, a hypothetical example will serve to illustrate this point.

Suppose that the revenue breakdown among the three Baskets (1/2/3) is 50%/25%/25%, respectively. Suppose further than the year-to-year increase in the GDP-PI is 2% (this is important for Basket 2, since the effective X-factor for Basket 2 equals the percent change in the GDP-PI). The effective X factor is calculated as shown in the following table:

Basket	Applicable X-factor	Revenue share	Weighted value
1	– 4.2%	50%	– 2.10%
2	– 2.0%	25%	– 0.50%
3	+ 10.0%	25%	+ 2.50%
EFFECTIVE X-FACTOR			– 0.10%

The Commission can, of course, perform the precise "effective X-factor" calculation by substituting the actual Basket revenue weights for the hypothetical values used in this example. Assuming, however, that the hypothetical values bear some general relationship to the (unknown) actuals (which I expect they do), this example demonstrates that when viewed comprehensively across all of the Company's intrastate services, the "productivity offset" all but vanishes under the Settlement Agreement's construct. Since even by its own data Qwest is experiencing total intrastate productivity growth in the range of 3.7%[19] (a value that is woefully understated), the adoption of an *effective X-factor* that is at or near zero will *by definition* result in pervasively excessive rate levels.

Q. One of the elements of the proposed Settlement Agreement calls for Qwest to provide an updated productivity study after two years, so that it can be considered as part of the "review" of the price cap plan that the Commission would undertake after the first three years of the plan's operation. Wouldn't that address your concern?

A. No. In the present case, Qwest has offered certain limited productivity data that produces a woefully inadequate estimate of Qwest's actual productivity growth rate. In addition to the various infirmities that I have already identified, the FCC has generally *rejected* the type of methodology employed by Staff using the Qwest data, and Qwest itself has accepted a substantially higher productivity offset in Utah, where an independent productivity study was performed by the staff, than it is proposing to accept here. There is no reason to believe that after two years Qwest will come forward with a study possessing any greater validity than the present one, or that the Staff will be in a position to undertake an independent study. Indeed, by employing a methodology that utilizes a

19. Response of the Arizona Corporation Commission Staff to AT&T Communications of the Mountain States, Inc.'s First Set of Data Requests AT&T1-001 dated October 19, 2000, at p. 3 of 4, *Average Productivity, 1995 - 1998* (SPR calculation).

revenue-weighted measure of output, which is Staff has done here, where some rates are decreasing as a result of the application of the 4.2% X-factor, it is entirely possible that the resulting productivity growth estimate will be even lower under this methodology than the 3.7% that Staff has calculated in this proceeding. Without a firm commitment for the Staff to develop an independent productivity growth estimate utilizing a methodology that has not been rejected by the FCC, that is based upon unseparated total company data, that incorporates an input price differential, and that will be applied across all studied services (monopoly as well as "competitive"), there is no assurance that after two or three years this Commission will be any closer to adopting an appropriate productivity offset than it is today.

Qwest will not be constrained by "marketplace forces" with respect to price increases for its "Basket 3" "competitive" services.

Q. In view of your concerns regarding potentially excessive rate increases in Basket 3, isn't it also true that the Company's ability to actually increase its "Basket 3" rates by as much as 10% annually (in addition to the $5-million increases in years 2 and 3 resulting from the corresponding decrease in switched access rates) will necessarily be constrained by marketplace forces?

A. That is clearly Qwest's claim, but in view of the Company's apparent willingness to accept a "settlement" in which nearly 60% of its revenue increase will come from so-called "competitive" services, it is highly unlikely that any such "marketplace"-driven constraint on Qwest price increases will actually be operative. In fact, one would normally expect that when competition arrives prices will *drop*, not rise. The very fact that Qwest expects to be able to *increase* its prices by as much as is contemplated in the Settlement Agreement undermines the Company's contentions as to the actual "competitiveness" of the so-called "competitive" services. While *some* of the "Basket 3" services may well confront actual competition sufficient to limit Qwest's ability to increase its prices for those services (what I have been referring to as "price-constraining competition"), there are, in fact, a number of "Basket 3" services that likely do not confront any such competition at all.

Q. To which "Basket 3" services in particular are you referring?

A. Local directory assistance and so-called "new" services that incorporate existing "Basket 1" basic services are prime examples. Others likely include single line ISDN Basic Rate Interface (BRI) service and Metropolitan Preferred Area Calling Service. In addition, by virtue of the fact that Qwest's *national* directory assistance service is accessed via the same '411' dialing pattern as its local DA service, coupled with the fact that Qwest does not offer the '411' dialing pattern to any other "competing" national or local directory assistance providers, I would also include national DA in my list of services that do not confront price-constraining competition. I will address this issue in more detail in my discussion of rate design issues later in this testimony.

Q. Why are you including Metropolitan Preferred Area Calling Service as a "competitive" service that does not confront actual price-constraining competition — isn't this service a form of intraLATA toll, which is competitive?

A. This service, also known as METROPAC, is an optional service that effectively extends its subscribers' local calling areas in certain selected exchanges. The price level for this service, which is at or less than five (5) cents per minute, is *substantially* below the 9 cents per minute switched access charge (covering both ends of each call) that would confront any competitor desiring to offer a comparable retail toll service. Consequently, there is no reasonable expectation that *any* competing interexchange carrier would undertake to offer a service competing with METROPAC that would necessarily have to be priced at roughly half of what the IXC would have to pay to Qwest for the underlying switched access services. Moreover, this condition will not change even under the proposed $5-million per year decreases in switched access charges because, at bottom, Qwest is not required to satisfy an imputation test for this service that incorporates the switched access rate. As I shall discuss below, this very same problem will arise under the proposed Settlement with respect to certain Basket 3 services.

The proposed reductions in switched access charges are insufficient and these rates should be subject to substantially larger reductions.

Q. Does the Settlement Agreement's plan with respect to reductions in switched access charges result in just and reasonable switched access rates?

A. No, it does not. Qwest-Arizona's intrastate switched access charge, at roughly 4.5 cents per minute per end (i.e., originating and terminating), is among the highest in the nation. By contrast, Qwest's *interstate* switched access charge is currently only about *half a cent* per minute per end.[20] In its original (pre-Settlement) testimony, Staff advanced the following specific proposal for reducing intrastate switched access charges:

> I propose that intrastate access prices be reduced by 20 percent per year from their initial levels so that by the end of the initial five year period [of the price regulation plan that was proposed in the initial pre-Settlement testimony] they are equivalent to U S WEST's interstate access charges at July 2000 levels. From that point on, I recommend that intrastate access charges be adjusted to "mirror" the interstate rates.[21]

This recommendation was both reasonable and generally consistent with the approach that has been adopted in the CALLS settlement, i.e., a five-year transition to cost-based access charges. It would, at the end of the transition period, essentially eliminate the existing disparity between Arizona intrastate and interstate switched access charges, and make it possible for intrastate toll (and particularly intraLATA toll) competition to develop to the same robust level that prevails in the case of interstate toll services.

Q. How has Staff modified its position in the Settlement Agreement?

A. Under the Settlement Agreement, switched access charges would be reduced by only $5-million per year, which amounts to a decrease of only 7.1% annually. At the end of

20. Stir (AT&T), Surrebuttal Testimony, Exhibit AS-1.

21. Shooshan (Staff), Direct Testimony, at 12.

three years, Arizona intrastate switched access charges will be 3.2 cents at each of the originating and terminating ends (i.e., 6.4 cents per minute for a two-ended call), whereas by that time the interstate counterpart will still be at 0.55 cents (i.e., 1.10 cents per minute for a two-ended call). The target interstate switched access rate of $0.055 cents closely reflects the underlying costs of providing this service, and of course there is no difference between the cost of providing intrastate and interstate switched access. On that basis, the existing 4.5 cent intrastate switched access rate is set approximately nine times its cost, and the 3.2 cent rate that will exist after the year 3 $5-million rate decrease will be six times the underlying cost. Neither the present nor the Settlement Agreement switched access rate level is economically reasonable, and the original Staff proposal should be substituted for the Settlement Proposal in order to assure just and reasonable access and intrastate toll rates.

Q. Will the specific proposal that the Settlement contemplates actually result in a $5-million decrease in access charge revenues in each of the three years?

A. No, the revenue decrease will be less than the amount stated in the Settlement Agreement. This is because when access prices are reduced, consumption will increase. In its *LEC Price Cap Order*,[22] the FCC adjusted the "raw" revenue effect of the annual price cap-based decrease in interstate switched access charges by applying a price elasticity factor for switched access services.

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22. Federal Communications Commission, *Second Report and Order*, CC Docket No. 87-313, FCC 90-314, adopted September 19, 1990, released October 4, 1990 ("*LEC Price Cap Order*"), at Appendix C.

Q. What is the effect of adjusting the test year quantities revenue effect for demand stimulation?

A. I can best answer that by way of an example. If the price elasticity applicable to switched access is, say, –0.49, then when rates are reduced by $5-million based upon test year quantities, the increase in demand based upon the reduced price will result in an additional $2.45-million in access revenues. Thus, a $5-million reduction in access charges based upon test year quantities but without considering the effects of demand stimulation translates into a *net* revenue decrease of only $2.55-million. Put another way, if the goal is to reduce Qwest's access *revenues* by $5-million each year, then its *rates* will need to be reduced by $9.9-million to account for the additional $4.9-million in revenues arising from the stimulated demand for switched access.

The Settlement Agreement's rate design proposal will produce excessive and anticompetitive prices.

Q. Please summarize your understanding of the rate design plan that is incorporated into the proposed Settlement Agreement.

A. The Settlement contemplates different types of treatment for each of the three "Baskets" of services that are defined in the price cap plan. Basket 1 consists primarily of basic monopoly services; Basket 1 rates would be subject to a price cap based upon the GDP-PI – 4.2% formula. Certain Basket 1 services will see a rate increase, while others, such as the residential nonrecurring installation charge, will be reduced. Assuming that the economywide inflation rate remains at the same roughly 2% level at which it has been growing over the past decade or so, rates in this Basket can be expected to decrease by roughly 2% in each of the next two years. Basket 2 rates would not be subject to the PCI, but would instead be frozen at their existing levels, with the exception of switched access, which would be reduced by $5-million in each of the three years covered by the Settlement. The remaining Basket 2 services, consisting primarily of UNEs and wholesale services for resale, would not see any rate decreases. Finally, Basket 3 services would immediately be subject to an increase of up to $25.9-million, followed by additional increases of $5-million in each of years 2 and 3, to offset the $5-million in access charge reductions. Additionally, rates for Basket 3 services could be increased by up to 10% annually in each of years 2 and 3.

Q. What specific problems do you see with this proposal?

A. I have already indicated that the 4.2% X-factor is insufficient and, as a result, the year 2 and year 3 rate decreases that would be required for Basket 1 services will similarly be insufficient. There is a real problem with the Settlement's proposed treatment of Basket 2 rates. Basket 2 consists of services that are provided to competing carriers. In the case of UNEs and wholesale services provided for resale, rates would remain frozen while the *retail* prices for the *Basket 1* services to which these elements correspond would be subject to annual price cap index-based *rate decreases*. The result is a price squeeze, in that as the retail prices are reduced while the wholesale rates remain unchanged, the operating *margin* between the two will necessary shrink, eroding competitors' profits and potentially making it impossible for them to compete.

To see how the price squeeze would operate, consider the following example. Suppose that the retail price of a service is $20 and that the wholesale price is currently $17.60, i.e., 12% less than the retail price. Assuming a 2% inflation rate, the following table summarizes the price levels that would be in effect for the retail and wholesale services over the three-year term of the price cap plan:

Year	Retail price	Wholesale price	Operating Margin
1	$ 20.00	$ 17.60	$ 2.40
2	$ 19.56	$ 17.60	$ 1.96
3	$ 19.12	$ 17.60	$ 1.52

Note that, in this example, the relatively modest 4.4% decrease in the *retail* price as between years 1 and 3 results in a whopping *36% decrease* in competitors' operating margin over that same period, i.e., from $1.20 initially to only $0.76 in the third year.

Q. Are there any other issues relating to the price freeze applicable to Basket 2?

A. Yes. Section 252(d)(3) of the federal *Telecommunications Act of 1996* establishes the pricing rule for wholesale services that are provided to resellers:

> Sec. 252(d)(3). WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES- For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

These "marketing, billing, collection, and other *costs*" can be expected to experience the same productivity growth as the *retail* services in Basket 1 (and, indeed, as I have noted, the X-factor calculation *includes* Basket 2 as well as Basket 3 services), yet the Settlement Agreement would deny the benefits of those efficiency gains to the unambiguously monopolistic wholesale and UNE services.

Q. As an economist, do you believe that the proposed treatment of Basket 2 services is consistent with the provisions of the *Telecommunications Act*?

A. No, I do not. While I am not an attorney and hence do not offer a legal opinion, the plain language and intent of the federal statute appears at odds with the proposed treatment of Basket 2 services. First, the disparate treatment of Basket 1 retail services and Basket 2 wholesale services with respect to the application of the PCI would, in my view, violate Section 252(d)(3), which *requires* that the wholesale price be set at the retail price *less avoided retailing costs*. There is no basis to believe or expect that the retailing costs that will be avoided will decline by the magnified amount that would arise as a result of this disparate treatment. Second, with respect to UNEs, Section 252(d)(1) requires that prices for UNEs "(A) shall be (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and (ii) nondiscriminatory, and (B) may include a reasonable profit." UNE costs are required to be based upon Total Element Long Run Incremental Cost (TELRIC).[23] For any given UNE, TELRIC studies are conducted periodically, not continuously. As with wholesale services, there is simply no reason to expect that the same productivity growth that will be experienced with respect to retail (Basket 1) services will not also apply with respect to UNEs. By failing to reflect the same productivity offset with respect to UNE prices, the Settlement Agreement discriminates against competing providers and subjects them to an anticompetitive price squeeze.

Q. Are there any other problems with the manner in which Basket 2 services are to be priced?

A. Yes. This concerns the relationship between Basket 2 and Basket 3 prices that would arise under the Settlement Agreement. One of the provisions of Basket 3 is that the Company will be permitted substantial pricing flexibility with respect to Basket 3 services, including the right to offer geographically differentiated rates. In fact, the only specific constraint that would be imposed upon Basket 3 prices is that such geographical pricing cannot have the effect of "red-lining" with respect either to race or wealth.[24]

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23. Federal Communications Commission, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers,* CC Docket Nos. 96-98 and 95-185, *First Report and Order* released August 8, 1996, para. 672, 47 CFR § 56.05.

24. Settlement Agreement at 6.

There is nothing to prevent Qwest from, from example, offering lower prices wherever a competitor has elected to offer service. In fact, since only the *overall* price level of Basket 3 services is subject to any sort of rate cap, Qwest would actually be permitted under the Settlement to lower prices for those Basket 3 services that confront actual, price-constraining competition while simultaneously offsetting these price decreases with price *increases* imposed upon customers who do not confront actual competitive choices. As long as the *average* price change *taken over all Basket 3 services* does not violate the 10% annual Basket 3 price cap increase constraint, such tactics would be permissible under the Settlement. The effect of this disparate treatment would be to create a cross-subsidy flowing from non- or minimally-competitive Basket 3 services to actually competitive Basket 3 services, which would directly violate Section 254(k) of the federal *Telecommunications Act* as well as A.A.C. R14-2-1109(C).

At the same time, Basket 2 wholesale and UNE rates would be frozen, which means that situations may well arise where the *retail* prices of some Basket 3 services (and, in particular, those that confront actual competition) could be set *below* the Basket 2 price for the underlying wholesale service or UNEs. Section 251(c)(4)(A) of the *Telecommunications Act* imposes upon Qwest the duly "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers." Hence, the possibility exists that the Basket 2 wholesale price could actually *exceed* the Basket 3 retail price or otherwise fail to reflect retailing costs that will be avoided when the service is furnished for resale, which would in my view violate the requirements of Section 252(d)(3).

Q. Are there any other concerns associated with the proposed treatment of Basket 3 services?

A. Yes. The Settlement Agreement permits Qwest to define "new" Basket 3 services that incorporate one or more Basket 1 services. By so doing, the Basket 3 service would be removed from the application of the price cap index, and would be subject to pricing flexibility. The only caveat that would apply to the pricing of the Basket 3 service is that if it incorporates 1FR (single-party residence flat-rate) service, the price of the Basket 3 offering cannot fall below the Basket 1 1FR rate.[25] Other than this one limitation, there is no imputation requirement applicable to Basket 3 services that incorporate one or more Basket 1 services. That means that Qwest could create "new" Basket 3 offerings that would not only fall below the prices for the underlying Basket 2 wholesale and UNE prices, but even fail to fully reflect the tariffed rate for the incorporated Basket 1 services. Under these circumstances, there is no reasonable prospect for the development of competition for such services. Add to that the ability to offer geographically-specific rates, and Qwest gets the ability to surgically "take out" any competition that might actually arise.

Moreover, while in theory all of the services that have been reclassified as "competitive" pursuant to A.A.C. R14-2-1108 have been placed in Basket 3, the Settlement Agreement does not *require* that such classification be approved for Basket 3 services and, indeed, explicitly permits Qwest to place "new" services or service "packages" into Basket 3

25. Settlement Agreement, Attachment A, Part 4.e.

without a Commission finding classifying such services as "competitive" under A.A.C. R14-2-1108. The effect of this provision of the Settlement Agreement is to eviscerate A.A.C. R14-2-1108 by affording the very same type of pricing flexibility to *all* Basket 3 services and, even worse, affording the Company the ability to engage in cross-subsidization *among* those Basket 3 services that have been officially reclassified pursuant to A.A.C. R14-2-1108 and those "new" services and service "packages" that have not. A.A.C. R14-2-1109(C) expressly prohibits such cross-subsidization, requiring that "[a] competitive telecommunications service shall not be subsidized by any rate or charge for any noncompetitive telecommunications services." Under the terms of the Settlement Agreement, such intra-Basket 3 cross-subsidization would be both possible and virtually undetectable. Moreover, to the best of my knowledge, in each and every case where Qwest has requested and received A.A.C. R14-2-1108 reclassification for a particular service, the evidence, such as it was, that was offered by the Company in support of its application was aggregated across the entire state, effectively *concealing* those communities in which no effective competitive alternative(s) for the subject service(s) was(were) available to customers as a practical matter. The presence of geographically selective competition coupled with *statewide* reclassification would clearly give Qwest the ability, under the Settlement Agreement, to discriminate against customers of Basket 3 services that do not confront actual competition by raising their prices while reducing those for which actual competition is present, and in so doing work to potentially eliminate competition even in those areas in which it has arisen or might arise. At the very least, the Commission will need to revisit its prior classification of services as "competitive" and reject outright any attempt to include services not so classified in

Basket 3. There is, in fact, no obvious basis under applicable statutes for the *automatic* assignment of all "new" services, including and especially those that are little more than a repackaging of existing Basket 1 monopoly services, into Basket 3.

Q. You had previously questioned the treatment of directory assistance (DA) as a Basket 3 service. Please explain the basis for your concern.

A. In my direct testimony at 28-33, I discussed the problem with the proposed collapsing of local DA into Qwest's national DA offering. While the Commission had previously determined that the local and national DA offerings satisfy A.A.C. R14-2-1108 and therefore should be classified as "competitive," local DA is currently *bundled* into basic exchange service (with respect to the first call each month) and the existing 47 cent charge for additional *local* DA calls continues to apply. Qwest's local DA service is accessed by dialing the familiar '411' sequence, and the Company has designed its "competitive" national DA service to also be accessed in exactly this same manner. Moreover and more importantly, while claiming that DA service is "competitive," Qwest does not offer or otherwise make available the same '411' dialing pattern to competing DA service providers. Section 251(b)(3) of the *Telecommunications Act* imposes upon all local exchange carriers

> The duty to provide dialing parity to competing providers of telephone exchange service and telephone toll service, and the duty to permit all such providers to have nondiscriminatory access to telephone numbers, operator services, directory assistance, and directory listing, with no unreasonable dialing delays.

Section (3)(a)(2)(39) defines "dialing parity" as follows:

> The term 'dialing parity' means that a person that is not an affiliate of a local exchange carrier is able to provide telecommunications services in such a manner that customers have the ability to route automatically, without the use of any access code, their telecommunications to the telecommunications services provider of the customer's designation from among 2 or more telecommunications services providers (including such local exchange carrier).

If directory assistance is a "competitive" service, then Qwest is *obligated* to offer '411' access to competing providers of directory assistance service. Its failure to do so is, in my view, a basis for reclassifying *all* directory assistance as a "monopoly" service to be included within Basket 1. The Settlement Agreement ignores my prior testimony on this point and entirely sidesteps this issue.

A settlement that adequately reflects the various concerns expressed here is possible, and if the Commission determines that a settlement should be pursued, the Settlement Agreement should be modified accordingly.

Q. Given the numerous concerns you have expressed with respect to the proposed Settlement, do you believe that the Commission should nevertheless pursue a settlement rather than continue with litigation of this case?

A. I believe that the Commission can consider modifying the proposed Settlement Agreement to reflect both the evidence presented in this proceeding and, more specifically, the various concerns that I have been discussing here. However, if Qwest and/or the Staff resist acceptance of these modifications, it is my recommendation that the Commission reject the Settlement Agreement and resume litigation.

Q. What specific modifications would you recommend?

A. I recommend that the following changes be made in the Settlement Agreement:

(1) The $42.9-million revenue increase should be changed to a rate decrease in the amount being recommended by Ms. Gately.

(2) The price cap plan should be modified as follows:

- The X-factor should be changed to 6.5%, the level that has been adopted by the FCC, or at the very least should be changed to 6.2%, the level that Qwest had itself agreed to in the Utah settlement.

- Inasmuch as the productivity growth has been calculated using operating data embracing all three Baskets, the X-factor should be applied to all three Baskets.

- The same wholesale discount should apply to all retail services, including those in Basket 3 and including those that are subject to geographically-differentiated pricing.

- Staff should commit to performing an independent productivity study in sufficient time to be considered in the price cap review proceeding, and should base its study upon the methodology that has been adopted by the FCC in its

Price Cap Performance Review Fourth Report and Order.[26] The productivity should include an input price differential to reflect the significantly lower rate of cost inflation being experienced by LECs with respect to their input prices vs. the economywide inflation rate as reflected in the GDP-PI. Alternatively, if the X-factor is to be applied solely to "monopoly" Basket 1 services, productivity should be confined to operating results applicable solely to those services.

(3) Switched access charges should be reduced annually until they reach parity with the interstate switched access rate level. In calculating the revenue effect of the access charge reduction, a price elasticity factor should be applied to account for the resulting demand stimulation that will result from the lower prices.

(4) Rates for Basket 2 services should maintain the same relationship with retail Basket 1 and Basket 3 rates so as to avoid a price squeeze for competing service providers and to comply fully with applicable federal law and regulation.

(5) Directory assistance should remain a monopoly Basket 1 service unless and until Qwest undertakes to provide '411' dialing parity to competing DA service providers.

(6) The Commission should not permit any "new" services or service "packages" to be placed in Basket 3 unless and until the Commission finds that such services or packages satisfy A.A.C. R14-2-1108.

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26. *Op. cit.*, footnote 4.

Attachment 1

Replication of Staff Productivity Study Utilizing "Unadjusted" Qwest Revenue Data

ECONOMICS AND TECHNOLOGY, INC.

Attachment 1 Qwest-Arizona Productivity Study Based Upon Unadjusted Revenues

Arizona Productivity Analysis 1994-1998
($000)

INPUTS

Line No.	Item	Source	1994	1995	1996	1997	1998*
1	Intrastate Expenses						
2	Maintenance	1990's Report	179,310	187,774	205,041	200,848	206,061
3	Engineering/Network/Access/Other	1990's Report	689,190	71,773	65,179	48,964	52,927
4	Customer Operations	1990's Report	140,269	153,528	161,304	172,445	164,816
5	Corporate Operations	1990's Report	120,992	116,448	127,985	143,530	155,888
6	TOTAL EXPENSE		509,481	529,521	559,509	565,787	579,692
7	DEFLATED EXPENSE (1998 $)	L6/GNPPI	418,433	423,617	438,274	433,369	439,731
8	YEAR OVER YEAR GROWTH			1.2%	3.5%	-1.1%	1.5%
	CAPITAL - Intrastate Investment						
9	Average Gross Plant in Service	1990's Report	2,748,270	2,896,085	3,075,298	3,249,626	3,351,980
10	Year Over Year Additions	L9 Curr. Yr.-Prev. Yr.		147,815	179,213	174,328	102,354
11	Deflated Additions (1998 $)			118,252	140,381	133,528	77,642
12	Plant in Service Without Inflation	L11+Prev. Yr. L12	2,839,976	2,758,228	2,898,609	3,032,137	3,109,778
13	Auth Rate of Return		9.75%	9.75%	9.75%	9.75%	9.75%
14	TOTAL CAPITAL EXPENSE	L12*L13	257,398	268,927	282,614	295,633	303,203
15	YEAR OVER YEAR GROWTH			4.5%	5.1%	4.6%	2.6%
16	TOTAL EXPENSE	L7+L14	675,831	692,544	720,888	729,002	742,935
17	YEAR OVER YEAR GROWTH			2.5%	4.1%	1.1%	1.9%

OUTPUTS

Line No.	Item	Source	1994	1995	1996	1997	1998*
18	REVENUES						
19	Operating Revenues	1990's Report	813,423	884,920	961,388	1,017,826	1,072,695
20	Rate Adjustments		0	0	0	0	0
21	TOTAL ADJUSTED REVENUES	L19+L20	813,423	884,920	961,388	1,017,826	1,072,695
22	YEAR OVER YEAR GROWTH			8.8%	8.6%	5.9%	5.4%
23	Growth in Outputs (Revenues)			8.8%	8.6%	5.9%	5.4%
24	Growth in Inputs (Expenses)			2.5%	4.1%	1.1%	1.9%
25	Productivity			6.3%	4.5%	4.7%	3.5%

AVERAGE PRODUCTIVITY 1994-1998	4.8%

*1998 based on Septmeber 1998 YTD results annualized

*Based Upon Shooshan Methodology. Direct Testimony of Harry Shooshan III, August 9, 2000 p. 13

EXHIBIT
AT&T 7
admitted

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN

Docket No. T-1051B-99-105

SURREBUTTAL TESTIMONY OF

SUSAN M. GATELY

ON BEHALF OF

AT&T COMMUNICATIONS

OF THE MOUNTAIN STATES, INC.

SEPTEMBER 8, 2000

TABLE OF CONTENTS

Background

Q. Please state your name, position, and business address?

A. My name is Susan M. Gately. I am the Senior Vice President of Economics and Technology, Inc., (ETI), One Washington Mall, Boston, Massachusetts. Economics and Technology, Inc is a research and consulting firm specializing in telecommunications economics, regulation, management, and public policy.

Q. Have you previously submitted testimony in this proceeding?

A. Yes. On August 8, I submitted prefiled Direct Testimony on behalf of AT&T Communications of the Mountain States, Inc. ("AT&T")

Q. What is the purpose of your testimony at this time?

A. I will respond to certain criticisms levied against my Direct Testimony contained in the reply testimony of Qwest witnesses Mr. Redding and Ms. Koehler-Christensen.

Summary of Testimony

Q. Please summarize the primary aspects of US West's filing that you address in your testimony.

A. My testimony primarily addresses the attempts by Qwest witnesses George Redding and Ann Koehler-Christensen to discredit the revenue requirement reductions proposed in my Direct Testimony of August 8, 2000. Specifically, I demonstrate that neither Mr.

Redding nor Ms. Koehler-Christensen offers any evidence what so ever in rebutting my proposed revenue requirement adjustments associated with Local Number Portability (LNP), interconnection, sale of exchanges, accrual treatment of PBOB expenses, imputation of yellow pages revenue, and the FCC's CPR Audit finding. As I demonstrate below, the bulk of the rebuttal is limited to statements that the Qwest witnesses do not agree with the adjustments that have been proposed.

QWEST has made no attempt to demonstrate that all of the costs associated with the deployment of the federally mandated LNP implementation have been removed from its intrastate revenue requirement.

Q. Have you reviewed Qwest witness George Redding's rebuttal of your proposed adjustments related to LNP expenses?

A. Yes, I have.

Q. Is he correct in asserting that your proposed rate base and expense disallowances relative to LNP implementation are "completely erroneous."

A. No. Mr. Redding has responded to my proposed LNP disallowance in much the same way he responds to my other proposed revenue requirement adjustments– with a broad wave of the hand saying little more than "she's wrong." Aside from disagreeing with my finding, Mr. Redding has done nothing to clarify the situation. He reiterates a statement from his Direct Testimony that "the elements covered by the surcharge were ordered to be removed from the separations process, and, thereby, from regulated results" (a statement I, in fact, acknowledged in my Direct Testimony), but has offered no new insight into the situation, nor answered any of the specific allegations raised in my Direct Testimony.

Specifically, Mr. Redding has offered no explanation as to why the adjustment for LNP capital expenses through year end 1998 was limited to $55.5-million[1] rather the $221-million in LNP related capital expenses Qwest reported in response to Data Request UTI-13-023. The fact remains that in its initial filing, Qwest indicated that through the end of 1998 it had incurred some $341-million in LNP-related costs ($221-million in capital, $120-million in expense)[2] Given an opportunity to provide a reasonable explanation as to why the full amount identified in UTI-13-023 was not removed from separations, Mr. Redding simply ignores the issue.

My proposed adjustment does nothing more than ensure that the full amount of LNP capital investment and expenses identified by Qwest in its own responses to UTI-13-023 and AT&T 11-104 through 11-107, are removed from Qwest's intrastate revenue requirement.

Q. Is Mr. Redding correct in his interpretation of the FCC's May 1998 LNP Order that any "items that were not included under the FCC LNP surcharge were to be recovered in the normal course of business?"

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1. Qwest response to AT&T 11-107.

2. Qwest response to UTI 13-023.

A. No. Mr. Redding's quote from the FCC here is taken completely out of context. The quote comes from the May, 1998 Order setting forth the LNP implementation schedule and the structure of the federal LNP cost recovery mechanism. Mr. Redding quotes from paragraph 144 of that Order, a paragraph that deals specifically and exclusively with the five-year implementation and amortization schedule for LNP capital investments. Put in the proper context, the quote reads as follows:

> 144. We choose the five-year period for the end-user charge because it will enable incumbent LECs to recover their portability costs in a timely fashion, but will also help produce reasonable charges for customers and avoid imposing those charges for an unduly long period. ... After a carrier establishes its levelized end-user charge in the tariff review process we do not anticipate that it may raise the charge during the five-year period unless it can show that the end-user charge was not reasonable based on the information available at the time it was initially set. Furthermore, once incumbent LECs have recovered their initial implementation costs, number portability will be a normal network feature, and a special end-user charge will no longer be necessary to ensure that incumbent LECs recover their number portability costs on a competitively neutral basis. Carriers can recover any remaining costs through existing mechanisms available for recovery of general costs of providing service.[3]

Clearly the FCC's directive that carriers could recover "any remaining costs" through existing mechanisms refers to costs that may be incurred in the normal course after number portability is implemented. Qwest's attempt to recover costs incurred for its initial, federally mandated implementation of number portability during the period 1996 through 1999 from intrastate rates in Arizona is not authorized by this FCC Order.

3. *In the Matter of Telephone Number Portability*, CC Docket 95-116 and RM8355, released May 12, 1998 at 144.

Q. To the extent that certain of Qwest's LNP implementation related costs are not being recovered via the FCC's end user LNP surcharge, is it appropriate for Qwest to now recover those costs from the intrastate jurisdiction?

A. There is no basis for Qwest to recover interstate LNP implementation costs from the intrastate jurisdiction. Clearly, whether and how a carrier is allowed to recover interstate capital investment and operating expenses in no way impacts the interstate nature of those costs. Moreover, Qwest made a choice to recover interstate LNP implementation costs via the LNP cost-recovery mechanisms of end user and query charges, a choice that was entirely optional. The FCC stated " We will allow but not require incumbent LECs subject to rate-of-return or price-cap regulation to recover their carrier-specific costs directly related to providing number portability through a federal charge assessed on end-users"[4] In many ways, the final determination of the rate levels that came out of the FCC's inquiry into LNP end user and query charges proposed by Qwest and the other ILECs was more in the nature of a settlement on an acceptable rate than a formal determination of actual costs. There is no basis in that FCC determination to support a finding by this Commission that Qwest is entitled to any recovery from Arizona rate payers in addition to the end user and query charges set forth in Qwest's federal LNP tariff.

Q. Can you provide an example?

4. *Id.*, at paragraph 135.

A. Yes. The excerpt below taken from the FCC's July 16, 1999 Order allowing Qwest's LNP tariff to go into effect provides just such an example. The excerpt reveals that the FCC was initially troubled by US West's use of a 1.89 overhead factor in the development of the LNP query charges. During the course of the investigation, US West convinced the FCC that the expenses being recovered by the 1.89 factor were in fact legitimately interstate costs associated with the implementation of LNP service. In the interest of getting the proposed price levels to a range that the FCC would feel comfortable approving, however, US West removed .89 of the 1.89 overhead factor from the development of the rates.

> Based on extensive discussions, reflected in *ex parte* submissions on the record, U S WEST has addressed our concerns with respect to the use of the 1.89 overhead factor. In an *Ex Parte* submission, however, U S WEST has agreed to remove the costs generated by the 1.89 factor from its query service rates. *[footnote omitted]* As reflected in its revised filing, the removal of the 1.89 factor lowers U S WEST's query services rates by 89% and makes them comparable to rates charged by other incumbent LECs for query services.*[footnote omitted]* We are, therefore, satisfied that U S WEST's recovery of its incremental overhead costs is reasonable.[5]

No determination was made that the overhead costs that would have been recovered by the 1.89 overhead factor were not appropriately interstate in nature, and there was certainly no determination made that those costs should be recovered from intrastate rates. Yet given Mr. Redding's repeated assertions that "all elements covered by the surcharge" have been removed (implying that that is all that needed to be removed), it

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5. *In the Matter of Long Term Number Portability Tariff Filings – US West, Inc.*, CC Docket 99-35, Memorandum Opinion and Order released July 16, 1999 at paragraph 82.

appears quite likely that those overhead expenses (clearly not being recovered via interstate charges by agreement of the FCC and Qwest), as well as others that were dropped during the movement towards "reasonable" LNP rates, are embedded in the intrastate revenue requirement results presented by Mr. Redding.

Q. Did the FCC Order approving the LNP rates based upon Qwest's revised LNP estimates transfer responsibility for the difference between the approved recovery amounts and those originally proposed to the intrastate jurisdiction?

A. No, absolutely not. The conclusory paragraph prior to the ordering clauses of the July 16, 1999 FCC Order rejecting US West's initial tariffs and approving its revised filing is quite clear – the *costs* (not just the rate levels) claimed by US West for LNP implementation were "unjust", "unreasonable" and "unlawful."

> Based on the entire record before us, we find that certain costs claimed in U S WEST Long-Term Number Portability Transmittal Nos. 965 and 975, filed January 26, 1999 and March 9, 1999, with effective dates of February 10, 1999 and March 24, 1999, respectively, are unjust and unreasonable and, accordingly, unlawful under section 201(b) of the Act.*[footnote omitted]*[6]

The FCC has refused to allow Qwest recovery of these costs on its watch, so Qwest is now attempting to recover them from intrastate prices in Arizona.

6. Id., at 100.

Q. Should this Commission heed Mr. Redding's assurances that all of the LNP-associated costs have been removed from the Arizona intrastate revenue requirement?

A. No, it should not.

Mr. Redding is wrong that the logic underpinning the Utah PSC's exclusion of interconnection costs from the general revenue requirement is not relevant to the current situation in Arizona.

Q. Have you reviewed Qwest witness George Redding's rebuttal of your proposal to exclude interconnection costs from the development of the intrastate revenue requirement?

A. Yes, I have.

Q. Do you agree with Mr. Redding's claim that you did not "tell the rest of the story" in describing the disallowance ordered by the Utah Commission?

A. No, I do not. Once again Mr. Redding has made only the most superficial of responses to the adjustment proposed in my Direct Testimony, in this case bizarrely mischaracterizing it. Contrary to Mr. Redding's assertions, the reference in my testimony to the Utah PSC Order of December 1997 quite clearly *highlights* the "rest" of the story. Quoting from that testimony: "In a recent case, the Utah Public Service Commission disallowed recovery of U S West's interconnection costs through general intrastate rates since these costs were the subject of separate proceedings designed to evaluate costs and pricing evidence directly related to the services U S West provides to its competitors."[7]

Q. Do you agree with Mr. Redding that the absence of an ongoing proceeding investigating interconnection costing and pricing is justification for leaving interconnection costs buried as part of the general intrastate revenue requirement?

A. Absolutely not. The *timing* of such an inquiry into the costs and prices associated with the provision of services to competitors (whether concluded, ongoing, or yet to be initiated) is irrelevant to whether those costs should be included in the determination of revenue requirement (hence prices) associated with the provision of service to the general body of Qwest's non-interconnection service customers.

Q. Would you make any revision to your proposed downward adjustment of $74-million to Qwest's intrastate revenue requirement based upon the exclusion of interconnection investment and operating expenses?

A. No. I would not. As I discussed in my Direct Testimony, according to its response to UTI 13-022, U S WEST has included all of its interconnection costs in the jurisdictional separations process since it intends to recover them in the normal course of business. This means that the $1.547-billion in capital costs and expenses incurred by U S WEST

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7. Gately Direct, at 19.

from 1996 through 1999[8] would be subject to the state allocation process used to allocate company-wide expenses to Arizona operations. It is inappropriate for recovery of extraordinary and non-recurring start-up costs designed to facilitate competition in accordance with the Act to be included in the *general rate structure* of the incumbent LEC if it is seeking recovery of those costs elsewhere.

Interconnection costs are recoverable in amounts assessed competitors pursuant to negotiated or arbitrated interconnection or resale agreements and in interconnection cost dockets setting unbundled network element ("UNE") prices. These are the only proceedings that allow a commission to fully evaluate the appropriateness of these very substantial costs. Buried within U S WEST's overall rate base and revenue requirement in this proceeding, the Arizona portion of the $1.5 billion overall interconnection expense will be recovered without an appropriate level of review and approval. This could result in double recovery – once from competitors and once from retail and wholesale customers.

Q. Did Mr. Redding or any other Qwest witness rebut the development of the dollar amount of the interconnection adjustment made in your Direct Testimony?

A. No, aside from Mr. Redding's assertion that the adjustment wasn't appropriate because there is not an interconnection cost and pricing investigation presently ongoing in

8. *See* U S WEST's response to AT&T 10-087.

Arizona, there was no rebuttal of the calculation of the $74-million adjustment.

Unless and until this Commission revises the conditions it presently requires before allowing utilities to adopt the accrual method of accounting for PBOPs, Qwest's proposed $29-million revenue requirement increase associated with adoption of such accounting treatment should be rejected.

Q. Have you reviewed Mr. Redding's rebuttal of your proposed rejection of the revenue requirement adjustment made by US West for adoption of the accrual method of accounting for PBOPs?

A. Yes, I have. Mr. Redding characterizes my proposal that US West's proposed revenue requirement adjustment be rejected because it has failed to meet the conditions mandated by the Commission for adoption of the accrual method of accounting as "patently ridiculous," suggesting that since no other party had opposed this element of the Company's proposal it must be fine.

Q. Do you agree with Mr. Redding?

A. No. Without question, Qwest has not met the Commission's required ten conditions. On that basis, the revenue requirement adjustment should be rejected. My testimony does not go to the nature or merits of US West's suggested "modification" to the conditions required by the Commission. Should the Commission decide to change its standards (adopting what Mr. Redding describes as a "modification"), then Qwest's proposed adjustment would be appropriate. Should the Commission decide to enforce its existing requirements, then the adjustment should be rejected. Based upon the Commission's standards as they have been enumerated to date, Qwest's revenue requirement should be reduced by the $29-million identified in my Direct Testimony.

Mr. Redding's rebuttal mischaracterizes my recommendation relative to an additional revenue requirement reduction associated with the sale of exchanges in Arizona.

Q. Have you reviewed Mr. Redding's rebuttal to that portion of your Direct Testimony dealing with adjustments related to Qwest's sale of exchanges in Arizona?

A. Yes, I have, and I'm afraid that Mr. Redding has entirely missed the point of my discussion.

Q. In what way has Mr. Redding misinterpreted your position?

A. Mr. Redding has read my criticism of the "net operating income" portion of Qwest's development of its "sale of exchanges" revenue requirement adjustment as applying to the whole of Qwest's "sale of exchanges" adjustment. In rereading my Direct Testimony from Mr. Redding's view, I can see that my choice of words was not the clearest in initially describing the problem I was attempting to correct, although a full reading of the section should have clarified the situation. In describing an unexpected outcome of "a revenue requirement increase" flowing from and alleged loss of net income, my discussion was limited to the revenue requirement impact of the net operating income changes taken alone, not the bottom line impact of all of the changes associated with Qwest's sale of exchanges.

Q. Did Mr. Redding dispute or discuss your criticism of the manner in which U S West developed its alleged "net operating income" results for the sold exchanges?

A. No, he did not.

Q. Did Mr. Redding specifically rebut your suggestion at page 39 that the Commission either reduce U S West's revenue requirement by $7-million or require U S West to make a more reasonable assessment of the expenses associated with the sale of the exchanges?

A. No. His rebuttal of my Direct Testimony proposing an adjustment incorporating the revenue requirement impact of eliminating the alleged shortfall in net operating income resulting from the sale of exchanges was limited only to the phraseology in the initial question and answer in that section – not to the merits of the proposed adjustment. Other than a blanket statement at the beginning of his rebuttal that he is "in complete disagreement" with all of my proposed adjustments, he did not specifically address my proposed $7-million adjustment (which would have increased the overall revenue requirement reduction resulting from the sale of exchanges in Arizona from the $11.7-million proposed by Qwest, to closer to $19-million).

Ms. Koehler-Christensen offers no evidence in rebuttal to my Yellow Pages imputation revenue requirement reduction recommendation.

Q. Have your reviewed Ann Koehler-Christensen's rebuttal of your proposed Yellow Pages imputation adjustment?

A. Yes, I have. Ms. Koehler-Christensen takes issue first with the base amount of the yellow pages revenue being imputed (developed in the Direct Testimony of Dr. Selwyn), and second with the application of U S West's gross revenue conversion factor to the imputed amount. Dr. Selwyn's Surrebuttal testimony deals with Ms. Koehler-Christensen's rebuttal of the imputation amount. I will address her critique of the application of the gross revenue conversion factor to the imputation amount below.

Q. What evidence does Ms. Koehler-Christensen offer to rebut the application of Qwest's gross revenue conversion factor to the imputed yellow pages revenues?

A. Ms. Koehler-Christensen offers no evidence disputing the development of a bottom-line revenue requirement reduction based upon the application of the company's "gross revenue conversion factor" to the yellow pages imputation amount recommended by Dr. Selwyn, she simply says its is wrong. She offers no explanation as to why it is wrong – but maintains that it makes "no allowance for a reasonable return" and "increases the already ridiculously high net income number."

Q. Do you agree with Ms. Koehler Christensen relative to the application of the gross revenue conversion factor to the imputed yellow pages recommendation?

A. No, I do not.

Q. Should the ACC be distracted from the issue at hand – the imputation of the full amount of revenues recommended by Dr. Selwyn in his testimony – by the question of whether the gross revenue conversion factor should be applied to that revenue imputation?

A. No. It is not necessary to make a determination as to whether the gross revenue conversion factor applies to the imputed Directory Assistance revenues at this time. Application of the gross revenue conversion factor will, at the end of the day, be determined based upon whether the revenue being imputed is on a pre- or post- tax basis. In point of fact, the gross revenue conversion factor will not be applied not to each adjustment that the ACC makes to Qwest's proposed revenue requirement, but the bottom shortfall or overage culminating from all of the adjustments taken together.

The ACC should act expeditiously to end the extraction of revenues from Arizona ratepayers for plant that the FCC CPR audits found to be "missing."

Q. Have you reviewed Qwest witness George Redding's rebuttal of your recommended revenue requirement reduction flowing from the findings of the Audit Division of FCC in its audit of the Continuing Property Records (CPRs) of the RBOCS as of June 30, 1997?

A. Yes, I have, and I'm somewhat baffled that Mr. Redding has chosen to rebut my six-page summary and revenue requirement calculation without responding to Dr. Selwyn's lengthy Direct Testimony on the relevance of the CPR Audits to Arizona intrastate ratemaking.

Q. Does Mr. Redding rebut any of Dr. Selwyn's Direct Testimony, or his recommendations relative to the audit results?

A. No. No where does Mr. Redding, or any other Qwest witness, rebut the thirty pages of Direct Testimony Dr. Selwyn submitted on this issue. Nor, apparently, does Qwest dispute the similarities Dr. Selwyn has identified between the findings of the FCC's Audit Division in the CPR Audits and results found in Arizona by Qwest's own auditors in an unrelated audit it undertook of plant in Arizona.

Q. Mr. Redding testifies that Qwest has filed a "strong" protest related to the Audits. Do you consider the fact that Qwest's protest reason enough not to adopt your proposed downward adjustment to Qwest's intrastate revenue requirement?

A. No, I certainly do not. All of the RBOCs, Qwest included, have a long history of protesting and appealing virtually every regulatory opinion that is released that results in an action or finding they view unfavorably. The filing of a protest as a reaction to the CPR Audit results was perfectly in keeping with historical behavior, and frankly, should have been entirely expected. Looking back over the twenty years that I have been involved participating in the regulatory process in this industry I can not recall a single incident where the initial reaction of an RBOC accused of regulatory misbehavior was to do anything but claim either that the behavior didn't matter, or that the regulator was wrong.

Q. Is it true that the FCC has not taken any regulatory action relative to the Audits beyond the docketing of the results?

A. The FCC has yet to enact any major regulatory action in response to the findings of its Audit Division. The procedural history of the Audit at the FCC is fairly well documented throughout pages 62 - 91 of Dr. Selwyn's Direct Testimony. One has to be careful, however, not to read too much into the FCC's inaction up until this time. The audit finding clearly represent quite a thorny, and somewhat embarrassing, problem for the FCC: after all, this inflation of the rate base with *phantom* plant occurred as an abuse of its regulatory rules, *under its regulatory watch*, over the course of decades.

The write-down of more than $1-billion of the $5-billion in undocumentable plant falls under the FCC's sole regulatory jurisdiction – a write down of this magnitude by a single regulator would require a level of political backbone that the FCC may not possess.

Q. Has there been much recent public discussion of the CPR Audit results?

A. No, the most recent tactic by the RBOCs has been an attempt to simply make the whole problem go away by including language that would "close" the audit as a part of a larger package of regulatory changes.[9] (Similar to the kinds of tag line items of legislation frequently found tacked onto legislative budget appropriations bills).

Q. Mr. Redding states that it is impossible to make an accurate revenue requirement adjustment based upon the CPR Audit findings, characterizing it "not as an audit of Qwest's books with respect to plant. It was a review of the individual property records." Do you agree?

A. I vehemently do not agree. Mr. Redding's attempt to dismiss the individual property records as having nothing to do with Qwest's "books" is laughable. The individual property records are part of the paper trail to Qwest's books – if one is flawed, so is the other. Mr. Redding is attempting to characterize the Audit results in precisely the manner warned against by Dr. Selwyn in his Direct Testimony (at 84 – 85) Rather than simply paraphrasing, I've taken the following quote directly:

> Viewed at its most superficial level, it might be argued (and in fact the RBOCs have advanced precisely this claim) that the FCC audits demonstrate little more than the failure of the RBOCs (including US West) to maintain accurate regulatory accounting records. From this perspective, the explanation for the FCC auditors' inability to find particular assets is not that the assets are no

9. [9] FNPRM *In the Matter of the 1998 Biennial Regulatory Review—Review of Depreciation Requirements for Incumbent Local Exchange Carriers, Ameritech Corporation Telephone Companies' Continuing Property Records Audit,* <u>et al,</u> *GTE Telephone Operating Companies Release of Information Obtained During Joint Audit*, CC Dockets 98-137, 99-117 and 98-26 at 15.

> longer useful (or perhaps may never even have been purchased), but rather that the RBOCs simply failed to track the movement of assets following the initial CPR entry. Such a notion undermines, at its most fundamental level, the very foundations of regulatory accounting and reporting: If the books and records are inconsistent with reality, blame the bookkeepers, not RBOC management. If audit results may be so lightly dismissed as merely reflecting sloppy recordkeeping rather than a systematic policy of exaggerating the basis for establishing the telephone company's rate level, there would seem to be little purpose in maintaining such records — or the regulatory machinery to review them — in the first place.
>
> But the purpose of a regulatory recordkeeping and reporting requirement is more than an exercise in testing the accuracy of the process: Rates and rate levels are linked, directly or indirectly, to the net book value of the regulated company's rate base. RBOCs confront a substantial financial incentive to overstate that value. Whether accomplished through deliberate deception or through recordkeeping practices that have the same practical effect, the result is just as unacceptable. Indeed, there would be no purpose in auditing BOC records if, in the end, the inconsistencies are dismissed as irrelevant.

Q. Should the Arizona Corporation Commission heed Mr. Redding's proposal that the Commission not take any action relative to the finding of the FCC Audit Division staff until the FCC has done so?

A. Absolutely not. The longer the inflated investment is allowed to remain on Qwest's books, the greater the damage to Qwest's intrastate ratepayers in Arizona. As Dr. Selwyn describes in great detail in pages 62 - 91 of his Direct Testimony, the FCC Audit Bureau's results are noteworthy and solid. The Audit was conducted using valid statistical sampling techniques, Qwest staff accompanied and assisted the FCC Audit Division during the audit tours, and Qwest was given an opportunity to respond to the Audit and request rescoring for items of equipment that it believed were inappropriately scored.

At an absolute minimum, this Commission should limit the extraction of additional revenue from Arizona ratepayers to fund and provide return on a rate base that is inflated by approximately 20% by reducing the rate base to eliminate the phantom plant immediately. Even so, while this approach can work to establish valid rates from the decision date forward, it will still do little or nothing to penalize the utility for its misreporting, nor capture for ratepayers any portion of the excessive amounts that they have paid in past years. The Arizona Corporation Commission should take responsibility for the misreporting that has occurred to date and put an end to the situation as soon as possible.

Q. Does this conclude your testimony?

A. Yes, it does.

EXHIBIT
AT&T 9
admitted

Before the

ARIZONA CORPORATION COMMISSION

In the Matter of the Application of US West Communications, Inc., a Colorado Corporation, for a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules Designed to Develop Such Return	**Docket No. T-1051B-99-0105**

Surrebuttal Testimony

of

LEE L. SELWYN

on behalf of

AT&T COMMUNICATIONS
OF THE MOUNTAIN STATES, INC.

September 8, 2000

TABLE OF CONTENTS

SURREBUTTAL TESTIMONY

Introduction

Q. Please state your name, position, and business address.

A. My name is Lee L. Selwyn. I am president of Economics and Technology, Inc., One Washington Mall, Boston, Massachusetts 02108.

Q. Have you previously submitted testimony in this proceeding?

A. Yes. On August 8, I submitted prefiled direct testimony on behalf of AT&T Communications of the Mountain States, Inc. ("AT&T")

Q. What is the purpose of your testimony at this time?

A. I will respond to certain statements and contentions contained in the reply testimony of Qwest witnesses Taylor and Koehler-Christensen.

Summary of testimony

Q. Please summarize the primary aspects of US West's filing that you address in your testimony.

A. My testimony primarily addresses the rebuttal testimony sponsored by Qwest witnesses Taylor, Teitzel, and Koehler-Christensen. Dr. Taylor challenges my conclusion that no consequential competition exists in the Arizona local exchange service market. He contends that my reliance upon market share is inappropriate, and that the Commission should focus upon the *future* prospects for competition rather than on the here and now. According to ARMIS Report 43-08 for December 31, 1999, Table 2, US West in Arizona served 2,861,742 switched access lines as of that date. In its just-released Local Telephone Competition Report as of December 31, 1999, CLECs currently serve only 125,991 end-user lines in the state.[1] On that basis, US West's market share expressed in terms of access lines, is 95.78%.[2] In view of Qwest's overwhelming 95.78% share of the Arizona local service market, it is of course not at all surprising that Dr. Taylor would undertake to dismiss market share as an indicator of market power. Unfortunately for Dr. Taylor, his theoretical discussion, which might perhaps be applicable in circumstances where more modest market shares are involved, simply cannot overcome the inescapable fact that Qwest maintains fortress-level control of the local telecommunications market in

1. *Local Telephone Competition at the New Millennium*, FCC Industry Analysis Division, August 31, 2000, at Table 4. Note that the figure for "CLEC End-User Lines" would necessarily include lines served by CLECs in non-Qwest operating areas. Hence, comparing this figure with the *Qwest-specific* end user access lines from ARMIS Report 43-08 would likely *understate* Qwest's actual market share within Qwest's Arizona operating areas.

2. Market share should be calculated in terms of *revenues* rather than access lines, as I discuss below. However, in this instance, the average monthly rate per end-user access line would not be expected to vary significantly as between US West and CLECs; if anything, CLEC prices are likely below those of US West because CLECs are "price-takers" in the market and may find themselves required to offer lower prices than US West in order to induce customers to switch. In that event, the 95.78% US West share based upon end-user access lines likely *understates* a revenue-based market share.

all of its Arizona operating areas, both in the areas proposed for "competitive zone" pricing and regulatory flexibility as well as in all other parts of Qwest's service territory. The Commission should not rely upon Dr. Taylor's or other Qwest witnesses' speculations as to the future prospects for competition, because these have persistently proven to be unfounded. It is now more than four and one-half years since enactment of the federal *Telecommunications Act of 1996*, yet the hoped-for influx of new entrants and effective competition has failed to materialize both here in Arizona and nationally. Indeed, the FCC has thus far lifted the interLATA services line-of-business restriction, pursuant to Section 271 of the *Act*, in only two (2) states, *neither of which are in Qwest's service area*, and even in those two cases the FCC's finding that the BOCs involved had satisfied the Section 271 "competitive checklist" was not without considerable controversy, controversy that persists even now as competitors in these two states continue to encounter difficulties in placing service orders and other transactions with the BOC. Qwest (then US West) did not receive FCC approval of its petition for regulatory forbearance in the Phoenix and Tucson MSAs, and despite the fact that the FCC had provided a clear roadmap for such approval (one that Dr. Taylor himself appears to accept), Qwest has yet to refile with the FCC or provide the FCC with evidence that it has satisfied the new requirements.

Mr. Teitzel takes issue with several specific points I have raised in my direct testimony. He disagrees with my view that services that are incremental to the core service "platform" and that have no independent existence (i.e., they cannot be provided to customers who do not subscribe for the core service) should be classified in the same category as the core service, i.e., as non-competitive. Despite his rhetoric on this subject, Mr. Teitzel has offered no evidence that my assessment is incorrect, or that the incremental services such as call waiting and caller ID confront greater competition than the underlying basic exchange access service with which they are associated. Incredibly, Mr. Teitzel also disputes my conclusion that the elimination of the one "free" directory assistance call allowance and the increase in the directory assistance rate from 59 cents to 85 cents constitutes an increase in basic residential exchange service rates. In fact, his contention that not all residential customers utilize the free call allowance, which in effect concedes that at least some do, undercuts his own contention that no rate increase is involved. By eliminating the one free DA call and by converting "local" DA into "national" DA, Qwest will indisputably realize a net revenue increase.

Finally, Ms. Koehler-Christensen disputes my analysis demonstrating that ratepayers are entitled to a substantial increase in the annual imputation of yellow pages profits, and in fact persists in her position that the present $43-million imputation should be eliminated. The various theories and contentions offered by Ms. Koehler-Christensen are virtually identical to those that she had made before the Washington Utilities and Transportation Commission, which soundly rejected each and every one of them. Qwest's directory publishing affiliate, DEX, continues to benefit from its affiliation with the local Qwest-Arizona operating telephone company, and the telephone company is entitled to a substantial increase in the annual imputation based upon the increasing value of the services it furnishes to DEX, as reflected in the extraordinary level of supranormal profit that DEX continues to generate from the Arizona yellow pages market. Ms. Koehler-

Christensen's various contentions that DEX confronts extensive competition for its yellow pages are simply not supported by any of the evidence that she has offered; indeed, the only "competitor" to DEX that she has discussed explicitly has just 300 employees and hardly represents any sort of realistic "threat" to DEX's overwhelming dominance of the Arizona yellow pages business. The Commission should reject Qwest's effort to extricate itself from the imputation requirement, and should instead increase the annual imputation level to better reflect the ongoing value of the services that Qwest-Arizona continues to provide the DEX, as reflected in DEX's continuing and growing profit levels.

Qwest's overwhelming 95.78%-plus share of the Arizona local exchange market provides compelling and highly relevant evidence of the extent of its monopoly market power.

Q. Dr. Selwyn, Dr. Taylor has attempted to rebut your position that Qwest is a monopoly provider that should remain subject to regulation by this Commission. Have you changed your opinion based upon Dr. Taylor's arguments?

A. No, I have not.

A. In claiming that Qwest should qualify for pricing flexibility, Dr. Taylor' argues that market share is not indicative of a firm's market power. Do you agree?

A. No, I do not. Dr. Taylor's discussion is, at best, entirely theoretical, and ignores entirely the context of the actual local exchange market conditions extant in Arizona. Market share information may indeed be of limited importance when the largest firm in a market controls only a moderate fraction of that market, for example, 30% to 40%. Here, however, Qwest controls fully 95.78% of the Arizona local exchange service market, a level of market dominance that by any objective standard indicates that Qwest, as dominant firm, has the *ability* to exercise substantial market power to control price levels and limit competitive entry. And Dr. Taylor's testimony as to the inapplicability of market share data[3] does nothing to negate the obvious and indisputable dominance that Qwest continues to maintain and to enjoy in Arizona.

Q. Dr. Taylor suggests that market share, if it is to be measured at all, should be stated in terms of revenues or profits rather than access lines. Do you agree?

A. Actually I do, and so did the FCC. As I observed in my direct testimony at page 41, in the FCC's decision in the US West petition for forbearance from regulation of its high-capacity services in the Phoenix MSA,[4] the FCC explicitly concluded that calculating market shares based upon DS1-equivalent channel *capacity* rather than on the basis of relative revenues *overstates* competitive entry.[5] The FCC concluded that *revenues*, not

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3. Taylor (Qwest), rebuttal at 37-41.

4. *Petition of US West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA* (CC Docket No. 98-157), *Fifth Report and Order and Further Notice of Proposed Rulemaking*, FCC 99-206, released August 27, 1999 (hereinafter, "*Pricing Flexibility Order*") at para. 77.

5. *Petition of U S West Communications, Inc. For Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, CC Docket No. 98-157 *et seq.*, FCC 99-365, *Memorandum Opinion and Order* Adopted and Released November 22, 1999. ("FCC Forbearance Order") The calculation that US West had proposed in that proceeding treated

(continued...)

DS1-equivalent channels, was the appropriate basis for measuring market share, and further concluded on that basis that US West and its Quality Strategies consultant had overstated competitor market shares:

> 27. In addition to the general shortcomings of the BOC petitioners' market share data, we also find that a market analysis based on "DS1 equivalents" fails to provide an accurate measure of competition for special access and high capacity dedicated transport services. The BOC petitioners use of a "DS1 equivalent" measure of market share overstates competitive inroads in a market by placing a disproportionate emphasis on DS3 circuits. For example, CTSI explains that a DS3 channel is equivalent to 28 DS1 channels; therefore, if a competitive LEC provides one DS3 channel to a customer and Bell Atlantic provides 28 DS1 channels to 28 different customers, Bell Atlantic claims that it has only 50 percent market share based on capacity. In contrast, CTSI states that if a CLEC provides a customer a DS3 channel at $100 per month and Bell Atlantic provides its customers with 28 DS1 channels at $50 per month per channel, then the CLEC's revenues would be $100 per month and Bell Atlantic's revenues would be $1400 per month. Measured on the basis of revenues, therefore, Bell Atlantic's market share would be 86 percent. Commenters note that 28 DS1 circuits will produce substantially more revenue and serve far more customers than a single DS3 circuit. We therefore reject the BOC petitioners' argument that the "DS1 equivalent" methodology provides a more accurate measure of market share than revenue data. Because one DS3 circuit costs less than 28 DS1 circuits, even though they provide equal capacity, measuring competitors' market presence on the basis of revenues gives a better indication of the extent to which competitors have made significant inroads into the market in question.[6]

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5. (...continued)
each DS3 channel as its equivalent in DS1 channels; for example, a DS3 was treated as the equivalent of 28 DS1 channels. The FCC determined that this calculation exaggerated actual competitive entry because US West's price for a DS3 channel is only a small percentage of the price for the equivalent number of DS1 channels.

6. *Id.*, at para. 27, footnotes omitted.

The Commission here should, in particular, take note of the fact that, while arguing against "channel equivalents" and in favor of "revenues" as a basis for assessing Qwest's market share, Dr. Taylor has not offered any evidence as to the revenue shares currently being held by its Arizona competitors. As I have noted, in the FCC *Forbearance* proceeding, the Commission found that market shares based upon physical circuits actually *overstated* the market share when viewed on the basis of revenues. Thus, in positing this refinement to a market share analysis, Dr. Taylor is blowing smoke, but without anything substantive in the way of actual, quantitative data, to back it up. Dr. Taylor asserts that "measuring market share loss in terms of lines may *understate* the real intensity of competition, i.e., the real degree of competitive loss."[7] In fact, as the text quoted above confirms, the FCC actually reached precisely the opposite conclusion to that asserted by Dr. Taylor, i.e., the FCC found that a market share based upon channels (lines) would actually *overstate* the extent of competition relative to a market share statistic based upon relative revenues.

Q. Dr. Taylor also claims that the Commission should look to the potential *capacity* of competing firms rather than to current sales as a basis for assessing the extent of competitive penetration.[8] Do you agree?

A. No. The "potential capacity" argument is a key element in the "market contestability" theory that Dr. Taylor espouses. The notion here is that the incumbent LEC's very

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7. Taylor (Qwest), rebuttal at 39, emphasis in original.

8. Taylor (Qwest), rebuttal at 40.

awareness that its rivals possess the capacity to expand into its market will work to constrain the incumbent's exercise of market power. Inasmuch as Qwest persists in charging grossly above-cost prices for many of its services, such as vertical features, DSL and switched access, the "market contestability" notion fails on its very face. However, to the extent that Dr. Taylor's argument has any merit, he is clearly focusing upon the *wrong* measure of capacity: That is, he is referring to competitors' "raw" capacity in the ground, rather than the capacity of Qwest to process competitor orders for services to the competitors' customers.

Q. Please explain this last point.

A. To the extent that "potential" competitor capacity offers any price-constraining pressure on the incumbent, it is because the competitors collectively possess relatively high "elasticity of supply." Elasticity of supply refers to the ability of, and the rapidity with which, competing firms to supply goods and services to the market in response to the prices charged or profits earned by the incumbent. A relatively high supply elasticity indicates that rival firms are able to respond quickly to excessive market prices, and such a capability would have the effect of bringing those price levels down to long run incremental cost. A low supply elasticity, on the other hand, suggests that competitors are not able to respond quickly to satisfy market demand, which permits the incumbent to maintain excessive prices, at least in the short run, until such future time as competing firms acquire the capacity to supply customers presently served by the incumbent.

Significantly, in the instant situation, the incumbent, Qwest, is actually able itself to limit the capacity of its rivals to respond rapidly to market demand and thereby to serve the market in a way that would compel Qwest to lower its own excessive price levels.

Q. Does Dr. Taylor appear to agree with you that the supply elasticity reflecting competitors' ability to rapidly satisfy market demand is, in fact, quite low?

Q. Yes. At page 43 of his rebuttal testimony, Dr. Taylor explicitly concedes that "[n]aturally, it takes considerable time and effort on the part of those entrants to bring about significant erosion in the market share of the incumbent firm."

Q. How is that possible?

A. Most of the "competition" in the local market that exists today involves, to varying degrees, the *resale* of services furnished by Qwest. Total service resale (TSR), pursuant to Section 251(c)(4) of the federal *Telecommunications Act of 1996* and the provision of Unbundled Network Elements to CLECs, pursuant to Section 251(c)(3), are excellent examples. Every time a competitor provides a service to one of its end user customers that utilizes Qwest facilities either on a TSR or a UNE basis, Qwest must necessarily be involved in facilitating and processing the transaction. Even where the competitor is wholly or partially facilities-based, Qwest will typically be involved in the physical cutover, except where the customer is not transferring his service from Qwest to a CLEC but is ordering entirely new service from the facilities-based CLEC. In the recent

Verizon strike, for example, competitor installations came to a virtual standstill throughout the 13-state Verizon operating region because Verizon's local telcos ostensibly lacked the personnel to perform the transactions. Qwest has not, in fact, satisfied the Section 271 competitive checklist in any of its fourteen states because (among other things) it has not demonstrated that it is capable of offering seamless processing of competitor orders, as expressly required by Sections 271(c)(2)(B)(i) and (ii). The FCC, in its *First Interconnection Order* in CC Docket 96-98, interpreted Sections 251 and 252 as expressly requiring that CLECs be able to process service order transactions through the incumbent LEC's operations support systems (OSS), and to be provided access to those systems on a nondiscriminatory basis vis-a-vis the access arrangements provided by the ILEC to itself.[9] Indeed, it was precisely this issue that held up Verizon-New York's bid for long distance authority, which was finally awarded, after extensive testing, last January. And in fact the post-award experience in New York has confirmed that Verizon

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9. *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98; *Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket No. 95-185, *First Report and Order*, FCC 96-325, Adopted: August 1, 1996, Released: August 8, 1996, at para. 316. The Commission stated that "to enable new entrants, including small entities, to share the economies of scale, scope, and density within the incumbent LECs' networks, we conclude that incumbent LECs must provide carriers purchasing access to unbundled network elements with the pre-ordering, ordering, provisioning, maintenance and repair, and billing functions of the incumbent LECs operations support systems. Moreover, the incumbent must provide access to these functions under the same terms and conditions that they provide these services to themselves or their customers. ..."

does not yet actually possess the capacity to process "market quantity" orders.[10] Qwest-Arizona is well behind Verizon-New York in satisfying Section 271.

The key point here is that what matters insofar as capacity is concerned is the *lesser* of the CLECs' capacity to serve and the ILEC's capacity to process CLEC orders. Even if a CLEC is capable of fulfilling 10,000 service orders a week, if the incumbent is capable of handling only 500 such orders, then the relevant "capacity," even under Dr. Taylor's largely discredited "market contestability" theory, is the smaller figure, i.e., 500 orders per week in this example. Dr. Taylor, of course, offers no quantitative evidence regarding the *relevant* capacity of his client's competitors to serve customers in the Arizona local service market, and certainly fails entirely to demonstrate that in fact the presence of whatever competitor capacity may actually exist in Arizona is sufficient to actually constrain Qwest's pricing and marketing practices.

Q. Dr. Taylor contends, at page 42 of his rebuttal testimony, that measures of market power, such as the Herfindahl-Hirschman Index ("HHI") are relevant only where mergers or

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10. See, e.g., New York State Public Service Commission, *Complaint of MCI Worldcom, Inc. against Bell Atlantic-New York concerning Billing Completion Notices, Firm Order Commitments, Acknowledgements and Tracking Numbers, filed in 99-C-1529*, NYPSC Case No. 00-C-0008; *Complaint of AT&T Communications of New York, Inc. against Bell Atlantic-New York concerning Acknowledgements, Completion Notices and Pre-Order Outages, filed in 99-C-1529*, NYPSC Case No. 00-C-0009, *Order Directing Improvements to Wholesale Service Performance*, Issued and Effective February 11, 2000; FCC, *In the Matter of Bell Atlantic-New York Authorization Under Section 271 of the Communications Act to Provide In-Region, InterLATA Service in the State of New York*, File No. EB-00-IH-0085, Acct. No. X32080004, *Order and Consent Decree*, Released March 9, 2000. See also "New York PSC Tells Bell Atlantic to Report OSS Results Daily," *Telecommunications Reports*, February 21, 2000.

acquisitions involving two or more firms in the same market are taking place. Do you agree?

A. I certainly agree that the HHI provides highly relevant information where a regulatory agency and/or the United States Department of Justice are evaluating the efficacy of a proposed merger or acquisition. However, the HHI is also highly relevant in providing a quantitative measure of market power when considering ILEC contentions that its market has become "competitive." Dr. Taylor correctly notes that the Department of Justice considers the extent of the increase in the HHI that would result from the merger or acquisition, but then attempts to imply that this is the *only* use to which the HHI can be put. That is obviously not true.

Q. What is the HHI for Qwest in Arizona?

A. The HHI is calculated as the sum of the squared market share percentages for each firm in the market. Dr. Taylor notes that HHI values as high as 1,800 "trigger no alarms from an antitrust perspective."[11] With a market share of 95.78% in Arizona, Qwest's HHI in this state is a whopping 9,174 out of a possible 10,000. While the selection of 1,800 as the upper limit of the HHI before any antitrust concerns are invoked may, as Dr. Taylor claims, be "arbitrary,"[12] there can be no question but that an HHI of 9,174 is so far

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11. Taylor (Qwest), rebuttal at 42.

12. *Id.*

above 1,800 that there can be little doubt as to the presence of extreme market power on the part of the incumbent.

Q. Dr. Taylor contends that there is an "asymmetry" with respect to increases vs. decreases in the HHI, and that in the instant situation Qwest's HHI is decreasing. Does such asymmetry exist?

A. Perhaps, but once again Dr. Taylor advances only theoretical arguments that are in no sense satisfied by the facts on the ground. As I have previously noted, Dr. Taylor agrees that "it takes considerable time and effort on the part of those entrants to bring about significant erosion in the market share of the incumbent firm." He goes on to claim that it is not necessary for the HHI to fall to the 1,800 range "before the market could be declared competitive."[13] He states that "[t]he critical test there is not whether the HHI has fallen precipitously but, rather, whether the incumbent firm has the ability to exercise market power even in the early stages of competition when the HHI is necessarily high. Without the ability to exercise market power, a high HHI says nothing about the actual and potential state of competition in the market."[14] This argument could be true at a theoretical level, but only if the HHI does drop precipitously. For example, in less than a year following the break-up of the former Bell System, AT&T's share of the customer premises equipment (CPE) market dropped from the high 80% range to well below

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13. *Id.*, at 43.

14. *Id.*

50%.[15] But in the four-and-one-half years since enactment of the federal *Telecommunications Act of 1996*, ILEC market shares have hardly decreased at all, and there is no indication that that situation will change any time soon. Dr. Taylor, in speculating as to the rapidity with which he expects price-constraining competition to arrive on the scene, he conveniently ignores this history and the inescapable fact that Qwest is still far from satisfying the Section 271 requirements that are expressly intended to *facilitate* competitive entry and development. Even if, in two to three years, Qwest's Arizona market share were to drop to only 90% (which would imply a 137% increase in competitor market shares relative to that which exists today), the HHI for Qwest in Arizona would still *exceed* 8,100, or some four-and-one-half times the upper limit of 1,800 that the DoJ utilizes as a trigger for antitrust concerns. And nothing that Dr. Taylor has offered in the way of hard facts would suggest that a decrease in Qwest's overall Arizona market share to as low as 90% over the next two to three years is even remotely possible.

Q. At page 46 of his rebuttal testimony, Dr. Taylor provides an example of a market consisting of one facilities-based carrier with a 40% market share and 30 resellers each with a 2% market share. Dr. Taylor contends that the HHI for this market would be 1,720. Has he correctly calculated the HHI for this hypothetical market?

A. No, he has not. There are, in fact, two separate "markets" here, one for the provision of the underlying services by the sole facilities-based carrier, and the second for the

15. Can we get a cite for this - check with Levinson

provision of retail services by the facilities-based carrier and its 30 resellers. The HHI for the underlying service market is 10,000, because there is only one firm with market share of 100%. The HHI for the *retail* segment is, as Dr. Taylor has calculated it, 1,720. By any stretch of the imagination, the sole facilities-based carrier will have market power, and apparently Dr. Taylor agrees with that point. However, what he has attempted to accomplish through this highly misleading example is to suggest that a firm can still have market power even where the HHI is below 1,800. Obviously his example fails because he has misstated the actual HHI for the market for the underlying facilities-based service.

Q. In quantifying Qwest's market share, should the Commission confine itself solely to the so-called "competitive zones" that Qwest has proposed, or should it develop and rely upon an overall Qwest-Arizona statewide market share figure?

A. The latter. A major source of Qwest's market power in its so-called "competitive zones" stems directly from its virtual monopoly control of the remainder of its Arizona operating territory. Even if the Commission were to nominally "remove" the "competitive zones" from rate of return regulation, it would still be required to allocate costs as between the "competitive zones" and the remainder of Qwest's service areas. Qwest is in a position to shift costs out of its "competitive zones" and into the area in which it concedes that no consequential competition is present, thereby affording it the ability to effectively cross-subsidize the services in furnishes under "competitive" conditions with higher rates and revenues from its monopoly areas. The Commission needs to make an overall assessment of the Company's statewide market share, because confining itself solely to the "competitive zones" would provide a misleading understatement of the actual extent of Qwest's market power even in these areas.

Q. Dr. Taylor challenges your dismissal of collocation as an indicator of the presence of competition. Please comment upon his discussion of this issue.

A. There is no question but that the presence of collocation in a large percentage of an ILEC's central offices is a *necessary* condition for effective competition in the areas in which such collocation is occurring. However, it is not in and of itself a *sufficient* condition to *prove* that competition is present at a level that is sufficient to adequately constrain Qwest's market power. Qwest's continuing failure to provide seamless and nondiscriminatory access to its operations support systems for purposes of permitted CLECs to perform preordering, ordering and provisioning of service functions essentially negates the effects of collocation insofar as it facilitates the CLECs' ability to gain effective access to Qwest's monopoly network resources. The *fact* that market penetration remains almost unmeasurable even in the central office serving areas in which CLEC collocation is present underscores this point, and undermines Dr. Taylor's argument.

Q. At pages 50-51 of his rebuttal testimony, Dr. Taylor contends that the FCC has rejected the use of market shares as a basis for pricing flexibility, and has instead adopted specific triggers that, once satisfied by an ILEC, would be used as a basis for approval of a petition for pricing flexibility. Has Dr. Taylor correctly described the FCC's actions in this regard?

A. No, and in fact his discussion appears to be deliberately misleading. Dr. Taylor states, at page 51, that "in first undertaking reform of interstate *switched access* charges, the FCC adopted a market-based, rather than an overtly-regulatory, approach."[16] His source for this statement is given in footnote 36, the FCC *Access Charge Reform* First Report and Order released May 16, 1997. Dr. Taylor provides no specific paragraph citation to support his characterization. In fact, *nothing in the First Report and Order expressly confers any pricing flexibility authority upon any ILEC*; at best the Commission expressed an *intention* to pursue this course in the future.

In the very next sentence on page 51 of Dr. Taylor's rebuttal testimony, immediately following the reference to the *Access Charge Reform* First Report and Order, Dr. Taylor goes on to introduce a quotation: "The FCC explained that deference thus:" In fact, the FCC order from which the quoted language was extracted was *not* the *Access Charge Reform* First Report and Order at all, but was instead the *Fifth* Report and Order released August 27, 1999, *more than two years later.* More importantly, the subject of the text reproduced from the Fifth Report and Order was pricing flexibility for *special access and dedicated transport*, distinctly *not* switched access. In fact, the FCC adopted far more stringent requirements for switched access than for special access and dedicated transport.

16. *Id.*, at 51, emphasis supplied.

At paragraph 108 of the Fifth Report and Order, relating to "Phase I Triggers for Other Switched Access Services," the FCC stated:

> 108. We conclude that an incumbent price cap LEC should be allowed Phase I pricing flexibility for common line and traffic-sensitive services, and the traffic-sensitive components of tandem-switched transport service, when it demonstrates that competitors, in aggregate, *offer service over their own facilities to at least 15 percent of incumbent LEC customer locations in the MSA.*[17]

And lest there be any doubt as to the fact that the FCC drew a bright line between switched and special access, one need look only as far as the very next two paragraphs in the same Fifth Report and Order, paragraphs 109 and 110:

> 109. We conclude above that Phase I relief for a particular service is warranted when an incumbent LEC demonstrates that competitors have made irreversible investment in facilities used to compete with the incumbent LEC in the provision of that service. For special access and dedicated transport services, we adopt a trigger based on collocation by competitors because competitors historically have collocated in incumbent LEC wire centers in order to provide transport and special access services. Thus collocation furnishes evidence of irreversible investment in facilities in part because it indicates competitive transmission facilities terminating at the collocation site. Although we acknowledge that some competitors provide these services exclusively over their own facilities (total facilities bypass), the extent of such competition is difficult to measure. Because collocation traditionally has served as the building block for competitive transport services, we conclude that it constitutes a sufficient measure of the degree to which competitors have invested in facilities to provide these services.[18]
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> 110. Competition for common line and traffic-sensitive services, however, is a much more recent phenomenon, and it may not develop in this same manner. For this reason, a different approach to granting pricing flexibility for

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17. FCC *Pricing Flexibility Order*, at para. 108, footnote omitted, emphasis supplied.

18. *Id.*, footnotes omitted.

> these services is warranted. For traffic-sensitive and common line services, we adopt a Phase I trigger that takes into account competitors that have wholly bypassed incumbent LEC facilities, as well as competitors that collocate in incumbents' wire centers so as to provide service over unbundled loops.

Q. Why is this distinction that the FCC has made as between switched and special access important in the context of the present proceeding here in Arizona?

A. Special access is furnished over dedicated facilities to a highly limited number of medium and large business/institutional/government customers and interexchange carriers. By contrast, switched access is provided over the same common line that is used to provide basic local residential and business exchange services. Competition for switched access will develop precisely in tandem with competition for basic local exchange service, and at the present time there is no consequential competition for basic local exchange or switched access service in Arizona.

Q. Given the fact that Dr. Taylor has extensively cited the FCC's Fifth Report and Order regarding pricing flexibility and the various triggers that, once satisfied, would permit an ILEC to attain pricing flexibility authority for special and switched access, as of this date has Qwest actually satisfied *any* of the specific conditions that are enumerated in the Fifth Report and Order?

A. No. In fact, the FCC soundly rejected US West's petition for forbearance, and to day Qwest has not re-petitioned the FCC for pricing flexibility authority pursuant to the Fifth

Report and Order.[19] Hence, as of this date there is not even a controversy as to whether Qwest has satisfied the Phase I and/or Phase II triggers set forth in the Fifth Report and Order, since it has not even so much as represented to the FCC that it has.

Q. Do you agree with Dr. Taylor's view that "[w]henever the benefits from granting pricing flexibility outweigh costs of such a policy," regulation should be relaxed?

A. I am not exactly sure what Dr. Taylor meant by this statement, since the "costs of such a policy" to which he refers in this sentence relate back to the granting of pricing flexibility. I assume that what Dr. Taylor intended to refer to were the costs of continued price regulation, not the costs of pricing flexibility. On that basis, it is difficult to disagree in principle with his statement, but his view is not supported by the facts. Absent actual *price-constraining* competition in the relevant market together with the inability of the incumbent to cross-subsidize those services it furnishes under such competitive conditions with revenues and profits from services that continue to be provided under unchallenged monopoly conditions, the risks to consumers and competitors of the kind of unfettered pricing flexibility that Dr. Taylor advocates grossly exceed any nominal "benefits" that might potentially result from permitting the ILEC to raise or lower prices at will. While it may be inconvenient for Qwest to come before this Commission with specific tariff changes, that inconvenience to Qwest is easily outweighed by the potential risks and costs that Qwest, through exercise of its extensive market power, can impose upon consumers and competitors. Accordingly, while I agree

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19. See McIntyre (Qwest), rebuttal at 15.

that a cost/benefit test is always appropriate when considering any regulatory initiative, Qwest's situation as it exists today does not come even remotely close to actually satisfying such a cost/benefit test.

Mr. Teitzel's contentions as to the presence of competition and the adequacy of regulation to protect competitors and consumers is not supported by the "facts on the ground."

Q. At page 47 of his rebuttal testimony, Mr. Teitzel takes issue with your position that "services and features that have no independent existence and rely on a common infrastructure should take the regulatory status of the core service." Please comment on his testimony in this regard.

A. Mr. Teitzel has conveniently abbreviated my statement on this subject. At page 26 of my direct testimony, I explained this point as follows:

> Services and features that are incremental to a monopoly service "platform," i.e., that have no independent existence in that they cannot be provided to a customer unless the customer also subscribes to the "platform," are no more "competitive" than the basic platform itself, and thus should take the same regulatory status as the "platform" service. Services that have an independent existence but that are furnished out of the same common infrastructure/resource base along with monopoly services and which could not as a practical matter be furnished by US West without the use of that common infrastructure should also take the regulatory status of the core "monopoly" services.

My point here relates to both the demand and supply sides of these "incremental" services. Qwest cannot sell a service such as call waiting, caller ID or, for that matter, switched access independently of the dial tone line, which is indisputably a monopoly service at the present time. Hence, there is no basis to consider any such vertical features, whether existing or new, as "competitive" because in fact there are no competitors who are in a position to provide these services to a Qwest dial tone line customer. That Qwest enjoys extensive market power with respect to such services is amply demonstrated by the price/cost relationships that presently exist: Most vertical features, such as call waiting and caller ID, exhibit incremental costs that are barely distinguishable from zero, yet carry prices set at hundreds of times these minuscule costs. Such prices could never be sustained if any of these features actually confronted effective competition independently of the core platform with which they are inextricably linked. Indeed, where the market for the core service is competitive, as is the case with wireless (cellular and PCS) services, vertical features such as call waiting, three-way calling, voice mail, and caller ID, are all offered free of charge.

My second point relates to the supply side. Qwest could not produce or provide many of its vertical and other services without the core infrastructure from which its basic dial tone line services are produced. There is no effective means for "allocating" costs of the common infrastructure between core and "incremental" services, because so much of the cost base is fixed, i.e., not materially affected by the demand for the "incremental" service. For example, Qwest's total operating costs would not be materially impacted if its penetration of caller ID were to increase to 100%, because the physical capability and capacity to furnish this service to each and every dial tone line served out of digital central offices is already in place. It makes no sense whatsoever for an incumbent LEC to be permitted to exploit its ratepayer-funded core infrastructure in this manner, and it certainly does not create a "level playing field" for competitors. Even where a particular service could have an independent existence separate from the core dial tone line platform, any competitor would necessarily have to acquire and construct its own facilities to furnish that service on a stand-alone basis, whereas Qwest is able to provide the service on an incremental basis by "piggy-backing" the service onto its existing plant and organizational resources.

Q. Mr. Teitzel also disagrees with your statement that "Qwest's directory assistance proposal '... should be considered as an additional increase in rates for basic residential service...'"[20] Is his disagreement well-founded?

A. No. The basis for Mr. Teitzel's dispute with my statement is that "the majority of residential customers do not utilize D.A. service each month, the service is completely discretionary and a wide range of competitive alternatives to Qwest's D.A. are available to each and every Arizona consumer."[21] Each and all of these contentions are off-point. First, whether any particular customer does or does not utilize D.A. service in a given month is immaterial: Basic residential service currently includes one "free" directory assistance call each month, with additional calls being charged at the rate of 59 cents each. Qwest would eliminate the one-call allowance and increase the per-call rate to 85 cents for "local" directory assistance calls (by withdrawing "local" directory assistance service altogether and merging it with "national" D.A.). For those residential customers

20. Teitzel (Qwest), rebuttal at 48-49.

21. *Id.*, at 49.

who do utilize D.A. in a given month, the effect of this proposal would be to increase their monthly charge by 85 cents. At the very least, if the one-call allowance is to be unbundled, the basic residential rate should be reduced on a revenue-neutral basis to reflect this diminution in the scope of the residential service offering. Qwest has made no such proposal, so the result will indisputably be a net rate *and revenue* increase for Qwest.

Mr. Teitzel's second point is that D.A. service is "completely discretionary." I take strong issue with this contention. Where a number is listed in the local white or yellow pages directory and the customer is simply too lazy to look it up, one could concede that the use of D.A. is a discretionary choice being made by the customer. However, where the listing is not included in the local directory (because, for example, the service was initially installed after the directory went to press) or where the customer does not have a copy of a particular directory in which the listing he or she needs appears, the requirement to obtain the desired telephone number from directory assistance is no more discretionary than the ultimate call to that number. I do not see Qwest contending that local calls are also "discretionary."

Related to this is Mr. Teitzel's third contention — that "a wide range of competitive alternatives to Qwest's D.A. are available to each and every Arizona consumer" — which is also off-point. First, only Qwest's D.A. offering can be accessed by a Qwest dial tone line customer by using the highly familiar '411' dialing protocol; all other "competing" D.A. services require the use of a different dialing sequence. Indeed, while I am not an attorney and thus do not offer a legal opinion, I would nevertheless note that Section 251(b)(3) of the *Telecommunications Act of 1996* imposes upon *all* local exchange carriers (which would clearly include Qwest)

> [t]he duty to provide dialing parity to competing providers of telephone exchange service and telephone toll service, and the duty to permit all such providers to have nondiscriminatory access to telephone numbers, operator services, directory assistance, and directory listing, with no unreasonable dialing delays.

Section 3(a)(2) provides a definition of "dialing parity" as follows:

> (39) DIALING PARITY- The term 'dialing parity' means that a person that is not an affiliate of a local exchange carrier is able to provide telecommunications services in such a manner that customers have the ability to route automatically, without the use of any access code, their telecommunications to the telecommunications services provider of the customer's designation from among 2 or more telecommunications services providers (including such local exchange carrier).

To the extent that Qwest does not comply with the "dialing parity" requirement of the federal legislation, it cannot credibly contend that viable "competitors" to its 411-based "national D.A." service are actually present. Certainly there can be no dispute that any such "alternative" providers of local or national D.A. are in no sense provided with any sort of "level playing field" when their services cannot be accessed by means of '411'. Mr. Teitzel's contentions to the contrary are without merit, and should be ignored by the Commission.

Q. Mr. Teitzel disagrees with your view that resale and UNEs do not constitute "viable forms of competition."[22] Please comment on his response.

A. Both Mr. Teitzel here, and as I have previously observed, Dr. Taylor as well, conveniently ignore the inescapable fact that the market for local telecommunications services must necessarily be analyzed and addressed as separate "wholesale" and "retail" segments. The presence of non-facilities-based competitors who utilize total service resale or UNEs to furnish local services to their customers constitutes competition *at the retail level*, but distinctly *not* at the wholesale level, since the underlying service and facilities continue to be provided by Qwest. Returning to Dr. Taylor's example of a market consisting of one facilities-based carrier with 40% of the retail market and 30 non-facilities-based resellers each with 2% of the retail market, in the real world case of Qwest, its *wholesale* HHI is precipitously close to the theoretical maximum value of 10,000, even if its *retail* HHI is slightly less. The point is that Qwest continues to exercise extreme market power even in geographic areas where non-facilities-based retail competition is present.

Q. But what about the argument that since wholesale rates will continue to be regulated, Qwest cannot exercise market power over its wholesale services?

A. There is no question but that continued regulation of Qwest's wholesale services is essential for any meaningful competition at the retail level to develop and be sustainable.

22. Teitzel (Qwest), rebuttal at 42.

However, Qwest retains strong incentives to shift as many joint costs as possible from its retail to its wholesale operations and to attempt to set wholesale rates (even if regulated) at levels that include disproportionate allocations of such costs. Moreover, competitors are not adequately protected by any "imputation" requirement, because the Commission will have no ability to assess the costs of Qwest's (effectively deregulated) retail operations, which must necessarily be added to the imputed cost of wholesale services to prevent an anticompetitive price squeeze from being perpetrated upon competitors. In addition, Qwest's retail operations will benefit from a wide range of non-tariffed corporate services and resources that are not even available to competitors, and for which no adequate "imputation test" can realistically be established and enforced. Both Dr. Taylor and Mr. Teitzel speak to and, in Dr. Taylor's case, cite to the FCC's determinations as to the difficulty in maintaining detailed regulatory oversight as a general matter, yet such oversight will be essential if regulation is to be relied upon to protect competitors and consumers from anticompetitive pricing and cross-subsidization. Their rhetoric aside, none of Qwest's witnesses have provided any basis for the Commission to conclude that it will have the capability to provide for this level of regulation in the event that Qwest's "competitive" retail services are afforded price-deregulation.

The Qwest/DEX Arizona yellow pages directory business is a regulatory asset of Qwest-Arizona, and ratepayers are entitled to all of the profits generated therefrom.

Q. Dr. Selwyn, Ms. Koehler-Christensen takes issue with your direct testimony regarding the imputation of yellow pages profits into Qwest-Arizona's revenue requirement. Have you reviewed her rebuttal testimony?

A. Yes, I have.

Q. Do any of her positions have validity in the context of this proceeding?

A. No, they do not. Ms. Koehler-Christensen contends, among other things, that ratepayers have been compensated for the transfer of the then-Mountain Bell yellow pages directory business to DEX in 1984, that DEX faces competition from seven other directory publishers in Arizona, and that DEX's extraordinary level of profitability is irrelevant to the Commission's determination as to the imputation issue. She is wrong with respect to each and all of these issues.

Q. Have Arizona ratepayers been compensated for the transfer of the yellow pages business from Mountain Bell/US West to DEX?

A. No. No such transfer ever took place, as most recently confirmed by the decision issued by the Washington Utilities and Transportation Commission (WUTC) to which I referred in my direct testimony. Attachment 1 is a copy of that decision, which I am providing for the Commission's convenience in reviewing its content. In that ruling, the WUTC determined that no actual transfer took place, that in effect Pacific Northwest Bell had "outsourced" or "leased" the directory publishing business to its directory publishing affiliate, but that no permanent "sale" of the yellow pages business had occurred, and that no payment reflecting the going business value of the (Washington) yellow pages business had been made.[23] The Commission concluded that the ongoing imputation amounts recorded on US West-Washington's books reflected the outsourcing arrangement, and in no sense represented installment payments against some unspecified purchase price.[24] The conditions associated with the assignment of the directory publishing function to DEX in Arizona were substantially the same as that which existed in Washington State. Ms. Koehler-Christensen contends that "Arizona ratepayers have had their rates reduced by more than $700-million"[25] and that this constitutes full "compensation for the transfer" of the yellow pages business to DEX. It is worth noting that Ms. Koehler-Christensen made *exactly the same argument* in her testimony before the Washington Commission, which soundly rejected it.[26]

Q. What about Ms. Koehler-Christensen's claim that DEX faces real competition in Arizona from other directory publishers — is her contention supported by facts?

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23. WUTC Order, at para. 154.

24. *Id.*, at para. 181.

25. Koehler-Christensen (Qwest), rebuttal at 14.

26. *Id.*

A. Hardly. Ms. Koehler-Christensen contends that I have not "provid[ed] evidence to support [my] claims" as to the lack of competition for yellow pages directories in Arizona. In fact, there is significant evidence regarding the lack of competition for yellow pages directories as presented in my testimony. In contrast, Ms. Koehler-Christensen has failed to provide any support for her contentions that such competition is actually present.

Q. Doesn't Ms. Koehler-Christensen state that "there are at least seven other directory publishers that compete with DEX in Arizona"?

A. She does, but then only names one of them, and in fact she even got that company's name wrong. She described a "Phone Directory Company" as a "large independent publisher that publishes directories in eleven states and a number of Canadian provinces and territories."[27] She provided no quantitative data as to this one company's size, revenues, or profits.

Q. Did you undertake to obtain any additional information about this "Phone Directory Company?"

A. Yes. I was unable to find any web site or listing for a "Phone Directory Company" on the Internet. I then requested that calls be placed to Qwest directory assistance in Arizona, Colorado, Minnesota and Washington State to obtain a telephone number for

27. *Id.*, at 17.

this firm; the only listing was in Seattle, and repeated calls to that number resulted only in "no answer"

Upon further investigation, I did find a "Phone *Directories* Company" web site and was able to obtain some information about the company. According to its web site, Phone Directories Company currently has 300 employees and publishes directories with a total circulation of 3.0 million in twelve states and in Canada. See Attachment 2. Other information I obtained from the Yellow Pages Publishers Association web site indicated that PDC's Arizona directories have a combined circulation of only 555,200 (DEX directory circulation throughout Arizona is nearly four million), and those circulation figures appear not to have been audited by any independent circulation auditing organization.[28] PDC does not publish any directories for the major Arizona markets of Phoenix and Tucson, and in the few small cities and towns in which PDC and DEX both appear to publish directories, PDC's circulation as reported is decidedly less than DEX's. See Attachment 3. As I noted, PDC currently has all of 300 employees, presumably spread across the twelve states and Canada (either physically and/or with respect to their responsibilities), and provides only "approximate," and probably unaudited, circulation figures that in any event suggest that PDC's circulation in Arizona is only about one-eighth that of DEX. For Ms. Koehler-Christensen to seriously suggest that Phone

28. Although I have not been able to determine whether PDC's provides audited circulation figures, data obtained from its web site provide only "round" numbers like 51,500 for Flagstaff vs. DEX's circulation for Flagstaff of 126.848. Moreover, PDC itself describes its circulation figures as "approximate" (see Attachment 4 to my testimony).

Directories Company is in any sense a "large independent publisher" that is even remotely comparable to DEX is nothing short of laughable.

Q. Have you been able to obtain any financial information about Phone Directories Company?

A. No. The firm does not appear to be publicly traded and does not file a 10-K with the SEC.

Q. What about the other six firms that Ms. Koehler-Christensen claims compete in the Arizona yellow pages market?

A. She did not identify any of them in her testimony (although they are listed in her Exhibit). The Yellow Pages Publishers Association web site[29] is, however, a source of some of this information. Phone Directories Company, the one firm that Ms. Koehler-Christensen did address specifically in her testimony, is actually the second largest of these so-called "competitors" to DEX in Arizona, with directories that have a combined circulation of "approximately" 555,200. National Directory Company seems to be slightly larger in Arizona, with a claimed (but probably unaudited) circulation of 625,000. By contrast, the circulation of DEX's Arizona yellow page directories is 3,977,582; hence, the competitive impact of the other ten firms listed on the Yellow Pages Publishers Association web site is surely inconsequential by any objective standard. A

29. www.yppa.org

total of nine other directory publishers (besides PDC and DEX) are identified on the Yellow Pages Publishers Association web site, and all but one of these are smaller than PDC. I have included the Arizona information from the Yellow Pages Publishers Association web site as Attachment 3 to my surrebuttal testimony. Incidentally, the data reported by the Yellow Pages Publisher Association does not track the data on Ms. Koehler-Christensen's Exhibit A Koehler-Christensen-1, and it appears that Ms. Koehler-Christensen's Exhibit overstates the actual extent of yellow pages competition, at least as reported by the Yellow Pages Publishers Association.

Attachment 4 to my surrebuttal testimony contains information provided to me by PDC with respect to each of its Arizona directories. As can be seen, these cover largely rural communities and certain individual communities on the periphery of the Phoenix metro.

The key point here is that all that Ms. Koehler-Christensen has done is to *identify* alleged competitors while providing absolutely no information as to the actual extent to which they represent substantive competition to DEX in Arizona. Her characterizations and information as to the competitiveness of this market would not even satisfy the extraordinarily loose standards set forth by Dr. Taylor for determining that competition is present.

Q. Ms. Koehler-Christensen is also asked "about [your] claim that DEX's earnings indicate that there is no effective competition." Are you satisfied with her response?

A. No, and in fact, Ms. Koehler-Christensen did not even answer the question that is propounded to her in her prefiled rebuttal testimony. My point was that the extraordinary rate of return that DEX has realized from its Arizona (and other) operations is inconsistent with what one would expect to find in a competitive market. If there were actual rivals in the market, the advertising rates would have been bid down toward cost, and the ROI would have decreased to "competitive levels." I estimated DEX's rate of return to be at least 90.5% based upon public (non-proprietary) data derived from the US West 1999 Annual Report, and significantly more based upon proprietary data. In its Order approving the split of US West and MediaOne, the Commission found that, for 1977, DEX's return on equity was given as 206.5%.[30] Profit levels of even the 90.5% magnitude, let alone the higher figures, are entirely inconsistent with competitive market conditions, and could never be sustained if actual competition were present in the Arizona yellow pages market.

Ms. Koehler-Christensen responded to this question by asserting that "[t]he Arizona Court of Appeals has already determined that the profits of DEX are not an appropriate basis for an imputation ..." The veracity and validity of that legal opinion requires a legal response; my point was simply that supranormal profits are consistent with monopoly and inconsistent with competition, a point to which Ms. Koehler-Christensen does not respond.

30. *In the Matter of the Notice of US West, Inc. and US West Communications, Inc. Concerning Restructuring of Holding Company*, Arizona Corporation Commission Docket No. T-01051B-98-0104, Decision No. 61075 issued August 10, 1998, at 3, para. 7.

I would note, however, that not everyone shares Ms. Koehler-Christensen's legal opinion. In his dissenting opinion to the Commission's decision in the US West/MediaOne split proceeding, then-Commissioner Renz Jennings stated:

> In 1996, Judge Noel Fidel said that the 1988 yellow pages imputation agreement between US West and the Commission entitles the Commission to adjust the "43 million imputation either upward or downward as the evidence of fees and services supports." (US West v. ACC, 2/2/96, 185 Ariz. 277) Even US West has said that yellow pages' revenues and profits have increased significantly since 1988. ...

The decision that Commissioner Jennings cited was, of course, the "Arizona Court of Appeals" ruling to which Ms. Koehler-Christensen refers and which she claims precludes the Commission from adjusting the imputation amount. In fact, a more careful reading of that decision belies her contention:

> US West argues that the quoted language sets a $ 43 million cap on imputed income because only downward adjustments are mentioned. *We reject this interpretation.* The agreement merely indicates one particular factor — Mountain Bell's negotiation of a lesser amount with USWD - that will not suffice alone to warrant a downward adjustment; *it singles out no factors that will not suffice alone to warrant an upward adjustment.* The apparent purpose of the disputed provision is to preclude U.S. West and USWD from assigning an artificial value to fees and services and thereby preempting the Commission's independent assessment. The agreement authorizes the Commission staff to "present evidence in support of or in contradiction to" whatever value U.S. West and USWD might assign to fees and services, and it entitles the Commission to adjust the presumptive $ 43 million imputation either upward or downward as the evidence of fees and services supports.[31]

31. *US West Communications, Inc. v. Arizona Corp. Comm'n*, 185 Ariz. 277, 281, 915 P.2d 1232, 1236 (1996).

Q. But in that case the Court expressly rejected the notion of treating DEX's "assets as if they were still a part of the regulated utility."[32] How does that square with your recommendation that all of DEX's profits attributable to Arizona be imputed to the Qwest-Arizona revenue requirement?

A. The $43-million grossly understates the value of the "fees and services" that Qwest-Arizona provides to DEX, as evidenced by the extraordinary and unique level of profits that DEX has been able to generate from its Arizona directories. The Washington Commission recognized this *ongoing* value of the affiliation and of the services that the operating telephone company provides to DEX, for example:

> Finally, some of Mr. Johnson's testimony relating to trademarks is not credible. We find no indication that the logo of U S WEST Communications, Inc., connotes in the popular view an entirely different company from that connoted by any other U S WEST corporate family logo. We find it not credible that consumers see the U S WEST Communications logo, with its stylized U S WEST lettering, see the identical U S WEST lettering with the name "Dex," and view them as totally distinct and unrelated companies as opposed to related products under a single umbrella. In any event, the substitution of the U S WEST logo for that of PNB was a choice made by U S WEST, Inc. and PNB and should not be used to justify the evaporation of any publishing rights or financial benefits previously held by PNB.[33]

32. *Id.*

33. *Id.*, at para. 151, pp. 39-40.

In fact, both the US West and DEX logos are prominently displayed on the front covers of several of Qwest's Arizona yellow pages directories (see Attachment 5, which reproduces Qwest's response to ACC Staff request UTI-43-011), and I have no reason to believe that the same is not also the case for every other DEX directory in Arizona. DEX clearly continues to receive enormous value from its affiliation with the telephone company and continues to exploit that relationship in presenting itself as 'the directory experts." Indeed if, as Ms. Koehler-Christensen contends, the Arizona yellow pages market is competitive, the only explanation for the extraordinary level of profit that DEX continues to amass and that continues to increase year-in and year-out is its affiliation with the monopoly local telephone utility.

The Court of Appeals ruling that Ms. Koehler-Christensen cited and that I have discussed above in no sense precludes the Commission from finding that the value of the services being furnished by Qwest-Arizona to DEX has in fact increased, and accordingly making an appropriate upward adjustment in the annual imputation amount. And, while the Commission may perhaps find that the ongoing value of the affiliation and of the services that DEX receives from Qwest-Arizona are less than the entire DEX profit attributable to Arizona (although I continue to believe that the full amount of DEX's profits most accurately represents the value of those services), there can be no question but that the value of the fees and services furnished by Qwest-Arizona to DEX grossly exceeds the nominal $43-million amount that was established way back in 1988.

Q. Does Ms. Koehler-Christensen offer any specific rebuttal to your calculation of DEX's overall profitability, the portion attributable to Arizona, or the fair market value of DEX?

A. No, she does not. In her summary, she states that I have "excluded a large portion of DEX's expenses in its calculation of DEX's profits and [have] compounded this error by multiplying pre-tax net revenues by a gross revenue conversion factor,"[34] but provides nothing more specific in the body of her testimony. The revenues, expenses and profits that I reported were contained in the Company's response to UTI-47-013, Confidential Attachment A. Ms. Koehler-Christensen has not offered any specific corrections to the figures I have presented, nor has the Company revised or modified its response to UTI-47-013. Finally, there is no obvious reason why the Arizona conversion factor would differ as between pre-tax and after-tax income, as her testimony implies (but provides no further details).

Q. Does this conclude your surrebuttal testimony at this time?

A. Yes, it does.

34. Koehler-Christensen (Qwest), rebuttal at i-ii.

Attachment 1

Washington Utilities and Transportation Commission
Yellow Pages Decision

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In Re the Petition of	)	DOCKET NO. UT-980948
	)	
	)	FOURTEENTH
U S WEST COMMUNICATIONS, INC.,*	)	SUPPLEMENTAL ORDER;
	)	
for an Accounting Order	)	ORDER DENYING PETITION
. . . .	)	

Synopsis

1 In this order, the Commission addresses a request by U S WEST Communications, Inc., (USWC) for an accounting order ending the Commission's practice of imputing to USWC, for ratemaking purposes, certain "excess" income earned by an affiliate in publishing directories of USWC subscribers and associated "Yellow Pages" commercial classified directory listings. The Commission denies USWC's request for an accounting order ending imputation. The Commission rules that, *U S WEST Comm. Inc. v. Wash. Util. & Transp. Comm., 134 Wn2d 74, 949 P.2d 1337 (1997),* does not require the end of imputation, that USWC has not shown the factual or legal existence of a permanent transfer of the publishing function, and that USWC has not shown a valid factual or legal reason to terminate imputation.

*The Commission notes that since this matter was presented, U S WEST has merged with Qwest Communications International, Inc. pursuant to the Commission's authorization in Docket No. UT-991358. Although the company is now authorized to use the name Qwest Corporation, we continue to use the names under which the matter was filed and presented.

TABLE OF CONTENTS

I. SUMMARY[1]

A. Procedural Summary

2 *Hearing.* This matter came on regularly before the Commission on July 26 through 30, 1999, and August 26, 1999, at Olympia, Washington before Chairwoman Marilyn Showalter, Commissioners Richard Hemstad and William R. Gillis, and Administrative Law Judges Lawrence Berg and C. Robert Wallis upon due and proper notice to all interested persons.

3 *Appearances.* Petitioner, U S WEST Communications, Inc. (also called the Company, USWC or U S WEST in this order) appeared by Lisa Anderl and Douglas N. Owens, attorneys, Seattle. The Commission Staff appeared by Gregory N. Trautman, assistant attorney general, Olympia. Public Counsel appeared by Simon ffitch, assistant attorney general, Seattle. Intervenor Telecommunications Ratepayers Association for Cost-based and Equitable Rates (TRACER) appeared by Arthur A. Butler, attorney, Seattle. Intervenor American Association of Retired Persons (AARP) appeared by Ronald N. Roseman, attorney, Seattle.

4 *Nature of the Proceeding.* In this matter, U S WEST has asked the Commission for an order formally terminating an accounting practice that the Commission uses in calculating the proper rates USWC may charge its customers for regulated services. In that practice, the Commission attributes or "imputes" to the revenues of USWC (a subsidiary of U S WEST, Inc. or USWI) a sum that is related to the income that is actually earned from Yellow Pages publication by U S WEST Dex, another USWI subsidiary.

5 *Commission decision.* The Commission denies U S WEST's request, holding that the Commission is not required to approve the request by virtue of a Supreme Court decision,[2] and that the issues presented here have never been litigated; that the Commission has never approved the disposition of a valuable asset to an affiliate by means of an arrangement between the companies; and that the Commission retains continuing jurisdiction pending regulatory action at USWC's request.

B. Summary of Issues

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[1] The purpose of this discussion is to provide a summary for the reader. Each of the elements summarized in this section is addressed at greater length elsewhere in the order, and it is the later discussion that includes our findings, conclusions, and reasoning in support of the Commission decision.

[2] *U S WEST Comm. Inc. v. Wash. Util. & Transp. Comm.*, 134 Wn2d 74, 949 P.2d 1337 (1997).

6 The issues in this proceeding are whether the Commission must or should end the practice of attributing - "imputing" - to U S WEST Communications, Inc., a portion of the earnings of its affiliate U S WEST Dex from publication of the U S WEST classified business telephone listings known as the "Yellow Pages." The value of imputation (i.e., the value of Yellow Pages operations to the local exchange company) is significant. It was fixed at $50,934,378 per year at last calculation, in 1995, in Docket No. UT-950200.

7 The events giving rise to this litigation began late in 1983, as the divestiture from AT&T of its local exchange company business was being implemented. The local exchange company business was placed with seven newly created Regional Bell Operating Companies (the RBOCs or "Baby Bells"). Federal Judge Harold Greene, who oversaw the divestiture, decided that Yellow Pages businesses should remain with the regional operating companies to maintain their contribution to local company earnings.[3]

8 In late December 1983, Pacific Northwest Bell (PNB)[4] asked the Commission for authority to transfer certain specified assets to Landmark Publishing Co. in exchange for a .21 share of Landmark stock.[5] The application disclosed that PNB would not keep the partial share Landmark offered in exchange for the assets but would transfer it immediately to U S WEST. The shifting of assets among affiliated companies was thus without compensation to the local exchange company.

9 The application also sought approval for an intercompany arrangement between the two subsidiaries in which PNB authorized Landmark to publish telephone directories for PNB in exchange for what the application described as a guaranteed stream of payments to the local exchange company.

10 In the last days of December 1983, the Commission approved the January 1, 1984 transfer of the specified assets and the change in publication arrangements. Under the state's affiliated interest statute, however, the Commission reserved a ruling on the financial consequences for ratemaking purposes. The

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[3] *United States v. American Telephone and Telegraph Co., et al.*, 552 F. Supp. 131 (1982)

[4] PNB, a local operating company that had been a wholly owned subsidiary of AT&T, was becoming a subsidiary of regional Bell operating company U S WEST. PNB eventually merged with Northwestern Bell and Mountain States Telephone companies to become U S WEST Communications, Inc. For purposes of this Order, the terms PNB and USWC are interchangeable terms referring to the Washington State operating company.

[5] Landmark, like PNB a U S WEST subsidiary, was the parent of U S WEST Direct, which later became U S WEST Dex. For purposes of this order, the three names are interchangeable.

Commission also approved the publishing agreements. PNB agreed, five years later, without compensation, to the termination of the "guaranteed" payments, and USWC now contends that the entire directory business was transferred to Landmark with the transfer of physical assets in 1984.

11 PNB twice voluntarily agreed to imputation of yellow pages earnings. First, in 1989 it agreed to imputation on a temporary basis in settlement of an overearnings complaint and establishment of an Alternative Form of Regulation (AFOR). Later, also in 1989, it agreed to imputation in resolution of the merger of PNB, Mountain Bell and Northwestern Bell into the present local exchange company, U S WEST Communications, Inc.[6]

12 Despite the continuing imputation ordered in the merger docket, which the Company did not appeal, the Company challenged the Commission's authority to use imputation on some eighteen separate grounds in a major general rate case, which it filed in 1995, Commission Docket UT-950200. The Commission rejected the challenge in an order that was affirmed in all regards by the Superior Court and, on review, by the Washington State Supreme Court.

13 That brief history brings us to the matter before us. On the issue of whether the end of imputation is mandated, as U S WEST contends, the parties present the Commission with a single basic choice.

14 U S WEST bases its presentation upon its contention that the Washington State Supreme Court ruled that the transaction leading to imputation was a complete transfer of the business effective on January 1, 1984, and that imputation must end when the value of the imputation reaches the value of the business at the time of that transaction. The Company and its witnesses offer views of significant events and decisions that are consistent with their contentions arguing that the Commission must end imputation under the terms of the Supreme Court decision.

15 Commission Staff, Public Counsel, and intervenors respond that the Supreme Court decision did not need to, and did not, address the precise nature or timing of the transaction giving rise to imputation, and that contemporaneous features and descriptions of the transaction are inconsistent with the Company's view. They argue that the Commission need not and should not end the imputation of Yellow Pages revenue.

16 The Commission rejects the Company's view. A reading of the entire Supreme Court

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[6] The Company entered a settlement agreement in the merger proceeding, agreeing to imputation for a five-year period. The Commission refused to approve the merger unless the five-year limitation were removed. The Company accepted that provision.

decision, an examination of the issues that it resolved, and attention to its holding compel us to conclude that the Court did not rule as the Company contends and that the decision does not require us to end imputation. USWC's principal contentions about the meaning of the decision appear to be inconsistent with the Court's holding and with specific language in the decision.

17 Looking next at the record in this docket and at prior administrative and judicial decisions, the Commission decides that the evidence proves that USWC's first proposition – that a permanent transfer of the entire business was completed on January 1, 1984 – is incorrect. USWC's second proposition – that a valuation must occur on January 1, 1984, or any other date found to be the date on which the transaction was completed – fails when the Company's first proposition fails. The Company's arguments also fail to consider the nature of the transaction as one among affiliates and fail to consider the Commission's authority and responsibilities under the affiliated interest statutes.[7]

18 Finally, we find no credible evidence in the record of facts supporting the Company's contention that present circumstances render imputation improper or inconsistent with the public interest.

19 We hold that the Yellow Pages publishing activity has not been transferred

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[7] The Fifteenth Supplemental Order in Docket UT-950200 found the affiliated transaction imprudent. *U S WEST Comm., Inc. v. Wash. Util. & Transp. Comm'n,* Docket No. UT-950200, 169 PUR4th 417, 442-48 (April 11, 1996). While we do not base our decision on that rationale, because it is unnecessary, the following Company actions raise serious questions about the prudence of management under its theory of their case: agreeing to the transfer of the lucrative Yellow Pages activity to an affiliate without compensation and, insofar as this record shows, totally without documentation; and agreeing to the termination of payments for publishing rights without compensation. Although the decision does not use the terms "prudence" or "imputation," the U. S. Supreme Court found improper an analogous transfer without compensation to an affiliate during the 1920s, and approved imputation as a remedy to protect ratepayers without reference to any affiliated interest statute. *United Fuel Gas Co. v. Railroad Comm. Of Kentucky*, 278 US 300, 73 L.Ed. 390, 49 S.Ct. 150 (1929), affirming *United Fuel Gas Co. v. Railroad Comm. Of Kentucky*, 14 F.2d 209(D.W.Va., 1926); *United Fuel Gas Co. v. Railroad Comm. Of Kentucky*, 278 U.S. 322, 73 L.Ed. 390, 49 S.Ct. 150 (1929), affirming *City of Charleston v. Public Service Commission,* 95 W.Va. 91, 126 (1923), in which the state court said, "[T]he commission had the right to wholly disregard the [transaction] and in determining the question of rates to be allowed . . . to treat the matter as if [the regulated company retained the assets]." Permanent placement in an affiliate does not demand treatment as a sale. *United Fuel Gas Co.* cases, *supra*. The Commission has ordered imputation in such situations. *WUTC v. Continental Telephone Company of the Northwest, Inc.*, Cause No. U-82-41, Second Supp. Order, (August 12, 1983), *WUTC v. General Telephone Company of the Northwest, Inc., (Cause No. U-84-18, Second Supp. Order, (January 15, 1985).* Approval of a permanent transfer thus does not make treatment as a sale, and amortization, a legally necessary result.

permanently to USWC's affiliate for regulatory purposes. We hold that the Commission may properly order continuing imputation under the facts and circumstances shown on this record. The Commission's order continuing imputation in the merger docket supplants earlier orders and defines the appropriate remedy for the transaction that the Commission has approved, and that it remains effective until changed. We hold that the Commission will consider altering imputation upon a showing of changed conditions that render such a change consistent with the public interest and with relevant affiliated transaction statutes on a going-forward basis.

20 Procedurally and historically, this docket is complex. Several motions were reserved for ruling at the conclusion of the proceeding. The discussion of the factual and legal contentions is made lengthy by their number. We will begin the discussion on the merits with a history of events based upon the contemporaneous statements of the parties and orders of this Commission. Then we will address the motions, describing their interrelationship with the principal contentions. We will conclude by determining the facts to be found from this record and by resolving the legal points argued to us.

II. HISTORY

21 The relationship of this telephone company or its predecessor to directory and Yellow Pages publishing functions has been an issue, and has thus been described in some detail, in at least five relevant Washington State proceedings, and in one proceeding at the federal level (the AT&T divestiture). The five Washington State proceedings were before the Commission, including one eventually heard in the State Supreme Court. These are PNB's 1983 application for property transfer and affiliate transactions (FR-83-159); the 1986 approval of a second publishing agreement (U-86-156); the 1989 Commission complaint against PNB for overearning that resulted in the alternate form of regulation (AFOR) and that included imputation as an element in the settlement (U-89-2698 and U-89-3245-P); the merger that resulted in the formation of U S WEST Communications, Inc. (U-89-3524-AT); and the 1995 general rate case (UT-950200) that USWC appealed, resulting in the December, 1997, Supreme Court decision cited above.[8]

A. AT&T Divestiture and the Modified Final Judgment

22 Prior to the implementation of the 1982 AT&T divestiture decision,[9] telephone

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[8] In this Order, a citation to the "Supreme Court decision" without further citation is to the 1997 decision set out at 134Wn.2d 48.

[9] *United States of America v. American Telephone and Telegraph Company, et al.*, 552 F. Supp. 131, (1982).

service in much of the United States was an integrated, regulated monopoly service provided by a dominant carrier, AT&T. That company owned a number of operating companies, including Pacific Northwest Bell, USWC's predecessor in the state of Washington. Historically, PNB published directories cf subscriber listings (white pages) that included classified business listings and advertisements printed on yellow paper and called the "Yellow Pages." It reported revenues from the advertising and publishing business in its regulated results of operation, that is, its statement of income and expenses for regulatory purposes.

23 Upon the divestiture by AT&T of its operating companies, U. S. District Court Judge Harold Greene held that the resulting seven regional Bell operating companies (RBOCs) should retain publication of the Yellow Pages businesses in their operating territories, in large part because of the contribution of Yellow Pages revenues to local telephone rates. *USA v. AT&T, supra., note 8, at pp. 193-4.*

B. Transfer of the Publishing Function

1. PNB's Application for Transfer

24 As part of the reorganization of AT&T and its former subsidiaries, on December 22, 1983, PNB applied to the Commission for approval of the transfer of certain assets to its affiliate Landmark Publishing Company and of agreements under which Landmark would publish directories for PNB. PNB asked that the transfer of the assets, associated with its Washington Yellow Pages business, and valued at about $13.7 million, be effective January 1, 1984.[10] Because chapters 80.12 RCW (transfer of property) and 80.16 RCW (affiliated interests) require full disclosure and prior approval of all property transfers and all affiliated interest transactions, the Company was required to and did apply for approval of the transaction.

25 The Application specifically sought approval of three aspects of the agreement: (1) a publishing agreement between PNB and Landmark by which Landmark agreed to publish directories and Yellow Pages advertising for PNB; (2) a memorandum of understanding for administrative services; and (3) the transfer of certain assets (cash and a leasehold, principally):

> . . . total company wide PNB assets in the amount of $24,101,000 . . . in exchange for .21 share of the sole share of stock of LPC. . . . The Washington assets shall consist of one leasehold, station equipment, office equipment and furniture. PNB will then transfer the LPC stock to U S WEST as a stock dividend payable

[10] This allowed the Commission five business days to evaluate the matter and to prepare and enter its order.

January 3, 1984.

Application, Cause No. FR-83-159, at pages 2 -3. The cash was to satisfy the working capital requirements of the directory publishing operation.

26 The application specified that the publishing agreement would govern the terms by which Landmark would publish directories and Yellow Pages for PNB. PNB represented:

> The Publishing Agreement is a good deal for PNB and its ratepayers because the Agreement effectively preserves a significant contribution from Yellow Pages revenue to PNB's earnings in the new more competitive marketplace after January 1, 1984. Further, **this revenue stream is guaranteed**, so that the risk and expense of this deregulated and increasingly competitive area of business are not borne in *[sic]* by PNB's ratepayers. *[Emphasis in original.]*
>
> The purpose of the transaction is a rearrangement of USW's assets to internally provide from PNB and USW's other operating telephone companies the initial capitalization for USW's publishing subsidiary LPC. . . . This transaction does not negatively impact PNB's ratepayers since the leasehold, cash and other property to be transferred will be removed from the rate base.

Id., at page 3.

27 The Commission approved the transfer within the few days required by the timing of the application – but only on an interim basis. *In re PNB Tel. Co., Order Granting Application in Part, No. FR-83-159, (December 30, 1983), p. 2.* The Commission determined that the transactions between PNB and U S WEST Direct were not arms' length dealings, and stated its concern that PNB not undervalue the advertising revenues in the publishing agreement with its affiliate. The Commission reserved the right to determine reasonable revenues and expenses, together with their proper regulatory treatment, in any formal proceeding before the Commission dealing with the results of U S WEST's operation for ratemaking purposes. The Commission directed PNB to record and maintain all records needed to perform the eventual valuation.

2. *Publishing Agreement, Cause No. FR-83-159*

28 The 1983 Application included a Memorandum of Agreement (MOA) between PNB and Landmark, and a Publishing Agreement. In 1984, the Company sought authorization under the original docket to replace the MOA with nine contracts and a Publishing Agreement having a three-year term, with provision for two additional one-year extensions. The MOA stated the fees Landmark was required to pay to PNB: \$21.18 million (1984), \$62.7 million (1985), and \$67.55 million (1986).

29 The Commission approved the Publishing Agreement and the contracts, but again reserved ruling on the reasonableness of the specified fees Landmark was to pay PNB until a future time. *Fourth Supplemental Order, Cause No. FR-83-159 (January 16, 1985).* The Commission also found again that the transactions between PNB and U S WEST Direct were not arms' length. The Commission's principal stated concern in approving the arrangement was to make it possible for PNB to do business with its affiliates legally and in an orderly way. The Commission was not able to determine the extent to which PNB was receiving full value for allowing Landmark to publish the directories, and expressly did not approve the reasonableness of the publishing fees nor any profit margin derived from them.

C. Revised Publishing Agreements

1. Revised Publishing Agreements, Cause No. U-86-156

30 On December 23, 1986, PNB filed an application seeking approval of ten separate agreements between PNB and U S WEST Direct[11] relating to various services to be provided by PNB. These included a new two-year publishing agreement for 1987 and 1988, which reduced the publishing fee to $41.6 million for 1987. *Ex. 112 at p. 14.* The fee for 1988 was to be renegotiated between the parties, and was ultimately set at $33.9 million. *Ex. 112 at 4. See also, Second Supplemental Order, Docket No. U-86-156 (October 12, 1988), at p. 6.*

31 The Commission again temporarily approved the agreements to permit the continued publication of directories, pending full review in the next PNB general rate proceeding, but it specifically found the amount of the publishing fees contained in the publishing agreement to be inadequate and improper for ratemaking purposes. *Id. at pp. 13-14.*

32 In that order, the Commission repeatedly acknowledged the temporary nature of the publishing arrangement when it noted that "the subject of the application under review in this proceeding is a group of ten agreements which govern the publication of telephone directories <u>on behalf of PNB by U S WEST Direct</u>." *Id. at p. 2.* [emphasis added] The Commission concluded that the publishing fee that PNB proposed to the Commission was "unreasonable and not in the public interest pursuant to RCW 80.16.020." The Commission ruled that appropriate compensation for PNB for allowing its affiliate to publish directories would be determined in the next Company general rate case.

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[11] U S WEST Direct was a subsidiary of Landmark Publishing Co. It has been succeeded by U S WEST Dex.

33 The Commission listed three possible remedies that it would consider: (1) approval of the contracts with an appropriate adjustment to the publishing fees – affirming that PNB retained the rights to publish the Yellow Pages; (2) return of the publishing function to PNB; and (3) treatment of the transaction as the sale of a capital asset.

34 Near the end of 1988, after only five years of the "guaranteed" revenue stream it had committed to the Commission, PNB agreed to the termination of publishing fees without Commission approval and without any further financial consideration from its affiliate. In a letter dated December 12, 1988, U S WEST Direct's Vice President-Marketing, Max G. Johnson, wrote Dennis Okamoto, then Vice President-Treasurer of PNB, advising him that "the intercompany 'subsidy' payment [publishing fee] will cease to be effective 12/31/88." Ex. 609. Mr. Okamoto agreed to this action.

2. *Further Revised Agreements, Cause No. U-86-156*

35 USWC subsequently applied for an order approving a newly revised, extended publishing agreement. The Commission again partially and conditionally approved the agreement, subject to a future review of the appropriate level of publishing fees in a full rate case setting. *Third Supplemental Order, In re Application of PNB, Cause No. U-86-156 (February 7, 1989).* Although it approved the publishing agreement, the Commission expressly stated its disapproval of the Company's "undisguised policy" of acting to "reduce and finally eliminate the publishing fee in order to enhance U S WEST's results at the expense of telephone subscribers." *Id. at pp. 1-2.*

D. Rate Complaint Case and AFOR, Cause Nos. U-89-2698-F, U-89-3245-P

36 In February 1989, the Commission filed a complaint against PNB alleging excessive earnings. As part of a settlement of the rate complaint and adoption of an alternative form of regulation (AFOR), PNB agreed by stipulation to imputation of a portion of Yellow Pages income as fulfilling a part of the Company's revenue requirement for regulated services. *WUTC v. Pacific Northwest Bell Tel. Co., WUTC Cause Nos. U-89-2698-F and U-89-3245-P, Appendix A, at pp. 14-17 (Fourth Supplemental Order, January 16, 1990).*[12]

[12] The Commission ordinarily does not infer very much from settlement agreements. In Docket No. UT-950200, however, USWC charged that it was improperly coerced into accepting imputation. The Superior and Supreme Courts affirmed the order in which the Commission found no basis for USWC's contention. USWC's choice to accept imputation was entirely voluntary a fact that is reflected in the pleadings and order of the merger docket, discussed at more length elsewhere in this Order.

E. The USWC Merger, Docket No. U-89-3524-AT

1. Second Supplemental Order

37 In December, 1989, PNB sought the Commission's approval of the merger of PNB, Mountain Bell, and Northwestern Bell Telephone Company into U S WEST Communications, Inc.[13] The Company entered a settlement agreement with other parties proposing to continue until the end of 1994 the imputation the Company had just accepted.

38 Commissioner A. J. Pardini dissented from the Commission's approval of the merger settlement, in part because the proposed settlement "forfeits an opportunity to, once and for all, resolve the issue of U S WEST's directory publishing revenues." *Second Supplemental Order, Docket No. U-89-3524-AT (November 9, 1990), Separate Opinion, Commissioner A. J. Pardini (dissenting), at p. 3 (unnumbered page).* The dissent quoted Judge Greene's discussion of directory publishing revenues, which we have described above.

39 The Commission's majority opinion took note of the dissent and observed, "The Commission has always intended that the revenue stream from directory services be considered income due the operating company." *Second Supplemental Order, Docket No. U-89-3524-AT (November 9, 1990), at p. 8.* The Commission conditioned merger approval upon modification of the Settlement Agreement so that advertising revenues would be imputed "into perpetuity." *Id., at pp. 8, 10.*

2. Third Supplemental Order

40 PNB sought clarification of the Second Supplemental order, arguing that the merger and imputation were unrelated issues, and that the condition of imputation could be construed as an inappropriate and unilateral change to the Settlement Agreement. *Petition for Clarification, Docket U-89-3524-AT (November 20, 1990), at p. 2.* U S WEST proposed an alternative condition, replacing "in perpetuity" with "until changed by WUTC order." The rationale for this change was, "to reflect the reality that today's commissioners cannot bind future commissions in perpetuity, . . . [and because] fundamental fairness requires that U S WEST at least be able to request a commission to readdress this issue, if that becomes necessary due to changed conditions." *Id. at p. 3.*

41 The Commission accepted USWC's proposal, and the Commission's Third Supplemental Order stated that the Settlement Agreement would be modified to require that directory advertising revenues "will continue to be imputed accordingly

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[13] Second Supplemental Order, Docket No. U-89-3524-AT (November 9, 1990), at p. 1.

unless and until altered by subsequent order of the Commission." *Third Supplemental Order, Docket No. U-89-3524-AT, at p. 2 (November 30, 1990).*

F. 1995 General Rate Case, Docket No. UT-950200

42 On February 17, 1995, following completion in 1994 of the five-year AFOR, USWC filed a general rate increase for telephone services of approximately $204 million a year. In calculating that revenue requirement, USWC proposed that imputation be discontinued. The Company there argued for the first time that imputation was illegal and advanced eighteen separate arguments for that conclusion.

43 The Commission rejected each of the Company's arguments against the imputation of Yellow Pages revenues. *Washington Utilities and Transportation Commission v. U S WEST Communications, Inc., Docket No. UT-950200, Fifteenth Supplemental Order, at pp. 30-39 (1996).*

44 USWC appealed the Commission's decision to the King County Superior Court and then to the Washington State Supreme Court which affirmed the Commission in all regards. Both the Superior Court and the Supreme Court upheld the Commission's Yellow Pages decision, ruling that the Commission acted lawfully to impute excess Yellow Pages revenue when calculating USWC's revenue requirement under both the affiliated interest laws (chapter 81.16 RCW) and statutory ratemaking authority (RCW 80.36.140). *134 Wn.2d 48, at p. 91.*

45 The Supreme Court decision specifically noted the Commission's continuing supervisory control over transactions among affiliates (RCW 80.16.050) and the power to disallow unreasonable compensation to an affiliated company for ratemaking purposes (RCW 80.16.030). *134 Wn.2d at p. 93.* The Court ruled that the Commission was within its statutory authority to disallow for ratemaking purposes the unreasonably low compensation USWC received from its affiliate, U S WEST Direct, for the profitable Yellow Pages operations. The Court stated:

> No one represents to this Court that U S WEST Direct has paid U S WEST the fair price for the Yellow Pages business. . . . The imputing of revenue is the result of the fact that the Company gave away a lucrative ratepayer-funded asset to an unregulated affiliate in return for little or nothing.

134 Wn.2d at pp. 94, 96. The Court observed that USWC could "apply for an end to imputation when it can show that it has received fair value for the asset." *134 Wn.2d at p. 102.*

G. USWC's Current Request

46 In this Docket, USWC again asks the Commission to put an end to imputation.[14] It argues that the Supreme Court decision ruled that a permanent transfer of the entire Yellow Pages business occurred on January 1, 1984, and that the imputation and publishing fees constitute full payment by USWC to ratepayers for the loss of the business that was transferred to Landmark without compensation.

III. PROCEDURAL MOTIONS

47 Three pending motions have been deferred for resolution until after conclusion of the evidentiary hearing. The first is a motion by U S WEST, earlier denied but renewed at the conclusion of the hearing, that would have us exclude certain responsive evidence filed by Public Counsel and Commission Staff on the basis of judicial estoppel. USWC contends that Commission Staff and Public Counsel made certain factual representations and prevailed on prior judicial review, and because of that they cannot in this proceeding make different representations. The second is a motion by Public Counsel and intervenors that asks the Commission to deny USWC's accounting petition on the basis that it fails to comply with the requirements or intentions of prior Commission orders regarding modification of imputation. The third is a Commission Staff motion for a ruling denying the element of USWC's petition arguing that imputation violates USWC's constitutional right of free speech. We will address each motion individually.

A. USWC's Motion to Strike Portions of the Testimony of Staff and Public Counsel

48 U S WEST argues that Commission Staff and Public Counsel are judicially and equitably estopped from characterizing the 1984 transfer of the directory publishing business from Pacific Northwest Bell to Landmark Publishing Co. as a renting of intangible assets or the "outsourcing" of the directory publishing function. It alleges that in arguments before the state Supreme Court, Public Counsel and the assistant attorney general representing the Commission on appeal of the rate case order, characterized the transaction as the transfer of the directory publishing business and the transfer of "an entire enterprise." U S WEST argues that the Court accepted the argument and, thus, Commission Staff is now estopped from making any argument (and the Commission is estopped from making any finding) that less than the entire enterprise was transferred in this case. USWC contends that the testimony of Staff and Public Counsel's witnesses supports USWC's argument that those parties now seek to reverse or contradict prior arguments made to the Supreme Court.

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[14] USWC does not petition to modify the merger order in which the imputation obligation is fixed, and it does not apply for approval of a sale or other divestiture of the asset or for any modification of the publishing agreement.

49 Commission Staff and Public Counsel respond that they have not taken "clearly inconsistent" positions in judicial proceedings involving the same question (an essential element required for the application of judicial estoppel). They argue that the word "transfer" can and often does encompass a much broader set of transactions than the transfer of ownership and title to property, including but not limited to rental or outsourcing arrangements. Although the parties to the prior proceedings asserted that a "transfer" of assets took place, they did not analyze the precise nature of that transfer as suggested by U S WEST. Staff and Public Counsel contend that such an analysis did not occur because the precise legal nature of the transfer was not at issue in the rate case.

50 Commission Staff and Public Counsel also respond that the allegedly inconsistent statements attributed to them – characterizing the legal nature and effect of the transfer of the Yellow Pages business – are conclusions of law, not assertions of fact, and argue that the doctrine of judicial estoppel applies only to bar inconsistent positions as to facts. U S WEST contends that the positions the respondents and the Commission took before the Court were factual assertions that U S WEST had transferred away a valuable asset to an affiliated company without obtaining fair value. U S WEST argues that Staff and Public Counsel must be estopped from denying the "fact" that the valuable asset was transferred away.

51 **The Commission denies U S WEST's motion.** First, the exact nature of the ownership of the directory function, and the exact nature of the transactions among USWI and its subsidiaries, were not at issue in the rate case proceeding. The only issue there was whether the Commission – given that USWC, for whatever reason, no longer recorded as its own the revenues of the U S WEST conglomerate's Yellow Pages business – had the power to impute revenues to the regulated entity. The Court answered that question in the affirmative. The business – that is, the directory and yellow pages publishing function – was conducted by Landmark after January 1, 1984 and not by PNB. The Court's decision could not approve imputation without first granting judicial recognition that in that circumstance, a sufficient transfer occurred to invoke the pertinent statutes. The Court's decision, however, did not require and did not produce a finding of complete, total, and irrevocable transfer of all rights as of any particular moment.

52 The Court did not make a finding, or remand to the Commission for a finding, that a complete transfer occurred. Passages in the decision appear to characterize the transfer as completed. On balance, however, we do not believe that the decision resolved the issue we now face, or that it prevents us from examining the issue. The Court observed at page 98 that USWC "has always been free to sell" the directory business "for a fair value" and it held at page 102 that "USWC may petition the Commission for an end to imputation if and when it can show *it has received* fair value for the transfer of the asset." *[emphasis added]* USWC argues that the decision rules that a complete and final transfer occurred in 1984. If the Court had ruled that

USWC had made a permanent and complete transfer of the business, it would be inconsistent to say that the Company always had the right to sell, or that it may in the future receive fair value for the business.

53 U S WEST's position also has telling legal and regulatory implications. U S WEST in making this motion would shift the obligation and the right of fact finding from the administrative agency to the parties in any given docket, and from the order itself to the briefs, as the effect of the motion would be to rely on parties' briefs for statements of fact, not on agency orders or judicial decisions. The principle that the Company argues states that parties who advance facts in one proceeding may not contest those facts in later litigation. The case that USWC cites for its argument is not directly analogous to the present situation, in that the result argued there in briefs was clearly a central element clearly resolved in the earlier litigation.[15] Here, that is not the case, as the argued matter is not necessary to the result, had no factual basis in the prior litigation, was not clearly resolved in the cited decision, and arose under the state Administrative Procedure Act.

54 In the rate case, we see no factual or legal presentations of the sort received in this docket. There, the Commission made no finding of fact in the underlying administrative order that a complete and permanent transfer occurred on January 1, 1984. We see no findings of fact in the Supreme Court decision and no remand to the Commission so that appropriate findings could be made. USWC's argument rests on the premise that the Court found USWC's interpretation of the representations of Commission Staff and Public Counsel, on brief to be facts. U S WEST's position would give the power to make findings of fact to the parties to judicial review and to the Supreme Court, contrary to the requirements of RCW 34.05.461 and RCW 34.05.558.

55 We also see the definition of the relationship not as a matter of fact, but as a conclusion of law based on the application of narrow principles of law to specific facts. As Commission Staff and Public Counsel point out, the facts have been repeatedly recited in numerous contexts, including Commission orders. What is at issue is the interpretation of those facts. *Community College v. Personnel Board, 107 Wn.2d 427, 434-35, 730 P.2d 653 (1986).* The legal component is then reviewed under the "error of law" standard. U S WEST's challenge is addressed to an argument of law, not fact, in the manner of an agency's application of law to the facts of a case. See, *Franklin County v. Sellers, 97 Wn.2d 317, 646 P.2d 113 (1982).* It is therefore not subject to the principle that USWC posits.

56 Finally, the Company argument should be rejected on policy grounds, as well. The Commission grants parties some latitude to repeat positions previously denied or to back away from positions previously approved. Agencies are not bound so tightly by

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[15] *Tucker v. Brown*, 20 Wn.2d 740, 150 P.2d 604(1944).

the bonds of precedent as are the courts, and have a greater latitude in fashioning responses based on current circumstances. *Atchison, Topeka & Santa Fe Railway Co. v. Wichita Board of Trade, 412 U.S. 800, 808-09, 37 L. Ed. 2d 350, 93 S. Ct. 2367 (1973).* This result is consistent with an evolving regulatory environment in which an administrative decision might be rendered outdated by rapidly occurring events. *See, In re Burlington N. R.R. Co., 1994 Minn. App. 1001, 522 N.W.2d 371, 377 (1994).* Granting the Company's motion could require the Commission to accept similar arguments in this or other dockets, requiring the exclusion of relevant testimony, and could pose negative consequences for the Commission's and parties' ability to deal with future circumstances.

57 The Commission denies the motion.

B. Public Counsel, TRACER, and AARP Motion for Summary Judgment.

1. Changed Conditions

58 Public Counsel, TRACER, and AARP ("Movants" for purposes of this discussion) ask for a summary determination that there is no basis upon which U S WEST's petition can be granted, and that it should therefore be denied. Movants rely on the Commission's Second and Third Supplemental Orders in Commission Cause No. U-89-3524-AT — the merger proceeding in which Pacific Northwest Bell, Northwestern Bell, and Mountain States telephone companies asked permission to form U S WEST Communications, Inc.

59 The Movants argue as follows. The Commission's Second Supplemental Order in the merger proceeding approved the merger on the stated condition that directory revenues be imputed "in perpetuity." U S WEST's subsequent Petition for Clarification stated its acknowledgment that the issue of imputation for ratemaking purposes was "best laid to rest." U S WEST proposed that the condition be clarified to state that revenues be imputed until changed by Commission order because "future changed conditions" could make changes to imputation necessary. Movants argue that the Third Supplemental Order responded to U S WEST's concerns, acknowledged the problem, and amended the condition as U S WEST requested. Thus, Movants argue, U S WEST must establish "future changed conditions" as a prerequisite to seeking a change in directory revenue imputation.

60 U S WEST responds that its reference to "changed conditions" in its Petition for Clarification does not foreclose other bases for ending imputation. U S WEST asserts that the Commission's Third Supplemental Order did not impose any prerequisite to consideration of the issue in the future, and argues that it is not required to show changed conditions. However, U S WEST goes on to argue that unforseen changed

conditions do exist.[16]

61 The merger order should be given significant weight. It demonstrates the importance that the Commission attached to the continuation of imputation as an ongoing condition, necessary in order to realize the benefits the Company expected from the merger. It demonstrates equally well the Company's agreement to imputation for the indefinite future, expressed in an order that they did not appeal and that they agreed would "put the matter to rest."

62 We are concerned, however, that granting the motion could, (like the original order demanding imputation into perpetuity), restrict unduly the flexibility of this or a future Commission to address matters on a future record in light of future circumstances. The burdens imposed by RCW 80.04.200 on parties seeking a modification of an order are significant, but parties should not be deemed legally foreclosed from seeking modification, nor the Commission from granting it when circumstances warrant.

2. Equitable Estoppel

63 Movants also argue that U S WEST is equitably estopped from claiming that imputation of revenue constituted payments for the value of the Yellow Pages business, because the claim is inconsistent with U S WEST's position in the merger case[17] that imputation is an acceptable condition for approval of the merger. U S WEST responds that neither Public Counsel nor TRACER acted to their detriment in reliance on U S WEST's "commitment" and thus a necessary element of equitable estoppel is not met.

64 The Commission has discussed the application of equitable estoppel in the regulatory context in several prior orders.[18] The application of equitable estoppel requires the following:

> "(1) [A] party's admission, statement or act inconsistent with its later claim; (2) action by another party in reliance on the first party's act, statement or admission; and (3) injury that would result

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[16] We deal with this argument below.

[17] Cause No. U-89-3524-AT

[18] *See*, for example, *WUTC v. U S WEST, Docket No. U-89-3245-P (1989); WUTC v. Whidbey Tel. Co., Cause Nos. U-85-50, U-85-51, and U-86-30 (1986); Order M.V. No. 133363, Seafair Moving & Transfer, Inc., Hearing No. P-69394 (1986); Order M.V. No. 128063, Paul E. and P. Randal Savage, Hearing No. P-66336 (1983).*

to the relying party from allowing the first party to contradict or repudiate the prior act, statement or admission."

Mikhail Kramarevcky v. Department of Soc. & Health Servs., 122 Wash. 2d 738, 743 (1993), citing Robinson v. Seattle, 119 Wash. 2d 34, 82, 830 P.2d 318, cert. denied, 121 L. Ed. 2d 598, 113 S. Ct. 676 (1992).

65 Here, we find no reliance or injury in the nature of the reliance and injury discussed in the cases. While an order was entered based on the representation (U S WEST's agreement to imputation), that fact gives rise to a question of process as to the proper manner to change the order rather than a question of estoppel. *See, WUTC v. General Tel. Co. of the Northwest, Inc., Cause No. U-81-61 (1982).* Principles of equitable estoppel do not apply.

3. Waiver

66 Movants also argue that U S WEST waived any right to challenge imputation on grounds other than "future changed conditions" because the Company accepted the merger settlement and did not appeal the final order in that case. U S WEST reiterates its arguments that it is not limited to relief based on changed conditions, but if it were, changed conditions exist. U S WEST also argues that there was no explicit requirement that its entitlement to challenge imputation be limited to "changed conditions," and that waiver cannot be based on an implicit condition.

67 Here, U S WEST's arguments are consistent with our views on the need for regulatory flexibility, stated above, and are persuasive. We see nothing in the earlier actions that would constitute a waiver of alternative approaches in the context of this proceeding. To find waiver, we believe that we must also find either an explicit representation or a factual setting the equivalent of an explicit representation. USWC agreed to the result and waived the immediate judicial review of that order. We see nothing in this situation that expresses USWC's waiver of all alternative legal positions for all time to come. The prior order did not specify changed conditions as the only means by which to secure a change in the ordered imputation, although that is the principal ground for reopening an order under RCW 80.04.200. The order did not limit grounds for review of the order to changed circumstances.

4. Collateral Attack on Prior Order

68 Movants argue that U S WEST's Petition for an Accounting Order constitutes an improper collateral attack on the Commission's Third Supplemental Order in the merger case. U S WEST argues that the Third Supplemental Order only requires that imputation continue until subsequent order of the Commission, and that there is nothing improper in U S WEST's request that the Commission enter such a "subsequent order" at this time.

69 We reject Movants' argument for purposes of this proceeding. USWC is not attempting to negate the entire merger order. Instead, it is seeking a review of the framework for imputation that is established in that order, after the passage of a considerable period of time.

5. Conclusion

70 U S WEST is not legally barred, by any of the legal principles advanced by Movants, from seeking a change to the Commission's imputation practices. This ruling is consistent with RCW 80.04.200, authorizing rehearing of Commission orders. The underlying principle that the Commission finds pertinent is that a regulatory agency must, within the bounds of the law, retain the flexibility to regulate reasonably, in the public interest, pursuant to the public service laws, over time. *See, Farm Supply v. Util. & Transp. Comm'n, 83 Wn.2d 446, 452, 518 P.2d 1237 (1974); see, also, Util. & Transp. Comm'n v. United Cartage, 28 Wn.App 90, 621 P.2d 217 (1981), cert. denied, 95 Wn.2d 1017 (1981).* We are concerned that the Movants' interpretation of the principles they advocate would unnecessarily restrict the Commission's flexibility in a given case to address matters of public concern reasonably, lawfully, and consistent with the public interest. We therefore deny the motion.

C. Commission Staff Motion for Partial Summary Determination

71 U S WEST contends that the practice of imputation violates free speech protections found in the First Amendment of the United States Constitution and Article 1, Section 5, of the Washington Constitution. It argues that Yellow Pages publication is an expressive activity protected by the Speech and Press Clauses of the First Amendment of the United States constitution, which applies to the State of Washington through the Due Process Clause of the Fourteenth Amendment. It also argues that the activity is protected by Article 1, Section 5, of the Washington Constitution. The essence of its contention is that Yellow Pages publishing involves the exercise of creativity and editorial discretion, and that imputing directory revenue directly and substantially infringes on this editorial discretion and on the constitutional rights of U S WEST Communications, Inc., U S WEST, Inc., and U S WEST Dex.

72 Commission Staff moves to dismiss this count of USWC's petition. Staff contends that there is no issue of material fact; that on the recited facts there is no violation of constitutional protections as a matter of law; and that even if imputation were seen as affecting commercial speech – which Commission Staff does not concede – there is no violation of constitutional protections.

73 According to Commission Staff, the issue, properly stated, is:

Where the Commission has engaged in a common and well-established regulatory practice, namely, imputation of revenues to protect captive ratepayers from the inequitable effects of affiliated transactions, is there a violation of the First Amendment merely because the imputation in question concerns U S WEST's Yellow Pages advertising business?

1. Standing

74 Commission Staff argues that USWC has no standing to raise this issue, in that it suffers no harm from imputation and that only U S WEST Dex as publisher would have the right to present it. USWC responds that it does have the necessary standing, but cites no authority for the proposition. While we find that Staff is correct and standing does not exist, we will address other elements of the issue because of its significance.

2. Burden on Speech

75 Commission Staff argues that imputation has nothing at all to do with speech. Rather, Staff contends that it is a general policy applied to all utilities to protect ratepayers when a regulated utility's transactions with its unregulated corporate affiliates produce results that are inequitable to the interests of ratepayers. In numerous cases, Staff continues, the Commission has applied imputation to various companies' affiliate transactions that either shift costs to the regulated affiliate or shift profits to a non-regulated affiliate. Imputation neither "targets" speech, nor is it based in any other way on the content of speech. Imputation does not in any way affect any activity of U S WEST Dex. Imputation, as applied in this case, simply involves an accounting adjustment to the financial books of U S WEST, Inc., the regulated entity, for ratemaking purposes, that happens to be measured by reference to Yellow Pages earnings. The Commission does not touch the other company's earnings or the disposition of its income in any way at all.

76 U S WEST argues the Commission's imputation of Yellow Pages advertising revenues to USWC does burden speech because the imputation formula is not a generally applicable regulation — it is an individually fashioned remedy. U S WEST argues that the Commission has some authority to engage in individualized regulation but it may not exercise that authority where First Amendment interests are at stake. It concludes that individualized imputation violates the First Amendment in this case. It argues that even though Dex and the parent, U S WEST, Inc., are not parties, their free speech interests must be considered. It contends that the imputation of Dex revenues acts per se as a disincentive to publishing by providing a disincentive to maximize profitability.

77 Commission Staff responds that the imputation of Yellow Pages earnings imposes no burden on any exercise of free speech. Staff contends that imputation of excess

Yellow Pages revenue would be constitutional even if it were viewed as a regulation affecting commercial speech. The Staff argues that Yellow Pages are overwhelmingly commercial speech. The imputation of Yellow Pages revenues directly advances a substantial government interest – compliance with the laws requiring that charges to ratepayers be fair, just, reasonable, and sufficient – and the imputation is no more extensive than necessary to serve that interest.

78 The Commission finds that imputation, both in principle and as applied here, has nothing to do with and does not affect the exercise of free speech, commercial or otherwise. Imputation is strictly a mechanism by which the Commission balances the financial interests of regulated utilities' stockholders and ratepayers. USWC's contention fails first because the Company has no standing to raise the issue, second because imputation has no effect on speech, and third because the imputation mechanism is clearly a principle of general application. It is applied irrespective of the underlying activity to correct situations in which the Commission finds that a regulated company has given an ongoing benefit to its owners to the detriment of its ratepayers. *See, e.g., Fourth Supp. Order Accepting Settlement Agreement, WUTC v. Washington Natural Gas Co., et al., Docket Nos. UG-931405; UG-931442 (1994).*

79 The existence of imputation and/or the details of its application in defining the income of USWC have no impact whatever on the sibling or on the activity generating the revenues that define the level of imputation. Neither do they have anything to do with how that activity is conducted. We find no connection at all between imputation and speech. Imputation addresses neither the content of underlying speech nor even the existence of speech, and it neither impinges on speech nor affects it in any way.

80 Imputation is a mechanism by which USWC's operating results are restated to reflect earnings as if the Yellow Pages directory business were retained within the company's Washington operations. That was where the directory business was traditionally conducted, as confirmed by Judge Greene in the passage cited above. During the entire history of that operation, free speech issues were never raised. The creation of an affiliated-interest relationship in itself could hardly create a free speech claim that did not previously exist.

81 As we discuss at greater length, below, imputation is strictly a mechanism by which the Commission acts to protect ratepayer interests when the regulated company acts in a manner detrimental to those interests. Imputation in this case has been no more extensive than necessary to serve that interest. The Commission uses imputation to implement the public service laws requiring that rates be fair, just, reasonable, and sufficient, for both ratepayers and regulated companies. The public service laws, in turn, reflect and implement constitutional principles that define and balance the rights and responsibilities of companies that choose to enter regulated businesses.

3. Discretion

82 USWC contends that because the application of imputation and its details are a matter within the Commission's discretion, risks to speech are particularly dangerous and Commission action must be foreclosed. Again, we disagree with the Company. Even if imputation affected speech, which it does not, the areas of the Commission's discretion are narrowly circumscribed and extend only so far as the Commission must act to protect the financial interests of ratepayers. The Commission has and exercises jurisdiction only to the extent that is necessary to produce rates that are fair, just, reasonable, and sufficient. RCW 80.36.080. Imputation does not vest the Commission with unbridled discretion to burden speech unconstitutionally but only with reasonable discretion to exercise financial regulation to the extent necessary under the Constitution to produce rates that are fair, just, reasonable, and sufficient.[19]

4. Washington Constitution

83 Finally, USWC argues that the Washington Constitution's free speech provision is more broadly protective of speech than the First Amendment, and it applies here to prevent imputation. Commission Staff responds that the State Constitution gives commercial speech no greater protection than the Federal constitution provides. Staff argues that USWC fails to demonstrate that USWC has standing to raise the issue, that speech is affected at all, or that courts have decided cases addressing comparable situations.

84 We reject the Company's contentions. We find no cases interpreting the Washington Constitution in a manner analogous to that before us to prevent the exercise of regulatory power. The only significant element appears to be that an unregulated entity operates a directory advertising business, which we find insufficient to call forth the constitutional provisions.

5. Conclusion

85 We grant Staff's motion for partial dismissal. We find in the evidence no burden on speech in the Commission's use of imputation in order to correct U S WEST's affiliated-interest transaction.

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[19] *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia,* 262 U.S. 679, 43 S. Ct. 675, 67 L. Ed. 1176 (1923). *Federal Power Commission, et al v. Hope Natural Gas Co.,* 320 U.S. 591, 64 S. Ct. 281, 88 L. Ed. 333 (1944).

IV. PARTIES' ARGUMENTS ON THE MERITS

A. U S WEST Communications, Inc.

1. The Supreme Court Decision

86 On the merits of this proceeding, U S WEST argues that the Washington State Supreme Court decision[20] determined that a complete transfer occurred on January 1, 1984, and decided that U S WEST is entitled to the end of imputation when it demonstrates that the value of imputation is equivalent to the value of the yellow pages directory business as of that date. USWC repeats arguments that it made in support of its motion to strike certain of its opponents' testimony. USWC contends that the Court's decision is based on parties' representations that the entire Yellow Pages directory business was permanently transferred on January 1, 1984, that the decision accepts that interpretation, and that this interpretation thus became "the law of the case." USWC bases its arguments on express language within the decision and notes that in fourteen separate instances the Court stated that the business had been "transferred" and that in ten instances the Court states that the transfer was for insufficient consideration. The Company also notes that the Court states that the Commission has the power to rectify the inadequacy of the compensation.

87 USWC concludes from these statements that the Court finds as a fact necessary to the decision's result that a complete and permanent transfer occurred in 1984. USWC also concludes that the Commission's power to "rectify" the disadvantage to ratepayers is limited, in light of such a finding, to securing compensation for ratepayers for the value of the asset that was transferred. The Company ends its argument by stating that, because it proved the value of the business on that date, and because it proved that the amount imputed for the benefit of ratepayers exceeds that value, it has demonstrated that imputation must cease.

2. The Transfer of the Yellow Pages Business

88 USWC acknowledges that no documents support its view that a complete transaction occurred, but contends that no documentation is necessary to support a complete transaction among affiliates. It also contends that there is no fact of record to support the argument of Commission Staff and Public Counsel that the 1984 transaction was actually a lease of the intangible going-concern value.

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[20] *U S WEST Comm., Inc. v. Wash. Util. & Transp. Comm.*, 134 Wn.2d 74, 949 P.2d 1337 (1997).

89 USWC argues, by analogizing to arms' length transactions, that the 1984 transaction was in fact complete. It admits that it did license many of the intangibles associated with the directory operation, but argues that it could not have transferred intangibles such as a right to be permanently free from competition or exclusive access to subscriber lists without illegally restraining trade. It argues that it could not transfer its own name to Landmark permanently and still retain the name for its own operations. The remaining intangibles, such as skilled employees and relationships with advertisers, do constitute part of the "going concern value."

90 USWC argues that the Court has found that a complete and permanent transfer occurred as a gift or as part sale, part gift. The Company argues that a sale is not required to accomplish a permanent transfer, citing *Richardson Roller Mills v. Miller, 99 Wash. 654, 170 Pac. 357 (1918)*, involving an arms' length transaction.

91 USWC argues that a sale occurred because Commission Staff admitted that the effect of imputation – reducing rates for ratepayers in a manner determined by the Commission – is the same as the effect of payments in a sale. It argues that Commission Staff made a crucial admission in acknowledging that imputation was undertaken in lieu of either a sale or publishing fees.

92 USWC contests Commission Staff's and Public Counsel's argument that the failure to design the 1983 intercompany transaction documents as a sale implies it was not a sale. USWC asserts that Staff's and Public Counsel's view is inconsistent with the law of the case decreed by the Supreme Court. USWC cites Prof. Perlman's testimony to the effect that among affiliates, no documentation may be needed at all to effect a permanent transaction. USWC argues that to the extent there was ambiguity in the written agreements, that has been resolved by the parties' subsequent actions (i.e., that the parties' later behavior demonstrates their intention to make a permanent transfer in 1984).

93 USWC argues that the transaction could not be a lease, which is for a defined period, because the assets (largely cash) and intangibles (such as employees) were transferred without a determinate period. USWC argues that the Company never held a beneficial interest on behalf of ratepayers and that the Company's position is supported by the *Democratic Central Committee* case.[21]

94 USWC also argues that licensing its name and trademarks are consistent with a sale, not a lease. It cites *Wilkinson v. Sample, 36 Wn.App. 266, 674 P.2d 187 (1983)*, involving an arms' length transaction, for the proposition that goodwill is transferred

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[21] *Democratic Central Committee v. Washington Metro Transit Comm.*, 485 F.2d 786 (D.C. Cir., 1973).

merely by the new owner announcing the succession to customers, which Landmark did.

95 USWC argues that at all times it provided all information pertinent to the transfer that was required by law. It had no duty to disclose the value of the ongoing business concern, it says, because that is not subject to regulatory accounting. It argues that none of the Commission's orders is inconsistent with the result that USWC advocates.

3. Valuation

96 USWC argues that it has supplied in the testimony of Mr. Golden the only credible evidence of record to value the business as of the time of the of transfer. It argues that it has incorporated several suggestions from Commission Staff and Public Counsel in its valuation and that Staff has conceded the validity of the result. USWC argues that Public Counsel criticized the result, but offered no alternative.

4. Imputation Issue

97 USWC argues that the accumulated value of imputation to Washington ratepayers exceeds the value, with interest, of the directory business as of the time of the transfer in 1984. The company calculates that the accumulated value of imputation exceeded USWC's calculation of the 1984 value of the business at some time during 1995. Modified to accept Public Counsel's suggestions, the accumulated value of imputation exceeded the value of the business in 1997. In any event, USWC argues that this compensation to ratepayers satisfies the requirement that USWC receive fair value for the asset.

98 The transfer cannot be considered a temporary or lease transaction, USWC contends, stating that both Commission Staff and Public Counsel concede that imputation compensates ratepayers for the value of the asset. Therefore, the Company contends, imputation must cease.

5. Other Issues

99 USWC contends that imputation is forbidden by Section 253 of the Telecommunications Act of 1996 because it artificially lowers rates and thus constitutes a barrier to competitive entry. The FCC has ruled that regulations that hold rates below cost are such a barrier and are impermissible.

100 Finally, USWC contends that imputation is an unconstitutional taking of property without just compensation. It cites *Kimball Laundry Co. v. United States, 338 U.S. 1, 93 L.Ed. 1765, 69 S.Ct. 609 (1949)*. The Company argues that the application of imputation takes property from U S WEST Dex and denies USWC, the opportunity to

earn a fair return. Even if imputation is found not to violate the Constitution per se, USWC argues, allowing imputation to continue after ratepayers have been compensated does constitute a violation.

6. Recommended Commission Action

101 USWC asks that the Commission enter an order ending imputation because there is no basis on which imputation can be continued. If the Commission finds that the valuation date is January 1, 1984, but that some portion of the fair value remains uncompensated, USWC suggests that the portion should be credited to rate base by crediting depreciation accounts.

B. Commission Staff

102 Commission Staff disputes USWC's arguments and contends that the Commission should continue to impose imputation. Staff contends that USWC has engaged in a consistent strategy to avoid paying fair compensation for the Yellow Pages business. Staff argues that the Commission approved the transfer of tangible assets, but did not approve the publishing agreements or the level of publishing fees. USWC agreed to imputation in the AFOR and merger dockets, but only challenged the Commission's right to impose imputation in the 1995 rate case, UT-950200. Never in the past has USWC argued or the Commission found that USWC transferred the complete ownership of the Yellow Pages business to Landmark, and never has USWC before this docket contended that imputation was compensation for the value of the Yellow Pages business.

103 USWC is attempting to create the illusion, Staff argues, that the Commission merely must ratify the Supreme Court decision to grant the Company's request. However, Staff contends that doing so is improper because the Court did not determine the ownership of the asset, it did not determine the date on which to make a valuation, and it did not determine that imputation constitutes payment for the transfer of the Yellow Pages business.

104 The proper date to make a valuation, according to Commission Staff, is the date on which USWC decides to treat the transaction as a sale and receives fair market value for the Yellow Pages business.

105 Commission Staff argues that while the Court did find imputation proper as a result of inadequate compensation in the transaction in question, the Court did not hold that imputation constitutes compensation for the value of the asset. It is not a payment at all, but merely an adjustment to the books of the regulated company. USWC's arguments are an exercise in revisionist history, Staff argues, seeking to rewrite the events of the past in order to excuse USWC from the imputation of Yellow Pages excess return.

1. History

106 Commission Staff contends that under the original publishing agreement in Cause No. FR-83-159, PNB in effect leased to Landmark the right to publish PNB's directories in exchange for publishing fees, providing a guaranteed revenue stream to PNB. PNB did no valuation study and provided the Commission with no valuation of the business. The Commission allowed the transfer of the tangible assets (principally cash) but reserved judgment on the financial aspects of the arrangement, requiring PNB to maintain pertinent financial records.

107 In Cause No. U-86-156, brought on by USWC's request for approval of ten separate agreements between USWC and U S WEST Direct (including a new Publishing Agreement), the Commission found the fee unreasonably low compared to the estimated reasonable value of the right to publish the Yellow Pages. The Commission ruled that the full value of the publishing enterprise must be available to PNB for ratemaking purposes. Remedies include, the Commission said, invalidation of the agreements and return of the Yellow Pages to PNB, determining an appropriate publishing fee, or treatment as the sale of a capital asset.

108 Commission Staff contends that the Commission Order in Cause No. U-86-156 was clear in finding that the initial 1984 transaction merely empowered Landmark to conduct the publishing operation on PNB's behalf. The Order was forward-looking, and stated some possible future consequences including treatment as a sale - should PNB elect that treatment. USWC has not yet made that election.

109 Commission Staff calls attention to the Company's agreement to imputation in the AFOR and rate complaint docket. Staff also notes that PNB agreed to imputation in the merger settlement. The Commission directed that imputation continue until further order of the Commission. Commission Staff describes the 1995 rate case, noting the Company's challenge of imputation in that docket, and analyzes the 1997 Supreme Court decision.

110 Commission Staff argues that the Court was not asked to and did not decide whether there had been a permanent transfer, and, if so, to determine the date of valuation. The Court noted correctly that the purpose of imputation is to treat Yellow Pages revenues and expenses as though the Yellow Pages transaction had never occurred.

2. The Nature of Yellow Pages Transactions

111 Commission Staff argues that the Yellow Pages transactions were interaffiliate transfers made without true negotiation, and were not arms' length transactions. Staff argues that it is improper, therefore, to apply standards of arms' length transactions to interpret or define the relationships among the participants. Also, it is improper to

call the transactions a "gift" of a lucrative asset when the Commission did not approve a gift. Staff concludes that there is no principled way to argue that the Yellow Pages business should be valued as of January, 1984. Rather, Staff contends, it should be valued at the time the Company elects treatment as a sale and demonstrates payment by U S WEST Dex of the fair market value at that (future) time.

3. *Inadequate Disclosure*

112 Commission Staff argues that if the Company were transferring the entire Yellow Pages business, it failed to disclose that intention. In that, the Company violated RCW 80.12.020, which forbids the disposition of properties without Commission approval and the Company violated WAC 480-143-010, which requires an application for authority to transfer property to "state in full detail" the facts and circumstances of the proposed transaction. Commission rules also require the submission of a full description of any unwritten provisions. The Company did not disclose that it was going to cede all rights in the Yellow Pages publishing business and did not submit to the Commission any document that so stated.

4. *Prior Representations*

113 Commission Staff points out that U S WEST has confirmed numerous times in other proceedings that it transferred only the physical and tangible assets in the 1984 transaction. Staff notes that USWC argued to the Commission on brief in Cause No. U-86-156 , the proceeding in which the Commission considered revised publishing agreements, that because PNB could resume Yellow Pages publication at any time, *nothing* was transferred.

5. *Necessary Steps Omitted*

114 Commission Staff argues that no transfer occurred because PNB failed to take a number of steps that would have been necessary to transfer ownership of the Yellow Pages business in 1984. It conducted no valuation of the Yellow Pages business, and it prepared no documentation to support a full transfer of ownership. Staff states that Landmark paid no compensation for the fair market value of the business, and PNB leased valuable rights to Landmark under the publishing agreement in a manner inconsistent with the theory of a sale.

6. *Beneficial Interest*

115 Commission Staff argues that the theory of the *Democratic Central Committee* case, above, requires a beneficial interest in the Yellow Pages operations to be preserved for ratepayers. Because Yellow Pages operations affected the Company's operations, ratepayers were exposed to risk of loss. Staff contends that it is improper to focus on

the nature of the individual components, as USWC urges. Staff suggests that it is necessary instead to look at the business operations as a whole as an asset of PNB, as USWC's witness Mr. Golden did. Commission Staff argues that there is no barrier to recognition of capital appreciation, as USWC contends, as of January 1, 1984, because there was no transfer of the business effective at that time. Indeed, no transfer of the business has yet occurred.

7. *Valuation Issues*

116 Commission Staff presented a calculation of the business value as of January 1, 1999, through witness Dr. Lee Selwyn. The methodology the Staff witness used is comparable to Mr. Golden's, and returned a total valuation of $5.6 to $7.4 billion overall, or $1.04 to $1.35 billion on a Washington-separated basis.

8. *Imputation Issues*

117 Commission Staff contends that imputation is not compensation for the capital value of the business. Staff argues that U S WEST Direct has not paid anything for the fair market value of the business. Moreover, Staff argues, it is inconceivable that USWC could have believed that imputation constitutes payment for an asset, when the Company agreed to imputation in a way that did not specify a formula to amortize value; when it did not argue in the merger docket that imputation must end once amortization was complete; when it did not argue in the 1995 rate case that imputation should stop because it had paid for the fair market value of the business; and when it did not ask the Supreme Court to end imputation because the business had been paid for.

118 Staff argues that imputation is a means to rectify inadequate compensation arrangements and not for amortization of a capital asset. Prior Commission orders, Staff says, demonstrate that the Commission was concerned with, and later used imputation to rectify, inadequate compensation to PNB from Landmark for the publishing agreement and for services rendered. Staff points out that in a 1985 transaction, the parent of Continental Telephone of the Northwest sold its directory subsidiary, Mast Directory Company, to an unaffiliated interest. Prior to the sale, excess directory revenues were imputed to CTNW in the manner used for PNB despite the permanent placement of Mast as a separate subsidiary. The Commission computed the gain on the sale for regulatory treatment without reference to any capital offset from imputation, because imputation is not a regulatory means to recognize capital transactions.[22] In another example, excess directory earnings of an

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[22]*WUTC v. Continental Telephone of the Northwest, Inc.*, Cause No. U-82-41, Second Supp. Order, (August 12, 1983).

affiliate were imputed to GTE-NW even though the commonly owned directory company merely owned, and was not acquiring or divesting, the directory business.[23]

9. *Other Issues*

119 Commission Staff argues that there is no violation of Section 253 of the Telecommunications Act of 1996 because the Commission found in UT-950200 that no subsidy exists from imputation. The State Supreme Court affirmed that finding and noted that no competitor, who would presumably be hindered under USWC's theory had supported the Company.

120 Staff argues that Yellow Pages imputation is not an unconstitutional taking without just compensation. The Commission seizes no revenues from the affiliate, does not regulate the affiliate, and does not interfere in any way with the affiliate's conduct of business. Neither has the Commission "taken" revenue from USWC, Staff argues. Staff contends that USWC is wrong in its contentions that rates under imputation are set by reference to property in which "ratepayers have no interest" and for which "fair value has been received." Neither, Staff notes, has USWC demonstrated that the resulting overall rates are so low as to jeopardize the financial integrity of the Company, a requirement for a finding of unconstitutional taking under *Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989).*

C. TRACER, AARP and Public Counsel.[24]

121 TRACER's brief begins with the observation that USWC's case rests entirely on a misreading of language in the decision of the Washington State Supreme Court and an attempt to revise history.

122 TRACER argues that the 1984 transaction was not a complete and permanent transfer of ownership of the directory publishing business. TRACER points out that at the time of the transaction there was no valuation, no buyer or seller, no consideration for the going-concern value of the business, no application for approval of the transfer, and no Commission disposition of the gain. In the absence of an application from PNB for approval of a sale transaction, the Commission implemented imputation. TRACER argues that USWC should not be allowed to characterize the transaction

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[23]*WUTC v. General Telephone of the Northwest, Inc.*, Cause No. U-84-18, Second Supp. Order, (January 15, 1985).

[24] Intervenors TRACER and AARP coordinated their efforts with Public Counsel to produce a joint brief. For convenience, we will refer to their combined brief in this docket using only TRACER's name. We acknowledge the considerable effort of each of the contributing parties. In many respects this brief parallels that of Commission Staff, and this Order for the sake of brevity and clarity will not repeat parallel arguments.

retroactively as a sale. TRACER contends that the imputation adjustments and publishing fees were not installment payments on a hypothetical sale, because no true sale occurred, no consideration was paid or received for the value of the business, no amortization schedule was established, no gain was available for Commission distribution, and publishing fees were never referred to as consideration. TRACER contends that ratepayers are entitled to the gain on the sale of the Yellow Pages business because they have continued to be at risk and are entitled to share in the growth of the value of the business. Finally, TRACER contends that imputation may cease only when the full current market value of the Yellow Pages business is determined, received by USWC, and credited to ratepayers.

1. History

123 TRACER's thorough recitation of the history of the transaction and the significant orders parallels that of Commission Staff and will not be repeated at length. TRACER notes that the Second Supplemental Order in Cause No. U-86-156 speaks prospectively about characterization of the transaction as a sale, saying "*if* U S WEST Direct seeks to ultimately acquire all of the opportunity for profit. . . " (emphasis added). Only at the time of an application, valuation, and credit to ratepayers, TRACER contends, may conditional treatment as a sale begin.

124 TRACER calls attention to language in the Supreme Court decision, observing that "The record shows the Company has always been free to sell the business for a fair value." TRACER argues that this observation, and the Court's observation that imputation may cease when the Company receives fair value for the business from its affiliate, demonstrate the fallacy in the Company's contention that the Court found a complete transfer to have occurred.

125 TRACER describes the details of the 1983 application packet and concludes that the 1984 transactions did not constitute and were never intended to constitute a permanent transfer of ownership of the directory business. TRACER notes that USWC's argument that the 1984 transaction was all or part gift causes the Company a problem because the Company has never asked the Commission to approve a transfer of the entire business operation without consideration, as it must under RCW 80.12.020. TRACER observes that the Company's version of history is incompatible with the requested and actual regulatory treatment, and concludes that no transfer of ownership occurred.

2. Valuation

126 TRACER argues that the central issue in valuation is selection of the proper time period. TRACER argues that there is no basis to conduct the valuation as of January 1984, because no change in ownership was disclosed, was approved, or occurred. TRACER cites to asserted errors in the methodology of Mr. Golden's proffered

valuation, but also argues that the basic premises of a sale as of that date were not met and that the extraordinary appreciation of the Yellow Pages business value since then offers strong motivation to the Company for insisting upon the 1984 date and valuation.

3. *Imputation Issues*

127 TRACER cites to the Commission's order in Docket No. UT-950200 and the Commission's observation there that it and other Commissions have used imputation to prevent regulated companies from transferring profitable assets to unregulated affiliates while saddling captive utility customers with the expenses of operation but reduced offsetting revenues from related services. TRACER concludes that imputation is not an installment payment for the transfer of the fair value of the publishing business. Similarly, TRACER finds no reason to consider publishing fees as payment for the value of the business as opposed to their stated purpose. TRACER also notes that USWC has never availed itself of the opportunity to secure treatment as a sale.

128 TRACER defends the accuracy of a "rental" analogy, and notes that even USWC's witness Golden uses the term "rent" in conjunction with the payment for temporary use of intangible assets. TRACER argues that ratepayers continue to bear the risks of the publishing function because they have remained at risk for the risks and costs of the publishing business under imputation. Ratepayers, argues TRACER, are entitled to the gain on sale when they have borne the risks. TRACER cites to Washington decisions, including one on the distribution of gain by USWC on the sale of Bellcore and another on the sale by Puget Sound Power and Light of certain assets in Cause No. U-85-53 (1986). TRACER disputes USWC's interpretation of TRACER's brief to the Washington State Supreme Court in the appeal of the Commission's orders in the rate case, and disputes USWC's interpretation of the testimony in this docket of Public Counsel and Intervenor witness Mr. Brosch.

4. *Other Issues*

129 On the same basis as Commission Staff, TRACER opposes USWC's contention that imputation is impermissible under the Telecommunications Act of 1996. TRACER also opposes USWC's contention that imputation constitutes an impermissible taking, arguing that imputation does not affect the publishing business in any way and citing a Colorado court decision holding that imputation in that state did not constitute an impermissible taking.[25]

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[25] *Mountain States Telephone and Telegraph Co. v. Public Utilities Commission*, 763 P.2d 1020 (Colo., 1988), cited with approval in the 1997 Washington State Supreme Court decision, 134 Wn.2d at p. 100.

V. DISCUSSION AND COMMISSION DECISION

130 The Commission has set out above a summary of the parties' arguments. In this segment of the order, we state our decision on the issues presented to us and our reasoning for those decisions.

A. Basis for USWC's Position

1. The Supreme Court Decision

131 U S WEST makes a number of representations about the meaning of the 1997 State Supreme Court decision affirming the Commission's rate case order. Consequently, we have read the decision closely and carefully.

132 USWC argues that the Court ruled, at least implicitly, that the January 1, 1984, transaction was complete and final; that a valuation must take place as of that date; that the purpose of imputation is to offset or pay for the capital value of the business; and that if the value of imputation exceeds the 1984 valuation of the directory business, imputation must cease.

133 USWC's argument is not without shortcomings. USWC takes its position despite the apparent context, holding, and language of the judicial decision to the contrary; despite the lack of administrative or judicial findings of fact supporting the theory; despite the Company's prior representations, actions, and litigation positions to the contrary; despite witnesses' prior sworn statements to the contrary; despite the prior Commission orders to the contrary; and despite the inherent admission that if its position were true it would be admitting its failure to disclose the total disposition of a lucrative asset to an affiliated interest, contrary to the requirements of chapters 80.12 and 80.16 RCW.

134 USWC and its witnesses acknowledged freely that the Company never in the past contended facts and legal relationships that it now argues control the transaction. Its positions are contrary to its prior representations to the Commission,[26] contrary to

[26] Brief of Applicant Pacific Northwest Bell Telephone Company, Docket U-86-156, at 23-24 (June 24, 1988).

prior Commission orders,[27] contrary to the prior sworn statement of a USWC witness,[28] and contrary to the holdings and observations of the Supreme Court decision.[29] USWC explains all of these inconsistencies by saying that it is only following the mandate of the state Supreme Court and what USWC calls "the law of the case."

135 We do not find that the Court's decision supports USWC's interpretation of the Court's decision. The Court ruled that the Commission acted properly within its discretion in using imputation as a means to rectify injury to ratepayers from an affiliated interest transaction. While the Court did refer to the transaction in some instances in the past tense – a transaction must have occurred to invoke the relevant statutes – it made no rulings on the timing or nature of any complete transfer of all rights to the Yellow Pages business or the proper valuation of that business because the issues were not presented.

2. *USWC's Interpretation of the Supreme Court Decision*

136 USWC argues that if there had been no "transfer," then the premise of the Court decision was wrong. USWC argues that the Court therefore ruled that a complete and final transfer occurred on January 1, 1984, that a valuation must be made as of that date, and that because the amounts of imputation now total more than the 1984 valuation, imputation is now illegal. The Commission disagrees.

137 USWC's first fundamental fallacy is to state that the Court's acknowledgment of a transfer of rights and benefits sufficient to invoke regulatory review and action was in fact a holding that a complete, total, and final transaction occurred as of a specific date. The Commission did not make a finding to that effect in the order appealed from nor in any prior case, and in fact over time made unambiguous holdings to the contrary, in orders that were never appealed. No record was made in the rate case to support such a finding. No party argued as much to the Court. The Court did not make a finding of fact to that effect nor did it remand the issue to the Commission for

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[27] *In the Matter of the Application of Pacific Northwest Bell Company, Order Granting Application, Cause No. FR-83-159 (December 30, 1983); In the Matter of the Application of Pacific Northwest Bell Company, Second Supplemental Order, Docket No. U-86-156 (1988); Washington Utilities and Transportation Commission v. U S WEST Communications, Inc., Fifteenth Supplemental Order, Docket No. UT-950200, (1996).*

[28] Rebuttal Testimony of Max Johnson in Docket U-86-156; testimony of Ms. Koehler-Christiansen, transcript p. 1001

[29] *U S WEST v. Utils. and Transp. Comm'n, 134 Wn.2d 74, 89, 98, 102 (1997).*

an appropriate finding under RCW 34.05.558. The Court simply did not make the ruling that U S WEST contends the Court made.

138 Some of the confusion – or at least the missed communication – among the parties results from the difference in meaning, interpretation, and inference that the parties assign to the term "transfer."

139 USWC notes the term "transfer" in the parties' arguments on review of the Commission's Order in Docket No. UT-950200, and the Supreme Court's use of the term in its decision at 134 Wn.2d 49, and reads it to mean a complete, total, permanent transfer of all aspects of the Yellow Pages directory business.

140 All parties in the rate case acknowledged that after January 1, 1984 Landmark published the PNB directories and kept the proceeds from Yellow Pages advertising sales. All parties acknowledge the existence of contracts between PNB and Landmark regarding publication. The Commission ruled in orders that were not appealed that the consideration PNB received from Landmark was inadequate. No more was necessary to invoke the relevant statutes authorizing imputation and no more was necessary to decide the issues in the our order UT-950200 and its judicial review. While the parties in argument and the Court in ruling on the transaction did on occasion use the past tense, that was neither the argument nor the ruling that the transaction is complete and permanent for all purposes or that it was completed at any particular time.

141 The 1984 transaction in which certain assets changed ownership and in which responsibility for publication of the White and Yellow Pages directories moved from PNB to Landmark was a transfer, whether or not permanent, of the business operations. It was a sufficient transfer – shifting as it did the right to publish and to collect advertising revenues – to invoke the provisions of chapters 80.12 and 80.16 RCW. The term "transfer" need not, and did not, for the Commission or other parties, mean total and permanent transfer of the entire business. USWC's use of the term is not consistent with others' use.

142 In its appeal of the Orders in UT-950200, USWC did not challenge any lack of findings by the Commission as to whether the transfer was complete and final. It did not argue to the Court, so far as this record reveals, that the Commission's decision failed to make necessary findings or that the Court should remand the matter back to the Commission for necessary findings.

143 Courts can rule only on issues that are before them. The issue that USWC presented to the Court, on its challenge of the Commission Order in Docket No. UT-950200, was whether the Commission's use of imputation is legal to rectify adverse effects on ratepayers from what all parties acknowledged to be an affiliated interest transaction involving inadequate compensation. The Court ruled that the Commission's use of imputation is legal under the pertinent statutes in those circumstances. It rejected, or found it unnecessary to reach, each of the 18 reasons that USWC posited as making imputation illegal.

144 USWC's theory of the decision appears to be inconsistent with significant portions of the Court's ruling. It is inconsistent with the Court's observation at page 98 that "[t]he record shows that the Company has always been free to sell the business for a fair value," because use of the present perfect progressive tense implies an ongoing, continuing ability to sell rather than a past, consummated sale.[30] The Court's observation at p. 102 that the Company is free to ask the Commission for an end to imputation "when it can show that it [USWC] has received fair value for the transfer of the asset" (emphasis added) is inconsistent with USWC's contention that it is ostensibly entitled to that result when it can show that it has provided a value to ratepayers.

145 USWC does not present evidence that it has received fair value for the asset. Instead it argues that the Court's decision makes the imputation of Yellow Pages revenues illegal because the value of the asset was "paid off" by imputation to USWC's earnings.[31]

146 USWC's theory is misguided. It is inconsistent with the factual record in this and prior dockets; it is inconsistent with the regulatory record; and it is inconsistent with the Supreme Court decision that it ostensibly seeks to implement.

B. The transfer of the Yellow Pages Business

147 U S WEST argues that the transaction was complete and final on Janauary 1, 1984. We find that it was not. We find that the 1984 transaction was represented to be, and actually was, a transfer in which Landmark began publishing directories and engaging in the Yellow Pages business "for" PNB[32] and agreed to make a guaranteed stream of payments for that privilege. That is what this record reveals, and that is what the Commission finds. Only in that context can the documentation presented by PNB,

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[30] William A. Savin, The Gregg Reference Manual, (7th Ed. 1999).

[31] USWC argues that the Company always took the position that imputation is illegal. USWC Opening Brief, at p. 26. A glance at prior Commission orders reveals that this statement is not supportable. In particular, in the merger dockets the Company accepted imputation on a continuing basis. This is inconsistent with the Company's new theory of illegality. In pleadings related to the merger order, the Company admitted that "it is time to put the issue (of imputation) to rest." It consented to the ongoing imputation as an integral element of the merger transaction, and it did not appeal the order.

[32] Order of Dec. 30, 1983 in Cause No. FR-83-159.

the unappealed decisions of the Commission, and the Supreme Court decision be understood to make sense.

1. Indicators of Arms' Length Transactions

148 USWC argues that the transaction must be treated as a sale or other permanent transfer if there are certain indicia of a permanent transfer, according to the legal standards applied to arms' length transactions. Examples include the transfer of goodwill, copyright licensing, and use of trademarks.

149 The analogy and the citations are invalid, because this is not an arms' length transaction. Mr. Inouye confirmed at TR 492-3 what has been clear from the outset of this transaction in 1983 — that USWI controlled the negotiations regarding the Yellow Pages. Indeed, it was only sound business that USWI control the transaction in every regard. It did so in an attempt to shift the income of the lucrative directory publishing business from PNB, where it was a benefit shared by ratepayers and stockholders, to an unregulated subsidiary where the benefit could be enjoyed exclusively by shareholders. To the extent that witnesses represented that this was not the case, and that dealings between the companies *were* at arms' length, their testimony is not credible.

150 The Company repeatedly analogizes for selected purposes to standards applicable to third-party or arms' length transactions. The Commission gives those standards no weight in this context, as they are inapposite to this series of transactions. Every one of the incidents of this transaction was subject to the ultimate discretion, direction, and control of USWI and could be molded to resemble or not resemble an arms' length transaction at USWI's direction. USWC clearly concedes this when it strongly argues the reverse of this issue, for example, when it points out that the transaction needs no documentation because it is a transaction between affiliates, or when it states that it needs none of the indicia of a third-party transaction because affiliates are free to make gifts to one another.

151 Finally, some of Mr. Johnson's testimony relating to trademarks is not credible. We find no indication that the logo of U S WEST Communications, Inc., connotes in the popular view an entirely different company from that connoted by any other U S WEST corporate family logo.[33] We find it not credible that consumers see the U S WEST Communications logo, with its stylized U S WEST lettering, see the identical U S WEST lettering with the name "Dex," and view them as totally distinct and unrelated companies as opposed to related products under a single umbrella. In any event, the substitution of the U S WEST logo for that of PNB was a choice made by

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[33]Mr. Johnson, TR pp. 410-421.

U S WEST, Inc. and PNB and should not be used to justify the evaporation of any publishing rights or financial benefits previously held by PNB.

2. *Gift Theory*

152 All parties acknowledge the lack of contemporaneous adequate compensation for the transfer of the assets.[34] The Commission ruled on more than one occasion, without contest or appeal, that the compensation provided for the publishing agreements was inadequate or nonexistent. USWC argues that because the Court said that USWC "gave away" the asset for little or no return, it ruled that the transaction constituted a completed gift of the entire directory business on January 1, 1984. Therefore, the Company argues, the transaction was a fully executed gift of the entire Yellow Pages publishing business and no formal evidence of sale transfer is needed.

153 There was no gift because a gift requires donative intention.[35] Here, as the Commission has repeatedly noted, the intention was to enrich stockholders at the expense of ratepayers. It was not a permanent transfer of the entire publishing business, because the approved transaction was neither designed nor presented to effect a permanent transfer, nor did it effect a permanent transfer.

154 Moreover, the transaction is not a completed transfer of the entire publishing business because PNB did not receive Commission authorization under Chapters 80.12 and 80.16 RCW to give away the exceptionally valuable asset. A no-compensation transfer of the entire business would clearly have been subject to disclosure and Commission approval under both the transfer of property and the affiliated interest statutes. While the no-compensation nature of the asset transfer was disclosed, we find that USWC presented the transfer of the publishing business function as an outsourcing or a lease, with compensation over its term, in a way that clearly precludes treatment as a gift.

155 As we repeatedly note, the limited transfer of the publishing function that PNB described to the Commission and then effected in the 1984 transaction neither demands nor implies the relinquishment of all rights in a permanent transfer.

3. *Regulatory Consequences*

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[34] Consideration for the asset transfer was nonexistent. PNB immediately transferred to U S WEST (the parent company) the entire 21/100 share in Landmark that it received for the capital assets and so far as the record shows derived no benefit from that transfer. *See, Cause No. FR-83-159 (Order of Dec. 30, 1983), and Second Supplemental Order, Cause No. U-86-156, pp. 11-12 (1987).*

[35] *Oman v. Yates*, 70 Wn.2d 181, 422 P.2d 489 (1967); *Tucker v. Brown*, 199 Wash. 320, 92 P.2d 221 (1939); *Dingley v. Robinson*, 149 Wash. 301, 270 Pac. 1018 (1928).

156 For regulatory purposes, as suggested by Commission Staff and other parties, we must look to the regulatory interpretation of the actions that the regulated company took and that it disclosed to the Commission. From a regulatory perspective, the following occurred or failed to occur.

157 PNB did not represent in its December, 1983, application that it was intending to part permanently with all aspects of ownership of the Yellow Pages business. Instead, it clearly stated that "This application concerns the implementation of the new Publishing Agreement between PNB and USWDC *for the publication of PNB's White and Yellow Page directories*." Application, Cause No. FR 83-159, p. 3. (emphasis added) The application by its own terms was for an agreement for publication, and not for the transfer of a valuable business.

158 The relationship that was thereby created for regulatory purposes – the relationship that the Commission approved – was not a sale or other permanent transfer. Instead, it was the transfer of certain assets along with a license and series of agreements for services for a term of years. PNB's representation to the Commission was of a temporary outsourcing (in common parlance, as Mr. Selwyn notes, a "lease") of the publishing function, under a publishing agreement, in exchange for a fee. Only in this context do the contemporaneous representations, the contemporaneous regulatory treatment, and the relevant orders all make sense.

159 The Commission recognized the impermanence of the authorized relationship in a later order, telling PNB that it should make an election about the transfer. The Commission listed three possible means to treat the transaction:

> The remedies to be considered include the approval of the contracts with appropriate adjustment of publishing fees, the return of the publishing function to PNB, or the treatment of the transaction as the sale of a capital asset. If, as the evidence appears to show, PNB and USWD intended a permanent transfer of the Yellow Pages, treatment as a sale may be most appropriate. Such treatment would allow for determination of consideration at the time of transfer that would fairly compensate PNB. PNB would assume none of the risk, and USWD would assume all of the risk attendant to the publishing enterprise. *Such a result is appropriate if U S West Direct seeks to ultimately acquire all of the opportunity for profit.* Treatment as a sale is very likely to reflect a result that might have been achieved by parties bargaining at arms' length.

Docket No. U-86-156, Second Supplemental Order, at p. 12 (emphasis added). It is clear from this discussion that the Commission had not authorized a permanent transfer. None of the discussion would make sense if a permanent transfer had been approved. USWC neither sought clarification nor appealed the order or its description of the transaction. Nor did it ever come back to the Commission with a request to treat the transaction as a sale.

160 U S WEST states that it always provided full disclosure about the transaction. *USWC Brief, p. 33*. In light of the record and USWC's earlier positions, this statement is difficult to understand. If it intended a transfer of the entire business, not only did it not tell the Commission it was transferring the entire business (nor the value of the ongoing business ostensibly transferred), its application stated that it was arranging for publication, and it subsequently represented through the sworn statements of witnesses (Ms. Koehler-Christianson[36] and Mr. Johnson[37]) and legal positions[38] that no transfer of intangible assets occurred. Mr. Inouye states at transcript pages 263-264 and Ms. Koehler-Christianson acknowledges at transcript page 1001 that the changes in their statements are the result of the Company's desire to support the existence of a completed, permanent transfer that the Company contends is demanded by its interpretation of the Court's decision.

161 U S WEST's statements now about the facts and the meaning of its own actions are so clearly contrary to the events and representations at the time that they cast serious doubt on the credibility of the Company's case. If we are to believe that it did in fact transfer all rights to the business, it never once told the Commission that it was effecting the complete and total transfer of an immensely valuable asset, contrary to its obligation under law to seek approval for such a transaction. The Company failed to maintain the documentation ordered by the Commission that is essential to the valuation of the asset that it now seeks us to make. Again and again, the contemporaneous information that PNB and USWC provided and its arguments are inconsistent with the facts and the positions that USWC now espouses.

162 In summary, USWC asks the Commission to look at legal documents prepared by the Company's own lawyers in response to its legal obligation to define and disclose every relevant aspect of the transaction, and then to disregard the language of those documents, and to infer an intention that is not evident within the documents. We cannot find on the facts in this record that a transfer of the business occurred in 1984.

4. Regulatory Treatment

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[36] Ms. Koehler-Christianson, Tr. 1001; Ex. 519, part 1 of 2, at 107-8 (referring to testimony in deposition in USWC's federal proceeding challenging imputation on First Amendment grounds).

[37] See, Tr. 378-79; Ex. 309 at 2-3 (referring to Rebuttal Testimony of Max Johnson in Docket U-86-156).

[38] "As noted above, the fact is that PNB could publish now if it chose, so nothing was actually transferred in 1984." Brief of Applicant Pacific Northwest Bell Telephone Company, Docket U-86-156, at 23-24 (June 24, 1988).

163 Regulatory requirements are the most telling argument regarding the transfer of the business. USWC has never asked the Commission to approve the permanent transfer of the entirety of the Yellow Pages business to Landmark or any other entity. As we have noted above, under RCW 80.12.020, USWC had no authority to dispose of property without receiving Commission authority to do so, and under RCW 80.16.020 it had no authority to consummate a transaction with an affiliate without receiving Commission authority to do so.

164 Chapter 80.12 RCW severely restricts public utilities' ability to transfer property without prior Commission approval. RCW 80.12.020 says, in part,

> No public service company shall sell, lease, assign or otherwise dispose of the whole or any part of its . . . properties . . . without having secured from the commission an order authorizing it to do so.

165 The consequence of failure to do this is made clear in RCW 80.12.030:

> **Disposal without authorization void.** Any . . . sale, lease, assignment, or any other disposition, merger, or consolidation made without the authority of the Commission shall be void.

166 RCW 80.16.020 requires a regulated company to

> file with the commission a verified copy, <u>or a verified summary if unwritten</u>, of a contract or arrangement providing for the . . . purchase, sale, lease, or exchange of <u>any property, right, or thing</u> . . .. The filing must be made prior to the effective date of the contract or arrangement. Modifications or amendments to the contracts or arrangements must be filed with the commission prior to the effective date of the modification or amendment.

(Emphasis added.)

167 The 1983 application was for approval of the transfer of certain assets worth $13.7 million (for which the Company received nothing) and the approval of publishing agreements under which Landmark agreed to publish directories including company listings and Yellow Pages for PNB and to pay PNB a guaranteed stream of income.

168 The Company in this docket does not ask the Commission to approve the transfer of the entirety of the Yellow Pages business to Landmark. Instead, it merely asks the termination of imputation – allegedly pursuant to order of the Washington State Supreme Court. The Company's current request for regulatory treatment retroactive to 1983 is incompatible with regulatory requirements. The Company never asked the Commission to treat the transfer as a sale or any other completed transaction or otherwise give regulatory approval or regulatory permission for a permanent transfer (which would require a modification or amendment of the original approved agreement under the terms of the statute) even after the Commission invited it to do so. It never asked the Commission to distribute the realized gain from a sale. It never kept the necessary records that the Commission directed it to keep.[39] USWC has not received authority to transfer the business asset. We find that for regulatory purposes any arrangement or disposition that purported to effect a transfer other than the limited transaction approved in 1983 is void. RCW 80.12.030

169 We conclude that USWC retains the asset, both by the factual history of the transaction and as a matter of law. We will continue to regulate USWC as though it retains all rights to the asset. No complete transfer occurred in 1984, and we have no evidence of any later sale or other disposition to which PNB or USWC was a party. Neither PNB nor USWC applied for approval of such a transaction, and we have not approved such a transaction. Any such transaction would therefore be void in any event. The Commission has continuing jurisdiction over any such arrangement, dating back to the original application. The Commission can, but is not required to, institute an investigation. "At any time after receipt of the contract or arrangement," the Commission may disapprove such a contract or arrangement if the Commission finds that the public service company has failed to prove that contract or arrangement is reasonable and consistent with the public interest. RCW 80.16.020.

5. Consequences of a Transfer

170 The first fundamental fallacy in USWC's position is that a transfer occurred. Its second fundamental fallacy is its assumption that proof of a transfer removes imputation as an appropriate remedy for the inter affiliate transaction. It is clear that this is not the case.

171 The Commission's Order of October 12, 1980 in Cause No. U-86-156 sets out three potential means of rectifying the consequences of the transaction. That list is not exclusive.

172 Imputation is the implementation of "Imputed Value," i.e., the logical or implicit value that is not recorded in any accounts. *ATTORNEYS' DICTIONARY AND HANDBOOK OF ECONOMICS AND STATISTICS, by Les Seplaki, New York: Professional Horizons Press, 1991, p. 121.* It is the ascription or attribution to another. *Webster's II New Riverside University Dictionary, Boston, 1984.* Here, imputation is the ascription or attribution of income, not recorded otherwise on any of USWC's accounts, implemented by an accounting adjustment. It revises USWC's earnings for regulatory purposes (that is, for setting rates), to reflect a portion of

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[39] *In the Matter of the Application of PNB,* Cause No. FR-83-159, Fourth Supp. Order, at 7 (January 16, 1985).

affiliate U S WEST Dex's earnings. It is a means by which the Commission may exercise the authority granted in Chapter 80.16 RCW to protect ratepayer interests affected by affiliated transactions.

173 There is no principle of law or policy that constrains the Commission from using imputation on an ongoing basis when the affiliate of a regulated telecommunications company owns and operates a directory publishing business that serves the regulated company. The Commission has used imputation in such settings. *See, Second Supplemental Order, WUTC v. Continental Telephone Company of the Northwest, Inc., Docket No.* U-82-41 *(August 1983); Second Supplemental Order, WUTC v. General Telephone Company of the Northwest, Inc., (January 1985).* Imputation is thus an alternative to a distribution at the time of a transfer, when the transfer is to an affiliate. Its application to U S WEST has been to substitute the earnings imputation, for ratemaking purposes, for the actual payments (if any) by Dex for rights or services that USWC provides and that allow Dex to publish directories containing Yellow Pages advertising on behalf of USWC. That repricing of affiliated payments offsets the loss to ratepayers of the benefit they would have received if PNB had not transferred the business operation. The loss to ratepayers occurs on an ongoing basis, and the offsetting benefit from imputation of "excess" earnings compensates ratepayers for the immediate period's loss, not for the capital value that might be distributed in the event of a sale to a third party in an arms' length transaction. Imputation is not a substitute for, nor is it a means to implement, the amortization of any value to be distributed.

174 The Court appears to have understood this perfectly, for it stated that USWC could ask for an end to imputation when *it received* consideration for the asset, not when it *paid* or when *ratepayers received* consideration for the asset.

175 The Commission does not rule out any Yellow Pages treatment, nor does it predict what the Commission will do given the facts of any possible future record. The Company may come forward in a proper procedural setting to ask for a change in imputation. If that occurs, the Commission will receive evidence, hear arguments, and make a responsible decision, under law, on the facts of record.

6. Conclusion

176 U S WEST's arguments about the actual nature and timing of the transaction are factually incorrect. The transaction and the pertinent documentation that PNB represented to the Commission, and that the Commission approved, was for the transfer of certain assets and the temporary outsourcing of the directory publishing business in exchange for a guaranteed stream of payments from the temporary publisher for the right to conduct the publishing business. The Commission has approved no other transaction and it expressly refused to approve the adequacy of the publishing fees. For regulatory purposes, no other transaction has occurred.

177 When we examine the evidentiary record, we see no objective indicators demonstrating that the publishing business was formally transferred. We see none of the indicators of an arms' length transaction – even of a receipt for a transaction without consideration – that might constitute a part of the evidence that the transaction occurred as USWC contends. We see no request for other regulatory approval, and no summary of any unwritten agreements. We conclude on the facts of record that no permanent transfer occurred, factually or legally.

C. Valuation

178 USWC argues that because the complete and permanent transaction was consummated on January 1, 1984, the value of the transferred asset must be valued as of that date. We have found that the transaction did not occur on that date and that there is neither evidence of a transaction at any other date nor of regulatory approval of a transaction for regulatory purposes. Consequently, we need not discuss the issue of valuation and we cannot without a transaction to approve determine whether valuation is needed or what is the proper date for valuation of the ongoing business.

179 The Commission will continue to use imputation to preserve and balance the positions of stockholders and ratepayers until the Company demonstrates a change in conditions that warrants a change in imputation.

180 The Commission will then have the opportunity to determine whether to end imputation and, if so, determine the appropriate disposition of any gain.

D. Other Issues

1. Publishing Fees as Payment for an Asset

181 USWC urges that the publishing fees should be considered payment for the capital asset that has been transferred. It is clearly improper to do so. We find and conclude above that the purpose of the 1984 transaction, as expressed in the supporting documents and in Commission orders, was to authorize and require Landmark to publish directories and conduct the classified advertising business for PNB for a limited period in exchange for the publishing fees. The fees were established and represented as compensation for the rights to perform that activity and for other services rendered by PNB.

2. Barrier to Entry

182 USWC contends that imputation is a barrier to entry forbidden by Section 253 of the Telecommunications Act of 1996 because it subsidizes rates and makes it more difficult for competitors to enter the market. The Commission disagrees.

183 The question of subsidy was resolved by the Supreme Court when it upheld imputation against USWC's challenge in the rate case. *134 Wn.2d at p. 83.* No competitors challenge imputation or contend that it constitutes a barrier. There is no evidence, as opposed to the mere allegation, that imputation constitutes a barrier to competition. The Commission rejects this challenge.

3. Unconstitutional Taking

184 USWC again contends that imputation is unconstitutional, this time as a taking of Landmark's revenues without compensation under the Fifth and Fourteenth Amendments to the United States Constitution and Article I, Section 16 of the Washington State Constitution. We reject the argument.

185 First, neither USWI nor Landmark is a party, and USWC does not have standing to raise the issue as to the rights of others.

186 Moreover, as we have previously held and the State Supreme Court affirmed, revenues of the nonregulated company, Landmark, are not affected. Imputation is established for a limited purpose, authorized by statute, and for a purpose that has been found fully lawful by the United States Supreme Court.[40]

E. Conclusion

187 USWC's petition for an accounting order is premised on a selective reading of the Washington State Supreme Court's decision and on alleged facts that are contrary to the facts that we find on this record. Imputation is merely a means to preserve the relative benefits of Yellow Pages operation to ratepayers and stockholders that existed prior to the Commission's authorization of the temporary transfer of the publishing function from PNB to Landmark in January1984. Imputation also operates to reprice the ongoing affiliated transactions in an equitable manner. There is no evidence of an actual transfer from PNB or USWC to Landmark, and there has been no regulatory approval of any permanent divestiture of ownership of the publishing function from PNB or its successor, U S WEST Communications, Inc. The Commission denies USWC's petition for an accounting order ending imputation.

VI. FINDINGS OF FACT

188 Having discussed above all matters material to our decision, and having stated general findings and conclusions, the Commission now makes the following summary findings of fact. Those portions of the preceding discussion that include findings

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[40] *United Fuel Gas Co. v. Railroad Comm. of Kentucky*, 278 U.S. 300, *Supra.*

pertaining to the ultimate decisions of the Commission are incorporated by this reference.

189 1. The Washington Utilities and Transportation Commission is an agency of the State of Washington that is vested by statute with the authority to regulate telecommunications companies offering service to the public for compensation.

190 2. U S WEST Communications, Inc., is a subsidiary of U S WEST, Incorporated. USWC is engaged in providing telecommunications services to the public of the state of Washington. It is the successor in interest to Pacific Northwest Bell Telephone Company, which disappeared as a separate entity upon its merger with two other local exchange telecommunications companies to form U S WEST Communications, Inc.

191 3. Landmark Publishing Company is a subsidiary of U S WEST, Incorporated. Landmark is the owner of U S WEST Dex, formerly called U S WEST Direct, a subsidiary engaged in the business of publishing telephone directories.

192 4. On December 22, 1983, PNB filed an Application for authority under Chapter 80.12 RCW to transfer as of January 1, 1984, Washington assets valued at $13.7 million to Landmark Publishing Co., in exchange for a 21/100 share in Landmark. The application disclosed that PNB would immediately transfer that compensation to its parent, U S WEST.

193 5. The Application also sought approval of the asset transfer as an affiliated interest transaction under Chapter 80.16 RCW along with approval to enter a publishing arrangement in which Landmark would publish PNB's directories, including Yellow Pages advertising, under contract, in exchange for a guaranteed stream of payments.

194 6. The Commission allowed the transaction to proceed, reserving the right to determine the ratemaking effect of the transaction at a later time. Assertions that the transaction was intended to effect a complete transfer of the directory publishing business, and that it did so, are not credible.

195 7. In 1988, U S WEST Dex proposed and PNB consented to the termination of the publishing fee that was an element of the 1984 transaction.

196 8. The Yellow Pages directory publishing business as of Dec. 31, 1983, was a valuable asset of Pacific Northwest Bell Telephone Co..

197 9. Neither PNB nor USWC has sought, and the Commission has not granted, regulatory approval for any transaction involving Yellow Pages publishing except the one described in the application in Cause No. U-83-159.

198 10. U S WEST in 1989 accepted the imputation of Yellow Pages publishing excess earnings until the practice is changed or terminated by later Commission order.

VII. CONCLUSIONS OF LAW

199 1. The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of this proceeding and the parties to the proceeding.

200 2. Chapter 80.12 RCW requires regulated public utilities to secure prior Commission approval of any sale or other disposal of an asset and provides that any sale or disposition without such approval is void.

201 3. Chapter 80.16 RCW requires regulated public utilities to secure prior approval for certain transactions with affiliates, and provides that the Commission has continuing jurisdiction over such transactions.

202 4. The transaction that the Commission approved in 1983 in Cause No. U-83-159 was a temporary transfer from PNB to Landmark of the right to publish directories on behalf of PNB that include Yellow Pages advertising, coupled with PNB's agreement to provide certain services to Landmark.

203 5. Neither PNB nor USWC has sought, and the Commission has not granted, regulatory approval for any transaction involving Yellow Pages publishing except the one described in the application in Cause No. U-83-159.

204 6. The transaction involving the Yellow Pages publishing function that the Commission approved in Cause No. U-83-159 did not vest Landmark with the complete and total permanent right to engage in the publishing business theretofore operated by PNB.

205 7. The Commission is not required by virtue of the Supreme Court decision of December 24, 1997, to terminate imputation to USWC of excess earnings from Yellow Pages publishing.

206 8. No facts appear of record that would render termination of the imputation to USWC of excess directory earnings consistent with the public interest.

207 9. The application for an accounting order terminating imputation should be denied.

VIII. ORDER

208 The Commission denie; U S WEST's request for an accounting order.

209 Dated and effective at Olympia, Washington this __ day of July, 2000.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

MARILYN SHOWALTER, Chairwoman

RICHARD HEMSTAD, Commissioner

WILLIAM R. GILLIS, Commissioner

NOTICE TO PARTIES: This is a final Order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this Order pursuant to RCW 34.05.470 and WAC 480-09-810, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-09-820(1).

Attachment 2

Information on Phone Directories Company From PDC Web Site

PHONE DIRECTORIES COMPANY
Canada United States

About Us
Products
Customer Service
Online Directories
Locations

ABOUT PHONE DIRECTORIES - History

The Place To Go For Your Business To Grow

In an effort to give a choice in products back to the consumer, Phone Directories Company (PDC) began publishing independent phone directories in 1973. At that time, our offices were located in Price, Utah. Shortly after the birth of this family owned and operated company, PDC moved to Colorado.

In 1978, the company moved again. The headquarters were then located in Orem, Utah where PDC now resides. Years of steady growth during that time period brought about a high level of respect from the business community. This respect grew and PDC began to expand nationwide.

PDC then made a shift in 1985. The owners relocated the company to their basement and made the decision to take only their top eight employees with them. To help with the transition, the forward-thinking owners provided options to their employees that were ahead of their time. Day care was provided for the convenience of the employees. Realizing that not everyone works on the same schedule, the owners also allowed employees to work on flextime schedules. The team responded to these conveniences, and the company grew.

After two years in the basement and some streamlining, revenues began to rise. This increase in revenue helped the company grow in directions ownership had envisioned for years. This growth has moved us away from the basement into our current Orem, Utah facility. Our 30,000 square foot building houses more than 300 employees.

PDC is currently one of North America's largest independent telephone directories publishers. We distribute telephone books to more than 130 markets throughout the U.S. and Canada. The total number of books distributed in 1998 totaled more than 3.0 million.

PDC is a leader in providing an innovative source of information for the businesses and communities it serves. It is our goal to become the standard of excellence in the phone directory industry by providing quality phone directories uniquely tailored to the customer's needs.

Attachment 3

Information on Arizona Yellow Pages Market
From Yellow Pages Publishers Association Web Site

Directories by State	Code	Pub Code	Pub Initials	Close Date	Pub Date	Issue Length	WP Close Date	Pop (000)	#Co	Distribution	PPub Date	PIssue Length	Split Run
ARIZONA (AZ)													
Ahwatukee	003061	0760	SWG	03/14/01	05/01			52	3	34,736	05/00		
Apache Junction	003034	0754	SD	07/01/01	11/01			25	3	37,370	11/00		
Apache Junction	003037	0833	PDC	05/30/01	11/01		05/30/01	40	2	25,000	11/00		
Bellaire-West Univ	101902	0754	SD	05/05/01	09/01		05/05/01	90	2		09/01		
Carefree-Cave Creek	003116	0754	SD	09/20/00	03/01		09/20/00	38	2	30,000	03/00		
Casa Grande	003120	0738	USW	11/13/00	01/01		12/04/00	73	2	41,827	01/00		
Casa Grande	003123	0833	PDC	03/06/01	08/01		03/06/01	75	2	24,500	07/00	13	
CaveCreek-Crfree-Ant	101702	0786	NDC	08/04/01	11/01		08/04/01	28	3		11/00		
Chandler-Gilbert	003134	0754	SD	12/10/00	04/01			75	3	75,520	03/00	13	
Clifton-Safford	003670	0738	USW	09/01/00	11/00		09/22/00	32	2	17,436	11/99		
Cochise County	003145	0738	USW	08/30/01	12/01		09/20/01	111	2	75,526	12/00		
Flagstaff	003271	0833	PDC	04/12/01	08/01		04/12/01	95	2	51,500	08/00		
Flagstaff	003270	0738	USW	02/01/01	04/01		02/22/01	154	2	126,848	04/00		
Flagstaff-N Arizona	101505	0915	JHZ	09/20/00	12/00			165	3	80,000	12/00		
Fountain Hills	003287	0754	SD	11/15/00	03/01		11/15/00	29	2	12,000	03/00		
Gila River	100517	0621	CDK	05/25/01	09/01		05/25/01	10	2	4,500	09/00		
Globe	003320	0738	USW	01/03/01	03/01		01/24/01	70	2	20,715	03/00		
Green Valley	003351	0760	SWG	11/19/00	02/01			38	3	25,415	02/00		
Keams Canyon	003391	0558	LMB	05/19/01	09/01		05/26/01	9	2	3,566	09/00		
Kingman	003406	0833	PDC	06/30/01	11/01		06/30/01	15	2	28,500	11/00		
Lower Colorado Riv	003067	0833	PDC	05/23/01	10/01		05/23/01	150	2	41,500	10/00		
Mesa	100088	0786	NDC	01/22/01	04/01		01/22/01	307	3	185,000	04/00		
Mesa	003418	0754	SD	04/01/01	07/01		04/01/01	384	3	115,000	07/00		
Mohave County	003431	0738	USW	06/09/01	09/01		06/30/01	107	2	105,516	09/00		
Mohave County	003395	0558	LMB	08/11/01	12/01		08/18/01	145	4	142,697	12/00		
NE Arizona-Holbrook	003361	0833	PDC	02/03/01	07/01		02/03/01	60	2	38,000	06/00	13	
Nogales Santa Cruz	003476	0833	PDC	11/03/00	04/01		11/03/00	38	2	21,500	03/00	13	
Nogales-Green Valley	003470	0738	USW	08/15/01	11/01		09/05/01	60	2	37,031	11/00		
Page Lk Powell Kane	003504	0833	PDC	03/05/01	07/01		03/05/01	20	2	19,900	07/00		

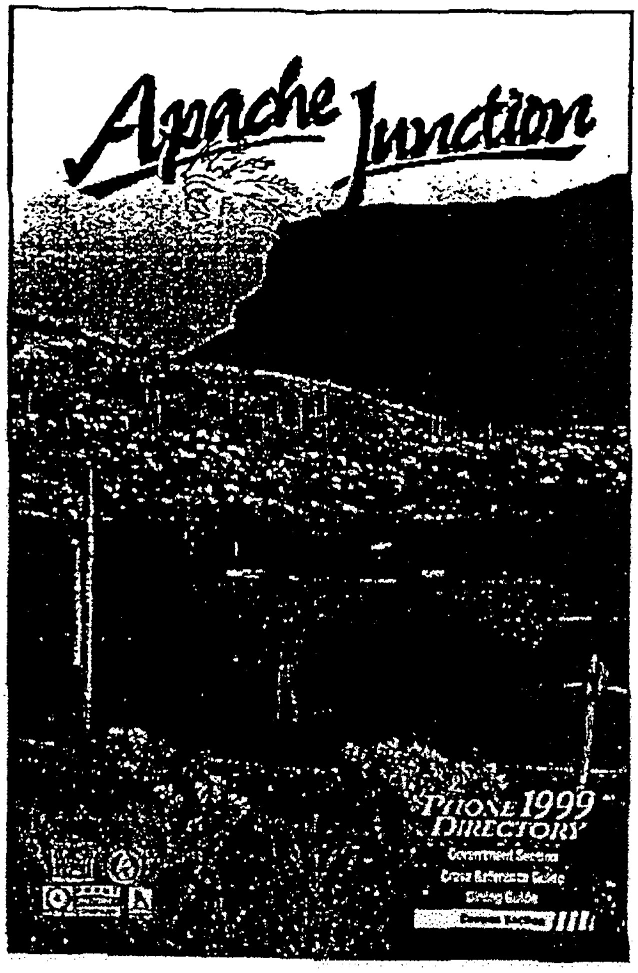
DIRECTORY INDEX

Directories by State	Code	Pub Code	Pub Initials	Close Date	Pub Date	Issue Length	WP Close Date	Pop (000)	#Co	Distribution	PPub Date	PIssue Length	Split Run
Page-Lake Powell	003507	0790	WVA	03/01/01	05/01			6	2	22,000	05/00		
Paradise Valley	003511	0754	SD	11/15/00	03/01		11/15/00	20	2	12,000	03/00		
Parker	003520	0682	VZ	01/19/01	05/01		02/09/01	12	2	38,085	05/00		
Payson	003545	0738	USW	01/04/01	03/01		01/25/01	19	2	18,284	03/00		
Payson	003547	0833	PDC	12/26/00	06/01		12/26/00	50	2	21,500	05/00	13	
Phoenix E Valley(W)	003420	0738	USW	06/20/01	09/01		07/11/01	755	3	442,572	09/00		
Phoenix E Valley(Y)	003421	0738	USW	06/20/01	09/01		07/11/01	755	4	442,572	09/00		
Phoenix North	101637	0786	NDC	07/14/01	10/01		07/14/01	275	3		10/00		
Phoenix On The Go	100152	0738	USW	03/12/01	06/01		04/02/01	500	3		06/00		
Phoenix(W)	003569	0738	USW	11/27/00	03/01		12/18/00	2312	3	1,015,247	03/00		
Phoenix(Y)	003570	0738	USW	11/27/00	03/01		12/18/00	2401	4	1,336,405	03/00		
Phoenix-Gr Nw Valley	003800	0738	USW	06/07/01	09/01		06/28/01	758	3	384,802	09/00		
Phoenix-Gr Sw Valley	003070	0738	USW	06/07/01	09/01		06/28/01	78	3	33,710	09/00		
Phoenix-Scottsdale	003745	0738	USW	06/07/01	09/01		06/28/01	338	3	238,602	09/00		
Prescot & TriCity AW	100360	0915	JHZ	02/24/01	06/01		02/24/01	80	3	52,000	06/00		
Prescott	003620	0738	USW	01/23/01	04/01		02/13/01	77	2	68,214	04/00		
Prescott-Verde Vly	003622	0833	PDC	02/09/01	07/01		02/09/01	109	2	55,000	06/00	13	
Scottsdale C Phoenix	100086	0786	NDC	10/06/00	01/01		10/06/00	301	3	165,000	01/00		
Scottsdale North	100085	0786	NDC	09/08/00	12/00		09/08/00	192	3	60,000	12/99		
Sedona-Verde Valley	003747	0833	PDC	03/28/01	08/01		03/28/01	25	2	36,300	08/00		
Show Low	003370	0558	LMB	12/15/00	04/01		12/29/00	70	3	77,426	04/00		
Sierra Vista	003754	0833	PDC	09/29/00	02/01		09/29/00	48	2	33,000	02/00		
So Central Arizona	003756	0833	PDC	03/26/01	08/01		03/26/01	43	2	25,000	08/00		
Southeastern Arizona	003758	0833	PDC	10/18/00	03/01		10/18/00	45	2	33,000	02/00	13	
Sun City-Visto-SdlBk	003765	0760	SWG	02/28/01	05/01			7	2	8,119	05/00		
Sun Cty-Sun Cty West	003763	0760	SWG	08/14/01	11/01			90	3	62,466	11/00		
Tempe	100087	0786	NDC	03/12/01	06/01		03/12/01	319	3	215,000	06/00		
Tempe	003766	0754	SD	05/01/01	09/01			238	3	84,000	09/00		
Tucson Central	003776	0738	USW	10/12/00	01/01		11/02/00	354	2	102,286	01/00		
Tucson East	003777	0738	USW	10/11/00	01/01		11/01/00	446	2	181,265	01/00		
Tucson North-Nw	003778	0738	USW	10/11/00	01/01		11/01/00	298	2	153,639	01/00		
Tucson Regional	003597	0835	WPZ	11/15/00	02/01			750	4	316,000	02/00		
Tucson(W)c	003773	0738	USW	05/01/01	08/01		05/22/01	722	3	464,541	08/00		
Tucson(Y)	003771	0738	USW	05/01/01	08/01		05/22/01	722	4	464,541	08/00		
White Mountain	003806	0833	PDC	02/08/01	07/01		02/08/01	42	2	36,000	06/00	13	
Wickenburg	003820	0738	USW	11/20/00	02/01		12/11/00	15	2	11,773	02/00		
Window Rock	003865	0558	LMB	09/15/00	01/01		09/29/00	155	2	29,768	01/00		
Winslow	003870	0738	USW	02/07/01	04/01		02/28/01	23	2	13,591	04/00		
Yuma	003920	0738	USW	12/18/00	02/01		01/08/01	136	2	102,999	03/00	11	
Yuma Metro	003921	0833	PDC	06/03/01	10/01		06/03/01	86	2	65,000	10/00		

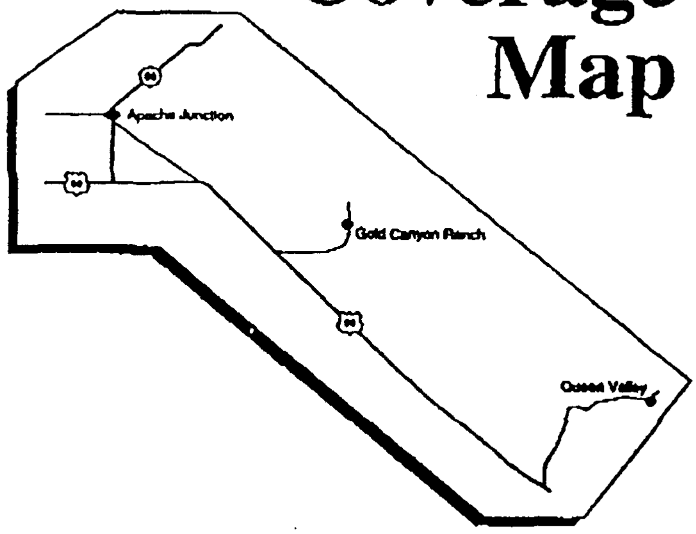
Attachment 4

Phone Directories Company
Information Sheets on its Arizona Directories

PHONE DIRECTORIES COMPANY



Apache Junction Phone Directory Coverage Map



Directory YPPA #: 003037
State(s) & Area Code(s): AZ (520, 602)
Counties: Pinal
Directory Area Population: 18,500
Approximate Directory Circulation: 25,000
Produced Since: 1998
Directory Code: AJC

This Directory Serves Your Local Market Area - Covering All Or Portions Of The Following Utility Directories:

Globe....................USW Phoenix East Valley...USW

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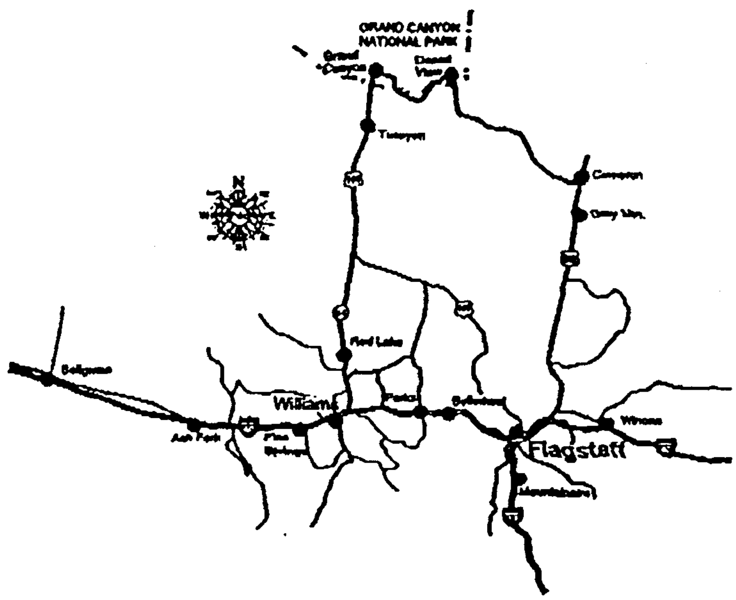
Flagstaff Directory Area Coverage Map



This Directory Serves Your Local Market Area - Covering All Or Portions Of The Following Utility Directories:

Flagstaff.................USW

Directory YPPA #: 003271
State(s) & Area Code(s): AZ (520)
Counties: Coconino
Yavapi
Directory Area
Population: 54,600
Directory Circulation: 50,000
Produced Since: 1994
Directory Code: FLG

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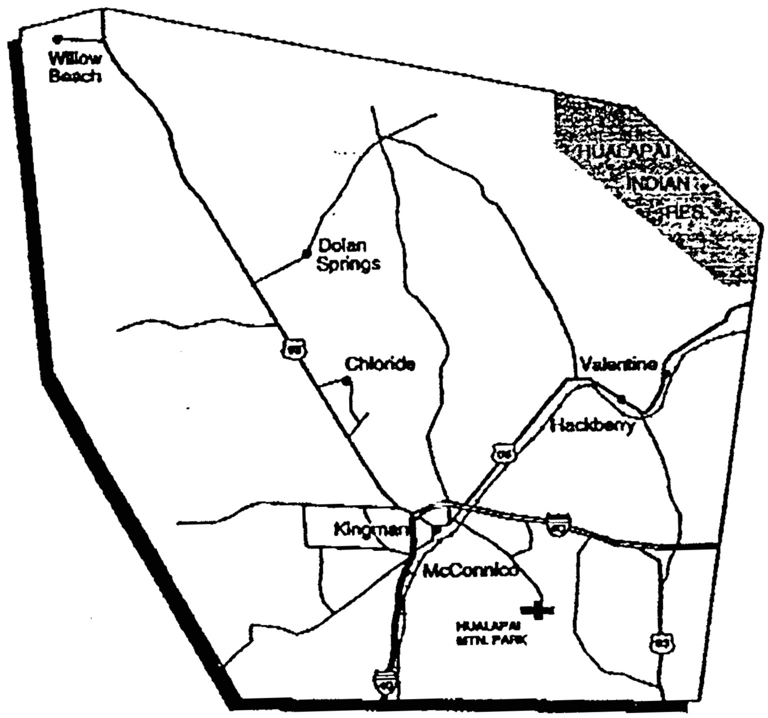
Kingman Directory Area Coverage Map



This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Mohave Co	LMB
Mohave Co	USW

Directory YPPA #:	03406
State(s) & Area Code(s):	AZ (520)
Counties:	Mohave
Directory Area Population:	14,697
Directory Circulation:	28,500
Produced Since:	1994
Directory Code:	KIN

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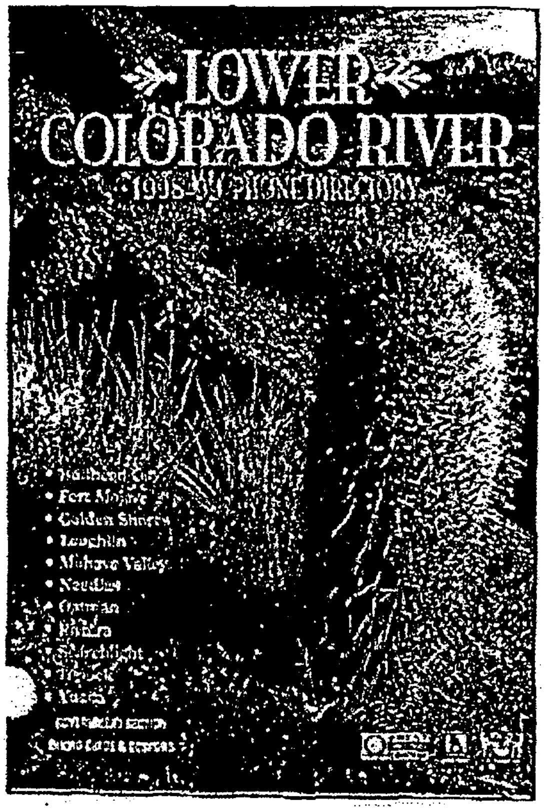

Lower Colorado River Directory Area Coverage Map

Directory YPPA #:	003067
State(s) & Area Code(s):	AZ (520) CA (619) NV (702)
Counties:	AZ - Mohave CA - San Bernardino NV - Clark
Directory Area Population:	41,575
Directory Circulation:	41,000
Produced Since:	1994
Directory Code:	LCR

This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Laughlin.........RHD/CNT
Mohave Co..............LMB
Mohave Co D..........USW
Needles.....................GTD

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Toll Free: 1-800-553-0801
If you are interested in having a salesperson contact you, please call:
(801) 225-0801 • FAX (801) 225-0991

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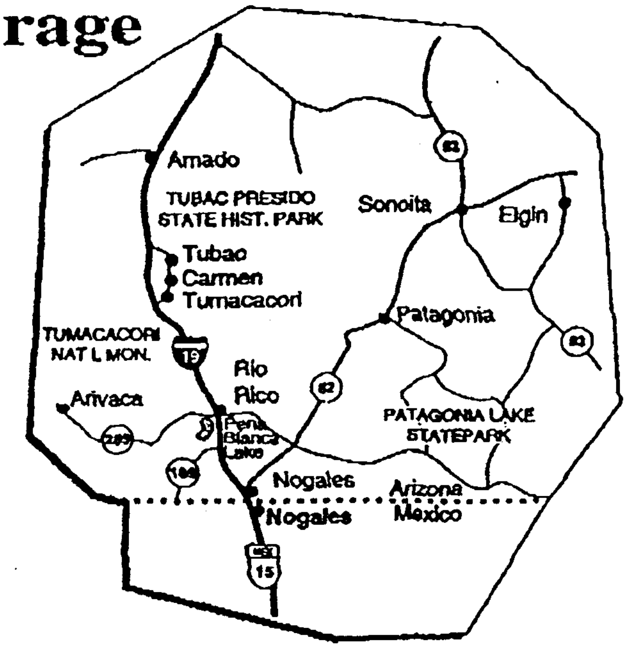
Nogales Directory Area Coverage Map



This Directory Serves Your Local Market Area - Covering All Or Portions Of The Following Utility Directories:

Nogales - Green Valley	USW
Sonora Nogales	Mexico

Directory YPPA #:	03476
State(s) & Area Code(s):	AZ (520) Mexico
Counties:	AZ - Pima & Santa Cruz Mexico - Sonora
Directory Area Population:	32,000
Directory Circulation:	21,500
Produced Since:	1986
Directory Code:	NOG

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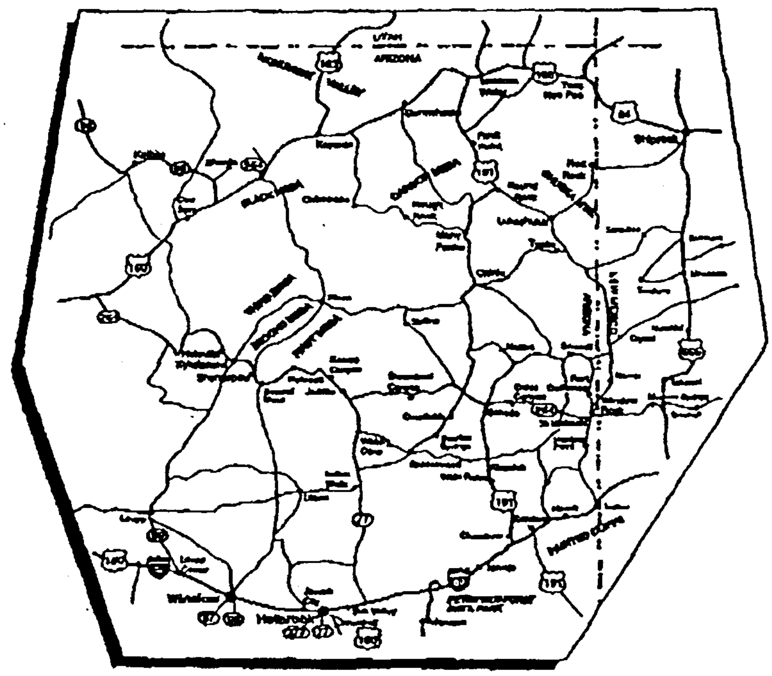
Northeast Arizona Directory Area Coverage Map



This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Gallup	USW
Canyon	LEM
Window Rock	GTE
Show Low	ADS
Winslow	USW

Directory YPPA #:	003361
State(s) & Area Code(s):	AZ (520)
Counties:	AZ - Navajo Coconino Apache NM - McKinley San Juan
Directory Area Population:	60,381
Directory Circulation:	38,000
Produced Since:	1988
Directory Code:	HOL

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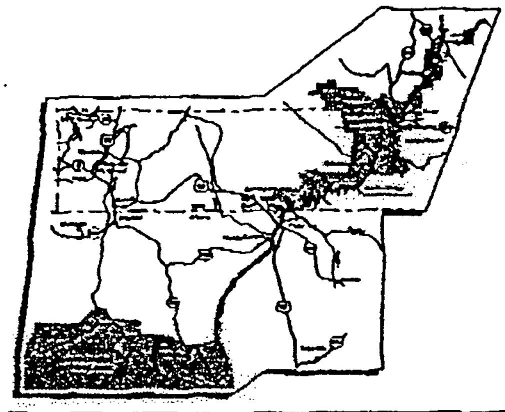
Page/Kane County Directory Area Coverage Map



Directory YPPA #:	003504
State(s) & Area Code(s):	AZ (520)
	UT (801)
Counties:	AZ - Mohave
	Navajo
	Coconino
	UT - Kane
	Garfield
	San Juan
Directory Area Population:	19,893
Directory Circulation:	19,900
Produced Since:	1986
Directory Code:	PAG

This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Flagstaff............USW
Moab................LEM
Southern Utah.....USW
Window Rock......GTE

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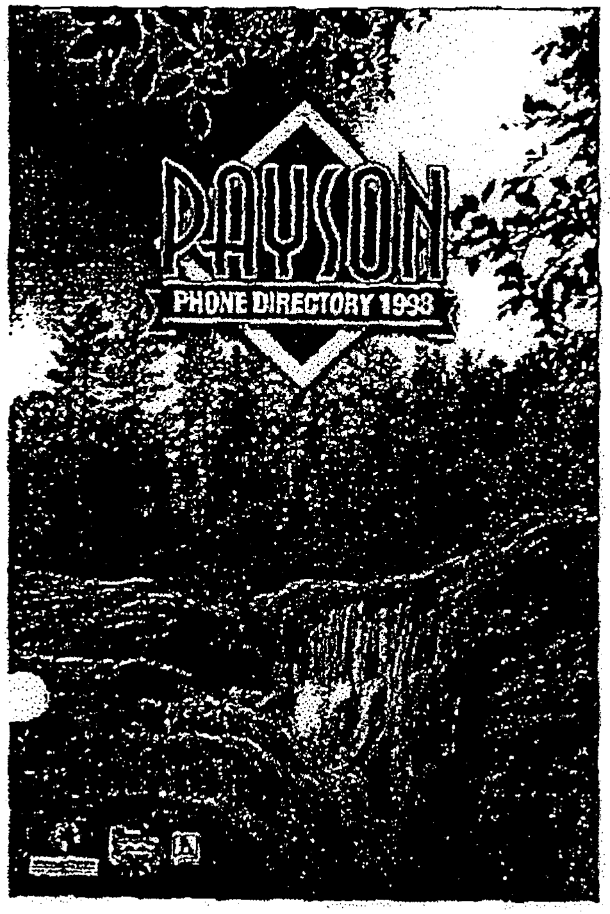
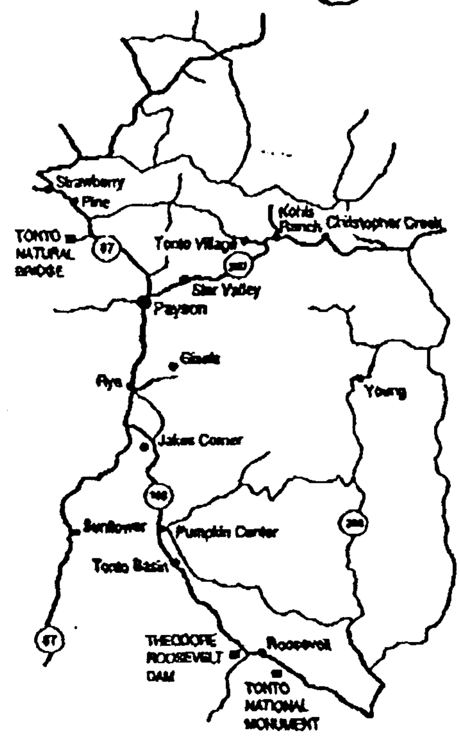


Payson Directory Area Coverage Map



This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Payson.........USW

Directory YPPA #:	003547
State(s) & Area Code(s):	AZ (520)
Counties:	Gila
Directory Area Population:	13,097
Approximate Directory Circulation:	21,500
Produced Since:	1995
Directory Code:	PAY

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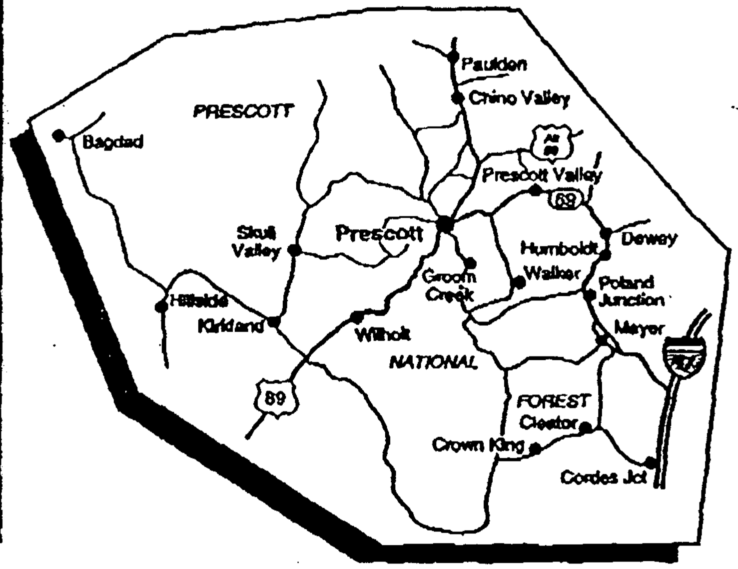
Prescott Directory Area Coverage Map



This Directory Serves Your Local Market Area - Covering All Or Portions Of The Following Utility Directories:

Prescott..................USW

Directory YPPA #:	003622
State(s) & Area Code(s):	AZ (520)
Counties:	Yavapai
Directory Area Population:	87,488
Approx. Directory Circulation:	55,000
Produced Since:	1992
Directory Code:	PRE

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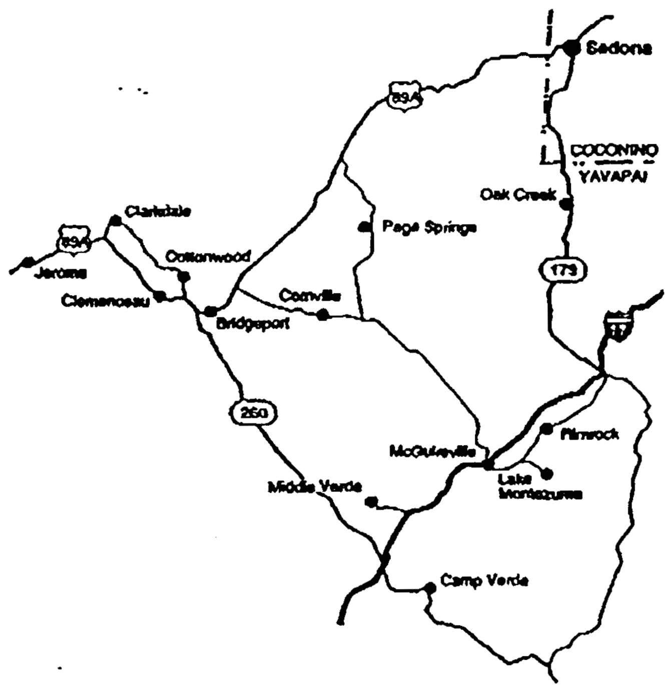
Sedona Directory Area Coverage Map



This Directory Serves Your Local Market Area - Covering All Or Portions Of The Following Utility Directories:

Flagstaff......................	USW

Directory YPPA #:	003747
State(s) & Area Code(s):	AZ (520)
Counties:	Coconino Yavapai
Directory Area Population:	22,808
Directory Circulation:	40,000
Produced Since:	1977
Directory Code:	SED

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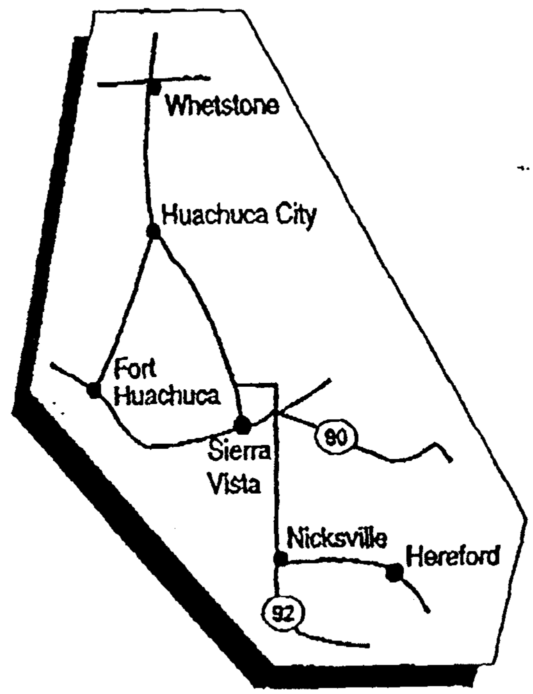
Sierra Vista Directory Area Coverage Map



This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Cochise County...USW

Directory YPPA #:	003754
State(s) & Area Code(s):	AZ (520)
Counties:	Cochise
Directory Area Population:	36,921
Approximate Directory Circulation:	33,000
Produced Since:	1982
Directory Code:	VIS

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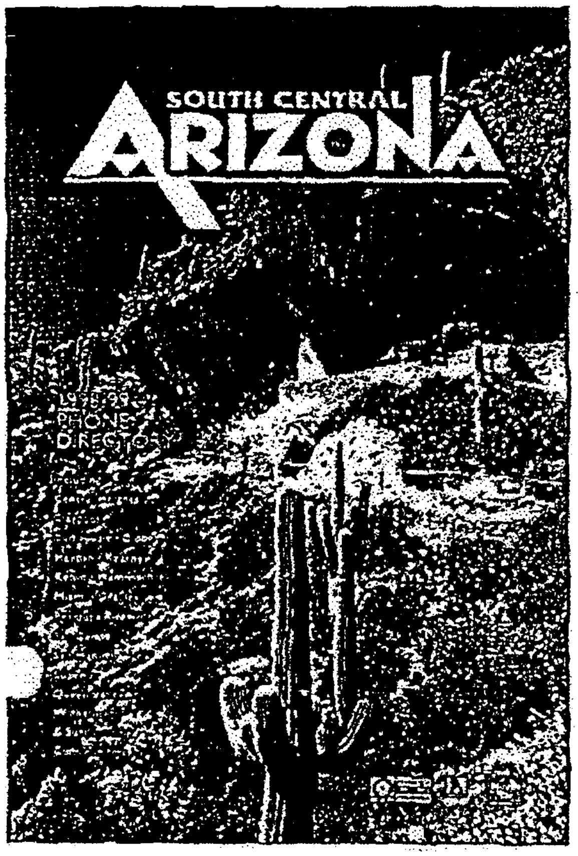
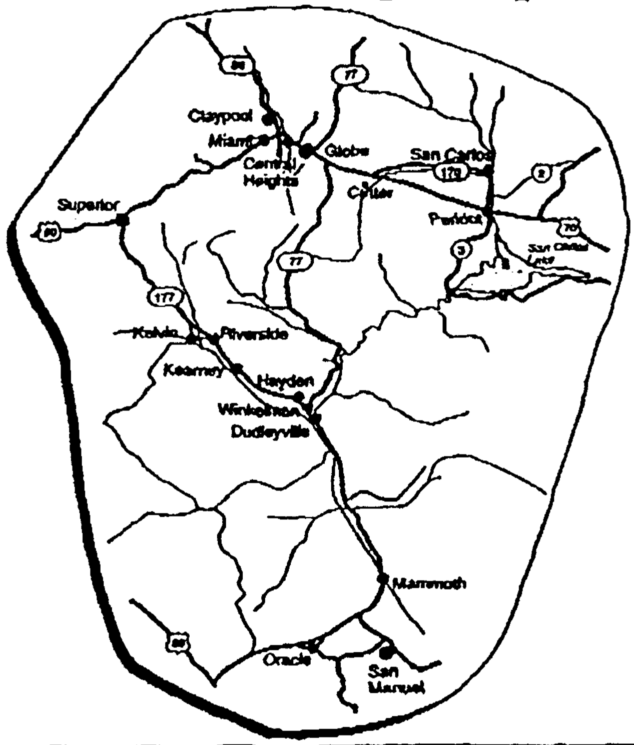


South Central Arizona Directory
Area Coverage Map



This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Casa Grande	USW
Globe	USW
San Manual	USW

Directory YPPA #:	003756
State(s) & Area Code(s):	AZ (520)
Counties:	Pinal Gila
Directory Area Population:	42,594
Approximate Directory Circulation:	25,000
Produced Since:	1995
Directory Code:	SCA

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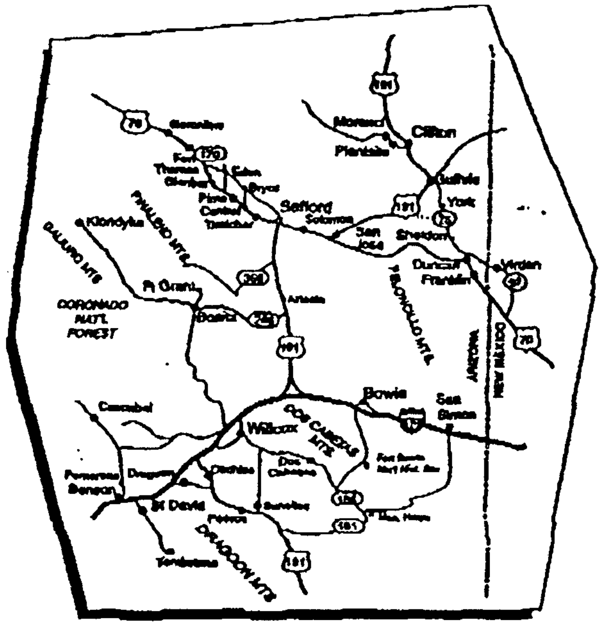
South East Arizona Directory Area Coverage Map



This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Cochise County........	USW
Safford....................	USW

Directory YPPA #:	003758
State(s) & Area Code(s):	AZ (520) & NM (505)
Counties:	AZ - Graham Cochise, Greenlee, Gila NM - Hidalgo
Directory Area Population:	44,900
Approximate Directory Circulation:	33,000
Produced Since:	1985
Directory Code:	SAZ

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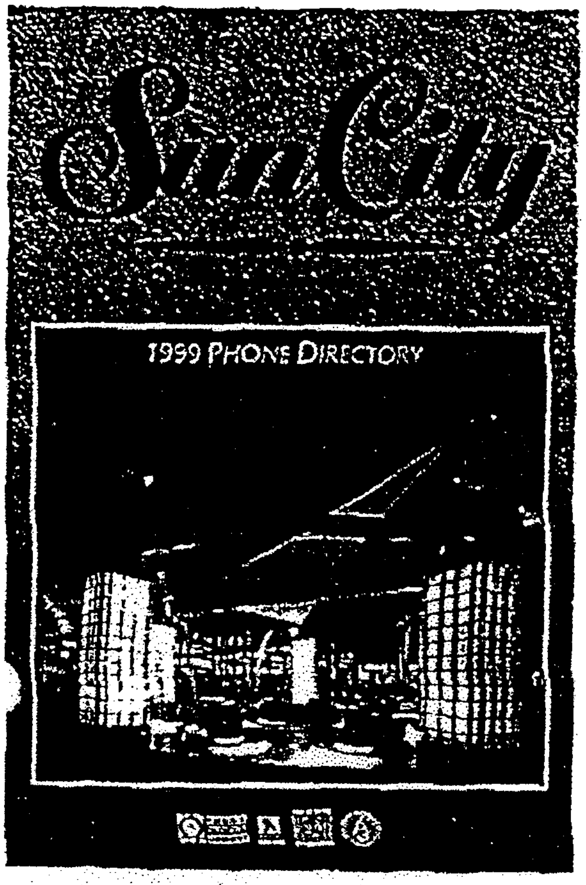
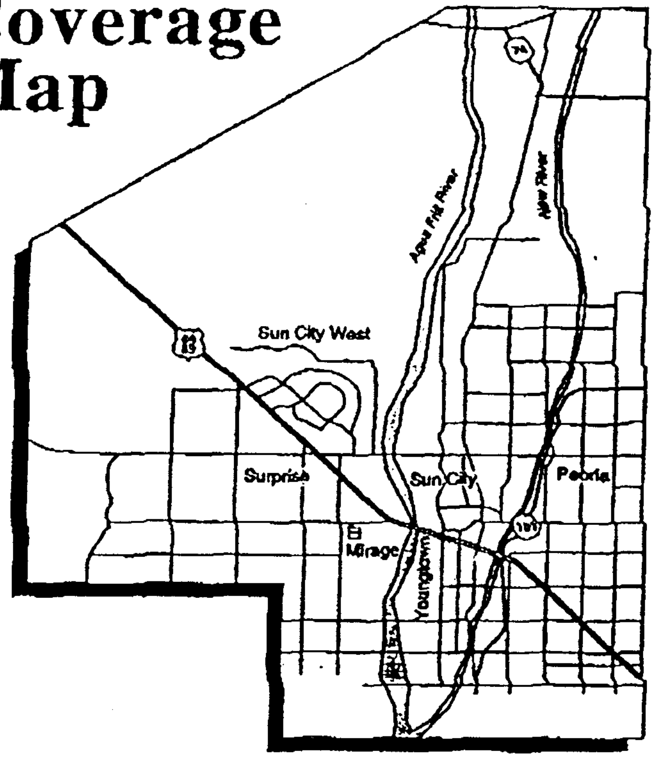


Sun City / Sun City West Directory Area Coverage Map



This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Greater Northwest Valley...USW

Directory YPPA #: 003764
State(s) & Area Code(s): AZ (602)
Counties: Maricopa
Directory Area Population: 123,762
Approximate Directory Circulation: 56,500
Produced Since: 1996
Directory Code: SWP

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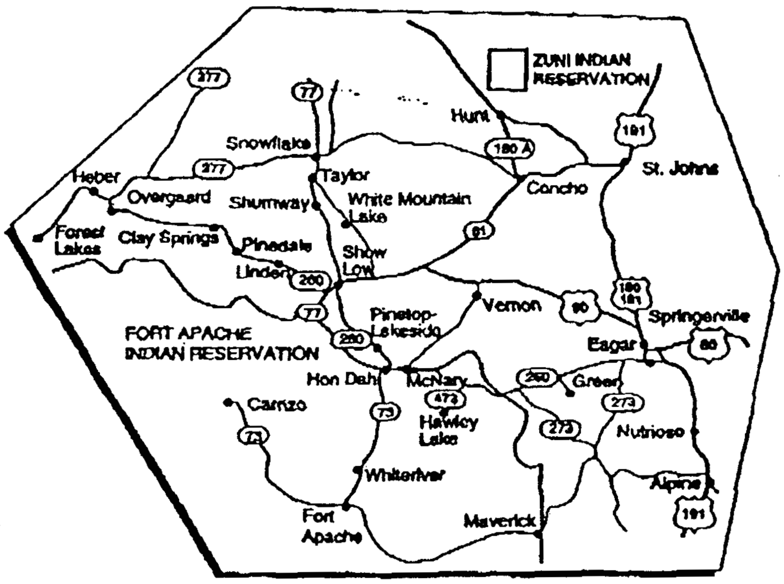
White Mountain Directory Area Coverage Map



This Directory Serves Your Local Market Area

Directory YPPA #:	003806
State(s) & Area Code(s):	AZ (520)
Directory Circulation:	36,000
Directory Code:	WHI

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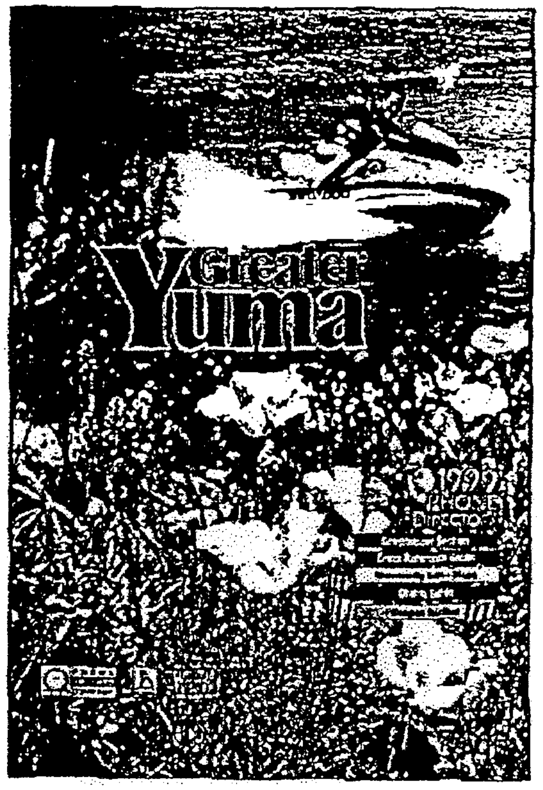
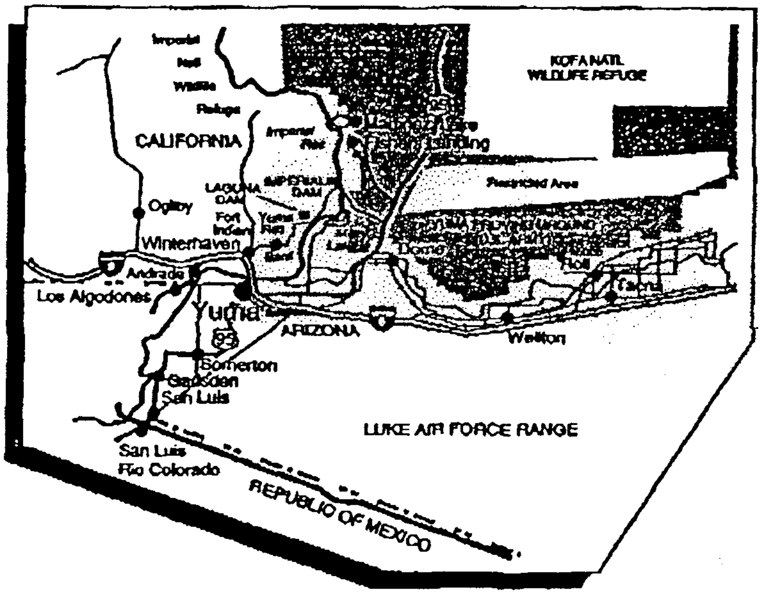


Yuma Directory Area Coverage Map



This Directory Serves Your Market Area - Covering All Or Portions Of The Following Utility Directories:

Imperial Co............	PAC
Yuma......................	USW
Mexicali..................	Telnor

Directory YPPA #:	003921
State(s) & Area Code(s):	AZ (520)
	CA (619)
Counties:	AZ - Yuma
	CA - Imperial
	Mexico
Directory Area Population:	84,706
Directory Circulation:	65,000
Produced Since:	1994
Directory Code:	YUM

Phone Directories Co. Inc.
A UTAH and ALASKA CORPORATION
PO BOX 887 PROVO, UT 84603-0887
yellow pages (801) 225-0801 • FAX (801) 223-1285

Attachment 5

Cover pages of US West/DEX Yellow Pages Directories

(Qwest Response to UTI-43-011)

Arizona
Docket No. T-1051B-99-105
UTI 43-011

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 011

At page 14 of her supplemental direct testimony, Ms. Koehler-Christensen refers to the covers of Dex directories. Please provide copies of the front and back covers of the five largest white and yellow pages directories published in Arizona by Dex, before and after the policy change referenced at line 8.

RESPONSE:

Attachment A provides copies of the current front covers on DEX's five largest directories in Arizona. Directories published before this policy change are in archives and copies of the front covers will be provided as soon as they can be retrieved. This is estimated to be approximately one week. Back covers of DEX directories are paid advertising and are not relevant to this request.

Ann Koehler-Christensen
Manager
1600 7th Avenue, Rm. 3008
Seattle, WA

ARIZONA
DOCKET NO. T-01051B-99-105
UTI 43-011
ATTACHMENT A

JSA
36USC380
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U.S. Olympic Team

Phoenix Metro

March 2000/2001

Area Codes 480, 520, 602, 623

USWEST Dex®

Your Directory Expert

The Greater Metro Edition

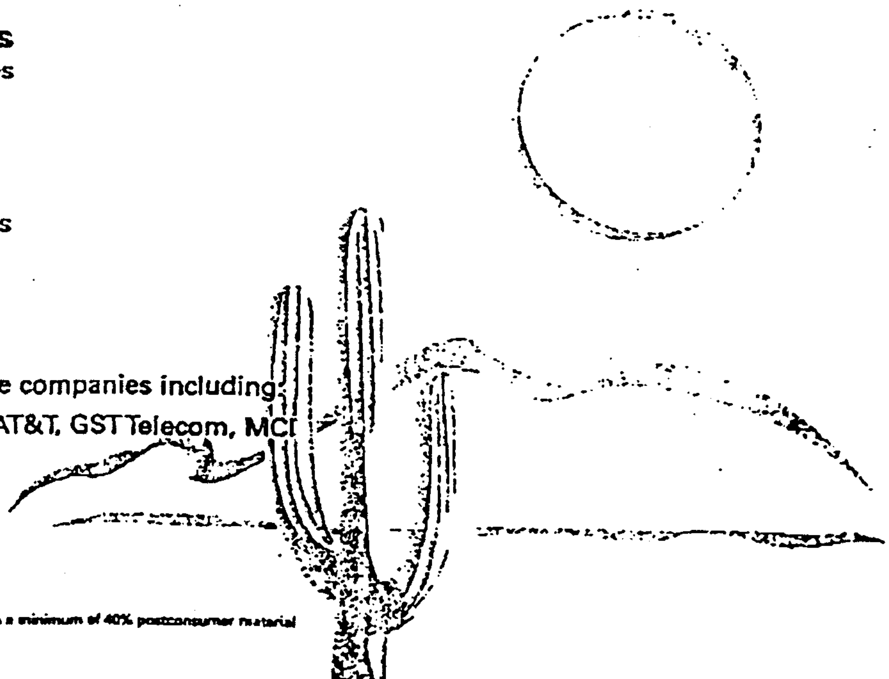
Residential White Pages For The Entire Phoenix Area

Internet Pointer
Look for this familiar symbol throughout the directory to locate Internet addresses

Phone Service Pages
See the Business White Pages

Government Pages
See the Business White Pages

Complete Listings
Listings for all local telephone companies including U S WEST, 1-800-RECONEX, AT&T, GST Telecom, MCI
See page one for details.



USA
36 USC 380
...icial Sponsor of the
...o U.S. Olympic Team

Phoenix Metro A-L

March 2000/2001

Area Codes 480, 520, 602, 623

U S WEST Dex®

Your Directory Expert

The Greater Metro Edition

Yellow Pages For The Entire Phoenix Area

Internet Pointer
Look for this familiar symbol throughout
the directory to locate Internet addresses

Audio Information
Look for this symbol for free
24-hour audio information

Complete Listings
Listings for all local telephone companies including:
U S WEST, 1-800-RECONEX, AT&T, GST Telecom, MCI
See page one for details.

Internet Guide
Preceding the Internet headings
in The Yellow Pages

GET AN IDEA

uswestdex.com
Turn on your Yellow Pages

USA
36 USC 380
icial Sponsor of the
U.S. Olympic Team

Tucson
and Surrounding Area
August 1999/2000

Area Code 520

US WEST Dex®
Your Directory Expert

The White Pages

Phone Service Pages
Information, tips & area codes

Government Pages
City, county, state & federal agencies

Business Listings
Following the residential listings

Complete Listings
Listings for all local telephone companies including:
U S WEST, 1-800-RECONEX, e.spire Communications, GST Telecom, Tohono O'odham Utility Authority
See page one for details.

uswestdex.com
Turn On Your Yellow Pages

The U S WEST Dex White Pages are printed with a minimum of 40% postconsumer material

S A
USC 380
Sponsor of the
S. Olympic Team

Tucson
and Surrounding Area
August 1998/1999

Area Code 520

U S WEST Dex

Your Directory Expert

The Yellow Pages

Audio Information
Look for this symbol for free
24-hour audio information

Community Pages
Events, maps & ZIP codes

Complete Listings
Listings for all local telephone companies including:
U S WEST, Arizona Telephone Co., e.spire Communications, Inc., MCI, Tohono O'Odham Utility Authority
See page one for details.

http://uswestdex.com
Visit our Internet Yellow Pages for
complete business listings

New! Internet Guide
See the "Internet Products & Services" heading in the Yellow Pages

The U S WEST Dex Yellow Pages are printed with a minimum of 40% postconsumer material

USA
36USC380
Sponsor of the U.S. Olympic Team

East Valley

Mesa • Tempe • Chandler

Ahwatukee, Apache Junction, Chandler Heights, Gilbert, Guadalupe, Higley, Palm Springs, Queen Creek, Sun Lakes, Superstition

September 1999/2000

Area Codes 480, 520, 602, 623

USWEST Dex®

Your Directory Expert

The White Pages

Phone Service Pages
Information, tips & area codes

Government Pages
City, county, state & federal agencies

Business Listings
Following the residential listings

Complete Listings
Listings for all local telephone companies including:
U S WEST, 1-800-RECONEX, AT&T Local Services, GST Telecom, MCI/Worldcom

See page one for details.

uswestdex.com
Turn On Your Yellow Pages

The U S WEST Dex White Pages are printed with a minimum of 40% postconsumer material

Sponsor of the
U.S. Olympic Team

East Valley

Mesa • Tempe • Chandler

Ahwatukee, Apache Junction, Chandler Heights, Gilbert, Guadalupe, Higley, Palm Springs, Queen Creek, Sun Lakes, Superstition

September 1999/2000

Area Codes 480, 520, 602, 623

USWEST Dex®

Your Directory Expert

The Yellow Pages

Audio Information
Look for this symbol for free 24-hour audio information

New! Internet Guide
Preceding the Internet headings in The Yellow Pages

Complete Listings
Listings for all local telephone companies including:
U S WEST, 1-800-RECONEX, AT&T Local Services, GST Telecom, MCI/Worldcom
See page one for details.

http://uswestdex.com
Visit uswestdex.com to get the most accurate business information for your area

Phoenix Coyotes Schedule
See fold-out tab for hockey information

GET AN IDEA.

The U S WEST Dex Yellow Pages are printed with a minimum of 40% postconsumer material

USA
36 USC 380
...ial Sponsor of the U.S. Olympic Team

Scottsdale Paradise Valley

Arcadia–East Phoenix, Biltmore, Carefree, Cave Creek, Fort McDowell, Fountain Hills, Rio Verde, Town of Paradise Valley

September 1999/2000

Area Codes 480, 602, 623

USWEST Dex®

Your Directory Expert

The White & Yellow Pages

New! Internet Guide
Preceding the Internet headings in The Yellow Pages

Government Pages
City, county, state & federal agencies

Complete Listings
Listings for all local telephone companies including:
U S WEST, 1-800-RECONEX, AT&T Local Services, GST Telecom, MCI/Worldcom
See page one for details.

http://uswestdex.com
Visit uswestdex.com to get the most accurate business information for your area

Phoenix Coyotes Schedule
See fold-out tab for hockey information

GET AN IDEA.

The U S WEST Dex White & Yellow Pages are printed with a minimum of 40% postconsumer material

Greater Northwest Valley

Sun City • Sun City West

Black Canyon City, Central Corridor, Christown, Deer Valley, El Mirage, Glendale, Litchfield Park, Luke AFB, Moon Valley, New River, Peoria, Phoenix (West Side), Sunnyslope, Surprise, Youngtown

September 1998/1999

Area Code 602

USWEST Dex®

Your Directory Expert

The White & Yellow Pages

Community Pages
Events, maps & ZIP codes

Government Pages
City, county, state & federal agencies

Complete Listings
Listings for all local telephone companies including:
U S WEST, GST Telecom, MCI, 1-800-RECONEX
See page one for details.

http://uswestdex.com
Visit our Internet Yellow Pages for complete business listings

Phoenix Coyotes Schedule
See fold-out tab for hockey information

EXHIBIT
ATT 10
admitted

LEE L. SELWYN — SUMMARY AND SURREBUTTAL

In my supplemental testimony, I expressed concern about the proposed settlement's treatment of "Basket 2" services. I noted that the proposed settlement would create a mechanism under which a retail/wholesale "price squeeze" could occur because *retail* prices would be decreasing for noncompetitive Basket 1 services and for some "competitive" services in Basket 3, while at the same time Basket 2 *wholesale* rates remained unchanged. In his responsive testimony, Mr. McIntyre for Qwest and Mr. Dunkel for the Staff dismiss this possibility, arguing that Basket 2 rates would be set or changed pursuant to pricing rules established in the federal *Telecommunications Act of 1996* ("Act") and by the FCC.[1] However, neither witness has elected to even address, let alone rebut, the price squeeze issue with respect to *UNE rates*, which will also be classified in Basket 2. The settlement would freeze UNE rates, denying them the same productivity benefit being afforded retail Basket 1 services. UNE rates are supposed to be based upon *cost*, and neither the Company nor the Staff has explained why the *costs* of providing UNEs would not also experience the same productivity-based reductions as would the cost of providing retail Basket 1 services. Accordingly, Basket 2 UNE rates should receive exactly the same X-factor/PCI treatment as applies for the retail Basket 1 services *of which the UNEs are components*. Moreover, UNE *rates*, not Qwest's costs, should be imputed into the price floor for all Basket 3 services.

I have also expressed the concern that the pricing rules that the proposed settlement would establish for Basket 3 services may be anticompetitive because Qwest could reduce prices *selectively* where a service faced actual competition while increasing it where no current competition is present. This would be possible because, in determining that a given service satisfied A.A.C. R14-2-1108, the Commission was required to apply this standard *statewide* rather than limiting it to those geographical areas where competition is actually present. I note with some interest that the Company and Staff appear to have different understandings as to what services are eligible for Basket 3 treatment. According to Mr.

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1. McIntyre (Qwest) rebuttal at 9, Dunkel (Staff), rebuttal at 11-12. If rates for bundled wholesale services offered for resale will be maintained pursuant to Sec. 252(d)(3) of the *Act* and will be adjusted proportionately with changes in the *retail* prices as these witnesses contend, my concern at least with respect to bundled wholesale rates would be resolved.

Teitzel for Qwest, "services in [Basket 3] are competitive *or non-essential.*[2] However, "non-essential" services that do not confront effective competition have not been found by the Commission to satisfy A.A.C. R14-2-1108. Mr. Shooshan for the Staff, by contrast, appears to believe that only those services that the Commission has found to have satisfied A.A.C. R14-2-1108 are eligible for Basket 3 treatment:

> Simply put, Qwest will find it very difficult – at least in the long run — to sustain price increases on Basket 3 services *that are out of line with marketplace conditions*, unless it wants to lose customers. In its classification decisions, the Commission has, in effect, *determined that competitive marketplace forces are sufficiently strong for these services to provide a reasonable check on Qwest's pricing.*[3]

Mr. Shooshan is, of course, in error, because noncompetitive "non-essential" services, including those vertical features that can have no existence independent of the monopoly basic exchange access line, as well as all "new" services, are to be afforded Basket 3 pricing treatment. For these services, competitive marketplace forces are nonexistent, and thus cannot be relied upon "to provide a reasonable check on Qwest's pricing."

Mr. Teitzel appears to contend that Qwest would not be able to apply geographic pricing to Basket 3 services, citing a series of "restrictions" including, *inter alia*, A.A.C. R14-2-1109. *Nothing in any of the "restrictions" he cites or in A.A.C. R14-2-1109 would preclude Qwest from increasing its prices in, for example, rural areas while reducing them in the Phoenix and Tucson metros.* Additionally, I note that one of the specific restrictions he cites, contained at Section 4(k) of the proposed settlement, would "prohibit[] cross-subsidization of competitive services by non-competitive services." By Mr. Teitzel's own admission — i.e., that Basket 3 includes "non-essential" services for which no A.A.C. R14-2-1108 finding has been made — within Basket 3 are both competitive and non-competitive services and, as long as the *Basket cap* is not exceeded, there is nothing in the price cap plan that would prevent Qwest from raising prices of non-competitive "non-essential" services while setting rates for its truly competitive services at the TSLRIC floor. As Mr. Dunkel would appear to agree, this tactic would relieve the competitive service of making any contribution toward the common/joint/shared costs of the Company's operations.

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2. Teitzel (Qwest), rebuttal at 2, emphasis supplied.

3. Shooshan (Staff), rebuttal at 7, emphasis supplied.

Moreover, while both Mr. Shooshan for the Staff and Mr. Teitzel for Qwest contend that the "price floor at TSLRIC" requirement forecloses the possibility of anticompetitive pricing,[4] it would appear that Mr. Dunkel for the Staff would disagree with that position. According to Mr. Dunkel, "the TSLRIC floor excludes all joint and common costs," and so "[t]he reasonable, proper, *and subsidy-free price* for a service is a price that is between the TSLRIC floor and the SAC [stand-alone cost] ceiling."[5] Mr. Dunkel goes on to observe that "[p]ricing above the direct cost or TSLRIC of a service is how the common/joint/shared costs of a company are recovered."[6] If Basket 3 services are priced *at* TSLRIC, then no contribution toward the common/joint/shared costs will be made, and these "competitive" services will get a "free ride" on the common/joint/shared costs that are being charged to and recovered from *monopoly* basic services. Staff has offered no basis upon which different standards should be applied to competitive and access services — i.e., TSLRIC for competitive services, and TSLRIC-plus-common/joint/shared costs for access services.

Contrary to Mr. Dunkel's claim, reductions in access charges to parity with interstate will not result in rates that fail to recover the common/joint/shared costs associated with the subscriber line. Mr. Dunkel confuses the issue of cost recovery with the manner in which traffic-sensitive and non-traffic-sensitive costs are recovered through usage-based and fixed monthly charges. The Carrier Common Line Charge (CCLC), which has been eliminated in the interstate access rate structure, improperly imposes a usage-sensitive charge to recover a non-usage-sensitive cost. The costs of the subscriber line do not vary with the volume of access usage, and it is economically inefficient for usage-based rates to be inflated to recover loop costs. And contrary to Mr. McIntyre's utterly baseless claim to the contrary,[7] there is

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4. Shooshan (Staff), at 9-10, Teitzel (Qwest) at 9-11.

5. Dunkel (Staff), rebuttal at 4, emphasis supplied.

6. *Id.*, at 6.

7. McIntyre (Qwest), rebuttal at 7. The sole basis for Mr. McIntyre's contention that the effect of stimulation should be ignored is his claim that "stimulation modeling is a very inexact science." *Id.* While there has indeed been considerable debate over the years as to the correct quantification of the demand elasticity for intrastate toll, *no credible study has ever contended that toll or access price elasticity is zero*, which is what Mr. McIntyre claims. I would note that the California PUC, in its 1994-95 rate rebalancing proceeding, devoted an (continued...)

ample historical evidence that access charge decreases *will be flowed-through to consumers* in the form of lower toll rates, and the lower toll rates *will stimulate additional and beneficial use of the public switched network*, usage that is currently being *suppressed* as a result of the *excessive* non-cost-based intrastate access charges.

Finally, I feel compelled to address the comments of Ms. Arnold for Qwest and Mr. Shooshan for the Staff on the matter of the X-factor. Both witnesses emphasize the feature of the proposed settlement's price cap formula that would prevent rates from increasing if the annual inflation rate were to exceed 4.2%. Indeed, Ms. Arnold goes so far as to portray this as "a significant concession on [Qwest's] part that it will be prohibited from raising rates in years when inflation exceeds the productivity offset."[8] The US inflation rate has been in the range of about 2%-3% or less for at least the past eight years and is expected to stay there; indeed, the last year in which the change in the GDP-PI exceeded 4.2% was 1982! Qwest's acceptance of this limitation is more of an "empty gesture" than a "significant concession."

As to the 4.2% X-factor itself, which Mr. Redding claims to be "near the top of the range" of X-factors approved by state PUCs,[9] none of the Company or Staff witnesses have addressed the fact that, by limiting the X-factor to Basket 1 and by permitting Basket 3 rates to rise by as much as 10%, the *effective X-factor* applicable across *all* of Qwest's intrastate operations will be perilously close to zero, putting it at the *bottom*, not the top, of the "range." Mr. Redding also mischaracterizes my testimony when he states that I am "not adverse to a jurisdictional productivity factor."[10] What Mr. Redding conveniently omits from his recitation of my testimony is that a jurisdictional productivity factor would be appropriate *so long as both the FCC and the state commissions adopted consistent positions*. Since Qwest is subject to a total company 6.5% X-factor in the federal jurisdiction, it should similarly be subject to this same X-factor for its Arizona intrastate services.

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7. (...continued)
extensive amount of time to this issue and concluded that the price elasticity for *intraLATA* toll was –0.50. California Public Utilities Commission, *Implementation and Rate Design (IRD)* order in *Phase III* of I.87-11-033, D.94-09-065, 56 CPUC 2d 117, 203-206.

8. Arnold (Qwest), rebuttal at 5.

9. Redding (Qwest) at 15-16.

10. *Id.*, at 13.

Before the

Arizona Corporation Commission

In the Matter of the Application of US West Communications, Inc., A Colorado Corporation, for a hearing to determine the earnings of the company, the fair value of the company for rate-making purposes, to fix a just and reasonable rate of return thereon and to approve rate schedules	)	DOCKET NO. T-01051B-99-0105

Testimony of

JOHN B. LEGLER

On Behalf of the

RESIDENTIAL UTILITY CONSUMER OFFICE

August 2000

EXHIBIT
RUCO-4
admitted

TABLE OF CONTENTS

Testimony of John B. Legler

Before The

Arizona Corporation Commission

DOCKET NO. T-01051B-99-0105

Q. PLEASE STATE YOUR NAME AND ADDRESS.

A. John B. Legler, 1040 St. Andrews Court, Bogart Georgia 30622.

Q. ON WHOSE BEHALF ARE YOU APPEARING?

A. I am appearing on behalf of the Residential Utility Consumer Office. My academic affiliation until my recent retirement was professor of Banking and Finance in the Terry College of Business at the University of Georgia, Athens, Georgia. This testimony represents the opinion of the author. It carries no official endorsement by the University of Georgia.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE?

A. I received my B. A. with Honors in Economics from Allegheny College in 1962, and my M.S. and Ph.D. degrees in Economics from Purdue University in 1965 and 1967, respectively. I was an assistant professor of economics at Washington University, St. Louis, Missouri, where I also served as the Assistant Director of the Institute for Urban and Regional Studies from 1966-1971. I joined the University of Georgia faculty in the Fall of 1971 as an associate professor of

Banking and Finance. From 1971 to 1974, I served as administrator of the Research Division in the Institute of Government in addition to my teaching duties in the Department of Banking and Finance. I became Director of the Georgia Economic Forecasting Project on July 1, 1974 and served in that capacity until September 15, 1982. I was promoted to full professor in 1977. I have been a consultant to federal, state and local government agencies in Alabama, Arizona, California, Connecticut, Florida, Georgia, Hawaii, Illinois, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, Missouri, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, Virginia and Washington. My consulting has been mainly in areas of economic forecasting, governmental finance, and the cost of capital. I have testified before the House Utilities Study Committee of the Georgia Legislature, the State Board of Equalization in Georgia, the Chatham County (Savannah) Superior Court, and the National Association of Security Dealers.

My publications include many articles in professional journals, books and monographs. I am a member of Beta Gamma Sigma, a business honorary. Until recently I was a research associate of the National Bureau of Economic Research, Inc.

Q. **HAVE YOU SUBMITTED TESTIMONY IN OTHER HEARINGS BEFORE PUBLIC SERVICE COMMISSIONS OR OTHER REGULATORY AGENCIES?**

A. Yes, I have testified extensively before Commissions on the cost of capital. My participation in hearings before regulatory agencies is indicated in Schedule 1. I have submitted testimony and/or testified before this Commission on several occasions.

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

A. I was retained to prepare a study on which to base an independent estimate of US West's cost of equity and overall cost of capital to be presented to the Commission.

Q. **HAVE YOU REVIEWED THE TESTIMONY ON THE COST OF CAPITAL SUBMITTED BY THE COMPANY IN THIS CASE?**

A. Yes, I have. I have reviewed the testimony of Mr. Peter C. Cummings. Mr. Cummings recommends a cost of equity of 14% which I find to be excessive.

Q. **DO YOU HAVE ANY GENERAL COMMENTS ON THE APPLICATION OF FINANCE THEORY TO THE REGULATORY PROCESS BEFORE DEVELOPING YOUR ESTIMATE OF THE COST OF EQUITY?**

A. It is my opinion that the application of finance theory can provide help and guidance in the decision process, but that the issue of the fair rate of return is still largely judgmental. This is particularly true with respect to the return on equity component of the overall rate of return. Each finance theory suffers from the necessity of making crucial assumptions requiring judgment in the process of its application. Although proponents of any particular theory tend to minimize or even overlook the importance of the necessary assumptions, often the assumptions that are necessarily made are crucial to their results. It is for this reason that I use several methods to estimate the cost of equity capital, using one method to check on the reasonableness of another. In addition, using several methods enables me to estimate a range rather than a single value for the rate of return on equity. I believe that providing the Commission with a zone of reasonableness with respect to the cost of equity capital permits the Commission the flexibility of weighing other factors such as the rate base and capital structure in its decision, with the assurance that the estimate of the cost of capital is within a reasonable range. I believe that, should this Commission adopt my recommendation, the Company would be afforded the opportunity to earn a fair rate of return consistent with the <u>Hope</u> and <u>Bluefield</u> decisions.

It is also my opinion that reasoned judgment is important at this time because of the volatility in the markets. The results of mechanical approaches to estimating the cost of equity are likely to change even on a daily basis. While these changes in the calculated cost of equity may be relevant for market investment decisions, I believe that estimating the cost of equity for ratemaking purposes must take a longer term view.

Q. HOW DO YOU PROPOSE TO ORGANIZE YOUR TESTIMONY?

A. For US West, my testimony is divided into the specific tasks necessary to arrive at the overall cost of capital. First, I discuss the appropriate capital structure. Next, I discuss the cost of debt, and develop the cost of common equity. The last task applies the cost of debt and the cost of common equity to the capital structure thereby determining a weighted average cost of capital.

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS IN THIS PROCEEDING.

A. I recommend that the Company's proposal to use a cost rate for common equity of 13.00% be rejected. I recommend that a cost of common equity of 11.50% be adopted based on the Company's proposed capital structure and embedded cost rates for debt. My recommendations are summarized in an overall weighted average cost of capital of 9.51% compared to the Company's requested 10.86%.

Capital Structure

Q. WHAT CAPITAL STRUCTURE DO YOU ADOPT FOR PURPOSES OF CALCULATING A WEIGHTED AVERAGE COST OF CAPITAL?

A. I have consistently supported the use of a consolidated capital structure approach for telephone utilities in recent years. With the increasing activity in the nonregulated sector of the business, I believe that separating the capital structure into regulated and nonregulated is reasonable. Accordingly, in principle, I support the use of the US West-AZ capital structure limited to regulated activities.

The capital structure for USWC-Arizona is shown in Mr. Cummings testimony dated May 3, 2000. I have long supported the updating of capital structure, and should a more recent capital structure and embedded cost rates become available, I believe that the capital structure should be updated. The capital structure as of February 2000 consisted of 39.77% long-term debt, 7.80% short-term debt, and 52.4% common equity. I find a capital structure with an equity ratio of less than 60% to be reasonable in comparison to other telephone companies. I do note that this capital structure includes short-term debt, and it appears that the short-term debt balance changes considerably over time. I will use this capital structure in making my weighted average cost of capital calculations pending a possible update. I consider this capital structure to be tentative, but the issue of the capital structure is likely to be swamped by differences in the estimates of the cost of common equity among the witnesses.

Cost of Debt

Q. WHAT IS THE BASIS FOR DETERMINING THE COST OF DEBT?

A. The cost incurred by the Company for debt is determined in the capital market at the time the debt is issued. Once issued, the debt becomes, in effect, a contractual arrangement between the Company and the investor. The cost will remain constant during the term of the investment and will not be altered by changes in the Company's financial integrity or general economic conditions. Thus, the cost of debt is the weighted average cost of the Company's embedded debt.

Q. WHAT COST RATE HAVE YOU ASSIGNED TO US WEST'S LONG-TERM DEBT?

A. I have consistently adopted the position that embedded cost rates should be updated for known and measurable changes. The embedded cost rate should be consistent with the adopted capital structure if an actual capital structure is used. Accordingly, an embedded cost rate consistent with the capital structure as of February 2000 would be appropriate. It is approximately 7.54%. I am assuming that this rate is an actual rate for debt that has been placed and does not involve any forecasted rates. As in the case of the capital structure, should more recent embedded cost rates become available, the weighted cost of debt should be updated.

Q. WHAT COST OF SHORT-TERM DEBT SHOULD BE USED IN CALCULATING THE WEIGHTED AVERAGE COST OF CAPITAL?

A. Similar to the cost of long-term debt, the cost rate for short-term debt should be consistent with the adopted capital structure. Since I am assuming that the short-term debt balance is for debt in place, I will accept the Company's proposed rate. I also believe that this rate should be updated, if possible.

Cost of Equity

Q. PLEASE DESCRIBE THE METHODS YOU USE IN ESTIMATING THE COST OF EQUITY CAPITAL FOR US WEST.

A. The cost of common equity is a forward looking cost rate in typical rate cases, and this is no exception. Therefore, the standard methods used in rate cases are appropriate in this case. I have considered two methods to estimate the cost of equity capital: (1) applications of finance theory, and (2) the comparable earnings approach. There are several applications of finance theory that may be considered: (1) the Capital Asset Pricing Model (CAPM), (2) the bond yield plus risk premium method, and (3) the dividend yield plus growth or simply the DCF method. The traditional comparable earnings method estimates the rate of return directly by analyzing rates of return on book equity earned by other companies with similar risks. The applications of finance theory rely on data on stock market returns and are considered indirect measures. The ultimate task requires that these returns on market be translated into return on book for regulatory purposes.

Q. ARE THESE THE SAME METHODS YOU HAVE USED IN COST OF CAPITAL TESTIMONY BEFORE THIS AND OTHER REGULATORY COMMISSIONS?

A. Yes, they are. Over the years I have made certain refinements in my testimony, but the basic methods remain the same. I have performed the same basic analysis that I have used in testimony before Commissions for many years.

Discounted Cash Flow Method

Q. **DID YOU USE THE "DIVIDEND YIELD PLUS GROWTH RATE METHOD" TO ASSIST IN ESTIMATING THE COST OF EQUITY FOR U.S.WEST?**

A. Yes, I did.

Q. **PLEASE EXPLAIN THE METHOD AND HOW YOU USED IT IN THIS CASE.**

A. This method recognizes that investors in stocks expect to receive total returns consisting of dividends and capital gains. Although investors may in fact suffer capital losses, it is reasonable to assume that most investors would not buy a common stock unless there were reasonably good prospects that the stock would increase in value over time.

Since US West-Arizona stock is not publicly traded, a proxy must be used in implementing this method. As a first approximation, the parent corporation is often used where the estimate for a subsidiary is involved. Since there is considerable merger activity in the industry, I have applied the DCF method to data for groups of independent telephone companies and the remaining Bell Regional Holding Companies.

The basic equation used to describe this method, which is commonly known as the DCF method and is widely used in rate of return testimony, is:

$$k = D_1/P_0 + g$$

where,

k = the cost of equity

D_1 = the dividend next period

P_0 = the market price of the stock

g = the expected growth rate.

This is a "constant growth model"; and in its simplest form it is assumed that a company has a constant payout ratio and its earnings are expected to grow at a constant rate. Thus, if a stock has a market price of $30 a share and an expected annual dividend in the coming year of $3 a share, and if its earnings were expected to grow at 5% a year, then the cost of equity for the company is the 10% dividend yield plus the growth rate of 5% or a total of 15%.

Q. DO YOU BELIEVE THAT THE ANNUAL VERSION OF THE DCF MODEL IS ADEQUATE FOR MEASURING A UTILITY'S COST OF EQUITY?

A. Yes, I do. The annual version of the DCF model typically is criticized for its failure to recognize that dividends are paid on a quarterly basis. In my opinion, it is important to remember the context in which the DCF model is being used. Essentially, the purpose of estimating the cost of equity is to enable the calculation of the revenues required to meet investors' return requirements. The ultimate question is with respect to the adequacy of the revenue dollars to meet those requirements. While it may be argued that reinvestment of quarterly dividends during the year has the effect of raising investors' expected returns compared to the returns produced by the annual version of the model, the reinvestment of earnings during the year also will provide additional compensation to investors. Clearly, dividends are not paid at the end of the year, but neither do ratepayers pay their bills at the end of the year. The irrelevance of the quarterly adjustment is considered in the professional literature in an article by Charles M. Linke and J. Kenton Zumwalt, "The Irrelevance of Compounding Frequency in Determining a Utility's Cost of Equity," which appeared in Financial Management, Volume 16, Number 3 (Autumn 1987), pages 65-69.

As a practical consideration, the accuracy of a quarterly dividend version of the DCF model depends on the validity of the assumptions made regarding the pattern of dividends and the timing of dividend increases. Obviously, it is invalid to assume that the quarterly dividend is increased each and every quarter. The computationally easy version of the quarterly model makes this assumption. A more rigorous version of the model assumes that the dividend will be increased once a year. If this is the assumption, the quarter in which the dividend is increased relative to the point in time the DCF estimate is calculated is relevant.

In this regard, although I have used the annual version of the model, my annual dividend for the groups of telephone companies assumes an increase based on a full year's growth. That is, the current dividend which in some cases may have just been increased is assumed to increase by a full year's growth [$D_1 = D_0(1 + g)$]. This in fact might create an upward bias in my estimates. Depending on the circumstances, the annual version of the model which I have used may actually produce a higher estimate of the cost of equity than the quarterly version of the model. I believe that it would be inappropriate to simply adjust my DCF results by adding an increment for the difference between annual and quarterly estimates to my results even if the Commission were to determine that the quarterly timing of dividends was important to the estimate of the cost of equity.

Marvin Rosenberg and Ronald N. Lafferty in an article, "The FERC's Discounted Cash Flow: The Right Direction Without Compromise," Public Utilities Fortnightly, February 4, 1988, pages 46-48, demonstrate that the quarterly dividend DCF model equates to the annual version of the DCF model with an adjustment of half the annual dividend growth. That is:

$$k = D_0(1 + .5g)/P_0 + g$$

Thus, if a stock has a market price of $30 a share and if the last annual dividend paid was $3 a share, and if its earnings were expected to grow at 5% a year, then the cost of equity for the company is an adjusted dividend yield of 10.25% plus the growth rate of 5% or a total of 15.25%. My annual version of the model basically assumes a growth rate of a full g compared to the .5g of this model.

It is clear that the quarterly compounding of dividends raises the expected return if applied in the customary way. The point is that it is unnecessary for regulators to provide this incremental return through allowed rates. Investors can obtain this incremental return for themselves simply by reinvesting their dividends if they so desire. Only if investors were required to leave their dividends in the firm, as is the case with time deposits in banks, would the quarterly adjustment for dividends have merit in the regulatory context.

Based on these considerations, I believe that the annual version of the DCF model is adequate for the purposes it is intended and the context in which it is used.

Q. **DO YOU BELIEVE THAT THE CONSTANT GROWTH VERSION OF THE DCF MODEL IS ADEQUATE FOR PURPOSES OF ESTIMATING THE COST OF EQUITY?**

A. Yes, I do, but certainly the results must be used with judgment in setting the cost of equity. The constant growth version of the model assumes that a company's dividends, earnings, book value and stock price increase at the same constant rate. I agree that dividends, earnings, and stock prices are not likely to grow at the same rate as required by the model. Indeed, the model can be modified to incorporate more than one growth rate. But this certainly adds to the mathematical complexity of the model and further complicates an already complicated process of selecting the growth rate.

I believe that it is important to consider what version of the model is likely to be used by <u>investors themselves</u>, not what another witness or I believe to be more acceptable. In this regard, I doubt that the average investor has the ability or inclination to attempt the mathematics required by the multiple growth version of the model. Under the constant growth version of the model it is relatively easy to determine the reasons for the differences in results among the witnesses which could benefit the Commission in its deliberations should another witness in this case submit testimony using the DCF method.

Q. PLEASE CONTINUE WITH YOUR DISCUSSION OF THE DCF METHOD.

A. The most difficult aspect of implementing the DCF method is estimating the future growth rate. If a company's past trend in growth has been erratic, it is difficult to project future growth on the basis of past trends.

Q. ARE THERE OTHER METHODS OF FORECASTING GROWTH RATES?

A. Another method used by security analysts is to estimate future growth based on the percentage of retained earnings and the rate of return on book equity. Quite simply, if we call the percentage of earnings retained (b), and multiply it by the rate of return on equity (R), the estimate of future growth (g) is: $g = b \times R$. For example, if a company earns 10% on equity, but pays all the earnings out in dividends, the "plowback" factor will be zero and earnings per share will not grow. Conversely, if the company retains all of its earnings and pays no dividend, it would grow at an annual rate of 10%.

Q. DOES THIS PROCEDURE FOR ESTIMATING FUTURE GROWTH REQUIRE ANY ASSUMPTIONS?

A. Three assumptions must hold for the procedure to produce an accurate (exactly correct) estimate:

1. The rate of return on equity is constant over time.
2. The percentage of retained earnings is constant over time.

3. The company sells no new common stock or sells it only at book.

While these assumptions have not held in the past for most utilities in general, it is the future, not the past, that is relevant. Also, while year to year fluctuations in the variables may be expected, the average return on equity and retention rate over time may be expected to be reasonably stable.

If a company were to sell common equity at above book value, proceeds from the sale possibly could be used to support a somewhat higher growth rate than suggested by the basic equation. Since most utility stocks are now selling well above book value, this is more of a consideration than when utility stocks were selling below book value. For this reason, I do not believe exclusive reliance should be placed on this method of estimating the dividend growth rate at this time.

In my opinion, the retention growth rate method provides a useful check on the sustainability of adopted growth rates. For any particular growth rate, the combinations of retention rates and returns on equity necessary to produce that growth rate can be determined. For example, we can see from the table below that for a growth rate of 6%, with retention rates of 25% to 40%, returns on equity from 15.0% to 24.0% must be sustainable.

Retention Rate	x	Return on Equity	=	Growth Rate
25%		24.0%		6.0%
30		20.0		6.0
35		17.1		6.0
40		15.0		6.0

In my opinion these returns and retention rates are unlikely on a sustainable basis. Accordingly, the acceptability of a 6.0% or higher growth rate in DCF calculations is questionable, and I believe even my estimates for individual companies reflecting growth rates above this level should be viewed with that premise.

Q. HAVE YOU APPLIED THIS TECHNIQUE TO THE GROUPS OF TELEPHONE COMPANIES?

A. Despite its limitations, it is still useful and I have applied it in this case. To apply it, we need two numbers, a company's expected retention rate and an estimate of its future return on common equity. Value Line projects a longer-term (2003-2005) earnings and dividend estimate for each of the telephone companies. Value Line also forecasts a longer-term (2003-2005) return on common equity for each company. I have used these Value Line projections to calculate the retention growth for each company. In applying the formula, I have increased Value Line's return on equity by 0.5% to reflect conversion from a year end to an average year basis. Value Line's direct dividend growth rate forecasts also were used as an alternative growth rate.

Q. **WHAT PRICES DID YOU ADOPT FOR PURPOSES OF YOUR DCF ESTIMATES?**

A. The price of a stock is likely to fluctuate from day to day because of market conditions and factors such as dividend payments. In my opinion, in applying the DCF method to a single company, it would be appropriate to use the average price of the Company's stock over a period of time rather than the price on a particular day. The time period is admittedly judgmental, but it is my opinion that it is still better than a spot price. The use of a spot price in a situation where there are wide swings in the stock market over relatively short periods of time makes the resulting DCF calculation very much dependent upon the particular day chosen to perform the analysis. While the most recent stock price may be quite relevant for market investment decisions based on DCF calculations, I believe the use of the DCF method for ratemaking purposes must take a longer term view.

I have consistently used three month average prices in my DCF analysis in testimony. I have also provided estimates using the closing prices on the last day of the three month period. I will continue my practice in this case. I believe that these prices are reflective of current market conditions while the average price smooths out day to day fluctuations. The current time period in this testimony is April 2000 through June 2000.

Q. WHAT DIVIDEND DO YOU ADOPT FOR PURPOSES OF THE DCF CALCULATION?

A. Conceptually, the appropriate dividend is the expected dividend for the coming year. Defined as D_1, it is equal to the current dividend times 1 plus the growth rate [$D_1 = D_0(1+g)$]. Utilizing this formula, the current dividend of each company was multiplied by one plus the growth rate based on either projected retention growth or <u>Value Line's</u> projected dividend growth rate. For the groups of telephone companies, the formula just described was applied to each company.

Q. WHAT DCF ESTIMATES OF THE COST OF EQUITY DID YOUR CALCULATIONS PRODUCE?

A. DCF calculations for the Bell Regionals and the independents are shown in Schedules 4 and 5. For the independent telephones the expected dividend yield was 1.62% based on prices as of June 30, 2000. The average retention growth rate was 13.15% with a resulting average estimated cost of equity of 14.77%. Based on <u>Value Line's</u> direct growth rate forecasts, the average expected dividend yield was 1.48% and the average growth rate was 7.1% resulting in an average expected return on equity of 8.61%. Based on average prices for April through June 2000 for the independent telephones, the returns averaged 14.79% and 8.62%, respectively.

For the Bell Regional Holding Companies, the expected dividend yield was 2.40% based on prices as of June 30, 2000. The average retention growth rate was 17.37% with a resulting average estimated cost of equity of 19.77%. Based on Value Line's direct growth rate forecast, the average expected dividend yield was 2.14% and the average growth rate was 4.0% resulting in an average expected return on equity of 6.14%. Based on average prices for the Aril through June 2000 time period, the returns averaged 19.68% and 6.06%, respectively.

Additional estimates were calulated based on average 5-year historical growth in earnings and dividends. The adjusted results are summarized below. For purposes of the historical estimates, those estimates below 8.50% were eliminated.

	Average Prices	June 30, 2000 Prices
Independent Telephones	13.58%	13.38%
Bell Regional Companies	13.19%	13.05%

Q. DO YOU BELIEVE THAT THESE AVERAGE EXPECTED RETURNS ON COMMON EQUITY ARE APPROPRIATE FOR US WEST?

A. I would not recommend this approach for estimating the expected return on equity to any individual company without examining the factors influencing a particular company. I do believe, however, that the averages are useful in forming a judgment about USW's cost of equity.

Although the companies are similar in certain respects, we would expect there to be some differences in perceived riskiness of the individual companies, and accordingly, would expect some variation in the estimated cost of equity by company.

Furthermore, based on Value Line projected dividend growth, some of the estimates fall below the currently prevailing bond yield on comparable risk long-term utility debt. For the independents, deleting the results for all but CenturyTel results in revised estimates of 19.79% based on June 30, 2000 prices and 19.83% based on average prices for the April through June 2000 time period.

Deleting the results below 8.50% for the Bell Regionals eliminates all of the estimates based on Value Line forecasted growth rates.

In reality, with the fundamental changes going on in the telecommunications industry, few of the individual DCF estimates make a great deal of sense. Fairly short-term dividend growth forecasts probably understate long-term prospects as diluted earnings are causing slower growth in dividends for some companies. For some companies stronger earnings growth and high returns on book equity result in very high retention growth rates.

I believe that it would be reasonable to give weight to all growth rates in estimating investor expected returns using the DCF method. I also believe that it would be reasonable to exclude all estimates which fall below 8.50%. Based on these considerations, the revised average DCF estimated returns are:

	Estimate Based on:	
	Average Prices	06/30/00 Prices
Independent Telephones		
Retention Growth	17.05%	17.03%
Projected Dividend Growth	19.83%	19.79%
Average Historical Growth	13.58%	13.38%
Bell Regional Holding Companies		
Retention Growth	19.68%	19.77%
Projected Dividend Growth	NA	NA
Average Historical Growth	13.19%	13.05%

Q. HAVE YOU EXAMINED THE RELATIVE RISKINESS OF US WEST TO THE GROUPS OF TELEPHONE COMPANIES?

A. Yes, I have. Risk differences may be divided into financial risk and business risk. Financial risk, as I am sure this Commission is aware, is concerned with the proportion of debt in a company's capital structure. The higher the proportion of debt, or conversely the lower the proportion of common equity, the greater the financial risk. As shown in Schedule 6, the average common equity ratio for the group of independent telephone companies was 41.0% in 1998 and is projected by Value Line to 47.9% in 1999. The average common equity ratio for the group of Bell Regional Holding companies was 52.0% in 1998 and is projected to be 56.5% in 1999. By comparison, US West's equity ratio was 8.0% in 1998 and is projected to be 11.0% in 1999.

Thus, in terms of financial risk, US West is above average risk in comparison to either the independents or the Bell Regional Holding Companies, on average, based on these Value Line estimates. The equity ratio for US West-Arizona suggests below average financial risk compared to the independents and somewhat above average risk compared to the Bell Regionals.

Business risk in a formal sense is defined as the uncertainty involved in the projections of future operating income. Many things can affect business risk and in the case of a utility, the size and economic base of a company's territory certainly would be one. General risk indicators, specifically Value Line's beta, Safety Rank, Financial Strength rating, and Price Stability Index for the groups of telephone companies, are shown in Schedule 7. Based on these measures, US West is somewhat more risky compared to the group of Bell Regionals on some measures and less risky on others. US West is less risky than the group of independent telephones based on the measures except Safety Rank and Financial Strength.

I recognize that it is almost impossible to select a sample of utilities which is strictly comparable to the company being reviewed. I do believe, however, that such calculations are useful and should be given weight by the Commission in its deliberations on the cost of equity. A broad sample of companies does have the advantage of "smoothing out" the inherent problems of estimating the growth rate for a single company. Given the rather diverse results from my application of the DCF method, I will comment on the meaningfulness of these results and propose a way of interpreting these results in my cost of equity summary section.

Risk Premium Method

Q. DID YOU USE THE "BOND YIELD PLUS RISK PREMIUM METHOD" TO ASSIST IN THE PREPARATION OF THE ESTIMATED COST OF EQUITY CAPITAL?

A. In virtually all the cases in which I have testified on the cost of capital I have utilized this method. Because of the volatile conditions in the bond market, there are problems with this method and its application in the traditional manner often used by analysts. I will discuss this method, the problems associated with it and why, at the present time, I do not believe exclusive reliance should be placed upon it for estimating the cost of equity. I do believe, however, that the Commission should give it consideration in setting the cost of equity. All methods suffer from the necessity of making assumptions and judgments in their application. The risk premium method is no exception.

Q. WHAT CONCLUSIONS HAVE YOU REACHED REGARDING THE RISK PREMIUM APPROACH?

A. I believe it should be used with care and be reflective of current conditions. Therefore, it should not stand on its own but be used in conjunction with other estimating techniques.

Q. WHAT IS THE THEORETICAL BASIS OF THE BOND YIELD PLUS RISK PREMIUM METHOD?

A. Basically, the theory suggests that the required rate of return is higher for riskier securities than less risky securities. Thus, normally we would expect that corporate bonds would carry a higher cost than U.S. Government securities. Accordingly, corporate equity securities would have a higher return than its debt. The theory usually is implemented by adding a risk premium to the yield on a company's long-term debt or utility bonds of the same rating. The yield on the company's long-term debt would be established by market conditions; and relative riskiness of a company's bonds, basically, is assessed by bond ratings. Alternatively, a risk premium may be developed relative to a risk-free U.S. Government security and the cost of equity estimated by applying that risk premium to the currently prevailing rate on the government security.

Q. IS A COMMON EQUITY INVESTMENT IN A PUBLIC UTILITY INVARIABLY MORE RISKY THAN AN INVESTMENT IN THE DEBT OF A PUBLIC UTILITY?

A. Circumstances may exist such that a negative risk premium or well below average risk premium may be calculated. The conventional approach states that equity is more risky than debt because the equity holder stands last in line as a claimant on the earnings of a corporation. Bonds represent a long-term commitment at a fixed interest rate. The return on common equity is not fixed at the time of purchase and will change in response to changing financial and economic conditions. Thus, in the case of a regulated industry, the return on common equity may be adjusted to reflect current money cost more than likely with some lag. In the case of the bondholder, however, no adjustment in the interest rate takes place after the bond is issued. If the bondholder did not correctly anticipate future rates of inflation at the time of purchase, the transaction may turn out to be a poor investment despite the fact that interest payments continue and the principal is repaid at maturity.

This additional risk is called interest-rate risk. It has nothing to do with the financial condition of the company issuing bonds and can only be protected against by demanding a higher interest rate when the bond is issued. In my opinion, this is one important reason for the high interest rates experienced during the 1980s, despite substantial slowing in the rate of inflation during that period. Investors recognize that interest rate risk is important and have demanded higher interest rates as protection against possible future worsening economic conditions and higher interest rates.

As a practical consideration bondholders have suffered low returns on public utility bonds for several decades despite the industry's good record of interest and principal payments. In my opinion, the perception that interest-rate risk is important has increased the relative riskiness of debt compared to equity.

Q. IS THE EXISTENCE OF A NEGATIVE RISK PREMIUM CRUCIAL TO YOUR REJECTION OF THE RISK PREMIUM METHOD AS THE PRIMARY METHOD OF ESIMATING THE COST OF EQUITY IN A RATE CASE.

A. No, it is not. The point of my risk premium discussion and presentation of data is not to establish a negative risk premium. The point that I am making is that the method as conventionally applied in rate cases may produce an unreliable estimate of the cost of equity. The conventional approach adds an average long-term risk premium calculated in a variety of ways to a current bond yield to arrive at a cost of equity. Implicitly, this assumes that the risk premium is constant. My analysis raises serious doubts about the validity of this assumption, and consequently, the usefulness of the method.

I do not disagree with the basic finance theory which indicates that investors expect higher returns on riskier investments. I do believe, however, that contemporary institutional market factors affecting relative risk should not be ignored for the sake of the simplicity found in historical relationships.

Q. DESPITE YOUR RESERVATIONS ABOUT THIS METHOD, HAVE YOU DONE ANY STUDIES OF RISK PREMIUMS FOR US WEST OR THE INDEPENDENT TELEPHONE COMPANIES?

A. Yes, I have prepared studies for US West and for a group of independent telephone companies. I have developed risk premiums based on a discounted cash flow approach. I based the necessary growth rates on <u>Value Line's</u> projected data for dividends per share, earnings per share and return on equity from its published reports on US West and the independent telephones. For US West, the dates of the <u>Value Line</u> reports and the necessary data are shown in Schedule 8. In addition, I performed the same analysis using <u>Value Line's</u> direct forecasted dividend growth rates from those same reports.

Q. WHAT RISK PREMIUM AND COST OF EQUITY DOES YOUR ANALYSIS INDICATE FOR US WEST?

A. The results of my study are shown in Schedules 8, 9 and 10. The schedules may be viewed in the following way: an estimate of the cost of equity for US West is made for the beginning of each quarter since the third quarter of 1984. It is then compared to the existing bond yield at the time which I have assumed to be the reported Moody's public utility bond yield for the Aaa rating class of the previous month. Alternatively, the expected return on US West stock is compared with the 30-year Treasury bond rate for the previous month. The expected risk premium is the difference between the DCF calculated return on equity and the then current bond yield, whether it is based on the Government bond rate or the utility bond rate. I have calculated the average risk premiums excluding negative values (and very low positive premiums). The calculated expected risk premium for US West averaged 3.92% relative to the utility bond yield and 4.80% relative to the Treasury bond rate for the period from the third quarter of 1984 to the first quarter of 1999 based on the DCF analysis using <u>Value Line's</u> retention growth. The risk premium based on the DCF estimated returns using <u>Value Line's</u> direct growth forecasts are lower. The average premiums based on the utility bond rate and the Treasury bond rate for the period from the third quarter of 1984 to the second quarter of 1994 averaged 2.80% and 3.68%, respectively. Risk premiums subsequent to the second quarter of 1994 were negative or very low, and I have excluded them from the analysis.

The current yield on 30-year U.S. government bonds is approximately 5.8% (as of mid-July 2000). As of late May 2000 the yield on Aaa rated public utility bonds is 8.13%. Moody's Public Utility Bond Yields are shown in Schedule 14.

Thus, adding the average long-term risk premiums (excluding negative values or very low positive values) to the current yield produces a required return in a range from 9.48% to 10.60% based on the 30-year Treasury bond rate and from 10.93% to 12.05% based on the Aaa utility bond rate.

<u>Based on Treasury Bond Rate:</u>

5.8% + 3.68% = 9.48%
5.8% + 4.80% = 10.60%

<u>Based on Aaa Utility Bond Rate:</u>

8.13% + 2.80% = 10.93%
8.13% + 3.92% = 12.05%

The risk premium study for the Independents is based on the same methodology as the study for US West except that annual rather than quarterly figures were used and the study encompasses the 1978-1999 time period. Essentially, the annual estimates are the same as the first quarter estimates of each year for the US West study. The calculated expected risk premium for the Independents averaged 5.48% relative to the Treasury Bond yield for the period from 1978 to 1999 based on the DCF analysis using <u>Value Line's</u> retention growth. For the last five years (1995-1999) the premium averaged 9.93%. The risk premiums based on the DCF estimated returns using <u>Value Line's</u> direct dividend growth forecasts are lower. The average premiums based on the Treasury Bond Yield are 3.10% and 1.07%, respectively. The current yield on 30-year U.S. government bonds is approximately 5.8% as of mid-July 2000. Thus, adding the average risk premiums for the entire period to the current yield produces a required return in a range from 8.90% to 11.28%. Adding the current yield to the shorter five year premiums places the required return in a range from 6.87% to 15.73%. For the reasons cited earlier in my testimony, I believe that these calculations should be supported by other estimating techniques to be meaningful, and in my opinion, there is little support for the short-term risk premium analysis.

<u>Longer-term Risk Premiums</u>:

5.8% + 3.10% = 8.90%
5.8% + 5.48% = 11.28%

<u>Shorter-term Risk Premiums:</u>

5.8% + 1.07% = 6.87%
5.8% + 9.93% = 15.73%

<u>The Capital Asset Pricing Model</u>

Q. DID YOU USE THE CAPITAL ASSET PRICING MODEL (CAPM) TO ESTIMATE THE COST OF EQUITY?

A. I consider the CAPM to be a subset of the risk premium approach. As with all the methods we use, assumptions are required in its implementation. I believe that there are fairly severe problems with the required data inputs usually employed by analysts using this method which result in internal inconsistencies. For this reason for many years, I did not to use this method in my testimony. Since the method is enjoying increased popularity among cost of capital witnesses, I feel compelled to comment on the use of this model and offer an estimate using the CAPM.

Q. CAN YOU BRIEFLY DESCRIBE THE CAPITAL ASSET PRICING MODEL?

A. Very briefly, the model states that the cost of equity to a company is equal to a risk-free rate, usually approximated by the yield on a government security, plus a risk adjusted premium for equity compared to the risk-free rate. The adjustment factor is called beta, which is a measure of the relative volatility of the stock in question to the volatility of the market. The equation used to estimate the cost of equity is:

$$k_j = k_{rf} + \beta(k_m - k_{rf})$$

where, k_j is the return on the stock

k_{rf} is the risk-free rate

β is beta

k_m is the return on the market

Q. CAN YOU BE MORE SPECIFIC ABOUT THE INTERNAL INCONSISTENCIES?

A. Yes, I can. Value Line betas are commonly used in the implementation of the capital asset pricing model (CAPM). The Value Line beta is an adjusted beta and the New York Stock Exchange Composite Index is used in its construction as a surrogate for the market. Merrill Lynch's betas are also adjusted much the same as Value Line's. A surrogate for the market in the Ibbotson study, which is frequently used to estimate the market premium, is the S&P 500. To the extent that the surrogate for the market and the estimating technique affects the beta, the estimated return will be affected. Since there is a high correlation between the return on the S&P 500 and the New York Stock Exchange Index, this is not of great concern, but certainly the use of an adjusted beta compared to a raw beta affects the estimated return very significantly.

The Value Line betas "are adjusted for their long-term tendency to converge toward 1.00." (Arnold Bernhard, How To Use The Value Line Investment Survey, page 61) The actual adjustment procedure involves the application of a regression equation which may be closely approximated by averaging the raw beta with 1.0 giving twice the weight to the raw beta. All stocks are adjusted in the same manner, and also, they are rounded to .00 or .05.

While the adjustment procedure may be appropriate for the construction of a risk indicator, the theoretical linkage between the adjusted beta and the CAPM model is tenuous, at best. I know of no recent empirical tests which indicate that the betas of all stocks converge towards 1.0 or even that the betas of utility stocks converge the same as other stocks. The CAPM, unlike the DCF, is a one period model. Thus, even if a forward looking beta is appropriate, the adjustment to the raw beta is too large to be realized in the near term. An article by M.J. Gombola and D.R. Kahl, "Time-Series Processes of Utility Betas: Implication for Forecasting Systematic Risk," which appeared in the Autumn 1990 issue of Financial Management suggests that the Value Line adjustment formula may not be appropriate for utilities. Furthermore, I also should point out that beta is estimated relative to a risk-free rate. The estimated beta will vary depending upon whether a short-term or long-term government security rate is used as the proxy for the risk-free rate. There has been growing support for the use of a long-term government security rate as a proxy for the risk-free rate when using the CAPM in regulatory proceedings. It is possible, however, that the beta was estimated relative to a different risk-free rate or no risk-free rate at all.

The market premium is often based on the historical spread between realized market returns and risk-free rates. The Ibbotson study covering a very long time period beginning in 1926 often is used in developing this estimate. The beta usually is estimated using the most recent five years of monthly data. Again, we have a mismatching of time periods. Quite likely the historical market premium for the same time period used to estimate the beta will be different than the very long-term differential provided in the Ibbotson study.

Q. DESPITE YOUR RESERVATIONS ABOUT THE USEFULNESS OF THE CAPM METHOD, HAVE YOU ESTIMATED THE COST OF EQUITY TO THE COMPANY USING THIS METHOD?

A. Yes, I have. First, I have used the current yield on the 30-year U.S. Treasury bonds as the risk-free rate. Second, I have assembled both Value Line adjusted and S&P raw betas for US West, the other Bell Regional Companies, and the independent telephone companies. The betas are shown in Schedule 15. Based on these betas, a risk-free rate of 5.8% and the long-term historical market premium of 8.0% (based on the income return on these bonds), the CAPM estimated returns for US West is in a range from 9.32% to 11.80%; 10.68% to 12.36%, on average, for the other Bell

Regionals, and in a range 11.00% to 12.20% for the independent telephones.

US West:

5.8% + .44(8.0%) = 9.32%

5.8% + .75(8.0%) = 11.80%

Bell Regionals:

5.8% + .61(8.0%) = 10.68%

5.8% + .82(8.0%) = 12.36%

Independent Telephones:

5.8% + .65(8.0%) = 11.00%

5.8% + .80(8.0%) = 12.20%

Comparable Earnings

Q. DR. LEGLER, YOU STATED THAT THE COMPARABLE EARNINGS APPROACH IS ONE METHOD OF ESTIMATING THE COST OF EQUITY CAPITAL. PLEASE EXPLAIN THE BASIS OF THIS APPROACH.

A. The basis of the comparable earnings approach is the often cited case of the Federal Power Commission vs. Hope Natural Gas Company (1944). Briefly, two principles are involved in the comparable earnings approach as applied to ratemaking. One states that an investor should be able to earn a return comparable to the returns available on alternative investments with similar risks. The other principle states that the return should be sufficient to enable the utility to attract additional equity capital required on a reasonable basis and maintain the financial integrity of the firm. Basically, the comparable earnings test is what economists refer to as the opportunity cost principle.

Q. WHAT PROBLEMS ARE INHERENT IN THE COMPARABLE EARNINGS APPROACH?

A. The major problem in applying the comparable earnings approach is the difficulty in determining what companies are comparable to the utility in question. Some analysts suggest that the valid comparison is with a broad sample of unregulated firms such as the S&P 400. Other analysts select groups of specific firms of comparable risk based upon criteria such as similar beta coefficients, and standard deviations of returns. In short, the problem is not so much the concept, but its implementation. In fact, it is these problems and the fact that the method is backward looking rather than forward looking which, at least in part, have led to the application of finance theory such as the DCF method in utility rate cases.

Q. DR. LEGLER, DO YOU BELIEVE THAT UTILITIES AND INDUSTRIALS ARE COMPARABLE?

A. In addition to the protection afforded by regulation to utilities, there are accounting differences in the measurement of returns which call into question strict comparability between utilities and industrials.

There is also a problem comparing utilities and industrials when there is a significant disparity in the market to book values. An illustration should make this point clear. If an industrial stock is selling for two times its book value, and earning 20% per year on book value, it would be erroneous to suggest that a new or prospective investor would receive a return of 20% on his or her investment. Thus, comparing book returns of utilities selling closer to book to the book returns of industrials selling well above book is an invalid comparison. This is not to suggest, however, that the investor could not receive a market return of 20% on one or both investments.

Q. WHAT CONCLUSION HAVE YOU REACHED REGARDING THE COMPARABLE EARNINGS APPROACH USING INDUSTRIALS AS THE ONLY STANDARD OF COMPARISON?

A. I reject the application of the comparable earnings approach using industrials as the only basis of comparison, in principle, because of the questionable comparability of the measured earnings and differences in risks of regulated and unregulated companies.

Q. HAVE YOU PERFORMED ANY OTHER COMPARABLE EARNINGS ANALYSIS?

A. Not in a strict sense, because my DCF analysis for the groups of telephones has the attributes of a forward looking comparable earnings analysis since it is a market based approach. The cost of equity for a group of comparable companies, or a risk adjusted cost of equity for a group of reasonably similar companies, if awarded to US West conforms to the <u>Hope</u> and <u>Bluefield</u> standards. Consequently, my DCF analysis parallels the traditional approach and leads to the same conclusion.

Q. BY LIMITING THE STUDY TO OTHER TELEPHONE COMPANIES AREN'T YOU INVOLVING CIRCULARITY IN YOUR REASONING?

A. No, I don't believe so. If all commissions set allowed returns on the basis of what other companies were expected to earn or have earned, circularity of reasoning would be a problem. By using a market based approach, it is assumed that the market accounts for differences in risk among companies and among industries in setting stock prices.

Q. HAVE YOU APPLIED ANY TESTS OF REASONABLENESS OF A COMPARATIVE NATURE TO YOUR ESTIMATES BASED ON THE FINANCIAL MODELS?

A. I have provided the Value Line projected returns on book equity for US West, the Bell Regionals, and the independent telephone companies in Schedule 16. These projected returns indicate returns substantially above those produced by the market based approaches. Despite the relatively low level of interest rates, these returns are well above the level of allowed returns in recent years. I believe that they provide very little information on what reasonable allowed returns should be at the present time.

Market Pressure and Flotation Costs

Q. ESTIMATES DERIVED FROM THE BOND YIELD PLUS RISK PREMIUM APPROACH AND THE DCF METHOD ARE MARKET VALUE ESTIMATES OF THE COST OF EQUITY. SINCE COMMISSIONS REGULATE ON A BOOK VALUE BASIS, IS IT NECESSARY TO ADJUST THESE MARKET ESTIMATES TO PROVIDE A FAIR RATE OF RETURN ON BOOK EQUITY?

A. When a company sells a new issue of stock, certain flotation costs are involved, and in theory, there will be pressure on the price of the stock caused by its increased supply. Thus, in theory, if the allowed rate of return on book is set equal to the market cost of equity, a new stock issue would sell below book value. That is, the equity per share of current shareholders would be diluted. To protect against this dilution of capital, theoretically, the return on book should be set somewhat above the market value cost of equity.

Q. WHAT THEORETICAL ADJUSTMENT IS REQUIRED?

A. In my opinion, the proper relationship is a highly complex problem. Some of the factors to be considered include the current state of the stock market, the volatility of the stock in question, the issuing company's earnings and dividend growth rate, its current market to book ratio, and the capital structure of the company. Further, if the purpose of the adjustment is to protect existing shareholders from dilution when stock is sold, then the need for capital in the future (i.e., whether or not the company will be selling new stock) must also be relevant.

Market pressure should be measured by taking into account consideration of the trend in the market. The decline in a company's stock at the time of issuance should be measured net of any general market decline. A study by John W. Bowyer, Jr. and Jess B. Yawitz, "The Effect of New Equity Issues on Utility Stock Prices," Public Utility Fortnightly, May 22, 1980, examined 278 public stock issues from 1973 through 1976. They found an average market pressure of 0.72%. Other studies include "Equity Issues and Offering Dilution," by Paul Asquith and David W. Mullins, Jr., in the January/February 1986 issue of the Journal of Financial Economics; and "Impacts of New Equity Sales Upon Electric Utility Share Prices," by Richard H. Pettway and Robert C. Radcliffe in the Spring 1985 issue Financial Management. These studies found market pressure based upon specific concepts of the general term of 0.9 percent and 3 percent, respectively. Other studies for individual utilities may be found in the testimony of rate of return witnesses in utility cases including my own.

Q. DR. LEGLER, WHAT ADJUSTMENT DO YOU BELIEVE IS NECESSARY?

A. Company witness Mr. Cummings in his original direct testimony estimated that an adjustment to the cost of equity of 10 to 20 basis points is necessary based on issuance expenses of 2.0% of gross proceeds. It appears to me that he effectively has applied the adjustment only to externally raised capital in that he recommends an adjustment of only 1.0117%. This would be consistent with my position on the issue that the adjustment should only be applied to externally raised equity although I would have calculated the adjustment differently. This adjustment is reasonably close to my own estimates in other cases, and conservative compared to those adjustments usually proposed by company witnesses. What Mr. Cummings has not provided is evidence that the proceeds of the stock issues have provided benefit to the Arizona ratepayers he expects to bear a portion of the issuance expenses. In the absence of such evidence, I recommend that no adjustment be made.

I should note that in making his calculations of the adjustment, Mr. Cummings has used the equity balances of US West and not the equity balance of US West-Arizona. I assume that this results in a proportional sharing of these alleged costs which include public stock issues in 1990, 1993 and 1994 as well as the dividend reinvestment plan, and with the company's initial capitalization. I find the inclusion of the costs associated with the company's initial capitalization troubling.

Although the magnitude of Mr. Cummings' proposed adjustment is relatively minor, the whole issue of the flotation cost adjustment, is really a policy issue for the Commission. Some commissions provide for an adjustment others do not. Some Commission's consider an adjustment on a case by case basis. I support the position that the Company must demonstrate that it will have a public offering in the reasonable near term, and the proceeds from that issue will benefit ratepayers of the jurisdiction.

Cost of Equity Summary

Q. PLEASE SUMMARIZE THE RESULTS OF YOUR STUDIES OF THE COST OF COMMON EQUITY TO US WEST.

A. I have relied on the discounted cash flow method, the risk premium method, and the capital asset pricing model. I have applied the DCF method to two groups of telephone companies, a group of independent telephone companies and the other remaining Bell Regional Holding Companies. I applied the risk premium method to US West and a group of independent telephone companies. I estimated the capital asset pricing model using US West, a group of independent telephone companies, and the Bell Regional Holding Companies.

The results of these financial models are shown below. These results are exclusive of a flotation cost or market pressure adjustment which I believe is unnecessary at this time. It has consistently been my position that the need for a market pressure flotation cost adjustment should be considered on a case by case basis. US West has not had a recent public offering, and to the best of my knowledge has no announced intentions of an offering which would benefit the Arizona ratepayers. Therefore, there is no need to make such an adjustment in this case.

DCF Method	Based on: Average Prices	Current Prices
Independent Telephones using:		
-Retention Growth	17.05%	17.03%
-Value Line Growth (Adjusted)	19.83%	19.79%
-Historical Growth	13.58%	13.38%
Average	16.82%	16.73%
Bell Regional Holding Companies using:		
-Retention Growth	19.68%	19.77%
-Value Line Growth	NA	NA
-Historical Growth	13.19%	13.05%
Average	16.44%	16.41%

Risk Premiums

US West:	
-Longer-Term Premiums	9.48%-12.05%
Independent Telephone:	
-Longer-Term Premiums	8.90%-11.28%
-Shorter-Term Premiums	6.87%-15.73%

Capital Asset Pricing Model

-US West	9.32%-11.80%
-Independent Telephones	11.00%-12.20%
-Bell Regional Holding Companies	10.68%-12.36%

It is my opinion, that based on my studies discussed earlier, the cost of equity to the Company lies in a range from 11.00% to 12.00%. As is my practice, I am recommending a range rather than a point estimate. The results of the financial models suggest that US West is reasonably comparable in risk to the other Bell Regional Holding Companies, on average, and less risky compared to the independent telephones. This is reasonably consistent with a risk evaluation based on the set of risk indicators I used.

The bottom end of my recommended range is slightly above the midpoint of my CAPM results. The upper end of my recommended range is the upper end of my risk premium analysis for US West.

But these results, as well as the results of the other financial models, are for US West and the Bell Regionals, not US West-Arizona. A company's beta may be thought of as an average of the betas of its different activities. In my opinion, the beta for the Company's nonregulated activities is higher than the beta for its regulated activities. Thus, using the Company's beta overstates the cost of equity for the regulated activities. How much it is overstated is somewhat a matter of speculation. For purposes of calculating the weighted average cost of capital, I will use the midpoint of my recommended range, 11.50%, as the cost of common equity. In making this recommendation, I have taken into consideration trends in interest rates.

Weighted Average Cost of Capital

Q. HAVING ASSIGNED COST RATES TO THE CAPITAL COMPONENTS AND ADOPTED A CAPITAL STRUCTURE, WHAT WEIGHTED AVERAGE COST OF CAPITAL DO YOU RECOMMEND?

A. Based on the capital structure as of February 2000 consisting of 47.6% Long-term debt and 52.4% common equity, an embedded cost of debt of 7.39%, and a cost of common equity of 11.50%, the weighted average cost of capital is 9.51%. These calculations are shown in Schedule 17.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

Before the

Arizona Corporation Commission

In the Matter of the Application of US West Communications, Inc., A Colorado Corporation, for a hearing to determine the earnings of the company, the fair value of the company for rate-making purposes, to fix a just and reasonable rate of return thereon and to approve rate schedules	)	DOCKET NO. T-01051B-99-0105

Exhibits of

JOHN B. LEGLER

On Behalf of the

RESIDENTIAL UTILITY CONSUMER OFFICE

August 2000

EXHIBIT

RUCO-5

admitted

TABLE OF CONTENTS

Regulatory Participation of John B. Legler

Company	Docket No.	Date
Georgia Power Company	GPSC 2663-U	4/75
Savannah Electric and Power	GPSC 2842-U	8/75
Southern Bell (Georgia)	GPSC 2897-U	12/75-1/76
Georgia Power Company	NRC 50-424/425	1/76
Southern Bell (Georgia)	GPSC 2994-U	11/76-12/76
Savannah Electric and Power	GPSC 2995-U	5/77
Georgia Power Company	GPSC 3002-U	6/77-7/77
South Central Bell (Mississippi)	MPSC U-3359	2/78
Carolina Tel and Tel (North Carolina)	NCUC P7, Sub 524	6/78
Southern Bell (South Carolina)	SCPSC 78-353-C	11/78
Duke Power (South Carolina)	SCPSC 78-189-E	12/78
Alabama Power Company	APSC 17667	5/79
Savannah Electric and Power	GPSC 3147-U	6/79
Georgia Power Company	GPSC 3129-U	7/79
South Carolina Electric and Gas	SCPSC 18,362	7/79
Tucson Electric Power Company	ACC U-1933	8/79
Gas Light Company of Columbus (Georgia)	GPSC 3162-U	11/79
Atlanta Gas Light Company	GPSC 3167-U	12/79
Georgia Power Company	GPSC 3129-U	12/79
Southern Bell (South Carolina)	SCPSC 79-303-C	1/80
General Telephone of the Southeast (Alabama)	APCS 17850	4/80
Alabama Power Company	APSC 17859	5/80
Duke Power Company (South Carolina)	SCPSC 79-300-E	7/80
South Central Bell (Mississippi)	MPSC U-3804	7/80
Mississippi Power and Light Company	MPSC U-3850	9/80
Gulf Power Company (Florida)	FPSC 80001-EU	9/80
Savannah Electric and Power	GPSC 3220-U	11/80
Carolina Power and Light	SCPSC 80-69-E	11/80
Southern Bell (Georgia)	GPSC 3231-U	2/81
Southern Bell (South Carolina)	SCPSC 80-263-C	2/81
Cincinnati Bell	PUCO 80-476-TP-AIR	4/81
Continental Telephone of Kentucky	UCK 8182	6/81
South Central Bell (Alabama)	APSC 18076	7/81
South Carolina Electric and Gas	SCPSC 81-72-E	7/81
Georgia Power Company	GPSC 3270-U	7/81
General Telephone Company of the Southeast (Georgia)	GPSC 3268-U	7/81
Alabama Power Company	APSC 18117	7/81
General Telephone Company of the Southeast (South Carolina)	SCPSC 81-121-C	9/81
Thomaston Telephone (Georgia)	GPSC 3271-U	9/81
Duke Power Company (South Carolina)	SCPSC 80-378-E	9/81
Southern Bell (Georgia)	GPSC 3286-U	10/81

Company	Docket No.	Date
Gas Light Company of Columbus (Georgia)	GPSC 3282-U	10/81
Atlanta Gas Light Company	GPSC 3288-U	11/81
Columbia Gas of Kentucky	KPSC 8281	11/81
Puget Sound Power & Light	WUTC U-81-41	12/81
General Telephone Company of the Southeast (Alabama)	APSC 18199	1/82
Continental Telephone Company of the South (Alabama)	APSC 18216	1/82
Ohio Bell	PUCO 81-436-TP-AIR	3/82
Hawaiian Telephone Company	HPUC 4306	6/82
Carolina Power and Light	SCPSC 81-163-E	3/82
Central Illinois Public Service Co.	ICC 82-0039	7/82
Southern California Edison	PUCC 61138	6/82
Mississippi Power Company	MPSC U-4190	8/82
South Central Bell (Mississippi)	MPSC U-4191	9/82
Atlanta Gas Light Company	GPSC 3333-U	9/82
Alabama Power Company	APSC 18416	9/82
South Carolina Electric & Gas	SCPSC 82-239-G	9/82
Mississippi Power & Light Company	MPSC U-4224	11/82
Savannah Electric and Power	GPSC 3361-U	11/82
General Telephone Company of the Southeast (Alabama)	APSC 18488	12/82
Continental Telephone Company of the South (Alabama)	APSC 18522	1/83
South Carolina Electric & Gas	SCPSC 82-240-E	1/83
Mobile Gas Service Corp. (Alabama)	APSC 18590	3/83
Pacific Gas and Electric	PUCC 82-12-48	4/83
Virginia-American Water	VPUC 820077	4/83
Southern Bell (Georgia)	GPSC 3393-U	7/83
Georgia Power Company	GPSC 3397-U	7/83
Atlanta Gas Light	GPSC 3402-U	9/83
South Carolina Electric & Gas	SCPSC 83-217-G	9/83
Connecticut Light & Power	CDPUC 83-07-15	10/83
Hawaiian Telephone Company	HPUC 4588	11/83
Southern Bell (South Carolina)	SCPSC 83-270-C	11/83
Louisiana Power & Light	LPSC U-15684	12/83
Duke Power (South Carolina)	SCPSC 83-302-E	12/83
South Carolina Electric & Gas	SCPSC 83-307-E	1/84
Peoples Gas Light & Coke Co. (Illinois)	ICC 83-0580	5/84
North Shore Gas Co. (Illinois)	ICC 83-0630	5/84
South Central Bell (Alabama)	APSC 18882	6/84
Florida Power Corp.	FPSC 830470-EI	6/84
Southern California Edison	CPUC 83-12-53	6/84
Continental Telephone of the South (GA)	GPSC 3462-U	6/84
Continental Telephone of the South (Alabama)	APSC 18978	7/84

Company	Docket No.	Date
Southern Bell (GA)	GPSC 3465-U	8/84
Southern Bell (South Carolina)	SCPSC 84-308-C	10/84
Mississippi Power & Light	MPSC U-4620	1/85
General Telephone of the Southeast (SC)	SCPSC 84-390-C	2/85
Louisiana Power & Light	LPSC U-16091	3/85
San Diego Gas & Electric	CPUC 84-12-015	3/85
Continental Telephone of the South (ALA)	APSC 19297	4/85
AT&T Communications, Inc. (ALA)	APSC 19314	5/85
Duke Power Company (SC)	SCPSC 85-78-E	7/85
Hawaiian Telephone Company	HPUC 5114	12/85
Connecticut Light & Power	CDPUC 85-10-22	4/86
Pacific Gas & Electric	CPUC 85-10-042	5/86
Central Maine Power	MPUC 85-212	5/86
Duke Power Company	SCPSC 86-199-E	8/86
Atlanta Gas Light	GPSC 3582-U	8/86
Louisiana Power & Light	LPSC U-16945	12/86
Southern California Edison	CPUC 86-12-047	4/87
Middle South Services, Inc. & System Energy Resources, Inc. (a)	FERC EL86-58-000 & FERC EL86-59-000	3/87
South Carolina Electric & Gas	SCPSC 87-43-E	6/87
Georgia Power Company	GPSC 3673-U	8/87
South Carolina Electric & Gas	SCPSC 87-227-G	9/87
South Carolina Electric & Gas	SCPSC 87-10-E	11/87
Lockhart Power Company (SC)	SCPSC 87-435-E	11/87
United Telephone Company of the Carolinas (SC)	SCPSC 886-625-C	5/88
Carolina Power & Light (NC)	NCUC E-2, Sub 537	5/88
Carolina Power & Light (SC)	SCPSC 88-11-E	7/88
Alabama Gas Corporation	APSC 20533	7/88
Central Power & Light (TX)	PUCT 7560	8/88
United Cities Gas Company (SC)	SCPSC 88-227-G	8/88
Ringgold Telephone Company (GA)	GPSC 3782-U	9/88
San Diego Gas & Electric	CPUC 88-12-003	10/88
Southern California Edison	CPUC 88-07-023	10/88
Pacific Gas & Electric	CPUC 88-07-037	10/88
Southern California Gas Company	CPUC 88-08-001	10/88
Atlanta Gas Light	GPSC 3780-U	10/88
United Cities Gas Company (GA)	GPSC 3799-U	10/88
Fairmount Telephone Company (GA)	GPSC 3805-U	12/88
South Carolina Electric & Gas	SCPSC 88-681-E	4/89
Citizens Utilities Rural Co. (AZ)	U-1954-88-102	5/89
Southern California Gas Company	CPUC 89-05-011	8/89
Pacific Gas & Electric Company	CPUC 89-05-019	8/89
Southern California Edison	CPUC 89-05-021	8/89
San Diego Gas & Electric	CPUC 89-05-023	8/89

Company	Docket No.	Date
Georgia Power Company	GPSC 3840-U	9/89
Puget Sound Power & Light	U-89-2688-T	10/89
Central Maine Power Company	MPUC 89-68	10/89
Chickamauga Telephone Company (GA)	GPSC 3788-U	12/89
Southern Bell (GA)	GPSC 3905-U	6/90
Hawaiian Electric	HPUC 6531	6/90
Atlanta Gas Light	GPSC 3923-U	7/90
Alabama Gas Corporation	APSC 18046	8/90
Southern California Gas Company	CPUC 90-05-013	8/90
Pacific Gas & Electric Company	CPUC 90-05-011	8/90
Southern California Edison Company	CPUC 09-05-016	8/90
San Diego Gas & Electric Company	CPUC 90-05-014	8/90
South Central Bell (AL)	APSC 19983	8/90
GASCO, Inc. (Hawaii)	HPUC 6434	10/90
Mobile Gas Service Corporation	APSC 21530	11/90
United Telephone of the Carolinas (SC)	SCPSC 89-229-C	3/91
Southern Bell (SC)	SCPSC 90-626-C	3/91
GTE South (SC)	SCPSC 90-698-C	4/91
Central Illinois Public Service	ICC 87-0542	5/91
Georgia Power Company	GPSC 4007-U	8/91
Southern California Gas Company	CPUC 91-05-022	9/91
Pacific Gas & Electric Company	GPUC 91-05-016	9/91
Southern California Edison Company	CPUC 91-05-024	9/91
San Diego Gas & Electric	GPUC 91-05-023	9/91
Southwest Gas	CPUC 91-05-018	9/91
Duke Power Company (SC)	SCPSC 91-216-E	9/91
Atlanta Gas Light	GPSC 4011-U	10/91
GTE South (GA)	GPSC 4003-U	1/92
Hawaiian Electric	HPUC 6998	3/92
Public Service Electric & Gas (NJ)	NJBRC ER91111698J	7/92
Kauai Electric Division (a)	HPUC 7003	7/92
Pacific Gas & Electric	CPUC 92-05-009	8/92
Southwest Gas Corporation	CPUC 92-05-012	8/92
Southern California Edison	CPUC 92-05-013	8/92
Southern California Gas Company	CPUC 92-05-014	8/92
San Diego Gas & Electric	CPUC 92-05-016	8/92
Atlanta Gas Light	GPSC 4177-U	8/92
United Cities Gas (GA)	GPSC 4188-U	9/92
United Telephone (SC)	SCPSC 92-271-C	11/92
U. S. West Communications (NM)	NMSCC 92-227-TC	2/93
Detroit Edison	MPSC U-10102	3/93
South Carolina Electric & Gas	SCPSC 92-619-E	3/93
Puget Sound Power & Light	WUTC UE-92-1262	5/93
Fairmount Telephone Company (GA)	GPSC	6/93
Central Maine Power Company	MPUC	6/93
Detroit Edison	MPSC U-10102	6/93
Atlanta Gas Light	GPSC 4451-U	8/93
Pacific Gas & Light	CPUC 93-05-009	9/93

Company	Docket No.	Date
Southwest Gas Corporation	CPUC 93-05-020	9/93
Southern California Edison	CPUC 93-05-013	9/93
Southern California Gas Company	CPUC 93-05-012	9/93
San Diego Gas & Electric Company	CPUC 93-05-011	9/93
Mountain Fuel Supply (UT)	PSCU 93-057-01	11/93
Consumers Power Company (MI)	MPSC U-10335	11/93
GTE South Incorporated (SC) (a)	SCPSC 93-504-C	2/94
Hawaiian Electric Company	HPUC 7700	3/94
Pond Branch Telephone Company (SC)	SCPSC 93-750-C	4/94
Hawaiian Telephone Company	HPUC 7579	4/94
Southern Bell (SC)	SCPSC 93-503-C	8/94
Southwest Gas Corporation	CPUC 94-05-010	8/94
Pacific Gas & Electric	CPUC 94-05-011	8/94
San Diego Gas & Electric	CPUC 94-05-013	8/94
Southern California Edison	CPUC 94-05-017	8/94
Southern California Gas Company	CPUC 94-05-026	8/94
Hawaiian Electric Company	HPUC 7766	8/94
Southern Bell (GA)	GPSC 3905-U	10/94
Montana-Dakota Utilities (ND) (a)	NDPSC 399-94-297	10/94
Kauai Electric Division	HPUC 94-0097	4/95
Mountain Fuel Supply (a)	PSCU 95-057-02	8/95
Pacific Gas & Electric	CPUC 95-05-016	8/95
San Diego Gas & Electric	CPUC 95-05-022	8/95
Southern California Edison	CPUC 95-05-023	8/95
Southern California Gas Company	CPUC 95-05-021	8/95
Southern Bell (SC)	SCPSC 95-682-C	9/95
U.S West Communications (UT)	PSCU 95-049-05	9/95
Mobile Gas Service Corp. (AL)	APSC 24794	10/95
Southern Bell (SC)	SCPSC 95-862-C	10/95
South Carolina Electric & Gas	SCPSC 95-1000-E	11/95
San Diego Gas & Electric	CPUC 95-10-035	02/96
ALLTEL Companies of Georgia	GPSC 6746-U	07/96
Pacific Gas & Electric	CPUC 96-05-022	09/96
San Diego Gas & Electric	CPUC 96-05-043	09/96
Southern California Edison	CPUC 96-05-023	09/96
Southern California Gas Company	CPUC 96-05-024	09/96
Baltimore Gas & Electric	PSCM 8725	11/96
PECO Energy Company	PPUC R-00973953	08/97
Pacific Gas & Electric	CPUC 97-05-016	09/97
BellSouth Telecommunications (GA)	GPSC 7061-U	09/97
BellSouth Telecommunications (SC)	SCPSC 97-374-C	12/97
BellSouth Telecommunications (SC)	SCPSC 97-239-C	3/98
South Carolina Pipeline Corp.	SCPSC 90-588-G	5/98
Atlanta Gas Light	GPSC 8390-U	5/98
Pacific Gas & Electric	CPUC 98-05-021	09/98
San Diego Gas & Electric	CPUC 98-05-019	09/98
Southern California Edison	CPUC 98-05-024	09/98
Georgia Power Company	GPSC 9355-U	10/98
Black Mountain Gas Company (AZ)(a)	G-03493A-98-0705	06/99
BellSouth Telecommunications (GA)	GPSC 10692-U	07/99
Southern California Water Company(a)	CPUC 99-03-068	08/99
Pacific Gas & Electric(a)	CPUC 99-11-003	04/00
PacifiCorp (UT)	PSCU 99-035-10	05/00
Questar (UT)	PSCU 99-057-20	06/00

(a) Testimony filed, case settled.

Exhibit___(JBL-1)
Schedule 2

US West, Inc.: Dividends, Earnings & Retention Rates

Year	Dividends Per Share	Earnings Per Share	Retention Ratio
1994	$2.14	$2.42	11.6 %
1995	2.14	2.35	8.9
1996	2.14	2.44	12.3
1997	2.14	2.57	16.7
1998	2.14	3.02	29.1
1999	2.14	3.27	33.1
2000	2.14	3.40	38.9
2001	2.14	3.65	41.4
		Average	**21.5 %**
		Average 1997-2001	**31.8 %**

Source: *Value Line,* April 7, 2000, p.766.

Note: 2000 and 2001 are Value Line Projections.

US West, Inc.: Growth Rates, Selected Time Periods

Time Period	Dividends Per Share	Earnings Per Share
1994-1999	0.00 %	5.75 %
1995-2000	0.00	8.29
1996-2001	0.00	8.39

Source: Calculated from Schedule 2.

Telephones: DCF Estimated Cost of Equity

Company	Current Dividend	Ave Price April-June	Retention Growth (%)	Projected Dividend	Projected Yield (%)	Expected Return on Equity (%)
ALLTEL	$1.28	$64.63	14.27	$1.46	2.26	16.53
CenturyTel	0.19	27.25	14.66	0.22	0.80	15.46
GTE Corp.	1.88	73.34	16.19	2.18	2.98	19.17
Telephone & Data	0.50	104.88	7.48	0.54	0.51	7.99
Average	$0.96	$67.52	13.15	$1.10	1.64	14.79
BellSouth	0.76	45.47	20.23	0.91	2.01	22.24
SBC Communications	1.02	44.62	14.51	1.17	2.62	17.13
Average	$0.89	$45.04	17.37	$1.04	2.31	19.68

Source: *Value Line*, April 7, 2000; an Yahoo *Historical Quotes.*

Telephones: DCF Estimated Cost of Equity

Company	Current Dividend	Price as of 06/30/99	Retention Growth (%)	Projected Dividend	Projected Yield (%)	Expected Return on Equity (%)
ALLTEL	$1.28	$61.94	14.27	$1.46	2.36	16.63
Century Tel. Ent.	0.19	28.75	14.66	0.22	0.76	15.42
GTE Corp.	1.88	76.88	16.19	2.18	2.84	19.03
Telephone & Data	0.50	100.30	7.48	0.54	0.54	8.02
Average	$0.96	$66.96	13.15	$1.10	1.62	14.77
BellSouth	0.76	42.63	20.23	0.91	2.14	22.37
SBC Communications	1.02	44.00	14.51	1.17	2.65	17.16
Average	$0.89	$43.31	17.37	$1.04	2.40	19.77

Source: *Value Line*, April 7, 2000; an‹Yahoo *Historical Quotes.*

Telephones: DCF Estimated Cost of Equity

Company	Current Dividend	Ave Price July-Sept	Value Line Growth (%)	Projected Dividend	Projected Yield (%)	Expected Return on Equity (%)
ALLTEL	$1.28	$64.63	4.5	1.34	2.07	6.57
Century Tel. Ent.	0.19	27.25	19.0	0.23	0.83	19.83
GTE Corp.	1.88	73.34	0.5	1.89	2.58	3.08
Telephone & Data	0.50	104.88	4.5	0.52	0.50	5.00
Average	$0.96	$67.52	7.1	$0.99	1.49	8.62
BellSouth	0.76	45.47	2.5	0.78	1.71	4.21
SBC Communications	1.02	44.62	5.5	1.08	2.41	7.91
Average	$0.89	$45.04	4.0	$0.93	2.06	6.06

Source: *Value Line*, April 7, 2000; an Yahoo *Historical Quotes*.

Telephones: DCF Estimated Cost of Equity

Company	Current Dividend	Price as of 06/30/99	Value Line Growth (%)	Projected Dividend	Projected Yield (%)	Expected Return on Equity (%)
ALLTEL	$1.28	$61.94	4.5	$1.34	2.16	6.66
Century Tel. Ent.	0.19	28.75	19.0	0.23	0.79	19.79
GTE Corp.	1.88	76.88	0.5	1.89	2.46	2.96
Telephone & Data	0.50	100.30	4.5	0.52	0.52	5.02
Average	$0.96	$66.96	7.1	$0.99	1.48	8.61
BellSouth	0.76	42.63	2.5	0.78	1.83	4.33
SBC Communications	1.02	44.00	5.5	1.08	2.45	7.95
Average	$0.89	$43.31	4.0	$0.93	2.14	6.14

Source: *Value Line*, April 7, 2000; an Yahoo *Historical Quotes.*

Telephones: DCF Estimated Cost of Equity

Company	Current Dividend	Ave Price April-June	5-year Historical EPS Growth	5-year Historical DPS Growth	Average Historical Growth (%)	Projected Dividend	Projected Yield (%)	Expected Return on Equity (%)
ALLTEL	$1.28	$64.63	10.00	7.50	8.75	$1.41	2.18	12.18
Century Tel. Ent.	0.19	27.25	18.50	4.50	11.50	0.23	0.83	19.33
GTE Corp.	1.88	73.34	6.50	1.00	3.75	2.00	2.73	9.23
Telephone & Data	0.50	104.88	0.00	5.50	2.75	0.50	0.48	0.48
Average	$0.96	$55.07	11.67	4.33	8.00	$1.21	1.91	13.58
BellSouth	0.76	45.47	11.50	1.00	6.25	0.85	1.86	13.36
SBC Communications	1.02	44.62	10.50	4.00	7.25	1.13	2.53	13.03
Average	$0.89	$45.05	11.00	2.50	6.75	$0.99	2.19	13.19

Company	Current Dividend	Price as of 06/30/99	5-year Historical EPS Growth	5-year Historical DPS Growth	Average Historical Growth (%)	Projected Dividend	Projected Yield (%)	Expected Return on Equity (%)
ALLTEL	$1.28	$61.94	10.00	7.50	8.75	$1.41	2.00	12.00
Century Tel. Ent.	0.19	28.75	18.50	4.50	11.50	0.23	0.55	19.05
GTE Corp.	1.88	76.88	6.50	1.00	3.75	2.00	2.60	9.10
Telephone & Data	0.50	100.3						
Average	$1.12	$62.63	11.67	4.33	8.00	$1.21	1.72	13.39
BellSouth	0.76	42.63	11.50	1.00	6.25	0.85	1.88	13.38
SBC Communications	1.02	44.00	10.50	4.00	7.25	1.13	2.21	12.71
Average	$0.89	$48.03	11.00	2.50	6.75	$0.99	2.05	13.05

Source: *Value Line*, October 8, 1999; and Yahoo *Historical Quotes*.

Exhibit___(JBL-1)
Schedule 6
Page 1 of 1

Common Equity Ratios for Telephone Companies

Company	1995	1996	1997	1998	1999	2000	2001	2003-2005
Century Tel. Ent.	57.5 %	60.4 %	32.7 %	36.8 %	46.1 %	42.5 %	49.0 %	67.0 %
GTE Corp.	31.5	32.1	32.4	33.5	43.7	44.0	45.0	51.0
Telephone & Data Sys.	58.0	58.5	53.5	52.6	54.0	55.0	55.5	60.9
Average	**49.0 %**	**50.3 %**	**39.5 %**	**41.0 %**	**47.9 %**	**47.2 %**	**49.8 %**	**59.6 %**
Bell Atlantic	51.1 %	56.5 %	47.4 %	42.0 %	47.5 %	52.5 %	52.0 %	67.5 %
BellSouth	58.8	60.8	65.9	63.7	62.8	62.0	62.5	63.5
SBC Communications	52.4	55.4	43.2	50.3	59.1	61.5	64.0	66.5
Average	**54.1 %**	**57.6 %**	**52.2 %**	**52.0 %**	**56.5 %**	**58.7 %**	**59.5 %**	**65.8 %**
US West, Inc.	**37.9 %**	**40.9 %**	**45.5 %**	**8.0 %**	**11.0 %**	**16.0 %**	**22.5 %**	**39.5 %**

Source: *Value Line,* April 7, 2000.

Risk Indicators for Telephone Companies

Company	Value Line Beta	Safety Rank	Financial Strength	Price Stability
ALLTEL	0.70	2.0	A	90
CenturyTel	0.90	2.0	B++	90
GTE Corp.	0.85	1.0	A+	90
Sprint, Inc.	NMF	3.0	B+	NMF
Telephone & Data	0.75	3.0	B	75
Average	**0.80**	**2.2**	**B++**	**86**
Bell Atlantic	0.85	1.0	A+	90
BellSouth	0.80	1.0	A+	85
SBC Communications	0.80	2.0	A+	80
Average	**0.82**	**1.3**	**A+**	**85**
US West, Inc.	**0.75**	**3.0**	**B**	**90**

Source: *Value Line,* April 7, 2000.

US West, Inc.: Projected Growth Rates

Report	Projected Dividends Per Share	Projected Earnings Per Share	Projected Return on Common Equity (%)	Projected Retention Rate (%)	Retention Growth Rate (%)	Value-Line Dividend Forecast
January 1984	$6.25	$10.50	13.5 %	40.5 %	5.67 %	5.0 %
April 1984	6.35	10.70	13.5	40.7	5.69	5.5
July 1984	7.00	11.50	14.0	39.1	5.67	9.0
October 1984	7.20	11.80	14.0	39.0	5.65	7.5
January 1985	7.20	12.00	14.0	40.0	5.80	7.5
April 1985	7.20	12.00	14.0	40.0	5.80	7.5
July 1985	7.50	12.75	14.0	41.2	5.97	7.0
October 1985	7.50	12.75	14.0	41.2	5.97	7.0
January 1986	7.50	12.75	14.0	41.2	5.97	7.0
April 1986	3.75	6.50	14.0	42.3	6.13	7.0
July 1986	4.10	7.00	14.0	41.4	6.01	7.0
October 1986	3.80	6.75	13.5	43.7	6.12	6.0
January 1987	3.75	6.75	14.0	44.4	6.44	5.5
April 1987	3.75	6.00	13.0	37.5	5.06	5.5
July 1987	3.90	6.20	13.0	37.1	5.01	5.5
October 1987	3.90	6.20	13.0	37.1	5.01	5.5
January 1988	4.05	6.45	13.0	37.2	5.02	6.0
April 1988	4.05	6.45	13.0	37.2	5.02	6.0
July 1988	4.05	6.85	13.0	40.9	5.52	5.0
October 1988	4.25	6.85	13.0	38.0	5.12	5.5
January 1989	4.25	6.85	13.0	38.0	5.12	5.5
April 1989	4.55	7.20	14.0	36.8	5.34	7.0
July 1989	5.00	7.85	14.5	36.3	5.45	7.5
October 1989	5.00	7.85	14.5	36.3	5.45	7.5
January 1990	5.00	8.15	14.5	38.7	5.80	7.5
April 1990	2.50	3.90	14.5	35.9	5.38	7.5
July 1990	2.60	4.10	14.5	36.6	5.49	6.5
October 1990	2.60	4.10	14.5	36.6	5.49	6.5
January 1991	2.60	4.00	15.5	35.0	5.60	6.5
April 1991	2.60	4.35	15.0	40.2	6.24	5.5
July 1991	2.60	4.35	15.0	40.2	6.24	5.5
October 1991	2.60	4.35	15.5	40.2	6.44	5.5
January 1992	2.72	4.85	16.0	43.9	7.25	5.5
April 1992	2.72	4.55	16.0	40.2	6.64	5.0
July 1992	2.60	4.55	15.5	42.9	6.86	4.5
October 1992	2.60	4.45	15.0	41.6	6.44	4.5
January 1993	2.60	4.30	14.5	39.5	5.93	4.5
April 1993	2.80	4.30	16.5	34.9	5.93	5.0
July 1993	2.50	3.75	14.5	33.3	5.00	3.0
October 1993	2.50	4.50	23.5	44.4	10.67	3.0
January 1994	2.30	4.30	21.0	46.5	10.00	2.0
April 1994	2.35	4.30	20.5	45.3	9.52	1.5
July 1994	2.40	4.30	21.0	44.2	9.50	2.0
October 1994	2.30	4.00	20.0	42.5	8.71	1.5
January 1995	2.14	3.75	18.0	42.9	7.94	0.0
April 1995	2.14	3.70	16.5	42.2	7.17	0.0
July 1995	2.14	3.60	16.0	40.6	6.69	0.0
October 1995	2.14	3.60	16.5	40.6	6.89	0.0
January 1996	2.14	2.90	26.0	26.2	6.94	0.0
April 1996	2.14	2.95	27.5	27.5	7.69	0.0
July 1996	2.14	2.95	27.5	27.5	7.69	0.0
October 1996	2.14	3.00	28.5	28.7	8.31	0.0
January 1997	2.14	3.00	29.0	28.7	8.46	0.0
April 1997	2.18	3.15	26.0	30.8	8.16	0.0
July 1997	2.18	3.25	23.5	32.9	7.90	0.0
October 1997	2.18	3.25	23.5	32.9	7.90	0.0
January 1998	2.18	3.25	23.5	32.9	7.90	0.0
April 1998	2.14	3.55	24.0	39.7	9.73	0.0
July 1998	2.14	2.70	25.5	20.7	5.39	0.0
October 1998	2.20	4.15	25.0	47.0	11.98	0.0
January 1999	2.18	4.25	54.0	48.7	26.54	0.5

Source: Value Line.

Note: Retention Rate = 1 - Dividends/Earnings
Growth Rate = Retention Rate x (Return on Equity + 0.5%).
Return on equity increased by 0.5% to reflect conversion from year-end to average year basis.

US West, Inc.: Historical DCF Analysis

Year	Price	Projected Dividend	Projected Yield	Retention Growth Rate	Expected Return
1984.3	$57.750	$5.71	9.88	5.69 %	15.57 %
1984.4	63.000	5.71	9.06	5.67	14.73
1985.1	70.500	5.71	8.09	5.65	13.74
1985.2	74.875	5.71	7.63	5.80	13.43
1985.3	81.000	6.05	7.47	5.80	13.27
1985.4	73.625	6.06	8.23	5.97	14.20
1986.1	89.000	6.06	6.81	5.97	12.78
1986.2	98.625	6.06	6.15	5.97	12.12
1986.3	55.125	3.23	5.85	6.13	11.98
1986.4	53.250	3.22	6.05	6.01	12.06
1987.1	54.000	3.23	5.97	6.12	12.09
1987.2	55.000	3.24	5.88	6.44	12.32
1987.3	52.625	3.45	6.55	5.06	11.61
1987.4	58.875	3.44	5.85	5.01	10.86
1988.1	51.125	3.44	6.74	5.01	11.75
1988.2	52.375	3.44	6.58	5.02	11.60
1988.3	56.375	3.70	6.56	5.02	11.58
1988.4	58.625	3.71	6.34	5.52	11.86
1989.1	57.750	3.70	6.41	5.12	11.53
1989.2	62.375	3.70	5.93	5.12	11.05
1989.3	69.000	3.96	5.74	5.34	11.08
1989.4	71.500	3.96	5.55	5.45	11.00
1990.1	80.125	3.96	4.95	5.45	10.40
1990.2	73.875	3.98	5.38	5.80	11.18
1990.3	35.875	2.11	5.87	5.38	11.25
1990.4	34.875	2.11	6.05	5.49	11.54
1991.1	38.875	2.11	5.43	5.49	10.92
1991.2	39.125	2.11	5.40	5.60	11.00
1991.3	35.375	2.21	6.25	6.24	12.49
1991.4	35.875	2.21	6.16	6.24	12.40
1992.1	37.875	2.21	5.85	6.44	12.29
1992.2	34.125	2.23	6.54	7.25	13.79
1992.3	36.500	2.26	6.19	6.64	12.83
1992.4	38.000	2.29	6.02	6.86	12.88
1993.1	38.375	2.29	5.98	6.44	12.42
1993.2	43.625	2.28	5.23	5.93	11.16
1993.3	45.875	2.29	4.99	5.93	10.92
1993.4	49.250	2.29	4.65	5.00	9.65
1994.1	45.875	2.30	5.02	10.67	15.69
1994.2	40.750	2.30	5.66	10.00	15.66
1994.3	41.875	2.32	5.54	9.52	15.06
1994.4	38.750	2.32	5.99	9.50	15.49
1995.1	35.625	2.31	6.50	8.71	15.21
1995.2	40.125	2.31	5.75	7.94	13.69
1995.3	41.625	2.31	5.55	7.17	12.72
1995.4	47.125	2.31	4.90	6.69	11.59
1996.1	35.625	2.35	6.59	6.89	13.48
1996.2	32.375	2.26	6.97	6.94	13.91
1996.3	32.000	2.40	7.49	7.69	15.18
1996.4	29.875	2.14	7.16	7.69	14.85
1997.1	32.250	2.14	6.64	8.31	14.95
1997.2	33.875	2.14	6.32	8.46	14.78
1997.3	37.063	2.14	5.77	8.16	13.93
1997.4	38.500	2.14	5.56	7.90	13.46
1998.1	45.125	2.14	4.74	7.90	12.64
1998.2	54.625	2.14	3.92	7.90	11.82
1998.3	46.813	2.14	4.57	9.73	14.30
1998.4	52.500	2.14	4.08	5.39	9.47
1999.1	64.625	2.14	3.31	11.98	15.29

Source: Price is closing price of previous quarter.
Projected dividend is annualized dividend of previous quarter times 1 + the growth rate.
Figures adjusted for stock splits.

US West, Inc.: Historical DCF Analysis

Year	Price	Projected Dividend	Projected Yield	Value Line Growth Rate	Expected Return
1984.3	$57.750	$5.70	9.86	5.50 %	15.36 %
1984.4	63.000	5.89	9.34	9.00	18.34
1985.1	70.500	5.81	8.23	7.50	15.73
1985.2	74.875	5.81	7.75	7.50	15.25
1985.3	81.000	6.15	7.59	7.50	15.09
1985.4	73.625	6.12	8.31	7.00	15.31
1986.1	89.000	6.12	6.88	7.00	13.88
1986.2	98.625	6.12	6.21	7.00	13.21
1986.3	55.125	3.25	5.90	7.00	12.90
1986.4	53.250	3.25	6.11	7.00	13.11
1987.1	54.000	3.22	5.97	6.00	11.97
1987.2	55.000	3.21	5.83	5.50	11.33
1987.3	52.625	3.46	6.58	5.50	12.08
1987.4	58.875	3.46	5.88	5.50	11.38
1988.1	51.125	3.46	6.77	5.50	12.27
1988.2	52.375	3.48	6.64	6.00	12.64
1988.3	56.375	3.73	6.62	6.00	12.62
1988.4	58.625	3.70	6.30	5.00	11.30
1989.1	57.750	3.71	6.43	5.50	11.93
1989.2	62.375	3.71	5.95	5.50	11.45
1989.3	69.000	4.02	5.83	7.00	12.83
1989.4	71.500	4.04	5.65	7.50	13.15
1990.1	80.125	4.04	5.04	7.50	12.54
1990.2	73.875	4.04	5.47	7.50	12.97
1990.3	35.875	2.15	5.99	7.50	13.49
1990.4	34.875	2.13	6.11	6.50	12.61
1991.1	38.875	2.13	5.48	6.50	11.98
1991.2	39.125	2.13	5.44	6.50	11.94
1991.3	35.375	2.19	6.20	5.50	11.70
1991.4	35.875	2.19	6.12	5.50	11.62
1992.1	37.875	2.19	5.79	5.50	11.29
1992.2	34.125	2.19	6.43	5.50	11.93
1992.3	36.500	2.24	6.13	5.50	11.63
1992.4	38.000	2.15	5.66	5.00	10.66
1993.1	38.375	2.14	5.58	4.50	10.08
1993.2	43.625	2.14	4.91	4.50	9.41
1993.3	45.875	2.14	4.66	4.50	9.16
1993.4	49.250	2.14	4.35	5.00	9.35
1994.1	45.875	2.14	4.66	3.00	7.66
1994.2	40.750	2.14	5.25	3.00	8.25
1994.3	41.875	2.14	5.11	2.00	7.11
1994.4	38.750	2.14	5.52	1.50	7.02
1995.1	35.625	2.14	6.01	2.00	8.01
1995.2	40.125	2.14	5.33	1.50	6.83
1995.3	41.625	2.14	5.14	0.00	5.14
1995.4	47.125	2.14	4.54	0.00	4.54
1996.1	35.625	2.14	6.01	0.00	6.01
1996.2	32.375	2.14	6.61	0.00	6.61
1996.3	32.000	2.14	6.69	0.00	6.69
1996.4	29.875	2.14	7.16	0.00	7.16
1997.1	32.250	2.14	6.64	0.00	6.64
1997.2	33.875	2.14	6.32	0.00	6.32
1997.3	37.063	2.14	5.77	0.00	5.77
1997.4	38.500	2.14	5.56	0.00	5.56
1998.1	45.125	2.14	4.74	0.00	4.74
1998.2	54.625	2.14	3.92	0.00	3.92
1998.3	46.813	2.14	4.57	0.00	4.57
1998.4	52.500	2.14	4.08	0.00	4.08
1999.1	64.625	2.14	3.31	0.00	3.31

Source: Price is closing price of previous quarter.
Projected dividend is annualized dividend of previous quarter times 1 + the growth rate.
Figures adjusted for stock splits.

US West, Inc.: Expected Risk Premiums, 1984-1999

		Bond Yield		Risk Premium	
Yr./Qtr.	Expected Return on USW Stock	30-Year Treasury Bonds	Aaa Utility Bond Rate	On Treasury Rate	On Utility Rate
1984.3	15.57 %	13.44 %	14.90 %	2.13 %	0.67 %
1984.4	14.73	12.29	13.43	2.44	1.30
1985.1	13.74	11.52	12.49	2.22	1.25
1985.2	13.43	11.81	13.08	1.62	0.35
1985.3	13.27	10.45	11.17	2.82	2.10
1985.4	14.20	10.61	11.27	3.59	2.93
1986.1	12.78	9.54	10.24	3.24	2.54
1986.2	12.12	7.96	8.75	4.16	3.37
1986.3	11.98	7.57	9.02	4.41	2.96
1986.4	12.06	7.62	8.91	4.44	3.15
1987.1	12.09	7.37	8.41	4.72	3.68
1987.2	12.32	7.55	8.21	4.77	4.11
1987.3	11.61	8.57	9.37	3.04	2.24
1987.4	10.86	9.59	10.53	1.27	0.33
1988.1	11.75	9.12	10.64	2.63	1.11
1988.2	11.60	8.63	9.72	2.97	1.88
1988.3	11.58	9.00	10.27	2.58	1.31
1988.4	11.86	9.06	10.15	2.80	1.71
1989.1	11.53	9.01	9.67	2.52	1.86
1989.2	11.05	9.17	9.87	1.88	1.18
1989.3	11.08	8.27	9.13	2.81	1.95
1989.4	11.00	8.15	9.10	2.85	1.90
1990.1	10.40	7.90	8.92	2.50	1.48
1990.2	11.18	8.55	9.48	2.63	1.70
1990.3	11.25	8.45	9.38	2.80	1.87
1990.4	11.54	9.01	9.73	2.53	1.81
1991.1	10.92	8.24	9.18	2.68	1.74
1991.2	11.00	8.29	9.04	2.71	1.96
1991.3	12.49	8.47	9.10	4.02	3.39
1991.4	12.40	7.95	8.65	4.45	3.75
1992.1	12.29	7.68	8.38	4.61	3.91
1992.2	13.79	7.97	8.39	5.82	5.40
1992.3	12.83	7.84	8.26	4.99	4.57
1992.4	12.88	7.33	8.04	5.55	4.84
1993.1	12.42	7.43	8.01	4.99	4.41
1993.2	11.16	6.82	7.64	4.34	3.52
1993.3	10.92	6.80	7.37	4.12	3.55
1993.4	9.65	5.99	6.76	3.66	2.89
1994.1	15.69	6.34	7.06	9.35	8.63
1994.2	15.66	6.91	7.60	8.75	8.06
1994.3	15.06	7.50	8.20	7.56	6.86
1994.4	15.49	7.71	8.41	7.78	7.08
1995.1	15.21	7.87	8.55	7.34	6.66
1995.2	13.69	7.45	8.18	6.24	5.51
1995.3	12.72	6.57	7.39	6.15	5.33
1995.4	11.59	6.55	7.42	5.04	4.17
1996.1	13.48	6.06	6.94	7.42	6.54
1996.2	13.91	6.60	7.45	7.31	6.46
1996.3	15.18	7.06	7.83	8.12	7.35
1996.4	14.85	7.03	7.76	7.82	7.09
1997.1	14.95	6.63	7.33	8.32	7.62
1997.2	14.78	6.93	7.70	7.85	7.08
1997.3	13.93	6.70	7.55	7.23	6.38
1997.4	13.46	6.50	7.33	6.96	6.13
1998.1	12.64	5.99	6.99	6.65	5.65
1998.2	11.82	5.95	6.96	5.87	4.86
1998.3	14.30	5.70	6.80	8.60	7.50
1998.4	9.47	5.20	6.66	4.27	2.81
1999.1	15.29	5.06	6.43	10.23	8.86
			Average	**4.80 %**	**3.92 %**

Source: Return on BellSouth Stock from Schedule 9, page 1 of 2.
Utility Bond Yields, *Moody's Public Utility Manuals* and *Bond Survey. 30-Year Treasury Bond Yield from Federal* Reserve Bulletin and Value Line.

US West, Inc.: Expected Risk Premiums, 1984-1999

		Bond Yield		Risk Premium	
Yr./Qtr.	Expected Return on USW Stock	30-Year Treasury Bonds	Aaa Utility Bond Rate	On Treasury Rate	On Utility Rate
1984.3	15.36 %	13.44 %	14.90 %	1.92 %	0.46 %
1984.4	18.34	12.29	13.43	6.05	4.91
1985.1	15.73	11.52	12.49	4.21	3.24
1985.2	15.25	11.81	13.08	3.44	2.17
1985.3	15.09	10.45	11.17	4.64	3.92
1985.4	15.31	10.61	11.27	4.70	4.04
1986.1	13.88	9.54	10.24	4.34	3.64
1986.2	13.21	7.96	8.75	5.25	4.46
1986.3	12.90	7.57	9.02	5.33	3.88
1986.4	13.11	7.62	8.91	5.49	4.20
1987.1	11.97	7.37	8.41	4.60	3.56
1987.2	11.33	7.55	8.21	3.78	3.12
1987.3	12.08	8.57	9.37	3.51	2.71
1987.4	11.38	9.59	10.53	1.79	0.85
1988.1	12.27	9.12	10.64	3.15	1.63
1988.2	12.64	8.63	9.72	4.01	2.92
1988.3	12.62	9.00	10.27	3.62	2.35
1988.4	11.30	9.06	10.15	2.24	1.15
1989.1	11.93	9.01	9.67	2.92	2.26
1989.2	11.45	9.17	9.87	2.28	1.58
1989.3	12.83	8.27	9.13	4.56	3.70
1989.4	13.15	8.15	9.10	5.00	4.05
1990.1	12.54	7.90	8.92	4.64	3.62
1990.2	12.97	8.55	9.48	4.42	3.49
1990.3	13.49	8.45	9.38	5.04	4.11
1990.4	12.61	9.01	9.73	3.60	2.88
1991.1	11.98	8.24	9.18	3.74	2.80
1991.2	11.94	8.29	9.04	3.65	2.90
1991.3	11.70	8.47	9.10	3.23	2.60
1991.4	11.62	7.95	8.65	3.67	2.97
1992.1	11.29	7.68	8.38	3.61	2.91
1992.2	11.93	7.97	8.39	3.96	3.54
1992.3	11.63	7.84	8.26	3.79	3.37
1992.4	10.66	7.33	8.04	3.33	2.62
1993.1	10.08	7.43	8.01	2.65	2.07
1993.2	9.41	6.82	7.64	2.59	1.77
1993.3	9.16	6.80	7.37	2.36	1.79
1993.4	9.35	5.99	6.76	3.36	2.59
1994.1	7.66	6.34	7.06	1.32	0.60
1994.2	8.25	6.91	7.60	1.34	0.65
1994.3	7.11	7.50	8.20	-0.39	-1.09
1994.4	7.02	7.71	8.41	-0.69	-1.39
1995.1	8.01	7.87	8.55	0.14	-0.54
1995.2	6.83	7.45	8.18	-0.62	-1.35
1995.3	5.14	6.57	7.39	-1.43	-2.25
1995.4	4.54	6.55	7.42	-2.01	-2.88
1996.1	6.01	6.06	6.94	-0.05	-0.93
1996.2	6.61	6.60	7.45	0.01	-0.84
1996.3	6.69	7.06	7.83	-0.37	-1.14
1996.4	7.16	7.03	7.76	0.13	-0.60
1997.1	6.64	6.63	7.33	0.01	-0.69
1997.2	6.32	6.93	7.70	-0.61	-1.38
1997.3	5.77	6.70	7.55	-0.93	-1.78
1997.4	5.56	6.50	7.33	-0.94	-1.77
1998.1	4.74	5.99	6.99	-1.25	-2.25
1998.2	3.92	5.95	6.96	-2.03	-3.04
1998.3	4.57	5.70	6.80	-1.13	-2.23
1998.4	4.08	5.20	6.66	-1.12	-2.58
1999.1	3.31	5.06	6.43	-1.75	-3.12
			Average	**2.24 %**	**1.36 %**
		Average 1984.3-1994.2		**3.68 %**	**2.80 %**

Source: Return on BellSouth Stock from Schedule 9, page 2 of 2.
Utility Bond Yields, *Moody's Public Utility Manuals* and *Bond Survey. 30-Year Treasury Bond Yield from Federal* Reserve Bulletin and Value Line.

Independent Telephones: Value Line's Projected Earnings, Dividends, and Return on Equity, Retention Growth Rates, and Projected Dividend Growth Rates

Date	Dividends	Earnings	Return on Equity (%)	Retention Growth Rate (%)	Projected Dividend Growth (%)
11/04/77	$2.14	$3.59	12.9	5.41	7.3
11/03/78	2.34	3.81	13.1	5.25	7.9
11/07/79	2.54	4.16	14.1	5.69	7.8
10/03/80	2.78	4.47	14.4	5.63	7.2
10/30/81	3.05	5.22	15.4	6.61	7.3
10/29/82	3.11	5.49	15.2	6.81	6.3
10/28/83	2.77	4.96	15.1	6.89	5.4
10/26/84	2.82	5.23	15.0	7.14	4.9
10/25/85	3.02	5.56	15.2	7.17	5.0
10/24/86	2.73	5.02	14.5	6.84	4.1
10/23/87	2.44	4.32	15.6	7.01	5.3
10/21/88	2.94	5.33	17.9	8.25	8.4
10/20/89	2.66	4.99	19.1	9.15	10.6
10/19/90	1.59	3.16	18.1	9.24	6.4
10/18/91	1.69	2.88	17.3	7.35	5.5
10/16/92	1.74	2.74	15.9	5.99	5.2
10/15/93	1.76	3.10	19.0	8.43	6.6
10/14/94	1.49	2.95	18.8	9.55	4.8
10/13/95	1.48	3.25	19.3	10.78	4.5
10/12/96	1.52	4.08	23.7	15.18	4.2
10/10/97	1.27	3.06	22.3	13.34	3.3
10/09/98	1.14	3.29	21.7	14.51	3.3

Source: *Value Line.*

Independent Telephones: Historical DCF Estimates

Year	Year End Price	Dividend	Retention Growth Rate (%)	Projected Dividend	Projected Yield (%)	Expected Return (%)
1978	$24.14	$1.62	5.41	$1.71	7.07	12.48
1979	23.13	1.84	5.25	1.94	8.37	13.62
1980	23.16	2.05	5.69	2.17	9.36	15.05
1981	22.64	2.16	5.63	2.28	10.08	15.71
1982	27.67	2.30	6.61	2.45	8.86	15.47
1983	32.38	2.44	6.81	2.61	8.05	14.86
1984	31.42	2.24	6.89	2.39	7.62	14.51
1985	32.28	2.34	7.14	2.51	7.77	14.91
1986	38.25	2.42	7.17	2.59	6.78	13.95
1987	43.41	2.21	6.84	2.36	5.44	12.28
1988	33.19	2.05	7.01	2.19	6.61	13.62
1989	43.55	2.05	8.25	2.22	5.10	13.35
1990	55.00	1.66	9.15	1.81	3.29	12.44
1991	29.61	1.25	9.24	1.37	4.61	13.85
1992	32.85	1.29	7.35	1.38	4.22	11.57
1993	35.45	1.34	5.99	1.42	4.01	10.00
1994	36.09	1.35	8.43	1.46	4.06	12.49
1995	26.44	1.19	9.55	1.30	4.93	14.48
1996	36.25	1.21	10.78	1.34	3.70	14.48
1997	39.96	1.22	15.18	1.41	3.52	18.70
1998	38.33	1.12	13.34	1.27	3.31	16.65
1999	47.90	1.02	14.51	1.17	2.44	16.95

Independent Telephones: Historical DCF Estimates

Year	Year End Price	Dividend	Value Line Growth Rate (%)	Projected Dividend	Projected Yield (%)	Expected Return (%)
1978	$24.14	$1.62	7.3	$1.74	7.20	14.50
1979	23.13	1.84	7.9	1.99	8.58	16.48
1980	23.16	2.05	7.8	2.21	9.54	17.34
1981	22.64	2.16	7.2	2.32	10.23	17.43
1982	27.67	2.30	7.3	2.47	8.92	16.22
1983	32.38	2.44	6.3	2.59	8.01	14.31
1984	31.42	2.24	5.4	2.36	7.51	12.91
1985	32.28	2.34	4.9	2.45	7.60	12.50
1986	38.25	2.42	5.0	2.54	6.64	11.64
1987	43.41	2.21	4.1	2.30	5.30	9.40
1988	33.19	2.05	5.3	2.16	6.50	11.80
1989	43.55	2.05	8.4	2.22	5.10	13.50
1990	55.00	1.66	10.6	1.84	3.34	13.94
1991	29.61	1.25	6.4	1.33	4.49	10.89
1992	32.85	1.29	5.5	1.36	4.14	9.64
1993	35.45	1.34	5.2	1.41	3.98	9.18
1994	36.09	1.35	6.6	1.44	3.99	10.59
1995	26.44	1.19	4.8	1.25	4.72	9.52
1996	36.25	1.21	4.5	1.26	3.49	7.99
1997	39.96	1.22	4.2	1.27	3.18	7.38
1998	38.33	1.12	3.3	1.16	3.02	6.32
1999	47.90	1.14	3.3	1.18	2.46	5.76

Expected Risk Premiums: Independent Telephones, 1978-1999
(Return based on Retention Growth)

Year	Expected Return on Equity (%)	30-Year Treasury Bond Yield	Expected Risk Premium (%)
1978	12.48 %	7.94 %	4.54 %
1979	13.62	8.88	4.74
1980	15.05	10.12	4.93
1981	15.71	12.40	3.31
1982	15.47	13.45	2.02
1983	14.86	10.54	4.32
1984	14.51	11.88	2.63
1985	14.91	11.52	3.39
1986	13.95	9.54	4.41
1987	12.28	7.37	4.91
1988	13.62	9.12	4.50
1989	13.35	9.01	4.34
1990	12.44	7.90	4.54
1991	13.85	8.24	5.61
1992	11.57	7.68	3.89
1993	10.00	7.43	2.57
1994	12.49	6.34	6.15
1995	14.48	7.87	6.61
1996	14.48	6.06	8.42
1997	18.70	6.63	12.07
1998	16.65	5.99	10.66
1999	16.95	5.06	11.89
		Average	**5.48 %**
		Average 1995-99	**9.93 %**

Source: Expected Returns from Schedule 12, page 1 of 2; 30-Year Treasury Bond Yield, *Federal Reserve Bulletin.*

Expected Risk Premiums: Independent Telephones, 1978-1999
(Return based on Value Line Growth)

Year	Expected Return on Equity (%)	30-Year Treasury Bond Yield	Expected Risk Premium (%)
1978	14.50 %	7.94 %	6.56 %
1979	16.48	8.88	7.60
1980	17.34	10.12	7.22
1981	17.43	12.40	5.03
1982	16.22	13.45	2.77
1983	14.31	10.54	3.77
1984	12.91	11.88	1.03
1985	12.50	11.52	0.98
1986	11.64	9.54	2.10
1987	9.40	7.37	2.03
1988	11.80	9.12	2.68
1989	13.50	9.01	4.49
1990	13.94	7.90	6.04
1991	10.89	8.24	2.65
1992	9.64	7.68	1.96
1993	9.18	7.43	1.75
1994	10.59	6.34	4.25
1995	9.52	7.87	1.65
1996	7.99	6.06	1.93
1997	7.38	6.63	0.75
1998	6.32	5.99	0.33
1999	5.76	5.06	0.70
		Average	**3.10 %**
		Average 1995-99	**1.07 %**

Source: Expected Returns from Schedule 12, page 2 of 2; 30-Year Treasury Bond Yield, *Federal Reserve Bulletin.*

Moody's Public Utility Bond Yields

Year	Aaa	Aa	A	Baa
1968	6.22 %	6.35 %	6.51 %	6.87 %
1969	7.12	7.34	7.54	7.93
1970	8.31	8.52	8.69	9.18
1971	7.72	8.00	8.16	8.63
1972	7.46	7.60	7.72	8.17
1973	7.60	7.72	7.84	8.17
1974	8.71	9.04	9.50	9.84
1975	9.03	9.44	10.09	10.96
1976	8.63	8.92	9.29	9.82
1977	8.19	8.43	8.61	9.06
1978	8.87	9.10	9.29	9.62
1979	9.87	10.23	10.49	10.97
1980	12.30	13.00	13.34	13.95
1981	14.64	15.30	15.95	16.54
1982:				
January	15.79	16.48	16.83	17.83
February	15.88	16.33	16.84	17.83
March	15.05	15.57	16.50	17.16
April	14.86	15.12	16.31	17.00
May	14.68	15.01	16.04	16.68
June	15.32	15.78	16.42	17.21
July	14.96	15.67	16.42	17.09
August	13.98	14.71	15.83	16.37
September	13.24	13.92	15.40	15.68
October	12.42	13.21	14.79	15.10
November	12.11	12.92	14.46	14.81
December	12.32	12.76	14.43	14.69
1983:				
January	12.29	12.74	14.24	14.56
February	12.48	13.02	14.26	14.61
March	12.19	12.67	13.94	14.33
April	12.00	12.43	13.61	14.07
May	12.01	12.44	13.50	14.05
June	12.23	12.64	13.64	14.16
July	12.69	12.86	13.58	14.01
August	13.04	13.18	13.57	14.21
September	12.85	13.04	13.42	14.10
October	12.66	12.88	13.25	13.95
November	12.82	12.97	13.38	14.12
December	13.00	13.14	13.52	14.23

Moody's Public Utility Bond Yields

Year	Aaa	Aa	A	Baa
1984:				
January		13.02 %	13.39 %	14.05 %
February		13.04	13.41	14.05
March		13.66	13.87	14.56
April		13.93	14.16	14.82
May		14.66	14.90	15.28
June		14.90	15.09	15.50
July		14.42	14.82	15.50
August		13.67	14.43	14.79
September		13.43	14.17	14.51
October	13.00	13.38	13.80	14.17
November	12.66	13.00	13.23	13.72
December	12.49	12.76	13.11	13.46
1985:				
January	12.47	12.68	12.99	13.36
February	12.61	12.87	13.08	13.44
March	13.08	13.50	13.87	14.19
April	12.77	13.17	13.61	14.11
May	12.18	12.65	13.12	13.62
June	11.17	11.68	12.13	12.66
July	11.18	11.55	12.07	12.70
August	11.23	11.65	12.13	12.73
September	11.27	11.68	12.13	12.72
October	11.23	11.61	12.01	12.52
November	10.71	11.10	11.49	12.04
December	10.24	10.57	10.97	11.48
1986:				
January	10.14	10.44	10.79	11.24
February	9.65	9.98	10.26	10.74
March	8.75	9.16	9.48	9.91
April	8.45	8.87	9.14	9.63
May	9.07	9.38	9.59	10.02
June	9.02	9.36	9.62	10.03
July	8.66	9.05	9.37	9.69
August	8.59	9.03	9.29	9.70
September	8.91	9.28	9.52	9.96
October	8.84	9.24	9.52	9.95
November	8.59	9.01	9.28	9.69
December	8.41	8.81	9.12	9.49

Moody's Public Utility Bond Yields

Year	Aaa	Aa	A	Baa
1987:				
January	8.23 %	8.62 %	8.95 %	9.27 %
February	8.29	8.69	9.00	9.24
March	8.21	8.64	8.93	9.19
April	8.83	9.15	9.38	9.85
May	9.34	9.63	9.91	10.40
June	9.37	9.61	10.02	10.46
July	9.56	9.70	10.13	10.62
August	9.92	10.05	10.45	10.90
September	10.53	10.66	11.22	11.58
October	10.92	11.11	11.34	11.91
November	10.43	10.62	10.82	11.40
December	10.64	10.78	10.98	11.55
1988:				
January	10.39	10.52	10.76	11.34
February	9.77	9.91	10.10	10.65
March	9.72	9.92	10.09	10.69
April	10.07	10.29	10.54	11.23
May	10.29	10.53	10.81	11.38
June	10.27	10.52	10.79	11.27
July	10.50	10.76	11.04	11.52
August	10.66	10.85	11.17	11.69
September	10.15	10.34	10.61	11.13
October	9.62	9.79	9.97	10.31
November	9.52	9.80	9.90	10.35
December	9.67	9.90	10.06	10.44
1989:				
January	9.72	9.89	10.08	10.38
February	9.71	9.93	10.07	10.38
March	9.87	10.05	10.23	10.50
April	9.88	10.02	10.18	10.49
May	9.60	9.79	9.99	10.29
June	9.13	9.37	9.64	9.80
July	8.98	9.23	9.50	9.64
August	9.02	9.27	9.52	9.64
September	9.10	9.35	9.58	9.70
October	9.01	9.28	9.54	9.64
November	8.92	9.25	9.51	9.64
December	8.92	9.26	9.44	9.60

Moody's Public Utility Bond Yields

Year	Aaa	Aa	A	Baa
1990:				
January	9.08	9.39	9.56	9.74
February	9.35	9.59	9.76	9.96
March	9.48	9.60	9.85	10.06
April	9.60	9.81	9.92	10.13
May	9.58	9.83	10.00	10.16
June	9.38	9.60	9.80	9.96
July	9.36	9.61	9.75	9.92
August	9.54	9.78	9.92	10.12
September	9.73	9.87	10.12	10.32
October	9.66	9.77	10.05	10.28
November	9.43	9.59	9.90	10.12
December	9.18	9.42	9.73	9.96
1991:				
January	9.17	9.39	9.71	9.96
February	8.92	9.16	9.47	9.68
March	9.04	9.23	9.55	9.74
April	8.95	9.14	9.46	9.64
May	8.93	9.16	9.44	9.64
June	9.10	9.28	9.59	9.79
July	9.10	9.26	9.55	9.69
August	8.81	9.06	9.29	9.47
September	8.65	8.95	9.16	9.34
October	8.57	8.92	9.12	9.32
November	8.52	8.87	9.05	9.28
December	8.38	8.71	8.88	9.07
1992:				
January	8.22	8.63	8.84	8.98
February	8.30	8.76	8.93	9.09
March	8.39	8.82	8.97	9.16
April	8.36	8.76	8.93	9.11
May	8.32	8.69	8.87	9.01
June	8.26	8.63	8.78	8.90
July	8.12	8.45	8.57	8.69
August	8.04	8.30	8.44	8.58
September	8.04	8.28	8.40	8.54
October	8.06	8.42	8.54	8.76
November	8.11	8.51	8.63	8.86
December	8.01	8.32	8.43	8.69

Moody's Public Utility Bond Yields

Year	Aaa	Aa	A	Baa
1993:				
January	7.94	8.14	8.27	8.57
February	7.75	7.92	8.04	8.31
March	7.64	7.76	7.90	8.10
April	7.50	7.64	7.81	8.11
May	7.44	7.64	7.86	8.18
June	7.37	7.54	7.75	8.05
July	7.25	7.38	7.54	7.93
August	6.94	7.07	7.25	7.59
September	6.76	6.89	7.04	7.35
October	6.75	6.89	7.03	7.27
November	7.06	7.17	7.30	7.69
December	7.06	7.18	7.34	7.73
1994:				
January	7.05	7.18	7.33	7.66
February	7.19	7.34	7.42	7.76
March	7.60	7.74	7.85	8.11
April	8.00	8.12	8.22	8.47
May	8.11	8.24	8.33	8.61
June	8.07	8.21	8.31	8.64
July	8.21	8.38	8.47	8.80
August	8.15	8.32	8.41	8.74
September	8.41	8.56	8.64	8.98
October	8.65	8.78	8.86	9.24
November	8.77	8.90	8.98	9.35
December	8.55	8.69	8.76	9.16
1995:				
January	8.53	8.66	8.73	9.15
February	8.33	8.45	8.52	8.93
March	8.18	8.29	8.37	8.78
April	8.08	8.17	8.27	8.67
May	7.17	7.80	7.91	8.30
June	7.39	7.49	7.60	8.01
July	7.51	7.60	7.70	8.11
August	7.66	7.71	7.83	8.24
September	7.42	7.48	7.62	7.98
October	7.23	7.30	7.46	7.82
November	7.13	7.22	7.43	7.81
December	6.94	7.03	7.23	7.63
1996:				
January	6.92	7.02	7.22	7.64
February	7.11	7.20	7.37	7.78
March	7.45	7.55	7.73	8.15
April	7.60	7.70	7.89	8.32
May	7.73	7.79	7.98	8.45
June	7.83	7.87	8.06	8.51
July	7.78	7.83	8.02	8.44
August	7.59	7.66	7.84	8.25
September	7.76	7.84	8.01	8.41
October	7.50	7.60	7.77	8.15
November	7.21	7.32	7.49	7.87
December	7.33	7.44	7.59	7.98

Moody's Public Utility Bond Yields

Year	Aaa	Aa	A	Baa
1997:				
January	7.53	7.68	7.77	8.18
February	7.47	7.60	7.64	8.02
March	7.70	7.84	7.87	8.26
April	7.88	8.00	8.03	8.42
May	7.72	7.85	7.89	8.28
June	7.55	7.68	7.72	8.12
July	7.29	7.43	7.48	7.87
August	7.39	7.46	7.51	7.92
September	7.33	7.43	7.47	7.79
October	7.18	7.28	7.35	7.67
November	7.09	7.15	7.25	7.49
December	6.99	7.07	7.16	7.41
1998:				
January	6.85	6.94	7.04	7.28
February	6.91	6.99	7.12	7.36
March	6.96	7.04	7.16	7.37
April	6.94	7.02	7.16	7.37
May	6.94	7.06	7.16	7.34
June	6.80	6.91	7.03	7.21
July	6.80	6.91	7.03	7.23
August	6.75	6.87	7.00	7.20
September	6.66	6.78	6.93	7.13
October	6.63	6.79	6.96	7.13
November	6.59	6.89	7.03	7.31
December	6.43	6.78	6.91	7.24
1999:				
January	6.41	6.82	6.97	7.30
February	6.56	6.94	7.09	7.41
March	6.78	7.11	7.26	7.55
April	6.80	7.11	7.22	7.51
May	7.09	7.38	7.47	7.74
June	7.37	7.67	7.74	8.03
July	7.34	7.62	7.71	7.97
August	7.54	7.82	7.91	8.16
September	7.55	7.82	7.93	8.19
October	7.73	7.96	8.06	8.32
November	7.56	7.82	7.94	8.12
December	7.76	8.00	8.14	8.28
2000:				
January	7.95	8.17	8.35	8.40
February	7.82	7.99	8.25	8.33
March	7.87	7.99	8.28	8.40
April	7.87	8.00	8.29	8.40
May	8.22	8.44	8.70	8.86

Source: *Moody's Public Utility Manuals* and *Mergent Bond Record.*

Value Line and S&P Betas: Telephone Companies

Bell Regional Holding Companies:

Company	Value Line Beta	S&P Beta
Bell Atlantic	0.85	0.63
BellSouth	0.80	0.42
SBC Communications	0.80	0.79
Average	0.82	0.61

Independent Telephone Companies:

Company	Value Line Beta	S&P Beta
ALLTEL	0.70	0.47
CenturyTel	0.90	0.79
GTE Corp.	0.85	0.66
Sprint	NMF	0.53
Telephone & Data	0.75	0.78
Average	0.80	0.65
U.S. West, Inc.	0.75	0.44

Source: *Value Line*, April 7, 2000;
Standard & Poor's Corporation, *Stock Reports, January 2000.*

Value Line Projected Returns: Telephones

Bell Regional Holding Companies:

Company	1996	1997	1998	1999	2000	2001	2003-2005
Bell Atlantic	23.4 %	29.0 %	32.5 %	30.5 %	29.0 %	29.0 %	26.0 %
BellSouth	19.0	18.4	20.2	25.8	26.0	26.0	21.0
SBC Communications	30.7	34.0	32.2	27.8	25.5	24.5	21.5
Average	**24.4 %**	**27.1 %**	**28.3 %**	**28.0 %**	**26.8 %**	**26.5 %**	**22.8 %**
Independent Telephone Companies:							
ALLTEL	17.4 %	18.1 %	17.7 %	18.0 %	18.5 %	19.0 %	20.0 %
CenturyTel	12.6	11.6	12.9	13.3	12.5	14.0	16.0
GTE Corp.	38.0	34.8	28.4	31.5	30.5	28.5	23.5
Sprint	14.4	10.2	17.1	16.5	14.5	16.0	16.0
Telephone & Data	3.0	NMF	NMF	2.5	4.0	4.0	8.0
Average	**17.1 %**	**18.7 %**	**19.0 %**	**16.4 %**	**16.0 %**	**16.3 %**	**16.7 %**
US West, Inc.	**29.7 %**	**25.0 %**	**NMF**	**NMF**	**NMF**	**NMF**	**41.0 %**

Source: *Value Line*, April 7, 2000.

Weighted Average Cost of Capital

Based on February 2000 US West Communications-Arizona Capital Structure

Components	Amount	Ratio	Cost Rate	Weighted Cost
Net funded Debt	$750,608	38.77 %	7.56 %	2.93 %
Capital Leases	19,376	1.00	6.19	0.06
Long-term Debt	$769,984	39.77	7.54	3.00
Notes Payable	$62,313	3.22 %	5.85 %	0.19 %
Current maturities	88,684	4.58	6.43	0.29
Short-term Debt	$150,997	7.80	6.61	0.48
Total Debt	$920,981	47.57	7.39	3.48
Common equity	$1,015,260	52.43 %	11.50 %	6.03 %
Total Capitalization	**$1,936,241**	**100.00 %**		**9.51 %**

Source: Supplemental Direct Exhibits of Peter C. Cummings, Exhibit PCC-02 and testimony of John B. Legler.

BEFORE THE
ARIZONA CORPORATION COMMISSION

U. S. WEST COMMUNICATIONS, INC.

Docket No. T-1051B-99-105

SURREBUTTAL TESTIMONY

OF

LARKIN & ASSOCIATES
HUGH LARKIN, JR.

ON BEHALF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

Phoenix, Arizona
September 2000

EXHIBIT
RUCO-8
admitted

TESTIMONY OF HUGH LARKIN, JR.
TABLE OF CONTENTS

Page

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Hugh Larkin, Jr.. My business address is: Larkin & Associates, 15728 Farmington Road, Livonia, Michigan 48154.

Q. ARE YOU THE SAME HUGH LARKIN, JR. WHO PREVIOUSLY SUBMITTED TESTIMONY IN THIS CASE?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony on behalf of the Arizona Residential Utility Consumer Office (RUCO) is to respond to certain issues presented in the rebuttal testimony of Qwest Corporation, the regulated telecommunications subsidiary of Qwest Communications International, Inc. Qwest Corporation is the new name of the former U S West Communications, Inc. Consequently, in my surrebuttal testimony, I will refer to the former U S West Communications, Inc. as Qwest or the Company. In my surrebuttal testimony, I am addressing two areas in my initial testimony that were rebutted by Qwest, specifically incentive compensation and directory revenues.

II. DIRECTORY REVENUE IMPUTATION

Q. PLEASE DISCUSS ANN KOEHLER-CHRISTENSEN'S REBUTTAL TESTIMONY ON THE SUBJECT OF DIRECTORY REVENUE.

A. In her rebuttal testimony, Ms. Koehler-Christensen attempts to rebut RUCO and Staff's position that the directory revenue imputation adjustment, which has been a regular recurring adjustment for over ten years, should be discontinued. The imputation was part of the settlement agreement entered into by the parties in 1988 and has recently been upheld by the Court of Appeals. Ms. Koehler-Christensen's rebuttal testimony is not persuasive and provides no compelling argument for reversing this long-standing and long accepted adjustment.

Q. PLEASE DISCUSS MS. KOEHLER-CHRISTENSEN'S REBUTTAL TESTIMONY IN REGARDS TO STAFF WITNESS BROSCH'S ASSERTION THAT THE COMPANY SHOULD HAVE OBTAINED COMPETITIVE BIDS FOR THE PUBLICATION OF WHITE PAGES.

A. Staff Witness Brosch claims in his direct testimony that the Company should have obtained competitive bids for the publication of the white pages. In rebuttal to his testimony, Ms. Koehler-Christensen asserts that Mr. Brosch has provided no evidence of what the results of such bids might have been and that none of the RBOCs have ever solicited bids. She indicates that "DEX has been publishing directories as a separate affiliate for the last sixteen years and has never been asked to bid for the right to be the official publisher of a CLEC or ILEC." Her arguments ignore the fact that DEX is an affiliated company to Qwest. As such, there should be a higher level of scrutiny in regards to transactions between DEX and Qwest. Without Qwest undergoing a competitive bid process, there is no way to know whether or not the transactions between itself and its affiliate are reasonable or what the actual value of those services may be. Mr. Brosch had "no evidence of what the results of such a bid may have been" because the Company has not instigated a competitive bid process.

Q. IS IT STILL YOUR POSITION THAT THE DIRECTORY REVENUE IMPUTATION ADJUSTMENT, WHICH INCREASES REVENUES BY $41.3 MILLION, SHOULD BE ADOPTED BY THE COMMISSION?

A. Yes, it is.

III. INCENTIVE COMPENSATION

Q. PLEASE DISCUSS THE COMPANY'S OVERALL REBUTTAL TO YOUR ADJUSTMENT TO INCENTIVE COMPENSATION EXPENSE.

A. Qwest's overall stance in this case appears to be that if it incurs a cost, that cost should not be questioned and should automatically be flowed through to ratepayers. Under the Company's overall annualization approach (i.e., December 1999 amounts times 12), it would not allow for the scrutiny of individual expense items. It appears that Qwest believes its overall cost levels are appropriate and that scrutiny of individual cost items is unwarranted.

Q. DO YOU AGREE WITH QWEST'S POSITION?

A. No. One of the purposes of regulatory oversight is to ensure that captive ratepayers are not held responsible for costs which should not be allocated to them. The Company's approach would essentially discontinue any sort of prudency reviews or analysis of specific cost items.

At page 6 of his Rebuttal Testimony, Mr. Grate contends that "Under cost of service regulation, ratepayers are protected from whatever market power utilities possess by the setting of rates based on cost and no more; Utilities are protected from confiscation by the setting of rates based on cost and no less." His rebuttal ignores one of the purposes of regulation, which is to ensure that the captive ratepayers are not being harmed through the market power of the utilities. There remains a need to scrutinize the costs the monopoly utility incurs, not to merely accept them at face value with no analysis or review.

Q. DID QWEST AGREE WITH ANY PART OF YOUR ADJUSTMENT FOR INCENTIVE COMPENSATION EXPENSE?

A. Yes and no, depending on if you rely on Qwest's rebuttal testimony, or its response to subsequent data requests. I my direct testimony, I recommended that 50% of the costs associated with the Short Term Incentive Plan (STIP), Annual Bonus Plan (ABP) and IT-Career Structure Bonus Plan be removed and 100% of the Long Term Incentive Plan (LTIP) be removed. In his Rebuttal Testimony, at page 5, Mr. Grate indicates that he does not oppose adjusting LTIP expenses out of the test year. As stated in his rebuttal testimony, "The LTIP has been replaced with a plan that relies exclusively on stock options, which generate no operating expenses." He continues, stating "the Company expects to bear no expenses for LTIP after 2000." Mr. Grate then acknowledges on lines 11-12 of page 5 of his rebuttal testimony that he does not oppose the removal of the LTIP expense. However, in response to UTI 71-008 (which was responded to by Mr. Grate), the Company responded as follows:

> Mr. Grate did not recommend adjusting the test year to eliminate LTIP expenses because the test year incentive compensation expenses, in total and with LTIP expenses being absent, are below the level the Company believes will be ongoing. See Mr. Redding's testimony regarding year end annualization to better reflect ongoing levels of expense.

Apparently, the Company agrees that the LTIP cost will not be incurred in the rate year and does not oppose the removal in its Rebuttal Testimony, then it directly opposes the removal in a subsequent data response. This once again demonstrates that the Company's proposed methodology is to ignore the prudency and/or appropriateness of specific expense items, and recommends that the Commission just rubber stamp all costs incurred by the Company regardless of the appropriateness. Clearly, the inclusion of non-recurring costs in the adjusted test year is not appropriate.

Q. DO ANY ADDITIONAL RECOMMENDATIONS IN MR. GRATE'S REBUTTAL TESTIMONY CONFLICT WITH THE COMPANY'S OVERALL APPROACH REGARDING APPROVING OVERALL EXPENSE LEVELS AND NOT SPECIFIC EXPENSE ITEMS?

A. Yes. At pages 29 – 30 of his rebuttal testimony, Mr. Grate addresses my assertion that some of the specific business unit goals are in direct conflict with ratepayer concerns, along with my recommendation that 50% of the ABP costs be disallowed. As mentioned above, the Company would prefer that overall cost levels be approved and that specific components of the costs be essentially ignored. For example, the Company has agreed that the LTIP costs will not be incurred after the year 2000, yet asserts that the overall cost level that includes the LTIP is "reasonable" and should be adopted, inclusive of the non-recurring LTIP costs. However, at page 29 of his rebuttal testimony, when addressing my concerns regarding the APB goals, Mr. Grate states that "I believe that the remedy for work that directly conflicts with ratepayer concerns is to determine whether the work is unnecessary or imprudent, and if it is, to disallow all the costs of it." In one regard, the Company indicates that overall cost levels should be evaluated and not individual costs, in the other regard the Company indicates that the hundreds of individual goals included in the ABP should be analyzed and quantified in making a recommendation for disallowance. Apparently, the Company wants the best of both worlds, depending upon which would better serve its interests.

Q. MR. GRATE'S TESTIMONY INCLUDES A HYPOTEHTICAL CALCULATION WHICH PURPORTEDLY DEMONSTRATES THAT RATEPAYERS ARE BETTER OFF IN SITUATIONS IN WHICH A UTILITY HAS AN INCENTIVE COMPENSATION PLAN. DOES THE HYPOTHETICAL INCLUDED IN HIS TESTIMONY PERTAIN SPECIFICALLY TO QWEST AND ITS SITUATION?

A. No, it does not. The hypothetical presented by Mr. Grate is very simplistic and based on the assumptions he presents. When asked specific questions regarding the hypothetical calculations presented in his testimony and the intent of the hypothetical in UTI 71-015 and UTI 71-016, Mr. Grate replied: "the purpose of the mathematical demonstration is pedagogical." The hypothetical is overly simplistic, is not specific to U S West's/Qwest's experience and should be given no weight.

Q. DID MR. GRATE'S REBUTTAL TESTIMONY CAUSE YOU TO REVISE YOUR POSITION REGARDING THE INCENTIVE COMPENSATION COSTS?

A. No, it did not. I continue to recommend that 50% of the costs associated with the STIP, ABP and Information Technologies Career Structure Bonus Plan be removed, along with 100% of the LTIP costs. The Company has not disputed the fact that shareholders also benefit from these plans and that several of the goals of these plans are driven by factors that serve to benefit shareholders, sometimes at ratepayer expense.

Q. AT PAGES 16 – 17 OF HIS REBUTTAL TESTIMONY, MR. GRATE STATES THAT YOUR RATIONALE FOR DISALLOWING 50% OF THE INCENTIVE PLAN COSTS IS NOT SOUND RATEMAKING POLICY. PLEASE COMMENT ON HIS REBUTTAL.

A. Mr. Grate indicates that my argument for allocating 50% of the costs to shareholders based on the fact that shareholders benefit from the targets in the incentive plans would discourage utilities from incurring costs to improve business efficiency and financial performance. He indicates that if my "rationale were consistently applied in ratemaking, then 50% of any cost aimed at fostering or improving business efficiency would be disallowed…" Mr. Grate misses the point. The implementation of the incentive compensation plan is at the discretion of the Company and its shareholders. It is the Company's management who has complete control over what targets and goals are set within the various incentive compensation plans. As discussed in my direct testimony, the Company has chosen to set the targets and goals based on factors that serve to benefit the Company's shareholders. Setting the annual goals and targets are within the complete control of the Company, with ratepayers having no input into the process. If such targets and goals serve to promote goals that are primarily within shareholders interest, they should share in bearing the cost of the associated plans. In fact, as pointed out in my direct testimony, several of the specific business unit goals under the ABP are in direct conflict with ratepayer concerns. Clearly ratepayers should not be responsible for 100% of these costs.

Q. DID QWEST REBUT YOUR RECOMMENDATION THAT 50% OF THE COSTS ASSOCIATED WITH THE INFORMATION TECHNOLOGY CAREER STRUCTURE BONUS PLAN BE REMOVED?

A. Yes. As pointed out in my direct testimony, the structure of the Information Technology (IT) unit has changed, with the employees having been transferred to an affiliated company, Qwest Information Technologies, Inc. RUCO specifically asked the Company if the IT bonus would continue at the level included in the 1999 test year and the Company did not directly answer the question posed. In his rebuttal testimony, Mr. Grate indicates that the costs of the employees who received bonuses under the IT Career Structure Bonus Plan (ITCSBP) have become employees of Qwest Information Technologies, Inc. and the costs are now recorded on that company's books. He also indicates that Qwest bears the costs of the plan to the extent the costs of Qwest IT employees are affiliate-billed to Qwest. However, the Company has presented no factual evidence, nor even a discussion, regarding the level of costs that will now be allocated to Qwest for these employees and how that cost level compares to the costs included in the adjusted test year which still reflects those employees as employees of Qwest. Mr. Grate states that "The cost of the plan should follow and be allowed to the same extent as all other employee compensation costs included in charges affiliate billed to Qwest."

Despite this assertion, Qwest has provided absolutely no information regarding the level of the ITCSBP costs that will now be allocated to Qwest from Qwest IT and how that amount compares to the amounts actually incurred by Qwest prior to the employee transfers. Accordingly, there is no evidence to support Mr. Grate's contention that future cost allocations of the IT costs will be commensurate with the level incurred during 1999 prior to the transfer of these employees to an affiliate.

IV. NON-PRODUCT ADS, OLYMPIC & SPORTS SPONSORSHIP

Q. THE REBUTTAL TESTIMONY OF QWEST WITNESS REDDING, AT PAGES 35-40, ARGUES THAT CUSTOMERS SHOULD BEAR THE COST OF NON-PRODUCT ADVERTISING. PLEASE RESPOND.

A. Non-product advertising, unlike product advertising, is of little or no benefit to the Arizona jurisdictional ratepayers. The purpose of non-product advertising is to promote the image of US WEST, now Qwest, and not to attempt to sell specific products to ratepayers, which would increase regulated revenue in Arizona. While the Company may argue that it is appropriate to promote the corporate or Company image, the link between non-product advertising and increased sales of regulated services in Arizona is remote and certainly not quantifiable. Therefore, it is appropriate to remove from the test year revenue requirement any non-product/image advertising expenses.

Q. AT PAGE 39 OF HIS REBUTTAL, MR. REDDING STATES THAT EVERY LARGE COMPANY, REGARDLESS OF INDUSTRY, ENGAGES IN IMAGE ADVERTISING

AND INCLUDES IN ITS PRICE AN ELEMENT OF THAT COST. DO YOU AGREE WITH THIS?

A. No. While large companies in many industries engage in image advertising, in competitive industries the price for service is based on market conditions, whereas for regulated telephone services, the price for non-competitive services is based on the recovery of costs associated with those products. Basic telephone service is considered an essential in today's economy. Image advertising by Qwest does nothing to change this. Consequently, the cost of such image advertising should not be included in the price of regulated, non-competitive services.

Q. HAS QWEST DEMONSTRATED THAT THERE IS A STRONG LINKAGE BETWEEN INCREASED SALES OF REGULATED TELEPHONE SERVICES TO ARIZONA CUSTOMERS AND IMAGE ADVERTISING?

A. No. The quotes from author Tom Peters on pages 36-37 of Mr. Redding's rebuttal testimony certainly do not demonstrate this.

Q. WOULD IT BE PUNITIVE TO DISALLOW THE COMPANY'S NON-PRODUCT ADVERTISING EXPENSE FOR ARIZONA INTRASTATE RATEMAKING PURPOSES?

A. No, it would not. Disallowance of such expense for ratemaking purposes would merely protect ratepayers of regulated, non-competitive services from paying a cost that provides them with no direct benefit. If Qwest management determines that there is benefit to the Company from non-product advertising, and that such benefits outweigh the cost being borne by shareholders, of course, the Company is free to engage in such image advertising efforts.

Q. HAVE CORPORATE IMAGE-BUILDING ADVERTISING COSTS TRADITIONALLY BEEN DISALLOWED FOR RATEMAKING PURPOSES?

A. Yes, they have.

Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

BEFORE THE
ARIZONA CORPORATION COMMISSION

U. S. WEST COMMUNICATIONS, INC.

Docket No. T-1051B-99-105

SURREBUTTAL TESTIMONY

OF

LARKIN & ASSOCIATES
RALPH C. SMITH

ON BEHALF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

Phoenix, Arizona
September 2000

EXHIBIT
RUCO-9
admitted

SURREBUTTAL TESTIMONY OF RALPH C. SMITH
TABLE OF CONTENTS

Attachments:

Attachment RCS-S1 (5 pages)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Ralph C. Smith. My business address is: Larkin & Associates, 15728 Farmington Road, Livonia, Michigan 48154.

Q. ARE YOU THE SAME RALPH C. SMITH WHO PREVIOUSLY SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING ON BEHALF OF RUCO?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony on behalf of the Arizona Residential Utility Consumer Office (RUCO) is to respond to certain issues presented in the rebuttal testimony of Qwest Corporation, the regulated telecommunications subsidiary of Qwest Communications International, Inc. Qwest Corporation is the new name of the former U S West Communications, Inc. Consequently, in my surrebuttal testimony, I will refer to U S West Communications, Inc. (USWC) as Qwest or the Company on a current or forward-looking basis. When referring to prior rate cases and past events, I generally refer to the regulated telephone operation as USWC.

Q. WHAT ISSUES ARE ADDRESSED IN YOUR SURREBUTTAL TESTIMONY?

A. I am addressing certain issues concerning rate base, net operating income, and adjustment summaries on behalf of RUCO in this proceeding. Hugh Larkin, Jr., of Larkin &

Associates is also presenting surrebuttal testimony to address Qwest's rebuttal to a number of recommended adjustments on behalf of RUCO in this proceeding.

Q. IN YOUR DIRECT TESTIMONY, YOU MENTIONED THAT THE COMPANY AND RUCO REACHED A POTENTIAL REMEDY FOR ALLOWING RUCO TO ADDRESS OTHER ISSUES, FOR WHICH LARKIN & ASSOCIATES HAD NOT COMPLETED ITS ANALYSIS OR QUANTIFICATION AS OF THE TIME THE DIRECT TESTIMONY WAS SUBMITTED. DO YOU RECALL THAT?

A. Yes. In my direct testimony I mentioned that I was advised by RUCO counsel that US West and RUCO agreed that RUCO may submit with its surrebuttal testimony additional adjustments and testimony resulting from the completion of the analysis of USWC's (now Qwest's) 1999 test year filing. I noted that our ability to analyze issues is heavily dependent upon receiving responsive answers from USWC in response to discovery.

Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?

A. The remainder of my testimony is organized in the following manner. I first respond to Qwest's attempt to essentially convert the test year concept into a "test month." I then respond to Qwest's rebuttal concerning specific adjustments I am sponsoring on behalf of RUCO. I address three issues for which our analysis had not been completed as of the time our direct testimony on behalf of RUCO was written. Finally, I identify the specific schedules that are being provided in Exhibit ___(L&A-2), which is being filed with RUCO's surrebuttal.

Q. WHAT AMOUNT OF REVENUE SUFFICIENCY DO YOU SHOW FOR QWEST'S ARIZONA INTRASTATE REVENUE REQUIREMENT?

A. As shown on Schedule A Revised, included with this surrebuttal, the revenue sufficiency for Qwest's Arizona intrastate revenue requirement is $34.1 million. This indicates that a rate reduction amounting to $34.1 million of intrastate revenue is warranted.

II. TEST YEAR

Q. WHAT TEST YEAR HAS BEEN USED ON BEHALF OF RUCO FOR COMPUTING THE INTRASTATE REVENUE REQUIREMENT FOR QWEST IN THIS PROCEEDING?

A. The test year that we have used on behalf of RUCO for computing the intrastate revenue requirement for Qwest in this proceeding is the calendar year 1999, adjusted for known and measurable changes and for disallowances of certain expenses that should not be charged to ratepayers.

Q. QWEST WITNESS REDDING'S REBUTTAL TESTIMONY ON PAGES 4 AND 5 QUOTES FROM CERTAIN TEXTS REGARDING THE CONCEPT OF A "TEST PERIOD." PLEASE COMMENT.

A. On pages 2 through 4 of his rebuttal, Mr. Redding mentions the term "test period" numerous times. However, nothing he says would render this Commission's traditional use of a test year inapplicable. To the best of my understanding, the Arizona Corporation Commission has traditionally used a test year (i.e., a full twelve month period) as the basis for determining the utility's revenue requirement. In the instant proceeding, Qwest proposes a year-end annualization for non-labor expenses and other items. In the prior

USWC rate case, this Commission did not use across-the-board annualizations based on the last month of the test year for items such as non-labor expense. Such blanket annualizations are improper and would essentially result in converting the 1999 test year into a December 1999 test month. The Commission should reject Qwest's attempt to scrap the use of a test year and replace it with a "test month" as the basis for determining the revenue requirement.

Q. DOES THE RESTATEMENT OF TEST YEAR NON-LABOR EXPENSE RESULT IN CONDITIONS THAT ARE NECESSARILY REFLECTIVE OF CONDITIONS WHEN NEW RATES ARE EXPECTED TO BE IN EFFECT?

A. No. Making specific pro forma adjustments for known and measurable changes is the process designed to address this. However, annualizing all non-labor expenses merely results in a distortion to the recorded test year expenses. Specific known and measurable changes are reflected to the test year to make the recorded results better reflect known conditions. However, this does not mean that items such as non-labor expenses in the last month of the test year should replace the actual recorded expenses in the full twelve month period constituting the test year. The Company has failed to demonstrate that the test year recorded non-labor expenses are unrepresentative of normal conditions and require an across-the-board adjustment. The Commission should reject Qwest's inappropriate attempt at converting the 1999 test year into a December 1999 test month. The Company's proposed non-labor expense annualization should be rejected.

Q. DO THE PASSAGES QUOTED ON PAGES 7 AND 8 OF QWEST WITNESS REDDING'S REBUTTAL SUPPORT THE COMPANY'S PROPOSED NON-LABOR ANNUALIZATION ADJUSTMENT?

A. No, they do not. The statements quoted by Mr. Redding on pages 7 and 8 of his rebuttal merely describe the selection of the test year, "which is usually the latest <u>12 months</u> for which there are complete data" and the well-recognized need for making pro forma adjustments for known and measurable changes occurring within the test year, and to a limited extent after the end of the test year. (Emphasis supplied.) One of the passages quoted by Mr. Redding at pages 7-8 of his rebuttal states that: "For many years, commissions have adjusted test-year data for 'known changes' i.e., a change that actually took place during or after the test period." This suggests that the regulatory commission's own prior treatment of a particular item can be used as some guidance for how the same item should be treated in subsequent regulatory proceedings. Qwest's proposed blanket annualization of non-labor expense is not consistent with and goes well beyond this Commission's method of adjusting test year expenses for known and measurable changes.

Q. AT PAGES 8 THROUGH 10 OF HIS REBUTTAL, QWEST WITNESS REDDING DESCRIBES A "TEST" HE PURPORTEDLY MADE TO "OVERLAY" THE STAFF AND RUCO REVENUE REQUIREMENTS "ON 2000 ACTUAL RESULTS." DO YOU AGREE WITH MR. REDDING'S ANALYSIS?

A. No, I do not. Mr. Redding's analysis is so severely flawed as to be essentially meaningless. First, he uses May 2000 year-to-date results, annualized, as the basis for his comparison of net operating income. It is not accurate to describe this as "2000 actual results" because it does not reflect the full year's results for calendar year 2000. There is no support for substituting five months of post-test year net operating income results for the 1999 test year results. To the best of my knowledge, this Commission has generally not accepted that type of blanket test year updating with post test-year results. Moreover, there is no indication that Mr. Redding reflected in his year-to-date May 2000 annualized results the types of adjustments that Staff and RUCO are recommending. To the extent that Mr. Redding's May 2000 results fail to include similar adjustments and expense disallowances to those being proposed by Staff and RUCO, he is making an "apples to oranges" comparison that proves nothing.

Q. IS MR. REDDING ALSO ATTEMPTING TO IMPROPERLY INFLATE THE RATE BASE IN HIS PURPORTED "TEST" OF THE REVENUE REQUIREMENT?

A. Yes. The presentation on page 9 of Qwest witness Redding's rebuttal attempts to use a May 2000 rate base of $1.630 billion. This is significantly higher than the $1.421 billion Arizona intrastate rate base filed by the Company using the 1999 test year. It is also significantly higher than the $1.399 billion Arizona intrastate rate base proposed in RUCO's direct testimony, as shown on RUCO Exhibit ___(L&A-1), Schedule B. Thus, Mr. Redding's attempt to utilize a new higher rate base by going out five months beyond the end of the 1999 test year contributes towards the distorted presentation of Staff and RUCO results on page 9 of his rebuttal.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THE "RESULTS OF THE TEST" PRESENTED BY MR. REDDING AT PAGE 9 OF HIS REBUTTAL?

A. Yes. As explained above, Qwest witness Redding's purported "test" presented on page 9 of his rebuttal is so severely flawed it cannot be relied upon for any conclusions regarding whether the Staff and RUCO revenue requirement recommendations are appropriate. However, Mr. Redding's presentation shows in the "Qwest" column that the Company's calculated revenue deficiency would produce a return on average investment of 11.04%,. This exceeds even Qwest's own recommended rate of return,. Thus, even by the standards of Mr. Redding's purported "test," the Company's calculated revenue deficiency is overstated.

Q. YOU MENTIONED THAT BECAUSE OF ITS SEVERE FLAWS, THE PRESENTATION ON PAGE 9 OF QWEST WITNESS REDDING'S REBUTTAL TESTIMONY DOES NOT LEAD TO ANY RELIABLE CONCLUSIONS REGARDING THE APPROPRIATENESS OF RUCO'S RECOMMENDED REVENUE REQUIREMENT. WHERE SHOULD ONE LOOK WHEN EVALUATING THE APPROPRIATENESS OF RUCO'S PROPOSED REVENUE REQUIREMENT?

A. When evaluating the appropriateness of RUCO's proposed revenue requirement, one should look at Exhibit ___(L&A-1) of RUCO's direct testimony and the update of that filed with RUCO's surrebuttal. These exhibits contain the schedules which show in detail the development of RUCO's recommended rate base, adjusted net operating income, rate of return, and the resultant calculation of the total change in the revenue requirement. As shown on Schedule A, for example, the revenues recommended on behalf of RUCO are sufficient to produce RUCO's recommended rate of return on the adjusted rate base, using RUCO's adjusted net operating income.

Q. AT PAGE 10, LINES 16-18, OF QWEST WITNESS REDDING'S REBUTTAL, HE INDICATES THAT, IN HIS OPINION, STAFF AND RUCO "ENGAGED IN A FAIRLY RIGOROUS DEVELOPMENT OF A REVENUE REQUIREMENT OR DEFICIENCY" AND SUGGESTS THAT THE "MUCH MORE GENERALIZED APPROACH" HE ATTRIBUTES TO DOD/FEA AND AT&T "SHOULD BE ACCORDED LESS WEIGHT THAN STAFF & RUCO." PLEASE COMMENT ON THIS OBSERVATION, IN VIEW OF THE "REVENUE REQUIREMENTS TEST" PRESENTATION SHOWN ON PAGE 9 OF MR. REDDING'S REBUTTAL.

A. The presentation on page 9 of Qwest witness Redding's rebuttal does not even rise to the level of a "much more generalized approach" that he attributes to DOE/FEA and AT&T. Accordingly, applying Mr. Redding's own suggestion on page 10 of his rebuttal, the presentation on page 9 of Qwest witness Redding's rebuttal should be accorded less weight than the presentations of <u>any</u> of the parties mentioned on his page 10, lines 16-20.

III. RECOMMENDED ADJUSTMENTS

Non-Labor Expense Annualization

Q. PAGES 13-18 OF QWEST WITNESS REDDING'S REBUTTAL TESTIMONY ADDRESS THE COMPANY'S PROPOSED NON-LABOR EXPENSE ANNUALIZATION ADJUSTMENT. DOES THAT TESTIMONY CONVINCE YOU THAT THE COMPANY'S PROPOSED NON-LABOR ADJUSTMENT IS APPROPRIATE AND SHOULD BE MADE?

A. No, it does not. A blanket annualization of non-labor expense, as proposed by Qwest, is not consistent with past Commission practice. Moreover, the analysis presented by Mr. Redding in his rebuttal is flawed. Consequently, the Company's proposed non-labor expense annualization adjustment should be rejected.

Q. HAVE YOU ACCEPTED SOME OF THE COMPONENTS OF U S WEST'S PROPOSED ANNUALIZATION ADJUSTMENTS?

A. Yes, as explained in my direct testimony, I have accepted USWC's annualization of deregulated revenue, wages and benefits expense, property taxes, rent compensation, and uncollectibles. Additionally, I agree with the concept of adjusting test year revenues, where appropriate, for known changes. As described in the direct testimony of RUCO witness Larkin, there are a number of concerns regarding U S WEST's derivation of its revenue annualization adjustment. In his direct testimony, RUCO witness Larkin discussed an alternative revenue annualization adjustment which better reflects known changes and a normal, ongoing level of operations than U S WEST's proposed adjustment does. On Exhibit E-1, filed with RUCO's direct testimony, I removed the component of U S WEST's adjustment that addresses revenue annualization. Additionally, in my opinion, the portion of U S WEST's adjustment which attempts to apply a blanket annualization of non-labor expense is not appropriate and is not consistent with past regulatory practice of this Commission. Therefore, I have also removed U S WEST's proposed non-labor adjustment. In the direct and surrebuttal testimony submitted on behalf of RUCO Mr. Larkin and I discuss adjustments to a number of specific expenses for known changes and/or recommended disallowances.

This approach is consistent with Commission practice, whereas applying a blanket annualization of non-labor expenses as proposed by Qwest, is not.

Q. AT PAGE 14, LINES 17-19, OF HIS REBUTTAL, QWEST WITNESS REDDING STATES: "I WILL COMPARE THE COMPANY'S ANNUALIZATIONS SIDE BY SIDE WITH THE RESULTS OF STAFF AND RUCO AGAINST THE LEVEL OF ACTUAL RESULTS FOR THE YEAR 2000. THIS IS THE TRUE TEST OF THE ADJUSTED TEST PERIOD LEVELS OF REVENUES AND EXPENSES." PLEASE RESPOND.

A. First, the actual results for the year 2000 are not yet known. Consequently, at this time, Mr. Redding cannot be comparing anything to the actual results for the full year 2000. He has only attempted to make a comparison using the first few months of 2000. Moreover, without analyzing in detail what the Company actually recorded in those months, one does not know if those months are representative of normal operating conditions. Typically, months outside the test year would not be analyzed in such detail because this Commission has traditionally not adopted adjustments after the test year, unless there has been a compelling reason to do so.

Remove Pension Asset from Rate Base

Q. THE REBUTTAL TESTIMONY OF QWEST WITNESS GRATE, AT PAGE 46, CHARACTERIZES THE PENSION ASSET RESULTING FROM THE FORMER US WEST'S OVERFUNDED PENSION PLAN AS A "PRIMARY COMPONENT THAT MUST BE CONSIDERED FOR INCLUSION IN RATE BASE." DO YOU AGREE WITH THAT CHARACTERIZATION OF THE PENSION ASSET?

A. No. Qwest has attempted to include $66.221 million in rate base for a pension asset. However, this asset has not been funded by shareholders and does not belong in rate base. The pension asset is not a "primary component" of rate base. It does not belong in rate base at all.

Q. AT PAGE 42 OF HIS REBUTTAL, QWEST WITNESS GRATE CLAIMS THAT THE PENSION ASSET HAS BEEN FUND "FUNDED" BY QWEST'S INVESTORS IN THE FORM OF DEBT AND EQUITY ON QWEST'S BOOKS. PLEASE RESPOND.

A. Mr. Grate apparently fails to recognize that a portion of the pension asset is related to an amount of Accumulated Deferred Income Taxes (ADIT), which is a deferred credit on the books of the former USWC (now Qwest). Moreover, merely pointing to the fact that USWC had, and Qwest has debt and equity on its books, is insufficient to demonstrate that investors have advanced excess pension amounts.

Q. WAS THIS SAME ISSUE ADDRESSED IN U S WEST'S PRIOR RATE CASE?

A. Yes, it was. In U S WEST's last Arizona rate case, Docket No. E-1051-93-183, the Commission issued Decision No. 58927. In that decision, the Commission denied U S WEST's request to include the net amount of the Company's pension asset in rate base. At page 5 of that decision, the Commission stated specifically that:

> … we find the Company has not presented sufficient evidence to clearly demonstrate that its shareholders have advanced the excess pension amounts. Accordingly, we must deny the Company's request to include the net amount of overfunding of $36,213,000 in rate base.

Q. IS QWEST ATTEMPTING IN THE INSTANT PROCEEDING TO RE-LITIGATE THE DECISION CONCERNING THE PENSION ASSET MADE BY THE COMMISSION IN THE PRIOR US WEST RATE CASE?

A. It certainly appears so. Page 53, lines 20-21, of Qwest witness Grate's rebuttal states that: "Qwest respectfully disagrees with the conclusion the Commission reached in the prior order." Thus, the Company is attempting in the current proceeding to re-litigate this issue, which it lost in the prior US WEST rate case.

Q. WHAT NEW AND DIFFERENT EVIDENCE HAS QWEST PRESENTED IN THE INSTANT CASE IN SUPPORT OF ITS ATTEMPTED RE-LITIGATION OF THIS ISSUE?

A. None. It is the same issue and the same arguments that the Company presented in the prior USWC rate case. The Commission made the correct decision in that case, and there is nothing new or different in the current case that would require a change. The pension asset should be excluded from rate base in the instant case, just as it was in the prior USWC rate case.

Q. CONCERNING ITS RATE BASE CLAIM FOR A PENSION ASSET, WHAT EVIDENCE, IF ANY, IS THE COMPANY RELYING UPON THAT THE OVER-FUNDED BALANCE WAS PROVIDED BY SHAREHOLDERS?

A. None. Data Request RUCO-9-1 asked the Company to provide such information. In response, the Company stated that: "In claiming that rate base should include the pension asset, the Company is relying upon its balance sheet upon which the pension asset appears. The balance sheet shows that the pension asset is funded by investor supplied capital in the form of debt and shareholders' capital."

However, the fact that a pension asset is on the balance sheet now is nothing new, and does not clearly demonstrate that the over funded pension balance was funded by shareholders. Moreover, the Commission has typically used lead-lag studies to determine cash working capital in rate base, and has not typically used balance sheet amounts for items such as pensions.

Q. IF THE OVER-FUNDED PENSION BALANCE WAS NOT FUNDED BY SHAREHOLDERS, BY WHOM WAS IT FUNDED?

A. The over funded pension balance was produced by a combination of the following factors: (1) the switch to accrual accounting when Statement of Financial Accounting Standards 87 (FAS 87) was adopted by the Company; (2) ratepayer payments to the Company for amounts of pension expense that were reflected in rates; and (3) earnings on the pension trust assets.

Additionally, there is an Accumulated Deferred Income Tax (ADIT) balance associated with the pension asset. The ADIT balance is a deferred credit on the balance sheet.

Q. HAS U S WEST OR QWEST CONTRIBUTED MONEY INTO THE PENSION PLAN SINCE IT ADOPTED FAS 87?

A. No. No contributions have been made to the qualified pension plan by or on behalf of USWC since the adoption of FAS 87. In other words, the Company has not contributed any funding into the qualified pension plan trust for many years, and has not contributed any since its last Arizona rate case.

Q. HOW ABOUT THE PERIOD 1994 THROUGH 1998, DID THE COMPANY MAKE ANY FUNDING CONTRIBUTIONS TO ITS QUALIFIED PENSION PLAN DURING THIS PERIOD?

A. No. The Company's response to Data Request RUCO-2-8 indicates that, due to the previous funding and earnings growth on the Pension Trust, the Company did not have a requirement to fund the Pension Trust for the years 1994 through 1998, and no funding contributions were made to the Pension Trust for those years. The Company's response to RUCO-2-8 states further that: "Nothing has been collected in rates for pension expense in the years 1994 through 1998." This response was not updated by USWC in conjunction with its 1999 test year filing; however, given the vastly over-funded status of the qualified pension plan, it is unlikely that USWC made any funding payments in 1999 either. Thus, the fund has grown during this period due to earnings on the pension trust assets, and not from any contributions from the Company's shareholders.

Q. WHAT RETURNS HAVE THE ASSETS IN THE QUALIFIED PENSION TRUST EARNED IN RECENT YEARS?

A. The Company's response to Data Request UTI-20-7 listed the annual earnings return achieved by the pension fund for each year, 1987 through 1998. That information shows that the returns have generally been quite good. Moreover, U S WEST's response to Data Request UTI-20-7, part b, indicates that the primary factor causing the pension credits is the return on plan assets. In other words, the high returns earned on pension plan assets have contributed to the growing over funded status of the qualified pension plan.

Q. SHOULD THE PENSION ASSET BE INCLUDED IN RATE BASE?

A. No, it should not. The Commission's decision in the prior USWC rate case rejected rate base inclusion for the pension asset. In the instant case, the Company has presented no new or different arguments. In the instant case, just like in the prior USWC rate case, the Company has not clearly demonstrated that the pension asset had been funded by shareholders. Therefore, the pension asset should be removed from rate base.

Q. PAGE 54 OF THE REBUTTAL TESTIMONY OF QWEST WITNESS GRATE CONTAINS TWO NEW RECOMMENDATIONS FROM THE COMPANY: (1) ENSURE THAT NO FURTHER PENSION ASSET IS CREATED BY CEASING ANY FURTHER RECOGNITION OF NEGATIVE PENSION EXPENSE IN REGULATED RESULTS OF OPERATIONS AND COST OF SERVICE, AND (2) RETURN THE PENSION ASSET TO INVESTORS BY AMORTIZING IT INTO COST OF SERVICE OVER AN APPROPRIATE AMORTIZATION PERIOD. DO YOU AGREE WITH EITHER OF THESE NEW RECOMMENDATIONS BY THE COMPANY?

A. No, I strongly disagree with each of these new Company recommendations. The negative pension expense reflected in the 1999 test year resulting from the funding surplus and the application of generally accepted accounting principles (GAAP) such as FAS 87 should be included in the operating results. In the recent Qwest/US West merger proceeding, the Commission stated that it will take into account the surplus in the pension trust fund in the current USWC rate case in establishing the on-going amounts to be paid by ratepayers. Ratepayers should receive the benefit of the lower pension expense resulting from the Commission's adoption of FAS 87 for ratemaking purposes. Moreover, this benefit should not be reduced or negated by the imposition of a return requirement for an improper rate base item, as the Company has attempted in the prior USWC rate case and again in the current rate case.

Including the pension asset in rate base is not only improper, but doing so would also largely negate the benefit to ratepayers from the negative pension expense resulting from the Commission's adoption of FAS 87.

The Company has failed to prove that the pension asset was funded by shareholders; consequently, there is no basis for requiring that the pension asset be "amortized into the cost of service" as Mr. Grate suggests. Moreover, such treatment would be contrary to GAAP, and the application of FAS 87, which the Commission has adopted for ratemaking purposes. In summary, these new proposals from Qwest are ill-conceived and should be rejected.

These new proposals are also contradicted by some of the testimony presented on behalf of the Applicants in the recent Qwest/US West merger proceeding concerning pensions.

Q. PLEASE ELABORATE UPON HOW THESE NEW PROPOSALS BY THE COMPANY ARE CONTRADICTED BY TESTIMONY PRESENTED BY APPLICANTS IN THE RECENT QWEST/US WEST MERGER PROCEEDING.

A. In the Qwest/US West merger proceeding, the rebuttal testimony of Applicant witness Carl Inouye stated at pages 7-8 as follows:

> It should be noted that the accounting practice, known as FAS 87, is a requirement that the Company must follow pursuant to Security and Exchange Commission rules. FAS 87 has been adopted by this Commission in prior rate cases.
>
> The claim that U S WEST shareholders are benefiting through inflated earnings is simply wrong. TRAA ignores that the requirement of FAS 87 to amortize the pension surplus as expense credits has caused Arizona customer rates to be lower than otherwise. Thus, any income effect of FAS 87, combined with ratemaking by this Commission, has not boosted the company's earnings. The fact of the matter is that revenue reductions achieved through ratemaking offset the pension credit to expense such that the net effect on income disappears.

At page 13, lines 18-21, of that same rebuttal testimony, Applicant witness Inouye stated:

> There is no discernible reason why the Commission's requirement for FAS 87 accounting rules should be re-looked at in the Arizona rate case. As I stated earlier, the pension credits required under FAS 87 have had the effect of lowering customer rates, but have not changed the level of pension funds.

Qwest witness Grate's new proposals in the instant rate case are inconsistent with the application of FAS 87, and are directly contradicted by the above-quoted statements from Applicant witness Inouye's rebuttal testimony in the recent Qwest/US West merger proceeding, Docket No. T-01051B-99-0497. The two new proposals by Qwest witness Grate are highly inappropriate and must be rejected.

Q. WHAT IS YOUR CONCLUSION REGARDING THE APPROPRIATE RATEMAKING TREATMENT OF THE PENSION ASSET?

A. Consistent with the Commission's findings in the prior US West rate case, the pension asset should be excluded from rate base because the Company has failed to demonstrate that it was funded by shareholders. The associated amount of ADIT should also be removed. RUCO Adjustment E-10, shown on Schedule E-10, filed with my direct testimony, reflects the appropriate adjustment.

Software Capitalization (SOP 98-1)

Q. WHAT IS AICPA STATEMENT OF POSITION NO. 98-1?

A. As noted in my direct testimony, the American Institute of Certified Public Accountants ("AICPA") has issued a Statement of Position ("SOP") No. 98-1 ("SOP 98-1") addressing the capitalization of software costs. SOP 98-1 has become a part of generally accepted accounting principles ("GAAP"). In general, SOP 98-1 requires that software costs be capitalized. Prior to the adoption of SOP 98-1, many companies, including USWC, had been expensing internally developed software costs, which now must be capitalized in compliance with GAAP.

Q. WHAT REASONS DOES QWEST PRESENT IN ITS REBUTTAL FOR <u>NOT</u> ADOPTING SOP 98-1 FOR RATEMAKING PURPOSES?

A. Qwest witness Redding's rebuttal, at page 19, states his opinion that SOP 98-1 should not be adopted for intrastate ratemaking purposes because there is no change in cash flows coupled with short lives. Consequently, on page 20, he advocates that the Commission ignore this accounting change for ratemaking purposes.

Q. DO YOU AGREE WITH MR. REDDING'S ANALYSIS THAT THERE IS NO IMPACT ON CASH FLOWS?

A. No. Capitalization of software costs pursuant to SOP 98-1 results in a significant reduction in Qwest's revenue requirement for Arizona intrastate telephone service in the current proceeding. Thus, if the Commission adopts this accounting principle for ratemaking purposes, which it should, there is an significant impact on the intrastate revenue requirement. The intrastate revenue requirement is lowered significantly under the accounting prescribed by SOP 98-1 because USWC (now Qwest) had been expensing large amounts for internally developed software, whereas SOP 98-1 requires that such costs be capitalized and amortized.

Q. HAS QWEST ADOPTED SOP 98-1 FOR ACCOUNTING AND FINANCIAL REPORTING PURPOSES?

A. Yes, for financial and book accounting purposes, Qwest has adopted SOP 98-1. Qwest will be following SOP 98-1 for financial reporting purposes, but has not reflected the impact of this accounting principle in its 1999 test year Arizona rate filing. This substantially increases the Arizona intrastate revenue requirement because millions of dollars of software cost that is now required to be capitalized, but which has been reflected for Arizona ratemaking purposes by Qwest in its rate filing as a current period expense. On its books, and for financial reporting purposes, Qwest is capitalizing such cost and depreciating it over a five-year period.

Q. PLEASE DISCUSS THE ISSUE ASSOCIATED WITH THE "SHORT LIVES" OF CAPITALIZED SOFTWARE.

A. US WEST's proposed treatment of software capitalization substantially increases the revenue requirement in the current case by not reflecting capitalization treatment in accordance with generally accepted accounting principles (GAAP). US WEST defends this treatment by pointing out that the relatively short time frame for depreciating software (usually five years) would cause a higher rate base, and approximately the same expense levels in five years, i.e., a higher revenue requirement at that time if capitalization is applied. However, in the instant rate case, we are setting rates for regulated services today. Five years from now, customers may have competitive choices for a variety of telephone services that exist only in very limited form today.

Q. SHOULD THE ADOPTION OF SOP 98-1 BE REFLECTED FOR RATEMAKING PURPOSES?

A. Yes, it should. This GAAP is appropriate for ratemaking purposes. It reflects the fact that software has a benefit lasting longer than a single year. It is appropriate to reflect the amortization into expense of software costs over a five year period, commencing with the adoption of SOP 98-1.

Q. HAVE YOU CALCULATED AN ADJUSTMENT TO REFLECT SOP 98-1 FOR USWC'S ARIZONA INTRASTATE RESULTS?

A. Yes. This adjustment is shown on Schedule E-15, which was filed with RUCO's direct testimony. Using a five-year amortization period, on Schedule E-15 I have reflected an adjustment for the generally accepted accounting treatment for software costs per SOP 98-1 in the Arizona intrastate results for the first three years of implementing this accounting change. The impact of this accounting change is greatest in the first year, so using a three-year average impact for the adjustment helps smooth the transition. The three year period also corresponds with the use by USWC and now Qwest of a three-year revenue requirement for certain items. For example, it is the same period used by USWC for the amortization of other items, such as the gain on sale of its interest in Bellcore. The Company's 1999 test year filing, as reflected in Mr. Redding's exhibits filed May 3, 2000 reflects a column for a three-year revenue requirement. While I have not presented items in a similar column, my treatment of SOP 98-1 over the initial three-year period of adoption is similar to the Company's calculation and use of a three-year revenue requirement for certain items.

Q. AT PAGE 23 OF HIS REBUTTAL, QWEST WITNESS REDDING CLAIMS THAT AN AUTOMATIC ADJUSTMENT RIDER WOULD BE NECESSARY IF SOP 98-1 WAS ADOPTED FOR RATEMAKING PURPOSES. DO YOU AGREE?

A. No, I do not. As noted above, my adjustment for the adoption of SOP 98-1 for ratemaking purposes reflects an average impact of the first three years, similar to Qwest's calculation of three-year revenue requirement impacts for other items, such as the recognition of the gain on the sale of its interest in Bellcore. There is no need for an automatic adjustment mechanism for ratemaking adjustments to reflect generally accepted accounting principles. I note that Qwest is not proposing that a similar automatic adjustment mechanism be implemented for decreases in pension expense occurring between rate cases as the result of applying the provisions of FAS 87. There is no need for an automatic adjustment mechanism associated with the adoption of SOP 98-1 for ratemaking purposes.

Q. WHAT WILL HAPPEN AFTER THREE YEARS UNDER YOUR PROPOSAL CONCERNING SOP 98-1?

A. Over a three-year period, Qwest's investment, revenue and expense will change. Accordingly, Qwest will have to review all items that contribute to its Arizona intrastate revenue requirements and determine if an Arizona intrastate rate filing is necessary at that time. There is no need to carve out one or two areas where costs could increase in the future for automatic adjustment mechanisms, when other items such as pension expense, computed pursuant to FAS 87 may be decreasing, and other cost savings may be realized as the result of work force downsizing and consolidation or operations after the Qwest/US West merger.

Service Quality Plan

Q. WHAT IS THE COMPANY'S "SERVICE QUALITY PLAN"?

A. As described in my direct testimony, the Company's Service Quality Plan was established in a prior USWC regulatory proceeding and is part of the Company's tariff in Arizona. It contains measures, such as penalties, to be paid by the Company to the Commission if the Company fails to meet service quality standards. It also requires the Company to pay for cellular phones, call forwarding, etc., when it cannot meet acceptable service standards, including timely installation of new services and repair of out-of-service conditions.

Q. AT PAGES 40-41 OF HIS REBUTTAL TESTIMONY, QWEST WITNESS REDDING ATTEMPTS TO JUSTIFY CHARGING CUSTOMERS FOR SUCH COSTS "BECAUSE THEY ARE A REASONABLE COST OF DOING BUSINESS, AND BECAUSE QWEST IS INDEED PROVIDING SERVICE TO THE CUSTOMER, EVEN IF IT IS NOT THE PRECISE SERVICE THE CUSTOMER HAS REQUESTED." (REDDING REBUTTAL, PAGE 41, LINES 3-5.) SHOULD SUCH COSTS BE CHARGED TO CUSTOMERS?

A. No. The cost incurred by Qwest associated with the failure to meet acceptable service quality standards should not be charged to customers. Ratepayers should not be forced to pay extra when the Company fails to meet minimum acceptable service quality standards. Ratepayers should not bear the extra cost incurred by the Company for cellular vouchers, paging vouchers or other accrued expenses under its Service Quality Plan that relate to its failure to meet minimum acceptable service quality standards. Consequently, the excess cost incurred during the test year under the Service Quality Plan associated with the Company's failure to meet minimum acceptable service quality standards should be disallowed. Shareholders, not ratepayers, should bear such cost.

At page 41, lines 9-11 of his rebuttal, Mr. Redding asserts that alternative services including paging vouchers, remote call forwarding, and voice messaging are quite similar to traditional services, and Qwest provides such alternative services "at no cost to the customer." That is just the point. When Qwest fails to meet the established quality of service standards, as specified in its Service Quality Tariff, it must provide such alternative services <u>at no cost to the customer</u>. RUCO's adjustment for Service Quality Plan expenses assures that there is no cost being charged to the customer for such alternative services, which are required under the Service Quality Plan, when the Company cannot meet the minimum service quality standards.

Q,. DO YOU HAVE ANY OTHER CONCERNS REGARDING THE COMPANY'S ATTEMPT TO CHARGE RATEPAYERS FOR THE COSTS IT INCURS ASSOCIATED WITH ITS FAILURE TO MEET ARIZONA SERVICE QUALITY STANDARDS?

A. Yes. Company management determines the level of Company resources to be devoted to meeting service quality standards. If the cost of non-compliance with service quality standards is borne by ratepayers, this would inappropriately remove the economic responsibility from the Company for its decisions regarding service quality compliance efforts, where such decisions lead to non-compliance situations. In recent years, USWC has failed to provide service that meets the minimum standards established by the Commission. As evidenced by the Service Quality Forum conducted by this Commission, and by the significant efforts devoted to addressing USWC service quality concerns in the Qwest/US West merger proceedings before this Commission and the regulatory commissions in a number of other USWC states, substantial regulatory difficulties have been encountered in getting US West to comply with service quality standards, particularly in the areas of timely installation of new service and prompt repair of out-of-service conditions.

Requiring ratepayers to bear costs associated with the Company's service quality failures – as Qwest is advocating -- would have the undesirable result of removing a substantial incentive to Qwest for achieving compliance with the Arizona quality of service standards set forth in the Company's Service Quality Plan tariff. If the costs imposed by the Commission on the Company for failure to meet service standards are passed on to ratepayers as just another "cost of doing business," this would remove an important economic incentive to Qwest for meeting the established Arizona service quality standards. By requiring that costs for failure to provide adequate service quality be borne by shareholders, and prohibiting the passing on of such costs to ratepayers, the Commission keeps the responsibility to meet service quality standards where it belongs – on the Company.

Sharing of Gain on Sale of 38 Arizona Exchanges with Traffic

Q. AT PAGE 31 OF HIS REBUTTAL, QWEST WITNESS REDDING ASSERTS THAT YOU PROPOSE TO INAPPROPRIATELY ADDRESS THE DISPOSITION OF THE GAIN THE COMPANY IS REALIZING ON THE SALE OF ARIZONA EXCHANGES WITH TRAFFIC IN THIS CASE, RATHER THAN IN THE ACCESS LINE SALE DOCKET. PLEASE RESPOND.

A. Contrary to Mr. Redding's assertion, it is not inappropriate to reflect the quantification of RUCO's recommendation in the concurrent proceeding addressing the sale of 38 exchanges, with traffic, Docket No. T-01051B-99-0737, in terms of its impact on the instant Qwest Arizona rate case. As I stated in my direct testimony:

> This adjustment is shown on Schedule E-22 and reflects the sharing of the estimated after-tax gain anticipated to be realized by USWC on the sale of 38 Arizona exchanges with traffic to Citizens Communications. The Commission is addressing the transaction in a concurrent proceeding, Docket No. T-01051B-99-0737. The sharing of the gain between shareholders and ratepayers is consistent with RUCO's position in the sale proceeding, as discussed in the testimony of RUCO witness Marylee Diaz Cortez. On Schedule E-22, I have reflected the sharing of the gain over a three-year period. Three years is the same period used by USWC to reflect the sharing with ratepayers of 50% of the gain it realized upon the sale of its interest in Bellcore.

I was asked by RUCO to reflect in the instant rate case the impact of RUCO's position in the concurrent proceeding, Docket No. T-01051B-99-0737, that the gain on the sale of the 38 Arizona exchanges, with traffic, be shared between shareholders and ratepayers, and have done so on Schedule E-22, which was filed with my direct testimony. This treatment, including the sharing of the gain over a three-year period, is similar to and consistent with the Company's reflection of the sharing with ratepayers of 50% of the gain it realized upon the sale of its interest in Bellcore and is consistent with prior Commission precedent, as discussed at length in RUCO's testimony in Docket No. T-01051B-99-0737.

Adjustment to Intrastate Depreciation Expense

Q. ON SCHEDULE E-8, FILED WITH YOUR DIRECT TESTIMONY, YOU HAD MADE AN ADJUSTMENT TO CORRECT THE AMOUNT OF TEST YEAR DEPRECIATION FOR THE IMPACT OF THE COMPANY'S SALE OF 38 ARIZONA EXCHANGES, WITH TRAFFIC. HAS THE COMPANY ADDRESSED THIS ISSUE IN ITS REBUTTAL TESTIMONY?

A. Yes. On pages 34-35 of his rebuttal testimony, in addressing a Staff adjustment for depreciation expense related to the sale of these Arizona exchanges, Qwest witness Redding agrees in principle that such an adjustment should be made.

Cash Working Capital

Q. PAGE 42 OF QWEST WITNESS REDDING'S REBUTTAL TESTIMONY STATES THAT YOUR CASH WORKING CAPITAL ADJUSTMENT IS BASED ON THE

TEST YEAR ENDED JUNE 30, 1998, RATHER THAN THE UPDATED TEST YEAR OF CALENDAR 1999 AND SHOULD BE DISREGARDED. PLEASE RESPOND.

A. The correct amount of intrastate rate base allowance for cash working capital for the test year ending December 31, 1999 is negative $46.232 million, according to the documentation provided by the Company in response to a number of data requests. On RUCO Exhibit ___(L&A-1), Schedule B, line 4, filed with my direct testimony, I had only reflected a rate base deduction for cash working capital in the amount of $45.020 million. Consequently, an adjustment to decrease the rate base amount shown on Schedule B by $1.212 million ($46.232 million less $45.020 million) is necessary. With my surrebuttal testimony, I am including a revised Schedule E-24 showing the appropriate adjustment.

Q. DID THE COMPANY STATE IN RESPONSE TO DATA REQUESTS THAT IT WAS NOT UPDATING THE JUNE 30, 1998 CASH WORKING CAPITAL AMOUNT?

A. Yes. The response to Data Request RUCO-28-6(a) stated that the Company confirms that the $41.772 million negative amount for cash working capital for the test year ending June 30, 1998 is not being updated. The Company's response to Data Request UTI-43-14 stated that: "U S WEST did not conduct a new lead-lag study in connection with the update test year." These responses by the Company may not have been totally accurate in describing whether the Company had or had not updated the cash working capital allowance amount for the test year ending December 31, 1999. However, other responses from the Company clearly indicate that the negative $46.232 million is the correct amount of intrastate cash working capital allowance for use with the December 31, 1999 test year.

Q. PLEASE DISCUSS THE RESPONSES WHICH ESTABLISH THAT THE NEGATIVE $46.232 MILLION IS THE CORRECT AMOUNT OF INTRASTATE CASH WORKING CAPITAL ALLOWANCE FOR USE WITH THE DECEMBER 31, 1999 TEST YEAR.

A. The responses are included in Attachment RCS-S1 to my surrebuttal testimony. The first two pages are from the response to Data Request UTI-42-1. The first page, at line 33 shows the calculation of the Commission Basis Cash Working Capital amount for the Company's Arizona intrastate operations for the test year ending December 31, 1999 to be negative $46.232 million. The second page, at line 19, shows this same amount. Page 3 of Attachment RCS-S1 shows the Company's response to Data Request RUCO-28-6. Part b of that request had asked the Company to "explain why the Commission Basis Cash Working Capital amount on line 19 is negative $46.232 million, as compared to the $41.772 million amount on the comparable USWC workpaper for cash working capital from the June 30, 1998 test year filing." The Company's response attributed the change to the updated test year. The Company's response to Data Requests RUCO-28-7 and UTI-56-1, are shown on pages 4 and 5 of Attachment RCS-S1, and contain the Company's admission that the cash working capital amount reflected in rate base in the Corrected Exhibits of George Redding, filed on June 12, 2000 was in error, and state that the correct amount should the negative $46.232 million as the rate base adjustment.

Q. HAVE YOU REVISED SCHEDULE E-24 TO REFLECT THE NEGATIVE $46.232 MILLION CASH WORKING CAPITAL ALLOWANCE AMOUNT?

A. Yes. A revised Schedule E-24 is attached to my surrebuttal testimony.

Q. ARE YOU EXPRESSING AN OPINION REGARDING THE OTHER STAFF-PROPOSED ADJUSTMENTS TO CASH WORKING CAPITAL, WHICH QWEST WITNESS REDDING DISCUSSES AT PAGES 43-44 OF HIS REBUTTAL TESTIMONY?

A. No, I am not.

Interest Synchronization

Q. DOES THE COMPANY PRESENT ANY REBUTTAL TESTIMONY CONCERNING INTEREST SYNCHRONIZATION?

A. Yes. Qwest witness Redding's rebuttal at page 48 merely notes that an interest synchronization adjustment should be recalculated once adjustments affecting rate base are finalized and accepted by the Commission. I agree with the concept of updating the interest synchronization calculation to reflect the Commission's final determination of rate base, weighted cost of debt, etc. With my surrebuttal testimony, I have included a revised Schedule E-25 to reflect the revisions made to RUCO's calculated adjustment.

IV. SUPPLEMENTAL DIRECT TESTIMONY

Q. AT THE TIME OF THE FILING OF RUCO'S DIRECT TESTIMONY, A NUMBER OF ISSUES WERE STILL UNDER INVESTIGATION, AND QWEST AND RUCO HAD AGREED THAT RUCO WOULD BE ALLOWED TO PRESENT ADDITIONAL

TESTIMONY ON SUCH ISSUES WITH RUCO'S SURREBUTTAL. ARE YOU NOW ADDRESSING SOME OF THOSE ISSUES IN YOUR SURREBUTTAL TESTIMONY?

A. Yes. On behalf of RUCO, I am addressing in this surrebuttal testimony a few of the areas for which analysis had not yet been completed as of the date of writing of RUCO's direct testimony in this proceeding. Because of time limitations, not all of the issues identified in my direct testimony have been analyzed and addressed for discussion and quantification in RUCO's surrebuttal testimony. Consequently, silence on a particular issue should not be construed as agreement with Qwest's proposed treatment. I have attempted to focus on those areas with the largest dollar impact, where a reasonable quantification of such impact could be made within the available time frame for preparation of surrebuttal.

Reciprocal Compensation Revenue and Expense

Q. WHAT IS RECIPROCAL COMPENSATION?

A. Reciprocal Compensation refers to the revenue received by Qwest from other carriers and payments by Qwest to other carriers associated with traffic generated by customers of a local carrier that relies upon the facilities of another carrier for completion of the call.

Q. WAS RECIPROCAL COMPENSATION ONE OF THE ISSUES FOR WHICH YOU HAD NOT YET COMPLETED YOUR ANALYSIS FOR INCLUSION IN YOUR DIRECT TESTIMONY?

A. Yes. In my direct testimony, concerning Reciprocal Compensation, I stated that:

> A response to Data Request UTI 49-1S1 was received on August 1. A response to UTI 64-15S1 was received August 2. We haven't had time to digest or follow

through on USWC's information. The treatment of reciprocal compensation is a controversial area, where USWC is asking for a revenue increase of $13.252 million, and an automatic adjustment clause. This is an important area, and adequate time should be allowed in which to analyze the information.

Q. HAVE YOU CALCULATED AN ADJUSTMENT FOR RECIPROCAL COMPENSATION?

A. Yes. On Schedule E-5, which is being filed with RUCO's surrebuttal testimony, I have calculated an adjustment for Reciprocal Compensation. This adjustment removes the Company's pro forma amounts of Reciprocal Compensation revenue and expense, and reflects the actual test year amounts.

Q. HAVE YOU USED THE SAME APPROACH ADOPTED BY STAFF TO ADDRESS RECIPROCAL COMPENSATION?

A. Yes, I have.

Q. DOES QWEST ADDRESS RECIPROCAL COMPENSATION IN ITS REBUTTAL TESTIMONY?

A. Yes. At page 49 of his rebuttal testimony, Qwest witness Redding addresses Staff's recommendations regarding Reciprocal Compensation. He acknowledges that the Staff treatment allows the Company to at least recover the test year level of reciprocal compensation, but criticizes Staff's recommendation because in his opinion it "makes no provision for the future." (Redding rebuttal, page 49, lines 2-3.) The Company proposes an automatic adjustment clause be implemented for Reciprocal Compensation.

Q. SHOULD AN AUTOMATIC ADJUSTMENT CLAUSE BE ADOPTED FOR QWEST'S RECIPROCAL COMPENSATION?

A. No. An automatic adjustment clause or "rider" should not be adopted for Reciprocal Compensation for the following reasons:

1) The Company's proposal represents improper, piecemeal ratemaking to single out one element of the overall revenue requirement.

2) Reciprocal Compensation of approximately $11 to $13 million is approximately one percent of Qwest's total Arizona intrastate operating revenues of approximately $1.2 billion. Moreover, the difference of approximately $1.6 million in revenue requirement ($13.2 million per Qwest versus $11.6 million per RUCO) resulting from Qwest's attempt to use amounts beyond the end of the 1999 test year is only about one tenth of one percent of Qwest's Arizona intrastate operating revenues. This is not material enough to warrant a departure from traditional regulation.

3) Incentives for Qwest to prudently negotiate and administer reciprocal compensation arrangements are diminished if the costs are automatically passed onto ratepayers.

4) The introduction of quarterly or semi-annual filings, reviews and rate adjustments for varying amounts of Reciprocal Compensation are not justified in view of the relative impact of such cost variations to the accurate measurement of Qwest's Arizona intrastate revenue requirement.

5) Under Arizona law, automatic adjustment clauses are reserved for those expenses that are extremely volatile and which widely fluctuate. There is no evidence that these criteria are applicable to the Reciprocal Compensation issue.

Q. DO YOU AGREE WITH STAFF WITNESS BROSCH'S CONCLUSION THAT, UPON INCLUSION IN THE ARIZONA INTRASTATE REVENUE REQUIREMENT CALCULATION OF QWEST'S ACTUAL 1999 AMOUNTS OF RECIPROCAL COMPENSATION, THERE IS NO NEED FOR A SEPARATE LINE ITEM ADDING $13.3 MILLION TO THE CALCULATED REVENUE REQUIREMENT, AND THERE IS NO NEED FOR FUTURE AUTOMATIC RATE ADJUSTMENT FOR CHANGES IN THIS LEVEL OF COSTS?

A. Yes, I do. I also agree with Staff witness Brosch (direct testimony, page 89) that the test period recorded values for Reciprocal Compensation represent the only known and measurable amounts that are consistent with the other test period revenue and expense levels.

Q. WHAT IMPACT DOES YOUR ADJUSTMENT FOR RECIPROCAL COMPENSATION HAVE?

A. The calculation of this adjustment is shown on Schedule E-5, which is being filed with my surrebuttal. In comparison with the "Per Company" amounts for Reciprocal Compensation included in Column A of Schedule C in RUCO Exhibit ___(L&A-1), which was filed with my direct testimony, using the test year recorded amounts for Reciprocal Compensation reduces revenues by $1.371 million, and reduces operating expenses before income taxes by $2.943 million. After taking into account the income tax expense impacts (shown on lines 24 and 25 of Schedule E-5), net operating income increases by $941,000.

Put another way, as shown in the following table, the Company's proposed $13.252 million revenue requirement for Reciprocal Compensation is reduced by $1.605 million, to $11.648 million:

Description	Per Qwest	Per RUCO	Difference
Net Operating Income Impact	$ (7,770)	$ (6,829)	$ 941
Gross Revenue Conversion Factor	1.7056	1.7056	1.7056
Intrastate Revenue Requirement Impact	$ 13,253	$ 11,648	$ (1,605)

FCC Deregulated/ACC Regulated Products

Q. ARE YOU PROPOSING A RATEMAKING ADJUSTMENT RELATED TO THE FCC DEREGULATED/ACC REGULATED PRODUCTS?

A. Yes. As stated in my direct testimony, it appears that an adjustment similar to the one presented by Staff in the prior USWC rate case would also be warranted in the current USWC rate case. As of the date of the writing of my direct testimony, we had not determined an adjustment amount. After additional analysis of this issue, it appears that the adjustment calculated by Staff represents an appropriate resolution of this issue, and should be adopted in calculating Qwest's intrastate revenue requirement.

Q. HAS QWEST INDICATED THAT IT IS IN AGREEMENT WITH THE CALCULATION OF STAFF'S PROPOSED ADJUSTMENT FOR FCC DEREGULATED/ACC REGULATED PRODUCTS?

A. Yes. At pages 45-46 of his rebuttal, Qwest witness Redding indicates that he agrees with Staff witness Carver's "financial end result" which is based on the premise that the FCC deregulated products should not cross subsidize regulated products. Staff witness Carver imputed revenues for the FCC deregulated/ACC regulated products to bring the return up to the level being recommended in the overall intrastate revenue requirement.

Q. DOES QWEST DISAGREE WITH ANY ASPECT OF STAFF'S ADJUSTMENT?

A. At pages 45-46 of his rebuttal, Mr. Redding appears to disagree with the "methodology" Staff used but not with the actual results of the calculation or its financial impact. At page 46, lines 14-16, of his rebuttal testimony, Mr. Redding states: "Qwest would have no disagreement with removing these items from regulation, thus achieving symmetry with their treatment in the interstate jurisdiction."

Q. IS IT NECESSARY TO TOTALLY REMOVE SUCH SERVICES FROM REGULATION BY THE ACC IN ORDER TO PROTECT RATEPAYERS FROM CROSS-SUBSIDIZATION?

A. Probably not. The Commission may want to keep such services as the provision of inside wiring maintenance services under regulation for some purposes, such as consumer protection, even though some other aspects of the service, such as pricing, are not subject to Commission regulation. That is, a particular product could conceivably be deregulated with respect to pricing, without it being totally removed from Commission regulation.

Q. HAVE YOU CALCULATED THE ADJUSTMENT FOR THE IMPUTATION OF REVENUE FOR FCC DEREGULATED SERVICES?

A. Yes. This is shown on Schedule E-6, attached to my surrebuttal testimony. As noted in my direct testimony, Schedule E-6 had been reserved for the purpose of calculating this adjustment.

Q. IS THE AMOUNT OF THE ADJUSTMENT FOR THE IMPUTATION OF REVENUE FOR FCC DEREGULATED SERVICES SLIGHTLY DIFFERENT FROM STAFF'S CALCULATION WHEN RUCO'S RECOMMENDED RATE OF RETURN IS APPLIED?

A. Yes. RUCO's recommended overall rate of return of 9.51% differs from Staff's recommended rate of return of 9.68%. This difference results in a slight variance between my recommended adjustment and the Staff's adjustment. Staff also made an adjustment to the Uncollectibles portion of the Gross Revenue Conversion Factor (GRCF), which also contributes to the variance.

Q. ARE YOU SAYING THAT YOU DISAGREE WITH STAFF'S ADJUSTMENT FOR THE UNCOLLECTIBLES PORTION OF THE GRCF?

A. No. I am just pointing out that my imputation of revenue for FCC deregulated services on Schedule E-6 does not include this impact.

Q. WHAT IS THE IMPACT OF YOUR ADJUSTMENT?

A. The adjustment reduces the intrastate revenue requirement by $3.52 million.

Broadband Cable TV

Q. PLEASE DISCUSS THE BROADBAND CABLE TV ISSUE.

A. U S West Communications, Inc., now Qwest, is providing services to a recently created affiliate, Broadband Services, Inc. ("BSI" or "Broadband"). In a concurrent docket, Docket No. T-01051B-99-0499, the Company has requested approval of a Company-proposed transfer of assets from USWC (now Qwest) to BSI and a Master Services Agreement between USWC (now Qwest) and BSI. When Qwest provides services to BSI, revenues and expense credits are recorded. Additionally, if the asset transfer from Qwest to BSI were to be approved by the Commission, in whole or in part, the transferred assets would need to be removed from rate base.

Issues are presented in the instant rate case concerning whether the revenues and expense credits associated with the provision of services to Broadband have been adequately reflected in the test year. The amount of rate base is also impacted by the uncertain status of the Company-proposed asset transfer. The concurrent asset transfer proceeding has been put on hold, while the telephone company, after being acquired by Qwest, re-evaluates whether it wants to pursue the asset transfer. As stated in my direct testimony (at page 21):

> Based on preliminary indications, it appears that USWC has understated the amounts of revenue it is receiving for services it is providing to BSI. USWC receives lease revenue from BSI for BSI's use of USWC-owned assets. USWC also provides a wide range of other services to BSI. For example, BSI contracts with USWC for all customer service, installation and repair functions, as well as for many other types of services described in the Master Services Agreement. As a result, USWC records credits to operating expenses associated with the services it provides to BSI. Based upon preliminary indications, it appears that USWC has understated the amount of expense credits associated with services it provides to the affiliate, BSI. The test year should be adjusted to reflect normalized levels of revenues and expense credits associated with BSI's use of USWC-owned assets and for the services USWC is providing to BSI.

Q. HAVE YOU REFLECTED AN ADJUSTMENT FOR BROADBAND CABLE TV TRANSACTIONS?

A. Yes. On Schedule E-7, which is attached to my surrebuttal testimony, I have reflected the adoption of Staff's proposed adjustments for Broadband revenues and expenses.

Q. DOES QWEST'S REBUTTAL ADDRESS SUCH STAFF ADJUSTMENTS?

A. Yes. At page 47 of his rebuttal testimony, concerning the Staff adjustment for revenues and expenses related to Broadband, Qwest witness Redding states that: "Given the start-up nature of BSI's operations, the Company does not believe that Mr. Brosch's adjustments to the estimated billing between Qwest and BSI are unreasonable." Concerning the asset amount, Mr. Redding states that, pending clarification of the Company's intent with regard to the transfer of the assets, he has no disagreement with Staff's proposed adjustment.

Q. DO YOU HAVE ANY CONCERNS THAT THE STAFF ADJUSTMENT, WITH WHICH QWEST EXPRESSES NO DISAGREEMENT, MAY UNDERSTATE THE REVENUES AND EXPENSE CREDITS THAT QWEST IS RECEIVING FROM BROADBAND?

A. Yes. At page 21 of my direct testimony, I discussed the ongoing levels of revenues and expense credits that the telephone company has been realizing during the first six months of 2000. These are substantially higher than the amounts reflected in the 1999 test year, even after reflecting Staff's adjustment.

Q. WHY HAVE YOU ADOPTED STAFF'S ADJUSTMENT FOR BROADBAND CABLE TV-RELATED COSTS AND REVENUES?

A. After additional review and analysis, I have concluded that the Staff adjustment appears to be a reasonable way of addressing the apparent understatement of test year revenues and expense credits associated with the provision of services by the telephone company (Qwest) to the affiliate, Broadband. While it appears that the ongoing level of revenues and expense credits, as evidenced in the data for the first six months of 2000, which was provided in response to Data Request UTI-51-8, is considerably larger than the amounts reflected in the test year, even after reflecting Staff's adjustment, to capture such ongoing levels would have required going outside of the 1999 test year. It is clear that the amounts recorded in the test year by the Company did not reflect a full year of BSI operations. Rather than attempt to update the revenues and expense credits associated with Broadband by going outside the test year, with all of the attendant problems in doing so, I have adopted Staff's approach of annualizing the test year recorded amounts as a reasonable way of dealing with this issue in the context of the Company's 1999 test year filing.

Q. HAVE YOU PRESENTED THE CALCULATION OF YOUR BROADBAND CABLE TV ADJUSTMENT?

A. Yes. The calculation of this adjustment is shown on Schedule E-7, which is being filed with RUCO's surrebuttal testimony. As mentioned in my direct testimony, Schedule E-7 had been reserved for this purpose. As described above, my Broadband adjustment adopts the Staff adjustment calculations which were presented on Staff Schedules B-6 and C-6, respectively.

Q. WHAT IS THE NET IMPACT OF YOUR BROADBAND ADJUSTMENT ON THE INTRASTATE REVENUE REQUIREMENT?

A. The net impact of my Broadband adjustment is a reduction in the intrastate revenue requirement of approximately $362,000.

V. UPDATED INTRASTATE REVENUE REQUIREMENT CALCULATIONS

Q. AT THIS TIME, HAVE YOU UPDATED THE SUMMARY SCHEDULES SUBMITTED ON BEHALF OF RUCO WITH YOUR DIRECT TESTIMONY TO REFLECT A RE-CALCULATION OF THE COMPANY'S ARIZONA INTRASTATE REVENUE REQUIREMENT?

A. Yes. As shown in RUCO Exhibit ___(L&A-2), on Schedule A Revised, the Arizona intrastate revenue excess for Qwest is $34.1 million. Supporting details are included on the other schedules previously filed with RUCO's direct testimony in Exhibit ___(L&A-1) and in the revised schedules filed with RUCO's surrebuttal in Exhibit ___(L&A-2).

Q. WHAT SPECIFIC SCHEDULES ARE YOU PRESENTING WITH YOUR SURREBUTTAL TESTIMONY?

A. The following table identifies the schedules contained in Exhibit __(L&A-2), which is being filed with RUCO's surrebuttal testimony:

Exhibit ___(L&A-2) of Larkin & Associates (Surrebuttal)

Schedule	Description	Pages	Witness	Redacted	Notes
A	Revenue Surplus or Deficiency	1	Smith	No	Revised
B	Rate Base	1	Smith	No	Revised
C	Adjusted Operating Income	1	Smith	No	Revised
D	Capital Structure and Cost of Capital	1	Smith	No	
E	RUCO Adjustments	7	Smith	Yes, Partially	Revised
E-5	Reciprocal Compensation	1	Smith	No	Calculated
E-6	FCC Nonregulated/ ACC Regulated Imputation/Loss Adjustment	1	Smith	No	Calculated
E-7	Broadband Revenues and Expenses	1	Smith	No	Calculated
E-24	Cash Working Capital - Adjust to US WEST Calculated Rate Base Amount	1	Smith	No	Revised
E-25	Interest Synchronization Adjustment	1	Smith	No	Revised
	TOTAL PAGES	16			

Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?

A. Yes.

U S WEST
Arizona Intrastate Operations
C-05 Cash Working Capital
Test Year Ending December 31, 1999
(In Thousands of Dollars)

Date: 5/3/00
Time: 8:34 AM

		(a)	(b = a/365)	(c)	(d)	(e = b*d)
		Fully Adjusted Test Year	Avg Daily Amt	Source	Lag	CWC
1	Local Service Revenue	928,693	2544.4	Worksheet 1	19.4	49,361
2	Network Access Service Revenue	115,252	315.8	Worksheet 2	42.0	13,262
3	Long Distance Network Service Revenue	22,413	61.4	Worksheet 3	42.5	2,610
4	Billing and Collection Revenue	15,803	43.3	Worksheet 4	42.0	1,818
5	Miscellaneous Revenue	116,039	317.9	Worksheet 5	24.6	7,821
6	Total Operating Revenues(L1 .. L5)	1,198,200	3282.7	Composite Revenue	22.8	74,872
7	Maintenance Expense	282,322	773.5	Worksheet 6	22.5	(17,403)
8	Engineering Expense	11,500	31.5	Worksheet 7	25.9	(816)
9	Network Operations Expense	52,199	143.0	Worksheet 8	19.9	(2,846)
10	Network Administration Expense	2,337	6.4	Worksheet 9	20.6	(132)
11	Access Expense	23,571	64.6	Worksheet 10	43.8	(2,829)
12	Other Expense	1,301	3.6	Worksheet 11	55.1	(196)
13	Customer Operations Expense	219,291	600.8	Worksheet 12	26.3	(15,801)
14	Corporate Operations Expense	206,976	567.1	Worksheet 13	32.1	(18,203)
15	Property Taxes	49,804	136.4	Worksheet 14	206.6	(28,190)
16	Other Taxes (Excl Income Taxes)	(1,764)	-4.8	Worksheet 15	(25.4)	(123)
17	Uncollectibles	16,481	45.2	Worksheet 16	22.8	(1,030)
18	Depreciation	328,884	901.1		0.0	0
19	Current Federal Income Tax	37,249	102.1	Worksheet 17	36.0	(3,674)
20	Current State Income Tax	9,821	26.9	Worksheet 18	61.1	(1,644)
21	Deferred Taxes	(52,783)	-144.6		0.0	
22	Total Operating Expenses(L 7 .. L21)	1,187,189				(92,887)
23	Interest Expense	50,058	137.1	Worksheet 19	92.2	(12,645)
24	Federal Excise Taxes	20,796	57.0	Worksheet 20	0.2	(11)
25	Sales Tax	62,755	171.9	Worksheet 21	10.6	(1,822)
26	Average Benefit Liability			Worksheet 28		1,072
27	Total Miscellaneous(L23 ..L26)	133,609				(13,406)
28	Total Cash Working Capital Requirement (L6 +L22+L27)	2,385,430				(31,421)
	Deduct Non Cash Items					
29	Depreciation	328,884	901.1	Composite Rev	22.8	(20,551)
30	Deferred Tax	(52,783)	-144.6	Composite Rev	22.8	3,298
31	Net Income (L6-L22-L23)	(39,047)	-107.0	Composite Rev	22.8	2,440
32	Total Non Cash Items(L29..L31)	237,054				(14,813)
33	Commission Basis Cash Working Capital (L28+L32)					<46,234> ←

	Booked	Intrastate	Intrastate Percent
Local Service Revenue	954,933,510	954,933,510	
Network Access Revenue	603,899,634	121,079,275	
Toll Revenue	30,371,863	30,318,408	
	1,589,205,007	1,106,331,193	69.6154%

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U S WEST
Arizona Intrastate Operations
C-05 Cash Working Capital
Test Year Ending December 31, 1999
(In Thousands of Dollars)

Date: 05/03/00
Time: 8:34 AM

		(a) Fully Adjusted Test Year	(b=a/365) Avg Daily Amount	(c) Source	(d) Net Lag	(e=b*d) CWC
1	Maintenance Expense	282,322	773.5	Worksheet 6	0.3	238
2	Engineering Expense	11,500	31.5	Worksheet 7	(3.1)	(97)
3	Network Operations Expense	52,199	143.0	Worksheet 8	2.9	416
4	Network Administration Expense	2,337	6.4	Worksheet 9	2.2	14
5	Access Expense	23,571	64.6	Worksheet 10	(21.0)	(1,356)
6	Other Expense	1,301	3.6	Worksheet 11	(32.3)	(115)
7	Customer Operations Expense	219,291	600.8	Worksheet 12	(3.5)	(2,098)
8	Corporate Operations Expense	206,976	567.1	Worksheet 13	(9.3)	(5,269)
9	Property Taxes	49,804	136.4	Worksheet 14	(183.8)	(25,078)
10	Other Taxes (Excl Income Taxes)	(1,764)	-4.8	Worksheet 15	48.2	(233)
11	Uncollectibles	16,481	45.2	Worksheet 16	0.0	0
12	Current Federal Income Tax	37,249	102.1	Worksheet 17	(13.2)	(1,346)
13	Current State Income Tax	9,821	26.9	Worksheet 18	(38.3)	(1,030)
14	Total Operating Expenses(L 1 .. L13)	911,088				(35,954)
15	Federal Excise Taxes	20,796	57.0	Worksheet 20	0.2	(11)
16	Sales Tax	62,755	171.9	Worksheet 21	10.6	(1,822)
17	Interest Expense	50,058	137.1	Worksheet 19	(69.4)	(9,517)
18	Average Benefit Liability			Worksheet 28		1,072
19	Commission Basis Cash Working Capital					(46,232) ←
20	Revenue Lags not Recoginized in the Netting Method					
21	Depreciation	328,884	901.1	Composite Rev	22.8	20,551
22	Deferred Taxes and ITC Amortized	(52,783)	-144.6	Composite Rev	22.8	(3,298)
23	Net Income	(39,047)	-107.0	Composite Rev	22.8	(2,440)
24	Total Non Cash Items(L21+L22+L23)					14,813
25	Total Cash Working Capital Requirement(L19+L24)					(31,419)

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Arizona
Docket No. T-1051B-99-105
RUCO 28-006

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 006

Cash working capital. Refer to the response to UTI 42-1, Attachment A and to the Company's original workpapers for C-05, Cash Working Capital for the test year ending June 30, 1998.

a. Please confirm that USWC is not updating the negative $41,772 million negative amount for Commission Basis Cash Working Capital shown on its workpapers for C-05, Cash Working Capital for the test year ending June 30, 1998. If this is not the case, please provide the updated Commission Basis Cash Working Capital amount, and all supporting workpapers and calculations.

b. Referring to the response to UTI 42-1, Attachment A, for C-05, Cash Working Capital for the test year ending December 31, 1999, explain why the Commission Basis Cash Working Capital amount on line 19 is negative $46.232 million, as compared to the $41.772 million amount on the comparable USWC workpaper for cash working capital from the June 30, 1998 test year filing. Identify exactly which items of the cash working capital calculation USWC has changed for its 1999 test year update filing, explain fully why each such item was changed, and provide the supporting workpapers and detail calculations showing how each new or revised amount in column a, "Fully Adjusted Test Year," and column d, "Net Lag," on Azty-1999,xls, WP2-AzCWCnc(CA) and column d, "Lag," on the preceding C-05 workpaper page, Azty-1999.xls, WP1-AzCWCnc(CA), were derived.

RESPONSE:

a. The Company does confirm that the $41,772M filed for the test year ending **June 30, 1998** is not being updated. The updated test year is December 31, 1999.

b. Anytime a test year changes the CWC will change because all line items on the income statement column will change. All back up was provided in UTI 42-001.

Fran Bendever
Finance Analyst
1801 California St. Room 1240
Denver, CO 80202

Arizona
Docket No. T-1051B-99-105
UTI 56-001

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 001

Re: Corrected Exhibits of George Redding, filed June 12, 2000) USWC's adjusted pro-forma Allowance for Cash Working Capital in rate base (GAR-S4) is $(39,211). However, the C-05 adjustment workpapers reflect "Commission Basis Cash Working Capital of $(46,232). Please explain and reconcile this apparent discrepancy and provide additional calculation workpapers supportive of the Company's position, if other than $(46,232).

RESPONSE:

The explanation is, an error occurred in the Company's adjustment. The correct amount should be $(46,232) as a rate base adjustment.

Fran Bendever
Finance Analyst
1801 California St.
Denver, CO 80202

Arizona
Docket No. T-1051B-99-105
RUCO 28-007

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 007

Cash working capital. Refer to the response to UTI 42-1, Attachment A. Does USWC have any explanation for why it failed to reflect the Commission Basis Cash Working Capital amount on line 19 of on (sic) Azty-1999.xls, WP2-AzCWCnc(CA) of negative $46.232 million as the Rate Base adjustment amount on Adjustment C-05 for its updated 1999 test year? If so, provide a complete statement of such explanation, along with specific citations to any and all Commission orders and other authority being relied upon by USWC for reflect an amount other than the Commission Basis Cash Working Capital in rate base.

RESPONSE:

The explanation is that the $14.8 M amount shown in the Company's adjustment is incorrect. The correct amount should be $46.232 Million as a rate base adjustment.

Fran Bendever
Finance Analyst
1801 California St. Room 1240
Denver, CO 80202

Before the

Arizona Corporation Commission

In the Matter of the Application of US West Communications, Inc., A Colorado Corporation, for a hearing to determine the earnings of the company, the fair value of the company for rate-making purposes, to fix a just and reasonable rate of return thereon and to approve rate schedules	DOCKET NO. T-01051B-99-0105

Surrebuttal Testimony of

JOHN B. LEGLER

On Behalf of the

RESIDENTIAL UTILITY CONSUMER OFFICE

September 8, 2000

EXHIBIT
RUCO-11
admitted

SURREBUTTAL TESTIMONY OF

JOHN B. LEGLER

BEFORE THE

ARIZONA CORPORATION COMMISSION

DOCKET NO. T-1051B-99-105

Q. WHAT IS YOUR NAME AND ADDRESS?

A. John B. Legler, my business address is 1040 St. Andrews Court, Bogart, Georgia, 30622.

Q. ARE YOU THE SAME JOHN B. LEGLER WHO HAS PREVIOUSLY FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, I am. A statement of my credentials and experience is contained in my direct testimony.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY AT THIS TIME?

A. I am responding to comments of Mr. Peter C. Cummings regarding my testimony, and in a limited manner, the testimony of Mr. Charles W. King, and Mr. Stephen G. Hill.

Q. DO YOU AGREE WITH MR. CUMMINGS THAT THE COST OF EQUITY RECOMMENDATIONS OF MR. KING, MR. HILL, AND YOURSELF ARE TOO LOW?

A. No, I do not agree with Mr. Cummings' assessment of our testimonies and recommendations. Recognizing that all three of us excercised our professional judgments, I find the range of our recommendations surprisingly close. Mr. King and I both recommend a point estimate of 11.5% and Mr. Hill recommends 11.75%.

Q. DO YOU AGREE WITH ANY OF MR. CUMMINGS COMMENTS REGARDING THE TESTIMONIES OF MR. KING, MR. HILL, AND YOURSELF?

A. Yes, I do. I agree with him that the Company's updated capital structure and embedded cost of debt are acceptable for purposes of estimating the cost of capital. I further agree that telephone companies are an appropriate group to use in the analysis of the cost of equity. I agree with him the use of other groups of companies, electric utilities, gas distributors and insurance companies are inappropriate for purposes of estimating the cost of equity to U S West (QWEST) and not comparable in riskiness to telephone companies. I also agree, that the arithmetic means rather than geometric means should be used in calculating risk premiums.

Q. DO YOU AGREE WITH MR. CUMMINGS REGARDING THE TECHNICAL ASPECTS OF THE ESTIMATING METHODS USED BY MR. KING AND MR. HILL?

A. I have not reviewed the testimonies of Mr. King and Mr. Hill and I am not prepared to comment on them.

Q. DO YOU AGREE WITH MR. CUMMINGS' COMMENTS REGARDING YOUR TESTIMONY?

A. No, I do not.

Q. PLEASE EXPAIN.

A. For consistency, I have used the same methods in my testimony before commissions for many years. Therefore, I included all of my estimates which admittedly produce an apparent wide range of estimates. I chose to include all of my estimates rather than eliminate companies from the sample or methods of estimating the cost of equity. I agree with him that extremely low estimates (those below the cost of a company's debt) should be eliminated. For this reason, estimates below 8.2% from the DCF method were eliminated from consideration in making my recommendation.

Mr. Cummings is correct that my recommendation was based primarily on my risk premium and CAPM results. Although I used the DCF method in my analysis in the same manner as I have in other cases, I found the range produced by that method is too broad to be of much value. This is attributable to the broad range of growth rates. Value Line's direct estimate of dividend growth is rather low, on average, and retention growth estimated from Value Line data is rather high. The required growth rate in the DCF model is a long-term sustainable growth rate, and for the reasons set forth in my direct testimony, I find growth rates in excess of 6 percent require unsustainable growth in either the payout ratio or the return on equity or both.

My comments regarding each of the methods, DCF, Risk Premium, and CAPM are meant to express the limitations of the models, and not to suggest that they should be eliminated from consideration in making a recommendation. I believe that my comments regarding the limitations of the models is consistent with my basis for arriving at my recommendation.

Q. DO YOU AGREE WITH MR. CUMMINGS' COMMENTS REGARDING YOUR RISK PREMIUM ANALYSIS?

A. No, I do not. As stated by Mr. Cummings I based my analysis on two studies of the risk premium. One study was for U S WEST and the other was for independent telephone companies. My purpose in doing the studies was to arrive at forward looking premiums rather than historical risk premiums. The current yield on bonds is a forward looking yield. It is the yield an investor will obtain if the bond is held to maturity. My DCF (and CAPM) estimates of the cost of equity are forward looking, and the resulting risk premiums are forward looking. Mr. Cummings is correct that I removed negative or near zero risk premiums not from 1994 forward, but for all years. His criticism that my estimating method produced single digit equity costs since the second quarter of 1993 is inappropriate since these estimates produces negative risks premiums which I eliminated.

Mr. Cummings calls my independent telephone companies risk premium study a "black box" since I did not identify the companies or how I calculated the dividend yields and growth rates or weighted them. The companies consist of the group of major independent telephone companies which have changed somewhat with mergers over the years, and the methods for calculating the dividend yields and growth rates are the same as in my DCF analysis. The calculated risk premiums for the 1995-1999 time period indicate extreme values 9.93% based on retention growth and 1.07% based on Value Line growth which is why I based my risk premium analysis on longer-term average premiums.

Q. MR. CUMMINGS STATES THAT THERE IS AN ALTERNATIVE SOURCE OF RISK PREMIUMS, AND CITES THE IBBOTSON ASSOCIATES STUDY. DO YOU AGREE WITH HIS COMMENTS?

A. No, I do not. While I agree that the Ibbotson study is used by analysts, it is commonly used by analysts in implementing the CAPM. The difference between long-term stock returns and long-term bond returns is often used as a measure of the risk premium for average risk stocks. Frankly, I do not know where Mr. Cummings got his risk premium of 7.4% as shown on page 38, line 6 of his rebuttal testimony. I believe that the most recent average difference between arithmetic stock and bond returns is over 8%. To estimate the cost of equity for any particular company would require an adjustment to the market risk premium (his figure of 7.4%). This adjustment factor is beta. Since telephone betas are generally less than 1.0 (the beta of an average risk company), the resulting cost of equity would be lower than Mr. Cummings asserts.

Q. MR. CUMMINGS ALSO CRITICIZES YOUR CAPM ANALYSIS, DO YOU AGREE WITH HIS CRITICISM?

A. No, I do not. Mr. Cummings criticism is based on my use of both unadjusted and adjusted betas. The unadjusted betas are from Standard

& Poor's and the adjusted betas are from Value Line. Contrary to Mr. Cummings assertion, I did not mix these betas, but separated them and base my CAPM results on separate sets of betas. In my direct testimony, I explain the difference between these two beta concepts and show how I arrived at my CAPM estimates.

CONCLUSION AND RECOMMENDATION

Q. WHAT IS YOUR RECOMMENDATION FOR A FAIR RETURN ON EQUITY FOR U S WEST (QWEST)?

A. My recommendation remains at 11.5%. I find most of Mr. Cummings criticisms of my testimony to be without merit, and my recommendation is supported by the other witnesses on the cost of capital, Mr. King and Mr Hill. We all agree that the Company's updated capital structure and embedded cost of debt is reasonable.

Q. WHAT IS YOUR RECOMMENDATION FOR A FAIR OVERALL RETURN ON RATE BASE FOR U S WEST (QWEST)?

A. Based on the Company's capital structure and embedded debt cost, my recommendation for a fair overall return on rate base is 9.55%.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

BEFORE THE
ARIZONA CORPORATION COMMISSION

U. S. WEST COMMUNICATIONS, INC.

Docket No. T-1051B-99-105

SUPPLEMENTAL TESTIMONY

OF

LARKIN & ASSOCIATES
RAPLH C. SMITH

ON BEHALF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

CONCERNING THE PROPOSED SETTLEMENT

Phoenix, Arizona
November 13, 2000

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Ralph C. Smith. My business address is: Larkin & Associates, 15728 Farmington Road, Livonia, Michigan 48154.

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS DOCKET?

A. Yes. On behalf of RUCO, I submitted prepared direct and surrebuttal testimony in this docket.

Q. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL TESTIMONY?

A. My testimony presents some of the concerns that RUCO has concerning the proposed Settlement Agreement between Staff and Qwest. Another witness on behalf of RUCO, Ben Johnson, is presenting testimony on other concerns regarding the settlement agreement and the alternative regulation plan provided for in the settlement.

Q. SHOULD QWEST BE GRANTED AN INCREASE IN ITS ARIZONA INTRASTATE REVENUES?

A. No. Qwest's Arizona intrastate revenues should be reduced, not increased. The testimony by RUCO in this proceeding, as well as other parties such as AT&T and DOE/FEA, each show that Qwest's Arizona intrastate revenues should be decreased, not increased. The settlement would provide Qwest with a $42.9 million intrastate revenue increase, which, in my opinion, is not warranted.

Q. HOW WAS THE $42.9 MILLION OVERALL RATE INCREASE PROVIDED FOR IN THE SETTLEMENT DERIVED?

A. From the information presented by Staff and Qwest, it appears that the parties agreed to use the Fair Value Rate Base and rate of return proposed by Staff, and without an issue-by-issue negotiation, derived the $42.9 million revenue increase "needed" by Qwest and the adjusted net operating income number necessary to back into the $42.9 million. Apparently, Staff and Qwest considered the differences between their filed positions, mainly focusing on four items, specifically: (1) software capitalization, (2) overheads assigned to the sale of exchanges, (3) incentive compensation, and (4) out-of-period wage and salary increases, as quantified in Staff's presentation. See Qwest's response to RUCO 35-001, appended to this testimony.

Q. IN DERIVING THE $42.9 MILLION REVENUE INCREASE PROVIDED FOR IN THE SETTLEMENT, WHAT CONSIDERATION DID STAFF AND QWEST GIVE TO THE RECOMMENDATIONS MADE BY OTHER WITNESSES WHO PRESENTED TESTIMONY ON BEHALF OF PARTIES OTHER THAN STAFF?

A. It does not appear that the revenue requirement calculations of the other parties, or their recommended adjustments, which in a number of instances were either different than, or supplemental to, Staff's rate base and net operating income adjustments, were factored into the Settlement Agreement revenue requirement. For example, the response to data request RUCO 3.9 to Staff concerning the settlement states that: "The revenue requirement calculations of the other parties included adjustments and positions not advocated by Staff that, upon review by Utilitech, were not explicitly factored into the Settlement Agreement revenue requirement." In this proceeding, of the four parties – Staff, RUCO, AT&T and DOD/FEA -- presenting revenue requirement recommendations besides Qwest, Staff was the only one advocating a revenue increase for Qwest.[1] As detailed on RUCO Exhibit ___(L&A-2), Schedules E-1 through E-25 (attached to Hugh Larkin's surrebuttal testimony on behalf of RUCO), twenty-five adjustments to Qwest's proposed revenue requirement were presented on behalf of RUCO. In many instances, these were different from, and in some instances supplemental to, the adjustments presented by Staff. I recognize that any particular party would not necessarily prevail on all of the adjustments it is sponsoring. The adjustments proposed by RUCO, as well as the testimony on revenue requirement adjustments proposed by other parties participating in this proceeding such as AT&T and DOD/FEA should receive consideration by the Commission in determining the revenue requirement for Qwest. Given the evidence presented by all of the parties in this proceeding concerning the revenue requirement, I do not believe that a revenue increase for Qwest is justified. The proposed settlement is unacceptable because it fails to give appropriate consideration to such evidence, and to the recommendations made by RUCO, AT&T and DOD/FEA showing that Qwest should have an intrastate revenue decrease.

Q. PAGE 2 OF STAFF WITNESS BROSCH'S TESTIMONY DISCUSSES THE DIFFERENCES BETWEEN STAFF'S PROPOSED AND QWEST'S PROPOSED RETURN ON EQUITY. WERE THOSE THE ONLY RECOMMENDATIONS ON COST OF CAPITAL MADE IN THIS PROCEEDING?

A. No. Staff's and Qwest's recommendations on the cost of equity and overall rate of return are not the only ones that have been presented for the Commission's consideration in this

[1] Staff advocated a $7.242 million intrastate revenue increase versus the intrastate revenue requirement increase of $201 million on original cost rate base and approximately $265 million on fair value rate base proposed by Qwest.

proceeding. RUCO witness John Legler has filed direct and surrebuttal testimony in this proceeding, and has recommended an overall return of 9.51% and an 11.5% return on equity.

Q. BESIDES THE REVENUE REQUIREMENT, DO YOU HAVE CONCERNS REGARDING ANY OTHER PROVISIONS OF THE SETTLEMENT?

A. Yes. The provisions of paragraph 13 of the proposed settlement are objectionable. Paragraph 13 of the settlement provides, among other things, that "... Qwest shall have no obligation to refund revenues collected during the period of time the Price Cap Plan is in effect" if the Arizona courts should ultimately find that the Price Cap Plan is unlawful. If the Price Cap Plan or the Settlement is found to be unlawful, Qwest should be required refund amounts that it collected. Removing Qwest's obligation to refund revenues collected under a Plan found to be unlawful appears to me to be contrary to the public interest.

Q. DOES THIS CONCLUDE YOUR SUPPLEMENTAL TESTIMONY?

A. Yes.

See ACC Staff Schedule A and RUCO Exhibit ___(L&A-2) Schedule A Revised.

Arizona
Docket No. T-1051B-99-105
RUCO 35-001

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 001

Refer to the October 27, 2000 Testimony of George Redding, which at page 4, lines 9-13, indicates that the income available from operations was not based on a compilation of specific adjustments, but "was the product of mutual agreement using the adjusted net operating income shown on the Staff's Schedule A and approximately one half the value of the adjustments described above."

a. Are the "adjustments described above" the adjustments mentioned at Mr. Redding's testimony, page 3, line 22, through page 4, line 2, specifically: capitalized software, overheads assigned to the sale of exchanges, incentive compensation and out of period wage and salary increases? If not, explain fully.

b. Provide the calculation that results in "approximately one half the value of the adjustments described above" per Mr. Redding's testimony at page 5, lines 12-13.

c. In reaching the settlement with Staff concerning the revenue increase of $42.9 million, what consideration, if any, was given to adjustments proposed by parties other than Staff (e.g., by RUCO, DOD and AT&T) that were in addition to or different from the adjustments affecting the intrastate revenue requirement proposed by Staff?

RESPONSE:

a. Yes.

b. Please see Attachment A.

c. Please see the Company's response to RUCO 35-3.

Judy Steward
State Finance Manager
1801 California St.
Denver, CO 80202

ARIZONA
DOCKET NO. T-01051B-99-105
RUCO 35-001
ATTACHMENT A

Qwest Inc.
RUCO 35-1(b)
Attachment A

Calculation that resulted in "approximately one half of the adjustments described above" ... Mr. Redding's testimony at page 5, lines 12-13.

From ACC Staff Exhibit E (page 1 of 2):

	Adjustments	(000's) Revenue Requirment
C-12	Incentive Compensation	$ (5,529)
C-13	SOP 98-1 (Income Statement)	(32,840)
B-2	SOP 98-1 (Rate Base)	(1,038)
C-14	USWC Payroll Adjustment Reversal	(13,322)
C-29	Exchange Sale Allocations Adjustment	(11,416)
	Total Adjustments	$ (64,145)
	Divide by Multiplier (1.6995)	(37,743)
	Divide by 2	(18,872)

Income Available (ACC Staff Schedule A)	134.3
Negotiated Income Available	
(Redding Testimony, page 5 & Brosch Testimony, page 4)	113.7
Negotiated Difference	20.6

EXHIBIT
Ruco-14
Admitted

QWEST CORPORATION
(U S WEST COMMUNICATIONS)

DOCKET NO. T-01051B-99-0105

SUPPLEMENTAL TESTIMONY

OF

BEN JOHNSON, PH.D.

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

NOVEMBER 13, 2000

TESTIMONY

OF BEN JOHNSON, PH.D.

On Behalf of

THE STATE OF ARIZONA

RESIDENTIAL UTILITY CONSUMER OFFICE

Before the

ARIZONA CORPORATION COMMISSION

Docket No. T-01051B-99-0105

Introduction

Q. Would you please state your name and address?

A. Ben Johnson, 2252 Killearn Center Boulevard, Tallahassee, Florida 32308.

Q. What is your purpose in submitting this testimony?

A. In this supplemental testimony I will be commenting on certain aspects of the proposed settlement agreement filed by Staff and Qwest, including the attached price cap plan. My testimony has two major sections. In the first section of my testimony, I summarize Staff and Qwest's proposed price cap plan, and the rate design aspects of Staff and Qwest's proposed settlement agreement, and I briefly discuss price cap regulation as an alternative to traditional regulation. In the second section I comment on various aspects of Staff and Qwest's proposed settlement agreement, including the attached price cap plan, and provide some concluding thoughts.

Section One

Q. Can you begin by summarizing the proposed settlement agreement?

A. Yes. Staff and Qwest have agreed upon a revenue requirement deficiency of $42.9 million. [Settlement Agreement, ¶ 2] This is lower than Qwest sought and higher than Staff initially recommended. These parties have further agreed to recover this deficiency through a combination of certain specific rate changes resulting in a net revenue increase of $17.6 million, and providing Qwest with the with broad flexibility to increase rates in certain other tariff categories by $25.3 million. The following table shows a summary of the revenue changes included in the $17.6 million revenue increase.

Table 1

Element	Revenue Increase (Decrease)
Directory Assistance	$24,572,391
Complete-A-Call	($1,459,775)
Residence NRC - Low Use Option	($30,015)
Residence NRC - Flat Rate Service	($7,968,113)
Residence NRC - Reseller	($137,990)
Business Zone Connection Charge (NRC)	($170,720)
Residence Zone Connection Charge (NRC)	($2,267,789)
Business Zone 1 Change	($189,312)
Business Zone 2 Change	($192,888)
Residence Zone 1 Change	($1,497,276)
Residence Zone 2 Change	($1,941,876)
Carrier Common Line	($1,189,627)
Switched Transport	($357,810)
Local Switching	$1,528,156
Interconnection Charge	($5,000,542)
Wholesale Directory Assistance	$5,224
Private Line Service	$13,697,701
Total	$17,399,740

Finally, Staff and Qwest have proposed to have Qwest be regulated by the provisions of a price cap plan, rather than traditional rate of return regulation.

Q. Can you now summarize the price cap plan which is included in the Staff and Qwest settlement proposal?

A. Staff and Qwest have proposed a price cap plan which separates Qwest's existing and future services into three baskets. Basket 1 is described as "Basic/Essential/Non-Competitive Services". Basket 1 includes basic local services, custom calling and certain other vertical features, basic listing service, and various other services that Staff and Qwest consider to be "basic", "essential" or "non-competitive". Basket 2 consists of "wholesale" services, such carrier common line access, switched transport, local switching, interconnection, and UNEs. Basket 3 contains "flexibly priced competitive services". These are services "that have been classified as 'competitive' and also includes those services for which [Qwest] has obtained flexible pricing authority". [Shooshan Direct, p. 11] This Basket will also contain all new services and service packages offered by Qwest. [Id.]

Q. What are the proposed terms and conditions for Basket 1 services?

A. Basket 1 is subject to an overall price cap based upon the weighted average price level of all services contained in Basket 1. Each year, the overall price cap will be adjusted for "inflation minus productivity." The measure of inflation is the annual percent change in the Gross Domestic Product Price Index ("GDP-PI"), calculated and reported by the Department of Commerce. The productivity offset is set at 3.7% plus a .5% "consumer dividend" for a total of 4.2%. [Shooshan Supplemental, p. 5] This "inflation minus productivity" calculation is capped at zero, and has no lower bound. Thus, if inflation exceeds 4.2%, the price cap will not be raised. However, if inflation is less than 4.2%, the cap will be lowered and Qwest will be required to lower some of the rates within this basket.

In addition to this overall cap on Basket 1, certain basic services are individually capped at their starting levels throughout the initial 3 year term of the Plan. The capped services include: flat rate residential, flat rate business, 2 & 4 party services, exchange zone increment charges, low use option service, service stations service, telephone assistance programs, individual PBX Trunks, including features, Caller ID block, toll blocking, 900/976 blocking and basic listing service. Rates for other services in Basket 1 may be increased up to a maximum of 25% within a given year.

Finally, it should be noted that all services in Basket 1 must be priced above their Total Service Long Run Incremental Cost ("TSLRIC").

Q. What are the proposed terms and conditions for Basket 2 services?

A. The price cap plan provides: "Basket 2 consists of wholesale services many of which are governed by their own specific pricing rules and will continue to be governed by such rules, as interpreted by the Commission and the Courts, under this price cap plan". [¶ 3.b] The price cap plan does provide for a change in rates for intrastate switched access. Under the Plan, intrastate switched access rates will be reduced by $5 million per year for the duration of the initial 3 year term of the Plan. Qwest explains: "These $5 million decreases are intended to be revenue neutral and will be offset in the second and third year of the Price Plan by $5 million increases in the price cap applicable to Basket 3." [Arnold Direct, p. 5]

Q. What are the proposed terms and conditions for Basket 3 services?

A. Services in Basket 3 are subject to a price cap equal to 110% of the weighted average price level of all of the services in the Basket. However, "the additional revenue level for purposes of headroom in Basket 3, shall be capped at $25.3 million, on a test year basis, for the term of the price cap plan". [¶ 4.b] Further, the price cap will be "adjusted upward $5 million in the second year of the Plan and an additional $5 million in the third year of the Plan, to reflect the switched access charge reductions in those years." [Id.] Thus, Qwest will be given broad flexibility to increase and decrease prices within this basket.

The overall constraints are rather limited, given the "headroom" which is created by the settlement. Prices for individual services and packages of services in Basket 3 must be priced above their TSLRIC.

A Basket 1 service may be moved to Basket 3 upon a showing that the criteria of Commission Rule R14-2-1108 have been met. Qwest may also package Basket 1 and Basket 3 services together and include the package in Basket 3. However, the Basket 1 service must continue to be offered as a stand-alone service in Basket 1 at the rate set in Basket 1.

Q. What is the main goal of a price cap system as an alternative to the type of regulation which has traditionally been used in Arizona?

A The main goal of a price cap formula is to eliminate, or at least weaken, the linkage between cost and rates, without greatly deviating from the desirable results which would normally be anticipated under traditional regulation or, for that matter, under effective competition (since traditional regulation is designed to simulate the results of competition).

Once the price cap is in place, it is fixed for a specified period, usually a year. In turn, the firm is expected to produce with the cost-minimizing input mix, invest in cost-effective innovation, and adjust optimally to changes in input cost conditions. The reason for this behavior is rooted in economic incentive. Since the firm is allowed to retain as profit (or, at least, a portion of the profit) any cost reductions achieved relative to the price cap, it will choose (in theory) to produce efficiently.

With an appropriate price cap formula, prices are controlled by the price cap formula; in turn, this reflects the normal variations in the prices of inputs used by the firm, offset by the expected productivity improvements encompassed by the formula. This contrasts with traditional regulation, where prices remain constant between rate cases, and are varied within the context of a rate case based upon whatever changes have occurred in costs and productivity since the prior proceeding.

With a price cap system, prices are regulated by focusing on changes in the overall level of costs that the firm faces (inflation of input costs), and subtracting the impact of productivity or expected productivity growth as it impacts the industry generally. Although the price cap should logically rise if the prices of a firm's inputs rise, the price cap is not linked directly to changes in the specific cost of service of the firm in question; instead, the system looks at inflation generally. Thus, carrier-specific cost changes do not necessarily lead to price changes, and management's incentive to minimize costs is not diluted.

Q. Can you clarify how a price cap formula differs from traditional rate base regulation?

A. Yes. When a price cap system is initially instituted, it closely resembles traditional regulation, since the price cap will most likely be based upon the existing tariffs, or some traditional measure of a reasonable set of prices. Over time, however, the two systems can diverge somewhat. The price cap approach allows the firm to vary its overall price level in accordance with industry-wide factors, while traditional regulation allows it to vary its price level in accordance with Company-specific data (in a rate case).

Section Two

Q. Lets turn to the second major section of your testimony. What specific aspects of the proposed settlement agreement will you discuss?

A. First, I will discuss the proposed beginning rates and associated rate design. Second, I will comment on the proposed inflation index and productivity offset. Third, I will discuss the specific baskets used to group existing services and classify new services under the proposed settlement agreement. Fourth, I will comment on the pricing freedom within each basket. Finally, I will discuss the service quality provisions of the proposed settlement agreement.

Beginning Rates

Q. Let's discuss the first aspect of the settlement agreement that you mentioned. Are the beginning rates important under a price cap plan?

A. Yes. The initial starting point, the price that is established when first going into price cap regulation, must be the "correct price" for this system of regulation to yield optimal results. These rates are typically based on the same cost-of-service and rate of return criteria used under traditional regulation. If the initial price cap is set too high, the firm may generate monopoly profits, unrelated to the skills and performances of its labor and management. If the price cap is set too low, the firm may incur losses or achieve a return which is far below its cost of capital. In that case, it will turn to the regulator in order to seek a higher price cap, abandonment of the price cap system, or other changes which will bail it out of its difficulties. Most regulators adopting price cap plans have either started with the firm's existing tariffs, or have required a downward reduction in those rates at the time the plan is initiated.

When initiating a system of price cap regulation, current and anticipated profit levels are of special concern. If the firm is not earning its cost of capital, capping prices at their existing level may deny the firm an opportunity to overcome the existing deficiency, and thus hold profits below a normal level for many years into the future. The converse is also true. If current rates are yielding a return that is significantly above the cost of capital, by capping prices at the current level, excess profits may continue for many years into the future.

Q. Do you think it would be appropriate for the Commission to accept the proposed starting rate levels included in the proposed settlement?

A. No. It is my understanding that the Commission is looking at the proposed settlement without evaluating all of the evidence concerning Qwest's current profit level. In my opinion, the level at which prices will be capped is crucially important. This issue cannot be adequately resolved without examining the evidence that current rates are too high, or the evidence that current rates are generating excess profits–profits which will increase even further as the merger "synergies" are achieved.

The proposed $42.9 million increase is certainly more reasonable than the Company's previously requested $86 million revenue increase. However, as explained by RUCO witnesses Ralph Smith and Hugh Larkin in their previously filed testimony, RUCO is convinced that Qwest is currently earning more than its cost of capital, and thus a substantial revenue reduction would be appropriate. Furthermore, in other jurisdictions LECs have often accepted, or been required to implement, rate reductions in order to gain the increased pricing freedom and other benefits of price cap regulation. These reductions are in addition to the price adjustments associated with productivity offset and other features of the actual price cap mechanism. Thus, from RUCO's perspective, one of the most disturbing aspects of the proposed settlement is that it "fast-tracks" a substantial rate increase under circumstances where a rate decrease would be much more appropriate. Moreover, the impact of this rate increase will tend to be even greater than if traditional regulation were to continue to be in force. The price cap plan could "lock in" excess profits for years to come. To the extent the Qwest merger results in substantial cost savings and other "synergies," for example, ratepayers may not have any opportunity to share in the benefit of these synergies, if the price cap plan is accepted–particularly if the plan is renewed or extended beyond its initial three year duration.

Q. Are you aware of any instances in which other jurisdictions have required a reduction in starting rates at the time a price cap plan is implemented?

A. Yes. In Illinois, Ameritech was required to reduce its starting rates by $93,000,000, based upon an authorized Return on Equity of 11.97% [Regulatory Reform - A Nationwide Summary, Issue No. 17, BellSouth Telecommunications, June 1995]. In Maine, Nynex accepted a $14,400,000 reduction in starting rates, based upon a Return on Equity of 12.5%. [Id.] In Wisconsin, Ameritech accepted a 10% reduction in basic service prices, followed by a three year freeze on residential and small business local service. [Id.] In New York, Nynex accepted a $170,000,000 (3.5%) reduction in its rates, based upon a 10.8% Return on Equity. [Id.] Southwestern Bell agreed to a $84,600,000 reduction in its rates in Missouri at the onset of an alternative regulatory system. In North Carolina, BellSouth agreed to a $15 million revenue reduction at the beginning of price regulation, and an additional $45 million reduction phased in over the 3 year life of the plan. [BellSouth Telecommunications, Inc.'s Statement of Acceptance of Price Regulation, Docket No. P-55, Sub 1013]. Other LECs have agreed to phased-in reductions in certain rates over the first few years of the plan, or have committed to substantial increases in their infrastructure investments, either in lieu of, or in addition to, reductions in starting rates as part of the "quid pro quo" for being granted authority to operate under price cap regulation. [Regulatory Reform - A Nationwide Summary]

These examples stand in stark contrast to the substantial rate increase which is included in the proposed settlement agreement. It is not unusual for an LEC to accept a substantial rate decrease as the "price of admission" into a price cap plan. Under the terms of the proposed settlement agreement, in contrast, Qwest would get increased pricing flexibility and other benefits of price cap regulation without having to reduce its overall rate level; to the contrary, if the settlement were accepted, it would be given the bonus of being allowed to increase its revenues.

Q. How would this proposed revenue increase be spread across the three service baskets?

A. Schedule 1 is adapted from Attachment B to the settlement agreement. It shows the proposed rate and revenue changes for the three service baskets. As shown, Staff and Qwest propose to reduce annual Basket 1 and Basket 2 revenues by $14.4 and $5.0 million, respectively, and increase Basket 3 revenues by $62.1 million.

As shown on Schedule 1, Basket 1 revenues will be decreased by:

- Lowering Residential non-recurring charges
- Eliminating the residential and business zone connection charges, and
- expanding zone 1 and zone calling areas

Basket 2 revenues will be reduced by:

- Lowering the carrier common line rate
- Raising and lowering various switched transport rates
- Adding 2 new switched access rate elements, and
- Reducing the interconnection charge

Basket 3 revenues will be increased by:

- Increasing the directory assistance charge
- Eliminating the complete-a-call charge
- Raising and lowering various private line rates
- Increasing unspecified rates by $25.3 million

Q. How does this compare to your previous rate design recommendation?

A. Schedule 2 shows my earlier recommendations, as set forth in revised Schedule 5 which was attached to my surrebuttal testimony, organized around the three baskets included in the proposed settlement. For instance, I recommended a $4.8 million reduction in Basket 2 revenues, which is roughly the same as the $5.0 million first year decrease included in the settlement agreement. However, the settlement calls for two additional $5 million decreases to switched access rates, which go far beyond Qwest's original request or my recommendation. As shown on Schedule 2, I have recommended a $26.6 million increase in Basket 3 revenues, compared to the $62.1 million increase allowed under the settlement agreement. For basket 1 revenues, I have recommended a $47.8 million decrease, compared to the $14.4 million decrease proposed by Staff and Qwest.

Q. What is your conclusion with regard to the rate changes which are set forth in the settlement agreement?

A. Obviously, the proposed $43 million increase is a significant improvement over the $83 million increase previously requested by Qwest. Further, the entire increase (and then some) would be borne by Basket 3 services, which would also be a significant improvement over the Company's previous proposal, which included an excessive increase in local rates. If the Commission accepts the proposed $43 million increase (which I don't recommend), my primary concern is the potential increase in Basket 3 rates, particularly if additional services are subsequently moved into this basket. The $25.3 million of "headroom" provides an opportunity for dramatic increases in individual services. This headroom will be increased to $35.3 million by the third year of the plan. Further, as I explain in more detail later, the price cap plan allows virtually unlimited freedom to increase rates for individual Basket 3 services, particularly if Qwest decides to reduce some of the rates in this basket. Even without making any reductions, it could place the entire $35.3 million increase on a single service, or a small handful of services, thereby giving it the freedom to increase these particular rates by ten-fold, or more.

Inflation Index and Productivity Offset

Q. Let's discuss the next aspect of the proposed price cap plan. Would you please elaborate on the inflation variable?

A. Certainly. One of the key variables in the proposed plan, as with most price cap plans, is the inflation index that will be used to determine the annual price cap. Once appropriate starting rates are set, an appropriate index is typically used as an indication of the extent to which overall price levels should be changing over time. In competitive industries, in the market clearing price level tends to equilibrate in the vicinity of the average level of costs incurred by members of the industry. Furthermore, one of the factors which influence price levels in the short run is the level of input costs incurred by the firms. Hence, if a price cap system is to be reasonably consistent with the pattern in competitive markets, prices should be determined, at least in part, by changes in the overall level of input costs experienced by firms in the industry.

Ideally, prices would be indexed to an accurate measure of the overall composite level of input costs borne by local exchange companies like Qwest. This composite would consider the cost of materials, labor and services that are used by the firm to produce the services whose prices are controlled by the price cap system. With such an index, regulators would be able to focus on industry-wide changes in input costs, without linking prices too closely to the individual firm's cost level. If Qwest is able to operate more efficiently, and thus incurs lower than average costs, it will gain the benefit of that efficiency. Yet, all firms are given the benefit of the opportunity to increase prices when their input costs are increasing, and customers are given the benefit of potentially lower prices when input costs are declining.

Unfortunately, no industry-specific index of input prices exists. Hence, regulators normally turn to one of the broader inflation indices, as a reasonable proxy for an index of telecommunications input costs. One option is the Consumer Price Index (CPI). While it's widely known and well understood, the CPI measures changes in the cost of final goods purchased by households, and thus it isn't very representative of changes in the cost of input factors used by carriers. Another alternative is the Producer Price Index (PPI). The PPI measures changes in the prices purchased by producers. However, the PPI in the aggregate includes numerous components that may not be inputs specific to the telecommunications industry. The Department of Commerce, Bureau of Economic Analysis also reports changes in the individual components that comprise the PPI.

Theoretically, one could choose those PPI subindices that best reflect the specific inputs used in the industry, and combine these with an index of labor costs, in order to arrive at a reasonable estimate of changes in input costs. For example, one could weight the changes in the PPI for communications equipment, computers, and other items purchased by LECs with an index of labor costs. However, there would be at least three disadvantages to this approach: it would be time consuming, it would be controversial, and it would not necessarily be reliable. All price indices have limitations; these limitations potentially become more significant as one moves from the macro to the micro level. Thus, for example, the PPI subindex for telecommunications equipment is potentially influenced by data gathering limitations, calculation errors, or other problems that tend to be far less significant or noticeable in the overall PPI.

In their proposed settlement agreement, Staff and Qwest use the GDP-PI in developing the price cap each year. The GDP-PI looks at the entire economy, as measured by Gross Domestic Product. Thus, it is an even more broadly based index than the CPI and PPI. Therefore, it is less volatile and potentially less subject to data gathering limitations and other problems. However, if the GDP-PI is used, it must be clearly understood that it is not an accurate index of changes in the production factors faced by any one particular industry. The GDP-PI is a reasonable proxy for the overall rate of inflation in the U.S. and it can reasonably be relied upon in developing a price cap system for a particular industry, provided that appropriate downward adjustments are made.

Q. Could you explain these adjustments?

A. Ideally, if a broad inflation measure, such as the GDP-PI, is used, an adjustment should be made to account for the differences between the rate of inflation in input prices within the particular industry and the overall rate of inflation. Historically, inflation has fluctuated widely, with large up swings and down swings. Input costs within a particular industry will not necessarily follow the same inflation pattern experienced by the overall economy. For example, in recent years LEC input prices have not increased as rapidly as price levels in the economy generally. It is well known that electronic equipment is not increasing in cost as rapidly as the overall rate of inflation. In fact, some equipment, such as computers, is actually declining in cost. Because of the importance of electronic equipment to the telecommunications industry, the GDP-PI tends to overstate the rate of inflation applicable to the items purchased by the LECs.

Q. In addition to input price discrepancies, are there any other reasons why a downward adjustment should be made to the inflation index in developing a price cap system?

A In price cap regulation, an adjustment for productivity changes is needed, to ensure that reasonably anticipated increases in LEC productivity are reflected in the price cap index, and thus in end user rates charged by the LECs. Such an adjustment would allow ratepayers to share not only in the long-term benefits of price-cap-induced efficiencies, but in the short-term benefits as well. Ideally, the productivity differential would reflect changes in telecommunications productivity in a manner that simulates the impacts of productivity changes in a competitive industry. However, if the selected productivity measure is inaccurate, it cannot serve these stated purposes. Furthermore, even if a reasonable figure is selected based upon historic data, there is no assurance that future productivity changes will be equivalent to the past. In a competitive industry, if there is a technological breakthrough, or if the total volume of production increases enough to increase economies of scale for the typical firm, most of the benefits will flow to consumers, though possibly after a lag.

With price cap regulation, in contrast, an increase in productivity over the historic trend will tend to result in windfall gains to the carrier, since the price cap will not decline as rapidly as costs are declining, or as rapidly as prices would drop in a competitive market.

Q. Have any studies been performed to measure changes in productivity in the telecommunications industry?

A. Yes. Probably the most widely cited studies are those relied upon by the FCC to establish productivity offsets for price cap regulation of certain local exchange companies. In various proceedings over the past 10-15 years, the FCC has reviewed numerous productivity studies prepared by FCC staff, industry participants, and other interested parties.

Q. What has the FCC concluded from its review of these studies?

A. The FCC has concluded that the telecommunications industry is one of the sectors of the economy where productivity is growing very rapidly. [_See, e.g., In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Report and order, April 17, 1989, Docket No. 87-313, FCC 89-91, para. 200]. Furthermore, the FCC's conclusions in this regard have been strengthened and expanded over the years.

In 1989, citing several productivity studies, the FCC concluded that 2.5% was the best estimate of LEC productivity. The FCC also concluded that the productivity offset should include a .5% "Consumer Productivity Dividend". [Id., para. 693].

In 1990, after reviewing additional studies the FCC concluded that the productivity offset should be increased to either 3.3% or 4.3% depending upon the level of profit sharing an LEC chooses. [In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, September 19, 1989, Docket No. 87-313, FCC 89-91, para. 74].

In 1994, the FCC initiated a docket to review LEC performance under the price cap rules established in 1990. [In re: Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, FCC 95-132.]. After evaluating an array of new studies and evidence, the FCC concluded that a range of 4.0% to 5.3% would be appropriate for the productivity offset, depending upon the extent of profit sharing, if any, that would be applicable. Although this factor is only applied to the interstate jurisdiction, the FCC accepted the arguments of the U.S. Telephone Association (USTA) that it should base its productivity factor on the overall industry productivity rate, including both interstate and intrastate services.

In 1997, based upon additional productivity studies, the FCC revised its price cap "X-Factor" to 6.5%, reflecting 6.0% productivity and a 0.5% consumer dividend. However, it should be noted that this decision was appealed and subsequently remanded to the FCC for further proceedings. During those proceedings, various parties proposed X-Factors ranging from 3.7% to 11.2% [See., Sixth Report and Order, Docket 94-1, May 31, 2000, ¶ 139] On remand, the FCC adopted an access charge reform proposal put forth by the Coalition for Affordable Long Distance Service ("CALLS"). [Id.]. The CALLs proposal included a 6.5% "X-Factor". However, under the CALLS proposal, the X-Factor is used as a transitional mechanism to reduce access charges to targeted levels, rather than simply as a productivity offset. This decision has also been appealed.

Q. What is your reaction to the productivity offset included in the proposed settlement agreement?

A. While this is probably less than the factor which would be justified by a detailed examination of the evidence, this is one of the less objectionable aspects of the settlement agreement. An productivity offset of 3.7% plus a consumer dividend of 0.5% results in a 4.2% offset, which is a bit higher than the analogous factors adopted in other states, where offsets of 3% to 4% are not unusual.

However, it is significantly less than the 6.5% offset which was most recently adopted by the FCC, and it is significantly less than the 5.3% offset chosen by most LECs under the FCC's previous sliding scale. The latter figure is particularly significant, since it provides an indication of the actual level of productivity improvement these firms believe they will be able to achieve. When given the opportunity to choose from a sliding scale of 4.7, 5.0 and 5.3 percent offsets with associated profit sharing levels, most LEC's chose the 5.3 percent offset. This allowed them to retain any and all excess profits they may be able to achieve under the price cap system. However, unless they anticipate achieving at productivity improvements in this range, any such excess profits would not materialize. Accordingly, the 5.3% choice is logically consistent with an expectation that productivity will grow in the range of 5.3% or more. Further, some states that set productivity factors in the 3% to 4% range several years ago, are discovering that companies operating under such price cap plans are significantly overearning–another indication that the 3% to 4% range is too low.

Moving from a known (traditional regulation) to an unknown (price caps) involves a certain amount of risk for customers. By selecting a relatively high offset factor, the Commission could help ensure that consumers will be treated fairly under the new system, by ensuring that consumers benefit from decreases in cost and increases in productivity that can be expected in the future.

Q. Are you suggesting that the Commission should accept Staff and Qwest's productivity offset?

A. No, not unless the "going in" rates are substantially reduced. As I said, 4.2% is within a plausible range for this particular variable, when looked at in isolation. However, under the current circumstances, RUCO cannot endorse this figure. For one thing, Qwest is expecting to achieve substantial cost savings and "synergies" as a result of its recent merger, which will effectively allow it to achieve higher than normal productivity gains. Also, the settlement calls for a revenue increase despite the fact that Qwest is currently earning excess profits, as explained in the testimony of RUCO witness Ralph Smith. Given this factual context, the 4.2% productivity offset is too low.

Service Baskets

Q. Let's discuss the third aspect of the settlement agreement you mentioned. Are the baskets proposed by Staff and Qwest appropriate?

A. The plan appropriately separates wholesale and retail services into distinct baskets. I strongly approve of placing all of the wholesale services offered to Qwest's competitors into a distinct "wholesale" basket, which is separate from the analogous retail services. As the Commission knows, the level and structure of the incumbents' wholesale rates will play a key role in either promoting or discouraging effective competition, particularly where incumbents retain a de facto monopoly on the provision of needed facilities. By separating these categories, the Company will have less opportunity to use its pricing flexibility in an anticompetitive manner.

While I approve of this aspect of the proposed plan, other related aspects of the plan are seriously deficient. In general, the three service baskets are too broad, and the basis of classification is too ambiguous and confusing. Further, the rules governing the classification of new services should be clarified and strengthened.

Q. Why should the price cap plan utilize more baskets than proposed by Staff and Qwest?

A. As I explained earlier, the Plan distributes all services into just three service classifications. ("Basic/Essential Non-competitive"; Wholesale"; and, "Flexibly Priced Competitive"). This is the bare minimum number of classifications which is feasible, and I believe a larger number of baskets (or sub-baskets) would be desirable. To begin with, I have some concerns with the proposal to lump residential and business customers in the same category, since this could facilitate a drastic restructuring of the rates paid by these two groups.

Both business and residential customers purchase essential services that are currently provided in a quasi-monopoly environment. However, these groups are not alike in their competitive characteristics. It is likely that the greatest degree of competitive pressure will be experienced in the business market--at least in these early stages of competition. Competitors have reason to anticipate that the business market will have the highest profit margins. Also, the total volume of service purchased by each customer tends to be higher (particularly for multi-line business customers); this means that competitors can more easily gain a given level of revenues by focusing on relatively few buyers. Finally, many business customers are viewed as quality-conscious, and thus carriers can more easily follow an entry strategy that does not simply emphasize cost savings. Given the likely differences in competitive pressure facing the business and residence categories, the Company will have strong incentives to reduce business rates and increase residence rates, to the extent allowed by the Plan.

Q. Doesn't the cap on flat rate residential service ameliorate this concern?

A. Yes, to a substantial degree. However, it is unclear how long this cap will last. The plan provides that the caps will last "throughout the term of the plan". [¶ 2(c)(i)] At least initially, the term of the plan is just 3 years. [¶ 6(a)] After this initial term, Qwest <u>may</u>

propose to renew the plan with the same terms and conditions or with proposed revisions. Further, the proposed settlement agreement provides: "Renewal or modification of the price cap plan at the end of the initial term is subject to approval by the Commission. Until the Commission approves the price cap plan, or orders a termination of the Plan after its term, the Plan shall continue in effect." [Settlement Agreement, p. 6] Therefore, as explained by Qwest, "if the Commission takes no action on the application for extension or revision, the plan remains in effect". [Response to RUCO 33-4]. While these provisions seem adequate to initially protect residential customers against excessive rate increases, I am concerned that the absolute cap on prices may seem anachronistic after 3 years, and thus this protection may not last.

In my opinion, it would be preferable to protect residential customers from excessive rate increases through caps on individual rate elements (as I discuss elsewhere in my testimony), or through structural separation (placing residential and business rates in separate baskets or sub-baskets). Ideally, the Commission would place residential and business local exchange services into separate baskets, with appropriate rate element pricing restrictions for each. If business service is placed in a different basket than residential service, the Company will not have as much freedom or incentive to "rebalance" rates by increasing residential rates and decreasing business rates. As a result, differences in market conditions or the degree of competitive pressure will tend to translate into differences in the rate of decline in rates, rather than decreases in some market segments, offset by increases in others segments. Also, the Company will have less freedom to engage in anti-competitive pricing strategies if the plan were structured in this manner.

Q. In addition to separating business and residential services into separate baskets, do you recommend further differentiation between services?

A. Yes. The proposed settlement would divide retail services into 2 baskets; one in which prices are strictly controlled, and one in which the Company has virtually unlimited pricing freedom. Accordingly, any attempt to reclassify Basket 1 services will potentially initiate a high stakes battle. It would be better to structure the plan in a way that avoids this "all or nothing" approach. With more baskets, the Commission would have more flexibility in achieving a gradual progression from strict price regulation to complete pricing freedom.

For example, retail services could be grouped into the following baskets or sub-baskets: Residence Basic; Business Basic; Discretionary; Emerging Competitive; and, Fully Competitive. Qwest would be given a limited degree of freedom to modify prices in the "Discretionary" basket, and it would be given even more freedom to adjust prices in the "Emerging Competitive" basket. Near-total pricing freedom, as contemplated for basket 3 under the proposed settlement, would be reserved for the "Fully Competitive" basket under this approach. Establishing additional subcategories makes it easier to vary the pricing rules that apply to each group, based upon differences in the characteristics of these services, and it avoids the problems which arise when subtle variations in the degree of competition are ignored. Under the approach used in the proposed settlement, for example, prices are rigidly controlled until the moment the service is declared to be "competitive" and thereafter Qwest would have virtually unlimited pricing freedom. This extreme dichotomy in pricing flexibility completely ignores the fact that competition tends to emerge gradually, and that few markets can be characterized as purely competitive or purely monopolistic. The typical market will display some of the characteristics of competition, at least to a limited degree, while also displaying some of the characteristics of market power. Given these typical circumstances, under the proposed settlement the Commission will be forced to make a black and white decision between two extremes–either by emphasizing the competitive aspects of the situation and ignoring the evidence of lingering market power, or by emphasizing the monopolistic aspects of the situation and ignoring the evidence of emerging competitive pressures. The Commission should not be forced to make a simplistic distinction between "competition" and "monopoly." A good price cap plan will provide it with an opportunity to classify each service in accordance with the subtle nuances of actual market conditions.

Q. What about wholesale services?

A. It is desirable to keep these separate from retail services. This is one of the good features of the proposed settlement. However, this category would ideally be subdivided into at least 2 separate baskets or sub-baskets, for essentially the same reasons I just discussed. Moreover, some wholesale services must be priced in accordance with federal law (e.g. UNEs), and thus pricing flexibility isn't really appropriate, while other wholesale services are regulated under state law. An example of the latter category might include the services that Qwest provides to the competitive firms that operate pay phones, or customer owned coin operated telephones (COCOT), as they are sometimes called. It might be legally feasible to provide Qwest with a degree of flexibility in pricing these wholesale service. For example, as competitive local exchange carriers like MCIWorldcom gain a larger share of the local exchange market, they may increasingly provide a viable alternative for COCOT operators, and thus it might be appropriate to provide Qwest with additional flexibility in pricing the services it provides to the COCOT operators.

Q. You mentioned that the basis for classifying services into individual baskets is ambiguous and confusing. Can you explain this criticism?

A. Basket 1 is labeled "Basic/Essential Non-competitive Services". Basket 3 is labeled "Flexibly-Priced Competitive Services". As I explained earlier, Mr. Shooshan stated in his direct testimony that Basket 1 consists of "all services that [Qwest] currently offers which have not been classified as 'competitive' or which are not currently afforded flexible pricing". The proposed Plan further provides that Basket 3 includes "those services that have been accorded pricing flexibility or have been determined by the Commission to be competitive under A.A.C. R14-2-1108". [¶ 4(a)] Rule 14-2-1108 provides:

> A telecommunications company may petition the Commission to classify as competitive any service or group of services provided by the company.... The petition for competitive classification shall set forth the conditions within the relevant market that demonstrate that the telecommunications service is competitive....

The rule further provides a list of specific information that must be provided as evidence of the competitiveness of the service or group of services in question.

Although the operative distinction between Basket 1 and Basket 3 seems to be the degree of competitiveness associated with the service, the Basket 1 label seems to imply that a further distinction is the degree to which the service is "basic" or "essential". This creates potential for confusion in the not uncommon situation where a service is not basic or truly essential, but it is not fully competitive either. By having only 2 retail baskets, the Plan effectively assumes that all non-competitive services are basic and essential, and that all competitive services can appropriately be grouped together as being neither basic nor essential. If this simplistic dichotomy were to be retained, any retail service which is not fully competitive should remain in Basket 1, regardless of whether or not it is basic, and regardless of whether or not it is essential. If this is the intent, then it would be appropriate to change the name of this basket to eliminate the words "basic" and "essential," thereby clarifying that the distinction between baskets is strictly based upon whether or not a service is competitive. However, an even better solution would be to this awkward dichotomy by adding additional baskets, or sub-dividing the baskets into more logical groupings, as I suggested earlier.

Q. Can you illustrate the approach you are recommending with regard to the service baskets?

A. Retail services could be separated into at least 4 baskets or sub-baskets, and wholesale services could be separated into at least 3 subbaskets, as shown below:

- Retail Services
  - Basic Residence
  - Basic Business
  - Discretionary
  - Emerging Competitive
  - Fully Competitive
- Wholesale Services
  - UNE's
  - Switched Access
  - Special Access and Other Wholesale Services

Q. What are the problems associated with classification of new services?

A. The plan provides that all new services and service packages will be placed into the competitive basket, subject to Commission consideration as provided in A.R.S. § 40-250. This statutory provision sets forth certain procedural requirements regarding hearings on rate changes and other proposed changes in operations.

This approach is fatally flawed, because it doesn't contemplate the possibility that a new service or service package might more appropriately be classified as non-competitive. Just because something is new doesn't automatically ensure that competitive alternatives exist, or that Qwest should be given total pricing freedom. The proposed settlement and referenced statutory provisions doe not contain any criteria or provisions which would allow the Commission to determine whether a new service properly belongs in Basket 3, or whether it more appropriately belongs in a different basket.

In addition to the requirements of A.R.S. § 40-250, new product offerings should be subject to the criteria and procedures contained in Commission Rule 14-2-1108. This will reconfirm the Commission's authority to control rates and protect the public interest. The mere fact that services are new does not mean that the public interest will best be served by providing Qwest with extreme pricing flexibility. To the contrary, as technology continues to advance, it is reasonable to expect that many newly offered services will be important to users of the "information superhighway" and as such will also be of considerable concern to the Commission.

Pricing Provisions

Q. Let's turn to the fourth aspect of the settlement agreement you mentioned. Are there any problems with the pricing flexibility provisions of the proposed price cap plan?

A. Yes. The proposed plan contains a combination of price ceilings and price floors which place some limitations on Qwest's pricing freedom. There are problems with both of these aspects of the proposed plan.

Q. What are the problems associated with the price ceilings?

A. First, as I explained earlier, there is some potential uncertainty regarding the status of the plan after the initial 3 year term. Qwest may request an extension or propose changes to the plan, but it is not required to do so. Similarly, there may be a delay before the Commission acts upon such a request. Yet, the caps on individual services in Basket 1, and the Price Index mechanism for all services in Basket 1 only apply for the first three years of the plan. It is unclear what would rule after three years, if the plan has not been formally extended or modified. Qwest could be free to charge "what the market will bear" for Basket 1 services.

Second, the proposed settlement would cap rates for certain Basket 1 services at current levels, and limit increases to rates for other Basket 1 services to 25%. This provides Qwest with too much pricing freedom because 25% is too loose a constraint, and because it would be applied to services as a whole. Instead, the Plan should include reasonable pricing limits on individual rate elements. This element-based approach provides significant additional protection for customers--particularly those who use more of a particular rate element than the average customer, and thus would be vulnerable to extreme increases in their bills under the settlement proposal.

To illustrate this point, consider Measured Service (TIMCODE E5.2.1). This tariffed service includes a monthly rate element, a weekday rate element and a night/weekend/holiday rate element. It also includes a detailed billing rate element and a nonrecurring rate element. Staff and Qwest's proposal does <u>not</u> place any constraints on these individual service elements, provided the overall price increase for the service as a whole stays below 25%. As a result, for example, Qwest could dramatically increase the night/weekend/holiday rates while lowering certain other rates, such as the non-recurring rates. Thus, customers that make most of their calls during the night/weekend/holiday period could face severe rate increases. There is no reason to assume the impact on individual customers would be reasonable merely because the service as a whole is subject to a 25% limitation. The best way to protect customers from "rate shock" is to limit the annual rate of increase in each individual rate element.

If the Commission were to provide Qwest with pricing flexibility, it should impose reasonable constraints on this flexibility, in order to protect consumers from extreme rate increases, and to ensure that any rate rebalancing is introduced gradually. By capping individual rate elements, the Company is given less freedom to rapidly increase rates, and customers will be given greater protection from rate shock during the interim period while competitive pressures are building. Eventually, these pressures should make it difficult for Qwest to impose extreme rate increases, and thus capping of individual rate elements will be a moot issue. In the meantime, this is a needed protection which also has the benefit of reducing Qwest's ability to engage in unreasonable price discrimination.

Q. What limits do you recommend for individual rate elements?

A. Reasonable annual percentage limits should be imposed, over and above the other protections provided in the proposed plan. These rate element limits should be more restrictive in categories where customers have the fewest opportunities to avoid price increases. For example, the most essential services in the proposed baskets 1 and 2 (other than UNEs) should be subject to a limitation on individual rate element increases of no more than 3% in a year. Less stringent limits, such 5% per year, could be allowed for the rate elements in other services. Finally, the limits on rate increases for elements in services which are highly discretionary, but are not fully competitive, should be the least strict of all, perhaps as high as 20% per year.

Q. What about rate elements for services which have been declared to be fully competitive?

A. Under the settlement proposal, Qwest will have essentially unbridled discretion to price services in basket 3 at profit maximizing levels. No caps will be needed on these rate elements, as long as there is <u>effective</u> competition for all of the services in this basket. If the Commission is concerned that the Company may have a lingering degree of monopoly power in some of these markets, then the Commission should impose appropriate caps on increases to individual rate elements in those services.

Q. Can you now explain the problems associated with the pricing floor provisions of Staff and Qwest's proposal?

A. For retail services, the proposed Plan provides that each service must be priced above its TSLRIC. The Plan provides the following: "Nothing in this price cap plan is intended to change or modify in any way the imputation requirements contained in A.A.C. R14-1-1310". [¶ 3(g)] Given the context in which this language appears, it appears that this provision of the Plan might be limited to wholesale services. Rule 14-2-1310(C) provides:

> An incumbent local exchange carrier shall recover in the retail price of each telecommunications service offered by the company the TSLRIC of all nonessential, and the imputed prices of all essential services, facilities, components, functions, or capabilities that are utilized to provision such telecommunications service, whether such service is offered pursuant to tariff or private contract.

Rule 14-2-1302 defines "Essential Facility or Service" as

> any portion, component, or function of the network or service offered by a provider of local exchange service: that is necessary for a competitor to provide a public telecommunications service; that cannot be reasonable duplicated; and for which there is no adequate economic alternative to the competitor in terms of quality, quantity, and price.

Q. Is 14-2-1310(C) limited to wholesale services?

A. It does not appear to be. Rule 14-2-1301 provides that Article 13 applies "to the provision of local exchange services <u>by</u> and between local exchange carriers..." To avoid and confusion, if the proposed plan were to be approved, paragraph 3(g) should be moved from the wholesale section to a more generic location, thereby making it clear that the existing imputation rules apply to all services and all baskets.

Q. Do you have any other concerns with regard to this provision of the proposed plan?

A. Yes. For example, the Commission should clarify that the requirement to impute the price of essential facilities and services applies even if the facility or service in question is not essential for some competitors. For example, switched access service should be imputed into the price floor for retail message toll service because this is essential for most competitors, even though other options may exist for at least some competing carriers. Similarly, the price of an unbundled loop should be imputed in the calculation of the TSLRIC floor for a package of local exchange, custom calling and toll service, despite the fact that the local loop may not be "essential" for Cox cable or the wireless carriers.

Service Quality

Q. Finally, let's discuss the fifth aspect of the settlement agreement you mentioned. Could you describe the service quality provisions of the proposal?

A. The proposed settlement agreement provides that for any year in which Qwest becomes subject to penalties under two or more of the five categories defined in Section 2.6 of the Service Quality Plan Tariff, additional credits shall be implemented. The additional credits will be in the form of one-time credits of $2.00 for each residential and business access line in Arizona. The Agreement further provides:

> No service quality penalties or credits will be assessed during the initial term of the price cap plan other than those provided for in the Service Quality Plan Tariff as modified by Decision No. 62672 and in this Agreement, except for any wholesale standards and penalties adopted in Docket No. T-00000B-97-0238 or in any other Commission proceeding addressing wholesale service quality standards or penalties. [§ 5]

Q. Are these service quality provisions adequate?

A. No. This is an area that clearly needs further scrutiny. The existing regulatory provisions have not been adequate to ensure that every customer consistently receives high quality service. While the settlement proposal takes some modest steps towards encouraging better quality, these are not adequate, especially considering the increased incentives which will exist under a price cap plan for Qwest to sacrifice quality in search of higher profits. To the extent it can cut costs under a price cap system, even if this results in a deterioration in service quality, this will enhance Qwest's profits, except to the extent any resulting penalties or credits exceed the cost reduction in question. Furthermore, in an increasingly competitive environment, Qwest will have a strong incentive to let its wholesale quality (e.g. service connection intervals for unbundled elements) deteriorate–since the adverse impact of this deterioration will primarily fall on its competitors. If the Commission were to consider adopting a price cap plan, it will be important to provide strong, comprehensive incentives for Qwest to improve and maintain service quality, particularly for its UNEs and other wholesale offerings.

Concluding Thoughts

Q. Do you have any concluding remarks you would like to make concerning the proposed settlement?

A. Yes. RUCO believes that the price cap plan as proposed in the settlement agreement affords Qwest far too much pricing freedom, given the lack of effective competition for most of Qwest's services in the state. In addition, existing provisions in the Arizona Constitution which contemplate fair value rate base regulation impose limitations on the type of regulation which is appropriate to use in this state. Moreover, it would be inappropriate to enact sweeping changes in the Arizona regulatory structure through a partial settlement involving just a few of the parties to this proceeding, and without providing RUCO and other parties a full opportunity to thoroughly examine the ramifications of the proposed changes, as well as various related issues. Finally, there are specific aspects of the proposed settlement which are clearly not in the public interest, including the excessive "going in" rate level and the lack of appropriate restrictions on changes to individual rate elements. Accordingly, I would urge the Commission to reject this proposal.

Q. Does this conclude your direct testimony, prefiled on November, 13, 2000?

A. Yes, it does.

Staff-Qwest Settlement Proposal

Net Revenue Change by Basket

Element		Current Rate		Proposed Rate		Difference		Revenue Effect
Basket 1 Services								
Residence NRC - Low Use Option	$	46.50	$	35.00	$	(11.50)	$	(30,015)
Residence NRC - Flat Rate Service		46.50		35.00		(11.50)		(7,968,113)
Residence NRC - Reseller		35.47		26.70		(8.77)		(137,990)
Business Zone Connection Charge (NRC)		53.30		-		(53.30)		(170,720)
Residence Zone Connection Charge (NRC)		53.30		-		(53.30)		(2,267,789)
Business Zone 1 Change		1.00		1.00		-		(189,312)
Business Zone 2 Change		3.00		3.00		-		(192,888)
Residence Zone 1 Change		1.00		1.00		-		(1,497,276)
Residence Zone 2 Change		3.00		3.00		-		(1,941,876)
Total Revenue Effect of Changes in Rate for Basket 1 Services							$	(14,395,979)
Basket 2 Services								
Carrier Common Line	$	0.01657	$	0.01586	$	(0.00071)	$	(1,189,627)
Switched Transport		[1]		[1]				(357,811)
Local Switching		[1]		[1]				1,528,156
Interconnection Charge		0.0062		0.0025		(0.0038)		(5,000,542)
Wholesale Directory Assistance		0.2255		0.3544		0.1289		5,224
Total Revenue Effect of Changes in Rate for Basket 2 Services							$	(5,014,600)
Basket 3 Services								
Directory Assistance	$	0.47	$	0.85	$	0.38	$	24,572,391
Complete-A-Call		0.35		-		(0.35)		(1,459,775)
Private Line Service		[2]		[2]				13,697,701
- Increase in Available Additional Revenue in Basket 3 Services Except Directory Services for One Year							$	25,300,000
Total Revenue Effect of Changes in Rate for Basket 3 Services							$	62,110,317
Overall Revenue Effect for All Baskets							**$**	**42,699,738**

[1] See Additional Detail in Attachment B to the Settlement Agreement
[2] See Additional Detail in Appendix A to the Settlement Agreement

BJA Recommended Revenue Changes

Net Revenue Change by Basket

Element		Current Revenue		Proposed Revenue		Difference
Basket 1 Services						
Local Residential Service	$	352,322,341	$	304,084,515	$	(48,237,826)
Local Business Service		163,565,380		141,607,589		(21,957,791)
Market Expansion Line		3,543,776		2,984,232		(559,544)
Listings		14,774,548		24,224,536		9,449,989
Optional Features		38,993,527		46,413,060		7,419,533
Toll Restriction Services		2,730,280		8,790,438		6,060,158
Other Services		8,918		11,219		2,301
Total Revenue Effect of Changes in Rate for Basket 1 Services					$	(47,823,181)
Basket 2 Services						
Switched Access Services	$	69,018,636	$	64,004,038	$	(5,014,598)
Other Services		10,305,422		10,484,880		179,459
Total Revenue Effect of Changes in Rate for Basket 2 Services					$	(4,835,140)
Basket 3 Services						
Long Distance Service	$	30,135,952.23	$	29,524,174.04	$	(611,778.19)
Switched Access Services		1,414,301		1,436,475		22,174
Private Line Transport Services		26,308,198		31,937,577		5,629,379
Public Access Line Services		551,288		2,205,151		1,653,863
Directory Assistance		21,192,762		40,936,058		19,743,296
Other Services		355,844		590,038		234,194
Total Revenue Effect of Changes in Rate for Basket 3 Services					$	26,671,128
Overall Revenue Effect for All Baskets					**$**	**(25,987,192)**

EXHIBIT
RUCO-15
Admitted

TESTIMONY
OF BEN JOHNSON, PH.D.
On Behalf of
THE STATE OF ARIZONA
RESIDENTIAL UTILITY CONSUMER OFFICE
Before the
ARIZONA CORPORATION COMMISSION
Docket No. T-01051B-99-0105

Introduction

Q. Would you please state your name and address?

A. Ben Johnson, 2252 Killearn Center Boulevard, Tallahassee, Florida 32308.

Q. What is your purpose in submitting this additional testimony?

A. In this additional supplemental testimony I will briefly comment on one aspect of the proposed settlement agreement filed by Staff and Qwest, based upon discovery responses which were recently received from these parties. For convenience, I have attached copies of their response to my testimony.

In particular, I want to provide some additional comments regarding the provisions of the proposed settlement agreement which purport to impose a minimum price floor, below which Qwest would not be allowed to set rates.

Q. Would you please explain your concern?

A. Yes. Price cap plans are designed to give carriers increased pricing flexibility during the transition to a more competitive market. However, pricing flexibility can potentially be abused in ways that will slow the transition to effective competition, or enable a carrier to retain or regain its market power.

Generally speaking, price cuts which are responsive to competitive pressures are considered a desirable outcome of the competitive process, and thus regulators should be reluctant to prevent or discourage price cutting of this type. However, there can be circumstances in which an incumbent carrier may use rate reductions in an anti-competitive manner. For instance, targeted price cuts may be used to discipline or punish certain of its competitors. Moreover, rate reductions may be used in a pre-emptive manner, to make competitive entry more difficult or impossible. Similarly, prices may be reduced to the point where competing carriers cannot cover their costs, including the cost of winning customers and gaining market share.

At first glance, it appears that the proposed settlement agreement contains some limited protection from anti-competitive underpricing. More specifically, the plan requires services in Baskets 1 and 3 to be priced above their Total Service Long Run Incremental Cost ("TSLRIC"). However, this portion of the plan relies heavily on cross referencing existing provisions of the Commission's rules, and it is not self-evident how these provisions will be applied or interpreted in this context.

To illustrate my concern, consider the relatively simple issue of whether Qwest will be required to set prices for its retail toll service which exceed its switched access rates. Access rates are paid to Qwest by its toll competitors under most circumstances. If Qwest is given the freedom to price its retail toll service below these wholesale rates, the competitors will incur costs which exceed their revenues, a condition which is sometimes describes as an anti-competitive "price squeeze." If Qwest is given the freedom to price in this manner, it will be able to force its toll competitors to choose between losing money and abandoning the market. Either way, setting toll prices below access is not in the public interest, although it may be in Qwest's corporate interest, since it will discourage competition and help it maintain or regain a large share of the market.

In response to this policy concern, regulators in various state jurisdictions have taken care to ensure that the incumbent LEC's retail toll rates remain above their access rates. One way this can be accomplished is by imposing an "imputation" requirement, which requires access charges to be included in calculating the cost of providing toll service. Clearly, an appropriate imputation requirement is a valuable and appropriate element of a price cap plan, since it will help protect against anti-competitive pricing practices.

Q. Does the proposed price cap plan include an adequate imputation provision?

A. No. Further clarification and improvement is needed. While it appears that Staff intended to include a pricing floor in the proposed settlement agreement, the proposed provision is too weak, and there is some ambiguity concerning how it stringently it would be applied.

For instance, in Qwest's response to our discovery, it seemed to indicate that it intends to impute access costs only to the extent access is deemed "essential" under the Commission's rules, and it concedes that "terminating" access is identified in the existing rules as an "essential" service. Thus, Qwest apparently intends to exclude originating access charges from its price floor calculations even though its toll competitors are generally forced to pay Qwest for originating access.

Admittedly, originating access isn't "essential" for some toll carriers under some circumstances. However, it represents an unavoidable expense for most toll carriers under most circumstances. To the extent carriers try to avoid paying originating switched access, they will incur other costs (e.g. special access charges). The function performed by originating access service (enabling retail customers to originate calls with the toll carrier of their choice) is clearly essential and cannot be avoided. While other options exist (e.g. special access) these are typically more expensive than switched access–at least when serving most residential and small business customers. While one might argue that switched access isn't "essential" since carriers have the option of using special access, that doesn't provide an adequate excuse for excluding one or the other of these costs in the pricing floor for toll service. If originating access is excluded from the price floor for toll service, Qwest will be free to subject its competitors to an anti-competitive pricing squeeze.

As I indicated earlier, RUCO submitted some discovery to both Qwest and Staff concerning this issue, in an effort to clarify the intent of this portion of the settlement agreement. While none of the responses are completely enlightening, they tend to confirm my concern that the proposed settlement is ambiguous and could potentially provide Qwest with too much downward pricing freedom. For example, with regard to the relatively straightforward issue of toll pricing, Qwest doesn't explicitly explain whether it will include originating access in the price floor calculations, but it leaves the impression that it doesn't want to. Staff doesn't say whether, or under what circumstances, Qwest will be allowed to set retail toll prices below access charges, nor does the Staff indicate whether, or under what circumstances, a distinction might be made between originating and terminating access (see the attached discovery responses).

Q. Is your concern limited to the imputation of switched access?

A. No. The same concerns apply to many other retail services, and ensuring that retail rates remain above the corresponding wholesale UNE rates paid by competitors. A price squeeze can easily result if an incumbent LEC is allowed to set retail prices below the level of UNE rates. If this is permitted, it will tend to discourage competitive entry, and make it difficult or impossible for competitors who are dependent upon UNEs to recover their costs and earn a profit.

An order issued by the Hawaii Public Utilities Commission provides a good explanation of this issue, and the need to maintain an appropriate balance between retail and wholesale rates:

> Imputation
>
> For competition to thrive, there must be a level playing field for all local service providers. This requires all players to price their services based on a common benchmark. It is equally important that the incumbent, GTE Hawaiian Tel, not cross-subsidize those services that become subject to competition. Cross-subsidization occurs when: (1) any fully competitive or partially competitive service is priced below the TELRIC of providing the service; (2) fully competitive services, taken as a whole, fail to cover their direct and allocated joint and common costs; or (3) fully competitive and partially competitive services, taken as a whole, fail to cover their direct and allocated joint and common costs.

> To ensure a level playing field and discourage cross-subsidization, we require GTE Hawaiian Tel to base its own prices for retail services on the same benchmark we set in this decision and order. That is, GTE Hawaiian Tel must price its services as if it were an entity separate and apart from the entity that controls and manages the physical facilities currently owned by GTE Hawaiian Tel. Thus, its services must be priced according to the same TELRIC (plus a reasonable allocation of common costs) for interconnection and unbundled network elements that it charges to CLECs. We do not, by this condition, require GTE Hawaiian Tel physically and organizationally to separate itself into different entities. We only require that GTE Hawaiian Tel price its services on the same benchmark as its competitors. [Decision and Order No. 16777, Docket No. 7702, page 18.]

Q. The Commission already has some rules concerning imputation. Aren't these sufficient to deal with these concerns?

A. No. Among other concerns, the rules in question are somewhat ambiguous, and there doesn't exist a large body of orders from the Commission which clarify or interpret these ambiguous provisions.

Q. Staff argues that the "interpretation of these rules is not at issue at the present time in this Agreement." What is your response?

A. Admittedly, the proposed settlement agreement simply cross references the existing rules. However, if the proposed price cap plan were to be accepted by the Commission, this would have the effect of making the correct interpretation and implementation of these rules far more important than before. Under the existing system of regulation, these pricing rules perform a "belt and suspender" function, providing some additional protection from anti-competitive pricing. However, the primary protection is provided by the Commission, and this is not dependent upon the correct interpretation of these rules.

Under the current system, the Commission regulates Qwest's retail rates, and it retains the discretion to reject rates which seem to be unreasonably low. Furthermore, if a competitor complains that Qwest is trying to drive them out of business by pricing below the imputed cost of essential services like access, the Commission can investigate the specific circumstances and make a determination whether or not the proposed tariff should be allowed. Thus, for example, the Commission can determine whether special access or switched access is most appropriately used in evaluating proposed prices included in any particular tariff.

The proposed settlement agreement would take away the protection provided by the Commission, leaving nothing but the specific pricing limitations which are included in, or cross referenced by, the plan. Furthermore, at least with regard to services which involve a package of residential basic exchange and other services, the proposed settlement might have the effect of overriding, or negating, the limited protection currently provided by the Commission's rules.

Q. In your previously filed direct testimony concerning the settlement, you indicated that UNE rates should be considered in a price floor. Would you please discuss the Qwest and Staff responses to this issue?

A. Yes. We asked Qwest and Staff some questions concerning UNE rates, but their responses did little to clarify the overall situation. One this is clear, however: Qwest and Staff both imply that Qwest would be free to price packages of competitive and basic local exchange service below the corresponding UNE rates, thereby subjecting competitors to an anti-competitive price squeeze.

Our discovery focused on a straightforward example: a package which includes basic local exchange service, call waiting, call forwarding and 100 minutes of toll service. If these services were bundled together and sold for a modest discount below the normal retail prices for the individual components, a competitor can profitably compete with Qwest while paying the UNE loop and switching rates. However, under Qwest's interpretation of the settlement agreement, it believes it will have the freedom to price far below its UNE rates, at levels that UNE-based competitors cannot possibly match. Qwest notes that the basic exchange rate is lower than the UNE loop rate, and it explains that "the current price of the residential basic exchange access line will be considered the price floor for any packages containing a residential access line."

Staff's response to this question is somewhat ambiguous, but it seems to leave open the possibility that Qwest would be allowed to drive its competitors out of business by pricing packages of basic exchange, vertical and toll services at levels which are equal to, or just slightly above, the price of basic exchange service alone. While a competitor doesn't need to recover the entirety of its UNE costs from basic exchange rates when this service is priced on a stand alone basis, it certainly needs to recover these costs from the combination of basic and other services provided to its customers. The proposed settlement agreement apparently would give Qwest the freedom to price packages of basic, vertical and toll services at levels which are below the UNE switching and loop rates, and thus it will have the opportunity to squeeze its UNE-based competitors out of business.

Q. What is your recommendation regarding this aspect of the proposed plan?

A. Given the discovery responses received from Qwest and Staff, this is an aspect of the proposed settlement agreement which is deeply deficient. While the plan cross references certain portions of the Commission's rules, these existing rules are not adequate in the context of the proposed settlement agreement, which would remove most of the Commission's discretion to prevent underpricing of services. The price cap plan provides Qwest with too much discretion, and it takes away too much of the Commission's discretion. Moreover, some of the language in the proposed settlement seems to weaken what limited protections currently exist in the Commission's rules, potentially allowing Qwest to slash prices on bundled packages to levels which are just slightly above the price for basic local exchange service–levels which would make it impossible for competitors to profitably use UNEs to compete with Qwest in the residential market. In my opinion, the proposed settlement agreement should be rejected, because it does not establish adequate protections against anti-competitive pricing tactics.

Q. Does this conclude your further supplemental testimony, which was prefiled on November, 15, 2000?

A. Yes, it does.

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES TO RUCO'S FIFTH SET OF DATA REQUESTS TO THE ARIZONA CORPORATION COMMISSION STAFF DOCKET NO. T-01051B-99-0105 NOVEMBER 13, 2000

5.1 Please refer to page 3 of the proposed Settlement Agreement, which shows Staff and Qwest's proposal to raise Private Line revenues by $13.7 million. Are all Private Line services included in the calculation of this amount included in the Basket 3 list of services attached as Exhibit 3 to the proposed Settlement Agreement? If not, identify each service included in the calculation of this amount, and the Basket in which Staff and Qwest propose to place such service.

RESPONSE: Yes.

RESPONDENT(S): William Dunkel, ACC Consultant

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES TO RUCO'S FIFTH SET OF DATA REQUESTS TO THE ARIZONA CORPORATION COMMISSION STAFF DOCKET NO. T-01051B-99-0105 NOVEMBER 13, 2000

The following questions refer to ACC Rule 14-2-1310(C), which provides:

> An incumbent local exchange carrier shall recover in the retail price of each telecommunications service offered by the company the TSLRIC of all nonessential, and the imputed prices of all essential services, facilities, components, functions, or capabilities that are utilized to provision such telecommunications service, whether such service is offered pursuant to tariff or private contract.

Rule 14-2-1302 defines "Essential Facility or Service" as

> any portion, component, or function of the network or service offered by a provider of local exchange service: that is necessary for a competitor to provide a public telecommunications service; that cannot be reasonable duplicated; and for which there is no adequate economic alternative to the competitor in terms of quality, quantity, and price.

5.2 In the context of setting a price floor for message toll service under the proposed Price Cap Plan, would you ever consider switched access to be an "essential service" as that term is defined in Rule 14-2-1302? Please explain under what circumstances switched access would be considered an "essential service" and explain under what circumstances switched access would not be considered an "essential service."

RESPONSE: **Section 3(g) of the Price Cap Plan states:**

> **Nothing in this Price Cap Plan is intended to change or modify in any way the imputation requirements contained in ACC R14-1-1310.**

Since the interpretation of these rules is not changed, the interpretation of these rules is not at issue at the present time in this Agreement.

The proposed Settlement does not change the rules cited in the Requests, nor does it change the interpretation of any of the above rules.

RESPONDENT(S): William Dunkel, ACC Consultant

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES
TO RUCO'S FIFTH SET OF DATA REQUESTS TO
THE ARIZONA CORPORATION COMMISSION STAFF
DOCKET NO. T-01051B-99-0105
NOVEMBER 13, 2000

5.3 Should the price of switched access be included as an imputed cost when calculating a price floor for any toll services under the proposed Price Cap Plan? If so, please identify the circumstances (e.g. specific tariffs) where this would be appropriate. If not, please explain why such imputation would not be appropriate.

RESPONSE: Section 3(g) of the Price Cap Plan states:

> Nothing in this Price Cap Plan is intended to change or modify in any way the imputation requirements contained in ACC R14-1-1310.

Since the interpretation of these rules is not changed, the interpretation of these rules is not at issue at the present time in this Agreement. Please see the response to Request 5.2.

RESPONDENT(S): William Dunkel, ACC Consultant

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES
TO RUCO'S FIFTH SET OF DATA REQUESTS TO
THE ARIZONA CORPORATION COMMISSION STAFF
DOCKET NO. T-01051B-99-0105
NOVEMBER 13, 2000

5.4 Assume that Qwest offers a packaged service which includes basic local service, call waiting, call forwarding and 100 minutes of toll service. In the context of setting a price floor for this package under the proposed Price Cap Plan, would you ever consider the local loop to be an "essential facility" as that term is defined in Rule 14-2-1302? Please explain under what circumstances the local loop would be considered an "essential facility" and explain under what circumstances the local loop would not be considered an "essential facility."

RESPONSE: See 3(g) of the Price Cap Plan, which states:

> Nothing in this Price Cap Plan is intended to change or modify in any way the imputation requirements contained in ACC R14-1-1310.

Since the interpretation of these rules is not changed, the interpretation of these rules is not at issue at the present time in this Agreement. Staff has not had sufficient opportunity to consider the specific package included in the Request and thus does not have a specific position at this time.

Staff notes, however, that the Agreement requires that the packages in Basket 3 that rely on basic service as a component of the package must impute the retail price of the basic service (1FR) in the TSLRIC to determine the price floor for the Basket 3 package.

RESPONDENT(S): William Dunkel, ACC Consultant; and Peggy Rettle, ACC Consultant

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES TO RUCO'S FIFTH SET OF DATA REQUESTS TO THE ARIZONA CORPORATION COMMISSION STAFF
DOCKET NO. T-01051B-99-0105
NOVEMBER 13, 2000

5.5 Should the price of the unbundled local loop be included as an imputed cost when calculating a price floor for the service package described in the above question under the proposed Price Cap Plan? If so, please identify the circumstances where this would be appropriate. If not, please explain why such imputation would not be appropriate.

RESPONSE: Section 3(g) of the Price Cap Plan states:

> Nothing in this Price Cap Plan is intended to change or modify in any way the imputation requirements contained in ACC R14-1-1310.

Since the interpretation of these rules has not changed, the interpretation of these rules is not at issue at the present time in this Agreement. See the response to Request 5.4. The switched access line is used to provide a family of services. The loop is an "essential facility" for the entire group of services that is provided using that facility. As a result of that, Staff's position has typically been that it would be inappropriate to place the full cost of that shared facility on the cost of just one of the services that share that facility. (Please see, including but not necessarily limited to, pages 40-59, and any schedules referenced therein of Mr. Dunkel's Direct Testimony and Schedules on Rate Design in this proceeding.)

Staff notes, however, that the Agreement calls for using the retail price of 1FR to determine the price floor of packages in Basket 3 that include 1FR.

RESPONDENT(S): William Dunkel, ACC Consultant; and Peggy Rettle, ACC Consultant

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES TO RUCO'S FIFTH SET OF DATA REQUESTS TO THE ARIZONA CORPORATION COMMISSION STAFF DOCKET NO. T-01051B-99-0105 NOVEMBER 13, 2000

5.6 In the context of setting a price floor for basic local service under the proposed Price Cap Plan, would you ever consider the local loop to be an "essential facility" as that term is defined in Rule 14-2-1302? Please explain under what circumstances the local loop would be considered an "essential facility" and explain under what circumstances the local loop would not be considered an "essential facility."

RESPONSE: Section 3(g) of the Price Cap plan states:

> Nothing in this Price Cap Plan is intended to change or modify in any way the imputation requirements contained in ACC R14-1-1310.

Since the interpretation of these rules are not changed, the interpretation of these rules is not at issue at the present time in this Agreement. The term "ever" is a broad and vague term. However, in general principle, at least the full amount of the local loop would not normally be included as being part of the price floor for basic local exchange service. The switched access line is used to provide a family of services. Therefore, Staff's position is that it would be inappropriate to place the full cost of that shared facility on the cost of just one of the services that share that facility. (Please see, including but not necessarily limited to, pages 40-59 and the Schedules referenced therein of Mr. Dunkel's Direct Testimony and Schedules on Rate Design in this proceeding.)

Staff notes, however, that the Agreement calls for using the retail price of 1FR to determine the price floor of packages in Basket 3 that include 1FR.

RESPONDENT(S): William Dunkel, ACC Consultant; and Peggy Rettle, ACC Consultant

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES
TO RUCO'S FIFTH SET OF DATA REQUESTS TO
THE ARIZONA CORPORATION COMMISSION STAFF
DOCKET NO. T-01051B-99-0105
NOVEMBER 13, 2000

5.7 Should the price of the unbundled local loop be included as an imputed cost when calculating a price floor for basic local service under the proposed Price Cap Plan? If so, please identify the circumstances (e.g. specific tariffs) where this would be appropriate. If not, please explain why such imputation would not be appropriate.

RESPONSE: Section 3(g) of the Price Cap Plan states:

> Nothing in this Price Cap Plan is intended to change or modify in any way the imputation requirements contained in ACC R14-1-1310.

Since the interpretation of these rules is not changed, the interpretation of these rules is not at issue at the present time in this Agreement. Please see the response to Request 5.6.

Staff notes, however, that the Agreement calls for using the retail price of 1FR to determine the price floor of packages in Basket 3 that include 1FR.

RESPONDENT(S): William Dunkel, ACC Consultant; and Peggy Rettle, ACC Consultant

Arizona
Docket No. T-1051B-99-105
RUCO 36-001

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 001

Please refer to page 3 of the proposed Settlement Agreement, which shows Staff and Qwest's proposal to raise Private Line revenues by $13.7 million. Are all Private Line services included in the calculation of this amount included in the Basket 3 list of services attached as Exhibit 3 to the proposed Settlement Agreement? If not, identify each service included in the calculation of this amount, and the Basket in which Staff and Qwest propose to place such service.

RESPONSE:

Yes, all Private Lines services in the $13.7M revenue increase are Basket 3 services.

Maureen Arnold
Director of Regulatory Affairs
3033 No. 3rd St.
Phoenix, AZ

Arizona
Docket No. T-1051B-99-105
RUCO 36-002

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 002

In the context of setting a price floor for message toll service under the proposed Price Cap Plan, would you ever consider switched access to be an "essential service" as that term is defined in Rule 14-2-1302? Please explain under what circumstances switched access would be considered an "essential service" and explain under what circumstances switched access would not be considered an "essential service."

RESPONSE:

To the extent that elements of switched access service are defined as "essential" in R14-2-1307(c)(2), which classifies the "termination of long distance calls" as essential, Qwest will continue to consider termination of intraLATA long distance calls to be essential until the Commission determines it to be otherwise in a rulemaking proceeding.

David Teitzel
Witness - Pricing and Policy
1600 7th Avenue
Seattle, WA

Arizona
Docket No. T-1051B-99-105
RUCO 36-003

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 003

Should the price of switched access be included as an inputed cost when calculating a price floor for any toll services under the proposed Price Cap Plan? If so, please identify the circumstances (e.g. specific tariffs) where this would be appropriate. If not, please explain why such imputation would not be appropriate.

RESPONSE:

Qwest will include the price of any switched access elements defined by the Commission as essential, as well as the TSLRIC of any elements defined to be non-essential, in the price floor of any Qwest intraLATA long distance service under the proposed Price Cap Plan.

David Teitzel
Witness - Pricing and Policy
1600 7th Avenue
Seattle, WA

Arizona
Docket No. T-1051B-99-105
RUCO 36-004

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 004

Assume that Qwest offers a packaged service which includes basic local service, call waiting, call forwarding and 100 minutes of toll service. In the context of setting a price floor for this package under the proposed Price Cap Plan, would you ever consider the local loop to be an "essential facility" as that term is defined in Rule 14-2-1302? Please explain under what circumstances the local loop would be considered an "essential facility" and explain under what circumstances the local loop would not be considered an "essential facility."

RESPONSE:

Qwest concurs that the Qwest unbundled loop can be considered to be an "essential facility" for setting price floors under the Price Cap Plan, until the Commission determines the unbundled loop to no longer be an essential facility, with the exception of establishment of price floors for residential basic exchange service. Since residential basic exchange service is currently priced below cost, parties have agreed that the current price of the residential basic exchange access line will be considered the price floor for any packages containing a residential access line (see Price Cap Plan 4E).

David Teitzel
Witness - Pricing and Policy
1600 7th Avenue
Seattle, WA

Arizona
Docket No. T-1051B-99-105
RUCO 36-005

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 005

Should the price of the unbundled local loop be included as an imputed cost when calculating a price floor for the service package described in the above question under the proposed Price Cap Plan? If so, please identify the circumstances where this would be appropriate. If not, please explain why such imputation would not be appropriate.

RESPONSE:

For Business services, the price of the unbundled loop will be included in calculating the price floor for service packages incorporating business basic exchange services, so long as the unbundled loop is classified by the Commission as "essential." For Residential services, see response to Ruco 36-004.

David Teitzel
Witness - Pricing and Policy
1600 7th Avenue
Seattle, WA

Arizona
Docket No. T-1051B-99-105
RUCO 36-006

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 006

In the context of setting a price floor for basic local service under the proposed Price Cap Plan, would you ever consider the local loop to be an "essential facility" as that term is defined in Rule 14-2-1302? Please explain under what circumstances the local loop would be considered and "essential facility" and explain under what circumstances the local loop would not be considered an "essential facility."

RESPONSE:

See response to Ruco 36-004.

David Teitzel
Witness - Pricing and Policy
1600 7th Avenue
Seattle, WA

Arizona
Docket No. T-1051B-99-105
RUCO 36-007

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 007

Should the price of the unbundled local loop be included as an imputed cost when calculating a price floor for basic local service under the proposed Price Cap Plan? If so, please identify the circumstances (e.g. specific tariffs) where this would be appropriate. If not, please explain why such imputation would not be appropriate.

RESPONSE:

See response to Ruco 36-005.

David Teitzel
Witness - Pricing and Policy
1600 7th Avenue
Seattle, WA

Arizona
Docket No. T-1051B-99-105
RUCO 35-006

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 006

Under Qwest's understanding of the Staff-Qwest rate case settlement agreement (see Qwest witness Maureen Arnold Exhibit dated October 27, 2000), will all of the Qwest-US West merger savings related to or attributed to Arizona intrastate operations flow to the benefit of Qwest shareholders?

a. If not, what provision is made within the Staff-Qwest rate case settlement agreement, to provide Arizona jurisdictional ratepayers with some portion of any Qwest-US West merger savings realized during the period covered by the settlement that are related to or attributed to Arizona intrastate operations?

RESPONSE:

Any potential savings (or risks) associated with the merger fall outside of the test year and do not meet the requirements for pro forma adjustments. For that reason, they should not be considered. The parties agreed to the productivity off-set to pass on to ratepayers benefits of improved productivity, including those arising from merger.

Reed Peterson
Regulatory Affairs Manager
3033 No. 3rd Street
Phoenix, AZ

EXHIBIT
RUCO-16
Admitted

Arizona
Docket No. T-1051B-99-105
RUCO 35-001

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 001

Refer to the October 27, 2000 Testimony of George Redding, which at page 4, lines 9-13, indicates that the income available from operations was not based on a compilation of specific adjustments, but "was the product of mutual agreement using the adjusted net operating income shown on the Staff's Schedule A and approximately one half the value of the adjustments described above."

a. Are the "adjustments described above" the adjustments mentioned at Mr. Redding's testimony, page 3, line 22, through page 4, line 2, specifically: capitalized software, overheads assigned to the sale of exchanges, incentive compensation and out of period wage and salary increases? If not, explain fully.

b. Provide the calculation that results in "approximately one half the value of the adjustments described above" per Mr. Redding's testimony at page 5, lines 12-13.

c. In reaching the settlement with Staff concerning the revenue increase of $42.9 million, what consideration, if any, was given to adjustments proposed by parties other than Staff (e.g., by RUCO, DOD and AT&T) that were in addition to or different from the adjustments affecting the intrastate revenue requirement proposed by Staff?

RESPONSE:

a. Yes.

b. Please see Attachment A.

c. Please see the Company's response to RUCO 35-3.

Judy Steward
State Finance Manager
1801 California St.
Denver, CO 80202

EXHIBIT
RUCO-17
Admitted

ARIZONA
DOCKET NO. T-01051B-99-105
RUCO 35-001
ATTACHMENT A

Qwest Inc.
RUCO 35-1(b)
Attachment A

Calculation that resulted in "approximately one half of the adjustments described above" ... Mr. Redding's testimony at page 5, lines 12-13.

From ACC Staff Exhibit E (page 1 of 2):

	Adjustments	(000's) Revenue Requirment
C-12	Incentive Compensation	$ (5,529)
C-13	SOP 98-1 (Income Statement)	(32,840)
B-2	SOP 98-1 (Rate Base)	(1,038)
C-14	USWC Payroll Adjustment Reversal	(13,322)
C-29	Exchange Sale Allocations Adjustment	(11,416)
	Total Adjustments	$ (64,145)
	Divide by Multiplier (1.6995)	(37,743)
	Divide by 2	(18,872)

Income Available (ACC Staff Schedule A)	134.3
Negotiated Income Available (Redding Testimony, page 5 & Brosch Testimony, page 4)	113.7
Negotiated Difference	20.6

EXHIBIT
Ruco-18
admitted

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES
TO RUCO'S FOURTH SET OF DATA REQUESTS TO ACC STAFF
RE PROPOSED SETTLEMENT
DOCKET NO. T-01051B-99-0105
NOVEMBER 6, 2000

RUCO-4.3 Would a $7.242 million revenue requirement deficiency (as recommended by Staff on its Schedule A) afford Qwest a reasonable opportunity to earn a fair return on its fair value rate base, while resulting in just and reasonable rates and revenues to be paid by customers? If not, explain fully why not.

RESPONSE: Staff's prefiled case would have provided Qwest with a reasonable opportunity to earn a fair return on its fair value rate base, if the Commission had adopted Staff's case in its entirety. No other party proposed that Staff's case should be adopted without change. As explained by Staff witness Michael Brosch in his Supplemental testimony, Staff has considered its prefiled position and the attached litigation risks and, through negotiation with Qwest, believes that the terms and conditions described in the Settlement Agreement will result in just and reasonable rates and revenues to be paid by customers. The Settlement Agreement represents a compromise of certain issues, as explained in the Supplemental Testimony of Mr. Brosch. Please see also the Staff's response to RUCO-4.1.

Respondent(s): Michael Brosch, ACC Consultant

5. EXCHANGE SERVICES

5.4 PREMIUM EXCHANGE SERVICES

5.4.10 *U S WEST* CUSTOM RINGING SERVICE (Cont'd)

C. Rates and Charges

1. This service is subject to the terms, conditions, rates and charges applicable to other exchange services and is in addition to the basic rates and charges for the service with which it is associated.

	USOC	NONRECURRING CHARGE[1]	MONTHLY RATE
a. Custom Ringing			
• Residence			
- First additional number	RGG1+	$13.00	$5.00
- Second additional number	RGG2+	13.00	2.80
- Third additional number	RGG3+	13.00	2.80
• Business			
- First additional number	RGG1+	13.00	7.45
- Second additional number	RGG2+	13.00	5.25
- Third additional number	RGG3+	13.00	5.25

(M)

[1] Only one nonrecurring charge will apply per order to install Custom Ringing Service.

(D)

(M) Material moved to 105.4.14.

EXHIBIT
RUCO-19
Admitted

ST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
YEAR-END WAGE & SALARY ANNUALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE

LINE NO.	DESCRIPTION (A)		Salaries & Wages – Management: Regular Payroll Expense (a) (B)	Management: Equivalent Employees (c) (C)	Management: Regular Pay Per Employee (D)	Occupational: Regular Payroll Expense (b)	Occupational: Equivalent Employees (c)	Occupational: Regular Pay Per Employee	Total
1	**Regular Pay Annualization**		[redacted]						
2	Oct-99								
3	Nov-99								
4	Dec-99								
5	Average Regular Pay								
6	Dec-99 Employee Level								
7	Times: Annualization Multiplier								
8	Annualization Adjustment - Regular Pay								
9	Add: Annualized Overtime/Premium Pay	(e)							
10	Add: TY Incentive Compensation	(d)							
11	Add: TY Termination Pay	(d)							
12	Add: TY Other Pay (not assignable)	(d), (h)							
13	ACC Staff Salary/Wage Annualization				$123,866,976			$246,450,544	370,317,520
14	Add: Benefits Loading (excluding Pensions &	(g)						20.737%	76,792,967
15	Add: Test Year Pension Expense	(j)							(18,034,372)
16	Add: Test Year Net PRB/OPEB Expense	(j), (k)							42,899,481
17	Total Benefits Expense								101,658,076
18	ACC Staff Proposed Payroll & Benefits Expense								471,975,595
							Salaries/Wages	Benefits	
19	Less: Test Year Expense	(f)					($365,705,291)	($99,673,981)	(465,379,272)
20	Less: USWC EOP Labor Annualization Adjustment (P-01)	(i)					(21,355,261)	(3,202,942)	(24,558,203)
21	Less: USWC Wage/Salary Increase Adjustment (P-02)	(i)					n/a	n/a	0
22	ACC Staff Proposed Annualization Adjustment						($387,060,552)	($102,876,923)	($17,961,880)

(000's) ACC ADJUSTMENT DISTRIBUTION	Salaries & Wages: TY Distribution	Salaries & Wages: Adjustment Distrib.	Benefits: TY Distribution	Benefits: Adjustment Distrib.	Total Arizona	%Intrastate	AZ Intrastate
Maintenance	50.35%	($8,431)	42.85%	($522)	($8,953)	74.39%	($6,660)
Engineering	1.24%	(208)	1.38%	(17)	(225)	76.16%	(171)
Network Operations*	8.87%	(1,485)	16.34%	(199)	(1,685)	75.08%	(1,265)
Network Administration*	0.44%	(73)	0.53%	(6)	(80)	72.38%	(58)
Access	0.00%	0	0.00%	0	0	n/a	0
Other	0.21%	(34)	0.15%	(2)	(36)	70.88%	(26)
Customer Operations	29.89%	(5,005)	32.23%	(393)	(5,398)	77.70%	(4,194)
Corporate Operations	9.00%	(1,506)	6.51%	(79)	(1,586)	79.22%	(1,256)
Total Operating Expense	100.00%	($16,743)	100.00%	($1,219)	($17,962)		($13,630)
	(f)		(f)			(f)	

EXHIBIT
RUCO-21
Admitted

L . .ST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
YEAR-END WAGE & SALARY ANNUALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE

FOOTNOTES:

(a) Management Regular Pay Components

	Oct-99	Nov-99	Dec-99
Basic Wages	[redacted]		
Paid Absence			
Short Period Sick			
Total			

Source: USWC Confidential response to UTI 42-5.

(b) Occupational Regular Pay Components

	Apr-98	May-98	Jun-98
Basic Wages	[redacted]		
Paid Absence			
Short Period Sick			
Total			

Source: USWC Confidential response to UTI 42-5.

(c) Source: USWC Confidential response to UTI 63-2.

(d) Source: USWC Confidential response to UTI 42-5.

(e) Overtime Annualization

	As Recorded	Multiplier	Annualized
Management Overtime			
1/99 -- 2/99	[redacted]		
3/99 -- 12/99			
Total Manag			
Occupational Over			
1/1/99 -- 8/14/			
8/15/99 -- 12/3			
Total Occup			
Totals			

Source: USWC Confidential response to UTI 42-5.

(f) Source: USWC Adjustment P-01 workpapers.

(g) Benefits Loading

	Benefits excl PRB	Salary/Wage	Benefits Factor
12ME December	[redacted]		
12ME December			
12ME December			

Source: USWC Confidential response to UTI 20-3, UTI 42-4, UTI 18-25 & UTI 42-5.

(h) TY Other Pay (not assigned) attributed to Occupational for presentational purposes.

(i) USWC Adjustment P-02 is reversed through a separate ACC Staff Adjustment.

(j) Source: USWC Confidential response to UTI 42-4.

(k) Test Year Net PRB/OPEB Expense

MR Basis Expense -- Test Year	[redacted]
OBK 172 -- Test Year	
Total	$42,899,481

Sources: USWC Confidential response to UTI 42-4 & USWC P-02 Workpapers.

EXHIBIT
RUCO-22
Admitted

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES
TO RUCO'S THIRD SET OF DATA REQUESTS TO ACC STAFF
RE PROPOSED SETTLEMENT
DOCKET NO. T-01051B-99-0105
NOVEMBER 2, 2000

RUCO-3.9 In agreeing to an overall revenue increase of $42.9 million, what consideration, if any, did Staff give to the fact that each of the other parties who presented testimony on the revenue requirement in this proceeding, including RUCO, DOD and AT&T, recommended an overall revenue decrease based upon their calculations which each showed significant revenue sufficiency for Qwest's Arizona intrastate operations?

RESPONSE: **The revenue requirement calculations of the other parties included adjustments and positions not advocated by Staff that, upon review by Utilitech, were not explicitly factored into the Settlement Agreement revenue requirement. See, for example, the responses to RUCO 3.5, above.**

Respondent(s): Michael Brosch, ACC Consultant

ARIZONA CORPORATION COMMISSION STAFF'S SUPPLEMENTAL
RESPONSES TO RUCO'S THIRD SET OF DATA REQUESTS TO ACC STAFF
RE PROPOSED SETTLEMENT
DOCKET NO. T-01051B-99-0105
NOVEMBER 13, 2000

RUCO-3.2 Refer to the Supplemental Testimony of Michael Brosch. At page 1, line 31, he states that: "My advice to Staff was based upon judgments associated with the litigation risk of presenting and arguing the many issues set forth in Staff's and other parties' prefiled evidence." Did Staff or its consultants perform any written analysis or quantification of the differences between (1) the adjustments that Staff recommended in its testimony that affected the calculation of the Arizona intrastate revenue requirement for Qwest and (2) the adjustments recommended in the testimony of witnesses for RUCO, DOD and AT&T that affected the calculation of the revenue requirement? If so, provide a copy of such written analysis and quantifications.

SUPPLEMENTAL RESPONSE:

Staff objects to this question. Any answer would require disclosure of information which is privileged and protected as attorney work product. Without waiving this objection, Staff files the following supplemental response.

Yes. Upon receipt of RUCO's filing, Utilitech prepared and provided to Staff a comparison of its filings to RUCO's, by appending columns to Staff Schedule E. That schedule is attached.

Respondent(s): Michael Brosch, ACC Consultant

EXHIBIT
RUCO-23

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
RECONCILIATION OF POSITIONS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

ACC Staff
Schedule E
Page 1 of 2

LINE NO.	SCH./ ADJ. NO.	DESCRIPTION	AMOUNT	DIFFERENCE IN PRETAX RETURN	REVENUE REQUIREMENT VALUE	RUCO Issues Per RevRqmtSumm. VALUE	REFERENCE
		(A)	(B)	(C)	(D)		
1	SCH. A	USWC'S Revenue Requirement			$201,221		
2	SCH. B	Return Difference At USWC'S Rate Base	$1,422,100	-2.05%	(29,159)	(32,211)	
3		Subtotal Revenue Requirement			172,062		
				PRE-TAX RETURN			
4		ACC STAFF RATE BASE ADJUSTMENTS					
5	B-1	UNRECORDED RETIREMENTS	0	13.99%	0		
6	B-2	SOP 98-1 (INTERNAL-USE SOFTWARE)	(7,417)	13.99%	(1,038)		
7	B-3	FAS87 PENSION ASSET	(42,344)	13.99%	(5,924)	(7,336)	E-10
8	B-4	CASH WORKING CAPITAL	(9,469)	13.99%	(1,325)	(1,076)	E-24
9	B-5	PROFORMA DEPRECIATION – RESERVE REVERSAL	64,565	13.99%	9,032		
10	B-6	BROADBAND CABLE TRANSACTIONS (ASSET TRANSFER)	6,791	13.99%	950		
11	B-7	FCC DEREG – SEPARATIONS ADJUSTMENT	1,061	13.99%	148		
12		Total Value of ACC Staff Rate Base Adustments	13,187		1,845		
13		ACC Staff Rate Base Recommendation	$1,435,287				
				REVENUE CONVERSION MULTIPLIER			
14	SCH. A	USWC Net Operating Income	$43,833				
15		ACC Staff NET OPERATING INCOME ADJUSTMENTS					
16	C-1	REVENUE ANNUALIZATION - RECURRING LOCAL SERVICE	5,314	1.6995	(9,032)	(20,075)	E-2
17	C-2	ANNUALIZATION OF INTRASTATE TOLL REVENUES	215	1.6995	(366)		
18	C-3	REVERSAL OF ACCESS ANNUALIZATION	(1,091)	1.6995	1,853		
19	C-4	MISCELLANEOUS REVENUE NORMALIZATION	(881)	1.6995	1,497	Incomplete	E-5
20	C-5	DIRECTORY IMPUTATION PER AGREEMENT	24,722	1.6995	(42,014)	(42,166)	E-3
21	C-6	BROADBAND CABLE TRANSACTIONS	950	1.6995	(1,615)	Incomplete	E-7
22	C-7	UNCOLLECTIBLES ANNUALIZATION	81	1.6995	(103)		
23	C-8	SERVICE QUALITY PROGRAM COST ELIMINATION	5,747	1.6995	(9,768)	(10,041)	E-23
24	C-9	AFFILIATE TRANSACTION TRUE-UP NORMALIZATION	(650)	1.6995	1,105		
25	C-10	EOP NONLABOR REVERSAL	5,751	1.6995	(9,774)	(5,185)	E-1
26	C-11	YEAR-END WAGE & SALARY ANNUALIZATION	8,151	1.6995	(13,852)	(20,506)	~~E-11~~
27	C-12	INCENTIVE COMPENSATION	3,253	1.6995	(5,529)	(5,553)	E-12
28	C-13	SOP 98-1 (INTERNAL-USE SOFTWARE)	19,323	1.6995	(32,840)	(37,409)	E-15
29	C-14	USWC PAYROLL ADJUSTMENT REVERSAL	7,839	1.6995	(13,322)	(1,978)	E-13, E-14
30	C-15	PROFORMA DEPRECIATION ANNUALIZATION	1,763	1.6995	(2,996)	(9,084)	E-8
31	C-16	INTEREST SYNCHRONIZATION ADJUSTMENT	46	1.6995	n/a	848	E-25
32	C-17	FCC DEREGULATED SERVICES REVENUE IMPUTATION	2,128	1.6995	(3,616)	Incomplete	E-6
33	C-18	FCC DEREG – SEPARATIONS ADJUSTMENT	(2,165)	1.6995	3,680		
34	C-19	PUBLIC AFFAIRS/RELATIONS EXPENSE DISALLOWANCE	452	1.6995	(768)	(837)	E-16
35	C-20	US WEST INC. DEPARTMENTAL DISALLOWANCES	683	1.6995	(1,161)		
36	C-21	EMPLOYEE CONCESSION ALLOCATION TO INTERSTATE	282	1.6995	(479)		
37	C-22	DEPRECIATION ON UNRECORDED RETIREMENTS	1,721	1.6995	(2,924)		
38	C-23	RESERVED RUCO Prod. Advert	0	1.6995	0	(744)	E-18
39	C-24	PROPERTY TAX CORRECTION	740	1.6995	(1,258)		
40	C-25	OUT OF PERIOD PROPERTY AND OTHER TAXES	(1,233)	1.6995	2,095		
41	C-26	OUT OF PERIOD INCOME TAXES	1,392	1.6995	(2,365)	(2,372)	E-21
42	C-27	IMAGE ADVERTISING, OLYMPIC/SPORTS SPONSORSHIP	5,939	1.6995	(10,092)	(11,392)	E-17, E-19, E-
43	C-28	RENT COMPENSATION	99	1.6995	(168)		
44	C-29	EXCHANGE SALE ALLOCATION ADJUSTMENTS	6,717	1.6995	(11,416)		
45	C-30	RECIPROCAL COMPENSATION	(6,830)	1.6995	11,607		
46	C-31	RESERVED RUCO USF	0	1.6995	0	1,397	E-4
47	C-32	RESERVED RUCO Gain Exch.	0	1.6995	0	(22,935)	E-22
48	C-33	RESERVED RUCO ITC amort	0	1.6995	0	(559)	E-9
		Total RUCO Issues				(229,214)	
49		Total Value of ACC Staff Net Operating Income Adj.	90,438		(153,620)		
50	SCH. A	ACC Staff Net Operating Income Recommendation	$134,271				
51		OTHER REVENUE REQUIREMENT DIFFERENCES					
52		Bellcore 3 Year Adjustment			0		
53		Automatic Adjustment Revenue Requirement			(13,252)		
54		Total Other Differences			(13,252)		
55		RECONCILED REVENUE REQUIREMENT			57,034		
56		UNRECONCILED DIFFERENCE			208		
57	SCH. A	ACC STAFF REVENUE REQUIREMENT RECOMMENDATION			57,242		

EXHIBIT
RUCO-25
Admitted

Arizona
Docket No. T-1051B-99-105
RUCO 36-003

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 003

Should the price of switched access be included as an inputed cost when calculating a price floor for any toll services under the proposed Price Cap Plan? If so, please identify the circumstances (e.g. specific tariffs) where this would be appropriate. If not, please explain why such imputation would not be appropriate.

RESPONSE:

Qwest will include the price of any switched access elements defined by the Commission as essential, as well as the TSLRIC of any elements defined to be non-essential, in the price floor of any Qwest intraLATA long distance service under the proposed Price Cap Plan.

David Teitzel
Witness - Pricing and Policy
1600 7th Avenue
Seattle, WA

EXHIBIT
RUCO-26
Admitted

Arizona
Docket No. T-1051B-99-105
RUCO 36-002

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 002

In the context of setting a price floor for message toll service under the proposed Price Cap Plan, would you ever consider switched access to be an "essential service" as that term is defined in Rule 14-2-1302? Please explain under what circumstances switched access would be considered an "essential service" and explain under what circumstances switched access would not be considered an "essential service."

RESPONSE:

To the extent that elements of switched access service are defined as "essential" in R14-2-1307(c)(2), which classifies the "termination of long distance calls" as essential, Qwest will continue to consider termination of intraLATA long distance calls to be essential until the Commission determines it to be otherwise in a rulemaking proceeding.

David Teitzel
Witness - Pricing and Policy
1600 7th Avenue
Seattle, WA

SUMMARY OF THE SUPPLEMENTAL TESTIMONY
OF
RALPH C. SMITH
ON BEHALF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE
CONCERNING THE PROPOSED SETTLEMENT

My supplemental testimony presents some of the concerns that RUCO has concerning the proposed Settlement Agreement between Staff and Qwest. One concern is that the $42.9 million revenue increase is too high. Another concern is that the Settlement contains a provision precluding refunds if the Price Cap Plan or the Settlement is found to be unlawful, which is contrary to the public interest.

Revenue Requirement. The proposed Settlement would provide Qwest with a $42.9 million intrastate revenue increase, which, in my opinion, is not warranted. As is evidenced by the filings of Staff, RUCO, DOD/FEA and AT&T witnesses in this proceeding, Staff is the only party (other than Qwest) who had recommended that Qwest be granted an increase in Arizona intrastate revenue:

Party	Calculated Intrastate Revenue Requirement Increase (Decrease) ($000)	Reference
Staff	$ 7,242	Utilitech Schedule A, Staff Direct filing
RUCO	$ (34,101)	Exhibit ___(L&A-2), Schedule A Revised, RUCO Surrebuttal filing
DOD/FEA	$ (51,972)	Surrebuttal testimony of Richard B. Lee, Attachment 6, Summary
AT&T [1]	$ (45,000)	Susan M. Gately, Direct Testimony, p.40, fn. 25 (note [1])
AT&T [2]	$ (308,849)	Susan M. Gately, Direct Testimony, p.40 and Exhibit SMG-1

[1] reflects the $43 million directory revenue imputation from prior case.
[2] reflects AT&T's recommended directory revenue imputation and 9.75% ROR from prior case

EXHIBIT
R-27
Admitted

The previously filed Direct and Surrebuttal Testimony in this proceeding of the other parties (RUCO, DOD/FEA and AT&T) each identified a revenue excess and recommended that Qwest's Arizona intrastate revenues be reduced.

As recently as September 7, 2000 when Staff's Surrebuttal Testimony was filed, Staff revenue requirement witnesses Brosch (and Carver) continued to advocate a revenue increase for Qwest of no more than approximately $7.2 million. It is surprising and disturbing that Staff witness Brosch is now advocating a revenue increase for Qwest of $42.9 million that is almost five times greater than the previous Staff recommendation of $7.2 million. ($42.9 / $7.2M = 5.96x) The $42.9 million revenue increase is excessive and not warranted based on the evidence presented by the parties in this case, including the Staff witnesses.

On page 2 of his November 20 rebuttal, Mr. Brosch states that he did not "factor in" two RUCO adjustments (E-22 and part of E-1) into his settlement recommendation because in his opinion they "are simply inappropriate and should have been disapproved if formally presented in a contested case." I disagree with Mr. Brosch with respect to both items.

Concerning RUCO Adjustment E-22, I was asked by RUCO to reflect in the instant rate case the impact of RUCO's position in the concurrent proceeding, Docket No. T-01051B-99-0737, that the gain on the sale of the 38 Arizona exchanges, with traffic, be shared between shareholders and ratepayers. I reflected this RUCO position on Schedule E-22, which was filed with my direct testimony. This treatment, including the sharing of the gain over a three-year period, is similar to and consistent with the Company's reflection of the sharing with ratepayers of 50% of the gain it realized upon the sale of its interest in Bellcore. It is also consistent with prior Commission precedent, as discussed at length in RUCO's testimony in Docket No. T-01051B-99-0737.

Concerning the portion of RUCO Adjustment E-1 criticized by Mr. Brosch, intrastate toll revenues were not annualized in RUCO's presentation because such revenues have generally not been annualized in prior proceedings. These revenues are volatile from month to month, and the methodology for annualizing toll revenues used by US West (now Qwest) in this proceeding of multiplying December 1999 times 12 is inherently unreliable.

Pages 3-4 of Mr. Brosch's November 20, 2000 rebuttal testimony mentions approximately $44.9 million of RUCO adjustments that he indicates "were implicitly compromised in Staff's negotiations with Qwest." In each instance, the RUCO adjustments cited by Mr. Brosch were calculated differently than comparable Staff adjustments. RUCO's adjustments should receive a full hearing on the merits rather than being "implicitly compromised" in a proposed settlement that RUCO does not endorse.

The "No Refund" provision. The provisions of paragraph 13 of the proposed settlement are objectionable. That paragraph provides, among other things, that "... Qwest shall have no obligation to refund revenues collected during the period of time the Price Cap Plan is in effect" if the Arizona courts should ultimately find that the Price Cap Plan is unlawful. If the Price Cap Plan or the Settlement is found to be unlawful, Qwest should be required refund amounts that it collected. Removing Qwest's obligation to refund revenues collected under a Plan found to be unlawful appears to be contrary to the public interest.

EXHIBIT
S-1
Admitted

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION	)	
OF U S WEST COMMUNICATIONS, INC.,	)	
A COLORADO CORPORATION, FOR A	)	
HEARING TO DETERMINE THE	)	
EARNINGS OF THE COMPANY FOR	)	DOCKET NO. T-01051B-99-105
RATEMAKING PURPOSES, TO FIX A	)	
JUST AND REASONABLE RATE OF	)	
RETURN THEREON, AND TO APPROVE	)	
RATE SCHEDULES DESIGNED TO	)	
DEVELOP SUCH RETURN	)	

SUPPLEMENTAL TESTIMONY OF

MICHAEL L. BROSCH

ON BEHALF OF

ACC UTILITIES DIVISION STAFF

October 27, 2000

BEFORE THE
ARIZONA CORPORATION COMMISSION
SUPPLEMENTAL TESTIMONY OF
MICHAEL L. BROSCH

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. Are you the same Michael L. Brosch who previously submitted prepared Direct and Surrebuttal Testimony in this Docket?

A. Yes. My qualifications and work experience were provided in my Direct Testimony.

Q. What is the purpose of your Supplemental Testimony in this Docket?

A My testimony explains the revenue requirement included within the Settlement Agreement between Staff and Qwest (previously U S West Communications) and why such revenue requirement is reasonable and in the public interest. I also describe the fair value rate base, rate of return and adjusted operating income findings associated with the Settlement Agreement and why the Commission should find such amounts reasonable.

Q. What is the total revenue increase Qwest may implement under the Settlement Agreement?

A. $42.9 million is the maximum revenue increase that can be implemented. Of this amount, approximately $17.6 million is to be implemented as an immediate revenue increase, while the other $25.3 million represents authorized increases in overall revenue from a basket of competitive services that Qwest may elect to implement in the future.

Q. Is the $42.9 million rate increase the result of negotiations between Staff and Qwest?

A. Yes. While I did not participate in the actual negotiations, I provided advice and assistance to the Staff in preparing for such negotiations. I advised the Utilities Division Director and Staff Counsel that the $42.9 million amount was, in my judgment, reasonable and consistent with the public interest.

Q. Was the $42.9 million revenue requirement amount the result of issue-by-issue negotiations between Staff and Qwest?

A. No. My advice to Staff was based upon judgments associated with the litigation risk of presenting and arguing the many issues set forth in Staff's and other parties' prefiled evidence. It is my understanding that Qwest engaged in its own assessment of such risks and presented settlement offers reflective of possible outcomes if the issues were litigated. However, there was no issue-by-issue negotiation and the total revenue requirement that was agreed upon is not premised upon specific outcomes for particular issues. The Settlement Agreement should not be viewed as an agreement regarding any ratemaking theories or positions that are at issue in this Docket. Rather, the Settlement is a compromise of all of the issues between Staff and the Company.

Q. Why is a $42.9 million rate increase reasonable and in the public interest?

A. Staff's prefiled direct evidence supported a rate increase of $7.2 million, after making many accounting adjustments and significantly reducing the Company's requested rate of return. In contrast, the Company's filing supports a total revenue increase of $201.2 million. Schedule E within the ACC Staff Joint Accounting Exhibit is a one-page reconciliation of the many issues between Qwest and the Staff that make up the approximately $194 million in dispute between Qwest and the Staff in this Docket. Line 2 of Schedule E indicates a $29.2 million difference in recommended rates of return associated with Qwest's requested 14 percent return on equity versus the Staff's recommended 11.75 percent ROE. With respect to original cost rate base issues, Staff and Qwest differ by only $1.8 million in revenue requirement (Schedule E, Line 12, column D). However, at lines 15 through 45, many operating income adjustments are summarized that total $153.6 million in revenue requirement value (see Line 49). Most of the major issues shown in this listing are vigorously disputed by Qwest. Several of the issues in dispute have no guiding precedent in prior ACC rate orders. If Staff were to <u>not</u> prevail on only a few of the larger operating income adjustments, the resulting approved rate increase would be much larger than the $42.9 million in the Settlement Agreement. Additionally, if the Commission were to grant a return on equity only modestly higher than Staff's 11.75 percent recommendation, the resulting rate increase could be much larger than Staff has recommended.

Q. What is the approximate revenue requirement impact of one percent in return on equity, applied to Staff's proposed rate base?

A. Each one percent (100 basis points) is worth about $12.6 million in revenue requirement. While it is not possible to accurately predict what the Commission may have found reasonable with respect to Qwest's Arizona ROE, it should be noted that the total spread between Qwest's and Staff's recommended ROE was 2.25 percent (225 basis points).

Q. Which of the operating income adjustments proposed by Staff have no guiding precedent in prior ACC rate orders?

A. Adjustment C-13 (Line 28 of Schedule E) reflects adoption of the new SOP 98-01 accounting pronouncement for computer software costs, causing certain software costs previously expensed to now be capitalized on the books. This adjustment is contested by Qwest and has the effect of reducing test period revenue requirements by $32.8 million in Staff's filing. Another issue not previously addressed by an ACC order is Staff's proposed disallowance of certain of Qwest's incentive compensation plan expenses (Line 27 of Schedule E). This adjustment is contested by Qwest and has the effect of reducing test period revenue requirements by $5.5 million in Staff's filing. Staff's Operating Income Adjustment C-29 challenges Qwest's proposed allocation of costs to the rural exchanges being sold in Arizona, reducing revenue requirements by $11.4 million (Line 44 of Schedule E). This issue has not previously been addressed in any ACC rate order. Staff has also proposed the reversal of Qwest's adjustment to reflect wage rate increases granted and effective after the end of the test period in Adjustment C-14 (Line 29 of Schedule E). Qwest has argued that this Staff position, which reduces revenue requirement by $13.3 million, is contrary to the precedent established in prior ACC rate orders. While Staff believes its position is fully supported in prefiled evidence for each of these adjustments, it is entirely possible that litigation of these issues and other Staff adjustments may result in much higher revenue increases in the final rate order than have been agreed upon through settlement.

Q. Is it significant that more than half of the authorized net overall rate increase for Qwest in the Settlement Agreement represents an opportunity to increase revenues from competitive services in the future?

A. Yes. In the absence of settlement, most or all of the revenue requirement ordered by the Commission might have been assigned to less competitive services, including basic local exchange services. Under the Settlement, intrastate access charges and certain base rate area and zone connection charges are actually reduced, while much of the rate increase is directed to competitive services that can be increased up to $25.3 million only to the extent market conditions permit such increases to be realized. Mr. Dunkel addresses the Settlement rate design in his Supplemental Testimony.

Q. Are future year rate reductions also contemplated by the Settlement?

A. Yes. Two future annual intrastate access charge rate reductions of $5 million each are scheduled to occur, which may be offset by increases in revenue from competitive services. In addition, through action of the productivity offset and consumer dividend under the Plan, further reductions in Arizona intrastate revenues are also possible.

Q. What fair value rate base value underlies the Settlement?

A. The parties have agreed that Qwest's jurisdictional Arizona fair value rate base is $1,445.8 million. This is the amount shown at Staff Schedule A, Line 1, in Column F.

Q. What fair rate of return underlies the Settlement?

A. By agreement of the parties, the fair rate of return is 9.61 percent. This is the return percentage shown at Staff Schedule A, Line 2, in Column F. This rate of return, when applied to the Fair Value Rate Base on Line 1, produces a Required Operating Income of $138.9 million, as shown on Line 3. In light of the many operating income issues in dispute and the uncertainties associated with litigating these issues, Qwest and the Staff jointly concluded through negotiation that Adjusted Net Operating Income of $113.7 million is reasonable for ratemaking purposes. The resulting rate increase needed by Qwest is the $42.9 million in the Settlement Agreement. These calculations are summarized below:

SETTLEMENT VALUES	$ MILLIONS
Fair Value Rate Base	$1,445.8
Fair Rate of Return	9.61%
Required Operating Income	$138.9
Adjusted Net Operating Income	113.7
Operating Income Deficiency	$ 25.2
Gross Revenue Conversion Factor	1.6995
Total Increase in Revenue Required	$ 42.9

Q. In your opinion, will the rate increases and overall revenue requirement included in the Settlement Agreement produce just and reasonable rates that are in the public interest?

A. Yes.

Q. Does this conclude your Supplemental Testimony?

A. Yes.

EXHIBIT
S-2
[handwritten initials]

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN	)	DOCKET NO. T-01051B-99-105

REBUTTAL TESTIMONY REGARDING
SETTLEMENT AGREEMENT

MICHAEL L. BROSCH

ON BEHALF OF

ACC UTILITIES DIVISION STAFF

November 20, 2000

BEFORE THE
ARIZONA CORPORATION COMMISSION
REBUTTAL TESTIMONY REGARDING SETTLEMENT AGREEMENT
MICHAEL L. BROSCH

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. Are you the same Michael L. Brosch who previously submitted Direct, Surrebuttal and Supplemental Testimony in this Docket?

A. Yes. My qualifications and work experience were provided in my Direct Testimony.

Q. What is the purpose of your Rebuttal Testimony Regarding the Settlement Agreement?

A This rebuttal testimony responds to the revenue requirement Supplemental Testimony of Ralph C. Smith on behalf of RUCO and Susan M. Gately on behalf of AT&T. I will explain why the Settlement Agreement revenue requirement is reasonable and in the public interest even though it does not explicitly address specific issues raised by the Staff, RUCO or AT&T directly. In particular, I will explain why the major differences in revenue requirements proposed by these two witnesses relative to the Staff are associated with a few large ratemaking adjustments that are not appropriate and should not be used to reduce the $42.9 million settlement revenue requirement.

Q. Mr. Smith's Supplemental Testimony notes that the Settlement Agreement revenue requirement was a compromise reached "without an issue-by-issue" negotiation (Supplemental Testimony, page 2, line 2). Does such an approach render the resulting revenue requirement inappropriate or arbitrary?

A. No. As I explained in my earlier Supplemental Testimony, the advice I provided to Staff Counsel in support of negotiations was mindful of the adjustments and issues raised by all parties to the proceeding, with specific reference to several of Staff's adjustments I considered to be most "at-risk". It should be noted that the many other Staff adjustments not specifically noted in my Supplemental Testimony were all effectively "won" in negotiations because the revenue requirement was based upon Staff's rate base, rate of return and starting point adjusted operating income. There is nothing arbitrary about a vigorously negotiated compromise of the revenue requirement that is not burdened with detailed issue-by-issue findings in favor of specific parties on each of the dozens of adjustments proposed in this proceeding. In fact, any attempt to reach a settlement by specific resolution of each proposed adjustment would likely have required detailed concessions that the parties would have been unwilling to make. Additionally, such an approach virtually guarantees full litigation of each of the various issues so that any non-signatories could contest the various concessions made or not made in such a settlement.

Q. At page 2 of his Supplemental Testimony, RUCO witness Mr. Smith quotes your response to a RUCO data request stating, "The revenue requirement calculations of the other parties included adjustments and positions not advocated by Staff that, upon review by Utilitech, were not explicitly factored into the Settlement Agreement revenue requirement." Were these adjustments not "factored in" for specific reasons?

A. Yes. In my opinion, most of the RUCO adjustments were implicitly considered to the extent they overlapped Staff's adjustments. However, two of the adjustments proposed by RUCO that were intentionally not "factored in" for settlement purposes are simply inappropriate and should have been disapproved if formally presented in a contested case. These include RUCO's Adjustment E-1 that reverses all of the Company's proposed Toll Revenue Loss Annualization ($3.3 million revenue requirement impact) and RUCO's Adjustment E-22 that would credit another $22.9 million of estimated Gain on Sale of Arizona exchanges into the revenue requirement. These two adjustments were not included in Staff's case because Qwest's competitive toll losses are clearly a known and measurable change that should be recognized and because the gain on sale of exchanges is being separately addressed in another pending Docket before the Commission.

Q. Mr. Smith's Supplemental Testimony discusses RUCO adjustments that are different from or in some instances supplemental to adjustments presented by Staff. Are there any omissions within RUCO's proposed revenue requirement that cause Staff's revenue requirement to serve as a better beginning point for Settlement purposes?

A. Yes. Staff was careful to post adjustments that were required to reflect known corrections to the Company's prefiled case, even if making such adjustments increased the revenue requirement. The RUCO filing does not reflect any of these corrections. The revenue requirement advocated by RUCO is therefore incomplete and should be increased to recognize at least the following Staff adjustments that were omitted by RUCO:

Reversal of Depreciation Reserve Proforma (Staff Schedule B-5)
Affiliate Transaction True-up Normalization (Staff Schedule C-9)
Out of Period Property/Other Taxes (Staff Schedule C-25)

The combined effect of these needed adjustments that were not made by RUCO is an increased revenue requirement of $12.2 million[1]. These omissions in RUCO's filing, along with the Toll Loss and Gain on Sale items mentioned above and RUCO's lower return on equity recommendation, explain most of the difference between Staff's and RUCO's recommended revenue requirements.

Q. Mr. Smith's Supplemental Testimony at page 3 also indicates that RUCO has recommended a revenue decrease rather than an increase. Does the RUCO rate reduction rely upon adjustments comparable to or "overlapping" Staff's SOP 98-01, incentive compensation, and out of period wage increase disallowances that were implicitly compromised in Staff's negotiations with Qwest?

A. Yes. The same litigation risks I referenced in my earlier Supplemental Testimony with respect to Staff's advocacy of these adjustments would, in my view, also apply to RUCO's corresponding adjustments. However, Mr. Smith's reference to RUCO's recommended overall rate reduction for Qwest is dependent in large part upon an assumption that RUCO and Staff would fully prevail on these significant issues, even though the adjustments represent major policy issues not previously resolved in a rate case before the ACC in the manner proposed by Mr. Smith. RUCO Adjustments E-15 (SOP 98-01), E-12 (Incentive Compensation), E-13 (Management Wages and Salaries – Post Test Year), and E-14 (Occupational Wages and Salaries – Post Year End)

[1] See Staff Schedule E, Column D, at Lines 9, 24 and 40.

collectively reduce Qwest's asserted revenue requirement approximately $44.9 million, as filed in RUCO's evidence.[2]

Q. At page 4 of his Supplemental Testimony, Mr. Smith references the return on equity ("ROE") recommendation of RUCO witness Mr. Legler of 11.5 percent. How does this ROE compare with Qwest's recommendation and the compromise ROE embedded within the Settlement Agreement?

A. Qwest proposed an ROE of 14.0 percent in its asserted revenue requirements. The Settlement Agreement reflects the adoption of Staff's proposed ROE of 11.75 percent, only one fourth of one percent (25 basis points) higher than is advocated by RUCO. Mr. Legler's modestly lower recommended ROE would change the Settlement Agreement revenue requirement by about $3 million. It is my belief that adoption of Staff's ROE is a reasonable compromise for settlement purposes, given the above stated range of recommendations and the inherent judgment involved in determining ROE for ratemaking purposes.

Q. According to AT&T witness Ms. Gately in Supplemental Direct Testimony at page 2, the Settlement Agreement revenue requirement "can only be described as arbitrary and began from an unreasonably inflated revenue requirement base". She then characterizes the $42.9 million amount as a "split the baby" treatment that must be "accorded to the proposed adjustments of other interested parties as well". How do you respond?

A. The Settlement Agreement revenue requirement did not begin with Qwest's asserted revenue requirement, but instead used Staff's rate base and rate of return outright. The settlement also used Staff's adjusted operating income rather than Qwest's, with upward adjustment to recognize that Staff would likely not prevail on every one of its many adjustments. For Ms. Gately's "split the baby" characterization of the settlement to be correct, the revenue requirement would be more than $104 million, the mid-point between Qwest's asserted $201 million revenue requirement and Staff's $7.2 million recommendation. It certainly does not follow from her mischaracterization that every

[2] RUCO Schedule E Revised, Page 4 of 7, Sum of Line 46 for adjustments E-12 through E-15.

unsubstantiated adjustment proposed by every non-signatory party must now be used to reduce the revenue requirement in a 50/50 factoring process.

Q. Ms. Gately references "nine specific corrections" in her Supplemental Direct Testimony starting at page 9. Then she claims seven of these AT&T adjustments "were not addressed by Staff and Qwest in the development of the negotiated revenue increase". How do you respond?

A. The seven listed items at pages 9 through 12 are not "corrections" at all, but are instead improper disallowances and imputation adjustments that are based upon incorrect assumptions, misunderstandings of Staff's case, improper ratemaking policies and are inconsistent with prior ACC Decisions. I will address her listed items in order:

1) Staff verified that Local Number Portability costs were properly treated in Qwest's filing through the jurisdictional separations process, through a series of detailed data requests and analyses[3]. No ratemaking adjustment is required to further adjust for LNP.

2) Qwest's interconnection costs are ongoing in nature and were not at extraordinary or non-recurring levels in the test period[4]. No ratemaking adjustment is required in this area.

3) Staff's filing and the Settlement did reflect the only plant and depreciation adjustments that could be supported with evidence applicable to Arizona continuing property records[5], even though Staff was fully aware of and had investigated the FCC audit reports and Qwest's responses to same. AT&T's proposed extrapolation of the pending FCC audit report to Arizona is inappropriate.

4) Staff's filing and the Settlement did reflect full imputation to eliminate FCC deregulated service losses for ratemaking purposes[6], contrary to Ms. Gately's representations to the contrary.

5) Staff's filing and the Settlement reflected sufficient imputation to meet the prior Settlement Agreement requirements[7], as previously ordered by the Commission upon appeal and remand in the last Arizona rate case.

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3 See, for example, data requests UTI 51-13, 54-01, 54-02, 57-11 and RUCO 28-17.
4 See, for example, data requests UTI 13-22, 24-19 and 17-03.
5 Staff Schedules B-1 and C-22 disallowed Unrecorded Plant Retirements estimated amounts.
6 Staff Schedules C-17 and C-18 reflect FCC Deregulated Services imputation and related separations.
7 Staff Schedule C-5 imputes directory revenues based upon the prior ACC-approved Settlement Agreement.

6) Staff's filing and the Settlement reflect full elimination of the $66 million pension asset from rate base, contrary to Ms. Gately's representation[8]. It is necessary, however, to remove the corresponding deferred tax reserves associated with such elimination, which are improperly ignored in AT&T's proposed adjustment.

7) Staff investigated Qwest's Post-retirement Benefits Other Than Pension (PBOP's) proposal for compliance with the Commission's criteria, as referenced by Ms. Gately, and found the Company's proposal to be in substantial compliance with the Commission criteria.

Q. Does this conclude your Rebuttal Testimony Regarding Settlement Agreement?

A. Yes.

[8] Staff Schedule B-3 at line 1 disallows the $66 million pension asset.

EXHIBIT
S-3
Admitted

BEFORE THE

ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF US WEST COMMUNICATIONS, INC. A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES	)))) DOCKET NO. T-01051B-99-0105))))

TESTIMONY

OF

WILLIAM DUNKEL

PERTAINING TO SETTLEMENT

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

OCTOBER, 2000

I. INTRODUCTION

Q. ARE YOU THE SAME WILLIAM DUNKEL WHO PREVIOUSLY SUBMITTED DIRECT AND SURREBUTTAL TESTIMONIES IN THIS PROCEEDING?

A. Yes.[1] My qualifications and experience were included in my Depreciation Direct testimony in this proceeding.

Q. WHAT IS THE PURPOSE OF THIS SUPPLEMENTAL TESTIMONY?

A. The primary purpose of this Supplemental testimony is to explain the rate design portions of the Settlement Agreement between Staff and Qwest.

Q. IS THE RATE DESIGN INCLUDED IN THE SETTLEMENT A RESULT OF NEGOTIATIONS BETWEEN STAFF AND QWEST?

A. Yes. I did not participate in the actual negotiations. However, I did provide assistance and advice to Staff during such negotiations. The Settlement is a compromise of issues between Staff and Qwest.

Q. WHAT SERVICES ARE INCLUDED IN BASKET 1?

A. Basket 1 generally contains the retail services that this Commission has not found to be competitive.

[1] Throughout this testimony, my "Direct testimony on Modernization, Depreciation, and RCNLD Issues" will be referred to as my Direct Depreciation testimony. My "Direct Testimony on Rate Design Issues" will be referred to as my Direct Rate Design testimony.

Q. WHAT IS THE RATE DESIGN FOR THOSE SERVICES THAT ARE IMPORTANT TO UNIVERSAL SERVICE?

A. The residential and business basic exchange service rates have a "hard cap", such that the prices for those services cannot increase during the term of this plan. The services that are hard capped include flat rate residential; flat rate business; 2 and 4 party service; exchange zone increment charges; low use option service; service stations service; telephone assistance programs; individual PBX trunks, including features; Caller ID block; toll blocking; 900/967 blocking; and basic listing service.

In addition, the current non-recurring residential charge of $46.50 is reduced to $35. This reduction will make it less costly for customers to connect to the network. Therefore, this reduction, along with the fact that the residential rates will not increase, is beneficial to universal service.

The Settlement also eliminates the residential and business zone connection charges. These are non-recurring charges that, under certain circumstances, apply to customers outside of the base rate area, in addition to the standard non-recurring charges. The elimination of these additional non-recurring charges is also beneficial to universal service.

Q. WHAT CHANGES ARE THERE IN THE ZONE CHARGES?

A. In addition to the elimination of the additional zone connection charges as discussed above, the base rate area is expanded in certain areas. This means there will be fewer customers paying the zone charges. For those customers that continue to pay these charges, there is no change in the rates.

The Settlement also will result in the elimination of the multi-party services.

Q. WHAT CHANGES OCCUR TO DIRECTORY ASSITANCE (DA)?

A. The Company will be allowed to immediately increase the current DA rate of 47 cents to 85 cents. The one-call allowance that currently exists would be eliminated. At the 85 cent rate, customers will also receive "call completion" service at no additional charge. After the first year, the Company could increase that rate further, subject to the overall price cap restraints that apply to Basket 3.

Q. WHAT CHANGES ARE THERE IN THE INTRASTATE CARRIER SWITCHED ACCESS CHARGES?

A. The switched access charges applicable to the carriers would be changed so as to reduce revenues by $5 million in the first year, an additional $5 million in the second year, and an additional $5 million in the third year. In total, over the life of the plan, the switched access rates would be reduced by $15 million per year.

Q. WHAT IS AN EXAMPLE OF A PRIVATE LINE SERVICE, AND WHAT DOES THE SETTLEMENT PROPOSE FOR THEM?

A. Most private lines are not connected to the switched network, and instead are dedicated to a particular function. For example, data lines that go to automatic teller machines (ATMs), or to a bank's burglar alarm system, are frequently private lines. Evidence in this case indicates that private line service rates are below cost. The Settlement includes a $13.7 million annual increase in private line revenues.

Q. DO YOU BELIEVE THE RATE CHANGES DISCUSSED ABOVE ARE REASONABLE AND IN THE PUBLIC INTEREST?

A. Yes, I do, recognizing that this is a compromise. The reduction of the non-recurring charges, the expansion of the base rate areas, and the "hard cap" on basic exchange and related rates, are beneficial to universal service.

In addition, the "inflation minus productivity" indexing mechanism has the effect of sharing the industry wide productivity gains with the ratepayers, and may result in a further reduction of rates in Basket 1.

Q. WHAT SERVICES ARE CONTAINED IN BASKET 3?

A. Basket 3 services include flexibly priced, competitive services. These include services that the Commission has determined to be competitive under ACCR14-2-1108, as well as new services and service packages offered by Qwest.

Services that are in the non-competitive Basket 1 can be components of a "new" package that would be offered in Basket 3. In an attempt to prevent this mechanism from being used to transfer non-competitive Basket 1 services into Basket 3, the Agreement does require Qwest to inform customers that the services in Basket 1 remain available as separate offerings.[2]

Q. ARE THERE RESTRICTIONS WHICH PREVENT QWEST FROM GEOGRAPHICALLY DISCRIMINATING, AT LEAST FOR THE BASKET 1 SERVICES?

A. Yes. Part 2(c)(v) of the Agreement prevents Qwest from charging different retail rates in different geographic areas, unless ordered by the Commission.

The Agreement does allow the "new" services and packages in Basket 3 to be offered to select customer groups based upon their purchasing pattern or geographic location, for example.[3]

Q. WHAT IS ONE OF THE RESTRICTIONS THAT EXISTS ON PRICE CHANGES IN BASKET 3?

A. The Agreement allows the Company to change rates in Basket 3 such as to produce $25.3 million in additional annual revenues during the first year. This cap is adjusted upwards an additional $5 million in the second year of the Plan, and an additional $5 million in the third year of the Plan, to reflect the switched access charge reduction in those years.

Q. WHAT MODERNIZATION REQUIREMENT IS INCLUDED IN THE AGREEMENT?

A. As part of the Settlement of this case, there is no specific level of modernization or replacement required. However, a review of Qwest's capital investments during the initial three years of the

[2] Paragraph 4(e).
[3] Paragraph 4(g).

plan is expected to be one of the items reviewed and considered at the time Qwest asks for renewal or revision of the Plan at the end of the three year initial plan period.[4]

Q. DO YOU BELIEVE THAT OVERALL, THE RATE DESIGN PORTION OF THE SETTLEMENT IS REASONABLE?

A. Yes, recognizing that any settlement agreement is the result of negotiations and "give and take." I believe the overall rate design incorporated in the Settlement is a reasonable overall result.

Q. DOES THIS CONCLUDE YOUR SUPPLEMENTAL TESTIMONY?

A. Yes.

[4] See page 6 of the Settlement Agreement.

EXHIBIT
S-4
Admitted

BEFORE THE

ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION	)	
OF US WEST COMMUNICATIONS, INC. A	)	
COLORADO CORPORATION, FOR A	)	
HEARING TO DETERMINE THE EARNINGS	)	DOCKET NO. T-01051B-99-0105
OF THE COMPANY FOR RATEMAKING	)	
PURPOSES, TO FIX A JUST AND	)	
REASONABLE RATE OF RETURN THEREON	)	
AND TO APPROVE RATE SCHEDULES	)	

REBUTTAL TESTIMONY

OF

WILLIAM DUNKEL

REGARDING SETTLEMENT AGREEMENT

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

NOVEMBER 20, 2000

I. INTRODUCTION

Q. ARE YOU THE SAME WILLIAM DUNKEL WHO PREVIOUSLY SUBMITTED TESTIMONIES IN THIS PROCEEDING?

A. Yes.[1] My qualifications and experience were included in my Depreciation Direct testimony in this proceeding.

Q. WHAT IS THE PURPOSE OF THIS REBUTTAL TESTIMONY REGARDING THE SETTLEMENT AGREEMENT?

A. The primary purpose of this Rebuttal testimony regarding the Settlement Agreement is to respond to the testimonies of other parties pertaining to certain rate design issues in the Settlement Agreement between Staff and Qwest.

Q. ON PAGE 2 OF MR. JOHNSON'S SUPPLEMENTAL TESTIMONY, MR. JOHNSON EXPRESSES THE CONCERN THAT:

> For instance, targeted price cuts may be used to discipline or punish certain of its competitors. Moreover, rate reductions may be used in a preemptive manner, to make competitive entry more difficult or impossible. Similarly, prices may be reduced to the point where competing carriers cannot cover their costs, including the cost of winning customers and gaining market share."

DOES THE STIPULATION ATTEMPT TO LIMIT THESE ANTI-COMPETITIVE USES OF PRICING FLEXIBILITY?

A. For Basket 1 services, the Agreement requires:

[1] Throughout this testimony, my "Direct testimony on Modernization, Depreciation, and RCNLD Issues" will be referred to as my Direct Depreciation testimony. My "Direct Testimony on Rate Design Issues" will be referred to as my Direct Rate Design testimony.

All services in this Basket shall be continued statewide at the tariffed rate, unless or until the Commission orders retail geographic rate deaveraging, or unless Qwest demonstrates a cost difference for the new service on which to base the price difference.[2]

This provision effectively prevents Qwest from cutting the price for a Basket 1 service in one area in order to disadvantage competitors or potential competitors in that area without reducing the prices statewide. Therefore, this provision does limit Qwest's ability to use its price flexibility in an anti-competitive manner for Basket 1 services.

Under Basket 3, the Company is generally allowed to offer different services to different customer groups or in different geographic locations:

> New services and packages in Basket 3 may be offered to selected customer groups based on their purchasing patterns or geographic location, for example. This provision shall not be construed to permit red-lining based on criteria such as wealth or race, or to permit Qwest to discriminate against any class of customers in violation of A.R.S. Section 40-334.[3]

Section 40-334 prohibits "undue" discrimination.

Q. IN HIS SUPPLEMENTAL TESTIMONY, DR. JOHNSON DISCUSSES THE IMPUTATION REQUIREMENT. DOES THE AGREEMENT CHANGE THE IMPUTATION REQUIREMENT?

A. No, it does not.

> Nothing in this Price Cap Plan is intended to change or modify in any way the imputation requirements contained in A.A.C. R14-1-1310.[4]

If in the future, Dr. Johnson or other parties believe that the imputation requirements are not being met, they could bring that to the Commission's attention. The Agreement clearly requires

[2] Attachment A, Part 2(c) (v), Price Cap Plan.
[3] Part 4(g), Attachment A, Price Cap Agreement.

that those imputation requirements must be met, and nothing in the Agreement changes the imputation requirements.

Q. IN MS. STARR'S TESTIMONY, SHE PROPOSES THE COMMISSION

> Eliminate the carrier common line charge and interconnection charge, which have no cost basis and are merely subsidies being provided to Qwest by IXCs at the ultimate expense of end users.[5]

IS IT TRUE THE CARRIER COMMON LINE CHARGE (CCLC) HAS NO "COST BASIS" AND IS A SUBSIDY?

A. No. There are very significant costs involved. The Carrier Common Line Access service utilizes the loop facilities of Qwest. The carriers, including AT&T, use the loop facilities to terminate calls to premises, and also to originate calls from premises. There is a significant cost to Qwest to provide and maintain those loop facilities. The CCLC is simply the charge whereby the IXCs support a portion of the cost of those loop facilities which they are sharing and utilizing. If the CCLC were eliminated, but the IXCs were still allowed to utilize the loop facilities, that would mean the IXCs would be getting a free ride on those loop facilities. The CCLC is not excessive. For most locations, paying the CCLC, and therefore using the shared loop facility, is the lowest cost way for AT&T and other IXCs to connect traffic to and from the premises.

The claim that the CCLC has no cost basis is false. There are two standard costs that must be calculated in order to properly evaluate a price. These are the TSLRIC "floor" and the "stand alone" cost (SAC) "ceiling." The loop cost is part of the SAC of Carrier Common Line Access

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[4] Part 3(g), Attachment A, Price Cap Agreement.
[5] Page 12, Starr Testimony.

Service. This is true because the loop facility would have to exist to provide Carrier Common Line Access service even if no other services were being provided (stand alone). At the other extreme, the TSLRIC floor excludes all joint and common costs, and therefore the cost of the loop facility would be excluded from the properly calculated TSLRIC of any service that shares that facility. The reasonable, proper, and subsidy-free price for a service is a price that is between the TSLRIC floor and the SAC ceiling.[6] Since the cost of the loop facility is part of the SAC of switched access and Carrier Common Line Access Service, the loop facility cost is properly included in establishing the upper limit of the range in which the subsidy free, reasonable carrier switched access rates fall. This is discussed in more detail on pages 97 through 100 of my Rate Design Direct Testimony. These widely accepted principles are discussed in the following quotation from an FCC Order:

> Economists would say that in order to give incumbent local exchange carriers the proper incentives to build multi-service facilities, where such facilities are economically rational, cost allocated to each individual service or subset of services should be less than the stand-alone cost but greater than the incremental cost. ... These are the upper and lower bounds within which costs allocated to regulated and nonregulated services should fall.[7]

No one requires AT&T to use Qwest loops, and therefore pay the CCLC. That is entirely AT&T's choice. The fact that AT&T chooses to use the Qwest loop and pay the Qwest CCLC clearly demonstrates that carrier access service is not a "cost free" service. If there was "no cost" to provide Carrier Access Service, then AT&T would provide that service itself at "no cost", and stop paying Qwest the CCLC. Of course, carrier access service is not a "no cost" service. Loop facilities must be installed and maintained in order for Carrier Access Service (along with other services) to be provided.

[6] Technically, it would also be subsidy free if it is equal to the SAC ceiling, or equal to the TSLRIC floor.

Q. WHAT WOULD BE THE RESULT OF THE ELIMINATION OF THE CCLC?

A. The result would be that AT&T would be allowed to take a "free ride" on the loop facility of Qwest. AT&T would be allowed to use the loop facility to originate and terminate toll calls, but contribute nothing towards the cost of those facilities.

Q. HAS AN AT&T WITNESS IN ANOTHER STATE STATED THE PROVIDING A FREE RIDE ON THE LOOP FACILITY WOULD BE IMPROPER?

A. Yes. Mr. Turner, testifying on behalf of AT&T Communications in Texas, in a very recent testimony stated that allowing the DSL providers to utilize the loop facilities at no charge would

> discriminate against facilities-based CLECs by giving other competitors a 'free ride' on the loop.[8]

Mr. Turner also stated,

> A zero price for HFPL [high-frequency portion of the loop] is both anti-competitive and unjustified when viewed in the light of the entire telecommunications marketplace.[9]

This AT&T witness further stated,

> A zero price for the HFPL permits the CLECs to bear no cost for one of the most important assets they utilize in providing their service.[10]

AT&T's testimony in the Texas proceeding is clearly inconsistent with the position AT&T is presenting in this Arizona case. Even AT&T recognizes that giving companies a "free ride" on the loop facilities is improper, as is demonstrated by AT&T's testimony in Texas quoted above.

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[7] Paragraph 20, FCC Notice of Proposed Rulemaking, CC Docket No. 96-112, adopted and released May 10, 1996.
[8] Prefiled Testimony of Steven Turner, filed on behalf of AT&T Communications of Texas L.P. before the Public Utilities Commission of Texas, Docket Nos. 22168 and 22469, September 5, 2000, pages 17-18.
[9] Turner, page 16.
[10] Turner, page 16.

However, in this proceeding, AT&T violates that concept by effectively proposing that AT&T and other IXCs receive a "free ride" on the loop facilities.

Q. ON PAGE 28 OF DR. SELWYN'S SUPPLEMENTAL REBUTTAL, HE ARGUES THAT THE SWITCHED ACCESS RATES ARE HIGHER THAN ITS INCREMENTAL "COST." IS IT PROPER TO SET PRICES ABOVE INCREMENTAL COST?

A. Yes, as was discussed in Mr. Regan's testimony:

> The proper range for a price is between the TSLRIC price floor and the Stand-Alone price ceiling. This is the range of subsidy-free rates where prices should generally fall. If a service is priced above its TSLRIC floor, this is not indicative of a problem, since prices are generally set above the floor to provide contribution toward the shared, joint and common costs of providing services. If a service is priced below its Stand-Alone ceiling, this is not indicative of any pricing problem either, since prices are normally set below their ceiling.[11]

Pricing above the direct cost or TSLRIC of a service is how the common/joint/shared costs of a company are recovered. For example, pricing above the direct cost of products is how stores and restaurants pay their rent and other joint and common costs. In the telephone industry, the cost of the loop facility is the largest shared facility cost. For Qwest in Arizona, their investment in the loop represents 56% of their investment in all facilities.[12] Since the switched access services share the loop facilities, it is appropriate that they be priced to provide a contribution to the costs of those shared loop facilities costs upon which switched access (along with many other services) depends.

[11] Page 7, Regan Direct.
[12] Qwest 1999 ARMIS Report 43-04, $685,528 (line 1275-COE Cat 4.13 Excl. Circuit Equipment-Jointly Used) + $2,024,056 (Line 1455-C&WF Cat 1 Excluding Line Joint Used Inv) divided by $4,799,921 (line 2194) = 56.45%.

The properly calculated TSLRIC "floor" of a service does not include any portion of the shared, joint and common costs. If a service was priced at TSLRIC, it would be making no contribution to many of the shared, joint, and common costs (shared costs). Even if a service uses, depends upon, and shares facilities, no part of certain shared costs are included in the properly calculated TSLRIC. This is reasonable because TSLRIC is only meant to be the "floor." Zero recovery of those shared costs is the minimum possible recovery, and therefore this establishes a "floor." However, this does not establish the reasonable or fair price. At the other extreme, the SAC includes 100% of the cost of all facilities needed to provide a service, even if those facilities are shared with other services. One hundred percent is the maximum possible inclusion. Therefore, this is a ceiling. The reasonable price is between these two extremes, which effectively means the reasonable price for a service is set to cover all of the costs that are directly caused by only that service, plus provide a contribution which supports a portion of the cost of the shared facilities.[13]

The switched access rates that will result from the Stipulation are well below the stand alone "ceiling". Therefore, these rates are not producing a subsidy. They are also well above their TSLRIC floor. This means they are not receiving a subsidy.[14] Therefore, these rates will be in the subsidy-free range, which is where prices are normally expected to fall. The switched access rates will be covering their direct cost (TSLRIC), plus making a contribution to cover a portion of the costs of the shared facilities which they share.

[13] Technically, the price is subsidy free if it is between these two ranges, or if it is equal to either the SAC or TSLRIC. The SAC actually includes all of the cost of the facilities that would be needed to provide that service. In the case of the loop, there is no reason to believe that the cost of the loop needed to provide switched access service, for example, would be significantly different than the cost of the loop needed to provide several services.

[14] A service is receiving a subsidy only if it is priced below its TSLRIC floor. A service is producing a subsidy only if it is priced above its stand alone ceiling. A service that is priced between these two extremes (or equal to one of them) is neither receiving nor producing a subsidy. See pages 3 and 6 of Mr. Regan's Testimony.

Q. DR. COLLINS' TESTIMONY RECOMMENDS THAT INSTEAD OF USING THE TSLRIC AS THE "FLOOR", THE COMMISSION SHOULD USE THE SUM OF ALL OF THE UNES (PLUS OTHER COSTS) AS THE "FLOOR." DR. COLLINS STATES:

> …the price floor of a service should be the full cost incurred in providing the service. Here, that price is the sum of the imputed TELRIC costs for the UNEs which technologically allow the service; any appropriately assigned balance of joint/shared cost; an appropriate amount of assignable common cost; and any specific cost to market the service.[15]

IS THE COST THAT INCLUDES ~~THE~~ FULL COST OF ALL THE UNES OF FACILITIES NEEDED TO PROVIDE THE SERVICE PROPERLY INCLUDED IN THE "PRICE FLOOR"?

A. No. There is no "one-to-one" mapping between UNEs and "service" prices. The UNE prices are for <u>facilities</u>, but many of those <u>facilities</u> are shared by many different services. To take a simple example, assume a street vendor's cart is used to sell both ice cream cones and ice cream bars.[16] When establishing a "floor" price that could reasonably be charged for cones, it would be inappropriate to include the full cost of the vendor's cart in the cost that had to be recovered from the price of the cones, because the cart is used for more than one product. The full cost of the cart would be included in the SAC of the cones, but that is the ceiling. The reasonable price would be below that ceiling. Including the full cost of shared facilities in the cost of one service that shares it is a SAC analysis which determines the "ceiling", but the shared facilities cost should not be included in determining the "floor" for a service that shares facilities.

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[15] Page 13, line 25, Collins' November 13, 2000 Testimony.

[16] This assumes the cost of the cart is a fixed cost that would not change if either ice cream cones or ice cream bars, or both were sold from the same cart.

For example, the loop facility is required to provide toll service. Therefore, the "stand alone" cost of toll includes the loop cost. However, that "stand alone" cost is the <u>ceiling</u> for the reasonable rate, not the "floor." When facilities are shared, the recovery of the cost of those facilities also has to be shared among the services that share that facility. Putting 100% of the cost of a facility that is shared by several services in the cost of just one of those services does not establish the appropriate "floor" price for that service. Instead, 100% is the maximum possible allocation of the shared costs, and therefore is included in establishing the "ceiling."

The full cost of ~~all~~ facilities needed to provide a service is the "stand alone" cost, which is appropriately the price ceiling. Calculating the costs including the full cost of all elements (even the full cost of the shared facility) needed to provide the service is a valid calculation, but that is the calculation for the "ceiling" not the floor. The TSLRIC is the price floor. All of this is discussed in more detail in Mr. Regan's testimony filed in this proceeding.

Q. THROUGHOUT HER TESTIMONY, MS. STARR OBJECTS TO THE $15 MILLION SWITCHED ACCESS REDUCTION AS BEING INSUFFICIENT, AND PROPOSES THAT THE SWITCHED ACCESS REDUCTION SHOULD BE EVEN LARGER.[17] WHAT ELSE DOES MS. STARR COMPLAIN ABOUT?

A. The Agreement allows Qwest to increase the rate cap in Basket 3 by $10 million in order to offset the $10 million of Basket 2 switched access reductions that will occur in the last two years of the Agreement. However, on page 11, Ms. Starr objects to increasing the revenue cap in Basket 3 by $10 million. She points out this would increase some of the charges that AT&T pays in Basket 3.

Ms. Starr does not appear to recognize that the revenue requirement of Qwest must be recovered somewhere. Ms. Starr wants to see the rates reduced in Basket 2 more than they have been reduced in the Agreement, but she objects to the revenue loss being made up in the other baskets (or at least any other basket that would effect any AT&T rates). If you reduce revenues in one basket, you have to increase revenues in another basket, in order to recover the overall revenue requirement of the Company.

Q. DO YOU HAVE ANY FURTHER COMMENTS ON THE SWITCHED ACCESS RATE REDUCTIONS THAT ARE INCLUDED IN THE STIPULATION?

A. Yes. The $15 million annual reduction that is included in the Stipulation is significantly higher than the reduction that Qwest proposed. In its original testimony, Qwest proposed a $5 million annual reduction in switched access revenues. (See Dr. Wilcox's Direct Testimony) The settlement includes a reduction that is three times the reduction in the switched access rates that Qwest had proposed in this proceeding. It must be remembered this is a negotiated settlement.

In addition, even at present rates, switched access services were not producing an unreasonable level of contribution to the joint and common costs, including the loop costs, as discussed on page 100 of my Rate Design Direct Testimony. There is no evidence that the contribution to joint and common costs being received from switched access is excessive. The switched access rates are well below the switched access stand alone cost.

[17]On page 8, Mr. Starr proposes that rates should be reduced down to the interstate rate level.

Q. SOME OF THE IXCS PROPOSE THAT THE INTRASTATE SWITCHED ACCESS CHARGES BE SET EQUAL TO THE INTERSTATE SWITCHED ACCESS CHARGES WHICH RESULTED FROM THE FCC'S CALLS ORDER.[18] SHOULD THE STIPULATION BE MODIFIED TO ADOPT THAT CONCEPT?

A. No. Following the FCC CALLS Order would result in a large increase in fixed monthly charges to Qwest customers in Arizona. The low interstate "per minute" rates charged to carriers are achieved by charging end user customers a large End User Common Line (EUCL) charge, which is currently $4.35 per month[19], and scheduled to increase further in the future. This EUCL charge to end users has the effect of "buying down" the per minute access charges that the IXCs otherwise would have to pay. It is not in the public interest to impose a similar intrastate EUCL charge on customers.

Q. ON PAGE 31, DR. SELWYN DESCRIBES THE WHOLESALE SERVICE WHICH IS PRICED AT A 12% DISCOUNT FROM THE RETAIL RATE.[20] DR. SELWYN ALLEGES THAT THE PRICE OF THE "AVOIDED COST" DISCOUNTED WHOLESALE SERVICE WOULD NOT CHANGE WHEN THE RETAIL SERVICE PRICE CHANGED. IS THAT A VALID CONCERN?

A. I do not believe so. Part 3(c) of Attachment A of the Terms and Conditions states,

> UNE and discounted wholesale offerings are priced based on the provisions of the Telecom Act of 1996.

Section 252(d)(3) of the Telecom Act require that the wholesale rates be priced at an "avoided cost" discount from the retail rates. For example, for residential basic exchange service, this

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[18] Dr. Selwyn, page 40, Supplemental Direct.

[19] This is the rate for the primary residential line and single line business customers. The EUCL charge is different for other categories of customers.

Commission requires that the Qwest "avoided cost" wholesale rate be 12% less than the Qwest retail rate. Therefore, if the retail rate is reduced, these requirements would result in that wholesale rate also being reduced, so as to maintain the 12% "avoided cost" discount from the retail rate.[21]

If it were true that the agreement would result in the avoided cost wholesale prices no longer being set at the "avoided cost" discount from the retail prices, I would also be concerned, but there is no basis for Dr. Selwyn's claim that this would be the effect of the Agreement. If Dr. Selwyn has any evidence on which to base his interpretation of this Agreement, he has not identified that basis in his testimony.

Likewise, on page 34, Dr. Selwyn alleges that:

> A Basket 2 wholesale price could actually exceed the Basket 3 retail price, and otherwise fail to reflect retailing costs that will be avoided when a service is furnished for resale, which would, in my view, violates the requirements of Section 252(d)(3).[22]

In addition, on page 35, Dr. Selwyn also alleges that the retail prices of "new" basket offerings may fall below the wholesale prices for those services. Dr. Selwyn provides no basis for these claims. There is no reason to believe that the stipulation allows these discrepancies. As previously discussed, the "avoided cost" discount requirement does apply under the Agreement. Therefore, these problems Dr. Selwyn alleges do not exist.

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[20] The "avoided cost" discount is 12% for residential basic and 18% for all other services.

[21] In the Telecom Act, the avoided cost wholesale rate is different from the UNE rate. The avoided cost wholesale rate is specifically a rate for a service, not a price for facilities, which is unlike the UNE rate which is a price for facilities.

[22] The section of the Telecom Act Dr. Selwyn refers to is the section that requires the "avoided" cost discount.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY REGARDING THE SETTLEMENT AGREEMENT?

A. Yes.

STRATEGIC
POLICY
RESEARCH

EXHIBIT
S-5
Admitted

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN	)	DOCKET NO. T-1051B-99-105

TESTIMONY OF

HARRY M. SHOOSHAN III

IN SUPPORT OF THE PROPOSED SETTLEMENT AGREEMENT

STRATEGIC POLICY RESEARCH, INC.

October 27, 2000

7979 OLD GEORGETOWN ROAD 7TH FLOOR BETHESDA, MARYLAND 20814-2429
301-718-0111 FAX - 301-215-4033 EMAIL - spri-info@spri.com WEBSITE: www.spri.com

TESTIMONY OF HARRY M. SHOOSHAN III IN SUPPORT OF THE PROPOSED SETTLEMENT AGREEMENT

Q. WHAT IS YOUR NAME AND OCCUPATION?

A. My name is Harry M. Shooshan III. I am a principal in, and co-founder of, Strategic Policy Research, Inc. ("SPR"), an economics and public policy consulting firm located at 7979 Old Georgetown Road, Suite 700, Bethesda, Maryland.

Q. DID YOU FILE DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes. I filed testimony on behalf of Staff in which I proposed a price cap regulation plan for Qwest Corporation (formerly U S WEST Communications, Inc.) in Arizona.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. I am filing this testimony in support of the Proposed Settlement Agreement offered by Staff and Qwest. I believe that adoption and implementation of this Agreement would benefit consumers, protect competitors and provide important incentives to Qwest to innovate, become more efficient and improve service quality.

Q. HOW WOULD THESE OBJECTIVES BE ACHIEVED UNDER THE AGREEMENT?

A. Adoption of the price cap plan prposed in the Agreement moves Arizona away from the traditional form of public utility regulation that relies on setting a rate of return as a means of controlling earnings and making decisions about the allowable costs of each individual service.[1] This form of regulation had only an indirect effect on prices charged by the utility.[2] Price cap regulation achieves many of the same objectives but relies on direct regulation of prices. It also has the beneficial effect of providing Qwest with the incentives to become more efficient and more innovative, and to make new investments more rapidly. In all of these respects, price cap regulation more closely mirrors the effects of a fully competitive market which should be the goal of regulation.

Q. WOULD YOU BRIEFLY EXPLAIN THE BENEFITS OF PRICE CAP REGULATION AS OPPOSED TO TRADITIONAL PUBLIC UTILITY REGULATION?

A. Yes. Telecommunications markets are being transformed rapidly as a result of new technology, changing customer needs, and public policy reforms. This transformation has been accelerated by the emergence of the Internet, which has evolved largely outside of regulation and has becomiea critical tool not only in the workplace but also in the home.

The major suppliers of telecommunications services are also changing as well as the result of both vertical and horizontal mergers. The acquisition of U S WEST by Qwest is an example of the former.

As a result of these changes, companies are now in many different lines of business. Some of these businesses are essentially vestiges of the old local telephone monopoly; but many are not. The services being offered by telecommunications providers, even at the local level, are also much more "feature-rich" and complex than they were in the days of monopoly-provided "plain old telephone service."

It follows that, in today's environment, regulating earnings at the corporate level is

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[1] This form of regulation is frequently referred to as "cost-plus regulation."

[2] The firm is permitted to set its prices so as to recover its prudently incurred costs plus the specified rate-of-return.

an extremely inefficient and indirect way to control what we really care about— the prices charged to basic telephone customers who today may have limited (or no) alternatives.

Moreover, earnings regulation distorts the primary signal the market gives to any company to guide its behavior— its profits. On the other hand, the more narrowly focused any regulation, the less market distortion it creates.

Price cap regulation also protects competitors and consumers who will continue to rely on basic services offered by the incumbent firm (in this case, Qwest) during the transition to fully competitive markets. As the number of services offered by regulated firms increases and as the offerings become more complex (*e.g.*, with additional features and functions), it becomes difficult for the regulator to "know" how to assign costs among those services. As a result, the process of assigning costs becomes more arbitrary. The risks of "getting it wrong" increase as well.

By "promising" to give the regulated firm the opportunity to recover prudently incurred costs, traditional regulation raises the risk that competitors and consumers (especially of basic services) will be confronted with cross-subsidies. Price cap regulation provides much more iron-clad protection for both consumers and competitors against the possibility of cross-subsidy by the incumbent during this transition. Because the prices of basic services are capped, the regulated firm (in this case, Qwest) cannot expect to make up its competitive losses by increasing those rates.

Price cap regulation also provides rate stability by locking in prices for basic services within a predefined range that is specified in advance.

Finally, price cap regulation ensures that consumers will benefit directly from productivity improvements in the form of decreased rates.

The benefits of price cap regulation have been recognized for some time and widely discussed,[3] and have moved forty states to adopt some form of price cap regulation.[4] I have included a chart prepared by SPR that provides a summary of state regulation. (See Attachment C.)

Q. YOU HAVE IDENTIFIED THE BENEFITS FOR CONSUMERS AND COMPETITORS. WHAT ARE THE BENEFITS FOR QWEST?

A. As I stated in my earlier Testimony, I believe moving to price cap regulation will provide Qwest with important incentives to innovate, increase its investment in the State, operate more efficiently and improve service quality. These results can also be expected to benefit consumers and also those competitors who rely on Qwest's network to provide all or part of their services (*e.g.*, Internet service providers and so-called "data LECs").

Q. WILL YOU COMPARE THE PRICE CAP REGULATION PLAN CONTAINED IN THE AGREEMENT WITH THE PLAN YOU PROPOSED IN YOUR DIRECT TESTIMONY?

A. The structure of the price cap regulation plan in the Agreement ("the Proposed Plan") conforms with my recommendation. There are three "baskets" of services: Basic/Essential Non-competitive Services; Wholesale Services; and Flexibly Priced Competitive Services. The most important element of this structure is the creation of a "wholesale" basket. As I stated in my earlier Testimony, placing wholesale services in a separate basket permits the Commission to focus on these important "inputs" that competitors rely on to compete with Qwest. Segregating these

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[3] I cited several articles in my earlier Testimony (*see* footnotes 5 through 13) and offer several more cites here. *See* Charles F. Stone and John Haring, "The Economics of Price Caps," *Alternatives to Traditional Regulation*, Harry Trebing and Patrick C. Mann, eds. (Proceedings of the Nineteenth Annual Conference of the Institute of Public Utilities: 1987), at 117-147. *See also* Alfred E. Kahn, "The Uneasy Marriage of Regulation and Competition," *Telematics* (September 1984), where Dr. Kahn describes the hazards of rate of return regulation in the context of competition and offers price index regulation as one of many improvements needed in regulation. In addition, I have attached to this testimony two articles that elaborate on the attributes of price cap regulation. *See* Attachments A and B.

[4] I note that twenty-one states have actually abolished earnings regulation by statute. *See* Attachment C.

services also permits reductions in intrastate carrier access charges to occur without offsetting increases in rates for basic services (as Qwest had originally proposed in this case). Under the Agreement, the phased reductions in carrier access charges will, instead, be offset by providing Qwest with more "headroom" to adjust the prices of flexibly-priced services in Basket 3.

The Proposed Plan also embodies my recommendation for an "inflation less productivity" cap for Basket 1 and adopts my recommendation of a productivity offset of 4.2 that includes the 0.5 "consumer dividend" I suggested. The Proposed Plan, however, "caps" the cap at zero with no lower bound which means that, if inflation exceeds productivity, the cap itself will not be raised, but, if as is more likely, the productivity offset exceeds the rate of inflation, the overall cap will be reduced forcing aggregate price reductions for the services in Basket 1. This is a significant concession by the company in that it has accepted the risk of inflation for the term of the price cap plan.

The cap for Basket 3 in the Proposed Plan differs from what I suggested in that it is set at the initial weighted average price level of all services in the basket, subject to annual updates in quantities. Basket 3 also includes "headroom" above the initial prices to provide Qwest the opportunity to achieve its full revenue requirement through the pricing of services in this basket. This change, among others, has been made to conform the price cap plan to the constitutional and legal requirements related to a "fair value" rate base and reasonable rate of return.

I still prefer the five-year term I proposed in my earlier Testimony to the three-year term in the Agreement. However, for a state making the important transition from earnings to price cap regulation, I certainly believe an initial three-year term is reasonable.

Q. WILL YOU ENUMERATE THE SPECIFIC BENEFITS TO CONSUMERS THAT YOU SEE IN THE AGREEMENT?

A. Yes. In addition to the benefits inherent in price cap regulation that I have already noted, the Agreement contains a number of significant benefits to consumers and competitors. The Agreement:

- Rejects Qwest's original plan which called for $88 million in overall rate increases[5] and a $ 32 million increase in rates for residential basic services[6];
- **Reduces existing rates** for some basic residential services (*e.g.*, residential basic service nonrecurring charges are reduced by 25 percent) and for certain business services;
- **Initiates a "price cap" plan** that will place limits directly on the prices that Qwest charges for services. The plan will run for three years, but can be extended by the Commission;
- **Promotes rate stability by capping "basic services" for three-years**; that is, they may not be increased, but may be reduced from initial levels. These services include: flat rate residential, 2 & 4 party service, low use option, telephone assistance programs, flat rate business, individual PBX trunks, Caller ID block, and basic listing service. Increases for other services are limited.
- **Enables consumers to benefit directly from Qwest's increased productivity by adjusting the price cap in Basket 1.** This is in addition to a Consumer Productivity Dividend that is included in the initial price cap;
- **Subjects Qwest to new penalties in the form of bill credits for failing to meet service quality standards;**
- **Requires Qwest to provide additional consumer information** in its bill inserts, including information about the Commission's complaint process;

[5] Teitzel Supplemental at 52.

[6] Allcott Direct Testimony confirmed by Teitzel Supplemental at 39-40.

- **Lowers charges made by Qwest to long-distance carriers by $15 million** over the three years (and eventually to the interstate level), with the result that long-distance prices for calls within Arizona will be reduced;
- **Encourages Qwest to offer a variety of new services and service packages** that will respond more directly to consumer needs and will have the flexibility to price these new offerings to meet the demands of the market.

Q. HOW WILL THE AGREEMENT BENEFIT COMPETITORS AND PROMOTE COMPETITION?

A. As I noted previously, competitors benefit from the basket structure of the proposed plan; that is, the creation of a separate wholesale basket that initially will contain carrier access, unbundled network elements, local service resale and payphone access lines. The pricing rules for these wholesale services are not affected by the price cap plan. As a result, the proposed plan insures that prices competitors pay for access to Qwest's local network will continue to be directly regulated by the Commission. This will help promote the growth of competition in Arizona and provide safeguards against possible anti-competitive pricing by Qwest.

Interexchange carriers, such as AT&T and WorldCom, further benefit from the phased reductions in carrier access charges that are mandated under the Agreement. The Agreement also retains the Commission's rules regarding imputation and requires that prices for services and packages in Basket 3 (flexibly priced competitive services) are set in excess of a cost floor (initially the Total Long Run Incremental Cost or "TSLRIC") of the service or package.

Q. IN YOUR OPINION, SHOULD THE AGREEMENT BE ADOPTED AS PROPOSED BY THE PARTIES?

A. Yes. I believe that Agreement is in the public interest and should be adopted by the Commission.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes.

13

REFORMING REGULATION OF LOCAL EXCHANGE CARRIERS OR IT *IS* BROKE, SO LET'S FIX IT!

by

Harry M. Shooshan III
Vice President
National Economic Research Associates, Inc.

Alvin Toffler defined "future shock" as "the shattering stress and disorientation that we induce in individuals by subjecting them to too much change in too short a time." He also described the phenomenon as "the dizzying disorientation brought on by the premature arrival of the future." In reacting to the Federal Communications Commission's price cap proposal, Congressional leaders appeared to be suffering from future shock.

Actually, it was much worse than that. In view of the regulatory reform which has already taken place at the state level, Congress' dizzying disorientation appears to be resulting from the belated arrival of the present! A majority of states have adopted some measure of regulatory reform, and one state (Nebraska) has virtually eliminated economic regulation of telephone service. After lagging behind federal policymakers for decades, many state legislatures and regulatory agencies have moved ahead aggressively to revamp regulation.

If regulatory reform is so well established at the state level (with several jurisdictions adopting reforms which are much more radical than the FCC's proposal), why did the FCC's price cap plan for the local exchange carriers (LECs) get off to such a rocky start on the federal level? Why has Congress reacted so strongly to a rather modest reform?

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I. IF IT AIN'T BROKE, DON'T FIX IT

Notwithstanding the general enmity between the Democratic leadership in Congress and the Commission which developed during the Reagan administration, the fundamental problem is that the case for eliminating rate-of-return regulation of the LECs has not been effectively made. Congress' view appears to be, "If it ain't broke, don't fix it." Or, "if it is broke, prove it." Congress is reluctant to throw rate-of-return regulation overboard, when such regulation has worked well for over half a century.

While the FCC is moving ahead with implementing price caps for AT&T, regulatory reform for the LECs is very much in doubt. The telephone industry should be working from the premise that it has "lost" price caps; in other words, that it must start over in making the case for reform.

Despite the good intentions of the current FCC leadership and some encouraging language in the Commission's order, consider the following *facts*. The FCC which will ultimately vote on LEC price caps will be virtually brand new with at least three and probably four new members. While there will be a new Commission, there will be the same old skeptical (or hostile) Congress. And there will be another powerful player in the already formidable ranks of the opposition—AT&T.

This is not to say that the FCC's price caps proceeding has not been valuable. It has served to open the debate, establish positions of the various interest groups and put a number of options on the table.

However, there are important lessons to learn from the initial failure on the part of the LECs to achieve price caps. First, the industry (and the FCC for that matter) never presented a compelling argument for reforming regulation of the LECs. The FCC originally intended price caps as an interim step towards deregulation of AT&T—a firm which many at the Commission believed would be disciplined by market forces rather than by the price caps anyway. A strong case had been made for reduced regulation of AT&T in a series of papers written by influential FCC staffers and by academics. It was also believed that MCI, AT&T's major competitor and regulatory antagonist, would ultimately accept a price cap plan for AT&T as a means of ending forced reductions of AT&T's rates by the FCC.

However, after intense lobbying by the telephone industry (especially by the RBOCs), the FCC agreed to expand its price cap plan to include the LECs. Since it could not be argued credibly that telephone companies' market power is effectively constrained by competition, the FCC suggested that price caps for the LECs were desirable in order to "improve" regulation and encourage efficiencies. However, neither the FCC nor the telephone industry developed compelling arguments as to why traditional rate-base, rate-of-return regulation needed to be improved or why it was inefficient.

The FCC's initial proposal was greeted with widespread confusion and skepticism in the Congress. Was the FCC suggesting that the local exchange market was as competitive as the long-distance market? Why should firms with monopoly power be allowed to earn whatever level of profits they could? By mixing apples and oranges, the FCC had created a lemon for the LECs. Although the FCC and the telephone industry worked hard to make the case for LEC price caps, they were unable to dispel the initial doubts about the plan. The LECs could not overcome the perception that the FCC's price cap plan amounted to "giving away the store" to the industry. As a result, the Commission's credibility with Congress (which was already diminished as a result of partisan political differences and fundamental disagreements on mass media policy) suffered.

Acceptance of any price cap or incentive regulation plan depends on the credibility of the regulators in striking a deal with the industry that benefits consumers. If the FCC is to regain its credibility, it will have to convince Congressional leaders that regulatory reform is needed and that the public will benefit from the elimination of rate-of-return regulation. If the LECs are to achieve regulatory reform, they will also have to develop a convincing case for change. Otherwise, Congress has a right to be skeptical. If the policy makers do not accept your premise, then you cannot expect them to accept your conclusion.

In the "first round" of the price caps fight, politicians saw only the downside of change. After all, who supported LEC price caps except the LECs? This leads to the second major lesson to be learned from round one. The LECs must address the legitimate concerns of other interested parties, primarily ratepayers and organized labor. The key issues which must be dealt with in any plan are rate levels, quality of service and the extent to which productivity gains are achieved through reductions in the workforce.

II. TELECOMMUNICATIONS INFRASTRUCTURE

We argue in this paper that telecommunications regulation is failing to provide needed infrastructure to promote economic development and competitiveness of American industry. In short, we advance a public policy rationale for reforming the regulation of the LECs which can make the theoretical arguments about the shortfalls of rate-of-return regulation much more compelling to policymakers.

Regulatory reform is critical to stimulating the investment in telecommunications infrastructure (especially in the public switched network) that is needed in order for the United States to remain competitive in global markets and to retain its lead in computer technology. In recent years, the United States has lagged behind its foreign competitors in investing in its public telecommunications infrastructure. While the United States remains the acknowledged world leader in achieving a modern telecommunications infrastructure, other nations are rapidly closing the gap. In telecommunications, the existing plant can become obsolete quickly as new technology is introduced. Therefore, continued expenditures are necessary to ensure a modern public telecommunications infrastructure. However, the U.S. ranks no better than sixth in the world (behind West Germany, Japan, Australia, France and the Netherlands) in per capita telecommunications expenditures on public telecommunications infrastructure.

Nations such as West Germany, Japan and Singapore have all specifically targeted investment in their public telecommunications infrastructure as critical to future economic development. Japan has already set the standard for commercial ISDN (integrated services digital network). By 1995, Japan will have invested $120 billion in its ISDN system. The Japanese have already committed $150 billion to modernize their fiber network. The Republic of Singapore has developed an electronic data interexchange (EDI) network which links together air, land and water travel authorities, traders and government trade agencies. The goal is to make Singapore the nerve center of international finance and trade.

In light of the impressive progress being made by other nations, modernizing and expanding our public telecommunications infrastructure will be increasingly important to U.S. competitiveness. Telecommunications firms must invest more aggressively to modernize the public switched network and to provide advanced services to network users.

III. THE IMPORTANCE OF REGULATORY REFORM

Regulatory reform is especially important if it can be shown that the existing regulatory structure does not provide adequate incentives for the type of investment needed to enhance our telecommunications infrastructure. Telecommunications infrastructure in the United States is owned by private firms rather than by government entities and is funded by private investment rather than by government subsidies. Since investments are not centrally directed, investment in the public network is not automatic. A public policy environment that provides firms with the greatest incentives to bring new products and services to *all* customers (large and small businesses, residential customers) would allow the U.S. to maintain its leadership position in telecommunications. At the same time, the regulatory system must be designed so that it offers incentives for the firm to act in the public interest and also protects consumers against abuses of monopoly power.

IV. RATE-OF-RETURN REGULATION IN A CHANGING ENVIRONMENT

Before we discuss the shortcomings of rate-of-return regulation, we acknowledge that such regulation was quite effective in the past, when telecommunications was an end-to-end monopoly. Rate-of-return regulation protected customers, while providing stability to attract huge sums for investment in telecommunications facilities. Under rate-of-return regulation, telephone companies had adequate incentives to make "plain old telephone service" universally available.

The era of offering "plain old telephone service" in a monopoly environment is rapidly coming to an end. Both the nature of telecommunications investment and the economic environment in which such investment is undertaken have changed dramatically. As a result of these changes, traditional rate-of-return regulation no longer provides adequate incentives for investment.

Under rate-of-return regulation, regulators establish a limit that a firm can earn on its allowed investment base. This rate is established by estimating what unregulated firms with a similar degree of risk would earn in a competitive market. This type of regulation worked well in the past because it provided the stability necessary to attract large amounts of investment capital. Because firms operated in a monopoly environment and served a growing market, investments were relatively safe.

Now, however, telecommunications carriers operate in an increasingly competitive environment and must adapt to rapidly changing technology. Demand for new services is uncertain and firms frequently face competition in the provision of such services. Consequently, if a firm wishes to invest in a new service offering today, such as videotex, ISDN or video programming service, it will incur substantial risk. For example, providers of videotex services face competition from private vendors. ISDN services face competition from private systems. Video programming services must compete with established cable operators and video cassette rental outlets.

Nevertheless, an unregulated telecommunications company might choose to invest in the facilities needed to provide such services. Stockholders would lose if the ventures failed, but they would have the prospect of large profits if the ventures succeeded in the market. In either case, consumers would benefit from having more alternatives available, and the economy as a whole would benefit from the improved infrastructure.

V. ASYMMETRIES CAUSED BY RATE-OF-RETURN REGULATION

Unfortunately, rate-of-return regulation contains perverse asymmetries which discourage telephone companies from making risky investments. Under rate-of-return regulation, a company that undertakes an investment which results in a rate of return higher than that allowed by the regulators will be forced to lower its rates. If, however, that company suffers losses as a result of its investment, regulators are reluctant to permit the firm to recoup those losses through higher rates. Even if regulators could be convinced to permit rate increases, the company's ability to raise rates will be constrained as markets become increasingly competitive. Moreover, if the venture loses money, the regulators could actually disallow the investment and force the company's shareholders to bear the loss.

The investment climate created by rate-of-return regulation is, therefore, asymmetrical. It is a "heads, I win small; tails, I lose big" proposition for regulated firms. Shareholders reap few of the benefits of a highly profitable investment and yet might very well bear the entire loss associated with an unsuccessful investment. Since the symmetrical relationship between risk and return disappears, the riskier the investment, the less likely it is that it will be undertaken by a firm subject to rate-of-return regulation. While this asymmetry may have been acceptable in a monopoly environment where new investment could be made conservatively as markets or technology became established, it is untenable in a competitive environment where firms must offer innovative services to generate revenues.

VI. INCENTIVES FOR INVESTMENT

Ironically, rate-of-return regulation has been criticized over the years for encouraging over-investment. Therefore, the argument that investment is *discouraged* requires some elaboration. A distinction must be made between the type of investment undertaken in the past and the type of investment necessary today to develop new services and contribute productively to the telecommunications infrastructure.

Investments which result in new product or new service offerings typically involve substantial risk, since their success depends upon uncertain customer demand. These are precisely the investments that are necessary in order to modernize the U.S. telecommunications infrastructure and to keep pace with the level of investment being maintained by our foreign competitors. Under rate-of-return regulation, firms may overinvest in "safe" projects such as expansion of existing facilities but will be reluctant to incur the risk of offering innovative services. However, safe investments alone will not provide an adequate telecommunications infrastructure to enable the United States to be competitive in the marketplace. By the time an investment becomes "safe," the United States may well be importing the technology and exporting the jobs related to that investment. Moreover, consumers will be harmed by the delay in bringing new services and products to the market.

In countries with a government-managed telecommunications system, the disincentive to engage in high-risk, high-return investment does not exist. Because investments are centrally directed, disallowance is not a danger. Although governments are traditionally risk averse, here they incur no risk. If an investment project supports a nation's infrastructure and contributes to economic development, the nation benefits even if the investment is not a commercial success. Private firms, however, benefit from an investment *only* if it is a commercial success. Therefore, under current regulatory policy, the introduction of new services is likely to take place overseas first. By the time U.S. companies are assured of the profitability of the new service and can justify the investment themselves, the risk will be lower but so will the benefits to the U.S. economy.

The above discussion is not intended to applaud government-managed systems but to point out one of the major reasons why other nations are making greater progress toward infrastructure modernization. Although the U.S. regulatory system has outperformed such government-managed systems for decades (and has even been emulated by some countries in privatizing their telecommunications carriers), that system must keep pace with changes that have occurred in the telecommunications environment. These changes include increased competition in some markets and a rapid rate of technological advance across the board which result in the need for modernization and innovative service provision. Only by *improving* the regulatory climate can the United States retain its leadership in telecommunications.

VII. REGULATORY REFORM: ENCOURAGING INVESTMENT

A regulatory policy that focuses on price instead of rate of return would promote vital new investments while continuing to protect telephone subscribers against monopoly abuses. By limiting the prices that firms can set, rather than their profits, regulators would encourage more risky investment. Because these price limits would be renegotiated periodically, firms would face implicit constraints against earning excessive profits. Although investment benefits would initially accrue to stockholders, they would ultimately accrue to ratepayers.

In effect, price regulation lengthens the "regulatory lag" associated with investment and permits more of the benefits of successful investment to flow through to stockholders. This situation encourages firms to undertake risky investments that have good prospects.

A regulatory policy that focuses on regulating price instead of profits also would restore the necessary balance between risk and return. Firms would assume the risk associated with an investment (because prices would be fixed, additional costs could not be recovered from ratepayers), but could then retain the profits that might accrue—at least until the plan for price regulation is renegotiated. If profits are considered excessive, ratepayers will ultimately benefit in the form of reduced rates when the price regulation plan is renegotiated. In the meantime, however, the investment has been made and the infrastructure benefits can be realized.

It is important to note that profits and consumer benefits are not mutually exclusive. From a consumer's perspective, the best industry structure is, in many respects, a competitive one. Firms in such a competitive industry must satisfy consumer needs or face shrinking market share and revenue losses. The first firm to provide consumers with a new product or service incurs substantial risk but can expect substantial profits if the venture is successful. Therefore, a firm in a competitive industry has a great incentive to undertake what are often risky investments in its quest for this profitable advantage. Consumers clearly benefit from these investments; they enjoy diversity and competitive entry (or the threat of entry) which keeps prices down.

When economies of scale prescribe a monopolistic market structure, firms must be regulated in order to protect consumers from potential abuses of monopoly power. However, the advantages of competition should not be ignored. Ideally, the regulatory environment should be such that consumers are as well off in terms of price and product offerings as they would be in a competitive market environment. Under rate-of-return regulation, consumers lose these important advantages.

A firm that is able to retain more of its profits is more likely to modernize and introduce new products and services more quickly in an effort to meet customer demand. These firms are likely to be much more responsive to customers than firms which stand little chance of profiting substantially from their anticipation of consumer needs. After all, in a competitive environment, it is the quest for profits that motivates the firm to satisfy customer demands.

In a competitive market, such profits do not last forever. Ultimately, competition forces the successful firm to pass supracompetitive profits on to consumers through lower prices. Under price regulation, such gains are passed on to consumers when the plan for regulating prices is renegotiated. In both cases, consumers reap the long-run benefits of successful innovation.

VIII. REGULATORY REFORM: THE NEED FOR A COMPELLING CASE

Traditional rate-of-return regulation is probably still adequate for firms that serve only secure, monopoly markets. However, the challenges in today's telecommunications industry go far beyond such markets. If the United States is to move rapidly forward into the information age, telecommunications carriers will have to invest aggressively in risky, competitive markets. Only in this way will the country have the public telecommunications infrastructure it needs to be competitive in the information services marketplace. Unfortunately, rate-of-return regulation provides inadequate incentives to encourage investment in risky, competitive markets.

The infrastructure and competitiveness arguments provide compelling support for replacing traditional rate-of-return regulation with some form of regulation which gives regulated firms more incentive to invest in new technology and to develop new services. The FCC and the telephone industry must make this case convincingly—backed up by hard data on, and in-depth analysis of, the strides being made by our foreign competitors. The debate must be refocused and the predicate for change must be established if policy makers at either the federal or state levels are to endorse real regulatory reform for the local exchange carriers. And, in refocusing the debate, the telephone industry must make certain, too, that the central theme is *regulatory reform* and not *deregulation*.

With the lessons of "round one" in mind, the telephone industry can achieve success but only if it takes nothing for granted and builds its case for change on a sound foundation.

14

LESSONS FROM THE BRITISH EXPERIENCE WITH PRICE CAP REGULATION

by
Professor Sir Bryan Carsberg
Director General of Telecommunications
OFTEL, United Kingdom

The main objective of regulation is to bring about behaviour that is in the national interest. It is to encourage the regulated industry to behave according to the interests of its customers and sometimes, perhaps, also to pursue social goals. One of the main reasons for regulation is to prevent the abuse of monopoly power, the restriction of output and the charging of excessive prices. In this situation, many of the regulatory objectives can be thought of as aiming to bring about the same situation as would prevail in a competitive market. In a competitive market, a business must operate with reasonable efficiency or it will not be able to survive. Regulation should similarly encourage efficiency. In a competitive market, a firm which provided unacceptably low quality of service would find that its customers switched allegiance to a rival: it would suffer financial loss. Regulation should also aim to make a company suffer financial loss if it provides an unacceptably low quality of service. In such ways, the aim of regulation can be said to mimic competition.

A good deal of regulatory interest has recently focussed on methods of price control that have the desirable property of promoting efficiency in the manner of competitive markets. The so-called price cap method has relatively good incentive properties. The purpose of this paper is to describe experience with the use of price cap regulation in the United Kingdom and to discuss some of its advantages and disadvantages and some of the issues that arise in applying it.

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I. EXPERIENCE IN THE UK

Price cap regulation was adopted in Britain in 1984 as a method of controlling the prices of British Telecom when it was converted into a private company. Permission to operate a telecommunications network is given in a licence which makes permission conditional on observance of a number of rules contained in the licence. Licences are issued by the Government in the first place, but I have powers to enforce them and also to amend them under a prescribed due process. Price control is applied under one of the rules in British Telecom's licence. The rule established in the original 1984 licence was that price increases should be limited to three percentage points below the rate of inflation for a period of five years. No formula was set down for price increases after the end of the five-year period, this being left to the licence amendment procedures. The price control rule actually applied to an average of prices so that individual prices could be increased by more or less the overall cap. The prices concerned were exchange line rentals (standing charges for dial tone) and direct dialed inland telephone calls, other than those made from public call boxes. The average was calculated as a weighted average, using revenues in the previous year as weights. Other prices were left without formal control. Within the controlled group of prices, exchange line rentals were subject to an individual limit of two percentage points above the rate of inflation; no floor was established for any prices.

British Telecom did not use the maximum allowed price increases in all years. For example, managers decided to forego permissible increase of a little over 1 percent in 1987. In 1986, average prices had to be reduced by about one-half of 1 percent, but the company took advantage of its flexibility to undertake a substantial rebalancing of prices.

In 1988, I began licence modification procedures to establish a new price control rule to come into effect in 1989 on the expiry of the original rule. My first step was to publish a consultative document. One of the questions asked by this document was about the desirability of continuing price cap regulation compared to the alternative of switching to some other method of control. Commentators were virtually unanimous in supporting a continuation of price cap regulation. No substantial body of opinion argued for a switch. To make a licence modification, I had to reach agreement with British Telecom or, if that agreement could not be obtained, to make a reference to the Monopolies and Mergers Commission and obtain their broad support subject, in either case, to publishing my proposals and allowing time for objections to be made. In the event, I was able to reach agreement, and the new rule is that price increases will be limited to 4.5 percentage points below the rate of inflation. The basket of services covered was extended to include operator-assisted calls. The individual limit of 2 percentage points above the rate of inflation was continued for exchange line rentals, and connection charges were also brought under this control. The new rule will last for four years, and a further modification will, therefore, be needed in mid-1993.

British Telecom's original licence did not contain any rules about quality of service, and no formal amendment has been made to deal with this. The quality of service improved slightly after privatisation up to the end of 1986, but it then deteriorated during 1987. Some people assumed that this deterioration was attributable to the lack of regulatory incentive to focus on quality of service. Reducing quality of service, they argued, would save money and, as there was no penalty for it, would lead to an increase in profit. A more convincing explanation is that the main cause of the deterioration was actually a strike of engineering staff that occurred early in 1987. This led to the neglect of maintenance work with a serious cumulative effect in a system that was excessively dependent on old technology. Difficulties were compounded with teething troubles associated with the introduction of the more modern technology. Quality of service has subsequently recovered to the point at which it is better than it has ever been before. However, I do believe it is desirable for a regulatory system to contain financial incentives to improve quality of service, and I shall return to say more about this issue below.

II. PRICE CAP VERSUS RATE-OF-RETURN REGULATION

I next turn to consider the general merits of price cap regulation. The choice of regulatory approach is often depicted as a choice between "rate-of-return regulation" and "price cap regulation." Rate-of-return regulation is regarded as a method which begins with an assessment of allowable cost and allowable investment—the regulator's assessment of the appropriate levels assuming a reasonable level of efficiency—and then determines acceptable prices as the prices that are expected to yield a satisfactory rate of return on the investment, taking account of estimated costs. Under this approach, prices are normally assumed to be approved in detail, item by item. Price cap regulation involves limiting prices—perhaps average prices—according to a formula for a set period of time.

This dichotomization is an exaggeration and an oversimplification. In my opinion—and I shall discuss this issue in more detail below—setting a particular level for the price cap should depend on estimates of the consequences for rate of return on investment. The price cap should be set at a level which is expected to produce a reasonable rate of return. To that extent, the price cap regulation seems similar in basic approach to rate-of-return regulation, and the main difference is actually the length of time which elapses between successive regulatory determinations of prices. Rate-of-return regulation involves setting prices in advance but perhaps setting them annually. Price cap formulae have been fixed for four or five years under British practice. This difference in term is important. It is fixing prices in advance that gives the approach its incentive properties. If prices are fixed, reductions in cost will mean increases in profit, and managers have an incentive to achieve greater efficiency to this end; the longer the term, the greater the gains from efficiency and the greater the incentives. However, if both approaches to price control depend on rate of return, they are similar, and this is the sense in which the dichotomization is an exaggeration. Perhaps it would be better to contrast short-term regulation and medium-term regulation rather than rate-of-return regulation and price cap regulation.

The contrast is an oversimplification, because we actually have available a family of price control measures rather than two clearly contrasting approaches. Rate-of-return regulation, under which prices are set for some future period, perhaps one year, can lead to profits which are different from expectations. Costs may be different from expectations, demand may vary, and so on. The regulated company may be required to accept the results, whatever they are. Alternatively, it may be required to make refunds to customers if rate of return exceeds some benchmark, and it could also be allowed to carry forward a shortfall and recoup it from subsequent revenues. If both these variants were to be adopted, we should have an extreme form of rate-of-return regulation under which incentive to improve efficiency would be at a minimum and certainty of result in terms of rate of return at a maximum. Without these variants, even rate-of-return regulation over a one-year horizon has some incentives to efficiency.

III. THE PRICE CAP HORIZON

Another way of looking at the family of regulatory arrangements is to consider the horizon of a price cap as variable. When a regulator sets a price cap, he or she is aware of taking some regulatory risk. The particular price cap chosen has to be based on estimates, and actual results are almost certain to differ from the estimates. Profits will be more or less than expected, and the regulator runs the risk of being criticised because the profits are "outrageously large" or, indeed, so small as to impair the operating capability of the company. The longer the horizon, the greater the risk. However, the longer the horizon, the greater also the incentive to efficiency. As the term of a price cap is shrunk, uncertainty and incentive both diminish, and the effect of the price cap comes closer to what I have called rate-of-return regulation. My experience with price cap regulation in Britain, including my experience of dealing with people who complained about prices from time to time, has led me to make the subjective assessment that in the telecommunications industry, under current conditions, the term of a price cap should be between three and five years. Below three years, the incentive becomes too small, and above five years, the uncertainty becomes too great.

IV. MORE COMPLEX PRICE CAPS

The balance between incentive and uncertainty can be affected by additional devices which generate additional members of the family of price controls. One such device is that of "profit sharing." This device is normally presented as a one-way risk for the regulated company. Price cap regulation may be adopted as the basic approach, but the regulators declare a rate of return which they regard as reasonable. Surpluses above this rate of return are shared between the regulated company and customers in some agreed proportion—this means that some proportion of excess profits is converted into a refund to customers. The regulated company has the incentive of keeping some of the profits that result from its efficiency, but unexpected profits are also limited.

Another way in which the incentive/risk trade-off can be altered is to adopt a price cap that is more complicated than the basic inflation plus or minus "x" format. If the aim of price cap regulation is mainly to encourage efficiency, regulators will wish to create a situation in which profits depend on efficiency and not on other unexpected events such as unexpected growth or depression in the economy, which may affect the volume of demand for telecommunications services at a given price, or unexpected price changes outside the control of the regulated company. To achieve such a result, prices must be made to depend on these unexpected factors. For example, permitted prices charged to customers could be made to depend on the prices of supplies to the regulated company. This approach was adopted in the price control for British Gas, where prices depend on the price of input fuels. Similarly, prices could be controlled according to a more complicated formula under which they depended partly on volume. This kind of approach involves some hazards. Very few prices are completely incapable of being affected by managerial action. If unexpected cost changes are fed through completely to output prices, managers will have no incentive to buy efficiently. Similarly, volume changes depend partly on managerial efficiency and partly on circumstances beyond their control. However, some incentives can be retained by setting the formula at a level which provides partial compensation for unexpected results but not total compensation.

One of the minor advantages of price cap regulation is its ability to convey a simple and understandable message to customers and its being relatively easy to administer. The more complexities are added of the kind discussed above, the less this potential benefit is likely to be realised.

I therefore decided, in the UK, to stay with the simple version of the formula. However, uncertainty in estimates of volume was a particular difficulty in the revision of the price cap rule last year, because of the British policy of encouraging competition and uncertainty about the effect of the regulatory arrangements on the share of the market that would be taken by British Telecom's competitor during the period of initial development of competition. To deal with this difficulty, I would have been prepared to consider some volume adjustment in the formula, but it eventually proved to be unnecessary.

V. THE LEVEL OF THE PRICE CAP

I next want to consider more directly the question of how the level of a price cap should be decided. Some people appear to take the view that the level of the price cap does not matter very much. They argue that the purpose of the approach is to give an incentive for greater efficiency and that the incentive arises more or less equally regardless of the level of the cap. Others would argue that the price cap should be equal to the rate of inflation minus a factor which represents an estimate of reasonably attainable improvements in productivity and that this level should be continued regardless of the level of profits at the start of the price cap period.

Neither approach seems to me to be economically efficient or politically realistic. Both approaches could lead to the earning of very high profits—profits that would be politically intolerable—and this would probably result in a political rejection of the whole approach. Furthermore, one has to consider the effects of the price control on matters other than simple operational efficiency. The price control should be consistent with giving appropriate incentives to invest up to an efficient level. This means that the regulated company should have a reasonable expectation of being allowed to earn an acceptable rate of return on investments that are worthwhile. Similarly, customers should be given the incentive to use the telephone system to an efficient level, and this will not happen if usage charges are too high.

All these factors persuade me to believe that the level of the price cap should be chosen as one that produces a reasonable expected rate of return. Sometime, this statement produces the shocked response that, surely, the whole idea is to get away from rate-of-return regulation. However, to say this is to misunderstand the argument. Creating an incentive to improve efficiency does not depend on neglecting rate of return but rather on fixing the price control for a fairly long period of time. This is the reason for my statement above that the important distinction is between short-term regulation and medium-term regulation rather than between price cap regulation and rate-of-return regulation.

When I revised the rule for controlling British Telecom's prices last year, I explicitly based my approach on financial modelling. My staff prepared a detailed model for predicting British Telecom's profits given values for variables such as the level of demand, the rate of inflation, efficiency gains, input prices and the price control rule itself. We built up this model from information available about British Telecom's past results, from information provided by manufacturers about trends in equipment prices and from other sources. We provided our model to British Telecom, invited it to criticise the model and took account of the criticisms. Having validated the model, we used it to make predictions, and we settled on a price cap that would produce a reasonable rate of return, given our expectations of the behaviour of the variables.

VI. CARRY OVER

The way in which results at the end of a price cap period are carried over into decisions about the next price cap is important for the incentive effects of the control. The incentive to achieve efficiency gains is always likely to be strongest at the beginning of a price cap period, because the prospect then exists of enjoying the surplus profits for some time. Towards the end of the period, the regulated company is more likely to wish to convince the regulator that life is becoming difficult and large uncontrollable cost increases are being faced. This danger will be particularly great if prices are reduced at the start of a new price cap period to eliminate any excess profits being earned at the end of the previous period. In that event, the regulated company would certainly prefer to delay efficiency gains that could be made at the end of one period and take them instead at the beginning of the new period.

I therefore believe that regulators should signal by their behaviour that they do not intend to pass on all efficiency gains to customers as soon as a price cap period is finished. One way of bringing this about is to set the price cap at constant annual rate over the period concerned and set it at such a level that expected profits come to be a reasonable rate of return on capital employed at the end of the period. If excess profits are being earned as a result of efficiency, this approach will cause a gradual decay of the excess but leave some reward for the regulated company.

VII. MID-TERM REVIEWS

One important question that the regulator has to answer concerns the case for altering the price cap before the end of the stated term. Once a price cap has been set, should it be left unaltered in all circumstances? I do not think that any absolute assurance can or should be given that the price cap will remain unaltered. The purpose of the price control is to encourage efficiency, and changes should not be made in a way that will eliminate the incentive to efficiency. However, if unexpectedly large profits—or indeed unexpectedly small profits—have been made because of unexpected changes in circumstances, rather than efficiency, it seems to me that a change in the formula can legitimately be made and, in some circumstances, will virtually be a political necessity. However, this is a sensitive matter, and the regulator must proceed with care. Frequent interventions, giving the impression of "fine tuning," may make the price cap approach come to seem very much like short-term rate-of-return regulation, particularly given the practical difficulty of distinguishing efficiency from uncontrollable effects. I believe that mid-term changes in the price cap should be quite rare. I have once conducted an investigation to assess whether or not a change was needed, but I have not yet made a mid-term change.

VIII. SCOPE OF PRICE CAP REGULATION

I want next to give some attention to the question of coverage of price cap regulation. What proportion of the business should be covered by price caps, and to what extent should prices be controlled individually instead of relying on an overall average control? My starting point is that the prices of all services that are subject to significant monopoly power should be covered by a price cap. My basic reason for believing this is that price caps are intended to provide an incentive for greater efficiency, and this incentive is valuable in all areas of business even though the potential for efficiency may be greater in some areas than others.

Some services—notably, for example, private circuits—have been omitted from price control in Britain. People can complain to me, if they believe that prices are excessive, and I then have the duty to conduct an investigation, and I can move to modify the licence and introduce a price control if I consider it desirable. However, in practice, my investigation has to rest heavily on an assessment of whether or not the rate of return being earned is excessive, and, consequently, the position comes to be very similar to rate-of-return regulation. For this kind of reason, I have publicly stated my belief that it would be desirable to have price cap regulation of private circuit prices, and I am currently working on procedures to bring this about.

One notable area of service which is still not subject to price control is international telephone calls. This is an area where British Telecom clearly continues to wield monopoly power. However, international telephone pricing raises some special difficulties because of the way in which international prices are set. An international price exists which is paid by one administration to another for delivering an international call. This price can be altered only by bilateral agreement. Prices for outgoing international calls from Britain are already relatively low by international standards, and if a price control were to cause further reductions relatively, the effect could be to provide a strong incentive to originate calls from Britain, and this could cause a sharp swing in the economics of international telephony with some detrimental effect on the national balance of payments. Considerable scope exists for the development of competition in international telephony, and this is already exercising a constraining influence on prices. Given the special difficulties of international telephony, I have decided not to introduce a formal price cap at present, but I shall keep the area under review and be ready to introduce a control if the need should become apparent.

IX. CAPS FOR INDIVIDUAL SERVICES

I have already mentioned that the British approach applies the price cap controls to broad averages. The existing price cap is an average for a basket of switched services, and the price cap I propose for private circuits is likely also to be aimed at a weighted average. In part, this approach has been adopted because of a recognition of the difficulty in defining costs and optimal prices at the level of individual services, taking account of time-of-day variations. Because of this difficulty of definition, we have thought it preferable to allow flexibility to the regulated company, though this is always subject to the right to intervene if an individual price is set at a grossly inappropriate level, implying anticompetitive behaviour or abuse of monopoly position. The potential threat of a licence amendment to deal with any such anomaly is a real one and is likely to be a sufficient sanction in most practical cases.

Accordingly, the only individual price cap in the British system is one designed to limit the speed of rebalancing of prices. We recognise the basic case for relating call charges more closely to usage-sensitive costs with the implication that standing charges will have to rise relatively. However, an excessively rapid rise would cause economic disruption—because people had made plans on the assumption of a reasonable stability in prices—and would also be politically controversial. We have, therefore, limited the speed of adjustment of standing charges to 2 percentage points above the rate of inflation, and we have made special arrangements for the protection of people with low incomes in the form of a low user tariff involving a low standing charge.

X. ACCOUNTING PROBLEMS

In discussing individual prices, I have touched a little on difficulties of cost measurement. The problems of accounting measurements to support regulation are a subject of great interest to me as a former accounting professor, and they are complex enough and interesting enough to merit a separate paper in their own right. I cannot do more in the present paper than leave one or two signposts—but two points are perhaps of particular interest in the current context.

I should first acknowledge that one reason why price cap regulation was considered attractive was the belief that rate of return could not be measured with acceptable accuracy—or even with any knowledge of how accurate the measurements were—and that price cap regulation avoided the need for accounting measurements. The difficulty was seen as being twofold. First is the difficulty in measuring the results for one year separately from another; and second is the difficulty of separating the results of regulated businesses from unregulated businesses, given the existence of joint costs. Regulators could indeed set a price cap independently of any accounting measurement if they were willing to settle for a price cap that broadly reflected attainable productivity improvements. However, for the reasons given above, I reject this approach, and I believe that the price cap must be based on computations of expected rate of return. Consequently, I cannot avoid the accounting difficulties. I therefore think that one has to proceed with the best attainable measurements under accounting. I recognise that practical measurement uncertainties will be inevitable. Where joint costs are concerned, we are dealing with a problem that is known to be unanswerable. However, I do not believe that the size of these difficulties is sufficient to invalidate the whole procedure.

One of the great accounting controversies concerns whether investment should be revalued at current prices for assessment of rates of return on capital employed. In accountants' jargon, a choice must be made between historical cost accounting and current cost accounting. I believe that little room exists for dispute about the preferability of current cost accounting from a point of view of the allocation of economic resources. However, businesses do not like to report to their shareholders on a current cost accounting basis because it makes profits look relatively small, and the accounting profession does not yet force them to do so. Many regulated companies would doubtless like to continue reporting to shareholders on the traditional basis but to be allowed to conduct their dealings with regulators on the basis of current values of assets. That, of course, would be intolerable because it might lead to the impression that companies were being allowed to earn very large rates of return, and this would lead to strong political pressure to change the system. If we have to live in a world in which company performance is normally assessed on the traditional accounting basis, using out-of-date values for assets, I see no practical alternative to using these numbers also for regulation.

XI. QUALITY OF SERVICE

I want, finally, to say a few words about incentives for quality of service. I have already noted that some incentive for achieving the desired level of quality of service should be incorporated in the price control arrangements. The first evident requirement is public accountability. Statistics for the main aspects of quality of service should be compiled regularly and published together with performance targets. If performance falls short of target, the regulated company should be required to report on the reasons for the shortfall and the plans in hand to correct matters. British Telecom commenced reporting under such a system in October 1987.

Public accountability on quality of service may be sufficient. However, financial incentives are more convincing, and regulators surely need to have plans for such incentives ready if not actually to apply them immediately. Under the British system, financial incentives could be introduced in at least three ways. One would be to link prices to quality-of-service statistics: price caps would be reduced if quality of service fell below target levels. A second possibility would be to require specified service levels to be attained as a licence condition; if the target levels were not met, financial penalties could then be applied for breach of licence conditions. A third possibility is to require the regulated company to accept some contractual liability to customers for quality of service. Contractual liability has the advantage that it leads to compensation of the customers who have suffered.

We have just introduced an arrangement under which British Telecom will accept contractual liability with effect from April 1, 1989. The liability will relate to provision of exchange lines and fault repair. It is limited in amount. In case of default, customers will be paid £5 per day in compensation unless British Telecom can show that it did all that a reasonable telephone company could have done. Higher amounts may be claimed up to a limit of £5,000 if losses can be proved. The amounts are low partly because of a wish not to put up prices as a consequence of the imposition of heavy costs. However, we believe that the incentive effect is likely to be strong, and we shall keep the working of the system under review, ready to seek an increase in the amount of compensation if it seems desirable.

I have not sought to apply the other methods of giving financial incentives to improve quality of service. They would add complexity to the regime, and present indications are that they are not needed. However, if quality of service were to deteriorate in the future, the complexity would be worth bearing, and I should not hesitate to seek the introduction of additional measures.

XII. CONCLUSION

Perhaps I can conclude by re-emphasising that we are pleased with the way price cap regulation is working in the UK. We believe we have set our controls at a level which gives British Telecom a tough challenge but also the opportunity to benefit from improvements in efficiency. Price cap regulation can make everyone concerned better off. One never knows what would have happened if an alternative system had been used, but the results of our present system are encouraging. British Telecom is making good profits, and the customer is receiving good protection. In the nine years following privatisation, price cap regulation will have reduced prices by at least 30 percent relative to inflation.

Things are also going well with quality of service. We have introduced arrangements for compensating customers for poor service which we believe to be unique worldwide. Actual quality of service is better than it has ever been. About 91 percent of faults are repaired within two working days, and British Telecom is on track to meet its target of repairing over 90 percent of business faults in five hours and residential faults in nine hours. Congestion of the network is at an all-time low, and operator response times are high. Customer satisfaction is also high. OFTEL conducted a survey recently in which customers were asked to rate service on a five-point scale. Eighty-three percent said that they were very satisfied with service or fairly satisfied with service—the top two points on the scale. As the difficulties of 1987 recede, it is now clear that we are not incurring any deterioration of quality of service because of our use of price cap regulation.

Summary of State Regulation©

State	Price Regulation	Earnings Regulation During Price Cap	Earnings Review as Condition of Price Cap	Earnings Deregulation by Statute
Alabama	Yes	No	No	No
Alaska	No	N/A	N/A	No
Arizona	No	N/A	N/A	No
Arkansas	Yes	No	No	Yes
California	Yes	Yes	N/A	No
Colorado	No	N/A	N/A	No
Connecticut	Yes	No	Yes	No
Delaware	Yes	No	No	Yes
District of Columbia	Yes	No	No	No
Florida	Yes	No	No	Yes
Georgia	Yes	No	No	Yes
Hawaii	No	N/A	N/A	No
Idaho	No	N/A	N/A	No
Illinois	Yes	No	Yes	No
Indiana	Yes	No	in litigation	No
Iowa	Yes	No	No	No
Kansas	Yes	No	No	Yes
Kentucky	Yes	No	No	No
Louisiana	Yes	No	No	No
Maine	Yes	No	Yes	Yes
Maryland	Yes	No	Yes	Yes
Massachusetts	Yes	No	No	No
Michigan	Yes	No	No	Yes
Minnesota	No	N/A	N/A	No
Mississippi	Yes	No	No	No
Missouri	Yes	No	No	Yes
Montana	No	N/A	N/A	No
Nebraska	Deregulated	No	No	Yes
Nevada	Yes	No	Yes	No
New Hampshire	No	N/A	N/A	No
New Jersey	Yes	No	No	Yes
New Mexico	No	N/A	No	Yes
New York	Yes	No	No	No
North Carolina	Yes	No	Yes	Yes
North Dakota	Yes	No	No	Yes
Ohio	Yes	No	Yes	No
Oklahoma	No	N/A	No	Yes
Oregon	Yes	No	No	Yes
Pennsylvania	Yes	No	No	No
Rhode Island	Yes	No	No	No
South Carolina	Yes	No	No	Yes
South Dakota	Yes	No	No	No
Tennessee	Yes	No	No	Yes
Texas	Yes	No	No	Yes
Utah	Yes	No	Yes*	Yes
Vermont	Yes	No	N/A	No
Virginia	Yes	No	No	No
Washington	No	N/A	N/A	No
West Virginia	Yes	No	No	No
Wisconsin	Yes	No	No	Yes
Wyoming	Yes	No	Yes	No
TOTAL YES/NO	Yes: 40	No: 39	No: 30	Yes: 21

N/A Not applicable.
*No follow-up review.

STRATEGIC
POLICY
RESEARCH

EXHIBIT
S-6
Admitted

Before the Arizona Corporation Commission

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN	)	DOCKET NO. T-1051B-99-105

Rebuttal Testimony Regarding Settlement Agreement

Harry M. Shooshan III

Strategic Policy Research, Inc.

November 20, 2000

7979 OLD GEORGETOWN ROAD 7TH FLOOR BETHESDA, MARYLAND 20814-2429
301-718-0111 FAX – 301-215-4033 EMAIL – spri-info@spri.com WEBSITE: www.spri.com

SUPPLEMENTAL REBUTTAL TESTIMONY OF HARRY M. SHOOSHAN III IN SUPPORT OF THE PROPOSED SETTLEMENT AGREEMENT

Q. **WHAT IS YOUR NAME AND OCCUPATION?**

A. My name is Harry M. Shooshan III. I am a principal in, and co-founder of, Strategic Policy Research, Inc. ("SPR"), an economics and public policy consulting firm located at 7979 Old Georgetown Road, Suite 700, Bethesda, Maryland.

Q. **HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?**

A. Yes. I filed Direct Testimony on August 9, 2000 and Surrebuttal Testimony on September 8, 2000 on behalf of Staff in which I proposed a price cap regulation plan for Qwest Corporation (formerly US WEST Communications, Inc.) in Arizona. Further, on October 27, 2000 I filed Direct Testimony in support of the Proposed Agreement ("Agreement") on behalf of Staff.

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

A. This testimony responds to criticisms of, and disagreements with, the proposed price cap plan raised by Intervenors' experts Dr. Lee Selwyn on behalf of AT&T, Dr. Ben Johnson on behalf of RUCO, and Dr. Francis Collins on behalf of Cox Arizona Telecom. In preparing this testimony, I have reviewed the comments filed by the Intervenors regarding the proposed Settlement Agreement. These comments encompass many dozens of pages. Out of these, I have attempted to distill the major substantive concerns and criticisms expressed by the Intervenors regarding the price cap plan portion of the Agreement. I respond to those concerns and criticisms in this Rebuttal Testimony.

Q. WOULD YOU PLEASE SUMMARIZE THOSE CONCERNS AND YOUR RESPONSES TO THE CONCERNS?

A. The issues that I address are those raised by these witnesses regarding the flexibility permitted for Basket 2 and Basket 3 services, as well as the potential for anti-competitive pricing by Qwest, under the terms of the proposed plan [Collins; Selwyn; Johnson Further Supplemental; Johnson Supplemental at 26-30]. I also respond to parties' criticisms of the agreed upon "X" factor [Selwyn at 13-24; Johnson Supplemental at 13-19]. I further respond to parties' testimony regarding the basket structure of the proposed price cap plan [Johnson Supplemental at 19-26]. Finally, I respond to Ms. Starr's and Dr. Selwyn's testimony regarding the adequacy of the $15 million per year reduction in access services for the three-year term of the plan [Starr at 7; Selwyn at 26-29].

As I describe in detail below, the concerns that Qwest could price anti-competitively under the terms of the plan are unfounded. The Agreement calls for services to be priced above TSLRIC. Further, imputation rules in Arizona will continue to be applied as they have been to ensure that no price squeeze occurs. The "X" factor in the plan, while developed and sponsored in my direct testimony, also reflects a compromise between the Company and the Staff, and is consistent with that adopted in other states, as I discussed in previous testimony [Shooshan Direct at 14]. The basket structure proposed in the plan separates basic/noncompetitive services from wholesale and competitive/flexibly-priced services, thereby preventing cross-subsidies as well as providing three degrees of pricing flexibility among retail services. While the agreed-upon reduction in intrastate access rates is less than my original recommendation, it is nonetheless a substantial movement in the right direction and represents one component of an Agreement that has sought to balance the interests of Qwest, its retail and wholesale customers, and competitors, and should be viewed in that light.

Q. HAVE ANY PARTIES FOUND THE TERMS OF THE PROPOSED AGREEMENT TO BE IN THE PUBLIC INTEREST?

A. Yes. On behalf of the U.S. Department of Defense and other Federal Executive Agencies ("DOD"/"FEA"), Richard Lee has testified that the Agreement does "strike an appropriate balance between the interests of Qwest and its ratepayers" [Lee at 3-4]. Mr. Lee astutely points out that the plan "appropriately places the burden on Qwest to realize the net revenue increase [from competitive services only] authorized under the Settlement Agreement" [Lee at 4]. It is important to keep these points in mind when reviewing the individual components of the Agreement.

1. RETAIL SERVICES BASKETS

Q. DR. JOHNSON AND DR. COLLINS CRITICIZE THE NUMBER OF RETAIL BASKETS IN THE PRICE CAP PLAN IN THE PROPOSED SETTLEMENT AGREEMENT AND RECOMMEND USE OF ADDITIONAL BASKETS [JOHNSON SUPPLEMENTAL TESTIMONY AT 19-23; COLLINS TESTIMONY AT 9-10]. DR. JOHNSON'S RECOMMENDATION ON BEHALF OF RUCO GOES THE FARTHEST. INSTEAD OF THE TWO RETAIL PRICE CAP BASKETS IN THE PRICE CAP PLAN IN THE PROPOSED SETTLEMENT AGREEMENT (BASKETS 1 AND 3), HE RECOMMENDS THAT FIVE BE USED: BASIC RESIDENCE, BASIC BUSINESS, DISCRETIONARY, EMERGING COMPETITIVE, FULLY COMPETITIVE. DR. COLLINS, TESTIFYING ON BEHALF OF COX ARIZONA TELECOM, RECOMMENDS REPLACING THE TWO BASKETS 1 AND 3 WITH THREE BASKETS: BASIC/ESSENTIAL NON-COMPETITIVE SERVICES, EMERGING COMPETITIVE SERVICES, AND FLEXIBLY-PRICED COMPETITIVE SERVICES. HOW WOULD YOU RESPOND?

A. Let me first address the question of the number of baskets for retail services. The Commission's rules provide for two classifications of retail services: non-competitive and competitive. The price cap plan in the proposed Settlement Agreement takes advantage of that existing framework. At the inception of the plan, Basket 3 includes only those services that have been afforded pricing flexibility or have been determined by the Commission to be competitive under the criteria set forth in A.A.C. R14-2-1108. A Basket 1 service may move to Basket 3 upon Qwest meeting those same criteria. By urging the use of additional retail baskets, Intervenors are, in effect, asking the Commission to change its policies regarding service classifications in the course of a rate case. In my opinion, such a change is both inappropriate and unnecessary. If Intervenors want the Commission to change its rules, they should enter through the front door with a petition for rulemaking and not through the back door of amending the Agreement. Moreover, it is unclear to me how placing additional pricing constraints on Qwest beyond those that exist today will advance competition. There is no evidence that I have seen to suggest the Commission's current rules have failed to advance competition or to protect consumers.

Dr. Johnson's proposal to have separate baskets for residential and business services would also add unnecessary complexity to the price cap plan. Dr. Johnson seems motivated, as the Staff has been, to provide additional protection for residence customers. To this end, Dr. Johnson's recommends three degrees of pricing flexibility, which the proposed plan in fact contains, but not in the specific form recommended by Dr. Johnson, which does not comport with Arizona classification of services. The proposed price cap plan provides protection by providing the least flexibility for a number of "basic" services that are subject to a "hard cap." These services include: flat rate residential, flat rate business, 2 & 4 party service, exchange zone increment charges, low use option service, service stations service, telephone assistance programs, and individual PBX trunks including features. The Agreement caps prices for these services at their levels going into the plan without an adjustment for inflation during the three-year term of the plan. Consequently, there is no opportunity under the terms of the proposed settlement for Qwest to increase residential flat rate service while lowering a business service rate. With this vital protection in place, I believe it is important to give Qwest at least some limited ability to adjust prices between residence and business services in Basket 1, which is the next degree of pricing flexibility in the proposed plan. Qwest has the greatest pricing flexibility for services in Basket 3 which are, initially, those services for which Qwest has **already been granted** pricing flexibility. Maintaining this flexibility for services in Basket 3 is important if we are to reach a point where, over time, prices are realigned to reflect more closely the results that would be obtained in a competitive marketplace. That is, after all, the primary goal of regulation.

Finally, Dr. Johnson seems to be missing a key point. The Agreement seeks to move Arizona in line with the vast majority of states that are regulating by direct controls on prices rather than by indirect controls on earnings. By focusing regulation instead on what we really care about—the prices charged to basic telephone customers who today may only be beginning to have alternatives—and doing this by capping directly the prices of basic services, the Commission will be providing consumers and competitors with very real and effective protection against making basic telephone customers bear the risk for Qwest's attempts to compete elsewhere.

2. WHOLESALE SERVICES BASKET

Q. WHILE APPARENTLY SUPPORTING THE CONCEPT OF PLACING WHOLESALE SERVICES IN A SEPARATE BASKET, RUCO AND AT&T HAVE BOTH EXPRESSED CONCERN ABOUT HOW THE WHOLESALE SERVICES BASKET WOULD WORK [JOHNSON SUPPLEMENTAL TESTIMONY AT 19, 23; SELWYN SUPPLEMENTAL DIRECT TESTIMONY AT 22, 30-34]. HOW WOULD YOU RESPOND TO THEIR CONCERNS?

A. While I am pleased that they support the concept of a wholesale basket as I recommended in my initial testimony, I believe Intervenors misunderstand how the pricing of services is Basket 2 would be handled. Wholesale prices are set today according to specific pricing rules (both federal and state) and prior decisions by the Commission. The price cap plan explicitly states that these services will continue to be governed by such rules and decisions. In effect, each wholesale service is within its own "sub-basket" and changes to the price of any wholesale service would come only after a determination by the Commission. The exception to this rule is that intrastate switched access rates are to be reduced by $5 million a year for each of the three years. However, the "headroom" created by these reductions is provided in Basket 3, rather than Basket 2. This prevents an outcome where Qwest would reduce access charges but increase rates for UNEs, for example. It is for this reason that there is ~~no~~ price index for Basket 2. Qwest is given no automatic discretion to change the price for any component of this basket. The price cap plan includes no mechanism that would permit an increase in any Basket 2 service to offset a price decrease in either a Basket 1 or a Basket 3 service. The price cap plan further provides no mechanism for offsetting price changes among the services within Basket 2.

The Agreement leaves existing pricing rules and prices in place for all wholesale services. If competitors seek changes in such rules or prices, they can still proceed under the mechanisms available to them today.

3. BASKET 3 PRICING FLEXIBILITY

Q. RUCO'S WITNESS DR. JOHNSON EXPRESSED CONCERN ABOUT THE POTENTIAL INCREASE IN BASKET 3 RATES [JOHNSON SUPPLEMENTAL TESTIMONY AT 12-13]. HOW WOULD YOU RESPOND TO THIS CONCERN?

A. It is important to keep in mind that the only services initially in Basket 3 are those services that have been afforded pricing flexibility or have been determined by the Commission to be competitive. Because of the competitive nature of these services, it is highly unlikely that the scenario that Dr. Johnson suggests would take place, namely, dramatic increases in individual service prices, perhaps by as much as ten-fold, or more. Simply put, Qwest will find it very difficult—at least in the long run—to sustain price increases on Basket 3 services that are out of line with marketplace conditions, unless it wants to lose customers. In its classification decisions, the Commission has, in effect, determined that competitive marketplace forces are sufficiently strong for these services to provide a reasonable check on Qwest's pricing. The Commission will continue to use the same criteria in any reclassification decision that involves moving a Basket 1 service to Basket 3.

Q. RUCO'S WITNESS DR. JOHNSON CRITICIZED THE PROPOSED SETTLEMENT AGREEMENT AS "FATALLY FLAWED, BECAUSE IT DOESN'T CONTEMPLATE THE POSSIBILITY THAT A NEW SERVICE OR SERVICE PACKAGE MIGHT MORE APPROPRIATELY BE CLASSIFIED AS NON-COMPETITIVE. JUST BECAUSE SOMETHING IS NEW DOESN'T AUTOMATICALLY ENSURE THAT COMPETITIVE ALTERNATIVES EXIST . . ." [JOHNSON SUPPLEMENTAL TESTIMONY AT 25]. HOW WOULD YOU RESPOND?

A. What Dr. Johnson is proposing runs contrary to consumers' interests. Putting truly new services in Basket 3 ensures that Qwest bears the risk for the success or failure of the new service, not basic telephone consumers. Part of what bearing the risk means is that Qwest decides what to charge and, thus, is in control of the success or failure of the new service. This greatly improves the incentives for Qwest to offer a variety of new services in a way that benefits consumers. Either it offers a new service that consumers embrace, and it is rewarded; or it fails to do so and its shareholders incur a loss. The Commission should understand that these beneficial incentives are created only by changing the way that current regulation treats new services, not by perpetuating the current system. In addition, the Agreement requires Qwest to submit any new service that it intends to offer in Basket 3 for review by the Commission at least thirty days in advance. The Commission will consider such a submission as provided in A.R.S. Sec. 40-250. This process will ensure that the appropriate requirements governing Basket 3 services have been met [see Attachment A (4) (a) & (e) to the Agreement]. Finally, it should be noted that the Agreement clearly states that "[t]he mere repackaging of existing Basket 1 services does not qualify existing services to be 'new services'" [see Attachment A (4) (e) (ii) to the Agreement].

Q. COX'S WITNESS DR. COLLINS ADVOCATES THAT "THE BASKET 1 SERVICES SHOULD CARRY THEIR BASKET 1 PRICE INTO THE BASKET 3 PACKAGE AND NOT THEIR TSLRIC" [COLLINS TESTIMONY AT 5]. WHAT IS YOUR RESPONSE TO THIS?

A. Dr. Collins' recommendation would actually serve to reduce competition. The very purpose of providing Qwest with additional freedom—and incentives—to offer packages and bundles of services is to permit Qwest to compete more effectively against companies such as Cox that are marketing such packages extensively. Presumably, a customer who decides to purchase a Qwest package would expect—and should receive—a discount below the "*à la carte*" prices of the individual services. As long as the package covers the TSLRIC of the services included, competitors are protected. The Agreement makes one exception to this "rule" in providing that Qwest impute the existing price of 1FR service in meeting the imputation test for any Basket 3 package that contains 1FR or its equivalent. Otherwise, as the Agreement makes clear, the Commission's existing rules which prohibit cross-subsidization of competitive services by non-competitive services and its imputation rules continue to apply and are unchanged by the price cap plan [see Attachment A (3) (g), (4) (l) to the Agreement].

Q. IN DR. JOHNSON'S LATE-FILED FURTHER SUPPLEMENTAL TESTIMONY, HE EXPRESSES THE CONCERN THAT THE PROPOSED SETTLEMENT AGREEMENT WOULD SOMEHOW WEAKEN THE COMMISSION'S SAFEGUARDS AGAINST ANTI-COMPETITIVE UNDERPRICING [JOHNSON FURTHER SUPPLEMENTAL TESTIMONY AT 2-4]. HOW WOULD YOU RESPOND TO THAT CONCERN?

A. Dr. Johnson seems to have not closely read—or perhaps simply misunderstands—the clear language of the Agreement. The Agreement preserves existing Commission rules that bar anti-competitive pricing and cross-subsidy. The Agreement, as I noted earlier, explicitly states that existing imputation rules remain in place and are not waived or overridden by the Agreement. The various hypothetical harms or theoretical problems conjured up by Dr. Johnson have no basis in fact.

Q. AT&T'S WITNESS DR. SELWYN IS CRITICAL OF THE PRICING FLEXIBILITY AFFORDED BASKET 3 SERVICES, RAISING THE POSSIBILITY OF "A CROSS-SUBSIDY FLOWING FROM NON- OR MINIMALLY-COMPETITIVE BASKET 3 SERVICES TO ACTUALLY COMPETITIVE BASKET 3 SERVICES . . ." [SELWYN SUPPLEMENTAL DIRECT TESTIMONY AT 34]. WHAT IS YOUR RESPONSE?

A. First, Dr. Selwyn's scenario seems to imply that the Commission has mistakenly classified some service or services as competitive. I do not accept this premise. Moreover, Dr. Selwyn, offers no specifics to support his hypothetical concerns. Second, with regard to Basket 3 services, Qwest would be in approximately the same position as AT&T (or any other competitive firm, for that matter). Qwest would not have any greater incentive than any competitive firm would to subsidize any particular Basket 3 service. Furthermore, the proposed plan includes specific safeguards against anti-competitive pricing by Qwest. These important safeguards include separate baskets which seek to divide basic/noncompetitive services, wholesale services, and competitive/flexibly-priced services, as well as the "hard cap" on basic services in Basket 1. Together, they prevent Qwest from financing a subsidy by raising a basic telephone service price. Further, the TSLRIC price floor for Basket 3 services is the subsidy safeguard within Basket 3. Also, as I testified above, the imputation rules in Arizona remain in place as a further safeguard against a price squeeze. The goal of establishing Basket 3 as proposed is to provide Qwest with the same opportunity that other firms in the competitive economy have to set their prices in response to conditions in the market, rather than based on arbitrary allocations of costs.

Q. AT&T'S WITNESS DR. SELWYN IS CRITICAL OF THE PRODUCTIVITY OFFSET FOR BASKET 1 IN THE PROPOSED SETTLEMENT AGREEMENT, CLAIMING THAT A PRODUCTIVITY OFFSET LESS THAN THE X-FACTOR USED BY THE FCC WOULD RESULT IN A "WINDFALL GAIN FOR QWEST" [SELWYN SUPPLEMENTAL DIRECT TESTIMONY AT 7]. HE IS ALSO CRITICAL OF THE ANALYSIS UPON WHICH THE 4.2 PERCENT PRODUCTIVITY FACTOR IN THE PROPOSED SETTLEMENT AGREEMENT IS BASED [SELWYN SUPPLEMENTAL DIRECT TESTIMONY AT 9-15]. HOW DO YOU RESPOND TO THIS?

A. The 4.2 percent productivity factor in the proposed Settlement Agreement must be seen in the context of the other elements of the formula. For example, the inflation minus productivity calculation is capped at zero and has no lower bound. This is a significant concession by the company in that it has accepted the risk of inflation for the term of the price cap plan. In this aspect, the proposed Settlement Agreement formula is quite different—and more constraining—than that used by the FCC or other states that allow an increase should inflation outstrip productivity.

The Staff recommendation of a 4.2 percent productivity factor came from an analysis of the only available Arizona-specific information on Qwest's productivity. As I discussed in my previous Direct and Surrebuttal Testimonies, we relied on the most relevant data available to us, which was intrastate data from Qwest from 1988 to 1998. We did not rely on unseparated data because the accounting rules differed between the FCC and this Commission, and, therefore, the data would not be consistent for use in an Arizona proceeding regarding regulation of intrastate services. While the use of revenue and cost data may be rough approximations for the units of input and output, it is important to recognize that the development of a TFP is a significant undertaking, as I described in my Surrebuttal Testimony. A variety of calculation methods for the "X" factor have been employed across the states engaged in price cap regulation. Those methods have included intra-state, company-specific data such as I have relied upon here [Shooshan Direct at 13-14; Shooshan Surrebuttal at 7-9]. We obtained results consistent with the productivity adjustments used in other states, as shown here in Attachment A.

As I noted previously, the Staff's initial recommendation of a 4.2 percent productivity factor was further based on an analysis of the productivity factors used by other state regulators [Shooshan Direct at 14]. My analysis concluded that a 3.7 percent productivity factor, coupled with a 0.5 percent consumer dividend, was very much in line with the practices of other state regulators.

This productivity factor ensures that consumers receive at least as much benefit of Qwest's increased productivity as has occurred under rate-of-return, plus the 0.5 percent consumer productivity dividend. Further, consumers will not bear the impact of inflation that exceeds productivity. While other parties may seek a higher productivity factor, we have not found evidence to support such a factor. Finally, the context of the Settlement Agreement as a whole is important for evaluation of the productivity offset.

Q. MS. STARR, ON BEHALF OF AT&T, HAS TESTIFIED THAT THE PROPOSED REDUCTIONS IN QWEST'S INTRASTATE ACCESS RATES ARE INADEQUATE AND LESS THAN YOUR ORIGINAL RECOMMENDATION [STARR AT 7]. HOW SHOULD THE AGREED-UPON RATE REDUCTION BE VIEWED?

A. While Ms. Starr is correct that I proposed a more accelerated reduction in the price of intrastate carrier access, the reductions contained in the proposed settlement are reasonable when viewed within the overall framework of the Agreement. In a number of respects, Qwest has accepted constraints that go beyond what I proposed in my testimony in August. For example, under the proposed price cap plan, Qwest would assume all of the risk of inflation for services in Basket 1. This provides a very important protection for both residence and business customers and ensures that overall prices for services in that basket will decline in real terms over the three-year term of the plan. Further, Qwest has agreed to a cap on Basket 3 services as a whole which does not today apply to Qwest services that have been accorded pricing flexibility today. It is important to keep in mind that the Settlement Agreement represents the balancing of a variety of interests among Qwest and its diverse customer groups. The objectives of the Settlement Agreement extend beyond meeting the interests of the long-distance carriers.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes.

Average of Productivity Adjustments Across States

State	Productivity Adjustment
California Pac Bell	5%
California GTE	4.80%
California Others	4%
Connecticut	5%
Delaware	3%
Wash DC	3%
Florida	1%
Georgia	3%
Illinois	4.30%
Iowa	2.60%
Kentucky	4%
Maine	4.50%
Massachusetts	4.10%
Michigan	1%
New Jersey	2%
New York Bell Atlantic	4%
New York Frontier	3.25%
North Carolina Basic	2%
North Carolina Other Svc	3%
Ohio	3%
Pennsylvania	2.93%
South Carolina	2.10%
Tennessee	2%
Wisconsin	3%
Average Among States	**3.2%**

J. Abel and Michael E. Clements, "A Time Series and Cross-Sectional Classification of State Regulatory Policy Adopted for Local Exchange Carriers," Divestiture to Present (1984-1998), National Regulatory Research Institute (December 1998).

EXHIBIT
S-9

BEFORE THE

ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION	)
OF US WEST COMMUNICATIONS, INC. A	)
COLORADO CORPORATION, FOR A	)
HEARING TO DETERMINE THE EARNINGS	) DOCKET NO. T-01051B-99-0105
OF THE COMPANY FOR RATEMAKING	)
PURPOSES, TO FIX A JUST AND	)
REASONABLE RATE OF RETURN THEREON	)
AND TO APPROVE RATE SCHEDULES	)

DIRECT TESTIMONY AND SCHEDULES

ON RATE DESIGN ISSUES

OF

WILLIAM DUNKEL

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

AUGUST, 2000

NOTICE: INFORMATION CLAIMED TO BE PROPRIETARY BY USWC HAS BEEN DELETED FROM THIS TESTIMONY. THROUGHOUT THIS TESTIMONY, PROPRIETARY INFORMATION IS DESIGNATED AS FOLLOWS: **PROPRIETARY**

TABLE OF CONTENTS
RATE DESIGN DIRECT TESTIMONY OF
WILLIAM DUNKEL
DOCKET NO. T-01051B-99-0105

TABLE OF CONTENTS (CONT.)

RATE DESIGN DIRECT TESTIMONY OF
WILLIAM DUNKEL
DOCKET NO. T-01051B-99-0105

PAGE

TABLE OF CONTENTS
RATE DESIGN DIRECT TESTIMONY OF
WILLIAM DUNKEL
DOCKET NO. T-01051B-99-0105

PAGE

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND YOUR BUSINESS ADDRESS.

A. My name is William Dunkel. My business address is 8625 Farmington Cemetery Road, Pleasant Plains, Illinois 62677.

Q. ARE YOU THE SAME WILLIAM DUNKEL WHO IS FILING TESTIMONY AND SCHEDULES ADDRESSING CERTAIN MODERNIZATION, DEPRECIATION, AND RECONSTRUCTION COST NEW LESS DEPRECIATION (RCNLD) ISSUES IN THIS SAME PROCEEDING?

A. Yes. My qualifications are included in that testimony.

Q. CAN YOU PLEASE SUMMARIZE YOUR TESTIMONY?

A. Yes. Below is a summary of my testimony.

1. When utilities face competition in limited areas, they will attempt to charge very low rates in the competitive areas, while charging much higher rates in other areas. It is this discriminatory pattern of rates in response to competition, that was the original reason the regulation of utilities began. This rate pattern is a natural reaction by a utility to competition in limited areas or for limited services. This pricing pattern is in the Company's interest, but it is anti-competitive, discriminatory, and not in the public interest.

2. Through its "competitive zone" proposal in this proceeding, USWC is attempting to implement the same type of pricing strategies that originally prompted the regulation of the railroad industry over a century ago. USWC should not be allowed to freely price discriminate and to use that freedom to impede the emerging competition.

3. Allowing USWC to price lower where there is competition while pricing higher where there is not competition would effectively load a higher share of the joint and common costs onto the monopoly ratepayers, while loading a lower share of those joint and common costs onto the prices of competitive services. This is

contrary to the requirements of Section 254(k), which specifically prohibits this type of price discrimination.

4. USWC's proposal to automatically classify any new service offerings as competitive should be rejected. To be deemed truly competitive, new services should have to pass the same competitive test that other services must pass. In addition, if a "new" service includes a service that is currently not classified as competitive, that "new" service clearly cannot be classified as competitive.

5. I recommend that the Commission deny the USWC "competitive zone" proposal. I recommend that whatever regulatory structure is adopted, include a requirement that prices in different geographic areas may not vary by an amount that is greater than the variation that is justified by any variation in the cost of providing service. If the regulatory structure allows price flexibility or "revenue neutral" restructuring, any such restructure may not increase the rate differential between geographic areas that is incorporated in the specifically approved ACC rates, without specific Commission approval.

6. USWC's "competitive zone" proposal is not supported by the evidence that the Commission rules require it to provide to show a service or area is competitive. Many of the services in many areas that USWC considers to be competitive will not meet the requirements of the Commission rule, and are not competitive by standard criteria.

7. The wire centers that USWC proposes be immediately classified as "competitive zones" for business services are the wire centers that serve ** ** of USWC's total business access lines, and produce ** ** of USWC's total business revenue in the State of Arizona. The residential "competitive" zones that USWC proposes be immediately established cover over ** ** of USWC's residential lines in service in Arizona.

8. Under USWC's "competitive zone" proposal, USWC could increase its rates as much as it wanted to, up to double the current rates, and up to $19.00 for Residential Basic Exchange Service. Even in areas where it has significant monopoly power, the approval of this concept would allow the Company to as much as double most of its current rates.

9. The data that USWC has provided in this proceeding indicates that fewer than ** ** of the residential lines in service have been ported in the 23 wire centers that USWC proposes be immediately established as residential "competitive zones".

10. The data USWC provided shows that USWC has "lost" only about ** ** of the business lines, and is serving ** ** of the business lines, even within the 49 wire centers that USWC proposes be immediately established as "competitive zones".

11. Under unbundled network element competition, the underlying facilities used to provide the services are still owned and operated by USWC, and the competitors merely rent the facilities owned by USWC. Therefore, competition using unbundled loops, to the small extent that it even exists in Arizona is not really effective competition to USWC.

12. The level of resale competition in Arizona does not put pressure on USWC's retail rates. USWC's wholesale rate is USWC's retail rate less a certain percent for avoided costs. Therefore, USWC's wholesale rates are automatically adjusted to reflect any changes in the retail rates.

13. Resale competition is actually only competition for the marketing and billing/collection for a service. Under resale competition, competitors are merely reselling the services that are provided by USWC. The actual service is provided by USWC using the facilities that are owned and operated by USWC.

14. Wireless and cellular service are not a practical alternative to USWC's residential basic exchange service. USWC's 1FR Residential Basic Exchange rate is $13.18. A wireless rate plan with the comparable number of usage minutes would cost abo~~ut~~ $49.99 per month.

15. Despite the fact that wireless service has been around for many years now, USWC continues to serve an ever-increasing number of access lines in Arizona. USWC's own forecast projections show that its lines in service will continue to grow in the future.

16. The standard definition of TSLRIC dictates that any costs that would not be eliminated if the service in question is eliminated or discontinues, while continuing to provide all other services, is not properly included in the definition of TSLRIC. The loop facilities would not be eliminated if basic exchange service was discontinued, while all other services were still being offered. Therefore, the loop cost is not part of the properly calculated TSLRIC using the standard definition of TSLRIC.

17. USWC's claims that residential basic exchange service is priced below cost, is being subsidized, or is in need of support, are all based upon residential basic exchange service TSLRIC costs that improperly include 100% of the loop facility costs, in spite of the fact that basic exchange service is only one of the services that shares the loop facility. Therefore, USWC's claimed TSLRIC costs of basic exchange service are in direct violation of standard TSLRIC costing principles.

18. USWC places other shared costs, such as the cost of the standard sized envelope and first unit of postage used to send that bill, entirely in the TSLRIC of basic exchange service. Despite the fact that the first unit of postage and the billing envelope are costs of billing services other than basic exchange service (e.g. toll,

vertical services, etc.,), USWC improperly places 100% of these shared costs in its claimed TSLRIC of basic exchange service. USWC includes none of the standard envelope or first unit of postage cost in its TSLRIC of toll services, or other non-basic services.

19. USWC's violation of the TSLRIC definition was "selective." Although USWC violated the definition of TSLRIC for residential basic exchange service, USWC did not make that violation when it calculated its claimed TSLRIC costs of toll and switched access services. When calculating the TSLRIC of toll and switched access services, USWC properly excluded the loop costs, since the loop costs would not be avoided if one of these services were discontinued while holding all other products or services offered by the firm constant.

20. The properly calculated TSLRIC of residential basic exchange service is ** ** per month for USWC. Determining the TSLRIC is important because the TSLRIC is generally accepted as being the "floor" for a proper price. TSLRIC is also the standard for determining whether a service is <u>receiving</u> a subsidy. As USWC admitted in this proceeding, a service is not receiving a subsidy if that service is priced equal to or above its properly calculated TSLRIC.

21. The result of this selective violation of the TSLRIC definition by USWC is to distort beyond recognition the actual contributions from each of the different services. When the TSLRIC costs are properly and consistently calculated across all services, it is found that residential basic exchange services provides the most per-line contribution above TSLRIC of any service that shares the residential loop facilities.

22. The current residential basic exchange service rates alone provide an average of ** ** per line, per month in contribution above TSLRIC toward the shared, joint and common costs of USWC in Arizona. This is more contribution above TSLRIC than any other service which shares the residential loop facilities.

23. Residential basic exchange service alone provides approximately ** ** the per-line contribution that USWC's intrastate switched access provides, and over ** ** the per-line contribution that USWC's intrastate toll services provide toward the shared, joint and common costs of USWC in Arizona.

24. The unbundled loop rate that the Commission approved for USWC is $21.98. Under the FCC's Part 36 Separations requirements, 25% of the loop costs are allocated to the interstate jurisdiction and recovered in interstate rates. Therefore, the intrastate portion of the loop rate is $16.49 per month. The contribution above TSLRIC provided by residential local services alone (including charges for basic exchange service and vertical services) is ** ** per line, per-month. Therefore, the contribution from residential local services alone covers over ** ** of the intrastate portion of the unbundled loop rate the Commission has established for USWC in Arizona.

25. In addition to local contributions, residential basic exchange subscribers pay an additional ** ** per line, per month for the interstate EUCL charge (average of primary and additional line EUCL rate) that residential end users also must pay in order to obtain basic exchange service.

26. Residential basic exchange service is currently contributing more toward the recovery of the joint, shared and common costs of providing telecommunications services in Arizona than is toll, switched access, or even vertical services.

27. USWC's inclusion of 100% of the loop cost on residential basic exchange service (while placing none of it on the other services that share the loop facilities) violates the requirements and findings of the TA96, the FCC, the Supreme Court, and the Commissions in the vast majority of other states.

28. Under the FCC's Separations Rules, 25% of the loop facility costs are allocated to the interstate jurisdiction, and are recovered in interstate rates. Therefore, if rates were to be based upon USWC's cost study that includes 100% of the loop facility costs in its claimed cost of intrastate services, those rates would result in a double-recovery of the interstate portion of the loop facility costs.

29. The Staff proposed rates are just and reasonable, and are in the public interest. Staff's proposed rates balance the numerous criteria that must be considered when establishing telephone service rates. Staff recommends the rates shown on Schedule WDA-20 be adopted.

II. USWC'S COMPETITIVE ZONE PROPSAL

A. IT IS IN A UTILITIES' FINANCIAL INTEREST TO IMPROPERLY PRICE DISCRIMINATE WHEN FACED WITH COMPETITION IN A LIMITED AREA

Q. WHAT REACTION IS IN A UTILITY'S SELF-INTEREST WHEN IT HAS MONOPOLY POWER IN SOME AREAS, BUT FACES COMPETITION IN OTHER AREAS?

A. In such a circumstance, it is in a utility's self-interest to charge lower prices where it faces competition, while charging higher prices where it has monopoly power. In fact, the utilities' reaction to such a situation is one of the factors that gave rise to the regulation of utilities.[1] For example, in the old days before railroads were regulated:

> Customers shipping goods from Chicago to New York always pick the route that offers even a few pennies saving. Thus, each of the three or four trunk lines would intermittently undercut the existing rate schedules, until finally a disastrously low level of rates was reached. At the same time, for short hauls where shippers had no alternative, the railroads would jack up the rates, thus creating an anomalous, discriminatory pattern of charges. We have seen that the Interstate Commerce Commission was established in 1887 to regulate railroad rates and earnings and prevent such unstable price conditions.[2]

As the above quotation indicates, one of the reason utility rates are regulated is because when faced with competition in some areas, the utilities will charge low rates where they have competition, but higher rates where they have little or no competition. This improper discrimination is a natural "self-interest" reaction by a utility to competition in limited areas or for limited services.

Discriminating based upon the level of competition is in the utilities' self-interest, but it is not in the public interest. The prevention of this type of undue price discrimination is one of the reasons that utilities are regulated, either by traditional regulation or by alternative regulation.

Q. WHY IS DISRIMINATION BASED UPON THE LEVEL OF COMPETITION FOR A REGULATED MONOPOLY IMPROPER?

A. If this is allowed, it has two adverse effects:. (1) It discourages the growth of competition, and (2) it allows the extraction of monopoly profits where the company has

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[1] These concepts generally apply to both "traditional" regulation as well as alternative regulation.
[2]Page 499, Economics, An Introductory Analysis by Paul A. Samuelson.

monopoly power. Both of these effects are in the company interest, but not in the public interest. For example, assume two areas are identical except that there is competition in one area and not in the other. If a company charges $20 per month for a particular service in the non-competitive area, but charges $10 per month for that same service in a competitive area, that is improper. If $10 per month is the fair rate where competition exists, there is no valid reason for the rate to be higher in the other areas where competition does not exist. In fact, one of the standard goals of regulation is to establish rates for monopoly services that are similar to the rates that would exist if competition existed. Allowing such discriminatory pricing clearly violates that concept. In addition, this type of pricing discourages competition. Companies, including the competitors, have joint and common costs that must be recovered in addition to their incremental or direct costs. Therefore, for a company to be profitable, it must be able to price its services not only to cover its "direct" (incremental) costs, but to cover its common costs as well.

Assume, for example, that a company must price a service at $15 in order to recover both its incremental and its joint and common costs. In the above example, the LEC would be recovering its common costs, because it is recovering more than a reasonable share of the common costs from the monopoly customers, while failing to recover a reasonable share of the common costs from the customers in the competitive areas. However, the competitor must also recover a total of $15 per service, but they cannot do so in the competitive areas, because they are facing a low "competitive" LEC price of $10. Therefore, the competitors lose money, and that discourages other competitors.

It should be noted that the high "monopoly" rate of $20 in this example will not attract competitors, because the competitors by experience will know that the utility would reduce the rate in that area to a low "competitive" rate if the competitor started doing business in that area. Therefore, if the LEC was charging the "non-competitive" $20 rate, as soon as the competitor started doing business, the LEC would cut the rate to the "competitive" $10 rate in this example. Therefore, the competitors would soon learn that the profitable rates would not be available for them to compete against.

Q. DOES USWC PROPOSE TO IMPROPERLY PRICE DISRIMINATE IN THIS PROCEEDING?

A. Yes. USWC has proposed a "competitive zone" proposal in which a significant portion of USWC customers would be deemed to be in competitive zones. USWC could establish rates and charges without Commission approval, within very broad maximum and minimum levels.

In his testimony, Mr. Teitzel states the following:

> Offerings and prices may vary between competitive zones. With this flexibility, U S WEST will be able to effectively respond to customer and market demands in the areas subject to competition.[3]

In short, USWC's competitive zone proposal would give USWC the freedom to improperly discriminate based upon the level of competition. This is in USWC's interest, but is not in the public interest, and should be rejected.

[3]Teitzel Direct, Page 19.

Q. DOES USWC'S OWN INTERNAL STUDIES INDICATE THAT **

**?

A. Yes. USWC's own internal study conducted by the U S WEST Consumer Services Group states:

> **
>
> .**[4]

USWC recognizes that it is in their interest to see that the existing competitors are not successful, so as to not encourage additional competitors. Under their proposal, USWC would have the price flexibility to discriminatorily price services in limited geographic areas so that USWC could help assure that competitors were not successful.

Q. CAN YOU GIVE AN EXAMPLE OF HOW USWC COULD USE THE PRICING FLEXIBILITY BASED UPON THE "MARKET DEMANDS" TO IMPROPERLY DISCOURAGE COMPETITION WHILE CHARGING MUCH HIGHER RATES IN AREAS THAT ARE OTHERWISE SIMILAR EXCEPT FOR THE LEVEL OF COMPETITION?

A. Yes. In limited geographic areas where it offers services, Cox Communications[5] offers residential basic exchange service at $11.75 per month to its cable subscribers.[6] USWC's

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[4] U S WEST Consumer Services Group, Cox, October 13, 1998, page 4. This study was provided by USWC in response to Data Request RUC6-6, Attachment C.

[5] Cox offers residential basic exchange service at $13.00 per month to customers who are not its cable subscribers. (Teitzel Direct, Exhibit DLT-9)

current rate of $13.18 is already over 12% higher than the $11.75 rate being offered by Cox. USWC's proposed rate for residential basic exchange service of $15.68 is over 33% higher than the rate that is currently being offered by COX.[7] Even USWC's proposed residential basic exchange rate of $13.93 for Lifeline service is over 18% higher than the $11.75 rate that is currently being offered by Cox.[8] Under the "competitive zone" proposal, USWC could choose to underprice the Cox rate in those zones in which Cox competes. This would discourage competitors. As will be discussed later, the criteria needed to establish a "competitive zone" does not ensure that competition actually exists. In the other so-called "competitive" zones where effective competition does not exist, USWC is proposing that it be allowed to charge any residential basic exchange rate it wanted to, up to a maximum of $19.00.[9] Discriminatory pricing is in USWC's interest, in that it would discourage competition and at the same time extract monopoly profits where monopoly power exists, but it is not in the public interest.

Q. WHAT DO YOU RECOMMEND ON THIS ISSUE?

A. I recommend that the Commission deny the USWC "competitive zone" proposal. I recommend that whatever regulatory structure is adopted, include a requirement that prices in different geographic areas may not vary by an amount that is greater than the variation that is justified by any variation in the cost of providing service. If the

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[6] However, in the wire centers where USWC wants to be granted "pricing flexibility", USWC is asking for the Commission to allow USWC to raise its residential basic exchange rates up to $19.00 per month.
[7]On page 29, line 2 of his Direct Testimony, Mr. Teitzel indicates that USWC's proposed rate for flat rate residential basic exchange service is $15.68 per month. ($15.68 - $11.75) / $11.75 = 33.45%.

[8]On page 28 of his Direct, Mr. Teitzel indicates that USWC's proposed flat one party rate for Lifeline is $13.93 per month.

[9] Teitzel Direct, page 18.

regulatory structure allows price flexibility or "revenue neutral" restructuring, any such restructure may not increase the rate differential between geographic areas that is incorporated in the specifically approved ACC rates, without specific Commission approval.

Q. YOU PREVIOUSLY DISCUSSED USWC BEING ABLE TO CHARGE HIGHER PRICES IN ZONES THAT HAD BEEN DESIGNATED AS "COMPETITIVE", BUT WHERE USWC ACTUALLY DID NOT FACE EFFECTIVE COMPETITION. IS THAT POSSIBLE UNDER USWC'S PROPOSAL?

A. Yes. If a competitor offers even one residential service in that zone, then all residential services are deemed competitive. This means a service could be deemed "competitive" even if there is no competitor providing a competitive service in that zone. Likewise, if a competitor offers even one business service in that zone, then all business services are deemed competitive. As Mr. Teitzel states in his testimony,

> Once an area is designated as a competitive zone, all services offered by U S WEST will be afforded the flexibility outlined above.[10] (Emphasis added)
>
> Of course, it is very likely there will be competition for both residence and business customers in a certain competitive zone, in which case all of U S WEST's product family will be afforded flexibility.[11] (Emphasis added)

In addition, all wholesale services within a competitive zone would be afforded flexibility under the USWC proposal. As Dr. Wilcox states in her Direct Testimony:

[10] Teitzel Direct, Page 19, lines 20-21.

[11] Teitzel Direct, page 19, lines 34-36.

> U S WEST is requesting pricing flexibility for finished wholesale services in all of the wire centers listed by Mr. Teitzel as being competitive. Competition for both residence and business local exchange service has direct impact on switched access, as well as other finished wholesale services. Therefore, U S WEST's proposal is that any wire center that is declared competitive for either residence or business services also is declared competitive for finished wholesale.[12]

Under USWC's proposed criteria, all USWC must do is demonstrate that there is some company that is at least offering one service that is competing with a USWC service. After that, USWC would be granted pricing flexibility on a host of other services, even if there is no alternative provider offering those services.

B. THE SO-CALLED "COMPETITIVE ZONES" HAVE NOT BEEN DEMONSTRATED TO BE COMPETITIVE, AND THEY ARE NOT COMPETITIVE BY ACCEPTED CRITERIA.

Q. MR. TEITZEL PROPOSES TO CLASSIFY CERTAIN WIRE CENTERS AS "COMPETITIVE ZONES". MR. TEITZEL STATES "THE PRESENCE OF SIGNIFICANT COMPETITION IN THESE WIRE CENTERS QUALIFIES THEM, UNDER ARTICLE 11, R-14-2-1108 OF THE COMMISSION RULES, FOR 'COMPETITIVE' CLASSIFICATION."[13] DOES MR. TEITZEL'S PROPOSAL MEET THE CRITERIA FOR BEING A COMPETITIVE SERVICE UNDER THE COMMISSION'S RULES?

A. No. USWC has not provided evidence that the Commission rules require it to provide to show a service or area is competitive. Many of the services in many areas that USWC

[12]Wilcox Direct Testimony, page 27, line 15.

[13]Teitzel Direct Testimony, page ii.

considers to be competitive will not meet the requirements of the Commission rule, and are not competitive by standard criteria.

Q. WHAT DO THE COMMISSION RULES REQUIRE BE DEMONSTRATED IN ORDER TO CLASSIFY A SERVICE AS COMPETITIVE?

A. Article 11, Section R14-2-1108 (B) of the Commission's Rules and Regulations set forth a number of pieces of information that must accompany any USWC petition for classifying a service or group of services as competitive. The current rules require the following minimum information to be provided:

1. A description of the general economic conditions that exist which make the relevant market for the service one that is competitive;

2. The number of alternative providers of the service;

3. The estimated market share held by each alternative provider of the service;

4. The names and addresses of any alternative providers of the service that are also affiliates of the telecommunications company, as defined in R14-2-801;

5. The ability of alternative providers to make functionally equivalent or substitute services readily available at competitive rates, terms, and conditions; and

6. Other indicators of market power, which may include growth and shifts in market share, ease of entry and exit, and any affiliation between and among alternative providers of the service(s).

It is important to note that the current rules require an indication of "market power." This is an important requirement. When a company has little market power, customers are protected from excessive rates, because they can go to alternative suppliers if one company's rates are excessive. However, when a company has high market power, that means there is little price-restraining, effective competition, and therefore, customers are not protected by competition.

Q. UNDER THE USWC PROPOSAL, WOULD THIS SAME INFORMATION BE REQUIRED TO SUPPORT USWC'S PETITIONS FOR CLASSIFYING WIRE CENTERS AS "COMPETITIVE ZONES"?

A. No. Under USWC's proposal, the information that the Commission's Rules require would not be required to classify a wire center as a "competitive zone." Under USWC's proposal, any wire center where any competitor, including a reseller, is offering even one service would be eligible to be classified as a competitive zone. Mr. Teitzel explains his proposed criteria for a wire center to be classified as a "competitive zone" in his Direct Testimony:

> Before a competitive zone can be established, at least one of the following criteria must be met: 1) A competitor has facilities in place and is marketing or offering services in competition with U S WEST; 2) A reseller is marketing or offering services in competition with U S WEST; or 3) A competitor is marketing or offering services through the provision of unbundled network elements purchased from U S WEST.[14]

These same criteria are also found in §2.16 (B) of USWC's proposed tariff in this proceeding. Under USWC's proposal, all that would need to be demonstrated to classify an exchange as competitive is that one other company was offering at least one alternative service in that area. No indication of market power, market share, or other information which indicates that competition is effective would be required. In short,

[14]Teitzel Direct, Page 18, lines 7-11.

USWC could declare areas as "competitive" even where there was no effective price constraining competition.

Q. CAN YOU GIVE US AN EXAMPLE OF THERE BEING A COMPETITOR IN A MARKET THAT DOES NOT REALLY PROVIDE EFFECTIVE COMPETITION TO USWC FOR MOST CUSTOMERS?

A. Yes. There are "competitors" who offer telephone service to customers who have been disconnected for non-pay, or otherwise cannot obtain telephone service from USWC due to credit or payment problems. The rates these competitors charge are sometimes much higher than USWC's rates. In response to discovery, USWC admitted that a reseller of residential basic exchange service who markets to customers with poor credit at rates much higher than USWC's rates would be sufficient competition to qualify a wire center as a competitive zone under the USWC proposal.[15] The existence of a very high priced competitor does not constrain USWC's prices, and does not provide effective competition (other than for a very limited category of customers).

Q. DOES THE AVAILABILITY OF RESELLERS PUT A "PRICE CONSTRAINT" ON USWC SO THAT NO FURTHER SIGNIFICANT PRICE REGULATION (EITHER TRADITIONAL OR ALTERNATIVE) BY THE COMMISSION IS REQUIRED?

A. No. Resellers resell service that is provided by USWC. The wholesale rate the resellers pay USWC is their major cost of doing business. In addition, the USWC wholesale rate is automatically increased when USWC's retail rate is increased. Therefore, if USWC increased its residential rate in an area, then the wholesale rate to the resellers would also increase the same percent, thereby forcing the reseller's price up as well. Specifically, USWC's residential wholesale service is provided at a 12% discount from their retail rate. (18% for business)[16] In addition to paying USWC the wholesale rate, the resellers must cover their own costs, such as marketing, billing and collection, and uncollectible. For example, if a hypothetical LEC doubled the price of its retail service, that would mean that the price of the wholesale service would also double.[17] As a result, the cost that makes up approximately 88% of the resellers' cost of doing business would automatically double at the same time the LEC doubled its rate.[18] This cost increase would force the reseller to go along with the LEC's doubling of the rate. The availability of resellers does not provide the customers any significant protection from improper price increases by the LEC.

Q. IS THERE ANOTHER PROBLEM WITH CONSIDERING RESALE OR EVEN UNE SERVICES AS BEING "EFFECTIVE" COMPETITIION TO USWC TO JUSTIFY EFFECTIVELY PRICED DEREGULATION?

A. Yes. It must be remembered that under both of these forms of "competition", USWC actually ends up with the vast majority of the revenues paid to the "competitors".[19] If USWC's price increase caused customers to leave USWC for a reseller, the majority of

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[15] USWC's response to Request WDA4-009(d) and (e).
[16] USWC response to Request WDA2-001.
[17] The hypothetical "doubling" of the rate is only to illustrate the mechanism being discussed. This section of testimony does not imply or contend that USWC intends to specifically "double" the rate.
[18] Assuming their prices are similar to USWC. If the reseller prices below USWC, then the wholesale increase would be more than 88% of their cost of doing business.
[19] For residential resale, the USWC wholesale rate is 88% of its retail rate. Therefore, USWC receives almost as much revenue from the wholesale service. Of course, USWC avoids the cost of billing and collection from individual customers, uncollectible from certain individual customers, and certain other costs.

those revenues would end up with USWC. They just take a different route in getting there.

C. USWC'S PROPOSAL WOULD INITIALLY DEREGULATED THE ** ** OF ITS BUSINESS LINES, AND ALMOST ** ** OF ITS RESIDENTIAL LINES

Q. ON PAGE 22 OF HIS DIRECT TESTIMONY, MR. TEITZEL STATES THAT USWC IS REQUESTING IMMEDIATE PRICING FLEXIBLIITY "ON A LIMITED GEOGRAPHIC BASIS." PLEASE COMMENT.

A. The wire centers that USWC proposes be immediately classified as "competitive zones" for business services are the wire centers that serve ** ** of USWC's total business access lines, and produce ** ** of USWC's total business revenue in the State of Arizona.[20] The residential "competitive" zones that USWC proposes be immediately established cover over ** ** of USWC's residential lines in service in Arizona.[21]

Q. ON PAGE 31, LINE 18 OF HIS SUPPLEMENTAL DIRECT TESTIMONY, MR. TEITZEL STATES "THE NUMBER OF 'PORTED' LOCAL TELEPHONE NUMBERS IS A ROUGH MEASURE OF THE NUMBER OF ACCESS LINES BEING SERVED BY LOCAL EXCHANGE COMPETITORS." DO YOU AGREE THAT THE NUMBER OF "PORTED" LOCAL TELEPHONE NUMBERS IS ONE OF THE BEST GAUGES WE HAVE FOR THE MAGNITUDE OF LOCAL EXCHANGE COMPETITION?

[20] USWC's response to Data Request WDA 2-13.
[21] USWC response to Request WDA 21-12, Attachments A and B.

A. Yes. Customers can move their existing telephone number to a different company at no charge. It is much more convenient for a customer to keep their existing telephone number than to change their number. It is much easier for the people who already know a certain telephone number to contact that number if the existing number is kept. Therefore, the tracking of ported numbers gives a good indication of the total number of customers served by other companies. The "ported" figure also includes all types of competitors, including resellers, companies utilizing UNE facilities, and facility based competitors.

Q. DOES THE "PORTED" NUMBER DATA DEMONSTRATE THE EXISTENCE OF SIGNIFICANT COMPETITION FOR RESIDENTIAL BASIC EXCHANGE SERVICES IN ARIZONA SPECIFICALLY IN THE WIRE CENTERS THAT USWC HAS ASKED BE IMMEDIATELY DECLARED COMPETITIVE?

A. No. Through April 2000, there were ** ** residential "ported" numbers in the 23 wire centers that USWC proposes be immediately classified as residential "competitive zones."[22] This compares to the over ** ** residential telephone lines of USWC in service in these 23 wire centers.[23] Therefore, the data that USWC has provided in this proceeding indicates that fewer than ** ** of the residential lines in service have been ported in the 23 wire centers that USWC proposes be immediately established as residential "competitive zones", as is shown on Schedule WDA-16.[24]

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[22] Teitzel Supplemental Direct, Exhibit DLT-44.

[23] USWC response to Request WDA 21-12, Attachment A.

[24] ** **.

Q. ARE THE AREAS WHICH USWC HAS PROPOSED BE IMMEDIATELY DECLARED COMPETITIVE, COMPETITIVE?

A. They are not by accepted standards. As previously discussed, the Commission's rules require that for an area to be considered competitive, market share information must be provided, and indications of market power must be considered. This market share is clearly indicative of a non-competitive area, in which USWC enjoys huge market power. The standard that both the U.S. Department of Justice and the Federal Trade Commission (FTC) utilize as their primary method of determining the degree of market concentration is the Herfindahl-Hirschman Index (HHI). The meanings of the scores on the HHI are as follows:

	HHI Score
Unconcentrated	Below 1,000
Moderately Concentrated	1,001-1,800
Highly Concentrated	Above 1,800

The HHI for the wire centers which USWC proposes be immediately declared competitive have an HHI of over ** **.[25] USWC has huge market power in these markets. A residential basic exchange market in this area is very "highly concentrated." These areas are nowhere near "competitive" by accepted definitions.

Q. USWC PROPOSES THAT 49 WIRE CENTERS BE IMMEDIATELY DECLARED COMPETITIVE FOR BUSINESS SERVICES.[26] DOES THE DATA USWC

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[25] The HHI is calculated by squaring the market share of each company in the industry with 100% being written as 100. (** **) The total score for this market would be slightly higher than this figure, as the squared market share of the other companies in the market could also be added, but that effect would be small. **(
).**

[26] USWC response to Request WDA 21-012, Attachment A.

PROVIDED DEMONSTRATE THAT THESE AREAS ARE COMPETITIVE FOR BUSINESS BASIC EXCHANGE SERVICES?

A. No. In his Supplemental Direct Testimony Exhibit DLT-38, Mr. Teitzel provided an Exhibit entitled "Business Access Line Losses: April 1997 Through April 2000". On this Exhibit, Mr. Teitzel is claiming that over the period April 1997 through April 2000, USWC had "business access line losses" totaling ** ** in the 49 wire centers that USWC proposes be immediately classified as business "competitive zones". For comparison, USWC serves over ** ** business lines in service in these 49 wire centers.[27] Therefore, the data USWC provided shows that USWC has "lost" only about ** ** of the business lines, and is serving ** ** of the business lines, even within the 49 wire centers that USWC proposes be immediately established as "competitive zones", as is shown on Schedule WDA-16. The HHI for this market is therefore ** **.[28] This is extremely "highly concentrated." This market is nowhere near competitive by accepted standards. USWC has huge market power in these areas.

USWC's market share may even be understated. USWC admitted that this business access line loss data shown on Mr. Teitzel's Exhibit "has not been adjusted to reflect customers lost to competition who have subsequently returned to U S WEST."[29] USWC offers a "Competitive Response" program that offers a waiver of nonrecurring charges and/or two months of recurring charges to customers who have left USWC and decide to

[27]USWC's response to Data Request WDA 21-12, Attachment A.

[28] ** **.

[29]USWC's response to Data Request WDA 22-31.

return to USWC. ** ** of small business customers that had left USWC for a competitor have subsequently returned to USWC through this program.[30]

Q. WHAT IS SCHEDULE WDA-16?

A. Schedule WDA-16 summarizes the competitive figures for the wire centers that USWC asks be immediately declared competitive. In addition to the data discussed above, this Schedule also shows the number of resold residential lines in those areas equals only ** ** of the residential lines.[31]

In the areas USWC has asked be declared competitive for business services, resold lines represent less than ** ** of the business lines in those areas. This Schedule also shows the UNE lines in the areas USWC has asked be immediately declared competitive represent less than ** ** of USWC's total access lines in those areas.

Q. ARE THE TINY COMPETITIVE FIGURES SHOWN ON SCHEDULE WDA-16 CONSISTENT WITH OTHER DATA USWC HAS PROVIDED?

A. Yes. USWC provided the results of a study conducted on USWC's behalf by a company called Quality Strategies. According to this study, USWC's share of the retail local exchange spending is ** ** for the "consumer" (i.e. residential) market, ** **

[30]USWC's response to Data Request WDA 24-7.

[31] It should be noted that it is not appropriate to add the "ported" numbers to the "resold" numbers, because there is significant overlap. The customers who are counted as "ported" also can be counted in the "resale" or "UNE loop" columns.

for the "small business" market, and ** ** for the "large business" market in Arizona.[32]

Q. SCHEDULE WDA-16 SHOWS THE COMPETITORS HAVE NOT OBTAINED VERY SIGNIFICANT MARKET SHARE IN ARIZONA, EVEN IN THOSE AREAS THAT USWC CLAIMS TO BE THE MOST COMPETITIVE. IS A SIMILAR STATEMENT TRUE NATIONWIDE?

A. Yes. This problem is not limited to Arizona. Competitive access providers (CAPs), competitive local exchange carriers (CLECs), resellers, and all competitive carriers have low overall market share nationwide. According to the FCC's Trends in Telephone Service report for 1998, the incumbent LECs' share of the local service revenues is 96.5% nationwide, whereas all CAPs, CLECs, resellers, and all other competitive carriers share a skimpy 3.5% share of the local service revenues.[33] This is a clear indication of the true dominance that the LECs enjoy in the local service market nationwide. A mere four-tenths of one percent of the major LECs' switched lines were sold as UNE loops nationwide.[34] One and one-half percent of all access lines were resold lines nationwide.[35]

In fact, nationwide, the wireline telephone market is far more concentrated than it has been at any time since divestiture. Currently, two companies control 66% of the access

[32] Fourth quarter, 1998, USWC response to RUCO Request 6-11, Attachment A, page 8.
[33] Trends In Telephone Service, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, Released March 2000, Table 9.1.
[34] Trends in Telephone Service, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, Released March 2000, Table 9.4.

[35]Trends in Telephone Service, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, Released March 2000, Table 9.3.

lines in the United States.[36] These two companies are SBC (which consists of the former Bell operating companies of SBC, Pacific Bell, and Ameritech), and the other company is Verizon (which includes the former GTE and Bell operating companies, Bell Atlantic and NYNEX).

Q. WHAT IS A MAJOR PROBLEM WITH DECLARING WIRE CENTERS TO BE COMPETITIVE WHEN IN FACT THEY ARE NOT COMPETITIVE, AND USWC STILL HAS SIGNIFICANT MONOPOLY MARKET POWER IN THOSE EXCHANGES?

A. Under USWC's proposals, USWC could increase its rates as much as it wanted to, up to double the current rates.[37] Even in areas where it has significant monopoly power, the approval of this concept would allow the Company to as much as double most of its current rates. As previously discussed, this would impact a high percent of the customers in the State. In most instances, those customers do not have any independent alternative provider available.

Q. IN HIS DIRECT TESTIMONY, MR. TEITZEL TRIES TO DEMONSTRATE THE COMPETITION THAT USWC IS EXPERIENCING IN ARIZONA BY ATTACHING SEVERAL EXHIBITS SHOWING PRICES THAT OTHER COMPANIES ARE CHARGING FOR CERTAIN SERVICES. DO YOU HAVE ANY COMMENT ABOUT THESE EXHIBITS?

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[36] Table 20.3 "Telephone Loops by Holding Company", Trends in Telephone Service, March, 2000.
[37] Except for the $19 limit on residential basic exchange.

A. Yes. Mr. Teitzel's exhibits focus primarily on services for which USWC has already been granted price flexibility in Arizona. For example, on his Exhibit DLT-5, Mr. Teitzel has provided a copy of a price quote from an AT&T account executive to a USWC business customer that compares the rates that the customer would pay under USWC's rates and the rates the customer would pay under AT&T's rates. Over 70% of the saving that the customer is shown to experience under the AT&T rates compared to the USWC rates, is attributed to lower Centrex rates. As Mr. Teitzel indicates on page 19, line 23 of his Direct Testimony, Centrex is a service that has already been deemed to be "competitive" on a state-wide basis by the Commission. On his Exhibit DLT-17, Mr. Teitzel has provided copies of toll service advertisements of three different companies. However, message toll service (MTS) is a service that has already been deemed to be "competitive" on a state-wide basis by the Commission.[38] Therefore, the evidence that USWC has provided that demonstrates competition for services that have already been deemed to be "competitive" services in Arizona, does nothing to demonstrate a need to adopt USWC's "competitive zone" proposals. At most, all that this evidence supports is maintaining the current competitive classification of these services in Arizona, which is not at issue.

Q. DOES PAST EXPERIENCE INDICATE THAT USWC'S CLAIMS PERTAINING TO THE LEVEL OF COMPETITION SHOULD BE REVIEWED VERY CAREFULLY?

A. Yes. Although this Commission has already designated the toll market as competitive, and I am not rearguing that classification, USWC's own testimony can be used to demonstrate the inaccuracy of USWC's market share claims. Back in USWC's 1993

[38] Page 19, Teitzel Direct.

General Rate Case in Arizona, USWC claimed that the intraLATA toll market was "very competitive", that other toll providers had made "significant inroads" and that USWC had lost intraLATA toll market share.[39] USWC's intraLATA toll witness in the 1993 case stated:

> USWC has lost 19% of the Arizona small business toll market and over 7% of the Arizona residence market based on minutes of use.[40]

However, in its testimony in this proceeding, USWC's witness Alcott states:

> As recently as 1996 U S WEST had virtually 100 percent of this market. U S WEST's share of this market has decreased significantly since that time, as the proprietary figures contained in Dave Teitzel's testimony demonstrate.[41]

The above referenced quote, Mr. Alcott states USWC had "virtually 100%" of the intraLATA toll market as recently as 1996. However, several years prior to 1996, USWC had claimed that competitors already had 7% to 19% of the toll market share. These two sets of USWC testimony are inconsistent. It is clear that either Mr. Alcott's testimony in this proceeding, or the USWC witness in the 1993 proceeding, or both, are misstating the market share of USWC.

Q. USWC IS CURRENTLY REQUESTING THAT 23 RESIDENTIAL WIRE CENTERS BE DESIGNATED AS COMPETITIVE ZONES. IF THEIR TARIFF WAS

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[39] Direct Testimony of Gary A. Rees in Arizona Docket No. E-1051-93-183, July 15, 1993, page 22.

[40] Direct Testimony of Gary A. Rees in Arizona Docket No. E-1051-93-183, July 15, 1993, page 21.

[41] Alcott Direct Testimony, page 13, line 15.

ACCEPTED, WOULD THEY BE ABLE TO CONVERT A NUMBER OF OTHER WIRE CENTERS TO COMPETITIVE ZONES?

A. Yes. The requirements are so lax that there are a large number of other wire centers that would also meet their requirements for being defined as a "competitive" zone. Exhibit DLT-41 attached to Mr. Teitzel's Supplemental Direct Testimony lists ** ** wire centers with resold residential services in March, 2000. Under USWC's proposal, the presence of any reseller reselling any residential service causes that wire center to meet the definition of being a "competitive" residential wire center. Therefore, all ** ** of these wire centers could be reclassified as competitive according to USWC's proposed tariff. This same Exhibit also shows a large number of wire centers that have some resold business services. Therefore, a large number of wire centers in addition to those USWC is currently asking be immediately declared competitive could readily be reclassified as competitive under USWC's proposal.

D. ONE OF USWC'S CLAIMED "PRIMARY COMPETITORS" IN ARIZONA HAS DECLARED BANKRUPTCY, AND OTHERS ARE LOSING MONEY

Q. USWC HAS LISTED SOME "PRIMARY COMPETITORS" IN ARIZONA.[42] PLEASE COMMENT.

A. One company Mr. Teitzel listed as a "primary competitor" is GST Telecommunications. However, since the filing of Mr. Teitzel's testimony in this proceeding, GST has since

[42] Teitzel Direct, page 6.

filed for Chapter 11 bankruptcy protection.[43] The GST shareholders likely will be left holding an empty bag after the sale of its assets:

> ...because the current sale offer is for substantially less than the amount of GST's debt, a distribution to shareholders is unlikely.[44]

As Mr. Teitzel explains in his testimony, GST established operations in Tucson back in 1994.[45] However, GST has been experiencing financial woes for some time. For example, for the nine months ended September 1999, GST suffered a <u>net loss</u> of over $103 million on total revenues of $225 million. In discovery in this proceeding, USWC provided a copy of its own internal study report that aptly described GST as having "poor cash flow."[46] One of the causes of the GST bankruptcy was GST's inability to "secure other financing."[47]

Q. ON PAGE 15 OF HIS DIRECT, MR. TEITZEL CLAIMS THAT e.SPIRE IS A PRIMARY COMPETITOR TO USWC. ON PAGE 17 OF HIS SUPPLEMENTAL DIRECT, MR. TEITZEL INDICATES THAT e.SPIRE'S REVENUES INCREASED FROM $156.8 MILLION IN 1998 TO $244 MILLION FOR THE YEAR ENDING

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[43] Telecommunications Reports, "Time Warner Telecom Sees Opportunity in GST Woes", May 22, 2000, page 23.

[44] Posted on the GST website according to published reports.

[45] Teitzel Direct Testimony, page 14, line 23.

[46] USWC's response to Data Request RUCO 6-8, Attachment A.

[47] Telecommunications Reports, "Time Warner Telecom Sees Opportunity in GST Woes", May 22, 2000, page 23.

DECEMBER 31, 1999. WHAT DOES MR. TEITZEL FAIL TO POINT OUT ABOUT e.SPIRE?

A. Mr. Teitzel fails to mention the fact that e.spire's net loss for the year ended December, 1999 was larger than its total revenues for the year. For the year ended December 31, 1999, e.spires's total revenues were $244 million and its net loss for the same period was $277 million. In addition, as a result of these astounding losses, e.spire's reported annual earnings worsened from a negative $4.46 per share for the fiscal year ending December 1998 to a negative $6.38 per share for the fiscal year ending December 31, 1999.[48]

Q. MR. TEITZEL LISTS ELECTRIC LIGHTWAVE, INC. (ELI) AS ONE OF THE PRIMARY COMPETITORS TO USWC IN ARIZONA. PLEASE COMMENT.

A. As Mr. Teitzel explains, ELI who "turned up its network in 1994" was one of the first competitors in the greater Phoenix area.[49] However, in just the nine months ended September 1999, ELI suffered a staggering net loss of $98 million on total revenues of $133 million.

As previously discussed, it is in the LECs' interest to have their competitors be unprofitable. As previously discussed, the "competitive zone" proposal of USWC would allow USWC to improperly price discriminate based on the level of competition. This

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[48]Mr. Teitzel lists other competitors, such as AT&T/TCG, MCI WorldCom/Brooks Fiber and COX. However, the financial reports for these companies do not separately show the financial performance of the competitive local exchange services these companies provide. For example, the primary business of AT&T and MCI is the provision of long distance toll services, and COX is mainly a provider of cable television services.

[49] Teitzel Direct, page 10.

would give them a powerful additional tool to further impede the profitability of any existing competitors, and to discourage any potential competitors.

Q. THROUGHOUT HER TESTIMONY, MS. STEWART EMPHASIZES HOW "WELL-FUNDED" SOME OF USWC'S COMPETITORS ARE.[50] EVEN IF THERE ARE SOME COMPANIES THAT ARE "WELL-FUNDED", DOES THIS MEAN THAT THESE COMPANIES WILL CONTINUE TO PROVIDE SERVICES IN COMPETITION WITH USWC, EVEN IF THEY ARE CONTINUALLY LOSING MONEY DOING SO?

A. No. It is not reasonable to expect that since a company is "well-funded", that company will continue to lose money attempting to compete with USWC. At some point, these services must be profitable, or else it is not likely that there will be competitors entering this market in the future.

Q. IN HIS TESTIMONY, MR. ALCOTT STATES:

> However, what we are seeing now is that competition is emerging in specific geographic areas within the state. It starts in one part of town and grows from there.[51]

PLEASE COMMENT.

A. To the extent that USWC or other LECs are successful in limiting the profitability, or forcing the competitors to be unprofitable, that limits their ability to grow and expand competition against USWC and other LECs. The "competitive zone" proposal of USWC

[50]For example, see Stewart Direct Testimony, pages i, iii, 4, 7 and 17.

[51]Alcott Direct Testimony, page 10, line 24.

is a powerful, additional tool that USWC could use to limit the profitability and therefore the growth of competitors, and also to discourage potential competitors.

Q. ON PAGE 36 OF HIS DIRECT, MR. TEITZEL CLAIMS THAT THERE IS NO MARKET FOR RESIDENTIAL BASIC EXCHANGE SERVICE COMPETITION, BECAUSE THE PRICES THAT USWC CHARGES ARE TOO LOW. PLEASE COMMENT.

A. Of course, as Schedule WDA-16 shows, there is also very little competition in the business markets either. First of all, competitors evaluate the total revenue opportunities, not just the revenues from only one service (basic exchange). For example, nationwide the average residential telephone bill is $55 per line per month. The bill for basic exchange service is only approximately 25% of that total.[52] A company considering offering service to a residential area would consider the revenues they would expect to receive from all services, including enhanced services, toll services, basic exchange service, switched access services to other carriers, etc. In addition, Mr. Teitzel states:

> Cox is already providing residential telephone service to over 5,000 residents of Chandler, with the potential to serve 40,000 additional subscribers there and plans to ultimately offer telephone service to all of its 600,000 subscribers in Phoenix and surrounding communities. Cox's efforts illustrate that the residential market is not immune to competition.[53]

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[52] Household Telecommunications Expenditures by Type of Provider in 1998, Table 3.6, FCC Reference Book of Rates, Price Indices, and Expenditures for Telephone Service, June, 1999. The average residential rates paid directly to the LECs average $33 per month.

[53]Teitzel Direct Testimony, Page 5, lines 8-12.

Q. WHAT ARE THE "FLOOR" AND "CEILING" UNDER USWC'S COMPETITIVE ZONE PROPOSAL COMPARED TO THE CURRENT COMMISSION RULES?

A. USWC's "competitive zone" proposal is a great departure from the Commission's rules on both ends of the range of acceptable rates. Under Section R14-2-1109(A) of the Commission's Rules, the minimum rate that USWC may charge for a competitive service is USWC's total service long run incremental cost (TSLRIC) of the service.[54] However, under USWC's proposal, the minimum rate for any service within "competitive zones" can be set below the TSLRIC of providing the service, as Mr. Teitzel explains:

> <u>Prices for specific services may be offered below Total Service Long Run Incremental Cost (TSLRIC) in competitive zones</u> only as long as the total revenue for the customer or group of customers is above TSLRIC.[55] (Emphasis added)

USWC's ability to set the rates so that the total for all services are not below the TSLRIC would make it even more difficult for competitors to cover their costs.

It must also be remembered that in order to be profitable, competitors must cover not only their TSLRICs, but also their joint and common costs as well. Mr. Thompson states:

> U S WEST must price its services to recover the common overhead costs in addition to its Total Direct and Network Support costs to remain a healthy, viable and growing corporation that can continue to invest in new products and services. If the firm can not receive contribution from products to help recover these overhead costs, the products are not likely to be offered by the firm.[56]

The same principle also applies to USWC's competitors. Current rules require the price for a "competitive" service cannot be below its TSLRIC. However, under the proposed rules, the price could be below its TSLRIC. Therefore, if a customer was subscribing to a

[54] Teitzel Direct, page 31.
[55] Teitzel Direct, Page 20, lines 7-9.

profitable service, the contribution from that profitable service could be diverted to another " below cost" service, thereby further eliminating the ability of a competitor to cover their joint and common costs in those areas where they are trying to compete with USWC.

For competitive services, the Commission's current rule that the maximum rate USWC may charge is the maximum rate stated in its tariff on file with the Commission. Mr. Teitzel states the new proposal is:

> The price ceilings will be double the rates approved in this filing; or for services not treated in this case, double the existing rates, except for residence Basic Exchange Service. Residence Basic Exchange Service will have a maximum rate of $19.00 established within competitive zones. In the case of services already classified as 'competitive' on a state-wide basis, the maximum rates will also apply outside of the competitive zones.[57]

Instead of the maximum being the existing tariff rate, under the USWC proposal the maximum would be double the existing tariff rate.

The fact that many of the customers would actually have no effective choice in these areas makes this potential "doubling" of the rate, less acceptable.

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[56] Thompson Direct, page 7.
[57] Teitzel Direct, Page 20, lines 11-16.

E. USWC'S "COMPETITIVE ZONE" PROPOSAL WOULD ALLOW USWC TO VIOLATE SECTION 254(K) OF THE TELECOMMUNICATIONS ACT

Q. DID THE AUTHORS OF THE TA96 ANTICIPATE THAT LECS WOULD RESPOND TO COMPETITION BY ATTEMPTING TO USE THEIR NON-COMPETITIVE SERVICE RATES TO SUPPORT COMPETITIVE SERVICE RATES?

A. Yes. The authors of TA96 anticipated that LECs like USWC would respond to competition by attempting to use their non-competitive services to support their rates for competitive services. The authors of TA96 also correctly anticipated the LECs would justify this support by allocating "more than a reasonable share of the joint and common costs of facilities used to provide those services", to the non-competitive services. The authors of TA96 anticipated this strategy by the LECs, and specifically prohibited it:

> Section 254(k)--SUBSIDY OF COMPETITIVE SERVICES PROHIBITED.--A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

Q. IF APPROVED BY THE COMMISSION, WOULD USWC'S "COMPETITIVE ZONE" PROPOSAL ALLOW USWC TO VIOLATE SECTION 254(K) OF THE TELECOMMUNICATIONS ACT OF 1996?

A. Yes, in at least two ways:

1. USWC would be able to shift the recovery of joint and common costs away from competitive services, and onto monopoly ratepayers across geographic areas of the state.

Under USWC's proposal, USWC would be allowed to charge higher rates for a service in areas that are subject to little or no competition and lower rates for that service where competition does exist. As Mr. Teitzel explains:

> Offerings and prices may vary between competitive zones. With this flexibility, U S WEST will be able to effectively respond to customer and market demands in the areas subject to competition.[58]

This difference in pricing would not have to reflect a difference in cost of providing service. Therefore, pricing lower where there is competition while pricing higher where there is not competition would effectively load a higher share of the joint and common costs onto the monopoly ratepayers, while loading a lower share of those joint and common costs onto the prices of competitive services. This is contrary to the requirements of Section 254(k). The Commission must establish cost allocation rules or other safeguards which prevent such a discriminatory recovery of the joint and common costs.

2. USWC would be able to subsidize competitive services across individual services or customer groups.

USWC proposes that for those wire centers that meet USWC's criteria to become a "competitive zone" for both residence and business customers, all of the services will be allowed pricing flexibility, as Mr. Teitzel explained in his Direct Testimony.[59]

[58]Teitzel Direct, Page 19.

With the ability to drastically change prices for both business and residence services within a wire center, USWC would easily be able to drastically reduce rates for one service or customer class but increase rates of another service or customer class, depending upon the level of competition that existed for each of those services or customer classes.

The result is USWC would easily be able to place an unreasonable share of joint and common costs on those services or customer groups within the wire center that are subjected to very little or no competition. They could use this to fund reductions in the rates for those services that USWC deemed to be competitive or at least potentially competitive.

Q. WHAT DO YOU RECOMMEND?

A. First of all, I recommend that the competitive zone proposal of USWC be rejected. In addition, in any alternative regulatory structure adopted by the Commission, the Commission should include a rule that requires any "revenue neutral" restructure include residential rates that are revenue neutral only within the residential category. Any "revenue neutral" restructure of the business rates must be revenue neutral within the business category. If there is no such requirement, USWC could reduce the business rates, (if it believes it has more competition there), and offset that by increasing the rates where it has less competition, which may include residential rates. This requirement

[59] Teitzel Direct, page 19, lines 34-36.

would apply to all services other than those that the Commission has determined to be truly competitive.

In addition, any rate structure adopted by the Commission should include reasonable proposals to prevent an unreasonable share of the joint and common costs from being allocated to the universal services.

F. NEW SERVICE OFFERINGS

Q. WHAT CRITERIA WOULD NEW SERVICE OFFERINGS HAVE TO MEET BEFORE THEY ARE CLASSIFIED AS COMPETITIVE, UNDER USWC'S PROPOSAL?

A. None. Under Mr. Teitzel's proposal, any new service offering USWC provides in the future, even outside of a wire center that has been classified as a "competitive zone" will be automatically classified as competitive, without having to demonstrate that any competition whatsoever exists for that service. Mr. Teitzel states:

> I am proposing that a streamlined process be adopted whereby all new services will automatically be classified as 'competitive' upon introduction.[60]

My experience in other states has been that the companies will slightly modify or combine existing services, and claim that this is a "new" service that is therefore competitively priced. For example, if an LEC combines basic exchange service with a new feature that it is not currently combined with, they would argue that is a new service,

[60]Teitzel Direct, Page 23, lines 15-16.

and therefore competitively priced. This wording could open a large "loophole", which USWC could use to have virtually any service considered "competitive", simply by creating a slightly modified form of it. It should be noted that even if the original form of the service was still available in the tariffs, that provides little protection to the consumers, since most consumers do not read the tariff to find out what service options are available. Most customers instead contact the USWC service representatives.

To be deemed truly competitive, new services should have to pass the same competitive test that other services must pass. If a "new" service includes a service that is currently not classified as competitive, that "new" service clearly cannot be classified as competitive. Likewise, I recommend that in any alternative regulatory structure adopted, the new services be subject to the same treatment of price caps as are existing regulated services, unless USWC provides the information needed to demonstrate that they are truly competitive services under Article 11, R-14-2-1108.

G. USWC'S PROPOSED TIME FRAME FOR CONSIDERING ITS FILINGS TO CLASSIFY A WIRE CENTER AS A "COMPETITIVE ZONE" IS NOT REASONABLE

Q. WHAT TIME FRAME DOES MR. TEITZEL PROPOSE FOR CHANGING A ZONE CLASSIFICATION TO "COMPETITIVE?"

A. Mr. Teitzel proposes that the Commission must object to USWC's proposal within 15 days, or the area will automatically become a "competitive zone." If objections are raised, the Commission must issue a formal notice of the objection, and the entire process would be considered within 60 days of USWC's notice.[61]

Q. IS MR. TEITZEL'S PROPOSAL REASONABLE?

A. No. The proposed time frame for considering USWC's proposals is not acceptable. It is not reasonable to expect that any party or the Commission would have sufficient time to evaluate a USWC claim of competitiveness in a 15 day or even a 60 day period.

Q. MR. TEITZEL PROPOSES CHANGES IN THE REQUIREMENTS PERTAINING TO PROMOTIONAL OFFERINGS.[62] PLEASE COMMENT.

A. USWC should be required to make promotional offerings available on a non-discriminatory basis to customers throughout the state. For example, USWC should not be allowed to discriminate on the promotional offerings based upon the level of competition that exists in a particular area, for the reasons previously discussed.

III. USWC'S COST STUDIES

A. USWC'S CLAIMED TSLRIC COST FOR RESIDENTIAL BASIC EXCHANGE SERVICE VIOLATES THIS COMMISSION'S DEFINITION OF TSLRIC, AS WELL AS USWC'S OWN DEFINITIONS OF TSLRIC

Q. HOW DOES USWC DEFINE TSLRIC COSTS IN THIS PROCEEDING?

A. In his Direct Testimony, Mr. Thompson defines TSLRIC:

> The TSLRIC studies identify the total cost of offering the service - defined as <u>the total costs incurred by U S WEST while offering the service, less the total costs</u>

[61] Teitzel Direct, page 22.
[62] Teitzel Direct, page 24.

that would be incurred by U S WEST if the service were not offered.[63] (Emphasis added)

In addition, USWC's cost studies in this proceeding provide a definition of "Direct Costs", which it also refers to as TSLRIC. The USWC cost studies state the following:

> **Total Direct Costs** - Total Direct cost is the total forward-looking direct cost of providing a product or service to the total universe of U S WEST Customers. It most closely reflects the cost of replacing all the facilities directly required to provide that product or service. It does not include costs that are required but which also benefit the provision of other products and services. It reflects the forward-looking cost of the entire service provided in the most efficient manner, holding constant the production of all other services produced by the firm. This cost has frequently been referred to as TSLRIC.[64] (Emphasis added)

Q. HOW DOES THIS COMMISSION DEFINE TSLRIC COSTS?

A. The definitions section of the Arizona Corporations Commission's Rules and Regulations, Section R14-2-1102 (17), provides the following definition:

> **"Total Service Long Run Incremental Cost."** The total additional cost incurred by a telecommunications company to produce the entire quantity of a service, given that the telecommunications company already provides all of its other services. Total Service Long run Incremental Cost is based on the least cost, most efficient technology that is capable of being implemented at the time the decision to provide the service is made.

The definition of the incremental cost or TSLRIC is addressed further in the Direct testimony of Thomas Regan.

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[63]Thompson Direct Testimony, page 4, line 23.

[64]Thompson Direct Testimony Exhibit JLT-1, page 7.

Q. DID USWC VIOLATE THE COMMISSION'S DEFINITION AND ITS OWN DEFINITION OF TSLRIC WHEN IT CALCULATED THE TSLRIC COSTS OF BASIC EXCHANGE SERVICE IN THIS PROCEEDING?

A. Yes. The loop is shared by many services, as shown on Schedule WDA-17. However, USWC included 100% of the unseparated loop cost in what it claims to be the basic exchange TSLRIC.[65] However, the loop facilities are required for the provision of other products and services. The loop facilities would not be eliminated if basic exchange service was discontinued, while all other services were still being offered. Therefore, the loop cost is not part of the properly calculated TSLRIC using any or all of the above-referenced definitions. It is an indisputable physical fact that the loop facility is shared by several services, only one of which is basic exchange service. It is an indisputable physical fact that the loop facility would still be needed even if basic exchange service was not provided, but USWC continued to provide all of its other services. This means the loop costs are not "caused" by basic exchange service alone.

Q. PLEASE EXPLAIN SCHEDULE WWD-17.

A. Schedule WWD-17 is a diagram that shows some of the facilities that are required to provide USWC's major services: basic exchange service, vertical services, toll switched access, and ADSL service. As the diagram clearly indicates, a loop facility[66] is required to provide all of these services.

[65] Thompson Direct, Exhibit JLT-27, page 7.

[66] The "loop" I am referring to is the switched access line as opposed to a dedicated private line.

In fact, the loop is sometimes referred to as the "common line" because it is a facility that is "common" to a number of services.[67]

Q. USWC'S DEFINITION OF "DIRECT COSTS" CLAIMS THAT "COSTS THAT ARE REQUIRED BUT WHICH ALSO BENEFIT THE PROVISION OF OTHER PRODUCTS AND SERVICES" ARE NOT INCLUDED IN THAT COST. DID USWC FOLLOW ITS OWN COST STUDY PRINCIPLE IN ITS RESIDENTIAL BASIC EXCHANGE SERVICE COSTS STUDY?

A. No. By far the most significant of the "costs that are required but which also benefit other products and services" are the loop facilities costs. As Schedule WDA-17 clearly demonstrates, the loop facility "benefits" services other than basic exchange service. All services that are provided using the loop facilities not only benefit from, but also depend upon the loop facilities.

Q. HOW DID USWC TREAT THE COST OF THE SHARED LOOP FACILITIES?

A. USWC placed 100% of the loop facility costs on basic exchange service. USWC placed none of the loop costs on any other service that also utilizes or "benefits" from the loop facility. As shown on Thompson Direct Testimony Exhibit JLT-27, page 7, USWC included 100% of the costs of the loop in the "Direct Cost" of residential basic exchange service - a direct violation of their claimed principle.

[67] The costs that are shared by more than one service are sometimes referred to as terms such as "joint", "common", or "shared." In this discussion, I will use these terms interchangeably.

Q. DID USWC LIKEWISE VIOLATE THE TSLRIC DEFINITIONS WHEN IT CALCULATED THE COSTS OF ALL SERVICES?

A. No. USWC's violation of the TSLRIC definition was "selective." Although USWC violated the definition of TSLRIC for residential basic exchange service, USWC did not make that violation when it calculated its claimed TSLRIC costs of toll and switched access services. When calculating the TSLRIC of toll and switched access services, USWC properly excluded the loop costs, since the loop costs would not be avoided if one of these services were discontinued while holding all other products or services offered by the firm constant.[68] The result of this selective violation of the TSLRIC definition by USWC is to distort beyond recognition the actual contributions from each of the different services. By properly excluding the loop cost from the TSLRIC of toll and switched access, USWC calculated a very low cost and therefore a high contribution.

Q. WHAT WOULD USWC'S TSLRIC OF RESIDENTIAL BASIC EXCHANGE SERVICE HAVE BEEN IF USWC HAD CALCULATED THE COST OF THAT SERVICE CONSISTENTLY WITH THE WAY IT CALCULATED THE TSLRIC OF SWITCHED ACCESS AND TOLL?

A. Had USWC also properly excluded the loop cost from the TSLRIC of residential basic exchange service (the same as if they excluded those costs from the TSLRIC of toll and access), the result would have also been a low TSLRIC and a high contribution for residential basic exchange service. Excluding the loop cost (which is how USWC calculated the TSLRIC for toll and switched access), the TSLRIC of USWC's residential

[68]USWC's response to Data Request WDA 1-35.

basic exchange service is ** ** per month, using the costs otherwise exactly as calculated by USWC, as is shown on Schedule WDA-18.[69] [70]

Q. WHAT RATE DOES RESIDENTIAL BASIC EXCHANGE SERVICE HAVE TO BE SET ABOVE IN ORDER TO PREVENT IT FROM BEING SUBSIDIZED?

A. The properly calculated TSLRIC of residential basic exchange service is ** ** per month for USWC. Determining the TSLRIC is important because the TSLRIC is generally accepted as being the "floor" for a proper price. TSLRIC is also the standard for determining whether a service is <u>receiving</u> a subsidy, as discussed in the Direct testimony of Thomas Regan. As USWC admitted in its response to Data Request WDA 2-006, a service is not receiving a subsidy if that service is priced equal to or above its properly calculated TSLRIC.

Data Request WDA 2-6 (b):

> Is it a correct statement that if a service is priced equal to or above its properly calculated TSLRIC, that service is not receiving a subsidy? If this is not a correct statement, please provide the corrected statement, as well as copy of the economic, regulatory or other standard that your Company claims supports the corrected statement provided..

USWC's Response:

> It is not receiving a cross-subsidy.

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[69] Calculated from USWC's May 2000 Residence and Business Basic Exchange Recurring Cost Study, provided by USWC in response to Data Request WDA 21-6, Attachment A, pages 25 and 31 (The figure shown is the sum of the Total Direct Costs "TSLRIC" for, Local Usage, Directory Listing and Billing & Collections for an additional residence line).

[70] This figure also excludes the cost of the first unit of postage and standard envelope, as will be discussed later in this testimony.

Therefore, as long as residential basic exchange service is priced above ** **, it is not receiving a subsidy using the widely accepted economic principles, principles which even USWC has agreed are the correct and appropriate economic principles.

B. CONTRIBUTION ANALYSIS

Q. IF THE SHARED COSTS ARE NOT INCLUDED IN THE TSLRIC, HOW ARE THOSE COSTS RECOVERED?

A. Services are priced above their TSLRIC so as to recover both the direct (TSLRIC) cost as well as a portion of the shared cost. This is a common practice in virtually all industries. For example, consider a restaurant where the rent for the building is $10,000 per month, and the incremental cost of each hamburger and each soft drink is 30¢.[71] The company cannot price its products at just their incremental cost of 30¢, because that would not give them funds to pay the rent. Therefore, they must price above the incremental cost, so as to cover the total cost, which includes both the direct cost (TSLRIC) as well as the fixed costs (i.e. rent). Even in highly competitive markets, the equilibrium pricing must be a price that covers the total cost of the efficient producers, which includes the incremental cost as well as the shared costs.

Q. YOU PREVIOUSLY STATED THAT THE CORRECT TSLRIC (DIRECT) COSTS EXCLUDE THE COST OF THE SHARED FACILITIES. HAVE YOU CONDUCTED AN ANALYSIS OF USWC'S MAJOR RESIDENTIAL SERVICE CATEGORIES

[71] In this example, I am assuming these are the only two products the restaurant sells. The principle is the same if more products are sold.

WHICH SHOWS HOW MUCH EACH OF THEM CONTRIBUTES (REVENUES IN EXCESS OF DIRECT COSTS) TO THE SHARED COST OF USWC?

A. Yes. Schedule WDA-19 is a contribution analysis that shows the actual level of contribution above TSLRIC that is currently being provided by each of these USWC major residential service categories. It also compares the contribution amounts for residential services to the unbundled loop rate that the ACC has established for USWC. The figures shown on this Schedule are "contributions." These contributions are calculated by taking the revenues for each service and deducting from that the direct cost (TSLRIC) of each service.

Q. WHAT DOES THE STAFF'S CONTRIBUTION ANALYSIS DEMONSTRATE?

A. Staff's contribution analysis demonstrates the following:

1. The current residential basic exchange service rates alone provide an average of ** ** per line, per month in contribution above TSLRIC toward the shared, joint and common costs of USWC in Arizona. This is more contribution above TSLRIC than any other service which shares the residential loop facilities. The per-line, per-month contributions from each major service category are as follows:

	Per-Line, Per-Month Contribution (Revenue - TSLRIC)
Intrastate	
1FR Service	** **
Residential Vertical Services	**$ **
Total Residential Local Services	**$ **
Intrastate Switched Access	**$ **
Intrastate Toll	**$ **
Interstate	
Interstate EUCL/SLC	**$ **
Interstate PICC	**$ **
Interstate CCLC	**$ **
Total Residential Contribution to Shared/Joint/Common	**$ **

2. Residential basic exchange service alone provides approximately ** ** the per-line contribution that USWC's intrastate switched access provides, and over ** ** the per-line contribution that USWC's intrastate toll services provide toward the shared, joint and common costs of USWC in Arizona.[72]

3. The unbundled loop rate that the Commission approved for USWC is $21.98. Under the FCC's Part 36 Separations requirements, 25% of the loop costs are allocated to the interstate jurisdiction and recovered in interstate rates. Therefore, the intrastate portion of the loop rate is $16.49 per month.[73] The contribution above TSLRIC provided by residential local services alone (including charges for basic exchange service and vertical services) is ** ** per line, per-month. Therefore, the contribution from residential local services alone covers over ** ** of the intrastate portion of the unbundled loop rate the Commission has established for USWC in Arizona.[74]

4. The discussion in Item 3 does not even include the additional ** ** per line, per month for the interstate EUCL charge (average of primary and additional line EUCL rate) that residential end users also must pay in order to obtain basic exchange service.[75]

Residential basic exchange service is currently contributing more toward the recovery of the joint, shared and common costs of providing telecommunications services in Arizona than is toll, switched access, or even vertical services.

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[72] ** **

[73] $21.98 x 75% = $16.49.

[74] This contribution is conservative. I have used the UNE loop "rate" as if it were the loop "cost." But the UNE loop rate already contains a 15% contribution to USWC's overhead costs and attributed joint and common costs. (See ACC Decision 60635, page 13, dated January 30, 1998, Docket No. U-3021-96-448 et al.) Therefore, the contribution to shared costs is even higher than the figure stated above and shown on Schedule WDA-19.

[75] This uses the rates that applied during the test year. I have not adjusted this for any increase in the interstate EUCL charge that may have occurred since that time.

C. COSTS ARE NOT "CAUSED" SOLELY BY BASIC EXCHANGE SERVICE

Q. ARE THE LOOP COSTS "CAUSED" SOLELY BY BASIC EXCHANGE SERVICE?

A. No. Some parties argue that the end user or basic exchange service directly causes the cost of basic exchange service, because it is the end user that orders telephone service. However, the major investment-related costs of the loop facilities were actually incurred as a result of the telephone company's decision to install those facilities. That decision was directly made by a telephone executive. The telephone executive's decision to incur the loop investment cost was not based solely on the desire to obtain basic exchange service revenues, but instead was based on the desire to obtain the whole family of telephone revenues that the loop facility would make possible. The average residential telephone bill per line is $55 per month nationwide. The bill for basic exchange service is only approximately 25% of that total.[76] A rational telephone company executive would consider the entire family of revenues that would be generated by installing those facilities as part of the decision to install them. There is no evidence that as part of this decision, the revenues derived from the loop facilities for services other than basic exchange service are ignored. No rational analysis would ignore those revenues. Some of the revenues generated are not even revenues received from the end user. For example, an IXC terminating an interstate toll call at that location pays USWC switched access charges for the use of the loop facility to terminate toll traffic. The payment for that is received from the IXC.

[76] Household Telecommunications Expenditures by Type of Provider in 1998, Table 3.6, FCC Reference Book of Rates, Price Indices, and Expenditures for Telephone Service, June, 1999. The average residential

Dr. Wilcox, in her testimony in this proceeding, correctly states that the companies consider more than just basic exchange revenues when they examine a particular customer. They also consider switched access revenues. Dr. Wilcox states:

> Each time U S WEST loses an existing or potentially new end-user customer to a facilities-based competitive local service provider, the Company also loses the ability to collect switched access charges for long distance calls going to and from that end-user.[77]

and;

> Quite simply, there is direct impact because the carrier that supplies local exchange service to a given end-user customer also controls the switched access to that customer.[78]

The concept that USWC, or other companies, would consider only basic exchange service revenues when evaluating a particular customer location is incorrect, and is contrary to Dr. Wilcox's above statements. In addition, when a customer orders telephone service, they are not ordering just basic exchange service. They receive toll service, and a variety of other services all at the same time.

Q. IS THERE AN ACCEPTED TEST TO DETERMINE WHETHER A COST IS "CAUSED" BY ONE SERVICE?

A. Yes. As USWC admitted in discovery, if a company does not avoid certain costs in the long run when a service in question is eliminated (or not offered), while holding constant the production of all other services produced by the Company, those costs which are not

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rates paid directly to the LECs average $33 per month.

[77]Wilcox Direct Testimony, page 29, line 23.

[78]Wilcox Direct Testimony, page 11, line 3.

eliminated if the service in question is eliminated are not properly considered to be "caused" by the provision of that service in question.[79]

As can be seen from the diagram on Schedule WDA-17, if USWC eliminated basic exchange service, while continuing to provide all other services which it currently provided, that would not eliminate the need for the loop facility. Therefore, the loop cost is not "caused" entirely by basic exchange service, but instead is caused by a whole family of services that share the loop facility.

D. USWC'S INCLUSION OF 100% OF THE LOOP COST ON RESIDENTIAL BASIC EXCHANGE SERVICE (WHILE PLACING NONE OF IT ON THE OTHER SERVICES THAT SHARE THE LOOP FACILITIES) VIOLATES THE REQUIREMENTS AND FINDINGS OF THE TELECOMMUNICATIONS ACT OF 1996 (TA96), THE FCC, THE U.S. SUPREME COURT AND THE COMMISSIONS IN THE VAST MAJORITY OF OTHER STATES

Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY IN THIS PROCEEDING VIOLATE TA96?

A. Yes. Section 254(k) states:

> Section 254(k)--SUBSIDY OF COMPETITIVE SERVICES PROHIBITED.--A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

[79] USWC response to Request WDA 2-007.

In this proceeding. USWC is placing 100% of the shared loop facility costs on basic exchange service, while proposing a "free ride" on those same facilities for toll, switched access, and other services. Basic exchange service is one of the "universal services."

Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY VIOLATE THE ORDER OF THE U.S. SUPREME COURT?

A. Yes. Decades ago, in Smith v. Illinois Bell Telephone, the U.S. Supreme Court reviewed a telephone company cost study which placed all of the loop costs on the intrastate exchange service. The U.S. Supreme Court rejected this, and required that an "apportionment" of these loop costs be made. The Court stated that unless an apportionment is made, an "undue burden" would be placed upon the intrastate exchange services:

> The appellants insist that this method is erroneous, and they point to the <u>indisputable fact</u> that the subscriber's station, and the other facilities of the Illinois Company which are used in connecting with the long distance toll board, <u>are employed in the interstate transmission and reception of messages</u>. While the difficulty in making an exact apportionment of the property is apparent, and extreme nicety is not required, only reasonable measures being essential (citations omitted) <u>it is quite another matter to ignore altogether the actual uses to which the property is put. It is obvious that, unless an apportionment is made, the intrastate service to which the exchange property is allocated will bear an undue burden</u>--to what extent is a matter of controversy. We think this subject requires further consideration, to the end that by some practical method the different uses of the property may be recognized and the return properly attributable to the intrastate service may be ascertained accordingly.[80] (Emphasis added)

[80]Smith v. Ill. Bell Tel. Co., 282 U.S. 131, 150-151 (1930).

The Smith vs. IBT ruling is still the Supreme Court ruling in effect on this subject. This ruling is regularly referred to in current orders.[81] The Supreme Court has specifically looked at the cost of the loop facilities, and found that you cannot properly allocate all of those costs to just one of the services that shares that facility, and "ignore altogether the actual uses to which the property is put." This Supreme Court requirement is valid requirement that must be met today.

Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY VIOLATE THE REQUIREMENTS OF THE FCC?

A. Yes. The FCC's Part 36 Separations Rules require 25% of the costs of the shared loop facilities be allocated to the interstate jurisdiction.[82] The separations procedures are the result of a FCC-State Joint Board proceeding. Section 410(C) of the Telecommunications Act of 1934, as amended, makes the use of the separations as established in the Joint Board proceeding mandatory on both the FCC and state commissions. Therefore, a 25% allocation of the loop costs to the interstate jurisdiction is mandatory. However, as discussed, USWC's residential basic exchange service cost study makes no allocation of these costs to the interstate jurisdiction. Rather USWC places 100% of these costs on residential basic exchange, which is an intrastate service. In addition, the FCC has on numerous occasions stated that the loop facility costs are "common" costs, and not just costs of local service. For example,

[81]The FCC, in its recent Access Charge Reform Order dated May 8, 1997, referred to this case in Footnote 23.

[82]CC Docket No. 80-286, Notice of Proposed Rulemaking and Notice of Inquiry at 24, (FCC July 13, 1995).

> [I]nterstate access is typically provided using the same loops and line cards that are used to provide local service. The costs of these elements are, therefore, common to the provision of both local and long-distance services.[83]

Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY VIOLATE THE FINDINGS OF THE FCC-STATE JOINT BOARD?

A. Yes. Both the FCC-State Joint Board[84] and the FCC properly concluded that recovery of the cost which includes the loop facilities should be spread over the family of services that share those facilities:

> As the Joint Board recommended, the revenue benchmark should take account not only of the retail price currently charged for local service, but also of other revenues the carrier receives as a result of providing service, including vertical service revenue and interstate and intrastate access revenues.[85]
>
> We include revenues from discretionary services in the benchmark for additional reasons. ... <u>Revenues from services in addition to the supported services should, and do,</u> contribute to the joint and common costs they share with the supported services.[86] (Emphasis added)

Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY VIOLATE THE ORDERS OF THE COMMISSIONS IN THE VAST MAJORITY OF OTHER STATES?

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[83] ¶ 237, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket No. 96-262 et al.,adopted December 23, 1996 and released December 24, 1996.

[84] The FCC-State Joint Board is made up of both state commissioners and FCC commissioners.

[85] ¶200, Report and Order, CC Docket No. 96-45, FCC 97-157, adopted May 7, 1997, released May 8, 1997 (hereinafter referred to as the *Universal Service Order*).

[86] ¶261, Universal Service Order, FCC 97-157.

A. Yes. Numerous state commissions have found that the loop is a shared/joint/common cost, and that it is not a cost of just basic exchange or local service. Here are a few examples:

In an Order dated October 28, 1998, the Indiana Utility and Regulatory Commission (IURC) specifically found that assigning 100% of the loop cost to one service would violate Section 254(k) of TA96. It found the loop was "included in the definition of common and joint costs." The IURC found that,

> For purposes of resolving 'takings' claims and 'a reasonable share of the joint and common costs of facilities used to provide those services,' the loop must, therefore, be included in the definition of common and joint costs in order to determine confiscation claims and to be in compliance with the second sentence of Section 254(k). We find that the direct assignment of 100 percent of the loop costs to any one service would be a violation of the second sentence of Section 254(k).[87]

In the State of Utah, the Commission specifically found:

> We are troubled by the Company's failure to take into account Commission past orders which deal with some of the pivotal issues and assumptions which go into the calculation of TSLRIC. One failure, in particular, is the Company's decision to assign all costs of access lines to basic residential service...The Commission has already rejected the Company's premise that the only purpose of access lines, the local loop, is for the customer to obtain a dial tone or local service. Without the local loop, the end user would not have access to switched access products or use of toll services.[88]

In the State of Iowa, the Utilities Board found:

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[87]Indiana Utility Regulatory Commission Order, Cause No. 40785, Section V.(C) Common and Joint Costs, Issued October 28, 1998.

[88]US West Communications, Inc Docket No. 95-049-05, Report and Order, page 95 (Issued November 6, 1995).

> The local loop is the <u>sine qua non</u> of virtually all of Northwestern Bell's products and services. Equity demands that the costs associated with the local loop be allocated reasonably to all the products and services which rely upon it. Unless the costs of the local loop are equitably allocated, local service customers would be shown in cost studies as not paying sufficient amounts for their services and, thus, prime candidates for significant price increases. Just coincidentally, the great majority of local service customers demonstrate an inelastic demand for telephone service making them vulnerable to large price increases (TR 83-84). This flaw alone makes the LRIC study unacceptable.[89] (emphasis in original)

In another Order:

> Designating the access line as a separate service and allocating all of its costs to the local service customer continues to be a major problem with U S WEST's LRIC methodology.[90]

The Washington Utilities and Transportation Commission found:

> Finally, the residential cost study contains a basic flaw: USWC improperly allocates 100% of the local loop to residential service, and 0% to services that rely and depend on the use of that facility. The Commission in the past has addressed this issue and found it appropriate to allocate a portion of the loop costs to toll and other services.[91]

The Colorado Public Utilities Commission found:

> The second argument defines the local loop as a system. This system has many different users demanding service, including residential customers; small, medium and large businesses; governmental bodies; resellers; long distance companies; and others. A local loop is required and used by all of these users. Consequently, it has value to all of these users, and all should pay a portion of customer access.[92]

The New Hampshire Public Utilities Commission found:

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[89]Northwestern Bell Tel. Co., Docket No. RPU-88-9, Final Decision and Order, p. 10 (IUB Dec. 22. 1989).

[90]US West Communications, Inc., Docket No. RPU-94-1, Final Decision and Order, p. 13 (IUB Nov. 21, 1994).

[91]US West Communications, Inc. Docket No. UT-941464 et al, Fourth Supplemental Order at 39. (WUTC Oct. 1995)

> The commission is well aware of the company's claim that basic local exchange service has been and continues to be subsidized by toll. In the past, the notion of various services contributing to the support of basic exchange has been reinforced by cost studies that have served to demonstrate that the 'contribution' paid by customers of other services represents a disproportionately greater share of the company's incurred costs. These studies have served to mislead due to the company's decisions to assign NTS costs to local exchange services despite the fact that both interstate and state toll services are provided over local NTS facilities. Without local exchange facilities there would be no mechanism to connect interexchange services to the majority of customers premises. Since clearly the availability of the local network for toll use is a benefit to interexchange carriers and all toll customers, the Commission believes that assignment of NTS costs solely to local exchange services is unreasonable.[93]

Q. WHAT HAS NARUC STATED?

A. Yes. The general position of most of the state commissions is summarized by the National Association of Regulatory Commissioners' (NARUC) statement,

> Interexchange carriers should pay a portion of the NTS loop cost because they use the LECs loop to provide their services.[94]

Q. DO YOU BELIEVE THAT IT IS NECESSARY TO MAKE A SPECIFIC ALLOCATION OF THE COSTS OF THE SHARED LOOP FACILITY TO EACH OF THE SERVICES THAT SHARE THE LOOP FACILITY?

A. No. I do not believe that it is necessary to make a specific allocation of the costs of the shared loop facilities costs to each of the services that share the loop facilities. Instead, I recommend that the Commission insure that the contribution (revenues above TSLRIC) that each service is making toward the shared, joint and common costs of USWC

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[92]Page 19, Colorado Public Utilities Commission Order, I&S Docket No. 1720, dated March 20, 1987.

[93]Pages 39-40, New Hampshire Public Utilities Commission Order, Docket No. DR-89-010, dated March 11, 1991.

[94]Page 13, Initial Comments of the National Association of Regulatory Utility Commissioners, CC Docket No. 96-262, January 29, 1997.

(including the shared loop costs) is reasonable. Residential local service is clearly making a very significant contribution towards the joint, shared, and common costs. The contribution to joint, shared, and common costs that is being produced by residential basic exchange service at present rates, is clearly within the range of reasonableness for such contribution, and even appears to be on the high side of the range of reasonableness, as shown on Schedule WDA-19. Therefore, I recommend that the Commission find that the current residential basic exchange rates are making a reasonable contribution toward the recovery of the shared, joint and common costs (including the shared loop costs).

Q. IN THIS PROCEEDING, YOU ARE NOT RECOMMENDING THAT THE COMMISSION MAKE ANY ALLOCATIONS OF THE SHARED LOOP COSTS AMONG THE VARIOUS SERVICES THAT SHARE THE LOOP FACILITIES. HOWEVER, IF THE COMMISSION WANTED TO MAKE AN ALLOCATION OF THE SHARED LOOP FACILITY COSTS, CAN YOU PROVIDE ANY INFORMATION THAT WOULD SERVE AS GUIDANCE FOR A REASONABLE RANGE OF ALLOCATIONS OF LOOP COSTS TO RESIDENTIAL BASIC EXCHANGE SERVICE?

A. Yes. Although it is not necessary for the Commission to attempt to determine some specific figure as being the "reasonable" and "proportionate" share of the loop cost to be recovered from local services, there are some basic facts that allow us to narrow down the range of possible cost recovery allocations of the loop facility costs to residential basic exchange service.

(1) First of all, in Smith vs. IBT, the U.S. Supreme Court rejected placing all of the loop costs on intrastate local service, therefore the allocation of loop costs to residential basic exchange service must be less than 100% in order to comply with this requirement.

(2) Secondly, the FCC-State Joint Board Part 36 rules allocate 25% of the loop facility costs to the interstate jurisdiction, and 75% to the intrastate jurisdiction.[95] The Communications Act of 1934 makes the Joint Board separations allocations mandatory on state commissions, as well as on the FCC. Therefore, only 75% of the loop costs can be considered in an intrastate proceeding, such as this. It is important to note that in its residential basic exchange service TSLRIC cost study, USWC did not even exclude the 25% of the loop cost that is the interstate costs.

For example, assume the $21.98[96] unseparated loop "rate" is used for the loop cost. Even with just the 25% interstate costs removed, the highest amount that could be considered the intrastate loop cost would be $16.48 (75%). In fact, the "cost" is below this figure, because the UNE loop "rate" includes a 15% coverage of joint and common costs as previously discussed.

(3) The portion of the loop cost that should be recovered from intrastate local service has to be significantly <u>less than</u> 75%, since other intrastate services share the loop facility (such as intrastate toll, intrastate switched access services, vertical services, etc.). For the same reason that some portion of the loop cost is allocated to the interstate jurisdiction

[95]Part 36.154(c).

[96]This is the rate the Commission has established as the unbundled loop rate for USWC in Arizona. See USWC's response to Data Request WDA 2-35.

(i.e. because interstate toll and switched access services share the loop), some portion of the loop costs must also be recovered from intrastate toll, intrastate switched access services and vertical services since they also share the loop facilities.

Within these limits, the exact portion of the loop costs that is recovered from residential basic is judgmental. As the FCC has stated:

> A telecommunications carrier will typically provide these services, together with numerous other telecommunications service, over a single network because the total cost of providing these services on shared facilities, under shared management, is less than the combined cost of providing these services on separate facilities particularly under separate management operations. A substantial portion of these costs of shared facilities and operations are joint and common costs; it is difficult, if not impossible to approximate the actual portion of such costs for which each product or service is responsible. For these types of costs, considerations other than cost causation must prevail in determining how the costs should be allocated among various services. [97]

And,

> These costs pose particularly difficult problems for the separations process: The costs of such facilities cannot be allocated on the basis of cost-causation principles because all of the facilities would be required even if they were used only to provide local service or only to provide interstate access services. A significant illustration of this problem is allocating the cost of the local loop, which is needed both to provide local telephone service as well as to originate and terminal long-distance calls. The current separations rules allocate 25 percent of the cost of the local loop to the interstate jurisdiction for recovery through interstate charges.[98]

As the FCC has clearly stated, within these limits the recovery of the loop cost is judgmental.

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[97]Implementation of §254(k) of the Communications Act of 1934, as amended, Order adopted and released May 8, 1998, Paragraph 8.

[98]¶23, *FCC Access Charge Reform Order*, FCC 97-158.

In this proceeding, I do not believe the Commission needs to try to select any particular allocation percentage, since it is obvious that, even at <u>present rates</u>, the contribution that residential basic exchange service is making towards the joint and common costs is more than ample, and falls well within the range of reasonableness.

<u>E. WHEN BILLING FOR SEVERAL SERVICES, USWC PLACES ALL OF THE COST OF THE STANDARD ENVELOPE AND FIRST UNIT OF POSTAGE ON BASIC EXCHANGE SERVICE</u>

Q. YOU HAVE PREVIOUSLY DEMONSTRATED THAT USWC PLACES ALL OF THE LOOP COSTS ON BASIC EXCHANGE SERVICE, IN SPITE OF THE FACT THAT THE LOOP IS SHARED BY SEVERAL SERVICES. DOES USWC PLACE OTHER COSTS THAT ARE SHARED BY MORE THAN ONE SERVICE ENTIRELY UPON BASIC EXCHANGE SERVICE?

A. Yes. Take as an example a residential customer's bill from USWC which contains billing for some intrastate toll calls, some interstate toll calls, for custom calling service, and local service. In its so-called TSLRIC studies, USWC places the <u>full</u> cost of the standard sized envelope and first unit of postage used to send that bill entirely in the TSLRIC of basic exchange service.[99] USWC has admitted this in response to Data Requests WDA 1-44 and WDA 25-1. However, USWC includes none of the standard envelope or first unit of postage cost in its TSLRIC of toll services, or other non-basic services.

[99]The first unit of postage is the postage for one ounce (one "stamp" for those who use stamps).

This is yet another example of USWC's selective violation of the TSLRIC definition in order to disadvantage basic exchange services as compared to other services. As previously discussed, proper TSLRICs do not include the shared costs. USWC does not violate the TSLRIC definition for toll or other non-basic services. However, USWC selectively violates the TSLRIC definition by including all of these shared costs in the claimed TSLRIC of basic exchange service.

The cost of the first unit of postage and the standard envelope are shared costs of the services for which billing is occurring. These shared billing costs benefit all of the services that are being billed for, but USWC allocates all of the standard envelope and first unit of postage costs to basic exchange service.

IV. RATE DESIGN

Q. WILL YOU PLEASE PROVIDE AN OVERVIEW OF USWC'S RATE DESIGN PROPOSALS IN THIS PROCEEDING?

A. Yes. The overall revenue impacts of the major rate changes under USWC's proposed rate design are summarized below by service category:

Service	Proposed Revenue Change
Residence Basic Exchange	$43,686,364
Business Basic Exchange	$1,788,036
Market Expansion Line	($559,705)
Long Distance Services	($1,693,703)
Directory Assistance	$19,743,296
Listings	$ 9,476,737
Custom Calling	$ 7,455,163
Start-Up Package Elimination	$ 60,000

Toll Restriction Services	$ 7,955,484[100]
Switched Access	$ (5,000,000)
Private Line	$ 5,600,000
PAL	$ (7,900)
PAL Directory Assistance	$ 1,700,000[101]

A. USWC RATE PROPOSALS WHICH STAFF DOES NOT OPPOSE

Q. ARE THERE USWC RATE PROPOSALS THAT YOU DO NOT OPPOSE IN THIS PROCEEDING?

A. Yes. Below is a list of some of the USWC rate proposals that I do not oppose in this proceeding, and the page(s) of the USWC witness that discusses each of these proposed rate changes:

1. Reduce Residential Non-Recurring Charge (Teitzel Direct, page 39)
2. Eliminate Multi-Party Service for Residence and Business (Teitzel Direct, Page 40)
3. Bundle Business Dial Tone Line w/ Local Usage Components, (Teitzel Direct, Page 43)
4. Restructure Bus. Resale/Sharing Measured Local Usage, p. 45, (Teitzel Direct, Page 45)
5. Increase Business Resale Line Monthly Rate, (Teitzel Direct, Page 45)
6. Eliminate Business and Residence Zone Connection Charges, (Teitzel Direct, Page 39)
7. Reduce Market Expansion Line Monthly Rate, (Teitzel Supplemental Direct, Page 41)
8. Increase Business/Residence Internet Listings Monthly Rate, (Teitzel Direct, Page 59)
9. Increase Business E-Mail Listings Monthly Rate, (Teitzel Direct, Page 59)
10. Caller I.D. - Name/Number - Increase Res. Monthly Rate, (Teitzel Direct, Page 61)
11. Caller I.D. - Number - Increase Residence Monthly Rate, (Teitzel Direct, Page 61)
12. USWC Receptionist - Name/Number - Increase Res. Monthly Rate, (Teitzel Dir, P. 61)
13. USWC Receptionist - Number - Increase Res. Monthly Rate, (Teitzel Direct, Page 61)
14. Grandfather Business Custom Calling Packages, (Teitzel Direct, Page 63)
15. Grandfather SingleNumber Service, (Teitzel Direct, Page 64)
16. Eliminate Scoopline service (McIntyre Supplemental Direct, page 15)
17. Eliminate Scoopline Access Restriction, (Teitzel Direct, Page 66)
18. Increase NRC for 10XXX1+/10XXX011+ Block, (Teitzel Supp. Dir., Ex. DLT-47)
19. Change Monthly Rates for 911 and E-911 Service, (Teitzel Direct, Page 45)
20. Eliminate Start-Up packages (Teitzel Supplemental Direct Testimony, page 48)
21. Increase Carrier Directory Assistance (Wilcox Direct Testimony, page 11)
22. Increase some Switched Access NRCs, (Wilcox Direct, page 12)

[100]Teitzel Supplemental Direct Testimony Exhibit DLT-48.

[101]McIntyre Supplemental Direct Testimony, page 4.

23. Revise service maintenance charges and due date changes - switched access/private Line (Wilcox Dir., p.12)
24. Increase Rates for Last Call Return service (Teitzel Supplemental Direct Testimony Exhibit DLT-46)
25. Establish a $12.50 residential/business NRC for Billed Number Screening (Teitzel Supplemental Direct Testimony Exhibit DLT-47)
26. Increase Premium Listing rates (Teitzel Direct, Exhibit DLT-20)

In addition, there are other USWC proposals, or portions of USWC proposals that Staff does not oppose, as will be discussed later.

Q. IS THERE ONE OF THE ABOVE USWC RATE PROPOSALS THAT YOU STRONGLY SUPPORT?

A. Yes. Mr. Teitzel proposes to reduce the residential non-recurring charge from $46.50 to $35.00. As Mr. Teitzel points out, USWC's residential non-recurring charge in Arizona is the highest of all the states in USWC's 14-state region.[102] A high non-recurring charge can be a barrier to universal service. I support this reduction.

B. RESIDENCE BASIC EXCHANGE SERVICE

(1). 1FR, TAP AND LIFELINE RATE PROPOSALS

Q. WHAT DOES USWC PROPOSE FOR FLAT RATE RESIDENTIAL BASIC EXCHANGE SERVICE IN THIS PROCEEDING?

A. USWC proposes to increase the initial line of flat-rate residential basic exchange rate by 19% from $13.18 to $15.68 per month.[103] For additional lines, USWC proposes to maintain the current rates, in order to "reflect the manner in which U S WEST's

[102] Teitzel Direct, page 39.
[103] Teitzel Supplemental Direct Testimony, page 39.

competitors are pricing non-primary lines in Arizona, and in recognition of the fact that additional residential lines are assessed an End User Common Line (EUCL) charge of $6.07 per line, while primary lines are assessed an EUCL charge of $3.50."[104]

Q. WHAT DOES USWC PROPOSE FOR LOW INCOME TELEPHONE ASSISTANCE PROGRAM AND LIFELINE SERVICE RATES?

A. Under USWC's proposed rates, Low Income Telephone Assistance Program[105] and Lifeline service customers would experience drastic increases in their monthly rates. Under USWC's proposal, customers in the Low Income Telephone Assistance Program (LTAP) would see a 23% increase in the monthly rate for the flat rate service.

Lifeline customers[106] would see a 21% increase in the monthly rate for the flat rate service under USWC's proposal. A comparison of the current and proposed LTAP and Lifeline rates is shown below:

	Current Rate	Proposed Rate	Increase	% Increase
LTAP Flat Rate Option	$ 8.05	$ 9.92	$1.87	23%
LTAP Low Use Option[107]	$ 4.58	$ 6.44	$1.86	40%
Lifeline Flat Rate Option	$11.43	$13.93	$2.50	21%
Lifeline Low Use Option	$ 6.75	$ 9.25	$2.50	37%[108]

[104]Teitzel Supplemental Direct Testimony, page 39, line 25.

[105] Low Income Telephone Assistance Program customers only have two single party basic service options - flat rate service and a low use option.

[106] Lifeline customers also have the option of choosing between flat rate service and a low use option.

[107] Additional charges for usage also apply for both the LTAP and Lifeline Low Use options.

[108]Teitzel Supplemental Direct Testimony, page 39.

Q. DOES STAFF SUPPORT THE ABOVE-REFERENCED PROPOSALS FOR 1FR, TAP AND LIFELINE?

A. No. Staff recommends that USWC's proposed 1FR, TAP and Lifeline rate proposals be rejected for all of the following reasons:

1. USWC's proposals are based on the flawed premise that residential basic exchange service rates are priced below cost. These proposed increases are based upon USWC selectively violating the TSLRIC definition by including 100% of the common line costs in the claimed costs of residential basic exchange service. The current residential basic exchange service rates are greatly in excess of the residential basic exchange TSLRIC, when TSLRIC is properly calculated, as shown on Schedule WDA-19.

2. At current rates, residential basic exchange service is already shouldering more of the burden of contributing in excess of TSLRIC costs toward the shared, joint and common costs (including the shared loop facility costs) than is any other service which shares the residential loop facilities, as shown on Schedule WDA-19.

3. These proposed increases would damage universal service in Arizona, as will be discussed later.

The simple fact is that the current rates for residential basic exchange service are currently covering all of the direct costs, a reasonable portion of the costs of the shared facilities used to provide the services, and are making a significant contribution to the common overhead costs of USWC. By any valid measure of cost, the current rates for residential basic exchange services are reasonable.

The justification that USWC gave for the difference between the initial and additional line, that the interstate EUCL charge was different, is not a valid reason. The EUCL charge is an interstate charge imposed by the FCC. If USWC does not agree with the

FCC's decision, it is not appropriate to ask the state commission to effectively "offset" the FCC's decision.

USWC's proposal, which is for a higher charge on the initial line than on the additional lines, would tend to damage universal service. The "additional" line is not critical for universal service. Customers who have one line have telephone service, and have the ability to call in the event of emergencies, and otherwise interact with their community. The "additional" line is not critical to universal service. In addition, the difference between the residential primary line and additional lines in the EUCL charge is now different than it was when USWC presented its testimony. On July 1, 2000, the residential primary line EUCL charge went from $3.50 to $4.35. However, there is not a similar increase in the residential additional line SLC.

(2) STAFF PROPOSED RATE DESIGN

Q. WHAT DOES STAFF PROPOSE FOR RESIDENTIAL BASIC EXCHANGE SERVICE RATES?

A. Staff's proposal for these and other rates is shown on Schedule WDA-20. The rate design Staff proposes are for a range of revenue requirement possibilities. At the top of page 1 of Schedule WDA-20, a summary of Staff's rate design proposals for services other than residential and business basic exchange services is presented. I will discuss those proposals later in this testimony. The bottom of page 1 of Schedule WDA-20 shows Staff's proposed residential and business basic exchange service rates. Staff's proposed residential and business basic exchange service rates would be calculated based upon the revenue requirement ordered by the Commission. Under Staff's proposal, as the first step in changing the basic exchange rates, the business basic rates would be reduced $2 from their current level. The purpose of this reduction is to modify the existing relationship that exists between residential and business basic exchange services. There are some valid reasons for a difference between business and residential basic exchange service. For example, business basic exchange service includes a valuable yellow page listing which is not included with residential basic exchange. Business basic exchange service is generally tax deductible to the customer, but residential basic generally is not. This affects the "affordability", which is an issue that must properly be considered in rate design. However, I am proposing to reduce the difference between residence and business basic exchange, by reducing the business basic exchange rate by $2 per line, with no equivalent residential reduction. As a next step after all of the rate changes previously listed on Schedule WDA-20 are accomplished, then both the residential and business basic exchange service rates would be increased or decreased by the same dollar amount per line in order to achieve the approved revenue requirement. At the bottom of Schedule WDA-20, page 1, the amount by which each residential and business basic exchange rate must be changed for each $1 million change in revenue requirement is shown.

Pages 2 and 3 of Schedule WDA-20 show Staff's proposal in more detail, with specific rates that would be produced at various revenue requirements.

(3). BASIC SERVICE LOW USE OPTION

Q. WHAT CHANGES DOES MR. TEITZEL PROPOSE FOR ALL RESIDENTIAL LOW USE OPTION CUSTOMERS?

A. As discussed on page 38 of his originally filed Direct Testimony, Mr. Teitzel proposes to convert all residential "Low Use Option" customers to a new measured service option called "Budget Measured Plan." Under Mr. Teitzel's proposed plan, customers will pay an increased line rate from their previous rate of $8.50 per month to a new rate of $11.00 per month. This is the same $2.50 per line increase USWC has proposed for flat rate residential service. The line rate will include one hour of usage, with any usage exceeding the hour being charged at a rate of $0.02 per minute. Under the existing Low Use Option, all calls are charged at a rate of $0.20 per call.

Q. WHAT RATIONALE DOES MR. TEITZEL PROVIDE FOR HIS LOW USE OPTION PROPOSAL?

A. Mr. Teitzel claims that he is making this proposal to "better meet the needs of the Low Use Option Customer."[109] In addition, Mr. Teitzel argues:

> A very small percentage of customers subscribe to the service, as the $0.20 per call charge, when added to the line rate, quickly makes flat rate service more attractive.[110]

Q. IS THE RELATIONSHIP THAT MR. TEITZEL PROPOSES BETWEEN THE BUDGET MEASURED PLAN AND FLAT RATE OPTIONS REASONABLE?

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[109] Teitzel Direct Testimony, page 38, line 27.

[110] Teitzel Direct Testimony, Page 38, line 20.

A. No. Under USWC's proposal, the line rate for the Budget Measured Plan would be $4.80 below the line rate for flat rate service. However, the cost of flat rate usage is much less than the $4.68 difference which USWC proposes. Therefore, the difference between these two rates is greater than can be explained by the fact that the flat rate includes usage whereas the measured rate does. The cost for local usage at the average for that rate level is ** **, as shown on Schedule WDA-18. This figure is from USWC's cost studies. In the past, the excessive discount from the flat rate charge for the "low use" line was made up for by the high charge for usage. However, under the new Budget Measured Plan, there is an hour of free usage, and after that the usage is 2¢ per call. Under the new proposal, the usage charge would not produce as large a contribution to make up the excessive difference in the line rates. The low use customers only make an average of about ** ** calls a month.[111] If five minutes per call is assumed, the average low use customers would be making about ** ** of calls per month. The new USWC proposal contains an hour of uncharged usage.

The above discussion uses the existing flat rate as the starting point. If the flat rate is increased or decreased, as shown on the bottom of Schedule WDA-20, page 1, the Budget Measured Plan line rate would increase or decrease along with it, so as to maintain the above-referenced $3.00 differential. Therefore, the average Budget Measured Plan customer would pay nothing for usage, and would pay a line charge of $4.68 below the flat rate. Providing service to these customers at $4.68 less than the service is provided to the flat rate customers, is a differential significantly greater than the difference in the cost of providing the service.

[111]USWC's response to Data Request WDA 1-2, Attachment A.

Q. WHAT DO YOU RECOMMEND?

A. I recommend that the Budget Measured Plan line rate, with the inclusion of one hour of usage, be set $3.00 below the flat rate. After the one hour of usage is exceeded, the USWC proposed rate of 2¢ per minute is acceptable. This is not a rate increase for the current customers. The current low use customers make an average of about ** ** calls per month, which at 20¢ each, would result in a ** ** per month usage charge. When this is added to their $8.50 current rate, the low use customers would have an average bill of ** **. Under my proposal, using the existing $13.18 as a starting point, the flat rate per line charge would be $3.00 below that, which is $10.18. The average low use customer would pay no usage charge (because their usage falls within the one hour of usage allowance).[112]

C. ZONE INCREMENT CHARGES

Q. WHAT CHANGES DOES MR. TEITZEL PROPOSE TO MAKE TO THE RECURRING ZONE INCREMENT CHARGES THAT APPLY CUSTOMERS LOCATED OUTSIDE OF THE BASE RATE AREA?

A. Mr. Teitzel proposes to expand the base rate area, thereby reducing the number of customers that will be required to pay the recurring zone increment charges.[113] Under the current zone increment structure, ** ** residence and ** ** business customer lines are charged a zone increment charge. Under USWC's proposal to expand

[112] The $11.00 rate that USWC discusses compares to the $15.68 residential flat rate proposal, which is the same difference of $4.80 between the $8.50 current rate and $13.18 current rate.
[113] Teitzel Direct, page 42, line 16.

the base rate area, the number of customer lines that will be considered outside the base rate area (and therefore charged a zone increment charge) would be reduced to ** ** for residence and ** ** for business.[114] For these customers that remain outside of the base rate area after the proposed expansion, Mr. Teitzel proposes to increase the zone increment charges. The current and USWC's proposed residence and business recurring zone increment charges are shown below:

	Current Rate	USWC Proposed Rate
Residence		
Zone 1	$1.00	$5.00
Zone 2	$3.00	$7.00
Business		
Zone 1	$1.00	$10.00
Zone 2	$3.00	$15.00[115]

Q. WHAT IS THE BASIS FOR MR. TEITZEL'S PROPOSED INCREASES FOR THE RECURRING ZONE INCREMENT CHARGES?

A. As discussed on pages 37-38 of his Supplemental Direct Testimony, Mr. Teitzel's proposed rates are in response to USWC's proposed de-averaged rates for the UNE loop in Docket No. T-00000A-00-0194.

Q. CAN YOU PLEASE PRESENT AN ANALYSIS OF THIS ZONE INCREMENT ISSUE?

[114]USWC's Recurring Priceouts 1999 Test Year, provided in response to Data Request WDA 21-3, Section E.

[115]Teitzel Supplemental Direct Testimony, page 38.

A. Yes. Nationwide, the trend has been to completely eliminate the OBRA charges. For example, the independent telephone companies, funded by the agency formerly known as the Rural Electric Administration (REA) generally have eliminated the OBRA charges.

First of all, it must be understood that the proposed OBRA charges generally apply only to certain rural customers, and do not generally apply to customers in certain urban wire centers. For example, there are no areas in the Phoenix Main wire center or Tuscon Main wire centers in which the OBRA rates would apply.

For those certain rural customers, imposing OBRA charges is effectively the same as imposing a higher basic rate on those customers than is imposed on urban customers. For example, the Zone 2 customer under USWC's proposal can be displayed as shown below:

	USWC Proposed "Urban" Basic Exchange Rate	Effective Proposed Basic Exchange Rate for Certain Rural Customers
Residential	$15.68	$15.68
OBRA Rate (Zone 2)		7.00
Total Effective Basic Exchange Rate	$15.68	$22.68

Charging higher rates to rural customers than are charged to urban customers for similar services conflicts with a number of public policy requirements. For example, Section 254(b)(3) of TA96 states:

> ACCESS IN RURAL AND HIGH COST AREAS - - Consumers in all regions of the Nation, including low-income customers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and

> information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.[116]

Of course, "similar" is a judgement, but USWC is clearly decreasing the similarity between the urban and rural rates under their proposal. In addition, TA96 requires that the rates for service be "affordable." Section 254(b)(1) states:

> QUALITY AND RATES.--Quality services should be available at just, reasonable, and affordable rates.

Affordability is also a matter of judgement. However, USWC's proposal would make the basic exchange service rates significantly less affordable in the affected rural areas. As discussed, above, the USWC proposed rate for basic exchange plus outside base rate area for Zone 2 rural customers is $22.68. In addition to this, the customers must pay the $4.35 interstate EUCL charge. When normal taxes and surcharges are added, the rural customers are looking at a rate just to have basic exchange service in the area of $30 per line per month. In addition to the approximate $30 charge for basic exchange service, rural customers on the average already pay much higher toll bills than do urban customers, because of the difference in the local calling areas, as will be discussed later.

Q. ON PAGES 36-38 OF HIS SUPPLEMENTAL DIRECT, MR. TEITZEL DISCUSSES THE COMMISSION'S ACTION TO DE-AVERAGE UNBUNDLED LOOP RATES IN ARIZONA, AND CLAIMS THAT IN ORDER TO "MAINTAIN A REASONABLE RELATIONSHIP BETWEEN UNE LOOP PRICES AND RETAIL PRICES", THE ZONE INCREMENT CHARGES FOR BASIC EXCHANGE SERVICE SHOULD BE

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[116] §254 (b) (3), Federal Telecommunications Act of 1934 (1996 Amended).

INCREASED. DOES UNE LOOP DE-AVERAGING PROMPT A NEED TO INCREASE THE ZONE INCREMENT CHARGES?

A. No. In order to determine whether or not a "reasonable relationship" exists between UNE loop prices and retail rates, you must compare the retail revenues obtained from all of the services that share the loop facilities to the costs of providing all services that share the loop facilities (including the cost of the UNE loop). Since the loop facility is shared by a number of different services, a study that compares the total contribution over and above direct cost derived from the family of services that share the loop facilities should be conducted to determine if a "reasonable relationship" exists between the UNE loop prices and retail prices.

Due to Mr. Teitzel's erroneous view of the loop facility as a cost of providing only basic exchange service, Mr. Teitzel has improperly linked a change in the price for the unbundled loop with a proposal to change the retail price for just one of the services that shares the loop facility - basic exchange service, via the zone increment charge. In reality it is the retail rates that are charged for the whole family of services that share the loop facilities that must be considered when determining whether or not a "reasonable relationship" exists between UNE loop rates and retail rates.

Q. IS USWC'S ARGUMENT THAT THE BASIC EXCHANGE RATES MUST BE ADJUSTED TO CONFORM TO THE UNE RATES VALID?

A. Not entirely. USWC's argument is based upon their misconception that the loop cost (as identified by the UNE rates) is directly a cost of only basic exchange service. As previously demonstrated, and as shown on Schedule WDA-17, that is an incorrect concept. The loop facilities are used by a whole family of services. Therefore, UNE costs cannot be directly related to just basic exchange service rates, or to any one of the family of services that share the loop facilities.

Twenty-five percent of the loop costs are separated to the interstate jurisdiction. In those areas where the loop costs are higher, that means the dollar amount per loop allocated to the interstate jurisdiction is higher than in other areas where the loop cost is lower. The remaining costs must be recovered over the family of intrastate services that share the facilities.

In addition, the higher rural intrastate costs must be compared to the total intrastate revenues being derived. In general, the intrastate revenues under present rates are already much higher for the average rural line than for the average urban line, primarily because of the higher levels of toll and switched access, as discussed below. Therefore, USWC has presented no evidence that an additional increase in the rural areas' total charge is required.

Q. WHY ARE THE RURAL REVENUES HIGHER ON AVERAGE THAN THE URBAN REVENUES FOR THE AVERAGE RESIDENTIAL CUSTOMER, EVEN WITHOUT AN ADDITIONAL OBRA CHARGE?

A. Rural customers generally have a more limited local calling area than do urban customers. As a result, rural customers pay toll rates for calls for which an urban customer pays local rates. As a result, the average rural customers' toll bills are generally significantly higher than the urban customers' toll bills. Without an analysis of the total revenues between rural and urban customers, it is not possible to determine that there is a need to increase rates on the rural customers. It is true that the loop cost per line in certain rural areas may be higher than in urban areas, but it is also true that the existing total revenues per line in the rural areas are also higher than the existing revenues in the urban areas. Staff attempted to obtain a breakdown of the difference in toll revenues between rural and urban customers from USWC, but USWC would not provide that information.[117]

Q. IS THERE EVIDENCE THAT USWC'S RURAL CUSTOMERS IN ARIZONA HAVE HIGHER TOLL BILLS THAN DO USWC'S URBAN CUSTOMERS?

A. Yes. In discovery, USWC provided the dial equipment minutes (DEM) minutes of use for a number of wire centers throughout USWC's service territory in Arizona. This data clearly demonstrates that a much greater percent of customer's minutes of use in rural areas is intraLATA toll or access minutes than is true for urban areas.

For example, in USWC's urban "Phoenix Main" wire center, only about ** ** of the total intrastate minutes of use are intrastate toll and intrastate switched access minutes.[118] Since the "Phoenix Main" wire center is part of the "Phoenix Metropolitan" exchange that

[117] USWC response to Request WDA23-001.

[118] USWC's response to data Request WDA 28-2, Attachment A, CLLI code "PHNXAZMADS4". Switched access minutes occur when a toll carrier other than USWC originates or terminates a toll call over USWC facilities. Therefore, these two figures combined is a measure of the total intrastate toll usage.

includes local calling to many access lines, it is not surprising to find that only a small percentage of the total intrastate minutes of use are from intrastate toll and intrastate switched access in the "Phoenix Main" exchange.

However, customers in the USWC rural Whitlow exchange can call only ** ** lines as their local calling area.[119] Any call outside of these few lines is a toll call. For customers in USWC's rural Whitlow exchange, an incredible ** ** of the total intrastate minutes of use are for intrastate toll and intrastate switched access.[120] The average customer in this rural USWC exchange are obviously incurring much higher toll bills, and generating much higher toll and switched access revenues per line for USWC, than is the average customer in the Phoenix exchange. Another example is the rural "Payson" wire center, where over ** ** of the total intrastate minutes of use are from intrastate toll and intrastate switched access minutes. Customers in the Payson wire center can call a total of ** ** lines as their local calling area.[121]

In USWC's rural "Casa Grande" wire center, over ** ** of the total intrastate minutes of use are from intrastate toll and intrastate switched access minutes.[122] The "Casa Grande" wire center is in the rural Casa Grande exchange, which does not have a local calling area that includes a major urban or metropolitan area. Customers in the

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[119]USWC's response to Data Request WDA 32-1, Attachment A.

[120]USWC's response to data Request WDA 28-2, Attachment A.

[121]USWC's response to Data Request WDA 32-1, Attachment A.

[122]USWC's response to data Request WDA 28-2, Attachment A.

"Casa Grande" exchange can call fewer than ** ** lines as part of their local calling area.[123] Any calls outside of these ** ** lines is a toll call.

In many rural areas, USWC is collecting much higher toll and switched access revenue per line than is true for urban areas. Even if the cost of providing facilities are higher in rural areas, the revenues per line are also higher. Therefore, there is no evidence at this time that an additional increase in the total rates charged to rural customers as compared to urban customers is needed at this time.

Q. WHAT DO YOU RECOMMEND WITH RESPECT TO USWC'S ZONE INCREMENT CHARGE?

A. I accept the expanded base rate area as USWC has proposed. I recommend maintaining the current recurring charges for both Zones 1 and 2.

Q. THE COMMISSION, IN THE UNE PROCEEDING, DID NOT APPROVE EXPANDING THE BASE RATE AREAS AS PART OF THE INTERIM UNE RATE CHANGE. WILL THAT CAUSE SIGNIFICANT CUSTOMER CONFUSION?

A. No. End user customers have no interaction with the UNE tariffs. Only certain customers, such as CLECs, deal with UNE rates.

[123] According to Section 5.1.1 of USWC's Exchange and Network Services Tariff, the Casa Grande Exchange has local calling to Casa Grande, Coolidge, Eloy, Florence and Maricopa. The lines for these exchanges were obtained from USWC's response to Data Request RUCO 27-4, Attachment A.

On the other hand, the rates that are being set in this case will be the retail rates that may be in effect, or may form the basis for the rates in effect, for many years in the future. In addition, many customers may have been aware that the Company was proposing to expand the base rate areas, thereby relieving them of paying the OBRA charges. Staff sees no valid reason to prevent that expansion.

D. BUSINESS BASIC EXCHANGE SERVICE

Q. WHAT DOES USWC PROPOSE FOR BUSINESS BASIC EXCHANGE SERVICE?

A. Overall, USWC proposes to increase business basic exchange service revenues annually by $1,788,036.[124] Included in USWC's proposal was a revenue-neutral collapse of the currently separate dial tone line and usage elements into a single flat business line rate.

Q. WHAT DOES STAFF PROPOSE FOR BUSINESS BASIC EXCHANGE SERVICE RATES?

A. Staff does not oppose the above-referenced revenue neutral collapse of the two elements. As previously discussed, Staff proposes to reduce the differential that currently exists between residential basic exchange and business basic exchange service. As a first step, Staff proposes reducing the business basic exchange rate by $2.00 per line per month. All of the other business basic exchange rates (PBX trunk, etc.) are also reduced by $2.00 per line per month. Following that change in the business basic exchange service rates, Staff proposes that the business basic exchange service rates be increased or decreased by

[124]Teitzel Supplemental Direct Testimony Exhibit DLT-48.

the same dollar amount per line that the residential basic exchange service rates are increased or decreased. This is shown on the bottom of page 1 of Schedule WDA-20. The specific rates at various assumed revenue requirements are shown on the other pages of that Schedule. The change in the per line rate for business basic exchange service includes all forms of business basic exchange service, such as single line flat rate business rates, PBX trunk rates, etc.

E. INTRALATA TOLL SERVICES

Q. WHAT DOES USWC PROPOSE FOR INTRALATA TOLL SERVICES?

A. USWC is proposing to make the following intraLATA toll rate changes:

1. Reduce the business and residence standard MTS rates;
2. Increase the Speech/Hearing impaired discount from 35% to 50%;
3. Eliminate the Simple Calling Plan for Residence and convert to MTS;
4. Eliminate Arizona Value Calling Plan I for Residence/Business - convert to MTS;
5. Eliminate Arizona Value Calling Plan II and convert to Super Savings
6. Eliminate Volume Discount Plans - convert Business to Simple Value Plan and Residence to MTS
7. Grandfather MetroPac Calling Plan[125]

The annual revenue impact of these USWC intraLATA toll proposals is a decrease of $5,106,829.[126]

Q. DOES USWC NEED THE COMMISSION'S APPROVAL IN THIS PROCEEDING TO REDUCE ITS TOLL RATES?

[125]Teitzel Supplemental Direct Testimony Exhibit DLT-45.

[126]Teitzel Supplemental Direct Testimony Exhibit DLT-45.

A. No. The Commission has already determined that the toll services are competitive, and that they are flexibly priced.[127] In response to discovery in this proceeding, USWC stated the following:

> With the pricing flexibility currently afforded toll services, U S WEST could certainly reduce its toll rates outside of this rate case without Commission approval.[128]

Q. IF USWC CAN REDUCE ITS TOLL RATES OUTSIDE OF THIS PROCEEDING WITHOUT COMMISSION APPROVAL, WHAT IS USWC ACTUALLY SEEKING BY PLACING THESE REDUCTIONS IN THIS PROCEEDING?

A. USWC is actually seeking an offsetting increase in the rates for other (primarily non-competitive) services to support the $5 million reduction in the rates for competitive toll services. Increasing the rates for non-competitive services to offset a reduction in the rates for competitive services violates the entire concept of designating these services as competitive. In a competitive market, the Company has the freedom to adjust its prices as needed (within limits), but does not have the right to ask the customers of non-competitive services to support the revenue changes that result from the change in prices in the competitive market.

Q. WHAT DOES STAFF RECOMMEND PERTAINING TO THE CHANGE IN TOLL RATES?

A. The intraLATA toll service has been classified by this Commission as competitive. USWC has the flexibility to reduce its toll rates without Commission approval. Staff

[127] ACC Decision No. 59637.
[128] USWC's response to Data Request WDA 2-21 (b).

does not, in any way, oppose the reductions deemed appropriate by USWC (providing they fall within the Commission allowed ranges, which Staff does not believe is an issue at this time). However, Staff does oppose the USWC concept that the rates for other services, primarily non-competitive services, should be increased to offset the change in revenues resulting from the change in price for a competitive service. That would be requiring the non-competitive services to support USWC in the competitive market, which is inappropriate and a violation of the concept of treating the competitive services separately from the non-competitive services. The Commission has given USWC the freedom to compete in those markets the Commission has deemed to be competitive.

Competition is supposed to drive prices down by forcing companies to become more efficient. If competition drives prices down by forcing greater efficiency, then customers have benefited. However, Mr. Teitzel proposes an effective shift of cost recovery away from the services that have already been classified as competitive and onto other services that are not competitive. Customers would not gain any benefit from reducing toll rates by shifting the costs onto non-competitive services.

Q. IS USWC'S REVENUE IMPACT CALCULATION FOR TOLL CREDIBLE?

A. No. The premise of the USWC proposed price change is that USWC would be more successful in the toll market at the new prices than they would at the existing prices. If that is true, that means USWC will generate as much or more revenues at the new prices than they would at the current prices (or else the change in price would not be reasonable). In short, if the change in price will improve USWC's position in the competitive markets, then that change does not result in a reduction of revenues, it results in the same, or if anything, an increase in revenues. The USWC revenue impact calculation, which pretends that the revenue impact of the change would be to decrease revenues by $5 million, is therefore inconsistent with their testimony.

Q. USWC CLAIMS THAT THE TOLL REDUCTIONS IT PROPOSES WOULD POSITION THEM BETTER IN THE MARKET THAN ITS CURRENT RATES.[129] PLEASE RESPOND.

A. USWC is free to make the rate changes it proposes. USWC management may believe that as a result of price reductions, USWC's market share will be higher than it otherwise would have been to offset the revenue losses that result from the price reductions. USWC would be better off in the market after the price reductions than if they had not made these price reductions. If management chooses to make those rate changes which better position them in the market, there is no associated revenue loss. (Management would have made these changes only because they thought they would be better off than if they had not made them.) On the other hand, if management does choose to make rate changes in this competitive market that do cause a revenue loss, that is a result of the management's decision. The result of a management decision in a competitive market is not something that should be recovered from the non-competitive services. The revenue impact to be recovered from non-competitive services is zero. This does not imply in any way that Staff is opposing USWC choosing to make price reductions, which the Commission has allowed them to do within the flexible pricing guidelines.

Q. MR. TEITZEL CLAIMS THAT USWC'S TOLL "IS PRICED MANY TIMES ABOVE ITS TSLRIC AND SHARED COST."[130] DOES THE "SHARED COST" THAT MR. TEITZEL REFERS TO INCLUDE ANY PORTION OF THE SHARED LOOP FACILITY COSTS?

A. No. The major shared cost associated with the provision of USWC's intraLATA toll services is the shared cost of the loop facilities. However, USWC has included no portion of these major shared costs in its claimed "TSLRIC and Shared cost." Therefore, Mr. Teitzel's claim that USWC's intraLATA toll services are priced many times the "TSLRIC and Shared cost" is based upon a distortion of the costs that excludes the major shared cost of providing the service.

Q. ON PAGE 49 OF HIS DIRECT TESTIMONY, MR. TEITZEL CLAIMS THAT USWC'S INTRALATA TOLL RATES SUBSIDIZE RESIDENTIAL BASIC EXCHANGE SERVICE. MR. TEITZEL STATES:

> With the move to price residence Basic Exchange Service towards cost, U S WEST can then coincidentally eliminate a portion of the subsidies represented by the contribution in Long Distance Services.[131]

IS THIS A VALID CLAIM?

A. No. Mr. Teitzel's claim that intraLATA toll rates subsidize residential basic exchange service rates is based upon a distortion of residential basic exchange costs that includes the full cost of the shared loop facilities. Despite the fact that several services share the

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[129] Teitzel Direct, page 49.
[130] Teitzel Direct Testimony, page 50, line 23.

[131] Teitzel Direct Testimony, page 49, line 29.

loop facilities, USWC chooses to unreasonably place the full cost of the shared loop facilities on residential basic exchange service. When this improper distortion is removed from the analysis, it is clear that residential basic exchange service covers its TSLRIC, plus makes a reasonable contribution to the shared costs of providing the service, including the shared loop facility costs.

Q. DOES INTRALATA TOLL PROVIDE AS MUCH CONTRIBUTION AS BASIC TOWARD THE SHARED, JOINT AND COMMON COSTS OF USWC?

A. No. At current rates, intraLATA toll services provide a mere ** ** per line per month contribution toward the shared costs of providing telecommunications services, including the shared loop facility costs, as shown on Exhibit WDA-19. As shown on that Schedule, the current residential basic exchange service rates provide over ** ** more contribution per-line toward the shared, joint and common costs of providing telecommunications services. USWC's claim that intraLATA toll is providing a "subsidy" to residential basic exchange service is nothing more than a distortion of the facts. Supporting a small portion of the costs of the loop facility that toll services share is not a "subsidy" to any other service, it is simply supporting a small portion of the cost of the facility that is needed to provide, among other things, toll service.

The above discussion of costs and contribution demonstrates that there is no valid reason for the rates of other customers to be increased to support toll services' price reduction. The toll services are not currently being burdened with any disproportionate share of the joint and common costs. In fact, the toll services' contribution to the joint and common cost is much lower than the contribution being received from basic exchange service rates.

F. OPERATOR SURCHARGES

Q. WHAT DOES USWC PROPOSE FOR OPERATOR SERVICES?

A. As indicated on his Supplemental Direct Exhibit DLT-45, Mr. Teitzel proposes to increase the rates for a number of Operator Service Surcharges.

Q. WHAT ARE OPERATOR SERVICE SURCHARGES?

A. Operator Service Surcharges apply when a customer requests an operator (either mechanized or human) to provide assistance with a call.

Q. ARE USWC'S PROPOSED OPERATOR SERVICE RATE INCREASES COST-BASED?

A. No. Of USWC's total proposed revenue increase of $3,413,126 for Operator Services, all but ** **[132] of that increase is for Operator Services whose current rates are already above the costs that USWC has filed in this proceeding (both the TSLRIC "Total Direct" and the "Total Direct Plus Network Support" costs).[133]

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[132] Mechanized calling Card is the only Operator Service whose current rate is below USWC's claimed costs. The revenue impact of USWC's proposed rate change for Mechanized calling Card is an annual increase of ** **, as shown in Section C6.2.1 of USWC's USWC's Recurring Priceouts 1999 Test Year, provided in response to Data Request WDA 21-3.

[133] The current and proposed rates for USWC's Operator Service Charges are shown on Exhibit DLT-45 of Mr. Teitzel's Supplemental Direct Testimony and the costs are shown on Exhibit JLT-1 of Mr. Thompson's Supplemental Direct Testimony.

In addition, a number of the operator surcharges that USWC proposes rate increases for already have current rates that are far in excess of USWC's claimed costs. For example, as shown on Mr. Teitzel's Supplemental Direct Exhibit DLT-45, the current rate for "Connect to Directory Assistance" service is $1.50 and USWC's proposed rate is $2.25. However, as shown on page 14 of Mr. Thompson's Supplemental Direct Exhibit JLT-1, USWC's claimed cost of this service is ** ** per call.

Q. WHAT DO YOU RECOMMEND FOR OPERATOR SERVICES?

A. Some of these charges are very high and greatly exceed costs. Some of the USWC proposed operator assistance rates are $6.00 or more for one call. For most operator services, I have proposed some increases, although the increases I propose are not as high as the Company has proposed. The changes which I propose produce a revenue impact of ** **, as shown on Schedule WDA-20.

G. DIRECTORY ASSISTANCE

Q. WHAT DOES USWC PROPOSE FOR DIRECTORY ASSISTANCE (DA) SERVICES?

A. USWC has made the following proposals for DA in this proceeding:

1. Eliminate the monthly call allowance for DA;

2. Increase the rate for "traditional" DA from $0.47 per call to the National DA rate of $0.85 per call;

3. Include "Complete-A-Call" for the $0.85 per call rate.[134]

[134]Teitzel Direct Testimony, pages 54-57.

4. Increase the current PAL DA rate of $0.15 per call to $0.60 per call[135].

5. Increase the rate for carrier DA from $0.22 to $0.35 per call.[136]

Q. ARE USWC'S DA AND NATIONAL DA NOW CLASSIFIED AS "COMPETITIVE" SERVICES IN ARIZONA?

A. Yes. In its December 18, 1997 Order (Decision No. 60545) in Docket No. T-1051-97-369, the Commission classified USWC's National Directory Assistance (National DA) services as "competitive" services. In its December 14, 1999 Order (Decision No. 62129) in Docket No T-01051B-99-0362, the Commission classified USWC's Directory Assistance (DA) services competitive. In that proceeding, USWC was requesting an increase in the DA rates, however, the Commission deferred the proposed rate changes to this rate proceeding.

Q. IF DA IS NOW FLEXIBLY PRICED, WHY DOES USWC NEED THE COMMISSION'S APPROVAL TO INCREASE THESE DA RATES?

A. In this proceeding, USWC is asking for changes that are outside the scope of what they can accomplish without Commission approval under price flexibility. The DA rate increase that USWC proposes for "traditional" DA would go above the ceiling price that applies to the flexibly priced range. Therefore, USWC needs the Commission's specific approval to change that ceiling price.

[135]Wilcox Direct Testimony, page 22, line 7.

[136]Wilcox Direct Testimony, page 11.

Q. WHAT DO YOU RECOMMEND?

A. Staff does not oppose raising the cap to $0.85 for DA, nor does Staff oppose the elimination of the one call monthly call allowance, and the other proposed changes listed above. The addition of the "completed call" service at no charge will provide an additional benefit to customers.

Q. IS THERE A PROBLEM WITH THE COMPANY FILING ON THIS ISSUE?

A. Yes. The Company admitted in discovery that it had miscalculated the revenue impacts, shown on Schedule WDA-21. USWC stated that the $18.3 million revenue impact they originally calculated should in fact have been $23.5 million. USWC stated it would update its rate case to reflect this change.[137] The Company's current filing still includes the above-referenced error. Based upon the 1999 test year data, the correct annual revenue impact of the Company's proposal is ** **, as shown on Schedule WDA-22. This compares to the $19,743,296 incorrect figure that is shown on Exhibit DLT-48 of Mr. Teitzel's Supplemental Direct testimony. The primary error appears to be in USWC's incorrect handling of the elimination of the free call allowance. This elimination of this allowance results in a revenue increase because calls that are currently free, will be charged for under this proposal.

Q. DOES USWC PROPOSE ANY OTHER CHANGES TO DIRECTORY ASSISTANCE OTHER THAN THOSE YOU HAVE JUST DISCUSSED?

A. Yes. As discussed on page 22, line 7 of her Direct Testimony, Dr. Wilcox proposes to increase the current PAL DA rate of $0.15 per call to $0.60 per call. The PAL DA would be expanded to include access to national as well as local numbers. According to Dr. Wilcox, these proposals are based on her claim that the present $0.15 per call rate is below cost.[138]

For alternatively billed DA calls such as calling card and third number, Dr. Wilcox proposes to offer DA with the addition of call completion for a rate of $0.85 per call.

Q. WHO PURCHASES PAL DIRECTORY ASSISTANCE SERVICE?

A. As Dr. Wilcox explains on page 22, line 8 of her Direct, this service is purchased by payphone providers for resale to their end user customers.

Q. WHAT DOES USWC CHARGE PAYPHONE USERS FOR DIRECTORY ASSISTANCE AT USWC-OWNED PAYPHONES IN ARIZONA?

A. USWC charges its payphone customers $0.35 for direct dialed calls to Directory Assistance.[139]

Q. WHAT DO YOU RECOMMEND FOR PAL DIRECTORY ASSISTANCE SERVICE?

A. To be competitive with USWC's 35¢ payphone DA charge, competitive payphone providers could not be expected to charge their customers more than 35¢ for a direct dialed DA call. However, under USWC's proposal, those competitive payphone providers would have to pay USWC 60¢ per DA call. This would force the competitive

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[137] These are the numbers that were based upon the test year ending June, 1998.
[138] Wilcox Direct Testimony, page 22, line 16.

[139] USWC's response to Data Request WDA 26-6.

payphone providers to provide service at a loss. Obviously, USWC is engaging a "price squeeze" on those that compete against USWC payphones. Such a price squeeze is anti-competitive. Therefore, Staff recommends that PAL rate for direct-dialed DA cannot exceed the current charge of USWC, which is 35¢.

H. PRIVACY LISTING SERVICES

Q. WHAT DOES USWC PROPOSE FOR PRIVACY LISTING SERVICES?

A. USWC is proposing to increase Non-Published Service monthly rates by 66% (from $1.80 to $3.00) for business customers and by 57% (from $1.90 to $3.00) for residence customers. For Non-Listed Service, USWC proposes to increase the monthly rate 37% (from$1.45 to $2.00) for business and 29% (from $1.55 to $2.00) for residence customers.[140]

Q. IS THERE ANY COST REASON FOR INCREASING THESE RATES?

A. No. According to the costs presented by Mr. Thompson in this proceeding, the cost to provide Non-Published and Non-Listed service is ** **.[141]

Q. DO YOU BELIEVE THAT NON-LISTED AND NON-PUBLISHED SERVICES ARE PROPER TARGETS FOR EXTRACTING HIGH LEVELS OF CONTRIBUTION?

[140]Teitzel Direct Testimony, page 58, line 16.

[141]Thompson Supplemental Direct Testimony Exhibit JLT-1, page 15.

A. No. An indeterminate number of these customers have themselves been targets of harassment or worse. These particular customers depend on restriction of access to their telephone numbers as a form of protection. Under the USWC rate proposal, these particular customers are a captive market. They must pay the higher rate to maintain the protective shield of their private telephone numbers.

Q. WHAT IS ONE ARGUMENT USWC MAKES?

A. On page 58 of his testimony, Mr. Teitzel says,

> These rates should be increased because Privacy Listings are discretionary services which serve to devalue the public switched network over time. As more customers make their telephone number unavailable for others through the use of such services, telephone service for other customers is devalued.

Q. ARE ADDITIONAL RATE INCREASES NEEDED TO CURB THE GROWTH OF PRIVACY LISTINGS?

A. No. The percent of residential listings omitted from the directories because of these services is declining. The percent of residential lines omitted from the directories as a result of these services is now ** ** lower than it was in the test year USWC utilized in the 1993 general rate case. Less than ** ** of business lines are omitted from the published directory due to privacy listing services.[142]

Q. WHAT DO YOU RECOMMEND CONCERNING THE RATES FOR THESE SERVICES BY USWC?

A. I recommend the current non-published and non-listed rates continue. They are producing a large contribution over the costs of providing these services.

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[142]USWC's response to Data Request WDA 2-27 and WDA 21-12 (c).

I. PREMIUM LISTING SERVICES

Q. BEGINNING ON PAGE 58 OF HIS DIRECT TESTIMONY, MR. TEITZEL PROPOSES RATE CHANGES FOR SEVERAL PREMIUM LISTINGS. DO YOU OPPOSE THESE PROPOSED PREMIUM LISTING RATE CHANGES?

A. No. An example of a premium listing service is if a customer wishes their E-mail address to appear along with their listing in the directory.

Q. WHAT IS THE ANNUAL REVENUE IMPACT OF THE RATE PROPOSALS FOR PREMIUM LISTINGS?

A. The annual revenue impact of these proposals is an increase of approximately ** **.[143]

J. CUSTOM CALLING SERVICES

Q. WHAT DOES MR. TEITZEL PROPOSE FOR CUSTOM CALLING SERVICES?

A. For residence Custom Calling services, USWC proposes to increase the Caller Identification (Caller ID) -Name and Number monthly rate from $5.95 to $6.95 and an increase for Caller ID - Number from $5.50 to $6.95 per month. In addition, USWC

[143]Calculated from USWC's Recurring Priceouts 1999 Test Year, provided in response to Data Request WDA 21-3.

proposes to increase U S WEST Receptionist - Name and Number from $10.95 to $11.95 per month and U S WEST Receptionist - Number from $10.50 to $11.95 per month.[144]

In addition, USWC proposes to increase the monthly and "Pay Per Use" rates for Last call Return Service for both business and residence customers. For residence, USWC proposes to increase the monthly rate from $2.95 to $3.95 and for business, USWC proposes a rate increase from $3.00 to $4.00. USWC proposes to increase the "Pay Per Use" rate from $0.75 to $0.95 per use.[145]

Q. ARE THESE CUSTOM CALLING RATE INCREASE PROPOSALS SUPPORTED BY USWC'S CLAIMED COSTS FOR THESE SERVICES?

A. No. According to USWC's cost studies for these services, USWC's claimed TSLRIC (Total Direct) cost to provide Caller ID - Name and Number is only ** ** per month; USWC's total monthly cost to provide Caller ID -Number is ** ** per month and USWC's total monthly cost for Last call Return service is ** **.[146] Therefore, USWC's current rates for these services already greatly exceed USWC's claimed costs.

Q. WHAT DO YOU CONCLUDE WITH RESPECT TO USWC'S RESIDENTIAL CUSTOM CALLING PROPOSALS?

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[144]Teitzel Direct Testimony, page 61, lines 16-27, and also Teitzel Supplemental Direct Testimony Exhibit DLT-46.

[145]Teitzel Supplemental Direct Exhibit DLT-46.

[146]Thompson Supplemental Direct Testimony Exhibit JLT-1, page 21.

A. There is no valid cost-based reason to increase these rates. However, these services are discretionary in nature. It is better to generate revenues from such discretionary services than raising rates for universal services, such as basic exchange service.

Q. WHAT DOES MR. TEITZEL PROPOSE FOR BUSINESS CUSTOM CALLING SERVICES?

A. Mr. Teitzel proposes to grandfather all existing packages of Custom Calling services with the exception of SMARTSET, SMARTSET PLUS and Call Manager Connection. As indicated on Mr. Teitzel's Supplemental Direct Testimony Exhibit DLT-46, these services are found in Section 105.4.3, pages 3-5 of USWC's Exchange and Network Services tariff.

Q. DO YOU OPPOSE THIS PROPOSAL?

A. No.

Q. WHAT IS THE REVENUE IMPACT OF THESE RESIDENTIAL CUSTOM CALLING RATE PROPOSALS?

A. The total annual revenue impact of the proposed custom calling rate proposals is an increase of $7.4 million. Of this total increase, ** ** is for residential custom calling services, and ** ** for business, as shown on Schedule WDA-20.

K. SCREENING SERVICES

Q. WHAT CHANGES DOES USWC PROPOSE FOR TOLL RESTRICTION SERVICES?

A. As shown on Exhibit DLT-47 of his Supplemental Direct Testimony, Mr. Teitzel proposes the following changes for Toll Restriction/Screening services:

1. Increase the residential non-recurring charge (NRC) for Toll Restriction Service;
2. Establish a $12.50 residential/business NRC for Billed Number Screening;
3. Withdraw ScoopLine Access Restriction;
4. Establish a $12.50 residential/business NRC for 900 Service Access Restriction;
5. Increase the residential/business NRC for 10XXX1+/10XXX011+ Blocking

Q. DO YOU OPPOSE ANY OF THESE PROPOSED CHANGES?

A. Yes. I oppose Mr. Teitzel's proposal to increase the residential Non-Recurring charge for Toll Restriction Service from $6.00 to $12.50.[147] As Mr. Teitzel admits, the rationale behind this proposal is to generate increased revenues for USWC. Mr. Teitzel states:

> An increase in the residence nonrecurring charge is designed to generate additional revenue in this case.[148]

However, Toll Restriction service may be subscribed to by customers who have trouble controlling their toll usage or the toll usage of others who have access to their telephone. Therefore, when a customer subscribes to toll restriction, they are making an effort to keep their telecommunications service bills affordable. In addition, USWC's proposal to increase the non-recurring rate from $6.00 to $12.50 is not cost-based. According to

[147]Teitzel Supplemental Direct Testimony Exhibit DLT-47.

[148]Teitzel Direct Testimony, page 66, line 6.

USWC's residential non-recurring cost studies, the cost is ** ** at the most.[149] I believe it would be inappropriate to extract large contribution from residential customers who are making an effort to keep their telephone bills more affordable. For all of these reasons, I recommend that the current residential non-recurring charge of $6.00 be maintained for residential toll restriction service.

In addition, Staff believes that USWC's proposed $12.50 non-recurring charge for 900 Service Access Restriction is excessive. Staff believes that many of the customers who are subscribing to 900 Service Access Restriction, similar to subscribers of Toll Restriction service, are making an effort to keep their telecommunications service bills affordable by preventing household members or other users of their telephone from making costly telephone calls that can greatly inflate the monthly telecommunications bill. Staff recommends that a non-recurring charge of $6.00 be established for 900 Access Charge Restriction. This rate is above USWC's claimed cost of ** ** shown on page 21 of Mr. Thompson's Supplemental Direct Testimony Exhibit JLT-1.

Q. DO YOU OPPOSE ANY OF THE OTHER TOLL RESTRICTION/SCREENING PROPOSALS ADVANCED BY USWC?

A. No. I do not oppose any of USWC's proposals for the other Toll Blocking and Restriction Services. The revenue impact of the remaining proposed changes is a revenue increase of approximately ** **.

[149]Thompson Supplemental Direct Testimony Exhibit JLT-1, page 21.

L. SWITCHED ACCESS SERVICE

Q. WHAT CHANGES DOES USWC PROPOSE TO THE SWITCHED ACCESS RATES?

A. USWC proposes a number of changes. The major impacts are a proposed reduction in the IC.[150] This reduces annual revenues by approximately ** **. The reduction of the carrier common line charge (CCLC) rate reduces annual revenues by approximately ** **. USWC proposes increases in the local switching rates and net decreases in switched transport rates. The total effect is an overall proposed decrease of approximately $5 million in switched access.

Q. ON PAGE 6, LINE 20 OF HER DIRECT TESTIMONY, DR. WILCOX CLAIMS:

> The carrier common line (CCL) charge today provides revenue contribution in support of basic telephone service for end-users. There are no direct access costs associated with this price element since it is generally related to the recovery of U S WEST's non-traffic sensitive (NTS) costs associated with the ubiquitous provision of basic telephone service.

IS DR. WILCOX'S DISCUSSION OF THE CCL CHARGE ACCURATE?

A. No. While Dr. Wilcox is correct that the CCL charge is the switched access rate element that is associated with the recovery of a portion of the non-traffic-sensitive loop facilities costs, Ms. Wilcox is incorrect that this represents a support for basic telephone service. Since switched access shares the loop, it should support a share of the loop costs. Dr. Wilcox is correct that the TSLRIC of switched access does not include the non-traffic sensitive (NTS) costs, such as loop costs, because the loop is a shared cost. However, for the same reason, the TSLRIC of basic exchange service also does not include the shared loop cost. However, proper prices must cover not only the TSLRIC (direct cost), but also must cover the shared costs as well. If all costs, including the shared costs, are not covered, companies will go out of business. A portion of those shared costs should be borne by the switched access CCLC, as this Commission has properly found in the past.

In addition, in a current USWC general rate case in the State of New Mexico, Dr. Wilcox stressed the fact that the CCLC is merely a charge to the IXCs to contribute toward the network that the IXCs depend upon:

> Elimination of the CCL would mean that long distance carriers would no longer help pay for the local loop or help support the ubiquitous local network, which end-users and carriers alike depend upon.[151]

Switched access supporting a portion of the facilities that it depends upon, benefits from, and shares is not payment in support of another service. As discussed elsewhere in this testimony, residential basic exchange service costs is ** ** per line per month, if its cost is calculated in the same way that USWC has done for switched access service, which is to exclude all of the shared loop costs, and joint billing costs (standard envelope and first unit of postage). Basic exchange service and switched access service are both part of the group of services which share the loop, and both should properly contribute toward the recovery of the shared cost of the loop. Of course, switched access service, toll service, basic exchange service, and other services should be priced above their TSLRIC so as to contribute to the shared costs.

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[150] The IC is sometimes referred to as the TIC, or the residual interconnection charge (RIC).
[151] Rebuttal Testimony of Barbara M. Wilcox, New Mexico Utility Case No. 3008, May 19, 2000.

Q. DO THE CURRENT SWITCHED ACCESS RATES MAKE AN UNREASONABLY LARGE CONTRIBUTION TO THE SHARED, JOINT AND COMMON COSTS OF PROVIDING TELECOMMUNICATIONS SERVICES IN ARIZONA?

A. No. As shown on Schedule WDA-19, the current intrastate switched access rates (including the intrastate CCLC) make a contribution of ** ** per line above their direct cost, toward the shared, joint and common costs of providing telecommunications services in Arizona. For purposes of comparison, the current residential basic exchange service rates make over ** ** more contribution per-line above direct cost toward the shared, joint and common costs of USWC.

Q. ON PAGE 7, LINE 1 OF HER DIRECT, DR. WILCOX CLAIMS THAT USWC'S INTERCONNECTION CHARGE (IC), WHICH WAS CREATED AS A RESULT OF LOCAL TRANSPORT RESTRUCTURE, IS A SUPPORT FOR BASIC TELEPHONE SERVICE. IS THIS AN ACCURATE CLAIM?

A. No. First of all, as discussed above, residential basic exchange service is not receiving a subsidy or support from other services. In addition, as Dr. Wilcox indicates in her Direct Testimony, in the last general rate case, USWC's switched access rates underwent a Local Transport Restructure that aligned USWC's transport rates with the interstate rates and rate structure.[152] The application of the IC was part of that restructure which copied the interstate rate structure. In the interstate jurisdiction, the FCC intentionally set the charge for the tandem switch rate element at 20% of its costs, and put the remainder of

[152]Wilcox Direct Testimony, page 5, line 5; Also see page 108, Decision No. 58927.

the tandem switch revenue requirement into the IC (sometimes referred to as the TIC). The FCC stated:

> The charge for the tandem switch was initially set to recover 20 percent of the Part 69 tandem revenue requirement. Finally, to make the restructure revenue neutral initially, we required incumbent LECs to establish a non-cost based transport interconnection charge (TIC), to recover the revenue difference between what the LECs would have realized under the equal charge rate structure and what they would realize from the interim facility-based transport rates, including the remaining 80 percent of the tandem revenue requirement.[153] (Citations omitted)

Q. ARE THE CURRENT SWITCHED ACCESS RATES PRODUCING AN UNREASONABLE LEVEL OF CONTRIBUTION TOWARDS JOINT AND COMMON COSTS?

A. No. As Schedule WDA-19 shows, switched access services are not producing an unreasonable level of contribution to the joint and common costs, including the shared loop costs.

Q. WHAT DO YOU RECOMMEND FOR USWC'S SWITCHED ACCESS SERVICES?

A. I propose the Commission allow a revenue neutral restructure of the switched access rates by USWC. If USWC objects to the level of specific rates, such as the level of the IC, their concern can be accommodated by a revenue neutral restructure. However, if the intent is to transfer the support of joint and common costs away from switched access onto other services, that concept is inappropriate and should be rejected. Switched access services are not providing an unreasonable level of support to the joint and common costs.

[153]FCC Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket No. 96-262 et. al., Released December 24, 1996, ¶182.

M. ALTERNATIVES TO USWC'S SWITCHED ACCESS SERVICE

Q. ON PAGE 28, LINE 19 OF HER DIRECT, DR. WILCOX SUGGESTS THAT THERE ARE "MANY CASES" WHERE PRIVATE LINE CIRCUITS ARE REPLACING SWITCHED EXCHANGE PBX TRUNKS AND 1FB LINES. ARE PRIVATE LINE SERVICES A COMPETITIVE THREAT TO USWC'S SWITCHED ACCESS SERVICES, OTHER THAN FOR VERY HIGH VOLUME LOCATIONS?

A. No. To connect to the average customer, switched access is a much more economical alternative than a private line for carrying toll traffic. The average USWC intrastate switched access revenues per line are ** ** per month, as shown on Schedule WDA-19.[154] This represents the average switched access charges paid by IXCs to USWC. A private line would require a separate loop. The monthly rate for just a dedicated loop portion of private line service would be many times the charge for switched access. Therefore, for the average customer location, it will not be an economical alternative to pay the private line rates compared to paying switched access rates.

Q. WOULDN'T MOST CUSTOMERS FOR WHOM PRIVATE LINE SERVICE IS AN ECONOMICAL ALTERNATIVE, ALREADY BE USING PRIVATE LINE SERVICE TO CARRY THEIR TOLL TRAFFIC?

[154]Calculated from USWC's responses to Data Requests WDA 21-13, Attachments A and C.

A. Yes. For those customers who originate and terminate extremely high volumes of toll traffic, private line services like special access is an economical alternative. However, the majority of those customers would already be using private line services to carry their toll traffic. There may be a small percentage of customers whose level of usage is on the borderline between making switched access and private line the more economical choice. In these instances, a change in one of these service's rates may have an impact on a customer's decision between the two services, however, this situation would be limited, certainly not typical or average.

Q. WHAT IS USWC'S SHARE OF THE SWITCHED ACCESS MARKET IN ARIZONA?

A. USWC has a virtual monopoly of the switched access services in Arizona. For example, according to the information provided by Dr. Wilcox in this proceeding, USWC's competitors' share of the switched access minutes of use in Phoenix is less than ** **.[155]

N. INTRASTATE PRIVATE LINE

Q. HAVE YOU DETERMINED THE REVENUE REQUIREMENT FOR USWC'S INTRASTATE PRIVATE LINE SERVICES?

A. Yes. In response to discovery, USWC provided its Part 36 Separations Studies for the year 1999.[156] These separations studies prepared by USWC separately show the

[155] Wilcox Direct Testimony Exhibit BMW-15 and Attachment L of USWC's response to Data Request WDA 1-15.

[156] USWC response to Requests WDA 23-7, 24-1 and 24-2.

intrastate interLATA and intrastate intraLATA private line revenue requirements. The local private line revenue requirement can also be determined from the figures that underlie that study. Data from USWC's own separations studies show that USWC's 1999 test year revenue requirement for its intrastate private line services is ** **, as is shown on Schedule WDA-23.

Q. WHAT WERE USWC'S INTRASTATE PRIVATE LINE REVENUES FOR ITS 1999 TEST YEAR?

A. USWC's intrastate private line revenues totaled ** ** for its 1999 test year.[157] Therefore, USWC's intrastate private line services have a ** ** annual revenue deficiency.

Q. WHAT DOES USWC PROPOSE FOR PRIVATE LINE SERVICES?

A. USWC has proposed the following for Private Line services:

1. Increase the recurring two-wire/four-wire Network Access Channel (NAC) Rates;
2. Increase some and reduce other Channel Performance rates;
3. Grandfather Local Area Data Service (LADS);
4. Increase fixed and per-mile transport mileage rates;
5. Increase some and reduce other Optional Features and Functions;
6. Increase some and reduce other Private Line NRCs;
7. Increase Digital Data Service (DDS) rates; and
8. Increase E911 Transport Rates.[158]

Q. WHAT IS THE REVENUE IMPACT OF USWC'S PRIVATE LINE AND E911 TRANSPORT SERVICE PROPOSALS LISTED ABOVE?

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[157]USWC's response to Data Request WDA 30-3, Attachment A.

[158]McIntyre Supplemental Direct Testimony, pages 6-13.

A. The annual revenue impact is an increase in revenues of $5.6 million for the Private Line service proposals, and an annual increase of $109,972 for the E911 transport proposals.[159]

Q. HAS THE COMMISSION DETERMINED THAT PRIVATE LINE SERVICES ARE COMPETITIVE?

A. The Commission has classified the interexchange private line services as competitive and flexibly priced.[160] The Commission has not classified the local private line services as competitive or flexibly priced. In discovery, USWC was unable to separate the private line revenues between the private line services the ACC has classified as competitive, and the private line services the ACC has not classified as competitive.[161] It is reasonable to expect that the majority of the private line revenues are in the category that the Commission has classified as competitive. USWC contends that all private lines are competitive, but the Commission Order which granted competitive status specifically referenced "interexchange" private line services.

Q. WHAT DO YOU RECOMMEND?

A. I propose that USWC's proposal for E-911 and 911 services be granted as filed without additional increases allowed. I recommend that the customers of USWC monopoly services not be required to support USWC's pricing of their private line services below cost. To allow this would be requiring the customers of what are primarily non-competitive services to support USWC's competitive services. Therefore, I recommend

[159]McIntyre Supplemental Direct Testimony, pages 12-13.

[160] Paragraph 7, ACC Decision No. 59637.

[161] USWC response to Request WDA 16-002.

this Commission authorize USWC to increase its private line rates such as to produce an additional ** ** in revenues.

Since at least a major portion of this service is flexibly priced, the Commission Order will not mandate the USWC management to increase the price for these competitively priced services, since that discretion has been given to management. However, the additional revenues will be imputed in the revenue analysis in this proceeding, regardless of whether the USWC management chooses to increase the private line rates or not. The revenue requirement that is being considered in this case includes in excess of ** ** in private line revenue requirement. However, the private line revenues are only ** **. Therefore, if the rates are not increased, or a revenue imputation is not made, that will mean the rates for non-competitive services will have to be priced to cover approximately ** ** of private line competitive service revenue requirement. If USWC chooses to price its competitive services at a loss, that is a USWC management decision which they are allowed to make under flexible pricing. However, in no event should the rates for other non-competitive services be set to remove the private line revenue requirement that the USWC management has elected to not recover in the private line rates.

In short, the revenue impact calculation should include a ** **[162] annual revenue increase for private line services, with the permission to make those increases

[162] The E911 increase of $109,972 is included in this proposal. Therefore, the increase for other services would be the stated amount less the E911 transport increase.

granted to USWC. That revenue impact should be used regardless of whether USWC chooses to take advantage of that permission or not.

Q. IF YOU DO NOT SPECIFICALLY ADDRESS A RATE DESIGN PROPOSAL OF USWC IN THIS TESTIMONY, DOES THAT MEAN YOU DO NOT OPPOSE THAT RATE PROPOSAL?

A. No. If I do not specifically address a rate design proposal of USWC in this testimony, that does not necessarily mean I do not oppose that rate proposal. I recommend that the rates shown on Schedule WDA-20 be implemented in this proceeding. I recommend that no other rate changes be made in this proceeding other than those shown on Schedule WDA-20.

V. UNIVERSAL SERVICE ISSUES

A. ARIZONA'S PENETRATION RATE IS BELOW AVERAGE. USWC'S PROPOSED RATE INCREASES FOR RESIDENTIAL BASIC EXCHANGE SERVICE WOULD HARM UNIVERSAL SERVICE.

Q. DOES ARIZONA ALREADY HAVE A BASIC LOCAL SERVICE PENETRATION PROBLEM?

A. Yes. Arizona lags behind most states in the USWC region and the majority of the states in the country in telephone service penetration rates. Only two states in USWC's 14-state region (New Mexico and South Dakota) have penetration rates that are below Arizona's current penetration rate of 93.2%. The average penetration rate for USWC's 14-state region is 94.9%. In addition, Arizona lags behind 33 states nationwide in penetration.

The current nationwide average penetration rate is 94.2%, leaving Arizona well below the average for both USWC's region and the nation as a whole.[163]

Q. IS USWC'S PROPOSAL TO DRASTICALLY INCREASE THE RATES FOR LOW INCOME AND LIFELINE CUSTOMERS IN THE PUBLIC INTEREST?

A. Absolutely not. USWC's proposal drastically increases the basic exchange service rates for the customers that Mr. Teitzel admits are least able to pay for these services.[164] This undermines the benefit of having assistance programs. USWC's proposal to drastically increase these rates will jeopardize the ability of these needy customers to obtain telephone service, is not in the public interest, and should be rejected by the Commission.

Q. ON PAGE 37 OF HIS DIRECT TESTIMONY, MR. TEITZEL CLAIMS THAT THERE ARE APPROXIMATELY 160,000 CUSTOMERS THAT ARE ELIGIBLE FOR STATE AND/OR FEDERAL ASSISTANCE IN PAYING FOR TELEPHONE SERVICE IN ARIZONA. HOW MANY CUSTOMERS ACTUALLY RECEIVE ASSISTANCE IN ARIZONA?

A. Only a small portion of those who Mr. Teitzel claims "qualify" for assistance actually receive assistance. For example, USWC indicates that the average number of USWC's customers that subscribe to Lifeline service in Arizona is 4,447 and the total number of subscribers who receive assistance from USWC's Low Income Telephone Assistance

[163]Data for annual 1999 unit penetration. FCC's Monitoring Report, CC Docket No. 98-202, December 1999, Table 6.3.

[164]Teitzel Direct Testimony, page 37, line 14.

Program (TAP) is 3,835.[165] The fact is that programs such as Lifeline and TAP, which provide assistance to low income consumers are helpful, however, such need-based plans are not the full answer. Many of the customers that would qualify for such programs, for a number of different reasons do not receive assistance from these programs. For example, they may not be aware of these programs, may not be willing to go through the administrative procedures required to qualify or may for personal reasons be unwilling to accept assistance on the basis of their income.

Such programs do help some customers, but in the interest of universal service it is also necessary that the residential basic exchange rates, which are available without requiring the customer to declare and prove that they have low income, should be as reasonably priced as possible.

Q. ON PAGE 35, LINE 33 OF HIS DIRECT, MR. TEITZEL CLAIMS THAT HIS PROPOSED RESIDENTIAL BASIC EXCHANGE INCREASES WILL HAVE A "NEGLIGIBLE" IMPACT ON SUBSCRIBERSHIP LEVELS IN ARIZONA. ARE THERE MANY CUSTOMERS IN ARIZONA THAT ARE BEING PRICED OFF THE NETWORK AT THE CURRENT RATES?

A. Yes. At USWC's current rates, USWC initiates the disconnection of over ** ** residential customers for non-payment per year.[166] This represents nearly ** ** of

[165]USWC's Response to Data Request WDA 21-12 (b), which is an updated response to USWC's response to Data Request WDA 2-16.

[166]According to Section E2.2.9 of USWC's Non-Recurring Priceouts 1999 Test Year, provided in response to Data Request WDA 21-3, USWC initiates the termination of an average of ** ** residential services per month.

USWC's total residential lines in service in the State of Arizona.[167] Many residential customers are having trouble paying the phone bill even at current rates. Clearly, drastically increasing the rates for residence basic local exchange service would make these situations even worse.

Q. WHAT SHOULD BE DONE TO PROMOTE AN INCREASE IN PERCENT PENETRATION IN ARIZONA?

A. In order to promote an increase in percent penetration in Arizona, the non-recurring and recurring residential basic exchange rates must be kept as low as possible. USWC's proposal to reduce the non-recurring residential basic exchange rates is a step in the right direction, but the USWC proposal to greatly increase the recurring rates will have a negative impact on penetration.

B. UNIVERSAL SERVICE SHOULD BE AFFORDABLE FOR ALL CUSTOMERS, NOT JUST "MOST CUSTOMERS"

Q. ON PAGE 36 OF HIS DIRECT, MR. TEITZEL ARGUES THAT "MOST CUSTOMERS" WILL BE ABLE TO AFFORD THE RESIDENTIAL BASIC EXCHANGE RATE INCREASES THAT HE PROPOSES IN THIS PROCEEDING. DO YOU BELIEVE THAT A BASIC EXCHANGE RATE INCREASE IS WARRANTED AS LONG AS "MOST CUSTOMERS" CAN AFFORD TO PAY IT?

A. No. First of all, the current residential basic exchange service rates are not only already well above the relevant residential basic exchange service TSLRICs, but also residential

[167]According to USWC's ARMIS Report 43-08 for the year 1999, Row 130, USWC has 2,009,298 residential lines in service in Arizona.

basic exchange service makes the largest contribution of any major service category to the joint, shared and common costs, as shown on Schedule WDA-19. Secondly, residential basic exchange service is one of the services included in the definition of universal service. Due to the importance of this foundational service, residential basic exchange service should be <u>universally</u> affordable to all of those who wish to subscribe to it, not just affordable for what USWC calls "most customers."

C. CHARGING EXCESSIVE RATES IN AREAS WHERE LITTLE OR NO COMPETITION EXISTS WILL NOT "ATTRACT" COMPETITORS

Q. ON PAGE 43, LINE 9 OF HIS DIRECT TESTIMONY, MR. TEITZEL CLAIMS THAT USWC'S PROPOSED RATE INCREASES FOR RESIDENTIAL BASIC EXCHANGE SERVICE "WILL INCENT COMPETITIVE GROWTH." WILL THESE PROPOSED RATE INCREASES PROMOTE COMPETITIVE GROWTH IN ARIZONA?

A. No. USWC is claiming that it is pro-competitive to reduce rates in those areas where they may face competition, while increasing rates in those areas where little or no competition exists. USWC is arguing that such a policy may attract competition to the areas or services where there is currently little or no competition. First of all, it is obvious that USWC would not propose a strategy that would actually result in increasing competition to itself. It is not in USWC's interest to propose a price structure that would attract competition for itself.

USWC lowering the prices where they face competition forces the competitors to lower their prices, which lower competitors' earnings. This does not benefit the competitors.

USWC charging higher prices where they have monopoly power does not attract competitors, as will be discussed below. The high monopoly rates would attract competitors <u>only</u> if those competitors knew that those high monopoly rates would continue to exist once the competitors arrived in the area. However, from their past experience with LECs like USWC, the competitors know very well that those high "monopoly" rates cease once the competitors enter the market. The competitors know very well that once they started competing in an area or service, USWC would drop their high "monopoly" rates and replace them with their low "anti-competitive" rates in those areas and for those services where competition existed.

By pricing competitive services to produce little or even negative earnings, the LECs can make the competitors unprofitable, limit their growth, and send a message to the potential competitors that their profits will be low or non-existent wherever it is they choose to compete with that LEC.

D. RELATIONSHIP BETWEEN UNBUNDLED NETWORK ELEMENTS AND RETAIL SERVICES

Q. ON PAGE 33 OF HIS DIRECT TESTIMONY, MR. TEITZEL ARGUES THAT THERE MUST BE A LOGICAL RELATIONSHIP BETWEEN THE PRICES FOR UNBUNDLED NETWORK ELEMENTS AND THE RATES CHARGED FOR INDIVIDUAL SERVICES. IN TELECOMMUNICATIONS, IS IT COMMON FOR THE APPROPRIATE RATE FOR AN INDIVIDUAL SERVICE TO BE LESS THAN

THE CHARGE FOR THE UNBUNDLED NETWORK ELEMENTS THAT ARE NEEDED TO PROVIDE THAT SERVICE?

A. Yes. In telecommunications, nearly all services are provided over shared facilities. When it is USWC that is providing the services to its end-users using those shared facilities, the proper rate design for those services is to price each service at a level that contributes to the recovery of the cost of the shared facilities.

When these facilities are rented to a competitor, these facilities are referred to as "unbundled network elements." When a competitor rents unbundled network elements from USWC, it is up to the competitor to properly price each of its services that it provides using these elements at a level that contributes to the recovery of the shared cost of renting those facilities from USWC.

E. WIRELESS SERVICES ARE NOT A PRACTICAL ALTERNATIVE TO LANDLINE TELECOMMUNICATIONS SERVICES

Q. MR. TEITZEL DEDICATES SEVERAL PAGES OF HIS SUPPLEMENTAL DIRECT TESTIMONY TO A DISCUSSION OF WIRELESS SERVICE PROVIDERS. ON PAGE 25 OF HIS TESTIMONY, HE REFERENCES A SURVEY THAT FOUND 45% OF PHOENIX HOUSEHOLDS AND 43% OF TUCSON HOUSEHOLDS SUBSCRIBE TO WIRELESS SERVICE. ON HIS SUPPLEMENTAL DIRECT TESTIMONY EXHIBIT DLT-43, HE PROVIDES DATA SHOWING AN INCREASE IN CELLULAR MINUTES OF USE IN ARIZONA. DOES THIS INFORMATION

DEMONSTRATE THAT CELLULAR SERVICE IS REPLACING LANDLINE TELECOMMUNICATIONS SERVICES?

A. No. At best, this information demonstrates that cellular services are a form of telecommunications that are a supplement to landline telecommunications services, not a replacement for them. As discussed elsewhere, the household penetration rate for basic exchange service in Arizona is 93.2%.[168]

Q. HAVE USWC'S LINES IN SERVICE BEEN INCREASING OVER TIME, DESPITE THE FACT THAT WIRELESS SERVICES HAVE BEEN AROUND FOR SOME TIME?

A. Yes. Despite the fact that wireless services have been around and growing for many years now, USWC's number of access lines in service in Arizona has grown year after year. In addition, in response to discovery, USWC provided its forecast of residential lines in service through the year 2003. This forecast shows that USWC anticipates the number of both residential main lines and additional lines to ** **.[169] In addition, nationwide the number of access lines (landline) has grown year after year, at the same time cellular service was also rapidly growing. Clearly, the growth of wireless service is not resulting in the decline of landline telephone service.

[168]FCC's Monitoring Report, CC Docket No. 98-202, December 1999, Table 6.3.

[169]USWC's response to Data Request WDA 3-22, Attachment A.

Q. ON PAGE 26 OF HIS SUPPLEMENTAL DIRECT TESTIMONY, MR. TEITZEL CLAIMS THAT THE RATES FOR WIRELESS SERVICES ARE "EXTREMELY COMPETITIVE WITH WIRELINE SERVICES." DO YOU AGREE?

A. No. One of the key determinants of the price of a cellular service package is the number of minutes that are included in the package. According to USWC, the average monthly residential basic exchange service flat-rate local usage on a USWC line is ** ** outgoing minutes.[170] Nationwide, the percent of households that have telephone service (landline) has grown over the last ten years, even while cellular service was rapidly growing.[171] Of course, a call that is outgoing on one line is incoming on another line, so the total usage for landline telephone service is approximately in excess of ** ** minutes per line. Cellular service generally charges separately for incoming as well as outgoing minutes.[172] In his Supplemental Direct Testimony Exhibit DLT-30, Mr. Teitzel provided a comparison of some of the wireless service packages that are offered in Arizona. Under the wireless plans shown on Mr. Teitzel's Exhibit, a wireless plan that included 1,000 minutes of use would cost a minimum of about $49.99 per month.[173] This is over 3.5 times the USWC charge for landline residential basic exchange service, which is $13.18 per month.[174]

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[170]USWC's response to Data Request WDA 1-32 (A).

[171] FCC's Monitoring Report.

[172] Some PCS allows the first incoming minute at no charge, but then charges after that.

[173]Of the plans shown on Exhibit DLT-30, VoiceStream Wireless Get More 2000 Service would be the closest reasonable charge. Under this plan, the customer is charged $39.99 per month for 500 "anytime" minutes and an additional $10.00 for 500 "weekend" minutes. Therefore, the total charge would be $49.99.

[174]Teitzel Direct Testimony, page 28.

VI. CONCLUSION

Q. WHAT DO YOU RECOMMEND?

A. Staff recommends the rate design as shown on Schedule WDA-20. The Staff recommendation is a reasonable proposal that balances the Company interest with the public interest. The Staff's recommendations are based upon proper rate design principles and requirements, including those included in TA96.

Staff recommends that the Commission deny the USWC "competitive zone" proposal. Staff recommends that any regulatory structure that is adopted should include a specific requirement that prices in different geographic areas may not vary by an amount that is greater than the variation that is justified by any variation in the cost of providing service. If the regulatory structure allows price flexibility or "revenue neutral" restructuring, any such restructure should not increase the rate differential between geographic areas that is incorporated in the specifically approved ACC rates, without specific Commission approval.

USWC's "competitive zone" proposal has not been supported by the evidence that the Commission rules require it to provide to show a service or area is competitive. Many of the services in many areas that USWC considers to be competitive will not meet the requirements of the Commission rule, and are not competitive by standard criteria. The data that USWC has provided in this proceeding indicates that fewer than **

** of the residential lines in service have been ported in the 23 wire centers that USWC proposes be immediately established as residential "competitive zones". The data USWC provided shows that USWC has "lost" only about ** ** of the business lines, and is serving ** ** of the business lines, even within the 49 wire centers that USWC proposes be immediately established as "competitive zones".

In addition, USWC's "competitive zone" proposal would allow USWC to violate Section 254(k) of the TA96. The proposal would allow USWC to shift the recovery of joint and common costs away from competitive services, and onto monopoly ratepayers across *geographic areas of the state.* Under USWC's proposal, USWC would be allowed to charge higher rates for a service in areas that are subject to little or no competition and lower rates for that service where competition does exist. This difference in pricing would not have to reflect a difference in cost of providing service. This is contrary to the requirements of Section 254(k). The Commission must establish cost allocation rules or other safeguards which prevent such a discriminatory recovery of the joint and common costs.

USWC's claims that residential basic exchange service is "below cost" and is receiving a "subsidy" from other services, is based upon a direct violation of the proper calculation of direct costs/TSLRICs. The accepted definition of TSLRIC dictates that only costs that are directly caused by one service are to be considered as the direct costs of that service. The loop facility is shared by several services, but USWC improperly included 100% of the loop cost in its claimed direct cost/TSLRIC for basic exchange service. However, for the other services that share the loop facility, which include toll, switched access, and vertical services, USWC included no portion of the loop facility costs. When the direct cost/TSLRIC of residential basic exchange service is calculated using the accepted TSLRIC definition, the direct cost of residential basic exchange service is ** **. If USWC ceased providing residential basic exchange service, while continuing to provide all other services, USWC would lose an average of $13.18 per month, per line in revenue, but would save only ** ** per line per month in costs, even in the long run. USWC is clearly better off with residential basic exchange service than without it. Residential basic exchange service makes the largest contribution toward the residential shared joint and common costs of any residential service.

Q. DOES THIS CONCLUDE YOUR RATE DESIGN TESTIMONY?

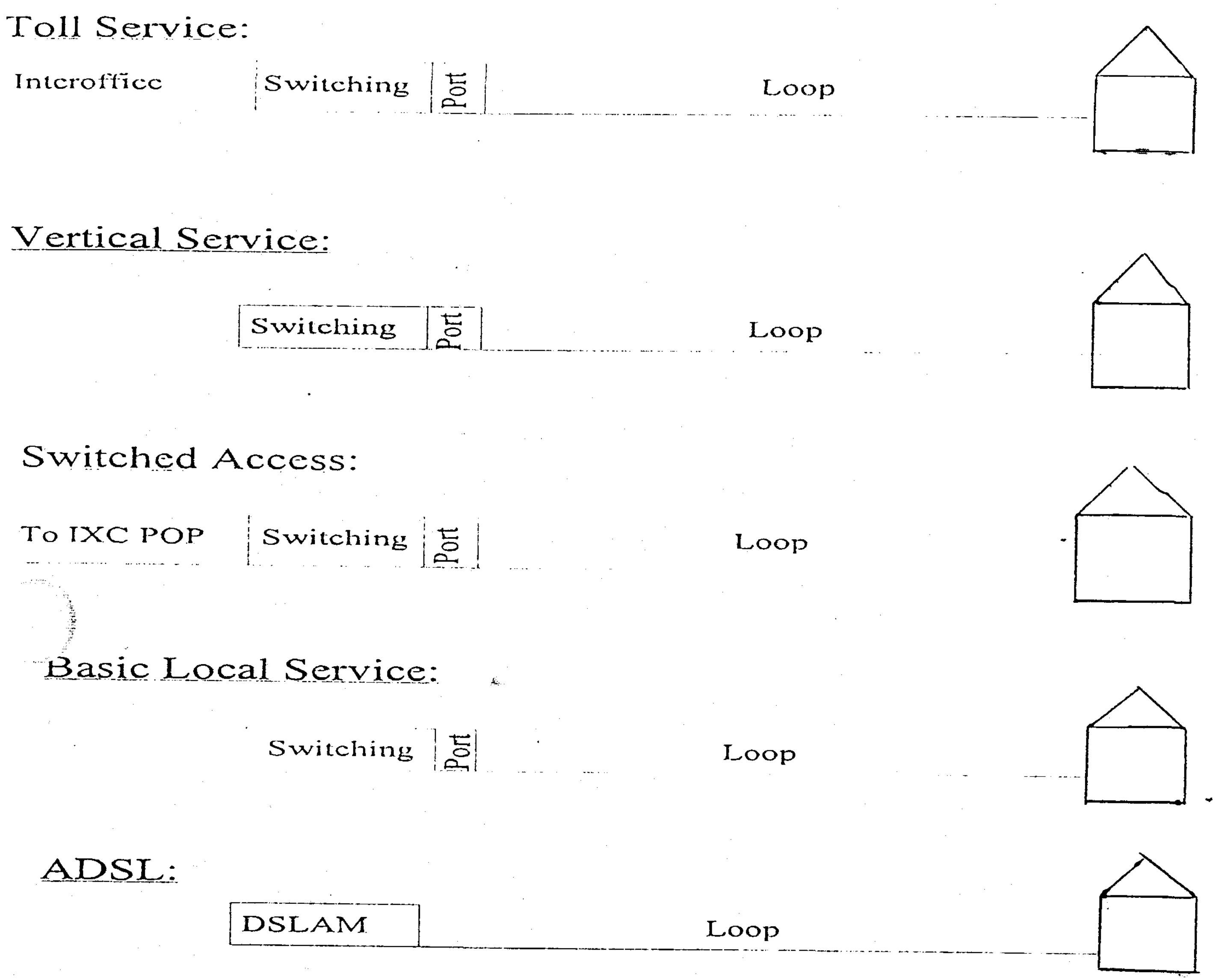
A. Yes.

SCHEDULE WDA-16 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.


Toll Service:
Interoffice
Switching
Port
Loop
Vertical Service:
Switching
Port
Loop
Switched Access:
To IXC POP
Switching
Port
Loop
Basic Local Service:
Switching
Port
Loop
ADSL:
DSLAM
Loop

SCHEDULE WDA-18 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

SCHEDULE WDA-19 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

SCHEDULE WDA-20 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

Arizona
Docket No. T-1051B-99-105
WDA 19-005

INTERVENOR: Arizona Corporation Commission Staff (Dunkel)

REQUEST NO: 005

With reference to USWC's June 28, 1999 petition to classify its Directory Assistance Service as competitive, USWC requested that the Commission allow USWC to implement a $1.50 maximum rate for DA service and to eliminate the one call allowance for DA.

A. Please provide USWC's estimated annual revenue impact of its proposed changes for DA. The revenue impact provided should show all present quantities, proposed quantities, present rates and proposed rates for DA.

B. Please provide a breakdown of the revenue impact provided in response to part (a) to separately show the revenue impact that results from the proposed rate increase and the revenue impact that results from the elimination of the one-call allowance for DA.

RESPONSE:

a. On December 7, 1999, the Commission approved U S WEST's petition to classify its DA service as competitive. However, the Commission did not approve the proposed pricing changes included in the petition, stating that the price changes and associated revenue impact would be addressed in the rate case. The original revenue impact of U S WEST's pricing proposal in the rate case was $18.261 million, as stated in the Direct Testimony of David Teitzel. However, since that time, the Company has received updated information indicating that the revenue impact should have been shown as $23.538 million. The Company is preparing an update to its rate case filing to reflect this change.

b. The revenue impact associated with the Company's revised rate case DA proposal is shown on Confidential Attachment A. Confidential Attachment A is being provided pursuant to the terms of the Protective Agreement in this proceeding.

SCHEDULE WDA-22 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

SCHEDULE WDA-23 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.